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# Analysis of Internal Causes of Losses in Mainland China's Small and Medium-sized Enterprises and Governance Countermeasures

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**Abstract:**
Since China's reform and opening-up, the market economy has developed rapidly. Driven by diversified and individualized social demand, enterprises, as the fundamental units of economic activity, play a critical role in improving the overall quality of the national economy. Particularly, the vast number of small and medium-sized enterprises (SMEs) in mainland China accounts for the overwhelming majority of total enterprises, making their sound development strategically significant. In recent years, many SMEs have frequently fallen into financial losses. Beyond external factors such as the macroeconomic environment and policy systems, the deeper causes often stem from internal deficiencies—such as imperfect governance structures, outdated management concepts, and weak institutional enforcement. Focusing on selected SMEs in Chongqing as case studies, this paper systematically analyzes the key internal factors restricting profitability, covering five dimensions: financing, investment, operations, profit distribution, and management culture. Based on these findings, it proposes practical governance measures. The study aims to provide theoretical reference and practical guidance to help SMEs clarify their development strategies, enhance management capacity, and strengthen risk resilience.

**Keywords:** SMEs; internal governance; financial risk; operational efficiency; loss countermeasures.

## 1. Introduction

With the continuous deepening of marketization in China, small and medium-sized enterprises (SMEs) occupy an essential position in the national economy. They are both a major driving force for rapid economic growth and a leading source of technological innovation. However, in the current context of

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economic downturn, many SMEs—as well as some large enterprises—are facing unprofitability or even sustained losses. The fundamental reasons include the impact of government policies, market fluctuations, and intensified competition. Among these, internal mechanisms of production and operation exert the most direct influence. Most loss-making enterprises share common characteristics: inadequate internal management systems, low production efficiency, and poor cost control.

To investigate these issues, this paper adopts a mixed-method approach combining literature review and fieldwork, analyzing typical SME cases in Chongqing. From the perspectives of financing, investment, operations, profit distribution, and internal management culture, the study explores the internal causes of losses and proposes targeted governance strategies, aiming to provide a roadmap for SMEs in China to achieve sustainable and high-quality development.

## 2. Internal Causes of Losses in Mainland SMEs

### 2.1 Financing Risks

First, irrational financing channels. According to the source of funds, financing can be categorized as internal or external. Internal financing refers to enterprises relying on retained earnings to accumulate their own capital, which can be converted into corporate funds. External financing refers to obtaining funds from outside sources. Internal financing can serve as permanent capital, available for long-term use. From another perspective, internal financing not only enhances corporate creditworthiness but also protects the rights of existing shareholders, which is why enterprises generally prefer this option. However, in practice, external financing dominates. This indicates that retained earnings are insufficient, and the funds required by enterprises cannot be fully obtained through internal financing. If liquidity is insufficient and long-term debt levels are high, enterprises will face heavy interest burdens, and some may even fall into situations where they cannot pay interest.

Second, regarding financing method selection, enterprises in developed Western economies usually prioritize internal financing, and when it is insufficient, they seek external financing. For external financing, they tend to prefer bond issuance or debt financing, with equity issuance considered last [1]. By contrast, most listed SMEs in China prefer debt financing and are enthusiastic about it. Due to regulatory reasons, bond interest in China is paid before tax and is deductible. However, the rules for bond issuance are relatively complex. After weighing pros and cons, listed enterprises lean toward equity issuance, which is subject to less restrictive policies.

Third, the financing environment has become increasingly unfavorable in recent years. With the disorderly expansion of capital, defaults and uncollectible debts occur frequently, pushing up financing costs and difficulties. Creditworthiness is a major criterion for bank lending, but improving credit is not easy [2]. According to the 2023 report of the National Bureau of Statistics, SMEs nationwide generally face financing difficulties and tighter credit conditions, further worsening their environment. Recent studies also show that SME growth and expansion are highly correlated with external financing capacity, while institutional environment and financial transparency have become key mechanisms in forming financing constraints [3].

### 2.2 Investment risks

Blind diversification and long payback periods, especially in government-supported emerging industries, often drain enterprise funds. Enterprises invest heavily in the early stages, but returns take a long time to materialize [2]. Whether these industries will ultimately thrive remains uncertain. Domestic markets are largely saturated, with limited consumer appeal, making overseas expansion an important component of business development. Many enterprises set up overseas production bases and sales outlets. However, as manufacturing already has long payback cycles, overseas markets—with their economic, political, and policy complexities—extend payback periods further, thereby increasing investment risk.

