

FINANCING STRATEGIES FOR SMEs IN INDIA – A WAY OUT

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ABSTRACT

In this paper, a random sampling of 200 SMEs including hotels, retail shops, retail stores, trading agencies, small to medium manufacturing industries, factories, and hydro power projects are included. I found that there are various financing options for SMEs but access to these funds has been difficult inspite of government initiatives. I also found that most of the SMEs raise funds from the informal sources as it is easy and flexible option. In case of hotels the revenue comes during peak season that makes them pay monthly installments during off season, but using informal source they may avoid pay monthly installments. I also found that most of the SMEs raise funds from both informal and formal sources and try to strike a balance between the two. SMEs rather should consider all financing options that maximize the value of the business enterprise.

KEYWORDS

Formal source, Fund, Informal source, SME, Working Capital.

INTRODUCTION

 Small and Medium Enterprises, including khadi and village/rural enterprises credited with generating the highest rates of employment growth, account for a major share of industrial production and exports. They also play a key role in the development of economies with their effective, efficient, flexible, and innovative entrepreneurial spirit. The socio-economic policies adopted by India since the Industries (Development and Regulation) Act 1951 have laid stress on SME's as a means to improve the country's economic conditions.

SMEs always represented the model of socio-economic policies of Government of India which emphasized judicious use of foreign exchange for import of capital goods and inputs; labor intensive mode of production; employment generation; non concentration of diffusion of economic power in the hands of few (as in the case of big houses); discouraging monopolistic practices of production and marketing, and finally effective contribution to foreign exchange earning of the nation with low import-intensive operations.

It was also coupled with the policy of de- concentration of industrial activities in few geographical centers. It can be observed that by and large, SME's in India met the expectations of the Government in this respect. SME's developed in a manner, which made it possible for them to achieve the following objectives:-

- High contribution to domestic production
- Significant export earnings
- Low investment requirements
- Operational flexibility
- Location wise mobility
- Low intensive imports
- Capacities to develop appropriate indigenous technology
- Import substitution
- Contribution towards defense production
- Technology – oriented industries
- Competitiveness in domestic and export markets

DEFINITION OF SMALL AND MEDIUM ENTERPRISES IN INDIA

There exist several definitions of the term small and medium enterprises (SME's), varying from country to country and varying between the sources reporting SME statistics. The commonly used criteria at the international level to define SMEs are the number of employees, total net assets, sales and investment level. If employment is the criterion to define, then there exists variation in defining the upper and lower size limit of a SME.

In the Indian context, small and medium enterprises as per the SME Development Act, 2006 are defined based on their investment in plant and machinery (for manufacturing enterprise) and on equipment's for enterprises providing or rendering services. According to the Small and Medium Enterprises (SME) Development Act of 2006, (India) a medium enterprise is where the investment in plant and machinery is more than five crore rupees but does not exceed ten crore rupees. A small enterprise is where the investment in plant and machinery is more than twenty five lakh rupees but does not exceed five crore rupees.

REVIEW OF LITERATURE

Berry, Edgard, and Henry (Jun 2010) in their work on small and medium enterprise dynamics in Indonesia, have mainly focused on the development of small and medium enterprises (SMEs) in Indonesia before and during crises and argued that SME productivity has risen substantially, at rates not far from those of larger firms. They also argued that rather than providing direct assistance to smaller firms, government should concentrate on creating a business environment conducive to small and medium business growth, and promoting provision of business development services by the private sector.

Bala (July 2003) in his research paper (Pattern of technological innovations in small enterprises: a comparative perspective of Bangalore (India) and Northeast England (UK) has mainly focused on the comparative perspective of the pattern of technology innovations carried out by small enterprises in the engineering industry in Bangalore of India and Northeast England of the UK. However, the two regions have similar features but the insufficient spread of previous inventions and innovations and some other factors explained the lesser extent of radical and incremental innovations of small enterprises in Bangalore relative to that of Northeast England.

Sikka (April 1999) in his research paper, Technological Innovations by SME's in India, while surveying the current Indian scene has mainly focused on the need for SME's to utilize the technical facilities available at the S&T infrastructure created in the country and vice-versa. He has also highlighted the entrepreneurship capabilities which are being developed by SME's in India for producing quality products as well as undertaking ancillarization and sub-contracting activities for the larger firms in India.

Raju (January 2008) in his work on Small and Medium Enterprises (SMEs) in India: Past, Present and Future, has focused on the growth and development of the Indian small scale sector from opening of the economy in 1991 and the present scenario of SMEs and the problems they face like lending, marketing, license raj issues in detail. He also has discussed micro, small, and medium enterprises Act, 2006 in his study.

