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Source of Finance in Small –Scale Industries

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Abstract

Financing your business is often the critical component to success. There are a wide variety of ways this can be accomplished. Finding financing for your business is just one aspect of your overall financial management of your business, but it is critical factor for the success of many small businesses. This main objective of this study is to find out the main source of financing used by small-scale industries for different purposes. For the said purpose data have been collected from 400 small-scale units through questionnaire, interviews and personal observation. After study it is found that in small-scale industries after maximum use of trade credit, for additional funds, most of the industries approach commercial banks for short-term borrowings. More than two-third industries in small sector have taken term loans for investments in plants & machineries, land and buildings or permanent addition to current assets. Out of them again more than two-third small industries have approached commercial banks for term loans due to stringent terms and conditions of financial institutions for granting term loans. . The owners' funds in small-scale industries, owing to their nature of organization and limited access of the owners to the market, are in short supply. Approximately only one-fifth industries are using more than two-third owners' funds out of the total capital used in the business for long-term.

Key words: Source of short-term loans, Source of term loans, Sources of long-term Financing, Trade Credits.

Source of Finance in Small –Scale Industries

Introduction

Finance is the key input for sustained growth of small-scale sector and its accessibility continues to be a matter of concern. The small-scale industries need both long run as well as short run credit. Source of finance plays a vital role in the survival, growth and development of these industries. There are various sources of finance such as equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, venture funding etc. These sources are useful under different situations. They are classified based on time period, ownership and control, and their source of generation. Sources of finance are the most explored area especially for the entrepreneurs about to start a new business. It is perhaps the toughest part of all the efforts. Having know that there are many alternatives of finance or capital available, a company can choose from. Choosing right source and right mix of finance is key challenge for every finance manager. The process of selecting right source of finance involves in-depth analysis of each and every source of finance. Based on a review of your financing needs and the various costs and benefits of different sources available, you can determine from which source to seek finance.

Review of Literature

Basu (1957) made an attempt to examine the financial problems of small- scale Industries and assess their place in the country's Second Five Year Plan. The study highlights the role of S F C in financing small-scale Industries.

Narayanan '' (I964) in his thesis discusses the financial problems faced by Industries in general and recommends the setting up of an Industrial development Bank at the state level for mitigating the problems.

Suresh Chandra Jain (I971) in his work analyses in detail the problems of institutional finance for small-scale Industries in the state of Utter Pradesh. Sharma (I973) in his study explains industrial financing by national level financial institutions. It also discusses the role of the state financial institutions in financing industries of Bihar. He suggests that the financial institution should act as a guide philosopher and promoter of industries and recommend the setting up of small industries bank.

Inderjith Singh & Gupta (1977) state that the expansion of the bank credit is not only desirable but also essential for the economic development of Jammu and Kashmir.Commercial banks have to take up this task of credit expansion on a challenging basis and should exploit the tremendous potentiality by establishing personal contact with small industrialists.

Pareek (I978) in his work reveals the role of financial institutions and state agencies in extending credit to small-scale units and pin point their attitude of indifference in catering to the need of the tiny units. He suggests that financial institutions have to tune their policies in consonance with the needs of small-scale sector in general and the smaller among small-scale units in particular.

Study conducted by Papola and Tewari '' (1981) on the impact of concessional finance on industrial development of backward areas found that the concessional finance was one of the important considerations in the location of new units in the backward districts.

Sarnara Kumar Mirra (1984) in his study states that due to lack of co-ordination between DIC personnel and implementing agencies, procedural delays, non-availability of services of important agencies and lack of entrepreneurship, the present system is not functioning well.

Radhey Shyam Singh (I986) in his study makes an analytical survey of the institutional sources of finance to the SSI and other small / tiny units, after critically examining the various aspects of the functioning of the financial institutions for the growth of the small-scale sector.

