

## **Recent Status and Challenges of Small and Medium Enterprises**

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*Abstract: Development of SMEs has a positive effect on stimulating domestic demand through job creation, innovation, and competition. SMEs, a driving force for accelerating economic growth and diversification, still there are constraints on the modernization of SMEs that is the gap between demand and supply of funds for financing. Bangladesh Bank is taking extensive financial measures to promote SMEs but the access to credit remains a challenge to SMEs in particular for those in the non-metropolitan areas. The main factors influencing financing decisions were: lending technology, information gap, processing of loan applications, collateral requirements, profit earning of SME, legal form of ownership, profiles of a firm, lack of data on the payment history of the firm, financial statements, and experience of SME in management and business<sup>2</sup>. The aim of this study is to analyze the contemporary status of SME in Bangladesh, factors influencing financing decision and some recommendations to overcome the challenges.*

*Keywords: Financing decisions, diversification, demand and supply of funds.*

### **1. INTRODUCTION**

SME stands for Small and Medium Enterprises. Small & Medium Enterprise (SME) plays a pivotal role by creating platform for job creation, income generation and accelerates the economic growth and development.

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Classification of industrial categories and definition of each changed with the change in the national industrial policies from time to time. Although the term SME has been used widely at policy levels, Bangladesh Economic Survey or publications like Bangladesh Statistical Year Book categorize industries into two categories: medium and large-scale industries, and small and cottage industries. Bangladesh Bank, however, processes and presents data covering large, medium, and small industries including cottage industries in their various publications. Definitions of different categories of industries center around two variables: total fixed asset excluding the value of land and building and the number of employees.

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### The operational definitions of the components constituting the term SME

Sector	Total Fixed Asset excluding land and Building (Tk. million)	Labor Employment
Medium industry/		
Manufacturing	100 - 300	100-250
Service	10 - 150	50-100
Trading	10 - 150	50-100
Small enterprise:		
Manufacturing	5 - 100	25 - 99
Service	0.5 - 10	10 - 25
Trading	0.5 - 10	10 - 25

#### Source:

**Note 1:** If any enterprise falls under a particular category under one Criterion (total fixed assets or employment) but a larger-size category of the other, then the enterprise will be classified into the latter category.

**Note 2:** The definition of the trading sector has been added by BB and is Applicable to the various financings made by BB.

## 2. OBJECTIVE OF THE STUDY

- To evaluate the present scenario of SME in Bangladesh.
- To identify challenges of SME and
- To recommend some suggestions to overcome those problems.

## 3. METHODOLOGY OF THE STUDY

Data has been collected from secondary sources. The study analyses published books, newspapers, magazines, different published research works, reports of various government authorities and websites.

## 4. LITERATURE REVIEW

Past studies have indicated that in the developing countries of South Asia, SMEs constitute over 97 per cent and contribute between 40–60 per cent of the total output or value-added to their national economies. While most of the SMEs are located in rural areas and they account for over 70 per cent of total employment [7], [1], [11].

In developing economy like Bangladesh, SMEs play a significant role in the development of the economy by creating employment opportunities and producing

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useful machine substitutes and machinery parts saving huge amount of foreign currency for our country [2].

The economic efficiency and overall performance of the SMEs especially in the developing countries are considerably dependent upon macroeconomic policy environment and specific promotion policies pursued for their benefit [3].

SMEs make up the largest portion of the employment base in many developing countries and, indeed, are often the foundation of the local private sector. The entrepreneurs behind them could and should play a much larger role in development, but too often are held back by a lack of ready access to financing from local formal sector financial institutions [4].

About 6.0 million SMEs are actively performing in Bangladesh which were contributing 25 per cent of the total GDP, employing about 31 million people and providing 75 per cent of household income. Various categories of SMEs together contribute between 80 to 85 per cent of industrial employment and 23 percent of total employment in Bangladesh [9].

Higher growth of the Small and Medium Enterprises (SMEs) can help cut poverty to a satisfactory level by eliminating various prejudices against labor intensive and creating jobs for the skilled manpower in the SME sector. Growth of SMEs in developing countries is certainly a desirable goal in view of their perceived contribution to decentralized job creation and generation of output [5].

The key reasons behind the SMEs are not entering into 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 (Bangladesh Bank Report, 2008).

