Introduction

Dynamic growth of small, privately owned firms is one the most important achievements of the economic transformations which occurred in the post-communist countries in the 1990s. Small and medium-sized enterprises constitute more than 99% of all the enterprises in Poland and their share in the GDP generation exceeds 50%. Only in the first 5 years of economic transformations, small and medium-sized enterprises created 1.5 million new jobs.¹

Many experts on SMEs problems believe that the growth of this sector is of unbalanced nature. It means that too many very small enterprises were created whose potential for growth is negligible.

One of the key factors deciding about the growth potential of a firm is the level of its innovativeness. On the basis of the research done by the Central Statistical Office and Polish Agency for the Enterprise Development it can be stated that the potential in question is at a very low level not only when compared to the EU countries but also when compared to some Central European countries. One may risk a statement that the low level of innovativeness in the Polish SME sector is a major obstacle for its development. There are several reasons for such a state of affairs. One of such reasons is a low supply of innovative ideas which may serve setting up a business of big growth potential. Another reason accounting for this problem are low managerial skills and little knowledge of innovative management techniques among proprietors and Presidents of small and medium-sized companies.

Representatives of organisations supporting SME development and also the entrepreneurs themselves share a belief that the low level of innovativeness in the sector can be explained by difficulties in obtaining funds for financing development processes.

All over the world small companies have a more difficult access to commercial credits than big firms. This is caused by the asymmetry of information which, due to the lack of credit history or too short a period of the company’s functioning in the market, does not let the bank assess by means of standard instruments the credit risk in the case of new companies. From a start, the costs of assessing the company’s credit reliability increase (if the very application is still considered by the creditor). It is worth mentioning that small companies apply to banks for much lower means than big firms. Considering the fact that the procedures and time spent on considering such applications are the same for big and small companies, then such conservative institutions as banks are not interested in financing innovative and newly established firms.²

As hitherto experience shows, a more appropriate form of financing this type of activity are special programmes of financial support from public funds (all types of such grant systems from both national and foreign sources) and capital investments of higher risk, the so called venture capital. It is the capital located in ventures of high risk but also promising a return on investment higher than the market rate. This paper focuses on these two methods of financing small and medium-sized enterprises as more interesting but not frequent forms of financing this type of enterprises.

**General principles of SME financing**

In order to run a business a continuous cash flow is necessary. These flows must be orderly and co-ordinated with the financial plan. These activities are subject to financial management understood, first of all, as preparing making concerning obtaining funds and their use by the enterprise. What is meant here is the presentation of rational premises and methods of selecting funds, their sources and ways of using. These tasks are carried out, especially in big companies, by financial managers and appropriate organisational units.

Financing is an activity which is to provide the company with capital. This activity can be considered in different aspects:³

- Capital structure (one’s own or loan capital)
- Legal guarantees (by forms of security provided)

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² A. Skowronek Mielczarek, Małe i średnie przedsiębiorstwa. Źródła finansowania. Warszawa 2003.
• Form of capital (cash, cashless, contribution-in-kind)
• Time of capital involvement (long-term, short-term)
• Conversions into the capital structure

Outside financing by means of one’s own consists of:
• issue of stocks
• shareholders’ additional payments,
• shares
• admittance fees
• grants
• venture capital

Outside loan financing consists of:
• financing by the financial market (short-term credits in current account and bills of exchange, long-term credits)
• via the market of commodities (deliverers and recipients’ credits)

Special forms of outside loan financing:
• leasing
• factoring

Internal financing can be accomplished:
• by transformation of property (current receipts from sales, from depreciation, from sale of transferable fixed assets, permanent accelerated turnover of assets),
• from retained profit
• by creating long-term reserves

A small enterprise, unlike a big one, incurs different costs of obtaining loan capital. Apart from the above mentioned lack of access to certain sources of financing, a small enterprise incurs higher costs of debt handling. In literature there is a term of discrimination of small enterprises which try to obtain a bank credit. The most important reasons for the discrimination of small firms as potential debtors are:
• bank handling costs,
• credit risk in the case of small firms.

