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# UNDERSTANDING SMALL AND MEDIUM ENTERPRISES (SMEs) LOAN APPLICATIONS: COMPREHENSIVE ANALYSIS FROM SMEs AND LOAN PROVIDERS

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## ABSTRACT

This comprehensive study investigates the financing landscape for small and medium enterprises (SMEs) from both the perspectives of loan providers and SMEs themselves. It employs a multifaceted approach to provide a holistic understanding of the factors influencing SMEs' financing decisions and shedding light on the crucial criteria that financial institutions consider when evaluating loan applications. This study utilized interviews with financial institutions to outline crucial loan approval criteria, emphasizing collateral, applicants' characteristics, and business plans. Simultaneously, this study recognizes that financing remains a significant hurdle to the growth of SMEs which include the challenges, risks, and sustainability factors influencing SMEs' decisions in seeking external financing. Notably, it highlights challenges such as accounting knowledge and fluctuating demand, which expose SMEs to various risks like liquidity and technological risks, and subsequently explores sustainability concerns in the dynamic economic context of Malaysia, with the aim of bridging the information gap and empowering SMEs to enhance their financing prospects.

**Keywords:** SME, Financing, Collateral, Challenges, Risk, Sustainability

## INTRODUCTION

The small and medium enterprises (SMEs) in Malaysia make up 97.2% of all business establishments. In 2020, there was 1,151,399 SMEs in the country, with Selangor and Wilayah Persekutuan Kuala Lumpur having the highest concentrations. These SMEs contributed significantly to Malaysia's GDP, accounting for 38.2% in 2020. However, SMEs face challenges, particularly in accessing external financing [1]. The government has introduced various programs and support to help SMEs grow, but their reliance on internally generated funds remains a limitation. Despite various government programmes aimed at supporting SMEs, a significant percentage of them face financial difficulties and fail within their initial years of operation. Previous studies highlighted the financial difficulties include high capital costs, lack of access to credit, labour shortages, insufficient funds, and a weakening local currency, all which impact sales [2],[3].

### *The Significance of Small and Medium Enterprises (SMEs)*

In today's rapidly evolving world, SMEs play a significant role in both developed and developing economies, contributing to employment and industrial productivity [4]. In Malaysia, SMEs are a critical component of the economy, accounting for approximately, 18.6% of total exports, and 66% of total employment [5]. SMEs are becoming global growth engines due to their capacity for innovation and adaptability in response to changing economic conditions [6]. Their smaller size allows them to be more flexible and quicker to innovate, giving them a competitive advantage [7].

The development of SMEs is crucial for linking sub-urban and rural areas with more structured urban SMEs in Malaysia. This contributes to balanced growth and shared prosperity, especially through micro-enterprises that make up the majority of SMEs. It also helps with poverty alleviation and the fair distribution of wealth across regions. SMEs in Malaysia have been supported by the government through various schemes and programs, such as financing gateways, outreach initiatives, and capacity-building efforts [8]. However, for SMEs to expand into the global market, they need access to working capital, information about foreign business opportunities, global market analysis, and the ability to reach potential clients worldwide [9].

### ***Challenges and Opportunities in SME Financing***

The external financing for SMEs is very important for them to compete in a competitive market. However, the information asymmetry between loan applicants and providers can create a financing gap, hence, hindering SMEs' optimal growth [10]. SMEs lack knowledge of banking information, while financial institutions have limited information about SMEs, making it uncertain whether SMEs can repay loans [11]. SMEs are considered riskier due to this uncertainty [12]. Financial institutions may need time to gather information before making lending decisions, and this information asymmetry can lead to moral hazard [13], [14].

Collateral plays a significant role in credit agreements and can influence the credit rationing behaviour of financial institutions [15]. SMEs may have difficulty providing collateral due to their smaller asset size. However, offering collateral can increase the likelihood of obtaining credit even in uncertain situations [15]. Still, some SMEs may fear rejection or losing collateral if the market conditions are unfavourable [15]. Additionally, applicant characteristics, such as age and education, can affect credit constraints. Younger firms may face more significant information asymmetry, making it harder for them to establish trust with financial institutions [15]. The quality of management and the ability to build a positive image are crucial for creditworthiness [16]. Providing a clear and concise business plan, including information on collateral and applicant characteristics, can assist financial institutions in making lending decisions [15]. Business plans should outline the vision and management strategy to achieve business objectives.

