# A Research of Financing Risk Management in Small and Medium-Sized Enterprises

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**Abstract:** Financing for a business is crucial, is the starting point for production and operation activities. Enterprises in the financing process are facing a variety of risks, the major causes of which are the external environment factors and internal management reasons. The paper analyzes the causes of Small and Medium-sized Enterprise (SME) financing risks and puts forward some measures that should be adopted by the Small and Medium-sized Enterprises (SMEs) to deal with financing risks.

**Keywords:** SME; Fina ncing risk; Countermeasure

## 1. The introduction of SME financing risk management

SMEs are the groundwork to promote economic development, to construct of the subject of market economic, and to promote the social stability, the strategic position of which can not be replaced with large enterprises, the advantages of which on the solution of employment are also prepared concern with the increasing pressure on social employment especially. Therefore, the development of SMEs in China is of special significance. At present, it has reached 42 million SMEs (including individual industrial and commercial households) in China, which constitutes more than 99 percent of the total businesses and become an important force in Chinese economic and social development. SMEs in Chinese have achieved the rapid, healthy and sustainable development, the contribution of which to economic growth is increasing. At present, the final products and services worth created by SMEs is equivalent to about 60% of GDP (gross domestic product), the tax revenue paid by SMEs is about 50% of the total National. However, suffered by the international financial crisis, the capital chain of many domestic companies is facing a "rupture" dangerous. Especially almost all of SMEs are in the shortage of funds to certain degree, owing to the smaller scale, poor risk tolerance, asset quality and credit status difficult to achieve the bank loan terms. There are strict restrictions to get the access into the capital market for the reason of the immaturity and the limited capacity of Chinese capital market. So a large number of SMEs will be rejected outside the securities market, due to their sizes difficult to meet the listing requirements for the motherboard. Issuance of corporate bonds is also subject to strict restrictions, requiring a higher credit rating, the larger asset size and higher profits, sometimes collateral or guarantee. Issuance of corporate bonds is also subject to strict restrictions, requiring a higher credit rating, the larger asset size and higher profits, sometimes collateral or guarantee. Therefore, SME direct financing is more difficult, and the financing focus on indirect financing such as bank borrowings. This makes the less financing channels and more financing difficult for SMEs in China than the general business, which led to the bland financing after for SMEs finding a way to finance, they have completely ignored the financing risk, let alone managed.

SME Financing Risk Management is a management activity that taking the initiative to create conditions in order to do our utmost to avoid or reduce the deviation between actual benefits and anticipated benefits, which caused by risk incidents, and to realize smoothly the financing and benefits through risk identification and risk assessment of SME financing [1]. There are both theoretical value and practical significance to explore the financing problems of SMEs in China: It is conducive to improving the SME overall quality and strength, expanding the scale of operation, occupying a larger market share, and enhancing the core competitiveness of enterprises in order to raise the funds required, at the same time, with a view to providing some help for SME entrepreneurs how to formulate financing strategy.

## 2. The analysis of SME financing risk and causes

### 2.1 The SME financing risk

SME financing risk is that the possibilities of being not implemented of the SME raising funds, excessive costs of financing, and falling short of the expected return, that is to say the loss or uncertainty to the business What brought about by the uncertainty about fund-raising benefits.

Generally, there are two kinds of SME financing risks.

First, the risk caused by unimplemented fund-raising. Funds are an indispensable factor of production in the SME development, so the stable financing channel is an important prerequisite for the development of SMEs, in which the most prominent problem at present is the lack of funding and poor financing channels. SME financing difficulties have long plagued the development of SMEs. At present, SMEs which can obtain bank credit supports are accounted for only about 10% of all SMEs in our country. Because of financing difficulties, the funding needs of SMEs can not be met, which seriously restricted the production, operation and development of enterprises.

Second, the risk brought by impossibility of repays. The main purpose of enterprise collecting fund is generally to expand the production scale, to improve economic efficiency, and to achieve financial management objectives finally. Fund-raising in order to obtain more economic benefits for businesses will definitely increase the burden of financing debt service schedule, which would make the rate of enterprise fund-profit to be higher or lower than the loan interest rate due to the uncertainty of the rate of enterprise fund-profit. If enterprises have the right decisions and effective management, they can achieve their business objectives. However in the market economy, the rapid change in the market condition and increasing furious competence among enterprises may all lead to failure decisions and misconduct management, which will make a great of uncertainty of fund-raising efficiency, resulting in financing risks [2].

## 2.2 The origin analysis of SME Financing Risk

We should analyze what factors SME financing risks resulting from and understand their occurrence regularity in order to adopt a scientific response measures to protect timely. Forming factors of enterprise finance risk are not only outside the enterprise, but also internal influence.