The aim of Pradhan (February 2010) research paper on R&D Strategy of Small and Medium Enterprises in India Trends and Determinants, work was to contribute to the literature on Indian R&D by analyzing the trends and patterns of R&D investment by Indian manufacturing SMEs during the period 1991–2008 and exploring various factors that determine their R&D behavior. The results show that Indian SMEs have lowest incidence of doing in-house R&D and their R&D intensities have fallen in the last decade.

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CONTENTS

Sr. No.	TITLE & NAME OF THE AUTHOR (S)	Page No.
1.	ECONOMIC ANALYSIS OF SAFFRON PRODUCTION IN IRAN <i>DR. MASSOUD KHEIRANDISH, M. V. SRINIVASA GOWDA & DR. SAJAD ABDULLAH SARAF</i>	1
2.	WHY CONSISTENCY OF ACCOUNTING STANDARDS MATTERS: A CONTRIBUTION TO THE PRINCIPLES –VERSUS - RULES DEBATE IN FINANCIAL REPORTING <i>DR. FISSEHA GIRMAY TESSEMA</i>	5
3.	EVALUATING THE FINANCIAL SOUNDNESS OF SELECTED COMMERCIAL BANKS IN SRI LANKA: AN APPLICATION OF BANKOMETER MODEL <i>NIMALATHASAN, B., BALAPUTHIRAN, S & PRIYA, K</i>	12
4.	A STUDY ON FDI IN SULTANATE OF OMAN <i>DR. R. DHANUSKODI</i>	15
5.	BOARD SIZE, CHIEF COMPLIANCE OFFICER AND FINANCIAL PERFORMANCE OF BANKS IN NIGERIA <i>AHMAD BAWA ABDUL-QADIR & MANSUR LUBABAH KWANBO</i>	19
6.	A STUDY ON EMPLOYEE JOB SATISFACTION IN CONSTRUCTION COMPANIES IN VIETNAM <i>NGUYEN PHI TAN</i>	23
7.	FACTORS INFLUENCE FINANCIAL DECISIONS UNDER THE PYRAMID OF NATURAL CONSTRAINTS <i>MEHTAB ARSHAD BUTT & ROZEENA SADDAR</i>	28
8.	A STUDY ON UNPRINCIPLED SELLING PRACTICES TOWARDS THE PHARMACEUTICAL INDUSTRY IN INDIA <i>DHANUNJAY GONUGUNTALA, M. MURUGAN & DR. K. P. V. RAMANA KUMAR</i>	31
9.	JOB STRESS & EMPLOYEE BURNOUT: AN OVERVIEW <i>DEEPIKA SHARMA & DR. M. L. GUPTA</i>	35
10.	THE CONSUMER BEHAVIOR TOWARDS PACKAGE OF COSMETICS <i>HEMAPATIL & DR. B BAKKAPA</i>	38
11.	NPA MANAGEMENT IN PUBLIC SECTOR BANKS: A STUDY OF CANARA BANK AND STATE BANK OF INDIA <i>K. V. RAMESH & A. SUDHAKAR</i>	42
12.	A STUDY ON CONSUMERS PERCEPTION TOWARDS GREEN PACKAGING INITIATIVES WITH REFERENCE TO CONSUMERS IN PUDUKKOTTAI DISTRICT <i>DR. S. SOLAIAPPAN & S. PALANIAPPAN</i>	50
13.	THE EMPIRICAL EVIDENCES OF SLOWDOWN OF FDI INFLOW IN INDIA SINCE 2009 <i>PEARLY JERRY</i>	55
14.	CORPORATE REPORTING - ITS IMPACT ON INDIVIDUAL INVESTORS <i>DR. P. SAIRANI & ANNIE KAVITA</i>	62
15.	KNOWLEDGE MANAGEMENT STRATEGY AND ACTION PLAN FOR SUCCESSFUL IMPLEMENTATION <i>C. RAMANIGOPAL</i>	67
16.	HUMAN RESOURCE ACCOUNTING IN INDIA – QUANTIFICATION OF QUALITATIVE FACTORS OF EMPLOYEES <i>DR. A. CHANDRA MOHAN, S C RAJAN DANIEL & DR. N. KISHOREBABU</i>	70
17.	THE IMPACT OF ADVERTISING APPEALS ON CUSTOMER BUYING BEHAVIOR <i>GUNJAN BAHETI, DR. RAJENDRA KUMAR JAIN & NIDHI JAIN</i>	75
18.	ASSESSMENT OF LIQUIDITY IN INDIAN PHARMACEUTICAL INDUSTRY – A STUDY <i>K. PADMINI & C. SIVARAMI REDDY</i>	79
19.	LIQUIDITY MANAGEMENT: AN EMPIRICAL STUDY OF CUDDAPAH SPINNING MILLS LIMITED, KADAPA (AP) <i>N.VENKATA RAMANA</i>	83
20.	INTRAPRENEURSHIP AND ORGANIZATIONAL KNOWLEDGE IN THE CORPORATE ENVIRONMENT: A THEORETICAL FRAMEWORK <i>DR. LEENA JAMES</i>	89
21.	SUGAR INDUSTRY IN INDIA – AN OVERVIEW <i>V. RAMESH BABU & DR. M. MADHUSUDHANA VARMA</i>	93
22.	PEPPER PRODUCTION TREND IN INDIA: AN OVERVIEW <i>DR. P. CHENNAKRISHNAN</i>	101
23.	FINANCING STRATEGIES FOR SMEs IN INDIA – A WAY OUT <i>AMITESH KAPOOR</i>	104
24.	BRAND LOYALTY- A MEASURE <i>DR. Y. JAHANGIR</i>	112
25.	ANALYSIS OF LIQUIDITY, PROFITABILITY AND WORKING CAPITAL MANAGEMENT - AN EMPIRICAL STUDY ON BSE LISTED COMPANIES <i>HUMA KHAN</i>	116
26.	COMPLAINTS MANAGEMENT IN BANKS: AN AID TO CUSTOMER SATISFACTION <i>DR. HARPREET KAUR KOHLI</i>	120
27.	PERFORMANCE MANAGEMENT: A HOLISTIC REQUIREMENT FOR ORGANIZATIONS <i>DR. RAJINI SINGH</i>	124
28.	WORK EFFICIENCY ACQUISITION: AN IMPERATIVE NEED FOR HUMAN RESOURCE PROFESSIONAL <i>DR. L. N. ARYA & SATYAM PINCHA</i>	128
29.	RETENTION AND SATISFACTION OF CONSUMERS: A STUDY OF UNIVERSITY OF JAMMU <i>ANJU THAPA</i>	132
30.	CUSTOMER SATISFACTION TOWARDS VARIOUS FACILITIES PROVIDED BY PUBLIC BANKS (A COMPARATIVE STUDY OF PNB AND SBP IN JIND DISTRICT, HARYANA) <i>ANJU BALA</i>	136
	REQUEST FOR FEEDBACK	142

