



Original Article

# The Study of Different Factors Influencing the Choice of Financing Sources by MSMEs

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## Abstract

Micro, Small, and Medium sized Enterprises (MSMEs) plays a crucial role in the economic development of the country by focusing on the entrepreneurship, employment generation, and by contributing to the GDP. Whereas, access to the appropriate financing options is major challenge for growth and sustainability of the businesses. This study examines the various factors that are influencing the financing choices of MSMEs, including firm-specific attributes, market conditions, regulatory frameworks, and the availability of financial products. By Secondary data, the research identifies key determinants such as business size, creditworthiness of the businesses, financial literacy of the owner, high interest rates, and government policies. Understanding these factors can help policymakers, financial institutions, and entrepreneurs in developing the suitable tailored-made strategies to improve the financial accessibility for MSMEs. Financing decisions are important for MSME sustainability and growth. Financial stability, higher rate of interest, requirements of working capital, and regulatory and legal challenges affects the choice of capital sources such as, debt or equity. The choices of capital also require effective financial planning, that makes sure that the businesses will maintain enough liquidity, focusing on growth and expansion in the field and is also financially ready for the uncertainties, which makes the businesses sustainable and are able to achieve the long-term growth. Thus, the study focuses on financing decisions and the factors that needs to considered by MSMEs while selecting a source of finance.

**Keywords:** Financial Management, Capital, Capital requirements, MSME, Financing options, Equity Capital, Debt Capital

## Introduction

Micro, Small, and Medium businesses play a key role in enhancing economic growth and creating jobs in both rich and poor countries. These firms known as Micro, Small, and Medium Enterprises (MSMEs), make a big impact on GDP new ideas, and money from exports worldwide. In fact, they form the core of developing economies generating a large chunk of jobs and income. Take India, for example. The latest government figures show that MSMEs there employ more than 110 million people and make up over 30% of the country's GDP. These companies help balance out differences between regions and sectors because they can adapt to work in many fields, from making things to offering services. Even though they play a big part, MSMEs often face problems staying stable. Getting enough money when they need it is a big hurdle that holds back their growth and ability to compete. MSMEs need funding to grow their business, upgrade their tech, and work more. But many small companies have a hard time getting the right financial help because of problems both inside and outside their control.

## Research Problem:

MSMEs encounter a distinct set of difficulties related to financing decisions. In contrast to larger corporations, they often lack collateral, a credit history, connections to traditional banking systems. Furthermore, financial knowledge and management capabilities are frequently limited among MSME proprietors, complicating their ability to make well-informed choices. External conditions, such as elevated interest rates, complicated application procedures, and underdeveloped financial ecosystem, intensify these issues. An additional layer of complexity comes from the diversity within the MSME sector.

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Elements such as business size, geographic location, and type of industry significantly affect financing preferences. While some MSMEs may favor bank loans, others may depend on informal sources or fintech solutions. Grasping these differences is crucial for a comprehensive approach to overcoming the challenges faced.

### **Significance of the Study:**

This research matters to many groups. Lawmakers can apply the results to create focused plans that tackle the unique funding needs of MSMEs. For instance, making loan applications easier or launching industry-specific credit programs can help more businesses get financing. Banks and lenders can learn about what MSMEs prefer allowing them to craft tailored financial offerings. MSME owners can better grasp the key factors that should shape their funding choices leading to smarter money decisions in the long run.

### **Research Objectives**

This paper seeks to achieve the following objectives:

1. To identify the key factors that influence the financing decisions of MSMEs.
2. To analyse how these factors impact the financial decisions of MSME owners.
3. To explore variations in financing preferences based on region, sector, and business size.

### **Literature Review**

The Pecking Order Theory, developed by Myers and Majluf (1984), explains hierarchy of financing preferences among firms. According to this theory, "Businesses prefer internal financing, such as retained earnings, instead of external sources like debt or equity. For MSMEs, this preference is driven by the lack of sufficient collateral, high transaction costs, and the wish to maintain control over business operations." The theory helps in understanding why many MSMEs rely upon self-financing or informal sources before approaching the financial institutions. The Trade-Off Theory explains the balance between the benefits of debt financing and its costs. MSMEs often struggle to achieve this balance due to limited resources and high sensitivity to financial risks. Unlike large firms, MSMEs may face excessively high costs of debt, making them more risk-averse. This theory is useful for analysing why MSMEs may avoid debt even when it is available. The resource-based view (RBV) claims that internal capability of a firm is fundamental determinant of achieving competitive advantage. According to RBV, those with higher financial literacy, sound cash flow management, and access to information are at a greater advantage to accessing the right amount of finance. The application of RBV to MSMEs brings out the internal determinants, such as owner's experience and the firm's financial well-being, which influence financing decisions.

