

MANAGEMENT ACCOUNTANT

Exclusive Interviews



“National SME Policy 2021 will soon be launched by the Hon’ble Prime Minister of Pakistan”

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Financial Challenges and Way Forward for Small Businesses



Institute of Cost and Management
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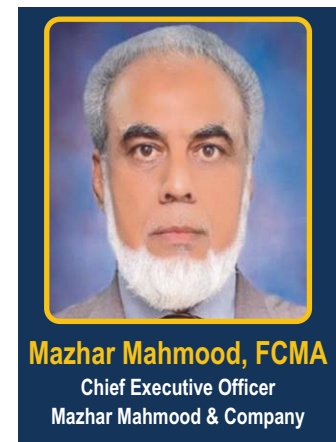
SME



A Roadmap for addressing the Financial Challenges of Small Business Enterprises

A Small Business Enterprise is commonly designated as a business with less than 500 employees in UK and 250 employees in Pakistan as a Small-Medium Business Enterprise. There are other important indicators used by different countries and organizations in Pakistan to define small businesses and SMEs. What one can conclude is that Small Business is set of MBE, SBE & SME - as given below in **Table-1**.

SBEs or SMEs play a vital role by generating employment, contributing to GDP, boosting exports, and enhancing the socio-economic status of the community. Let us see the contribution, in the numeric term, of SMEs in different countries as a driver to boost the economic activities **Table-2**.



Institution Small Enterprise Medium Enterprise	Bases	Micro Business Enterprise (MBE)	Small Business Enterprise (SBE)	Small Medium Enterprise (SME)	
State Bank of Pakistan	Employees Annual TO	Self-employed - less than 5 employees (Purely on research bases) - Not defined by any of institutions in Pakistan.	Up to 20 Up to PKR 75 million	From 21 to 250 From Rs. 75 to Rs. 400 m.	
SMEDA	Employees Paid up Capital Annual TO		Up to PKR 250 Full-time Up to PKR 25 million Up to PKR 250 million	Employees between 51 to 250	
	SME Bank		Employees Annual TO		Up to 50 Up to PKR 150 million
Punjab Small Industries Corporation	Fixed Assets			Rs. 10 m without Land & Building.	
Pakistan Bureau of Statistics				Up to 10 employees	
Sindh Industry Dept.	Fixed Assets			Rs. 10 m without Land & Building.	Rs. 10 m without Land & Building.
Examples of three business categories.	Number of employees		Tailor, barber, mason, street howker cobbler, lawyer, farmer, retailer etc.	Manufacturer, distributors, consultant, small hotel, cash & carry, law firm, partnership etc	Medium size- Textile unit, flour mill, steel mill, supply chain, transport company, hotel, supper store, grocery cash & carry, supplier etc.

Country	SMEs in (M)	Share in (%)			
		Total Entities	GDP	Export	Employment
Pakistan	5.00	90.00	40.00	30.00	80.00*
USA	43.20	99.90			
Japan	3.50	99.70	55.30	25.00	71.00
China	38.00	99.00	56.00	68.00	75.00
Bangladesh	7.00	80.00	50.00	75.00	82.00
Malaysia	1.15	97.20	30.00	48.10	40.00
India	63.00	99.60	32.00	13.50	56.00

*Non Agriculture Labor

The International Finance Corporation (IFC) estimates that 65 million firms, or 40% of formal micro, small and medium enterprises (MSMEs) in developing countries, have an unmet financing need of \$5.2 trillion every year, which is equivalent to 1.4 times the current level of the global MSME lending. The major formal sources of financing available for SMEs in Pakistan are Commercial Banks, SME Bank, SBP and SMEDA.