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STATEMENT OF THE PROBLEM

OBJECTIVES

HYPOTHESES

RESEARCH METHODOLOGY

RESULTS & DISCUSSION

FINDINGS

RECOMMENDATIONS/SUGGESTIONS

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Bakker, Marie, Gregory, and Leora (May 2004) in their study on Financing Small and Medium-Size Enterprises with Factoring: Global Growth and its Potential in Eastern Europe) have explored the advantages of factoring over other types of lending for firms in developing economies, and discuss the informational, legal, tax, and regulatory barriers to its growth. They also examined the role of factoring in the eight Eastern European countries that became EU members on May 1, 2004 - The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia, referred to as the EU 8.

Cull, Lance, Naomi, and Jean (July 2006) in their research paper on historical financing of small- and medium-size enterprises, mainly focused on the economies of the North Atlantic Core during the 19th and early 20th centuries and found that an impressive variety of local financial institutions emerged to supply the needs of SMEs wherever there was sufficient demand for their services and, in addition, by raising the return to savings for local households, they helped to mobilize significant new resources for economic development.

Young (March 1993) in their work on Policy Biases, Small Enterprises and Development, have mainly focused on the performance and contribution of the small scale industries in the development of country in terms of employment and productivity. They also have revealed that small firms are often more efficient in total resources use than the larger firms. Moreover, small enterprises are often productive in spite of policies that are biased against them, particularly agricultural, financial, and trade policies.

Hutchinson Patrick's (Oct, 2003) in his paper has shown that how much does growth determine SMEs' capital structure. Main focus was to examine the extent to which growth determines the capital structure of small and medium-sized enterprises (SMEs). This is done by considering some theories of capital structure in relation to SMEs and then testing the resulting ideas empirically. A key feature of the empirical studies reported in this paper is that they utilize the same database of SMEs. The data were analyzed using ordinary least squares regression. The results show that growth is not consistently a major determinant of SMEs' capital structure but is more important in some circumstances than others.

Pandey, Prasad, and Shivesh (December 2007) in their work on Routes of Survival of SSI in India and its Futurity - a study of pre and post reform period have compared the performance of SSI in pre and post liberalized period and focuses on policy changes which have opened new opportunities for this sector. Technology development and strengthening of financial infrastructure is needed to boost SSI and thus growth target can be achieved.