Agarwal (I987) reports that the Indian banking system has failed to extent appropriate amounts of loan to SSI. He is of the opinion that lending institution should be more practical and flexible in their attitude rather than strictly legal with a view to enabling the borrowing units to overcome any temporary difficulties.
Kalchetty Eresi (I989) throws light on the various sources of long term and short-term finance and the problem faced by the units in raising such funds. He also

enquires into the policies procedures and practices of small units in managing their finance.
Raghurama (I991) tries to analyze the problems faced by small-scale units while availing themselves of bank finance. The problems faced by the bankers and the procedures adopted by the bank in extending finance are also examined.

Ashok Arora (1992) in his study examines the role of various institutions at the state level responsible for rendering assistance for the growth of small-scale industries in Punjab. This study also outlines a profile of the growth of small-scale industries in Punjab.

James Manalel (1994) reported that the working of banks and financial institutions showed that the total assistance made available in Kerala for SSI units was comparatively small. The effectiveness of any incentive packages, however well designed it may be, depends 0x1 the quality of the system of delivery. The state has comparable package on record, but the quality of delivery of the same was perceived by the entrepreneurs to be poor in relation to what units in other states get.

Prasad (1995) in his study states that, there has been a steady growth in the flow of Institutional finance to SS1 during the last two decade. But inadequate accesses to credit both short term and long term remain a perennial problem of the small-scale sector.

Himachalam, Jayachandran, Narendra Kumar (1995) in their study on financing of small-scale units by Andhra pradesh state finance corporation reveals that though the state financial institutions came into existence to promote small-scale units, their effort to extend financial, managerial and technical assistance have been far from satisfactory, and they have failed to fulfill the expectations.

Bagchi (2000) reports that though the small-scale sector contributes significantly to industrial output, employment and earning of foreign exchange it suffers from severe technological obsolescence and lack of economies of scale. The small industries development organization under the ministry of SSI and ARI has been providing institutional support for the promotion of technology but in a vast country like India these facilities are inadequate.

Objective of Study

The main objective of the study is to examine the main source of financing used for different purposes in small-scale industries.

Scope of the Study

The present study deals with the small-scale industries in Haryana. It was not possible to cover all the states in India due to time and financial constraints. However, we believe that the findings of the study would have equal applicability for the enterprises in other States also, since there is much similarity among the small industries with respect to size, structure, operation and management.

Data Requirement

The present study is based on primary data. The data have been collected through questionnaire, interviews and observations. The primary data are the main base of the study. For this purpose we have undertaken intensive case studies of 400 selected small-scale industries. While selecting these units we have taken enough care to see that these are representative of all type of industries and all districts in Haryana. For the said purpose we have divided all the industries into six categories such as Garments, Auto-parts, Electronics, Metal Products, Rubber and Plastics, and Others (Table 1).

Table 1
Sample Size

Name of the Industry	Sample
1. Garments	80
2. Auto-parts	40
3. Electronics	60
4. Metal Products	78
5. Rubber and Plastics	56
6. Others (Machinery parts, Paper products, Chemical products, etc.)	86
Total	**400**

Main Sources of Short-term Capital in Small-scale Industries

Short-term financing plays a vital role in the financing of assets, regardless of the size of the firm. However, this source is of particular significance to the small business. Having limited access to the capital markets, the smaller company has to place greater reliance upon short-term sources, particularly trade credit and short-term bank credit. In contrast, the large corporations, while utilizing trade credit extensively, employ short- term bank loans as a means for providing greater flexibility if the need arises. Thus, for the large business entity, the importance of short-term bank credit comes in the form of increased discretion rather than as a result of the volume. The smaller organization has no such option. If after maximizing its use of trade credit additional funds are required, the smaller company, for the most part, must approach the banker for additional money. Finally, the small concern's inability to enter the long-term public markets places additional burden upon short-term financing. Thus, the small firm is restricted in its availability to long-term sources of financing. Accordingly, the significance of short-term funds takes on an extra dimension for the small organization.

Sources of Short Term-Credit

Sources of short-term capital may be segmented into two categories: (1) credit available from suppliers in the form of trade credit, and (2) debt provided by financial institutions.

Trade Credit

Trade credit is characteristically different from other forms of short-term credit in that this source is not associated with a financial institution. However, this fact should not minimize the significance of trade credit as a primary source of financing. Specifically, on average, approximately one-third of a firm's current liabilities come from trade credit. These payables are all the more important when viewed from the perspective of the small-scale industries.