Al-Afifi, Dr-Ahmed. (2019). Factors Affecting Decision Makers Preference of MSMEs in Financing Sources Choice. *International Journal of Business Ethics and Governance*. 2. 16-29. 10.51325/ijbeg.v2i2.31. "This study examined the different choice of the various financing theories to explain the capital structure source of Micro, Small and Medium enterprises (MSMEs) that seek to procure their capital, through examining the factors that were affecting the main capital structure decision. The study used a questionnaire for 220 of Palestinian MSMEs in order to study the financing decisions in these firms according to the main capital structure theories. The study found that in accord with the POT, it was confirmed as an approach comprising an initial check on the availability of internal resources, followed by the use of internal capital. Where the most of the sample preferred to depend on personal money rather than to increase their capital through the partners and loans. Hence, this suggests the need to raise awareness with regard to the concept of capital structure and the other determinations that affect MSMEs' capital financing." Prihastiwati, Diah & Sunaningsih, Suci & Nugraheni, Agustina. (2021). Between Expectation and Reality: Factors Determining Financing Sources Preferred and Used by MSMEs. *Jurnal Analisis Bisnis Ekonomi*. 19. 74-85. 10.31603/bisnisekonomi.v19i2.3927. "This study shows that MSMEs have a very important role in the Indonesian economy and capital is a central issue for them. Still, there are still many MSMEs that face challenges to grow despite different programs that are instigated to assist this sector. This study aims to provide evidence of mismatch between capital needs/preferences and use for MSMEs. That mismatch is financing gap. The financing gap was identified through analyses of various MSMEs and owner's characteristics that affect preference and use of financing sources by MSMEs. Questionnaires were distributed to MSMEs owners in Magelang City and 121 samples were collected. One-way Anova and Independent t-test were used to determine financing sources preferred by MSMEs across different owners and MSMEs characteristics. The result showed that MSMEs at different levels of growth and owners who have different levels of education and experience had different preferences toward bank debt. Furthermore, preference to government assistance and informal sources of financing were driven by MSMEs' sales and owner's motivation to start business, respectively. Multiple regression analysis was employed to determine the drivers of MSMEs' use of financing sources. The results of this study were ownership status, gender, acquisition mode, and education influenced the use of bank loans. Assistance from the government was affected by MSMEs' type of activity, sales, and experience of the MSMEs' owners. The use of informal financing sources was affected by motivation and experience of MSMEs' owners."

Zayed, Nurul & Mohamed, Isse & Islam, K. M. Anwarul & Perevozova, Iryna & Nitsenko, Vitalii & Morozova, Olena. (2022). Factors Influencing the Financial Situation and Management of Small and Medium Enterprises. *Journal of Risk and Financial Management*. 15. 10.3390/jrfm15120554. "This study was to identify the factors that influence the financial situations of small and medium enterprises (SMEs) in Somalia. The research objectives of this study was to determine how capital building affected the financial condition of SMEs in Somalia, how human resource capacity affected the financial condition of SMEs, and what the impact of access to financing was according to the business conditions of SMEs. This study uses both descriptive and quantitative research approaches. The study's main demographics consisted of 90 SMEs in Somalia; the shortage of female personnel may also be a disadvantage, considering that most paying customers were female. The study's first research question was to identify whether the use of committees improves the quality and efficiency of the board's tasks and requirements. The study's second research question was to determine the impact of human resources. The study's findings about market adoption of

technological trends also revealed a strong positive relationship between human resource performance and financial performance. The Somali government should implement SME policies based on development and new growth industries, such as migration. Investment and credit firms, such as private sector banks and donor organizations, should lower the requirements for their investments. SME owners and managers should hire educated staff and increase the number of female employees. SME owners and managers should develop training schedules focusing on financial management, innovation, communication, and promotional abilities.”

#### **Data Analysis**

##### **Factors Influencing Financing Choices:**

The decision-making process for MSMEs regarding financing is influenced by a combination of internal and external factors.

##### **A. Internal Factors**

###### **a. Business Size and age:**

The MSMEs that are having large operations and established in the market for a long period, do not actually face challenges in getting capital from the market, whereas, the startups face high amount of barriers due to unavailability of collateral and lesser credit history.

**Profitability and Cash Flow Stability:** MSMEs that are having consistent and stable cash flow and higher profitability are considered lower risky by lenders, which helps them in getting funds positively. Whereas, businesses with unstable income struggle to meet the eligibility criteria for traditional financing options.

**b. Owner’s Financial Literacy and Risk Appetite:** The financial knowledge and understanding of the business owner plays a very important role. Owners with higher financial literacy are better equipped to analyse the financing options, negotiate on the terms, and use and utilise the government schemes.

##### **B. External Factors**

**a. Availability of Financing Options:** MSMEs have access to many of financing options, including bank loans from commercial banks, equity funding, and other sources such as family, friends or local lenders in market. The choice often depends on the ease of availability, terms, conditions, trustworthiness of the lender.

**b. Interest Rates and Cost of Capital:** High-interest rates and hidden costs makes many MSMEs away from seeking formal credit. Informal channels, despite higher nominal and hidden costs, may be preferred more due to easy processes and flexible repayment terms.

**c. Government Schemes and Policies:** Government initiatives such as credit guarantees, subsidies, and tax benefits have a significant impact on generating capital for MSMEs. Schemes like Indian Government’s MUDRA scheme provides vital support to the MSMEs. However, lack of awareness about these schemes limits their utilization by small businesses in India.