Tewari & Pandey (2010) in their research paper on Conservation Of Energy in Small Scale Industries in India have focused on the prominence of the small-scale sector in the Indian economy & the need to improve the energy and environment performance of units operating in the sector. It drew upon the results of a major program initiated by TERI (Tata Energy Research Institute) in 1995 in the small-scale sector with the support of SDC (Swiss Agency for Development and Cooperation). The program aims at finding solutions to the energy problems of the SSI through technology up gradation and human and institutional development in some small scale energy intensive sectors.

Jha and Agarwal (June 2010), authors in their work on A Case Study of the Marketing Problems of Small Scale Industries have examined the marketing problems of small scale industries working in the district of Varanasi. The study opines that the marketing problems has arisen mainly due to cut throat competition from other industries, adoption of cost oriented pricing, lack of advertisement, non-branded products etc. The paper is empirical in nature based on primary data collected from the survey of 101 SSI units operating in Varanasi.

NEED OF THE STUDY

In my work I have highlighting the growth, performance and contribution of the small and medium scale industries in the development of the country and also the problems that small and medium scale industries are facing relating to project implementation, relating to production, marketing, and finance so that government can take important steps for small and medium scale industries.

OBJECTIVES

The Objective of the study is three fold:

- 1) To analyze the financing strategies presently used by various SME's.
- 2) To analyze the Growth and Performance of Small & Medium Enterprises (SME's).
- 3) To analyze the problems of the small and medium scale industries and a way out in deciding in the best mix of financial strategies.

PROBLEMS OF SMEs

Here I have mentioned some problems which SMEs mostly face these days relating to project implementation, finance, production, marketing, and management etc.

Project implementation

1. Non-availability of land at selected site.
2. Difficulty in procuring construction materials like cement steel etc.
3. Delay in delivery of machines.
4. Delay in getting power connection, water connection, and permission of concerned authorities.

Finance

1. Inadequate bank finance.
2. Lack of proper planning to pay the creditors.
3. Diversion of working capital funds for acquisition of fixed asset.

Production

1. Non-availability of raw materials or increase in the price of the raw materials with corresponding increase in sale price of the products.
2. Non availability of power, water, transport etc.
3. Lack of coordination between marketing and production planning.

Marketing

1. Entry of new which give rise to competition.
2. Dependence of the unit on the one buyer or on very few buyers.
3. Poor quality of products.
4. Lack of sales promotion.
5. Poor delivery schedules and lack of proper distribution system.