### 2.2.1 External reasons

The first reason is the national macro-economic policy. The national macro-economic condition plays a very significant impact on the survival and development of enterprises. First, banks and other financial institutions as money supply side, is responsible for the provision of finance for SMEs. In China, the major banks are state-owned. Therefore, the national policies are very important for SME lending. Secondly, national policies and measures bring direct and indirect effects to enterprise operating. The most prominent ones are the income tax policy and credit policy of taxes, which will encourage companies to make full use of external borrowing rather than their own funds, because corporate debt will bring enterprises tax benefit. Finally, the different economic development cycle would have significant impact on corporate financing. In the economic take-off and boom period, for all kinds of strong demand, enterprise products can be sold and loans can be repaid on time. On the contrary, during the economic downturn, due to reduced demand, enterprise product sales are sluggish, resulting in decreased product yield, increased unit cost and amplified enterprise business risk. Coupled with a large number of uncollectible accounts receivable, companies are faced with severe financial difficulties. In addition, in order to avoid bad debts, banks often develop more stringent lending standards, making enterprise loan financing to be worse [3].

The second is industry characteristics. Enterprises as a business entity, is in the market, a big environment, receiving the impact of various factors from the same or different industries, therefore, there are many uncertain factors in the production and management activities, such as sales price, sales volume, production and operation cost, mass consumption level, etc. The inherent profitability in every industry, the industry cycle or the industry characteristics is an essential factor to determine the profitability of an enterprise in the industry. In addition, with the development of market economy and adjustment of industrial structure, some of "sunset" industries will be eliminated gradually, enterprises in which must be eliminated if without corporation transformation in time, such as environmental pollution enterprises. Nowadays the uncertainty of the complicated, variable and fiercely competitive market leads to the expected return uncertain, resulting in financing risk.

The third is the financial markets and interest rate level. SMEs are mainly financed through bank loans, so the corporate financing is subject to the effect of financial market, which mainly refers to the money supply and interest rates. Moreover, the interest rate level determines the capital cost directly. When the state implements the "double loose" policy, that is expansionary fiscal policy and loose monetary policy, the money supply increases and the interest rate of loan reduces. If corporate raise the fund at this time, the capital cost is lower and the burden of operating costs on enterprises will reduce, thus the risk of enterprise financing will reduce. On the contrary, when the country implements a "double tight" policy, that is tight fiscal policy and monetary policy, the money supply shrinks and the interest rate of loans rise. If enterprises finance at this time, capital costs and operating costs borne by enterprises will increase, thus enterprises will bear a larger fund-raising risk.

The forth is financing risks caused by the irrational bank credit structure.

This stage, the security is regarded as the first operating principle for financial institutions what led by state-owned commercial banks, which favor only those large enterprises who have well enterprise credit relatively, while be cold and distant to SMEs who have the less standardized management, unstable efficiency and credit difficult to grasp. Therefore, the number of actual borrowing is significantly less than their credit limits in large enterprises, resulting to some bank resources idle, but then it is very difficult to finance for SMEs [4].


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#### 2.2.2 Internal reasons

First, the fail financing decision leads to financing risk. Many companies with financing risks do not carry out scientifically rigorous feasibility demonstration before finance but have great blindness, which brings adverse effects to companies instead of value.

Second, the imperfect management causes financial risk. Because of lack of modern theory and practice in enterprise management, the management concept is backward, the internal management basis is absent, management link is weak, the financial system is unsound and less transparent and financial statements provided for banks have low credibility because of containing false or even completely fictitious in SMEs. Because of various shortcomings in management, the continued growth of SMEs is insufficient. High start-up rate and high waste rate are main features of SMEs, which makes commercial financial institutions very cautious. In China, the phase-out rate is nearly 70% for 5-year in SMEs, approximately 30% of small businesses are in the red, only about 30% of which have potential development capacity, about 70% of which have poor development ability and only 1% of SMEs can survive more than a decade. Therefore, either the direct financing or indirect financing will be faced with many obstacles, and the financing risk is often great for SMEs [5].

Third, Asymmetric information leads to financing risk. The difficulty of SME financing is in the credit risk. On the one hand, the SME credit risk is difficult to control. The other hand, the information transparency of SMEs is relatively low and the information disclosure system remains to be established. Financial institutions are difficult to make accurate evaluation for SME credit conditions, so it is unable to make effective credit decisions. Borrowing enterprises with information superiority are likely to take actions which are conducive to their own but harm to banks, and to conceal the self-incriminating information. Thus banks will identify the type of enterprise risk before lending to enterprises. If the business is in the low-risk, banks will extend loans, otherwise not. Only when the benefit is greater after identification than no identification, banks would pay some transaction costs which are owing to asymmetric information for the identification of the enterprise. The existence of asymmetric information increases the transaction costs of both financing parties and restricts the level of financing for enterprises. Most of Chinese SMEs are family-owned, partnership-based, single property right, small sized, low technology content, low anti-risk capability and non-standard financial and operation management. The phenomenon of untrue or without financial statements exists in about 80% of SMEs. Moreover, the outbreak of the financial crisis, falling house prices and increasing corporate bankruptcies make banks more reluctant to lend to private enterprises.

Internal and external factors of financing risks are interlinked and interact together to induce the risk of financing.

