*Amity Business Journal*
2019, Vol. 8, No. 1
2278-0904)

Copyright 2019 by ABS,
Amity University Uttar Pradesh, Lucknow Campus (P-ISSN

# Delineating Financial Mechanics of Small and Medium Enterprises

Priyanka Kapoor*  Shobhit**

The 21st century is witness to SMEs as promoter of healthy business ecology and a forerunner of economic development especially in developing countries of the world (Keskin, ■entürk, Sungur, & Kiri■, 2010). Though small firms are the building blocks of entrepreneurial acumen and augmentation, they are highly prone to financial constraints and access to formal means of finance. This paper examines the financial mechanics of Small and Medium Enterprises. The capital need, construct and its various sources have been explored through an analysis of research and review of existing literature. The paper also highlights the constraints faced by small businesses in procuring access to finance and its effect on firm growth.

**Keywords** - Small and Medium Enterprises (SMEs), banks, financial constraints, economic development.

## Introduction

SMEs are considered as the engines of growth optimally utilizing the population especially in the developing economies of the world thus working as the accelerating force behind the macro objective of socio economic prosperity of nations (Cook & Nixon, 2000). In their policy research working paper, Ayyagari, Demirguc-Kunt, and Maksimovic (2011) have clearly laid down that small and medium enterprises are the biggest contributors to employment across countries. Not only do small firms and mature firms employ the largest number of people, they also generate most new jobs, across country and income groups. It is considered that development of SMEs can work as the aligning force between entrepreneurial augmentation, employment generation, innovation and economic headway. Progressive SMEs are the barometric indicator of a healthy and vibrant economy.

SMEs are the bedrock for the embarkment of large business houses. Most large businesses start from a small scale and evolve over a period of time to a magnified and diversified version of the same (Anderson, 1982). Molson Coors, Facebook, Microsoft, Tesla Motors, IKEA, Dell, Starbucks, Wrigley, eBay Media are some of the marked examples of companies, which are or have been in the Fortune 500 companies of the world but had initially had a very humble beginning.

## Objectives

Funding Gaps for smaller firms are a major impediment to growth (Brief, O. P., 2000). Lack of access to finance emerges as the major constraint for the entrepreneurs of these incumbent firms, the situation holds the same for firms of adequate size and experience (Levy, 1993).

The paper explores the various financial needs and constructs of contemporary Small and Medium Enterprises. It examines the financial mechanics of Small and Medium Enterprises. The paper also highlights the constraints these incumbent firms face in procuring access to finance and its effect on firm

growth. The paper fills the theoretical gap between the need, construct and bottleneck of finance among Small and Medium Enterprises in contemporary times.

## Methodology

The paper uses a deductive approach to understand what the contemporary financial needs of small and medium enterprises are through a heuristic enquiry of recent literature. The second part of the paper lays down the complementing and contrasting theories of capital structure in operational management. The paper tries to examine issues which obstruct the smooth flow of funds in an enterprise which in turn leads to growth limitation. Books, journals, research papers and reports have been extensively explored in order to provide a brief summary of the relevant work.

## Financial Needs and Constructs

The foremost responsibility of any business manager/owner is to achieve firm objective. Thus, all business decisions, strategies, policies and division of work are aligned with the objective/s of the firm (Dwivedi, 1980). Researches in the past have laid down various business objectives. Profit maximization has unambiguously been the most universal of them all (Walker, 1887; Hawley, 1893; Knight, 1921; Schumpeter, 1934). Maximization of sales revenue (Baumol, 1985), maximization of firm's growth rate (Marris, 1963), value maximization (Jensen, 2010) are some of the more contemporary business objectives which evolved as contradictions to traditional theories to suit changing business composition, strategies and practices.