Management

1. Poor industrial relations.
2. Lack of coordination and control.
3. Non availability of skilled man power.

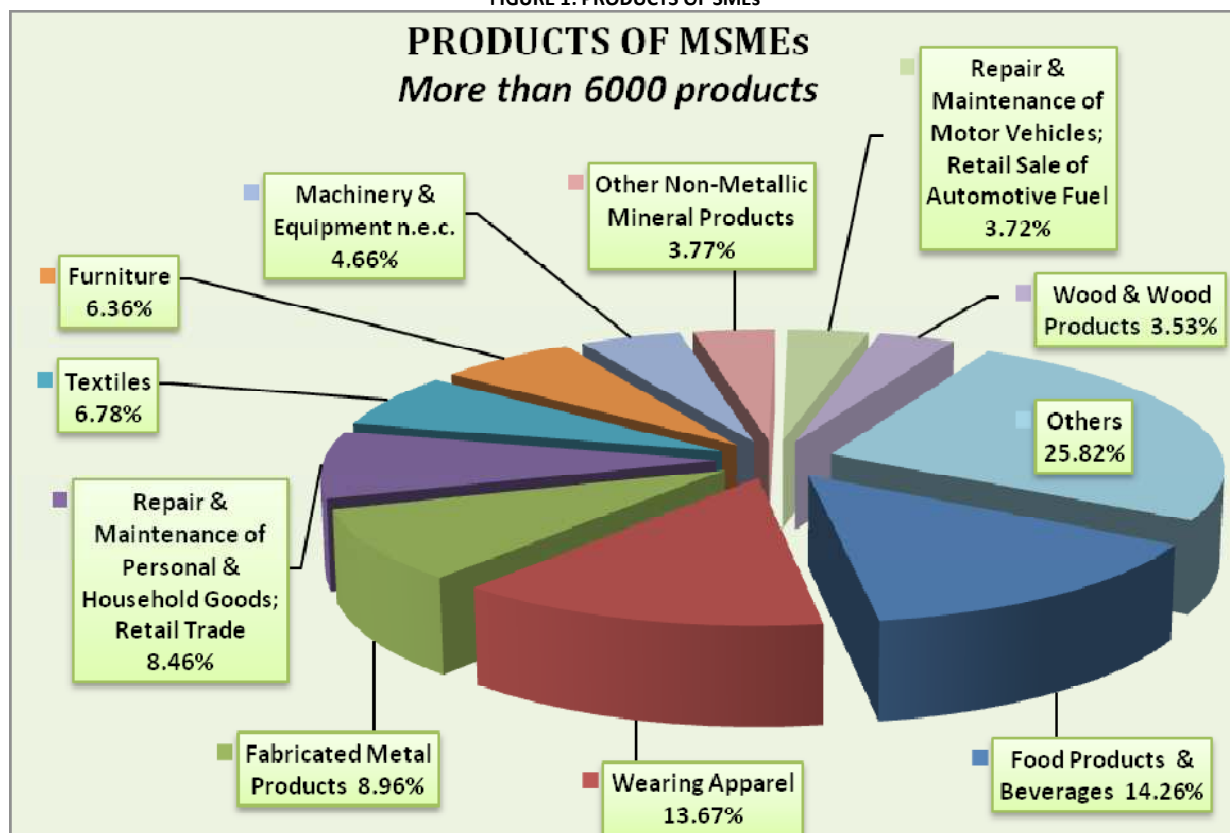
METHODOLOGY

Both primary and secondary data has been used. For primary data Questionnaires were used to collect data from SMEs. SMEs were randomly selected from various places like kullu, Manali, Banga, and Jalandhar etc. Simple correlation coefficient has been used as a statistical tool to show the dependency of SMEs on formal and informal sources of finance. For correlation coefficient I have used other statistical tools like standard deviation, covariance, and correlation, and sum.

SOME SMEs FACTS**GROWTH AND PERFORMANCE OF SMEs**

The small and medium enterprises (SME) sector contributes significantly to the manufacturing output, employment and exports the country. It is estimated that in terms of value, the sector accounts for about 45 per cent of the manufacturing output and 40 per cent of the total exports of the country.

The sector has employed about 65 million persons in over 28 million units throughout the country. Further, SME sector has consistently registered a higher growth rate than the rest of the industrial sector. There are over 6000 products (Figure 1) ranging from traditional to high-tech items, which are being manufactured by the SMEs in India. It is well known that the SME sector provide the maximum opportunities for both self-employment and jobs after agriculture sector.

FIGURE 1: PRODUCTS OF MSMEs

Source: - Final Report of the Fourth All India Census of Micro, Small & Medium Enterprises 2006-07: Registered Sector

EMPLOYMENT AND EXPORTS

FIGURE 2: MSMEs PERFORMANCE: UNITS, EMPLOYMENT, INVESTMENTS, PRODUCTION, AND EXPORTS

Sl. No.	Year	Total Working MSMEs	Employment	Fixed Investment	Production (Current Prices)	Exports
		(Lakh numbers)	(Lakh persons)	(Rs. crore)		
I	II	III	IV	V	VI	VII
1	2001-02	105.21	249.33	154349	282270	71244
		(4.07)	(4.44)	(5.11)	(8.03)	(2.07)
2	2002-03	109.49	260.21	162317	314850	86013
		(4.07)	(4.36)	(5.16)	(11.54)	(20.73)
3	2003-04	113.95	271.42	170219	364547	97644
		(4.07)	(4.31)	(4.87)	(15.78)	(13.52)
4	2004-05	118.59	282.57	178699	429796	124417
		(4.07)	(4.11)	(4.98)	(17.90)	(27.42)
5	2005-06	123.42	294.91	188113	497842	150242
		(4.07)	(4.37)	(5.27)	(15.83)	(20.76)
6	2006-07	261.12	595.66	500758	709398	182538
		(111.57)	(101.98)	(166.20)	(42.49)	(21.50)
7	2007-08	272.79	626.34	558190	790759	202017
		(4.47)	(5.15)	(11.47)	(11.47)	(10.67)
8	2008-09	285.16	659.35	621753	880805	N. A.
		(4.53)	(5.27)	(11.39)	(11.39)	
9*	2009-10	298.08	695.38	693835	982919	N. A.
		(4.53)	(5.46)	(11.59)	(11.59)	
10*	2010-11	311.52	732.17	773487	1095758	N. A.
		(4.51)	(5.29)	(11.48)	(11.48)	

The figures in brackets show the percentage growth over the previous year. The data for the period up to 2005-06 is Small Scale Industries (SSI). Subsequent to 2005-06, data with reference to Micro, Small and Medium Enterprises are being compiled. The growth for the year 2010 11 is based on the average growth rate for the previous three years. *: Provisional, #: Projected, N. A.: Not Available.