Credit handling costs have a character of fixed costs (overheads). No matter how high the credit is, bank workers perform similar activities with reference to granting a credit and its further control. A unit cost of smaller credits is higher here than in the case of big credits.
This entails a higher interest and higher charges related to credits for small enterprises. Consequently, banks are less interested in granting credits to the SMEs and concentrate their interest on the segment of big corporations. It is often emphasised that this reluctance to give credits to small and medium-sized enterprises is, to a large extent, the effect of the fact that Polish banks have been sold to foreign capital which is not interested in financing Polish companies posing a competition for foreign enterprises in banks’ countries of origin.4

This claim is to some extent confirmed by the situation in the leasing market. In 1996 the share of Polish companies in this market stood at ca. 60% and that of the banks’ leasing societies - at 32%. In 2000 these proportions were 36.9% and 48.9%, respectively and a year later - 8.7% and 86%, respectively. This state of affairs resulted from the following factors:

- strong competition of the banks’ leasing societies with a strong financial background and capital interrelations of both,
- cutting independent leasing firms off from bank credits re-financing leasing transactions.

The banks operating in Poland, majority of which are owned by foreign capital, definitely prefer financing their own leasing companies and, commencing with 2001, they stopped to finance independent leasing companies.

Irrespective of the claims about banks’ preferential treatment of companies from their countries of origin, it must be emphasised that such tendencies are observed all over the world and not only in Poland. They are a result of banks’ strive to maximise profits rather than support companies, even from the countries of their origin. The difficulties observed in the access to capital seem to have been caused by a poor condition of Polish enterprises and a high credit risk related to it. Having a chance to invest the capital in the narrow but profitable sector of corporate enterprises and treasury bonds, banks do not want to risk the resources entrusted to them. Maximum profit and providing security to the resources entrusted to them, not promotion of economic development, is their statutory objective.

Summing up, discrimination of small enterprises as credit recipients is related to the high risk of their going bankrupt. Crediting small enterprises characterised by a short history of business activities or just starting them is more risky because these firms have not been verified by the market yet. On the other hand, the experiences of well developed countries reveal that the reason for which small enterprises go bankrupt is the loss of their liquidity and

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not the losses they make. Therefore, it seems more justified to point to such instruments of financing business activities as Venture Capital or a possibility of using means from the EU structural funds as particularly suitable for use in small enterprises implementing innovative investments.

Financing an enterprise by means of Venture Capital

Venture Capital funds are investment funds, which are non-bank financial institutions of a non-deposit character.³ Contrary to classical investment funds investing in securities listed in the public market, venture capital funds seek investment among companies not listed on the stock exchange, frequently small ones but having more than average chances of development and dynamic increase in their value. In the capital market, venture capital funds play the role of a financial intermediary who participates in the allocation of free monies and makes the surplus funds flow into the enterprises realising venture capital investments and thus becoming credit recipients.

Providers of venture capital funds can be divided into the following groups:

- private (individual) persons
- enterprises and corporations
- banks
- public institutions
- scientific institutions
- foundations
- foreign investors

Depending on who provides the capital, venture capitals determine the investment target. For example, if the venture capital investor is another economic subject, the primary target is getting access to the latest technologies. In this way the economic subjects provide themselves with access to production methods and markets which have a significant potential for development. Participation of large enterprises in financing young businesses but possessing technological innovation can assume the form of corporate partnering. The aim of such a strategy is to provide both parties with profits.

Financing with venture capital is an alternative for the traditional form of financing for enterprises which do not meet either bank requirements or those allowing for the stock exchange turnover. The funds offering venture capital address their offer to persons or

partnerships which have an interesting idea promising a chance of a significant return on invested resources.