According to Wang (2016), the key determinants among firms' characteristics are size, age and growth rate of firms as well as the ownership of the firm. As companies move from one stage of growth to the other they need to innovate, refurbish itself to meet market demands and sustain competition. This situation necessitates financial preconditioning. Globalization and Digitalization has been highly instrumental in dilapidating the geographical barriers to flow of information and ideas, goods and services, product and customer for these firms. This growing transitory ecosystem has made way for fast changing technologies, newly empowered customer base, mushrooming new markets and heavy competition. Finance is the very lifeblood of all these entrepreneurial activities. Studying this phenomenon is thus of utmost importance. Hamel and Ruben (2000) in their stimulating book 'Leading the revolution' have invigoratingly outlined the need for enterprises to be abreast and formative in reshaping and re-conceptualizing business modules. Businesses which would be incapable or insurgent towards newer strategies would very soon cease to exist. Rude blow to competitors, value addition through persistent innovation, meteoric speed towards customer addressal and wealth creation for investors is the way forward.

Chesbrough (2006), the father of 'Open Innovation', has discussed in length about this contemporary issue. According to him, 'Open innovation has become a new paradigm for organizing innovation.' He explains the phenomenon as the assimilation and combined utility of both outside-in and inside-out open innovation, also termed as 'technology acquisition' and 'technology exploitation' (Lichtenthaler, 2008). He echoes a similar view as Hamel's of contemporary businesses having an agile, malleable and open business model. Chesbrough also expresses the importance of IPR to the current business domain. He believes that companies should be both active sellers of IP and active buyers of IP. He strongly believes that spillovers should not be looked upon as cost of business rather it should be perceived as opportunities for expansion. Chesbrough has pitched the universality of application of innovation processes to the community; it reaps result both in a large organization as well as a small business.

In their paper Van de Vrande, De Jong, Vanhaverbeke, and De Rochemont (2009) have empirically supported that open innovation is not just conducted by Multi National Enterprises, but equally applies to SMEs, and moreover, open innovation on an average is increasingly being adopted. Though a comparative analysis of small and medium enterprise show that the medium sized enterprises have adopted the innovation model more frequently than their smaller counterpart. The research highlights customer involvement, external networking and employee involvement among the common innovation practices. Outward and inward licensing of IP, venturing and external participations in other enterprises are also conducted but their numbers are limited, while Research & Development outsourcing is done by half of the sample. Assessment of available literature and research on open innovation bring to the fore that SMEs have gradually shown an increasing trend of adoption of open innovation processes, though the major bottlenecks are related to administrative area, the application is an unavoidable financial thrust on these firms. But SMEs regard this as a tool to keep up with customer demand and market development which eventually would lead to financial growth and increased market share.

Digital technologies fundamentally transform organizations. With the pace of technological change, organizations must have a coherent strategic layout that strictly has digitally equipped and skilled manpower at its epicenter. The speed of digital transformation is such that businesses need to adapt and move with lightning pace or would be wiped out of the playing arena. Digital adoption is no more a choice for firms. Irrespective of construct, size and financial availability, enterprises need to design and espouse a business process model with digital inclusions. The Business Model concept has become one of the most important domains in the field of Information Systems, thanks to recent rapid advances in Information and Communication Technologies (ICTs) (Al-Debi, El-Haddadeh, & Avison, 2008). Schumpeter, the 'prophet of innovation', has interestingly brought forward the relationship between technology and economic development as complementary as well as contradictory phenomenons. His concept of 'combination' propounded in 1934 hold good even today (Schumpeter, 1934).

Financial resource woven together with digital planning and penetration can lead to increased efficiency and value creation (Amit & Zott, 2001).

## Sources of Finance

Capital structure is one of the most intriguing fields of financial management (Šarlija & Harc, 2016). In financial management, capital structure theory refers to a systematic approach to financing business activities through a combination of equities and liabilities. Even though size is an important repressor on capital structure determination, firms belonging to different size groups seem to behave similarly regarding the relationship between the debt they use and their profitability, size, asset structure and growth (Daskalakis & Thanou, 2010). At the epicenter of this issue are questions about the financial needs of a growing company and the composition of equity and debt.