FIGURE 3: CONTRIBUTION IN THE GROSS DOMESTIC PRODUCT (GDP)

Year	Contribution of MSEs (%) at 1999-2000 prices in	
	Total industrial Production	Gross Domestic Product (GDP)
2004-2005	38.62	5.84
2005-2006	38.56	5.83
2006-2007	45.62	7.20
2007-2008	45.24	8.00
2008-2009	44.86	8.72

** Source: - Final Report of the Fourth All India Census of Micro, Small & Medium Enterprises 2006-07: Registered Sector

*The data for the period up to 2005-2006 is for Small Scale Industries (SSI)

It is clear from the Figure 3 that the contribution of the SMEs in gross domestic product of the country is very high and it is increasing every year.

FINANCING OPTIONS FOR SMEs

There are many organizations that have been set by the central governments and state governments and banks to support the development of the small scale enterprises as shown below :-

Central government

1. Central Board for Micro, Small and Medium Enterprises.
2. Small Industries Development Organization.
3. National Small Industries Corporation Limited Etc.
4. National Institute for SMEs.
5. Entrepreneurship Development Institute of India.

State government

1. District Industries Centers.
2. State Financial Corporations.

3. State small industries Development Corporation.
4. Khadi and Village Industries Commission.
5. State Industrial Development Corporations/State Industrial Investment Corporations

Banks

1. Small Industries Development Bank of India.
2. Commercial Banks.
3. Regional Rural Banks.
4. Cooperative Banks.
5. National Bank for Agriculture and Rural Development.

There are many other sources of finance which SMEs use which they think; this is best option for them. Mostly in the rural areas peoples are not that much educated but there are many peoples who are involved in the businesses. To start the business mostly they use their own money or from friends and relatives because they are not aware about the other sources, they are aware about the banks but they are afraid to take loan from the banks. But people who are fully aware about the banks take loan from the banks and use their own money as well along with raising some funds from the relatives, friends, and credit from the suppliers etc. I have divided this into Formal and Informal sources of finance as explained below.

INFORMAL AND FORMAL SOURCES

Informal sources of finance are mostly those which do not require written and formalized agreements as given below:-

Own Saving

Some avenues to gaining finance for a new business might include internal sources such as an owner's personal money. Where this is used in conjunction with external financial help, this can demonstrate that the owner has some confidence and commitment to the venture and might make it easier to gain money from others.

Family and Friends

To meet the financial requirements of a start-up through funding from family and friends might have the advantage of being interest free or carry a lower cost compared to that of a bank loan.

Credit from suppliers

It is possible that by taking longer to pay creditors that the company might be able to use such delays to fund its operations in part. Many business start-ups find it difficult to gain extended credit terms from suppliers who are naturally suspicious of their lack of trading history.

Formal sources of finance are those which require written and formal agreements. There are many organizations and banks for that like SIDBI, NABARD, regional banks, commercial banks, and cooperative banks. SIDBI, that is small industries development bank of India, it is a kind of refinancing institution which refinances the SMEs if they fail to pay back to the others which are instituted by RBI.

RESULTS AND FINDING

There are few findings through a questionnaire filled by the respondent which are represented graphically.

Figure 4: Question: Has the company ever applied to borrow money from the bank

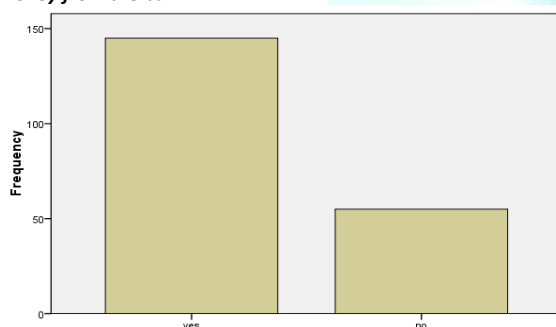


Figure 5: Question: Has the company ever applied to borrow money from the bank, if not than why?

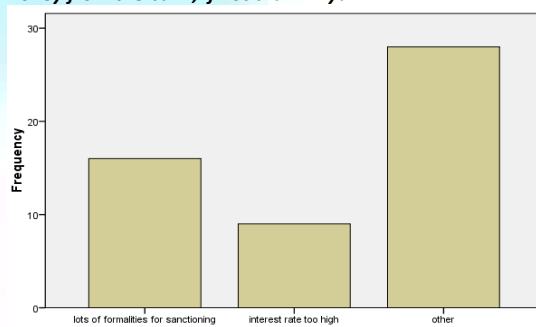


Figure 6: Question: What was the highest amount your company ever borrowed from a bank?