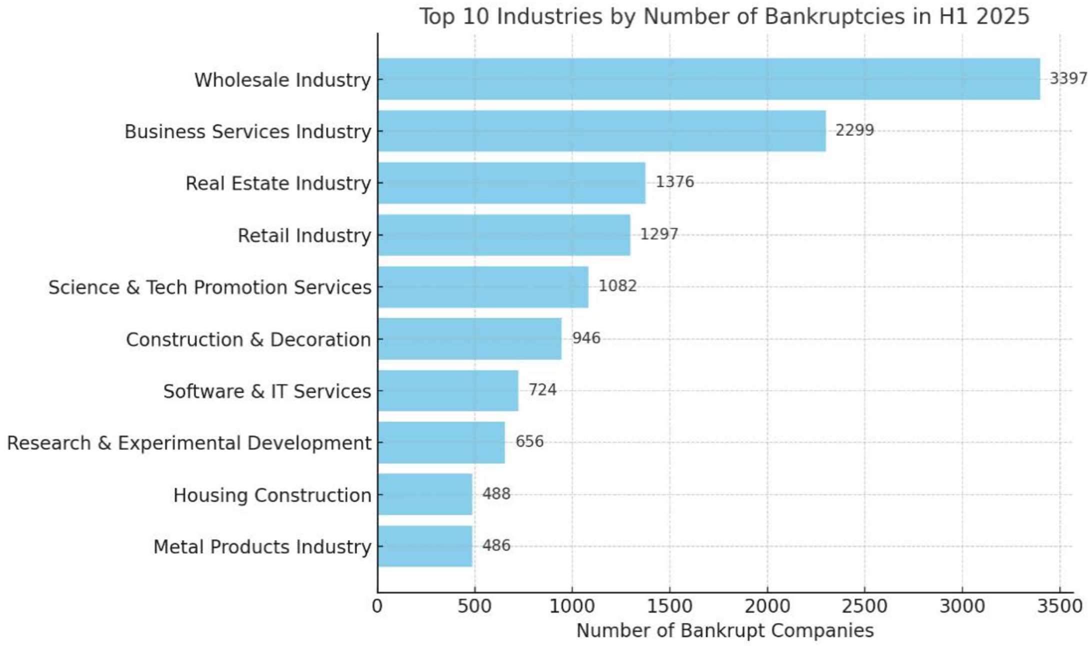


**Fig. 1 The top ten industries of the bankrupt enterprises in China in the first half of 2025(Picture credit: Original)**

Data from: https://zhuanlan.zhihu.com/p/1933472127689941521

In Figure 1, many enterprises are developing financial subsidiaries. Due to the nature of financial services, large initial capital is required. However, China's financial sector is overcrowded, with new firms frequently emerging and collapsing. As a result, SMEs should improve investment decision-making processes, strengthen pre-investment evaluation and post-investment feedback mechanisms, and establish risk-warning systems to reduce the probability of investment failure [4].

### 2.3 Operational Risks

First, accounts receivable risks. Evidence shows that many enterprises manage accounts receivable inadequately. Clients often view receivables as an interest-free loan: the later they pay, the more they benefit [5]. The weaker an enterprise's credit, the bolder the client becomes, making debt collection harder. A well-ordered enterprise must have a robust receivables management system, requiring credit reviews before contract signing and clear repayment terms and limits to avoid overdue payments.

Second, inventory risks. Excessive stockpiling generates unnecessary costs such as labor, storage, and maintenance. Given the uncertainty of consumer preferences and market conditions, inventories may depreciate or remain unsold. Enterprises should frequently reassess consumer demand and align with the market to prevent inventory accumulation.

Third, high production and operating costs. Effective cost control is critical to reducing losses. Research by Kędzior indicates that the profitability of service-oriented SMEs is primarily influenced by cost efficiency and human resource management [6]. Efficient cost control enhances productivity and creates greater profits.

### 2.4 Internal Management Risks

First, incomplete transition from "rule of man" to "rule of law" in management culture makes internal control system promotion difficult [7]. Many SMEs, particularly private ones, still operate under personalistic management. Management often undervalues or misunderstands internal controls, circumvents or overrides them, leaving systems incomplete, mechanisms vague, and supervision weak—rendering internal controls ineffective.