An enterprise supported by venture capital, apart from the financial means, obtains also benefits from the co-operation with the fund. The benefits include:\(^6\)

- consultancy in the field of strategic and financial management, and in the field of marketing
- professional services rendered by the managerial staff (managerial partnership) of the venture capital fund; impartial decisions,
- liberty of action for the hitherto bosses of the investment object,
- earmarking the means obtained from the fund for introducing new products to the market, improving the quality of already manufactured products, increasing the share in the market, improving reliability and competitiveness, which may lead to the improved position of the enterprise in the market in the eyes of customers and competitors,
- spreading of the investment risk over a larger number of capital providers encourages investors of lower risk tolerance,
- possibility of obtaining larger financial resources for the realisation of a venture than when the resources come from a single investor,
- co-operation with a well-reputed fund increases credit worthiness of the investment object; owing to this the enterprise can obtain access to additional forms of finance,
- long-term financing and no need of current debt handling,
- increasing equity by venture capital investment instead of increasing obligations on the liabilities side,

• implementation and usage of new technologies in enterprises,
• access to broad contacts within the sector thanks to earlier investments,
• increase in the value of the investment object as a consequence of the above changes,
• depending on the way of exit (winding up the fund), the investment object (at the very moment of disinvestment) obtains a branch investor, additional means from the financial investor or, thanks to being listed on the stock exchange, access to other ways of financing.

The benefits enjoyed by the capital provider are the following:7
• obtaining access to new technologies,
• using the possessed surplus of production capacity for entering market niches discovered by small enterprises,
• possibility of concentrating on R&D activities,
• reducing the market risk.

Also economy can benefit from introducing venture capital into enterprises. Together with the development of enterprises financed by venture capital, the following benefits are offered to economy:
• increased competitiveness of economy in the international arena thanks to the supply of new products, increased exports, economic animation as a result of a larger number of small and medium-sized enterprises and improved quality of their activities,
• more jobs,
• inflow of foreign investments into the country,
• development of economic sectors which suffered from recession,
• obtaining means for branches which were insufficiently provided with capital,
• re-structuring of outdated enterprises,
• making up for the technological gap,
• possibility of development for certain branches in the chosen region of the country,
• activation of economic regions threatened by strong unemployment,
• activation of young entrepreneurs and graduates of technical universities.

7 L. Lewandowska, Niekonwencjonalne formy finansowania przedsiębiorczości, Ośrodek Doskonalenia Kadr, Gdańsk, 1999, p. 36.
The most relevant thing from the point of view of the capital recipient seems getting prepared for this possibility of financing activities by creating the image of an enterprise as one worth attention of the investors participating in venture capital. It must be stressed here that the decision about the possibility of financing activities in this way is at the sole discretion of the venture capital managers and the only thing the company aspiring to obtain this type of financing can do is to create the image of itself as a perfect target of allocating invested resources.8

Decisions concerning investments are based on the knowledge of markets, evaluation of the company’s development prospects, managerial skills the company represents, ability to operate in the market. If the venture capital fund finds out that the company is a promising one, then it values it and provides the capital in exchange for a part of its shares. According to Richard Engel, Deputy President of the Pioneer Investment Poland, „investment in a given partnership depends primarily on the professional standards of the managerial staff. What counts is their clear and realistic vision of the company’s development and an additional asset is presenting a good business plan”. This opinion is confirmed by all the representatives of venture capital funds.9

While analysing and selecting investment projects, the fund evaluates: enterprise organisation, description and characteristics of products and the market, basic financial data (balance sheet, profit and loss account), competitive position of the enterprise and the outline of the investment project. At the same time, the fund identifies the projects for further work, i.e. Project development.

This report evaluates financial standing of the enterprise, verifies the presented forecasts and assumptions of the investment project. On the basis of these, the concept of the fund’s participation in the project is defined, i.e. the extent and period of involvement, financial instruments and adopted paths of exit (winding up the fund).

The basic criterion of qualifying a project for investment is the expected rate of return in relation to the assumed return rate on the fund’s investment portfolio and the risk the project poses.10

Obtaining financial resources from venture capital is not easy. Every year, the Klainer Perkins Fund receives 2,500 business plans from companies seeking financial support. Only

about 100 partnerships are short-listed for negotiations and, eventually, support in the form of the capital is obtained practically by ca. 20 partnerships.¹¹

Two basic methods are used within the venture capital method:

- direct investment - meaning purchase of shares in an enterprise directly by the investors themselves, usually private ones,
- indirect investment - with the venture capital fund in the role of an intermediary approaching investors.