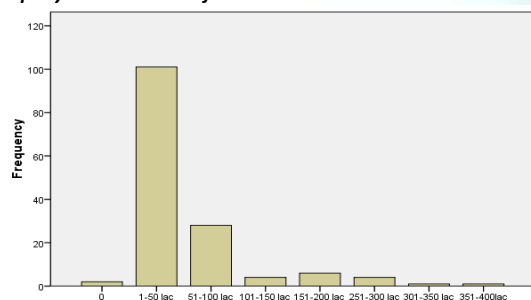


Figure 7: Question: Have you ever had problem repaying a bank loan?

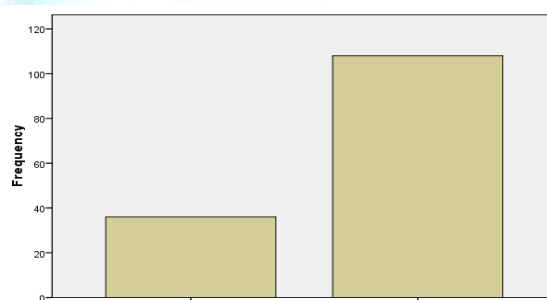


Figure 8: Question: How many employees you had in last 7 years

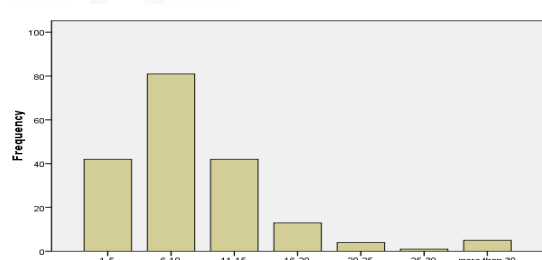
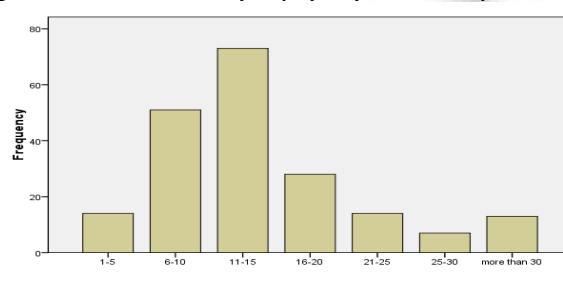


Figure 9: Question: How many employees you have today?



It is clear from the Figure 4 that 145 i.e. 72.5% SMEs says that they borrow money from the bank and only 55 that is 27.5% says no, and give certain reasons for that.

Figure 5 indicates that 16 says lots of formalities for sanctioning of loan, 9 says interest rate too high, and 28 goes with others, that is 8 %, 4.5 %, 14% , total 53 companies out of 200. It shows that they mostly prefer informal source to finance their business. Figure 6 shows that most of the SMEs take loan between 1-50 lakh and their % is 50.5%, there is balance between formal and informal. As given in the Figure 7 there are 144 respondents for this question, 36 says yes and 108 say no. The SMEs who says yes give certain reasons like due to low profits, new in the market, lean season, inadequate return from the hotel, interest rate too high and some says they face problem in paying monthly installments, due to fire in the building, fluctuation in the business and government change and also government policies, off season, recession etc. There are 148 respondents out of which the 86 SMEs have made full disbursement that is they are free from the loan and only 6 have made disbursement less than 25% and 32 less than 50% and 25 have made disbursement less than 75%. Out of 200 SMEs only 40 says that they have faced problem relating to project implementation like delay in legal formalities, labor cost is much, hard to build customer loyalty, in employing well trained personnel, warehouse maintain, maintain the stock, competition, construction of shop was difficult too much formalities, high cost of land, labor problem, lack of coordination, high cost of resources, land, did not get the selected site, electricity problem, legal formalities, high price of land and road, transportation etc., These are various problems they face during their project implementation.

Out of 200, 37 says they face problem relating to the finance like initial capita, initial investment, did not get full finance from the bank, underfinanced, working capital, formalities of the banks. Out of 200, only 26 says that they face problem relating to marketing and production.

PROBLEMS

Relating to Project implementation like delay in legal formalities, labor cost is much, hard to build customer loyalty, in employing well trained personnel, warehouse maintain, maintain the stock, competition, construction of shop was difficult too much formalities, high cost of land, labor problem, lack of coordination, high cost of resources, land, did not get the selected site, electricity problem, legal formalities, high price of land and road, transportation, etc. these are various problems they face during their project implementation.

Relating to finance like initial capita, initial investment did not get full finance from the bank, underfinanced, working capital, formalities of the banks.