On the other hand, proper financial management is also paramount for SMEs' growth and sustainability. Many SMEs rely on bank loans for financing, but new businesses often face rejections due to stricter financial policies in the wake of the global financial crisis [17]. It is a critical role of SMEs in the Malaysian economy to understand their challenges in obtaining financing, and the need for effective financial management. Therefore, the objectives of this study are twofold; (i) to explore the loan application experiences of SME owners in Kuala Selangor which include challenges, risks and sustainability; and (ii) to explore loan applications from the perspective of loan providers to determine success criteria.

## **MATERIAL AND METHOD**

This study comprises of two distinct data collection methods in order to fulfil the two objectives of this study. Firstly, to achieve research objective one, this study focuses on SME owners in Kuala Selangor, Malaysia. This study used random sampling and selected this location due to a research grant aimed at benefiting the community there. This study employed a qualitative approach and conducted structured interviews with seven SME owners, including four in the services sector and three in manufacturing. These sectors were chosen because they are significant contributors to Malaysia's SME economic activities and involve substantial investments in fixed assets. All SMEs in the study were registered with SME Corporation of Malaysia. We provided interview questions in advance to five respondents, with hand-delivery and a digital messaging applications for distribution. Each face-to-face interview lasted approximately 30 minutes and covered topics related to loan applications by SME owners, focusing on challenges, risks, and sustainability. The interviews took place at the SMEs' shops and were recorded in written form since the questions were pre-prepared, and this data was analyzed to explore information related to the three key aspects of the study: challenges, risks, and sustainability.

Secondly, research objective two is to explore the loan application process for SMEs from the perspective of loan providers. To fulfil this objective, interviews with representatives from two different banks were conducted. The interview questions were designed to address key aspects of the study, including collateral, applicants' characteristics, and business plans. The interviews took place at the banks' premises and were recorded through hand-written notes. Each interview lasts about thirty minutes, and the collected data is analyzed to examine information related to the three units of analysis: collateral, applicants' characteristics, and business plan.

## **RESULTS AND DISCUSSION**

### ***Loan Application Experiences of SME Owners***

From interviews conducted with SME owners in Kuala Selangor, financing challenges are primarily related to a lack of business knowledge and insufficient working capital. These challenges significantly impact the capital structure of SMEs, making it challenging to secure external loans. These challenges can be grouped into three, namely, knowledge, fluctuating demand, and sensitivity of cash flows. SME owners in the study possess some business knowledge and have taken relevant courses but opt not to hire qualified accountants or auditors to manage financial matters. This decision is often driven by the cost associated with hiring external professionals and concerns about information asymmetry, which may lead to loan application rejections. SMEs in Kuala Selangor face inconsistent demand for their products and services. Seasonal variations and university students' absence during breaks can result in lower sales. To address this challenge, SMEs need to maintain sufficient cash reserves to cover expenses during low-demand periods. Many SMEs, both in the study and reported by SME Corporation in Malaysia, struggle with cash flow and liquidity issues. Some SMEs prioritize their focus on available cash over submitting loan applications. Financing challenges persist even beyond the initial start-up phase, as SMEs face higher credit constraints compared to larger firms due to their unique nature of operations.

Furthermore, the risks faced by SME owners include interest rate and liquidity, potentially hindering external loan applications and sustainability. SMEs heavily reliant on external financing through loans may face interest rate fluctuations, impacting their monthly commitments to financial institutions. This uncertainty discourages four out of seven SME owners in Kuala Selangor from pursuing loan applications due to the variable interest rates, preferring fixed-rate loans with less risk. Liquidity risk, potentially leading to bankruptcy, can impose substantial indirect costs, including personal collateral and self-esteem loss for SME owners. Factors contributing to SMEs bankruptcy include lack of knowledge, debt accessibility issues, and economic conditions. To mitigate these risks, SME owners must maintain adequate cash reserves to support their operations, as they face greater vulnerability during economic crises. As a result, many respondents in the study avoid external loan applications to minimize bankruptcy and liquidity risks. Despite the potential benefits of e-business and technological advancements for SMEs, challenges arise regarding their adoption, implementation costs, and the need to identify individuals capable of operating technology. Some SMEs in Kuala Selangor face difficulties coping with e-business and digitalization, focusing on premises sustainability and daily cash operations. Failure to embrace these technologies may pose a risk, as competitors who do so could capture more revenue, given the evolving nature of technology adoption in the region.