Financial Challenges faced by existing SBEs

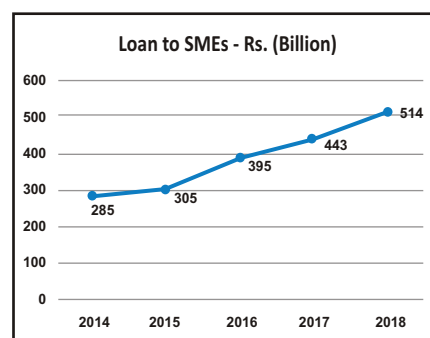
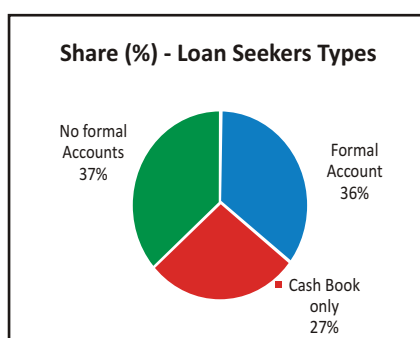
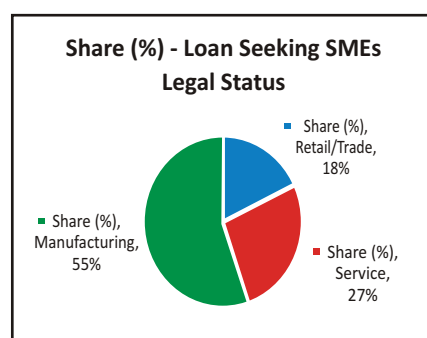
Most of the Financial Challenges faced by SBEs at the globe are common but still, exceptions are there due to the economic, cultural, and socio-economic status of different countries. Financial Challenges are faced by both the businessperson as well as the non-business person. As per a survey conducted by SMEDA 37% SBEs are facing taxation challenges in taxation matters followed by 34% by financial challenges. SMEs in Pakistan face Financial Challenges in two phases;

a) Pre-Start-Up Phase – This includes shortage of capital to finance the business; non-availability of sleeping partner or other investor: ineligible for bank loan having no business history; feeble idea or oral business plan unappealing to financier; no concept of angles investor to help start-up or new idea; and personal credibility though having a workable idea or feasible business plan.

b) Post Start-Up Phase.

1) No book keeping or accounts to be presented to bank for loan (34% maintain cash book, 23% formal accounts and remaining 23% run the business without any proper record SMEDA)

- 2) No or week bank statement depicting feeble business history (50% loan rejected on this ground).
- 3) Low education level of owner having least knowledge & skills to complete legal formalities (Owners of 31% SMEs are undergraduate)
- 4) Legal status as a Private limited Company has more acceptable options of collateral offered to bank, like hypothecation of stock that is finally registered with SECP to enhance the level of security to bank. (SMEs in Pakistan - 15% Limited liability companies, 22% partnerships and remaining 58% as sole proprietors)
- 5) Having risky collateral as a security to bank (69% offer the residential properties as security)
- 6) No awareness to entrepreneur about the formalities to qualify for bank loan facility
- 7) Banks are undue risk averse (UBL has leading share of 23% in funding followed by MCB, Meezan & MCB with 9%)
- 8) Head Offices of commercial banks do not delegate powers to branches for, even, a small /petty loan. Branch managers can accurately assess the risk having in direct contact with beneficiary
- 9) Banks hesitate small loans due to high cost of loan maintenances
- 10) Central Bank's irrational policies & tedious officialdom for loan processing.



- 11) Banks' focus on LSM/ MNCs rather than SMEs (Average share of SMEs in total lending is 8% only).
- 12) More than 50% of receivables, if not recovered in a reasonable time period.
- 13) Debtors' risk may create financial or creditors risk (Debt or receivable is one of the major killers in business ecosystem. Even the giant company has no exemption from this curse).
- 14) SOEs and LMU/ LBU always linger on invoices for months that stimulates financial challenge to SBEs more worsen.
- 15) No concept of venture capitalist for help and promotion or expansion of existing business (On average, 41% use personal references to bank, 31% seek information / working on prior history and only 23% seek helps from professional consultants)
- 16) To see the interest-based financing under Islamic teaching as a fear of God.