Second, unreasonable organizational structures and unclear responsibilities. Although reforms have brought positive changes, problems remain. At the micro level, departments are either too fragmented or overly centralized, causing overlapping or vacant functions and reducing efficiency. At the macro level, unclear responsibilities, blurred management boundaries, and ambiguous hierarchies create managerial difficulties.

## 3. Governance Countermeasures for Losses in Mainland SMEs

### 3.1 Strengthening the Establishment and Improvement of Internal Control Systems

First, improve corporate governance structures. The foun-

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dation of internal control construction is a sound governance framework. Mainland SMEs should establish and improve shareholders' meetings, boards of directors, and supervisory boards, while formulating rules of procedure that clearly define powers, duties, agendas, and processes to ensure smooth operation. At the same time, the responsibilities and authority of the management team should be clearly specified so that managers can effectively fulfill their duties within the authorized scope.

Second, establish a reasonable organizational structure. A rational organizational structure is the cornerstone of internal control construction. The functions of internal departments and job responsibilities must be clarified to avoid duplication, overlap, or gaps [8]. Vertical relationships of rights and responsibilities and horizontal communication among departments should be strengthened, establishing internal information transmission mechanisms to ensure smooth communication. A sound organizational structure allows clear division of responsibilities and smooth process operation, thereby improving the rationality and effectiveness of internal control implementation.

### 3.2 Selecting Appropriate Financing Methods

First, prioritize internal financing. Retained earnings and paid-in capital constitute internal financing, which arises during the enterprise's business activities and is characterized by low cost and low risk. It is therefore generally recommended that enterprises adopt internal financing first. However, when operations fall into difficulty and profits decline, internal financing may not be feasible.

Second, avoid excessive reliance on equity financing and broaden financing channels. Generally, bank loans and bond interest are deductible before tax, reducing tax burdens, whereas dividends can only be distributed after tax, offering no tax relief. This makes bond financing more advantageous than equity financing. However, China has strict requirements on bond issuance and quota controls, leading most listed firms to prefer equity financing. For SMEs, issuing shares, participating in joint ventures, and establishing financial subsidiaries can integrate capital with operations. Such subsidiaries can provide convenient financing channels and strong capital support [9]. Enterprises may also hold shares in banks, becoming major shareholders. Given the current stability and profitability of banks, this provides SMEs with reliable financing channels and creates a self-sustaining operational cycle. In addition, enterprises may pursue cooperation with other firms or seek overseas financing.

### 3.3 Improving Accounting and Cash Flow Management Systems

First, formulate sound production plans. Enterprises should integrate financing and investment plans with historical sales data and future market conditions to create comprehensive production schedules [10]. Specifically: Estimate available cash flow based on financing and investment plans for the year. Develop production, procurement, and storage plans accordingly .Since R&D and production require significant components, parts, and labor costs, detailed planning maximizes capital efficiency. Consult the sales department in a timely manner and coordinate to align production with expected sales, reducing excess inventory.

Second, strengthen cash flow management. Cash management can be divided into three segments: cash flow budgeting, actual cash flow, and cash usage feedback. Enterprises should prepare cash flow budgets according to investment plans and operational needs, then categorize actual cash flows into financing, investing, and operating activities. Monitoring the conversion among different categories is essential. Finally, compare actual cash inflows and outflows with budgets, evaluate efficiency, and analyze discrepancies to make improvements [11]. Cash flow is the lifeblood of enterprise activities. Only through standardized management of cash flows can enterprises achieve rapid and high-quality development.

## 4. Conclusion

With the ongoing deepening of the market economy and rapid technological progress, SMEs in mainland China face numerous structural and managerial challenges. Problems are particularly acute in areas such as restricted financing channels, blind investment expansion, weak cost control, and incomplete internal management systems. Taking selected SMEs in Chongqing as case studies, this paper analyzes the internal causes of losses—summarized into four categories: financing, investment, operations, and management risks—and proposes governance countermeasures through field research and literature review. This study enriches the empirical foundation for understanding SME losses and provides practical support for future policymaking and enterprise governance improvements.

Looking ahead, SMEs should gradually shift from "experience-based management" to "institutionalized governance," under the dual pressures of government policy guidance and market mechanisms. Enterprises are advised to continually strengthen internal control systems, promote digital transformation to enhance management efficiency, expand diversified financing channels to improve liquidity, and emphasize risk assessment and return measurement in investment decisions. Through such interconnected governance strategies, SMEs are expected to emerge from persistent losses and steadily progress toward high-quality and sustainable development.

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