**d. Accessibility and Ease of Obtaining Finance:** The difficulty in the process of getting funds such as of documentation issues, processing time, and collateral requirements often makes it difficult to get a financing source. Digital platforms are emerging as a solution to streamline processes and increase ease and accessibility.

##### **Impact of Key Factors on the Financing Decision of MSME Owners:**

MSME business owners make financial decisions based on various internal and external factors, that are impacting their business sustainability and growth. Such as:

###### **a. Choice of Financing Sources**

Financially stable MSMEs having collateral and creditworthiness can secure capital via traditional bank loans, that provides structured financing. However, entrepreneurs with poor credit history, having fear for debt obligations or unstable interest rates, may prefer self-funding through their personal savings or retained earnings to have the financial control.

###### **b. Debt vs. Equity Financing**

The cost of debt capital is a major factor that needs to be considered in financing decisions. Higher interest rates on loans is the major issue for MSMEs to issue debt, which makes them to prefer the equity financing, via partnership, venture capital funding, or government grants/subsidies. While equity financing minimises financial liabilities, it also requires owners to share the equity.

###### **c. Working Capital Management**

MSMEs often have instability of cash because of delay in customer payments and seasonal demand fluctuations. To have the operations efficiently, they depend more on short-term loans, trade credit, or bill discounting. Efficient working capital management makes sure that the liquidity meets the daily operational needs.

###### **d. Growth & Expansion Decisions**

Access to finance plays a major role in business expansion. Adequate funding enables MSMEs to invest into technology, infrastructure, and new product manufacturing. Conversely, limited financial resources may force entrepreneurs to focus on sustaining existing operations rather than growth and scaling up.

**e. Survival & Sustainability**

Challenges such as, Regulatory complications, market fluctuations, and economic issues, impact directly on the MSMEs to explore the financing sources like microfinance options, crowdfunding from locals, or government subsidy programs. Facing these challenges is difficult, but, crucial for the long-term sustainability and competitiveness in the market. Thus, financing decisions directly impacts the MSME's capacity to grow, manage the risks, and sustain in the complicated market conditions.

**Sectoral and Regional Variations**

**A. Sectoral Differences:**

- a. **Manufacturing:** Requires higher amount of capital investment for the machinery, infrastructure, and raw material requirements. Long-term loans and equity financing are preferred by such businesses.
- b. **Services:** Primarily need working capital for daily operations, making short-term loans and credit lines more appealing for these types of businesses.
- c. **Trading:** Relies heavily on informal sources or supplier credit due to the rapid turnover of goods and cash.

**B. Regional Variations:**

- a. In urban areas, MSMEs benefit from easy access to banks, financial institutions, and alternative funding sources.
- b. Semi-urban and rural MSMEs often depend on microfinance institutions and informal lenders due to insufficient banking infrastructure.
- c. Regional economic development also plays a role; MSMEs in industrial clusters or economically advanced states typically have better financing options.

**Emerging Trends**

- A. **Digital Financing Platforms and Fintech Solutions:** The increase in the digital platforms has actually helped the MSME in financing. Online marketplaces, peer-to-peer lending, and fintech solutions provides an ease access to the funds with as minimum documentation as possible. Platforms like Lending Kart in India offers specialised solutions to the MSMEs for finding. These innovations fills the gap between traditional financing, particularly for small businesses.
- B. **Impact of ESG (Environmental, Social, and Governance) Factors:** Considering sustainability is important in MSME financing. Lenders and investors are preferring to invest in businesses that are aligning with ESG principles. For example, MSMEs adopting green practices or promoting social inclusivity are eligible for some government financing schemes.

**Conclusion and Recommendations**

This study focused how many different factors are affecting MSMEs' funding decisions. Internal factors that are influencing decision-making include the size of the company, profitability, and owner's financial knowledge etc. Cost of financing, government regulations, and the availability of financial products are some examples of external factors that influence accessibility of various funding sources. The study highlights significant challenges that MSMEs must overcome, such as complicated lending practices, high interest rates, and lack of knowledge about available schemes/programs.

Difficulties of MSMEs in Getting Finance: The challenges include amongst others, strict eligibility requirements; high-interest rates and massive collateral that is also very cumbersome. Difficult documentation and long processing time further challenge most of the small businesses from approaching the traditional financial institutions. The problem is deepened by limited awareness of government schemes and banking infrastructure regional.

Financing decisions are important for MSME sustainability and growth. Factors like financial stability, higher interest rates, working capital requirements, and regulatory challenges influence the choices between different capital sources such as, debt, equity, or alternative funding. Effective financial planning ensures liquidity, growth and expansion opportunities, and sustainability, that enables MSMEs to direct market uncertainties and achieve long-term success and growth. Digital finance platforms and ESG focused funding options are the examples of evolving developments that provides positive ways to improve the sustainability and accessibility of funding. In order to maximize their financial strategy and make well-informed decisions, MSME owners now depend heavily on financial literacy.

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**Conflicts of interest**

There are no conflicts of interest.

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