## 3. Countermeasures to improve management of financing risk in SMEs

### 3.1 SMEs should strengthen the training of financial risk awareness of their managers, improve the level of financial budget management, and enhance the scientific rationality of decision-making.

First, the SME managers must make clear that risks are inevitable, have to face and undertake risks, and adopt effective measures to reduce and prevent risks, in particular, the leadership should have a more clear understanding and vigilance to the potential crisis and have some risk management knowledge and the capacity of prevention and control. Secondly, the SME managers should do all financial projections and plans well, arrange for all the budget work. The accurate financial budget plays an important role in the prevention and circumvention of the SME financing risk. According to the short-term production and business activities and long-term development planning, SMEs can forecast their own demand for capital, do financial budget well, arrange the financing plans and estimate the potential amount of money raised. At the same time, SMEs can determine whether funds can meet their needs based on the predictable funding and upon which they arrange production and business activities. Thus it can link SME production and business to the fund-raising organically, avoiding cash flow problems caused by the two divorced from each other and guarding against the SME financing risk[6]. Finally, after determining the total capital demand in accordance with the needs of production and operation, SMEs should arrange the time and number of fund-raising rationally, so that the fund-raising time links with the use of capital closely, the amount of idle funds is reduced and the capital profit rate increases. Meanwhile, in the process of financing decision-making, based on the calculation of the cost of capital and the analysis of risks of various funding methods, we should arrange the capital rationally, give full consideration to the repaying ability and formulate the plan of borrowing, repaying and financial arrangements of construction projects, in order to avoid the financing risk caused by funds being not implemented or unable to meet maturing obligations as they come due. In short, the SME managers should be based on reality, plan for the long term, give consideration to both the immediate interests and long-term development and pay attention to the scientific decision-making.

### 3.2 SMEs require the strong rather than pursuing big in the development process.

Every company has only to enhance its own core competitiveness to be of indomitable vitality. The pursuit of size in excess would cause heightening the debt ratio and increasing the enterprise's financial risks and operational risks. Absence of the consciousness of sound and being too risky are the primary reasons for indebted business failure. Consequences of indebted management are not the business failure, but also a serious affecting the future of commercial credit, and thus affecting the re-financing capacity[7]. Therefore, SMEs should expand the endogenous financing channels actively, explore the potential of internal funds fully, bring their enthusiasm of reproduction on extended scale into full play, speed up the flow of funds and improve continuously the efficiency of funds allocation and use.

### 3.3 SMEs should establish the modern concept that cash is king and distinguish the importance between "cash flow" and "profit"

Cash flow is the momentum for enterprises to maintain the capital liquidity and sustained development, of which the amount affects their financing decisions, investment risks, credit standard and enterprise value directly. Keeping an adequate and stable cash flow, particularly the net operating cash flow is able to show the ability to generate positive earnings and the potential of growth and be beneficial to reduce the bankruptcy risk and investment risk for SMEs. Therefore, budget preparation of the enterprise's cash flow is a very important part in the financial management. As the object of corporate finance is the cash and flow, in the short term, businesses can be maintained is not entirely dependent on profit, but on whether there is enough cash for various expenses. Accurate cash flow budgets can provide early warning signals for enterprises to enable operators to take early measures [8].

### 3.4 SMEs should enhance the risk management related information gathering

First of all, in terms of financing risks, SMEs should collect at least the following important information: domestic and international macroeconomic policies and economic performance, industry conditions, state industrial policies, the new laws, regulations and policies affecting enterprises, the relevant content of scientific-technical progress and technological innovation, credit conditions of major customers and major suppliers, and etc.[9] They should enhance the sensitivity to interest rate changes, in order to grasp the dynamics and lay the foundation for interest rate forecasts. Secondly, they must strengthen the basic study of financial theories and knowledge, analyze and research the law of financial situation, policy changes, and strengthen the forecast of interest rate changes. Finally, they should increase introduction of risk managers and training, make full use of external talent and improve forecast accuracy, in order to provide a basis for investment and financing decision-making.

### 3.5 SMEs should prevent financial risks caused by changes in interest rates

For the financing risk brought about by changes in interest rates, SMEs should investigate carefully the capital market supply-and-demand situation, and grasp its development trend according to interest rates, accordingly make the appropriate funding arrangement. Funding should be raised as little as possible or only for short-term much-needed during the period of high interest rates. While the interest rate is in the transition from high to low, it should minimize fundraising also and adopt the floating-rate interest-bearing way for the must needed fundraising. It is beneficial to finance when the interest rate is at a low level. During the period of interest rate being in the transitional from low to high, enterprises should raise long-term funds actively and adopt the fixed-rate interest-bearing manner as far as possible to reduce debt interest rates [10].

## 4. Conclusion

In modern society, SME financing channels and methods have become more extensive, but the risk is also growing. So SMEs need to strengthen their internal management, to improve operational strength, to give full consideration to each risk, to weigh up the pros and cons, to enhance risk awareness, to establish the mechanism of risk prevention, to control risks throughout every aspect of business operations, to build a risk prevention wall, so that they can find their self-development and boom in the fierce competition.

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