Financial Institutions as Supplier of Short – Term Credit

The volume of short-term credit supplied by financial institutions fluctuates more widely than does the volume supplied by trade credit. Although banks are the largest group of financial institutions supplying short-term credit, other financial institutions also play a major role in this type of lending.

Table 1.1

Main Source of Short-term Loans in Small-scale Industries in Haryana

Name of Industry	Commercial Banks		Other Financial Institutions		Friends/ Relatives or Money Lenders		Total		Total No.
	No.	%	No.	%	No.	%	No.	%	
1. Garments	72	90.0	–	–	03	3.75	75	93.7	80
2. Auto-parts	32	80.0	–	–	02	5.0	34	85.0	40
3. Electronics	53	88.3	—		03	5.0	56	93.3	60
4. Metal Products	65	83.3	–	–	08	10.3	73	93.6	78
5. Rubber & Plastics	48	85.7	–	–	02	3.6	50	89.3	56
6. Others	72	83.7	–	–	06	7.0	78	90.7	86
Total	**342**	**85.5**	**–**	**–**	**24**	**6.0**	**366**	**91.5**	**400**

Note: May be using more than one source, but we have considered only the main source.

Table 1.1 shows that 91.5 per cent small-scale industries depend on short-term borrowings for their short-term needs of finance. Out of them 85.5 per cent small-scale industries, approach commercial banks for short-term loans. In this category the maximum number is 90 per cent units in Garments industry, closely followed by Electronics industry 88.3 per cent, Rubber and Plastics industry 85.7 per cent, Others industry 83.7 per cent, Metal Products industry 83.3 per cent, and Auto-parts industry 80 per cent, who have taken short-term loans from commercial banks. In small-scale industries especially small units also approach their friends/relatives and money lenders for short-term funds and their number is 6 per cent of total units. Due to maximum number of small units in Metal Products industry, 10 per cent units approach friends/relatives and money lenders for short-term loans. In the remaining industries 3.6 per cent to 7 per cent units also use this source for short-term financing. Remaining 8.5 per cent units, in small-scale sector, internally manage their working capital requirement.

So, on the basis of above analysis we can say that commercial banks play the most significant role in providing working capital finance. Financial institutions have not provided short-term loans to any unit, because most of the financial institutions do not provide finance for working capital.

Main Source of Term Loans in Small-Scale Industries

Small-scale industries are generally not regarded as sufficient credit-worthy because they are not able to satisfy the criteria lay down by lenders. The grant of medium and long term loans involves not only an assessment by the lending agencies of the credit-worthiness of the borrowers and the securities offered by them, but also an observance of rules and regulation governing such advances. The financial position of a borrowing concern should be fairly sound and should show profit or should have the prospects of proving its earning capacity, if financial assistance is granted; the equipment and technical processes employed in the production of goods and services should be efficiently; the unit concerned should have an assured market or should produce items which are required by big industries; and the borrowing concern should be owned by men of integrity and business standing. The institutions, which normally respond to some extent to the needs of small-scale industries, are smaller banks, whose field of activity is restricted to a small area.

Source of Term Loans

Principal suppliers of term loans are commercial banks, small Industries Development Bank of India, State Financial corporations, National Small Industries Corporation and State Industrial Development corporations, etc.

Table 1.2

Source of Medium & Long-term Loans in Small-Scale Industries in Haryana

Name of Industry	**Commercial Banks**		**Other Financial Institutions**		**Friends/ Relatives or Money Lenders**		**Total**		**Total No.**
	No.	%	No.	%	No.	%	No.	%	
1. Garments	53	81.5	7	10.8	5	7.7	65	81.3	80
2. Auto-parts	26	76.5	6	17.6	2	5.9	34	85.0	40
3. Electronics	40	76.9	7	13.5	5	9.6	52	86.7	60
4. Metal Products	50	78.1	6	9.4	8	12.5	64	82.1	78
5. Rubber & Plastics	40	80.0	4	8.0	6	12.0	50	89.3	56
6. Others	58	73.0	8	10.5	10	13.2	76	88.4	86
Total	**267**	**78.3**	**38**	**11.1**	**36**	**10.6**	**341**	**85.3**	**400**

Note: May be using more than one source, but we have considered only the main source.