Competing capital structure theories explore the relationship between debt financing, equity financing, and the market value of the firm. Modern theory of capital structure has its roots strongly embedded in traditional researches like the Pecking Order Theory and the Trade-off Theory. Modigliani and Miller (1958) studied capital-structure theory intensely. They hypothesized that in perfect markets, it does not matter what capital structure a company uses to finance its operations and they theorized that the market value of a firm is determined by its earning power and by the risk of its underlying assets, and that its value is independent of the way it chooses to finance its investments or distribute dividends. It is thus the theory of capital structure irrelevance that a firm's value depends on the ability of its assets to create value, and is irrelevant if the assets originate in internal capital or external capital.

The pecking order theory assumes that there is no target capital structure. The firms choose capitals according to the following preference order: internal finance, debt, equity (Chen & Chen, 2011). According to Chirinko and Singha (2000) "The central friction in the Pecking Order Model of capital structure is the asymmetric information between managers and less-informed outside investors". They have highlighted the existence of a financial hierarchy descending from internal funds, to debt, to external equity. Fund raised through equity is only explored after the exhaustion of debt issue. Since information asymmetry for external financing is a major bottle neck for most SMEs (Thampy, 2010), the owner of these firms primarily prefers internal sourcing before debt financing. Thus, this theory is applicable to both big and small firms.

On the other hand the trade-off theory of capital structure is the financial framework that a company chooses to incorporate in terms of debt finance and equity finance by balancing the costs and benefits. The cost of financial distress is determined by the type of assets that a firm owns (Bas, Muradoglu, & Phylaktis, 2009). Cole (2013) through his research concluded that firm size and profitability are negatively related to leveraging and positively related to tangible asset cost. Contrary to Cole (2013), Ramlall (2009) inferred that firm size and profitability are positively related to leveraging and negatively related to tangible asset cost. Šarlija and Harc (2016) have extensively drawn a theoretical comparison from various past researches on the relationship of growth, size, profitability, tangible assets and capital structure.

Optimal capital composition has a reflective bearing on the maximization of firm value (De Vries & Erasmus, 2010). Adoption of accurate capital structure theory is guided by certain conditions and identification of the key determinants that affect the capital structure of the company. However, in different countries different determinants with opposite relation to the leverage are found to be significant. Thus, there is no optimum defined capital structure (Šarlija & Harc, 2016). The government policies, corporate law in the country, personal and corporate tax are some of the governing factors in the determination of capital structure of a company in their respective countries.

## Bottlenecks & Effect on Firm Growth

Small and Medium Enterprises (SMEs) work in extraordinary conditions. They constitute the most dynamic firms in an emerging economy. They are the ones most likely to move into areas of comparative advantage and high value addition. Given the scalable heterogeneity in business models of these firms in the current scenario, they are not immune to issues similar to big businesses. They often face economic, institutional, and legal obstacles. Lack of finance and cost of credit constitutes the main obstacles to the growth of SMEs (Pissarides, 1999). These firms are more exposed to relative risk and growth constrains than their larger counterparts (Schiffer & Weder, 2001).

SMEs especially in developing economies of the world resonate the framework of pecking order theory as their preferred primary source of financial is retained earning followed by debt and finally the issue of new shares to outsiders (Watson & Wilson, 2002). On the other hand Commercial Banks form an integral part of external financing for SMEs around the globe (Ghandi & Amissah, 2014). Alternative financing solutions like business angels, venture capital funds, different government support programs and seed funding, can form new avenues of financial leverage especially for new SMEs (Rupeika-Apoga, 2014).

The endogenous and exogenous components of lending infrastructure – the information environment, the legal and bankruptcy environment, and the tax and regulatory environments – may directly affect SME credit availability. SMEs can gain considerably through comparative advantage in different lending

technologies. Financing tools such as leasing and factoring can facilitate access to finance in the absence of well structured institutional set-up, as can systems of credit information sharing (Beck & Demirguc-Kunt, 2006). A well coordinated, structured and planned approach towards a fertile lending structure which is well informed about the SME financing requirements and has an open interface to address small business issue would not only let the SMEs be incubators of value creation but will also set pace to economic development of the respective country.