Key Reasons of financial constraints of SMEs

- 1) Feasibility not prepared before start-up
- 2) Avoiding government dues (Tax, PESSI, EOBI and Licensing where applicable).
- 3) Absence of Angel investor or venture capitalists as informal sources of funding the SBEs.
- 4) Ineffective business integrations like Chambers and trade unions to support small businesses
- 5) Absence of any linkage between actuarial / retirement funds with the investment.
- 6) Lack of Islamic mode of financing to attract entrepreneurs who prefer loss over interest bearing funds
- 7) Non availability of sector specific funding.

Way forward for existing SBEs

There are many models and strategies to address the financial challenges faced by SBEs/SMEs. These challenges have been created due to mushroom growth of SBEs / SMEs and mostly related to pre-start-up and post-start-up phases; operational and market challenges. These are discussed briefly as under:

(1) Pre-Start-up stage

SBP may authorize banks to extend loan facility against gold, silver and other such assets with Marginal Requirement (MR) upto fifteen (15) percent. Banks may also be allowed to extend financing to professionals against their educational credential and business plan/ prefeasibility study. The consideration for these loans should be, "loan

maintenance expenses with addition of nominal profit instead of high mark-up". These loans should be insured up to 50% to distribute risk in case of business failure. Mandatory three-days training / certification may be provided on the topics of business platforms, legal formalities, operational intricacies, financial challenges, financial sources, book keeping, final reports and how to make business decisions from final reports etc. No license or NTN would be issued until they complete this training. There should also be a mandatory business plan for all start-ups before entering into business.

(2) Post-Start-up stage

A SME faces two types of financial challenges categorized as internal and external challenges. Internal challenges include cost, expenses, capital budgeting and creditors payments etc. while external financial challenges comprise of receivables, volumes of sales, government dues and arrangement of formal or informal finances. After sale of products, the major issue that originates is 'Receivable' from buyers. This depends on customers' financial health payment policy such as SOE, LBU, SME, SBE, MBE or Consumer.

(3) Operational Challenges

There are certain challenges at operational level which are common to all SBEs such as:

- a) A unique business model to attract the more customers to enhance profitability.
- b) To control the variable cost and make rational decisions for capital expenditure to create a revenue generating assets rather expense bearing liability. An expensive car for business use is one example.
- c) Optimum level of inventory should be maintained by applying inventory management tools as huge financial resources stuck-up in inventory can lead to financial challenges for the SBEs
- d) Agreement with debtors (Credit policy) and creditors for timely receipts and payments
- e) Preparing cash forecast on regular basis to meet the financial constraints
- f) Daily book keeping and preparing different reports for operational / financial decisions
- g) To adapt the Ansoff's Business Growth matrix to expand the range of product / services, to expand market and diversification of business.
- h) Taking regular advice from a consultant or Adviser on how to meet business challenges
- i) Motivate the venture capitalists for business expansion with incentives of lucrative ROI.

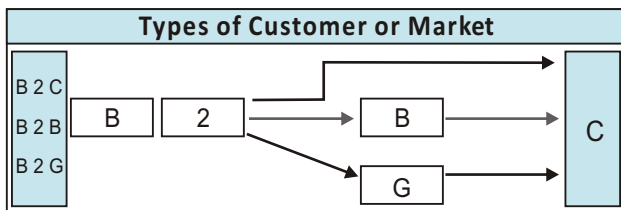
(4) External / Market Challenges

a) B 2 C: When SBE is supplying goods to consumers

In case of B 2 C, most of business is done on cash with end user or consumer. There is no exposure to credit risk in absence of massive receivables. Such situation will enable the entrepreneur to minimize the financial challenge to pay the creditor, payroll, taxes and expenses etc. Entrepreneur should continue business on cash or at mild credit and try to increase the sales.

b) B 2 B / B 2 G: When SBE is supplying goods to Govt. or business tycoon.

Business tycoon (LBU) and Government (SOEs) need supplies in bulk and pay the invoice after long officialdom. Hence the supplier /SME has to face the big financial challenge due to heavy investment both in inventory and receivable. The only solution lies in government intervention to chalk out special legislation for earliest recovery of receivables to protect entrepreneur from financial crunch.



