

## **Funding Sources for Small and Medium Business Enterprises in Bangladesh: A Descriptive Approach**

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*Abstract: The main objective of the study is to find out the sources of small and medium business funding in Bangladesh. In Bangladesh small and medium business has remarkable contribution to our GDP. It creates many opportunities for Bangladesh. So that, it considered a new hope for Bangladesh. For developing small business capital is the main constraint. In our study we find out there are available sources of small business funding in Bangladesh but a lot of challenges when a borrower getting the loan.*

*Keyword: Small Business funding, capital constraint, challenges.*

### **1. INTRODUCTION**

Small business enterprises play a vital role in the development of any national economy. Production of goods and services at a small scale, small business enterprises contribute to the GDP of a country by way of creating employment opportunities at greater level. A country whether it is developed or developing or even under-developed, must consider the development and progress of small business enterprises. Small business enterprises are the integral part of our economy. The contribution of small business enterprises towards socio-economic development in Bangladesh is remarkable from the local and national level. But the most influential challenges faced by the small business owners is the funding. In our country most of the small business enterprises run by the private sectors and they are the marginal people. They cannot easily access to the capital and in raising the capital they face many challenges. Those challenges do not allow the small business enterprises to sustain and to grow. This study has been aimed in identifying the major sources of funds for small business enterprises, the related challenges in obtaining funds and also incorporating some suggestions to overcome those challenges.

### **2. METHODOLOGY OF THE STUDY**

In order to conduct this study, we have used information from secondary sources. Different articles, books, newspapers and some related virtual sites have been used in this study. We have conducted this study from qualitative perspectives.

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### **3. LITERATURE REVIEW**

Ahmed pointed out that due to the lack of national quality policy and adequate support system, and also due to the lack of credibility of the quality certification authority, SMEs of Bangladesh have failed to ensure the quality of products and services both in domestic and international markets. He also argues that access to finance possess as one of the most important problems for the SMEs in Bangladesh. Lack of investment or operating funds remains as one of the most prominent complains of the SMEs in Bangladesh. [1]

Ahmed points out that due to the lack of national quality policy and adequate support system, and the lack of credibility of the quality certification authority, SMEs of Bangladesh have failed to ensure the quality of products and services both in domestic and international markets. He also argues that access to finance prevails as one of the most important problems for the SMEs in Bangladesh. Lack of investing or operating funds remains as one of the most prominent complains of almost all the SME in Bangladesh.[2]

Sulaiman observed that the 50.53 percent of SMEs had no access to formal source of finance. Only 35.79 percent of SMEs enjoy unrestricted access to the formal credit. Of the rest 13.68 percent have restricted access to formal credit. Bank credit is used by small percentage of entrepreneurs and provides financing of generally less than 20 percent of their total outlay. Majority of the SMEs (59.6 percent) seek finance for their working capital needs from banks, although only a half-of them get loan from banks. [3]

Bangladesh Bank Report says, the key reasons behind the SMEs are not entering manufacturing but are financial constraints, dismal state of utilities, technology and policy discriminations.

On the other hand, Bank and others financial institutions generally prefer large enterprise clients because of lower transition costs, and greater availability of collateral. The SMEs also fall outside the reach of micro finance schemes, and thus are compelled to depend on formal sources of funds at much higher interest rates, the Bangladesh Bank report said. The BB report, however, said that other interrelated problems like shortage of short and long-term finance, lack of modern technology and lack of promotional support services are major obstacles in the way of development of the SMEs sector. [4]

Ou and Haynes determined two situations when SMEs pursue financing from equity capital sources in order to meet expansion needs. The first case is when SMEs face financial distress coupled with a lack of alternative sources of finance. The second case is when cash outflows exceed the cash inflows generated from regular sources. Ou and Haynes attributed this attitude adapted by SMEs in these two particular cases to the reluctance of regular lenders to lend to the firm because of uncertainty about the firm's future growth opportunities. As a result, these firms are usually classified as high risk. Inconsistent with this, in their

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investigation of the determinants of financing mode chosen by young innovative SMEs in Germany, Schäfer, Werwatz and Zimmermann found that risky SMEs are more likely to receive equity financing.

Other arguments suggest that some SMEs owner–managers may choose not to use equity as a source of financing in order to avoid any undesirable changes in the ownership of their firm (Reid). Other entrepreneurs, nevertheless, may choose to source funding from external equity in order to share the risk with less risk-averse investors. However, the valid judgment of the importance of the external equity for SMEs should be based on the eventual success of firms that receives it, not on the quantity that the firm utilizes (Berger & Udell). [5]

Cumming most venture capital transactions include convertible securities. Bascha and Walz asserted that unlike traditional debt and/or equity instruments, convertible securities have the ability to mitigate the agency problem effects by leaving the owner–manager with some control during the investment period. In addition, as the price of conversion is a function of performance, the venture capitalist has a better chance to recover the investment if the venture is not successful.