## Conclusions

Change is the thriving force for all businesses today. Business practices are changing at a darting pace. Under the pressure of the external and internal phenomenons, enterprises need to equip themselves with coherent strategic business planning, endogenously armed with open innovation processes and ever transitory digital practices. Financial capital is a pivotal resource (Cooper, Gimeno-Gascon & Woo, 1994), which needs to be handled with proficient acumen. Apt financial leveraging backed by foresighted business planning incubating digital adoptions is the perfect recipe to financial escalation and enterprise growth.

In recent times entrepreneurship and Small and Medium Enterprises have been enjoying increased firm-level acceptability thus it deserves much scholarly attention (Zahra, Kuratko, & Jennings, 1999) especially in the contemporary setup.

---

** Priyanka Kapoor is a research scholar at Amity Business School, Amity University, Lucknow Campus. Her area of research is Small and Medium Enterprises. She is a lecturer in the Department of Commerce at Avadh Girls' Post Graduate College, Lucknow (Lucknow University). Priyanka has presented papers at various National and International Conferences and Seminars. She is a member of ASEDS, Confederation of Indian Industries (CII) and Lucknow Management Association (LMA). Email: priyak13_tandon@yahoo.co.in*

*** Dr. Shobhit Goel is an Assistant Professor at Amity Business School, Amity University, Lucknow Campus. His area of Specialization is Finance, Taxation and Financial Services. Dr. Goel has three books to his credit and has published various papers in journal of repute. He has attended and presented research papers in many National and International Conferences and Seminars. Email: drshobhitgoel@gmail.com*

## References


Al-Debi, M. M., El-Haddadeh, R., & Avison, D. (2008). Defining the business model in the new world of digital business. *AMCIS 2008 Proceedings*, 300.

Amit, R., & Zott, C. (2001). Value creation in e-business. *Strategic management journal*, *22*(6-7), 493-520.

Anderson, D. (1982). Small industry in developing countries: A discussion of issues. *World development*, *10*(11), 913-948.

Ayyagari, M., Demirguc-Kunt, A., & Maksimovic, V. (2011). Small vs. young firms across the world: contribution to employment, job creation, and growth. *The World Bank*.

Bas, T., Muradoglu, G., & Phylaktis, K. (2009). Determinants of capital structure in developing countries. Cass Business School, London, UK.

Baumol, W. J. (1972). Economic theory and operations analysis. Englewood Cliffs, New Jersey: Prentice-Hall, Inc.

Beck, T., & Demirguc-Kunt, A. (2006). Small and medium-size enterprises: Access to finance as a growth constraint. *Journal of Banking & Finance*, *30*(11), 2931-2943.

Brief, O. P. (2000). Small and Medium-Sized Enterprises. Local Strength, Global Reach.

Chen, L. J., & Chen, S. Y. (2011). How the pecking order theory explain capital structure. *Journal of International Management Studies*, *6*(3), 92-100.

Chesbrough, H. W. (2006). Open innovation: The new imperative for creating and profiting from technology. Harvard Business Press.

Chirinko, R. S., & Singha, A. R. (2000). Testing static tradeoff against pecking order models of capital structure: A critical comment. *Journal of Financial Economics*, *58*(3), 417-425.

Cole, R. A. (2013). What do we know about the capital structure of privately held US firms? Evidence from the surveys of small business finance. *Financial Management*, *42*(4), 777-813.

Cook, P., & Nixson, F. (2000). Finance and small and medium-sized enterprise development. Manchester: Institute for Development Policy and Management, University of Manchester.

Cooper, A. C., Gimeno-Gascon, F. J., & Woo, C. Y. (1994). Initial human and financial capital as predictors of new venture performance. *Journal of Business Venturing*, *9*(5), 371-395.

Daskalakis, N., & Thanou, E. (2010). Capital structure of SMEs: to what extent does size matter?

