

# A Study in the Financial Problems of Small Industries

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( Continued from Lost Issue )

IN the provision of long-term finance, organized security markets cannot be used by small localised companies. Not only are owners of such businesses generally reluctant to relax their control through sales of securities to the outside public, but the localised nature of most of these enterprises proves to be an important obstacle. The initial cost of flotation is relatively higher for a small stock or debenture issue than for large flotations of nationally known firms. Data collected by the Securities and Exchange Commission in the USA show that of 1035 public flotations of registered securities during 1945-49, there were only 85 companies with assets below \$1 million and the cost of flotation, whether of bonds, preference stock or ordinary stock was the highest in their case. The following table is revealing.

#### Cost of Flotation of New Issues

Under!	..	10.0	14.7	17.5
1 to 5	..	5.7	13.3	14.3
5 to 10	..	3.4	7.9	10.8
20 to 50	..	2.6	5.4	9.9
50 to 100	..	2.0	3.9	6.9

Source: Securities and Exchange Commission, February 1951.

#### Retained Earnings

A Department of Commerce Study in the USA covering 1,100 manufacturing concerns shows that in the case of small manufacturing companies only 2 per cent of the initial capital was raised through sale of stock to the general public. In the case of such concerns nearly two-thirds of the capital was supplied by officers and directors and one-third consisted of bank loans and mortgages. The initial investment in the case of the small concerns is likely to exhaust the owner's stock of available funds and the finance required for development, maintenance and expansion has to be sought elsewhere. The most important source of supply in their case is to be found in retained earnings. Small concerns whether unincorporated or not are generally wedded to the practice of declaring low rates of dividends and ploughing back a substantial part of their earnings. This characteristic of business financing peculiar to small concerns exists pri-

marily because of the absence of an alternative source of equity capital.

A potential source of long-term credit for small business in the USA is the life insurance company. In recent years there has been an increase in the business of long-term lending by American insurance companies to small concerns. Direct placements with insurance companies are less costly for small industries than an appeal to the investment market. But a number of small direct loans which involve costs of investigation, negotiation and serviceability do not appeal to insurance companies, which would generally prefer to invest their funds in large publicly traded issues. There is undoubtedly a case for insurance companies providing loans to finance companies which can relend the proceeds to small industries. Now that insurance companies have been nationalised in India, they can be effectively employed by the Government to finance both large scale and small scale industries by providing funds to finance corporations.

#### Limited fixed Assets

Though direct borrowing by small industrial concerns generally takes the form of mortgage loans, such concerns have hardly any tangible collateral security to offer. The fixed assets, particularly land and buildings, which they require, are generally rented and not owned. Recent surveys in West Bengal have clearly brought out the fact that small industrial units do not have adequate tangible and unencumbered assets to offer as security. In the case of the small engineering industries of Howrah the ratio of investment in land and buildings is only one-ninth as against 2/3rd in the more organised and large-scale sector of general and electrical engineering. 86 per cent of the firms operate in rented work-places. The West Bengal State Finance Corporation also reports that it is unable to provide mortgage loans to small and medium sized industries mainly because they cannot offer any tangible security in the shape of land and buildings as most of the industries operate in rented premises.

Even in the USA, where the growth of non-banking institutions

and the development, of new techniques of lending by both bank and non-bank lenders have increased the availability of both short and intermediate term credit and reduced the cost thereof for small concerns, there are several situations where credit requirements of such concerns are not fully met. At the same time, it appears that existing financial sources are often unutilised because of inadequate knowledge or lack of initiative on the part of either lenders or borrowers. Yet in some cases existing local sources are much too inadequate to meet the growing needs of small industries in the particular area. Without, complete and accurate financial reporting, such industries are obviously unable to establish banking contacts in an outside and larger community. (Staff Report to the Board of Governors, Federal Reserve System, 1952.)

#### Scope for Small-Scale Industries

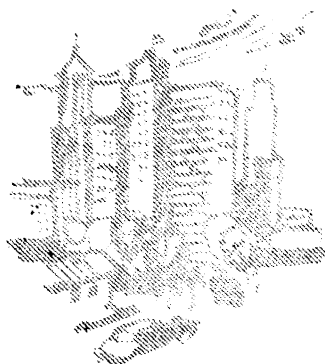
Small firms do not necessarily suffer from technological inefficiency. The extent to which small-scale production, if adapted to the lines in which it has special advantages, can be carried on with a high degree of technological efficiency, has been amply demonstrated in Japan. Where small firms are supported by co-operatives and other specialised agencies, providing them with facilities of finance, research and marketing, they can hold their own against large-scale producers. As the Second Five Year Plan has laid particular emphasis on the development of small-scale industries, a comprehensive scheme has to be formulated for meeting the financial and various other needs of such industries. The State Finance Corporations which have been established in different States are expected to play a significant part in financing a planned programme for their development. But their scope will be somewhat limited owing to the statutory ban on the provision of equity capital by them. Besides the State Finance Corporations, the Central and State Governments, the State Bank of India and commercial and co-operative banks have a part to play in the financing of these industries. The relative roles which they should play in an integrated credit scheme for the development of small industries have to be carefully de-



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terminated. The entry of public agencies into the market for industrial credit has also raised the important question of the relations between public and private lending agencies. It will be difficult at this early stage to weigh the effects of the operations of public agencies on the credit market and on the private agencies hitherto serving the market. In some respects the relations will probably be competitive but in most cases it is to be hoped they will be complementary and co-operative.