Throughout the investment time, the venture capital fund fulfils important functions in the area of the enterprise management. This must be taken into account while making a decision about using this method of financing. These functions include:

- control of the actual activities of the enterprise,
- co-deciding with reference to strategic problems of the enterprise,
- advising on current issues of the enterprise functioning,

Mutual relationships and the scope of the performed function depend, of course, on the number of shares or stocks of the enterprise the venture capital fund owns or on its general strategy.

The venture capital fund can perform the control function by obtaining the data from two sources: the enterprise and some institutions, e.g. consulting institutions which evaluate development of the sector, market and technology in which the enterprise operates. The information is provided by the enterprise in specified periods of time, according to the needs of the venture capital fund’s managerial staff. Most often, the fund uses the data coming from the following sources: financial reports, reports from the realisation of the production, sales and investment plans, information on financial liquidity, turnover, etc. Reliability of the data and the speed with which they are forwarded have a major influence on the success of the project which is carried out and attainment of profits.

Support for the enterprise is not accomplished only by providing financial means but also via know-how in the field of management. The venture capital fund acquiring minority or majority interest in the enterprise, is awarded the right to co-decide about the enterprise’s assets and activities. This right focuses on such activities as:¹²

- approving the business plan of the enterprise,
- introducing changes concerning managerial staff,

¹¹ According to the information presented on www.webmedia.pl. (data used on 11th January 2004)
• deciding on selling a part or the whole enterprise,
• opening divisions and branches,
• granting loans, warranties and guarantees,
• contracting obligations resulting from bills of exchange, credits and trade obligations.

**Financing investments with the use of grants from the EU structural funds**

Poland’s membership in the European Union enables Polish enterprises to benefit fully from the EU policy of regional development. The benefits that the economic subjects can derive from the possibility of financing their investments by means of obtained grants earmarked within the framework of structural funds cannot be overestimated.\(^{13}\)

Possibilities of financing investments by economic subjects were included in the documents called operational programmes. The possibility of financing investments by enterprises is foreseen in:

Sector-related operational programme - Growth of Enterprise Competitiveness - within the framework of such activities as:\(^{14}\)

• growth of enterprise competitiveness through consultancy
• growth of competitiveness with reference to product and technology,
• growth of the SME competitiveness due to investments,
• support for ventures adjusting enterprises to the requirements of environmental protection

Integrated Operational Programme of Regional Development

• grants for micro enterprises
Sector-related Operational Programme of Restructuring and Modernisation of the Food Sector and rural area development:\(^{15}\)

• improving food product processing and marketing,
• diversifying agricultural activities and those related to agriculture in order to ensure various activities and alternative sources of income

Possible grants can be used for financing different investments such as:

• purchase of fixed assets

\(^{14}\) www.mgpis.gov.pl. (data of usage: 22\(^{nd}\) May, 2005)
\(^{15}\) www.arimr.gov.pl. (date of usage 23\(^{rd}\) May 2005)
purchase of capital instalments on account of leasing fixed assets
purchase of intangible and legal assets
installation and start-up of fixed assets
purchase of work and building materials indispensable for the realisation of the venture.

What deserves a mention is the fact that the grant by definition is a means of outside financing and unrepayable which, of course, contributes to the increase in the enterprise’s assets.

Financing activities by means of this method is based on the application procedures specified by the above mentioned operational programmes which include submitting an investment project in the form of an application together with obligatory appendices such as a business plan or a feasibility study.\(^\text{16}\) The grant awarded has the character of a refund of incurred costs, which puts the applicants under the obligation to present their own contribution (shown as in as a percentage of total costs) and the credit they are going to take for the financing of the investment. An investment project is evaluated by the institution verifying projects and following successful verification an appropriate contract is signed with the financing institution, which is synonymous with a guarantee of a refund of the investment outlays incurred provided that investment realisation complies with the time-schedule included in the project.