Table 1.2 shows that 85.3 per cent small-scale industries have taken term loans for investment in plant and equipment, land and building or permanent addition to current assets. Out of them 78.3 per cent industries, due to the problems face by small scale industries in taking term loans from financial institutions as discussed in detail above have taken long term and medium-term loans from commercial banks. Only the bigger units which could fulfill the stringent terms and conditions of financial institutions have taken loans from these institutions and their percentage is just 11.1 per cent. Remaining 10.6 per cent industries have taken loans from non-financial institutions (friends, relatives and moneylenders). In small-scale industries bank financing is most popular. Banks also grant loans for medium or long terms after taking security of land or building or against the security of plant and machinery to be purchased from the loan amount. So, the smaller units, which cannot provide any security, do not get term loans from commercial banks. In that case their needs are fulfilled by non-financial institutions.

Out of these 78.3 per cent industries, which have taken term loans from commercial banks, in Garments industry maximum 81.5 per cent units closely followed by Rubber & Plastics industry 80 per cent, Metal Products industry 78.1 per cent, Electronics industry 76.9 per cent, Auto-parts industry 76.5 per cent, and in Others industry 76.3 per cent units have taken medium and long term loans from commercial banks. The main reasons of taking term loans from commercial banks by more than two-third units in small-scale sector are : easily approachable, flexible attitude, and expeditiously dispose of the loan applications.

As far as loan taken from other financial institution is concerned only (11.1 per cent) the big units have taken loans from them. In Auto-parts industry maximum 17.6 per cent units followed by Electronic industry 13.5 per cent, Garments industry 10.8 per cent, Others industry 10.5 per cent, Metal Products 9.4 per cent, and in Rubber & Plastics industry 8 per cent units have taken term loans from other financial institutions.

In small-scale industry friends/relatives or moneylenders also play an important role in providing term loans? In case banks or other financial institutions refuse to grant term loans the only source for small firms is friends/relatives or moneylenders. Normally they charge high rate of interest but they help the small firms in crisis. It is clear from the table that in Others industry 13.2 per cent units closely followed by Metal Products industry 12.5 per cent, Rubber & Plastics industry 12 per cent units have used this source for term loans. In Electronics industry, Garments industry and Auto-parts industry also 9.6 per cent,7.7 per cent, and 5.5 per cent units respectively have taken term loans from friends/relatives or moneylenders.

In small-scale industries remaining 14.7 per cent industries are not using any term loans. In this category both type of units are there: one which is financially sound or amount invested in fixed assets is not significant and the other which had taken term loans but already been repaid. In smaller units the requirements of working capital are more in comparison to fixed capital. So, some small units have arranged fixed capital themselves without taking the help of outsiders.

Long-term Financing in Small-Scale Industries

The source of finance has to be decided with reference to the period for which the funds are required. Fixed capital or long-term funds must be raised in such a manner that the enterprise will have uninterrupted use of such funds for a sufficiently long period. Long-term finance is required for investment in fixed assets like land and buildings, plant and machinery, furniture and fixtures, etc. It is generally required and raised for ten years.

Various sources of finance may be grouped under two heads, namely (i) Owners' Funds and (ii) Borrowed Funds. Owners' funds include capital contributed by the Shareholders and profits re-invested in the business. Borrowed funds are raised by way of loans and credit from the public, banks, financial institutions, etc.

The owners' funds in small-scale industries, owing to their nature of organization and limited access of the owners to the market are in short supply. The table 1.2 (discussed earlier) shows that 85.3 per cent small units have taken term loans for expansion, modernization or even for establishment from banks, financial institutions or non-financial institutions. Now, we will discuss with the help of two tables (1.3 and 1.4) given ahead the percentage of Owners' Funds and long-term loans used by small-scale industries for fulfilling long-term needs.