Other studies show other motivations for employing convertible debt, with examples including reducing the risk-shifting incentives of the entrepreneur (Green), resolving problems arising with debt financing and gaining indirect equity financing when issuing traditional equity is unattractive' [6]

Harrison and Mason there are three features that make angel financing an appropriate option for SMEs. First, angels are more active in the early stages of enterprises (seed and start-up) closing the so-called 'equity gap' by forming a 'bridge' between internal financing sources and outside investors. Second, by having lower rates of rejection and being a more patient form of capital with longer exit horizons, angel financiers tend to be more obliging to the needs of SME owner–managers. For example, German entrepreneurs have ranked business angels as the most desirable funding providers (Brettel). Finally, unlike venture capitalists, angel investors prefer to invest in their local economies where the majority of SMEs operate. [7]

Moro, Lucas, Grimm, &Grassi suggested that SMEs should only focus on bank financing. Keasey and McGuinness argued that in spite of the fact that bank financing is more expensive in comparison to other sources of finance, it generates a higher rate of return for SMEs. They further conclude that bank finance can help SMEs accomplish better performance levels than other financing sources can do. The explanation given by them is that SMEs employ the funds more efficiently when they are monitored by, and answerable to banks. [8]

Jun and Jen summarized short-term debt advantages as a funding source. These advantages include (i) zero interest rate in some short-term debt cases such as in the case of trade credit; (ii) in comparison to long-term loans, short-term debt has

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generally lower nominal interest rates; (iii) short-term debt is easy to adapt according to the firm's financial needs; and (iv) lower costs of flotation than those of long-term loans. In addition, from the lender's point of view, short-term debt is an efficient way to deal with asymmetry information problems as firms have to repay the debt and any associated charges over a shorter constant period (Myers). However, the main drawback of short-term debt is the higher level of risk. Hence, financially weak firms would prefer long-term debt as they perceive short-term debt benefits do not abolish its additional risks (García-Teruel&Martínez-Solano). [9]

Ibrahim argued that Islamic financing methods are better suited in satisfying the financial needs of SMEs. The focus in Islamic financing and investment, he explains, is on the transaction itself instead of the partner's creditworthiness. As such, entrepreneurs are granted funding without an obligation on them to provide strict securities or collateral which SMEs often lack. He adds that because profit and loss sharing is pivotal in Islamic finance, any securities or collateral demanded is not against the risk of loss, rather against possible fraud or repayment evasion [10]

From the literature review, it has been observed that most the researcher focus basically SMEs importance, present scenario, challenges and recommendation. But the present study finds out what are the small business funding sources? What are the documents needed for getting the loan? What are the challenges and solution when getting the small business loan? These questions are different from all previous studies.

## **4. FINDINGS AND ANALYSIS**

### **4.1 Meaning of small business financing**

Small business finance means finance for the small business. The financing that can be considered as small business financing are:

- i) To start new business.
- ii) To run the business operational activities.
- iii) To acquire any fixed assets
- iv) To further investment into a near future etc.

Bangladesh Bank clearly defines that small enterprise means to the business which is not public ltd company & fulfills the following criteria:

Table-1: Definition of SME [11]

Sector	Fixed asset other than land & building (Tk.)	Employed Manpower(not above)
Service	50000-5000000	25
Business	50000-5000000	25
Industrial	50000-15000000	50

#### 4.2 Sources of small business funding

There are lots of way to finance a small business around the world, which depends on each business criteria and its benefits. The most common sources of small business funding are given below:

**i) Personal funds-saved or inherited of their own capital**

Small business funds may be collected from his or personal funds or collected from his or her parents, uncles or relatives. There is no basically interest expense bear by the holder. It's like an inheritance property, aids, grants etc. Most of the cases of our country collect from this source.

**ii) Borrowings from relatives and friends**

Sometimes small business owners collected funds from his or her relatives and friends to a low rate of interest or no interest. It's like an informal channel of fund collection. There is no regulatory body to control this.

**iii) Trade credit**

The easiest and very crucial source of finance especially short-term finance is the trade credit. It means that to purchase goods and services on account without any cash payment. This payment will make on later date. It is very helpful for reducing and managing capital for the business. Small business owners can use this for its short-term source of fund. Because it is easy to arrange, representative amount, terms of the trade activity. There is no direct cost. There are basically three main indirect costs which are called cost of the trade credit. Such as discount of early payment and this discount is loss for the trader, if the traders/small business owners don't stick to the agreed terms, then there is indulging relationship between them and finally net impact of trade credit put the negative working capital situation.