50.53 percent of SMEs have no access to formal source of finance. Only 35.79 percent of SMEs enjoy unrestricted access to the formal credit. The rest (13.68 percent) of them have restricted access to the 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 [6].

Bangladesh Bank encourages banks to give loans to projects for diversified industrial development. From the point of view of limiting the credit risk exposures of the banks having a higher level of classified loan, the new rule is

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justified. However, to consider large loans as risky loans (by the new rule) is not reasonable. Moreover, for increasing the volume of lending to the SME sector, this sort of supply-side policy is not adequate. In fact, under both directed lending (before 1990) and deregulated lending (after 1990) regimes, the demand-side factors were not considered; consequently, resource allocation suffered [8].

Bangladesh's SMEs identified lack of finance as the major issue, with 55% SMEs reporting it. Bribes (21%), orders/marketing of product (28%), lack of knowledge (12%), and license for work (8%), along with new technology (8%) were also considered as major issues. Without the much vital capital, they have little chance of growth or even sustenance in this mobile world. This study has tried to pinpoint, through empirical research, the major, problems faced by SMEs and banks in Bangladesh in relation to financing and has provided recommendations based on the findings to improve the situation (World Bank survey, 2002).

SMEs have very limited bank finance, which is only around 10 percent, while self-finance remains the major source of their finance contributing 76.5 percent of fixed capital and 51.8 percent of working capital [10].

### 5. STATUS OF SME

The industrial sector has been characterized by the rising trend of its contribution to the GDP of the country. The growth rate of the industry ranged from 6.8 percent to 10.8 percent during the period 2006/07 to 2014/15. Analysis of the growth rates in the manufacturing sector showed an upward trend since 2006/07. The average annual compound growth rate of contribution to GDP of SMEs including cottage industries was estimated at 8.74 percent, the same for medium and large-scale industries was 9.02 percent during the period 2006/07-2014/15

Details are furnished in Table The average rate of increase of contribution to GDP of the small and cottage industry was Tk. 1538.62 crores while the same of large and medium scale industries was Tk. 8178.38 crore per year during the same period.

#### **Trends in the contribution of small and cottage industries, and medium and large industries to GDP since 2006/07 (at constant price of 2005/06)**

(In Crore Taka)

Type of industry	2006/7	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	Growth rate %)
<b>Small &amp; Cottage</b>	16113	17265	18525	20040	21176	22569	24558	26113	28907	<b>7.58</b>
<b>Medium &amp; Large</b>	65500	70331	74934	79631	88475	97998	108436	118540	1306763	<b>9.02</b>
<b>Total</b>	81613	87596	93459	99671	109651	120567	132994	144653	159583	<b>8.74</b>

Sources: Ministry of Finance, Government of Bangladesh. Bangladesh Economic Review (Yearly Publications of the period 2010 - 2015).

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Despite policy prescription of emphasis on SMEs development, gaps between the contribution of the small and cottage industries sector and the large and medium scale industries were found increasing during the last decade. Analysis of the sector-wise growth rate of the contribution by periods indicates that growth rates in both small and cottage industries, and medium and large-scale industries increased.

However, the rates of change in the GDP in both the medium & large-scale industries and small & cottage industries were not uniform over the years. Compared to those of the small & cottage industries, the growth rate in medium and large-scale industries sector always remained higher. Figure 1.4 shows the gaps between the contribution to GDP of the medium & large-scale industries and small-scale industries including cottage industries since 2006/07.

The growth rate of contribution of the small and medium scale industries sector to GDP increased to 8.60 percent during the period 2010/11- 2014/15 as against the growth rate of 7.07 during the period 2006/07-2010/11. In contrast, the growth rate of contribution of the large and medium scale industries sector to GDP jumped to 10.07 percent during the period 2011/12-2014/15 as against the growth rate of contribution of 7.81 during the period 2006/07-2010/11.

The primary cause for the decreasing rate of growth in the SME sector was a reduction in investment demand for the small and medium scale industries. The decreasing rate of growth might be attributed to the gap between demand and supply of utilities and infrastructural logjams, the increased cost of borrowed fund and reduced supply of investible capital due to rise in government borrowings, and short supply of matching level of public investment in infrastructure. The increase in the price of electricity, the decline in import of intermediate goods, industrial raw materials, and capital machinery, as well as depreciation of Taka also hurt the industrial growth in the country. The continuing gap between installed capacity and maximum generation capacity of electricity combined with low productivity in the sector contributed to increasing the cost of electricity, and this led to increasing trend in the price of electricity.