Table 1.3

Proprietary Ratios in Small - Scale Industries in Industries

Name of Industry	**0-24%**		**25-49%**		**50-74%**		**75-99%**		**100%**		**Total No.**
	No.	%	No.	%	No.	%	No.	%	No.	%	
1. Garments	15	18.8	35	43.8	13	16.2	2	2.5	15	18.7	80
2. Auto-parts	10	25.0	19	47.5	4	10.0	1	2.5	6	15.0	40
3. Electronics	17	28.3	24	40.0	8	13.3	3	5.0	8	13.3	60
4. Metal Products	20	25.6	33	42.3	5	6.4	6	7.7	14	18.0	78
5. Rubber & Plastics	18	32.2	22	39.3	5	8.9	5	8.9	6	10.7	56
6. Others	25	29.1	33	38.4	10	11.6	8	9.3	10	11.6	86
Total	**105**	**26.3**	**166**	**41.5**	**45**	**11.2**	**25**	**6.2**	**59**	**14.8**	**400**

Note: Equity = Equity Capital + Retained earnings.

Table 1.3 shows various categories of small-scale industries according to the use of equity capital (Owners' Funds) for long-term financing. For the purpose of analysis we have divided them into two categories. Firstly, which are using 50-100 per cent owners' funds (32.2 per cent) and secondly, which are using 0-49 per cent owners' funds (67.8 per cent). In the first category 14.8 per cent units are using 100 per cent owners' funds for long-term financing. These are mainly small units, which require less amount of fixed assets/capital, as well as old big units which had taken loan capital but have repaid them and presently are having no loan capital. In this category the maximum percentage is of Garments industry 18.7 per cent, followed by Metal Products industry 18 per cent, Auto-parts industry 15 per cent, Electronics industry 13.3 per cent, Others industry 11.6 per cent, and the least is in Rubber & Plastics industry 10.7 per cent, which are using only Owners' Funds for medium and long-term financing. Next 11.2 per cent small-scale industries are using more than 50 per cent but less than 74 per cent owners' funds in total capital. In this range also maximum percentage, 16.2 per cent belongs to Garments industry, followed by Electronics industry 13.3 per cent, Others industry 11.6 per cent. In Auto-parts industry, Rubber & Plastics industry and Metal Products industry 6 to 10 per cent units are using 50-74 per cent owners' funds in total capital. In the first category rest 6.2 per cent of small-scale industries are using more than 74 per cent but less than 100 per cent owners' funds in the total capital. In this category, the percentage of different industries varies from 2.5 to 9.3 per cent according to the nature of the industry.

In the second category of industries, which are using 0-49 per cent of owners' funds, 41.5 per cent of industries are using 25 per cent to 49 per cent owners' funds and 26.3 per cent are using less than 25 per cent owners funds for long-term financing. In this category are mainly bigger units, expanding units, and which require heavy investments in plants & machineries, as well as, financially weak units, which mainly depend on loan capital. In the category using 25-49 per cent owners' funds, the maximum percentage is of Auto-parts industry 47.5 per cent, followed by Garments industry 43.8 per cent, Metal Products industry, 42.3 per cent, Electronics industry 40 per cent, Rubber & Plastics industry 39.3 per cent, and least in Others industry 38.4 per cent. In the second category remaining units (26.3%) are using less than 25 per cent owners' funds in the total capital of the firm. The maximum percentage is of Rubber & Plastics industry 32.2 per cent, followed by others industry 29.1 per cent, Electronics industry 28.3 per cent, Metal Products 25.6 per cent, Auto-parts industry 25 per cent, and least in Garments industry 18.8 per cent. It means that these units are mainly depending on outsiders for long-term financing. The main reason of it is that these are mainly larger units, which require heavy investments in fixed assets. So, the owners are able in providing only less than 25 per cent of the total required capital.