**iv) Commercial Bank loans, Bangladesh Small and Cottage Industries Corporations (BSCIC) loans**

Bangladesh Small and Cottage Industries Corporation (BSCIC) provides support services to small, rural, and cottage industry in Bangladesh in the small and cottage industries sector. It was created through an Act of Parliament in 1957 which was later amended in 1992. BSCIC has country-wide institution network to

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provide door step services for entrepreneurs. Head Office of BSCIC is located at 137-138, Motijheel, Dhaka, Bangladesh. BSCIC offers medium and long term loans to small industries, either directly, or through consortium of commercial banks. BSCIC also helps in all other matters relating to development and expansion of small and cottage industries (SCI). The Bangladesh Small and Cottage Industry Corporation (BSCIC) is the official body which monitors the development of self-employment, cottage industries and small enterprises. It produces statistics on the types of enterprises, their activities and the number of people employed.

#### **Its major functions are**

- Promotion and registration of small and cottage industries.
- Conducting advisory and industrial promotion services including training of entrepreneurs.
- Skill development for artisans and craftsmen.
- Creation of jobs for SCIs.
- Construction and development of industrial estates with necessary infrastructural facilities for SCI.
- Development of linkages between SCIs and large and medium-sized industries.
- Online Service for registration of Industry, Application for Industrial plots, Application for Training facilities will be provided very soon.

#### **v) Bank loan**

Almost all the banks provide the small business loan. There are different types of banks like private commercial banks, state owned commercial banks, foreign banks, specialized banks. In Bangladesh this is the available sources of small business funding.

#### **vi) Mortgage loan**

A loan that is secured by property or real estate is called a mortgage. In exchange for funds received by the homebuyer to buy property or a home, a lender gets the promise of that buyer to pay back the funds within a certain time frame for a certain cost.

Now we discuss the SME scenarios in Bangladesh.

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**Table: 2 Sources of Loan sought and received by SMEs [13]**

Source	Percentage of respondents of loan sought	Percentage of respondents of loan received
Bank	59.6	53.57
Trade Credit	27.7	100
Relatives/friends	21.3	100
Money lenders	6.4	100
Samity	6.4	92.31
Others	2.1	100

The above table shows the major sources of financing. Almost 59.6 percent of the SME firms seeking finance want to meet up their working capital needs and about 54 percent of them can obtain that. Trade credit is rather common source for small entrepreneurs at high interest rates while informal sources are dominating in their investment (CPD, 2001).

**Table: 3 Average loan sizes for SME loan segment [14]**

Types	Disbursement of the year- 2010 BDT (in crore)			No. of beneficiaries			Average Loan Size (BDT in crore, 1 crore= 10 million)		
	SME	Small	Medium	SME	Small	Medium	SME	Small	Medium
SCBs	7523.98	3458.23	4065.75	29875	25802	4073	0.251849	0.13403	0.99822
PCBs	40494.57	17281.86	23212.71	262997	163924	99073	0.153974	0.105426	0.234299
SBs	2694.66	923.01	1771.65	5942	3952	1990	0.453494	0.233555	0.890276
FBs	1133.93	537.4	596.53	2790	1448	1342	0.406427	0.371133	0.444508
<b>Banks (total)</b>	<b>51847.14</b>	<b>22200.5</b>	<b>29646.64</b>	<b>301604</b>	<b>195126</b>	<b>106478</b>	<b>0.171905</b>	<b>0.113775</b>	<b>0.27843</b>
<b>NBFIs</b>	<b>1696.79</b>	<b>834.39</b>	<b>862.4</b>	<b>7122</b>	<b>6277</b>	<b>845</b>	<b>0.238246</b>	<b>0.132928</b>	<b>1.020592</b>
<b>Financial Sector -total</b>	<b>53543.93</b>	<b>23034.89</b>	<b>30509.04</b>	<b>308726</b>	<b>201403</b>	<b>107323</b>	<b>0.173435</b>	<b>0.114372</b>	<b>0.284273</b>

### 5. DOCUMENTS THAT NEED TO GET SMALL BUSINESS LOAN FROM BANKS/FINANCIAL INSTITUTIONS IN BANGLADESH

To take small loan from any Bank or financial institution borrowers need numbers of document that many of small loan seekers don't know. Here there is a checklist of documents that need to get small loan from a bank or Financial Institution:

- i. Trade license
- ii. Bank Account (Current Account) in the name of Business
- iii. National ID card
- iv. Drug License (only for drug business)
- v. BSTI certificate (For food producing companies)