De Vries, A., & Erasmus, P. D. (2010). Determinants of capital structure: A South African study. *Corporate Ownership and Control*, *8*(1), 591-599.

Dwivedi, D. N. (1980). Managerial economics. Vikas Publishing House.

Gbandi, E. C., & Amissah, G. (2014). Financing options for small and medium enterprises (SMEs) in Nigeria. *European Scientific Journal*, *10*(1), 327-340.

Hamel, G., & Ruben, P. (2000). Leading the revolution, 286. Harvard Business School Press, Boston.

Hawley, F. B. (1893). The risk theory of profit. *The Quarterly Journal of Economics*, *7*(4), 459-479.

Jensen, M. C. (2010). Value maximization, stakeholder theory, and the corporate objective function. *Journal of Applied Corporate Finance*, *22*(1), 32-42.

Keskin, H., ■entürk, C., Sungur, O., & Kiri■, H. M. (2010). The importance of SMEs in developing economies.

Knight, F. H. (1921). Risk, uncertainty and profit. Boston, MA: Hart, Schaffner.

Levy, B. (1993). Obstacles to developing indigenous small and medium enterprises: An empirical assessment. *The World Bank Economic Review*, *7*(1), 65-83.

Lichtenthaler, U. (2008). Open innovation in practice: An analysis of strategic approaches to technology transactions. *IEEE Transactions on Engineering Management*, *55*(1), 148–157.

Marris, R. (1963). A model of the 'managerial' enterprise. *The Quarterly Journal of Economics*, *77*(2), 185-209.

Modigliani, F., & Miller, M. H. (1958). The cost of capital, corporation finance and the theory of investment. *The American Economic Review*, *48*(3), 261-297.

Pissarides, F. (1999). Is lack of funds the main obstacle to growth? EBRD's experience with small-and medium-sized businesses in Central and Eastern Europe. *Journal of Business Venturing, 14*(5-6), 519-539.

Ramlall, I. (2009). Determinants of capital structure among non-quoted Mauritian firms under specificity of leverage: Looking for a modified pecking order theory. *International Research Journal of Finance and Economics, 31*(31), 83-92.

Rupeika-Apoga, R. (2014). Financing in SMEs: case of the Baltic States. *Procedia-Social and Behavioral Sciences, 150,* 116-125.

Šarlija, N., & Harc, M. (2016). Capital structure determinants of small and medium enterprises in Croatia. *Managing Global Transitions, 14*(3 (Fall)), 251-266.

Schiffer, M., & Weder, B. (2001). Firm size and the business environment: Worldwide survey results. The World Bank.

Schmitz, H. (1982). Growth constraints on small-scale manufacturing in developing countries: a critical review. *World development, 10*(6), 429-450.

Schumpeter, J. (1934). The Theory of Economic Development. Harvard University Press: Cambridge, MA.

Thampy, A. (2010). Financing of SME firms in India: Interview with Ranjana Kumar, former CMD, Indian bank; vigilance commissioner, central vigilance commission. *IIMB Management Review, 22*(3), 93-101.

Van de Vrande, V., De Jong, J. P., Vanhaverbeke, W., & De Rochemont, M. (2009). Open innovation in SMEs: Trends, motives and management challenges. *Technovation, 29*(6-7), 423-437.

Walker, F. A. (1887). The source of business profits. *The Quarterly Journal of Economics, 1*(3), 265-288.

Wang, Y. (2016). What are the biggest obstacles to growth of SMEs in developing countries? – An empirical evidence from an enterprise survey. *Borsa Istanbul Review, 16*(3), 167-176.

Watson, R., & Wilson, N. (2002). Small and medium size enterprise financing: A note on some of the empirical implications of a pecking order. *Journal of Business Finance & Accounting, 29*(3-4), 557-578.

Zahra, S. A., Kuratko, D. F., & Jennings, D. F. (1999). Guest editorial: Entrepreneurship and the acquisition of dynamic organizational capabilities. *Entrepreneurship Theory and Practice, 23*(3), 5-10.