In dynamic economies, innovation is crucial for SMEs survival. To thrive, SMEs must leverage available opportunities, foster creativity, and secure adequate funding for production and growth. To assess sustainability issues among SMEs in Kuala Selangor, interviews with respondents focused on their approaches to product and process innovation in comparison to competitors over the past years. Three respondents disclosed that they had not undertaken any product or process innovation in the past 12 months due to financial difficulties and a focus on cash flow. Respondents expressed uncertainty about fluctuating product demand and acknowledged a lack of innovation in their own businesses. Finance plays a crucial role in SMEs as it affects growth and impacts various key challenges they face. Survival is fundamental for sustainability, and economic crises can hinder a company's innovative capacity, subsequently influencing expansion and growth. In uncertain economic conditions, SMEs in less developed areas may rely on internal funding sources to ensure survival and, if possible, expansion.

### ***Loan Applications from the Perspective of Loan Providers***

From interviews conducted with loan providers, factors that influence the approval of loan applications by SMEs are collateral, applicant characteristics, and business plans. Collateral, such as assets or deposits, is often required by banks for loan approval. However, some banks offer loans without collateral, instead charging a percentage of the deposit as security. Different types of SME financing may have varying collateral requirements.

The characteristics of loan applicants play a significant role in the approval process. The applicant's personal characteristics and credit history are assessed during eligibility evaluation. Credit history, in particular, is a crucial factor in determining loan approval. A clean credit history, reflecting responsible repayment of debts, is vital for loan approval. Applicants are advised to maintain a smooth credit history and manage their cash flow effectively. The age of both the SME owner and the business

itself can impact loan approval. Most applicants fall within the middle-age range. Additionally, businesses typically need to be in operation for at least a few years to be eligible for loans. The sector in which an SME operates is considered in loan applications. While the services sector is dominant, there is no restriction on the type of business that can apply for loans. Business location can influence the sector's relevance.

Having a well-prepared business plan is crucial for applying for external financing. Small businesses may not always have comprehensive business plans, relying on family loans instead. Some banks may assist in preparing the necessary paperwork for loan applications. In summary, SMEs seeking loans should pay attention to their credit history, ensure they meet age and business operation criteria, and consider providing a clear and convincing business plan. The need for collateral varies, and some banks may assist with paperwork preparation. Additionally, the type of business and its location are factors that banks may consider during the approval process.

## CONCLUSION

This study finds valuable insights into loan applications by SME owners in the District of Kuala Selangor. Most respondents do not seek loans from financial institutions, primarily due to a desire to avoid monthly payment commitments. Instead, they prefer to self-finance or seek funds from sources other than banks. Additionally, the majority of these respondents are new entrants in their respective industries, operating for less than five years. This suggests that SME owners prioritize stabilizing their businesses for about a decade before considering expansion and loan applications. Their focus during the initial ten years is on prudent financial management to sustain their enterprises. The prospect of obtaining loans presents inherent risks and challenges for them. In addition, this study also investigates bank loan applications by SMEs, particularly on the factors that influence the success of the applications. This is done by conducting interviews with two bank representatives.

Nevertheless, there are certain limitations to this study. Firstly, the sample is limited to SMEs in the District of Kuala Selangor. A comparative study involving SMEs from other regions could yield interesting insights. Secondly, the study's findings may not be generalizable due to its location-specific nature. A more comprehensive approach involving a wider range of respondents across various sectors could enhance the explanatory results. Thirdly, to gain deeper insights into varying bank loan requirements, a larger sample size for interviews would be more relevant.

Overall, this study contributes to the limited literature on SMEs loan applications in Malaysia, enhancing our understanding of bank loan requirements for SMEs and shedding light on the loan application behaviour of SME owners in Malaysia. It provides a deeper understanding of the factors influencing loan applications among SME owners.

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