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- vi. Permission from DC (for Diesel and Acid Business)
- vii. Petro Bangla Certificate (for Diesel and Octane Business)
- viii. Last 1-3 years bank statement (demand can vary based on bank)
- ix. Agreement of shop or house
- x. Position Document
- xi. TIN certificate
- xii. VAT certificate (only in applicable case)
- xiii. Electricity Bill
- xiv. Telephone Bill
- xv. Educational qualification certificate
- xvi. Names of employees, salary, post and monthly salary sheet
- xvii. IRC (Import Registration Certificate) and IRE certificate (for Export & import business)
- xviii. Stored/Stocked products and price of that products
- xix. List and total price of fixed asset
- xx. List of creditors
- xxi. List of debtors
- xxii. Description of present loan from anywhere (if any)
- xxiii. CIB (Credit Information Bureau) report of Bangladesh Bank, here it has to be mentioned that, the particular bank provides CIB form to the entrepreneur to fill up and to give it back to the bank and the bank manage the other arrangements to get CIB report from Bangladesh Bank
- xxiv. Passport size picture of Loan applicant and guarantor, here it's mentionable that, financial Organization can take more than one guarantor if they want
- xxv. Trade License and CIB report of guarantor if guarantor is a businessman
- xxvi. Oneyear sales report and profit account of the business
- xxvii. Certificate of incorporation and Memorandum of Articles (for private limited company)
- xxviii. Resolution of loan taking decision (for private limited company)
- xxix. Audited Financial Statement, Balance sheet, Profit-loss account, Cash flow statement, trade account (for limited company)
- xxx. Current customers/clients list (for limited company)
- xxxi. Registered from Joint Stock Company and Notarized partnership deed from Notary club (for partnership business)
- xxxii. Resolution of partners for loan taking. [12]

Above mentioned documents are almost common documents for all kinds of bank loan. Depending on banks documents requirement it can vary.



**6. CHALLENGES AND SOLUTIONS FOR GETTING A SMALL BUSINESS FUNDING IN BANGLADESH**

Here we want to explore the challenges for small business in Bangladesh and recommends for solving the challenges:

**i. Have No Credit or Bad Credit**

Credit scores measure a business or person's creditworthiness. In general, a bank will look at both his business and personal credit scores to determine whether they are going to lend to his and at what interest rate. Each business and individual have several different credit scores that is reported to the credit bureaus. However, the main ones are CRAB, CRISAL etc. One of the main challenges that a small business faces is when they have no credit or bad credit. To overcome this, business owners must work to increase their business and personal credit scores by making all of their payments on time and spending less than their credit limit, as well as keeping all of their credit accounts open.

**ii. Cash Flow Challenges**

All businesses exist to make money. Due to this, banks will be very hesitant about offering to fund a company that is having cash flow issues. This is because if his business is not making enough profit to start with, then banks will not be willing to hand out a business loan in the hope that it helps your growth. This makes bank funding tough to obtain for very young companies and startups. Startups can try to apply for any loan, which is a loan that is guaranteed by the government. Many larger banks give out SME loans, and so make sure that borrower inquire about it at his/her local branch.

**iii. Lack Preparation**

Some businesses will get turned down for bank funding merely because they did not prepare enough. Often, business owners are not savvy enough when it comes to filing out their application and think that they can simply walk into a bank and automatically get approved. Before owner applies for a bank loan, make sure that he/she has thorough financial statements, projections, and a business plan, as well as bank statements, tax returns, and your business and

personal credit reports. He/she should also bring relevant legal documents such as leases, contracts, and articles of incorporation.

**iv. Dealing with Risk-Averse Banks**

Providing funding to a small business comes with risk to banks. Due to the 2008 financial crisis and consequences effect in our country, many banks raised their

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lending standards so that they could avoid taking on such risk. Banks in the post-recession are much warier, and small business loans are riskier than lending out big business loans or even consumer loans. To overcome the challenge of risk-averse banks, he has a better chance of obtaining a small business loan from a community bank, especially if he can create a relationship with the staff.

#### **v. Under Capitalized Loan Application**

Many times, borrowers make the error of under-capitalization when it comes to their loan application. This indicates that they applied using the wrong collateral or lacked the time it takes to complete the application thoroughly. The good news is that there is a variety of collateral and capital that he can draw upon. Make sure that he does his homework to avoid under capitalization and know what capital he has at his disposal. Know what he can pledge to a bank and what he can use to repay his bank loan and grow his business.

## **7. FINDINGS OF THE STUDY**

From our above discussion we find that:

- i. There are lots of sources for small business funding. Every source has some itself mechanism. Which sources is best it depends on the small business activities nature.
- ii. There are lots of documents needed for getting the loan, sometimes business are not able to collect all documents as a result they are not continue or runtheir business.
- iii. Small business faces lots of challenges but it can be overcome by proper planning, policy, guidelines and implementation.

## **8. CONCLUSIONS**

There are great potentialities of small business development in Bangladesh. Many people and different linkage business are engaged with these. This business develops the rural areas, urban areas as well as our nation economy. We already discuss from where small business owners get their funds, how they collect it, what their challenges etc. If concern authority can minimize the challenge of ease of capital, then small business is considered a driving force for industrialization for our country.

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