Relating to marketing and production like competition from others, inadequate raw material, lack of experience, lack of coordination, unawareness about the marketing tools, lack of good distribution, marketing is expensive.

EMPLOYEES

As it is clear from the Figure 8 and Figure 9 that the employees between 1-5 and 6-10 frequency have decreased from the 42 and 81 to 14 and 51 and frequency from 11-15 and 16-20 have increased from 42 and 13 to 73 and 28 and frequency have continuously increased today. It shows that there is a great increase in the employment in the SMEs. It shows the contribution of SMEs in the development of country is great.

PERCENTAGE OF FORMAL AND INFORMAL

TABLE 1: FORMAL SOURCE OF FINANCING

		Frequency	Percentage	Valid Percentage	Cumulative Percentage
Valid	0	4	2	2.7	2.7
	6	1	0.5	0.7	3.4
	10	1	0.5	0.7	4
	12	1	0.5	0.7	4.7
	15	2	1	1.3	6
	20	16	8	10.7	16.8
	23	1	0.5	0.7	17.4
	25	4	2	2.7	20.1
	30	15	7.5	10.1	30.2
	35	4	2	2.7	32.9
	40	25	12.5	16.8	49.7
	42	1	0.5	0.7	50.3
	45	5	2.5	3.4	53.7
	50	15	7.5	10.1	63.8
	55	1	0.5	0.7	64.4
	60	23	11.5	15.4	79.9
	65	4	2	2.7	82.6
	67	1	0.5	0.7	83.2
	70	18	9	12.1	95.3
	75	3	1.5	2	97.3
	80	3	1.5	2	99.3
	90	1	0.5	0.7	100
	Total	149	74.5	100	
	System	51	25.5		
	Total	200	100		

*Above table 1 is calculated with the help of SPSS.

TABLE 2: INFORMAL SOURCE OF FINANCING

	Frequency	Percentage	Valid Percentage	Cumulative Percentage
Valid				
20	3	1.5	1.5	2
25	3	1.5	1.5	3.5
30	18	9	9	12.6
33	1	0.5	0.5	13.1
35	4	2	2	15.1
40	24	12	12.1	27.1
45	1	0.5	0.5	27.6
50	15	7.5	7.5	35.2
55	5	2.5	2.5	37.7
58	1	0.5	0.5	38.2
60	25	12.5	12.6	50.8
65	4	2	2	52.8
70	14	7	7	59.8
75	4	2	2	61.8
77	1	0.5	0.5	62.3
80	16	8	8	70.4
85	2	1	1	71.4
88	1	0.5	0.5	71.9
90	1	0.5	0.5	72.4
94	1	0.5	0.5	72.9
100	54	27	27.1	100
Total	199	99.5	100	
System	1	0.5		
Total	200	100		

*Above table 2 is calculated with the help of SPSS.

TABLE 3: DESCRIPTIVE STATISTICS

	Formal	Informal
N Valid	149	199
Missing	51	1
Mean	44.87	66.26
Std. Deviation	19.729	25.981
Variance	389.252	674.990
Sum	6685	13185

*Above table 3 is calculated with the help of SPSS.

Following are calculated with the help of excel

Covariance = -0.13128

Correlation = -0.58508

Correlation coefficient = -0.17289

As we know correlation can be positive, negative and zero. Positive and negative shows the linear relation while zero correlation shows that there are no relation between two, they are independent of each other. We have calculated correlation is negative, it shows that there is a linear correlation between formal and informal and that they are negatively correlated and are dependent on each other. As we know that in negative correlation if one increases then other decreases. This is clear from the table and all values calculated above SMEs which we have covered in our survey have financed more from the informal. Financing from the informal have increased by 17% and financing from the formal have decreased by 17%.

FINDINGS

1. I found that there are various financing options for SMEs but access to these funds has been difficult inspite of government initiatives.
2. I found that most of the SMEs which are taken in our survey raise funds from the informal source. They told that it is easy for them because it is flexible and no need to pay monthly installments.
3. I also found that most of the SMEs raise funds from both by keeping a certain percentage.

SOME LIMITATIONS OF INFORMAL SOURCE

In case if person requests that the money is repaid at short notice and this in turn causes working capital shortages for the business.

SUGGESTION

While not every SME turns into a big multinational, but they all face the same problem in their early as well as subsequent days – finding the finance to enable them to start and build up their business and test their products or services. In majority, while the financing for SMEs was being provided by informal sources, financial institutions, commercial banks extended working capital. Besides the traditional needs of finance, the changing environment has generated demand for introduction of new financial services for SMEs. SMEs should consider all financing options that maximize the value of the business enterprise.

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