The Sector-related Operational Programme - Growth of Enterprise Competitiveness - offers the best possibilities of financing an innovative investment which is carried out by small and medium-sized enterprises. The grants meant for investment within the framework of this Programme aim at direct support for entrepreneurs intending to undertake new investments. Grants can be used, among others, for the purchase of fixed assets and for the purchase of intangible and legal assets. Additionally, grants can be awarded for the creation of new jobs.

In conformity with the provisions of the operational programme, the quality of production services is regarded as a key to the improvement and strengthening of the enterprise’s competitive position. A small number of enterprises holding the quality management systems certificates is a result of the high cost of obtaining such a certificate. The necessity of using telecommunication and information technologies as one of the ways to create a competitive advantage is unavoidable in the times when the information society is being built.

Knowledge has become a key factor of successful running a business in the changing environment. Polish enterprises, especially the small ones, very often have no access to specialist knowledge within the firm. Hence, the necessity to take advantage of services rendered by external providers. Again, it is not always possible on account of high costs of such services or difficult access to them. A part of these costs can be financed by the EU resources. In this way advisory services of chartered counsellors can be financed, especially if they refer to:

- rules of running a business in the conditions of the uniform European market,
- implementation of quality management systems, environment management systems and knowledge concerning legal requirements in the area of industrial safety,
- obtaining compatibility certificates for products, raw materials, machines and equipment,
- controlling and measuring equipment, and staff,
- implementation of the enterprise’s development strategy based on new technologies and innovative solutions,
- undertaking and developing exports,
- starting up companies based on advanced technologies.

According to the provisions of the Operational Programme, competitiveness of enterprises can also be improved thanks to the support for new investments leading to major changes in production, product or the production process and higher internationalisation of enterprises owing to promotion. The activities which can be financed with grants from the WKP (Increased Competitiveness Programme) comprise:

- projects aiming at new investments (as understood by the EU regulations) which include creation or expansion of the enterprise, both a manufacturing one or the one rendering services, or starting activities which include making major changes in the product manufacture or technological process.
- projects aimed at enterprise internationalisation - financing is accomplished by covering a part of costs related to entrepreneurs participation in international fairs and exhibitions and economic missions connected with fairs and exhibitions, including also promotion of technological and organisational innovation.

Using modern fixed assets for production and service rendering is another, apart from knowledge, key factor contributing to the competitive position of the enterprise in the market.
Many Polish SMEs are not competitive and their decapitalised assets as well as low profitability do not allow them for modernisation. As a result we deal with a technological gap which seems even bigger when SMEs are compared to foreign competitors.

In order to increase investment outlays in manufacturing and service rendering enterprises and, consequently, improve their offer in the areas of production and services, a possibility of financing based on grants specified in the regulation WE 70/2001 has been opened up. It is meant for such investments as:

- modernisation of SMEs,
- implementation of common investment ventures undertaken by enterprises,
- purchase of B&R work results and rights to industrial property by enterprises,
- implementation and commercialisation of innovative technologies and products,
- application of IT in management processes.

The possibility of obtaining resources for planned investments by submitting projects which have a chance of approval helps the company to work out a cohesive strategy of using the EU funds.

Such a strategy should be preceded by a complex diagnosis consisting of the following elements: 17

- Strategic diagnosis of the enterprise from the point of view of utilising the EU funds - including, among others, an answer to the question to what extent a given enterprise at this very moment is able to apply successfully for the EU funds and within which programme it should try to do it,
- Diagnosis of the investment financing programmes and consultancy - thanks to getting acquainted with these programmes it is possible to choose these which will satisfy the company’s needs in the best way;
- Diagnosis and prognosis concerning the EU funds development - fund development plans and programmes and the evaluation and prognoses concerning the interest in and utilisation of the resources.

A complex diagnosis helps to formula a strategy of using the EU funds by the enterprise, which includes:

- Strategic goals of the enterprise - defining the enterprise’s goals on the basis of perceived needs and restrictions at a given stage of its development.

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Defining the strategic direction of the enterprise basing on the use of the EU funds - building a strategic plan on the basis of strategic goals, defining the process of the strategy realisation and the expected outcome; emphasis on the realisation of activities from the point of view of support from the EU funds.