### Some Suggestions

The following suggestions are offered for improving the present position in regard to the availability of banking facilities for small industries.

1. Commercial banks may establish small business loan departments and publicise the financial services they render.

2. Steps may be taken to provide for the insurance of banks and other financial institutions by Government against loss of principal or interest on loans made to small concerns upto a certain size and upto a prescribed aggregate amount. A small beginning has recently been made in this direction.

3. The possibilities of establishing "credit pools" by banks, insurance companies and other lenders with a view to provide short and medium term credit to small industries may be explored.

4. On the lines of American commercial banks, Indian banks may develop the practice of lending to small borrowers on the security of an assignment of accounts receivables. Their value as collateral is a very high fraction of their face value and if the borrowers' trade customers fail to pay their accounts, the banks can always have recourse to the borrowers themselves. The cost of such credit to borrowers would, however, be rather high.

5. The practice of bank lending against receipts of field warehouses established by specialist concerns on the premises of a borrower is a new development in credit techniques in the USA much to the advantage of small and medium-sized enterprises. The technique of financing inventory on field warehousing receipts may be developed by banks in India in collaboration with the State Bank. But it involves complex problems of appraisal for bankers and calls for development of special methods of controlling risks.

6. Banks are unwilling to lend to small industrialists against Government bills, because of the delay involved in collecting payments. As the Shroff Committee suggested, the locking up of the slender resources of the small-scale industries can be avoided if letters of credit are opened by Government in favour of suppliers stipulating for payments on the presentation of inspection notes by a duly authorised officer of the indenting department.

In view of the difficulties of institutional methods of increasing the availability of equity capital for small concerns which have been stressed above, their main reliance would inevitably have to be placed on earnings ploughed back into the industry. A very pertinent question that arises in this connection is that of increasing the amount of earnings available for investment. Obviously a plausible method of aug-

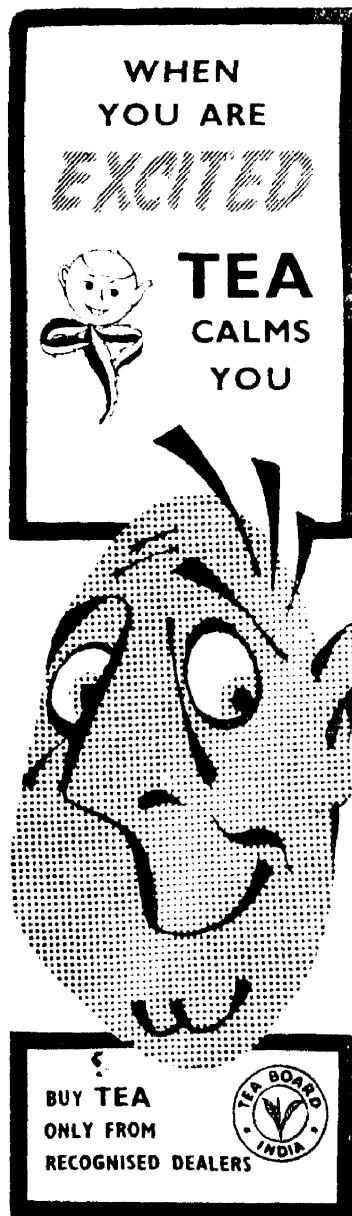
menting such earnings is by providing tax relief. But most of the small concerns happen to be unincorporated and are subject to individual income-tax. Provision of tax relief for such concerns may call for major changes in the existing structure of personal and corporate income-tax. But it is worthwhile exploring the possibilities of granting suitable tax exemptions to small industrialists so that a larger proportion of the earnings could be ploughed back into the business.

### Non-Financial Problems

Financial problems are not the only problems of small industries; the non-financial ones are sometimes as important and as acute as financial ones. Though the discussion of such problems is outside the purview of our study, a few of them may be briefly indicated. Lack of technical and managerial know-how is perhaps the greatest of these problems. A small concern obviously cannot employ specialists who would give engineering, technical and accounting advice of various kinds—production scheduling inventory control, financial planning and marketing research. Financial assistance would not be of much avail unless it was accompanied by the provision of suitable managerial and technical assistance.

To meet these technical problems of small-scale industries, four regional Institutes, one each at Bombay, Calcutta, Faridabad and Madurai, have been established. A National Small Industries Corporation has been set up for the purpose of assisting, promoting and financing small industries. Finally a Small-scale Industries Board has been constituted with the object of framing and implementing programmes for the development of small-scale industries and co-ordinating the activities of the regional Institutes of Technology and the National Small Industries Corporation.

The activities of these various organizations in the sphere of promotion and development of small industries will be watched with keen interest. It is hoped that they will not be mainly preoccupied with the problems of village and cottage industries alone but will evince the same interest in the problems of the small and middle sized industries in the urban centres which use power and some, simple modern tools and implements and have capital assets upto Rs 15-20 lakhs.



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