## **6. OBSTACLES TO ACCESS OF SMES TO INSTITUTIONAL FINANCE**

Despite the wide-ranging financial measures taken by Government to promote SMEs, SMEs face a variety of constraints. Some major constraints are discussed as follows;

### **Information Gap**

Access of SMEs to institutional finance is constrained by a gap between financial institutions and potential entrepreneurs. Availability of information on SMEs is necessary to assess the risk associated with

the SME lending. Most of the SMEs do not maintain proper books of accounts, and there are no other alternative means of collecting information on the creditworthiness of the potential entrepreneurs.

### **Grace period**

Entrepreneurs encounter difficulties in repaying the loans in the event of grace period being very short. PFIs ordinarily are reluctant to extend the period, and they structure the loans in such manner that the entrepreneurs have to start repayment of credit within a very short time immediately after disbursement. The grace period is particularly becoming a problem for those taking a loan for investment in fixed assets like machinery and equipment.

### **High-interest rate**

The high rate of interest combined with short grace period appears to be an obstacle to attracting potential entrepreneurs to take advantage of institutional finance.

### **Processing of Loan Applications**

One of the inhibiting factors affecting access to finance is a lengthy and cumbersome process of loan processing. Given the contents of application form being technical, entrepreneurs find the same to be difficult and complex.

### **Collateral Requirements**

Collateral is deemed as a major obstacle to managing required amount of finance to set up an enterprise with optimum size. Despite high potential of an SME to become a successful entrepreneur, banks and non-banking financial institutions cannot provide a fund to SMEs without collateral security.

## **7. RECOMMENDATIONS**

The following measures appear to be relevant in accelerating the pace of SME development:

The current mindset of the policy makers of financial institutions to provide short-term loans needs a change for medium and long-term finance to SMEs. In this regard, Bangladesh Bank may strengthen the system of monitoring.

Some of the steps for reaching the target population of SMEs may include preparing a database of existing and potential entrepreneurs at Upazila level, building awareness of the availability of finance to SMEs and strengthening SME desk at the branch level with appropriate technically qualified personnel.

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Bangladesh Bank may further strengthen the present system of monitoring of the activities of financial institutions at branch level in SME financing and supervision of activities of SMEs at the root level.

Bangladesh Bank may provide technical support to PFIs in the form of training in SME financing, a toolkit for decision making, simplified accounting format with minimum necessary information, and formats for monitoring activities of SMEs that took sub-loan.

Digitization of the database of SME clients at the banking and non-banking institutions may be done to avoid distortion, duplication, and redundancy of information regarding loan activities. Digitization may also help manage the risks of financing of SMEs with a minimum of efforts.

Awareness raising programs amongst potential entrepreneurs may be undertaken by PFIs at grass root level to create confidence amongst potential end-borrowers. To facilitate entrepreneurs to have access to medium and long-term finance with minimum risk of financial institutions, the possibility of introducing factoring system of collateral may help the clients who fail to take advantage of the medium and long-term loans due to their inability to provide traditional collateral.

Bangladesh Bank may establish a Central Credit Registry (CCR) to help financial institutions to have a full view of the prospective borrower's outstanding debt and credit history.

The establishment of the CCR, with mandatory reporting by all credit institutions about SME loans, may help overcome the problems arising out of the information asymmetries in the credit market.

## **8. CONCLUSION**

Accelerating economic growth and diversification is one of the major contribution of SME sector in Bangladesh. Development of prolific SMEs signifies positive outcome in stimulating domestic demand through job creation, innovation, and competition. Global economic trend suggests SMEs will continue to be a major driving force for income and employment generation. Hence, Government has also put forth substantial priority in exploration and expansion of SMEs by providing various schemes of financial aid and support. Regardless of existing constrains and a challenge, future of entrepreneurship appears to be very promising and is the need of the hour. We are living in the age of entrepreneurs, with entrepreneurship endorsed by government, business community, educational institutions, society, and corporations. Successful SMEs can undoubtedly be the protagonist in revolutionizing standard of living for the people of our county.

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