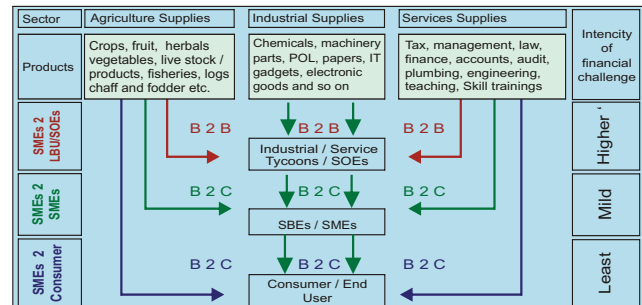
Policy for creating SBEs in the formal sector

SBEs can be created in all sub-sectors of agriculture under umbrella of cluster farming to provide the ready market, pivot target of business, to all sundries. Major problems for SBEs are to dispose of the final product on cash to avoid financial challenges. The duty of marketing in cluster is to pay the farmer at the spot and deliver the raw material onward to Agro-based industrial units against prior agreement. Livestock products to be disposed of to another market cluster such as hotels, restaurants, marriage halls and exporters. Similarly, the SMEs selling the industrial supplies/services to industrial units should be paid as per government supportive policy. It is the best option to feed the SBEs through cluster instead of hundreds are approaching to bank, under great constraints, to mitigate the financial challenges.

Relationship between SMEs & Large Business Units (LBUs)

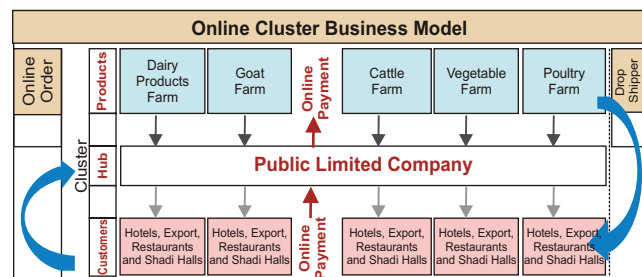
A Large Business Unit (LBU) accommodates many SBEs/SMEs in supplying goods / services such as a cement plant demands SMEs to provide coal, industrial parts, electrical supplies and other items. SOEs also demand different items and services from hundreds of SMEs. Small businesses face financial constraint when their invoices are not timely materialized before the next supply from LBUs. Resultantly, SMEs contact the banks for urgent relief but their concerns are mostly unresolved.

There is a challenge if B2B is in between the two SBEs. Financial risk is least in absence of receivables for SBEs if goods are sold to consumer (B2C) directly.



Online Business Cluster Model

Essence of business model is the Value Proposition - Incentives or advantages that company offers to attract the customers for maximization of profit and supplier for greater consideration. There are too many variables inducted in developing economic or financial model as illustrated below:



A business cluster is a geographic concentration of interconnected businesses, suppliers, and associated institutions in a particular field. Pothohar Plateau is best fit for livestock farming due to availability of natural pastures in all four districts of Pothohar. People have great danger of financial challenges lurking in their mind when they individually cultivate at high cost and sell their products at dust cheap prices in informal markets. The only solution is cluster farming by induction of a public limited company for quick purchase and earliest payment to SBEs so that farmers may not be trapped into financial challenges. The company may keep liaison with banks to seek loans in case of financial constraint. A Modaraba Company may be preferred so that the funds of pensioners could be utilized instead of interest-based bank finance. Multibillion pension fund are lying unproductive and pensions are looking for opportunities of investment. SMEDA can be helpful in materializing this proposal for the benefit of SBEs/SMEs in the country.

More model for cluster business can be design for subsectors of industrial and service sector.

About the Author: The writer is a Fellow Member of ICMA Pakistan and CEO at Mazhar Mahmood & Company, Rawalpindi. He is the official Trainer of SMEDA for Business Development and also Consultant at PIPS for commentary on Budget. In the past, he served as GM Finance at NFRD – A business incubation Centre of eight commercial units.