Table 1.4

Loan Capital to Total Capital Ratio in Small -Scale Industries in Haryana

Name of Industry	**0%**		**1-25%**		**26-50%**		**51-75%**		**Above 75%**		**Total No.**
	No.	%	No.	%	No.	%	No.	%	No.	%	
1. Garments	15	18.7	2	2.5	13	16.2	35	43.8	15	18.8	80
2. Auto-parts	6	15.0	1	2.5	4	10.0	19	47.5	10	25.0	40
3. Electronics	8	13.3	3	5.0	8	13.4	24	40.0	17	28.3	60
4. Metal Products	14	18.0	6	7.7	5	6.4	33	42.3	20	25.6	78
5. Rubber & Plastics	6	10.7	5	8.9	5	8.9	22	39.3	18	32.2	56
6. Others	10	11.6	8	9.3	10	11.6	33	38.4	25	29.1	86
Total	**59**	**14.8**	**25**	**6.2**	**45**	**11.2**	**166**	**41.5**	**105**	**26.3**	**400**

Note: Intermediate Loans + Long-Term Loans.

Table 1.4 shows the percentages of loan capital taken by various industries in small-scale industries. We can divide them into two categories for the purpose of analysis, one using 50 per cent or less loans capital of the total capital, and second, using more than 50 per cent loan capital. Let's discuss first category in which 32.2 per cent units are there. Out of 32.2 per cent units, 14.8 per cent are using no loan capital. Majority of them are small units requiring less amounts for plant and machinery. The aforesaid 14.8 per cent units also include financially sound units as well as the old units, which have already repaid the loan amount. Next 11.2 per cent units are which have taken long-term loans but the amount is between 26 to 50 per cent of total capital. These units are of moderate size where owners and outsiders are equally contributing for long term financing. Rest 6.2 per cent small-scale industries are using 1 to 25 per cent loan capitals. In this category the units mainly depends on owner's funds for long-term financing. In the first category, the maximum percentage is of Garments industry 37.4 per cent, followed by Others industry 32.2 per cent, Metal Products industry 32.1 per cent, Electronics industry

31.7 per cent, Rubber and Plastics industry 28.5 per cent, and Auto-parts industry 27.5 per cent units, which are using loan capital 50 per cent or less for long-term financing. This category includes mainly small units or less capital intensive units. In the second category, where in 67.8% industries more than 50 per cent loan capital is used for long-term financing, 41.5 per cent units are using more than 50 per cent but less than 75 per cent loan capital of the total capital. In this 41.5 per cent category of units the maximum number is of Auto-parts industry 47.5 per cent, followed by Garments industry 43.8 per cent, Metal Products industry 42.3 per cent, Electronics industry 40 per cent, Rubber & Plastics industry 39.3 per cent, and Others industry 38.4 per cent. The reason of Auto-parts industry having maximum percentage by using 51 to 75 per cent loan capitals is the heavy investment in fixed assets due to new technology and comparatively the big size of the units. In 26.3 per cent small-scale industries which are using more than 75 per cent outsiders' funds, the maximum percentage, 32.2 per cent belongs to Rubber & Plastics industry followed by Others industry 29.1 per cent, Electronics industry 28.3 per cent, Metal Products industry 25.6 per cent, Auto-parts industry 25 per cent, and least in Garments industry 18.8 per cent. All these units are using modern technology for production and for modernization, they have used more than two-third loan capital of the total required capital.

Conclusion

In small-scale industries after maximum use of trade credit, for additional funds, most of the industries approach commercial banks for short-term borrowings. Commercial banks play the most significant role in providing working capital finance to small industries because most of other financial institutions do not provided finance for working capital. More than two-third industries in small sector have taken term loans for investments in plants & machineries, land and buildings or permanent addition to current assets. Out of them again more than two-third small industries have approached commercial banks for term loans due to stringent terms and conditions of financial institutions for granting term loans. Only approx. and one-tenth of them have taken loans from these financial institutions. Remaining industries have taken term loans from non-financial institutions. The owners' funds in small-scale industries, owing to their nature of organization and limited access of the owners to the market, are in short supply. Approximately only one-fifth industries are using more than two-third owners' funds out of the total capital used in the business for long-term. And in 67.8% industries more than half of the total capital is contributed by outsiders. In small sector only 14.8% industries solely depend on owners' funds for long-term investment and these are financially sound, less capital intensive and as well as old units, which have repaid the loan amount.

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