Defining the strategy of obtaining the EU funds within the programmes addressed to enterprises - matching the programmes to specific needs and strategic goals.

Defining the optimum strategy of financing activities - actions and their accomplishment in the case financing is not obtained for the projects.

Financial plan together with forecasts - a plan presenting development of the enterprise which carries out other investments and projects in the subsequent years. Financial prognoses concerning the influence of accomplished activities on the development of the company, its income growth, employment growth and other indicators.

The final element related to an effective strategy of utilising financial opportunities offered to the enterprise activities from the EU funds is proper implementation, which consists of:

- description of procedures connected with the application for the EU funds,
- description of procedures concerning realisation of the project and settlement of costs for which the enterprise obtained the EU funds,
- financing activities in compliance with the adopted strategy - financing of carried out investments and consultancy. Realisation and monitoring of the strategy concerning management of the obtained subsidies; emphasis on the elimination of re-financing.

The procedure of using the EU offered opportunities of investment financing is characterised by a certain number of formal complications. For smaller enterprises which do not have money to hire professional counselling institutions the National System of Services for SMEs has been created. It is co-ordinated by the Polish Agency of Enterprise Development. The system is a network of voluntarily co-operating and non-commercial organisations which render services for the benefit of small and medium-sized enterprises. The services they render deal with counselling, training, information, finances and innovations.

The organisations which co-operate within this system have a vast experience in rendering services for the SME sector in Poland. They are the business support centres, enterprise support centres, agencies of regional development, employers’ organisations,
research and development centres, foundations, associations, etc. Participation in the system is voluntary and it does not offer any material profits. Co-operation between centres is aimed entirely at developing the system of small and medium-sized companies and, in this way, increasing their competitiveness.

The National System of Services is an open system involving almost 180 organisations. The full list of the organisations together with their tele-addresses is on the home page of the Polish Agency for Enterprise Development.

Summary

In the situation of growing competitiveness and new economic reality brought about by the EU enlargement, innovativeness gains a new meaning. Despite unquestionable development of SMEs, the new conditions entail a number of barriers which have become an obstacle to running business activities and have made development of these enterprises and implementation of innovative ventures difficult for them. Difficult access to the funds financing innovative investments is one of such barriers.

Traditional instruments of investment financing such as bank credits are conditioned by the necessity of meeting many requirements, frequently too difficult to be met. Particularly, innovative investments, the effects of which are difficult to assess, are not readily welcomed by banks.

In view of this situation, a more significant role is played by hitherto less popular instruments of financing company’s activities, such as venture capital or grants from the EU structural funds.

The possibility of using grants from the EU funds for financing SME’s investments has become more popular the moment Poland joined the EU. An increased interest in grants is revealed by a rapidly growing number of applications for such funds. It can be expected that this form of financing will become even more popular.

The integration with the EU market allows to hope for the development of venture capital financing. It is particularly important in the situation when we cannot fully use the potential of Polish science due to the lack of money and facilities indispensable to implement certain solutions in economic practice.

At the same time it cannot go unnoticed that on the supply-side of venture capital funds, Polish investors are a very meagre group and we cannot expect many investments to be financed from this source. The resources of these investors can be involved in venture of higher risk, provided that programmes offering tax relieves and exemptions as well as
Protection in case of the investment failure will be created. A group which can make the Polish market a more dynamic one are foreign investors. However, like Polish investors, they are discouraged by the lack of initiative from the state, instability of fiscal policy and unclear tax regulations.

In the case of SMEs, projects related to potential investment objects are abandoned due to costs of business activities, tax rates and foreign competition. Besides, resigning from an investment is often caused by fear of making a loss. An additional problem is the lack of knowledge about venture capital funds and the way they function as well as about opportunities which are offered as a result of co-operation within these funds. Perhaps, a short history of capital venture financing in Poland should be blamed for this state of affairs. What is more, education in this respect is neglected by the state. Entrepreneurs do not know how to present their strengths in the offers addressed to venture capital investors. Their offers are very unprofessional.

**Bibliography**