

## Development and Risk Analysis of Crowdfunding in China

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**Keywords:** Crowdfunding; Procedure of Crowdfunding; Risk Analysis; Risk Prevention

**Abstract.** As a new model of technological innovation, crowdfunding not only makes the internet finance possess the financing function, but also brings a breakthrough business model. With the deepening development of the Internet and the proposal of “Internet +” concept, crowdfunding, as a new way of financing, is also facing huge development and challenges. This paper analyzes the concept of crowdfunding and discusses its origin and current situation in our country, while analyzes the risk of the crowdfunding in our country from the perspective of procedure of crowdfunding, and make recommendations accordingly.

### Introduction

Entrepreneurship is a way to highlight the vitality of a country's economic development, but also the driving force of economic development. However, venture financing, high financing cost, venture capital financing project serious problem of asymmetric information, there is a high degree of uncertainty project constraints such prosperity entrepreneurial activity. Especially the funding support from the domestic banking system to the SMEs (small and medium enterprises) is so limited currently, and the venture capital fund system is also in the preliminary stages of development. Therefore, there must be an innovation in the investment and financing system. Nowadays, the development of the Internet platform provides the possibility for the remote communication, reduces transaction costs, and leads to changes in people's lifestyles and production and management styles directly. Many industries have got a rapid development with the help of Internet platform. Among them, the venture financing has also developed a lot in the Internet platform, the most obvious is crowdfunding. Crowdfunding financing because of its high efficiency and low standards are favored by entrepreneurs, but also get widespread attention and rapid development because of using the Internet as a platform.

### Basic Concepts and Modes of Crowdfunding Financing

Crowdfunding starts in 2009 as a network business model. It is a science and technology innovation of financing. It refers to a group of people get financial support through the Internet to replace such as banking, venture capital, angel investors or such entities or persons recognized as financing for a project or a creative [1]. The rapid development of crowdfunding enables the Internet financing has VC / PE financing function of the traditional investment banking, which is the kind of innovation of traditional financial industry, as well a challenge. The basic modes of crowdfunding can be classified into four different modes. The specific modes are as follows in Fig. 1.

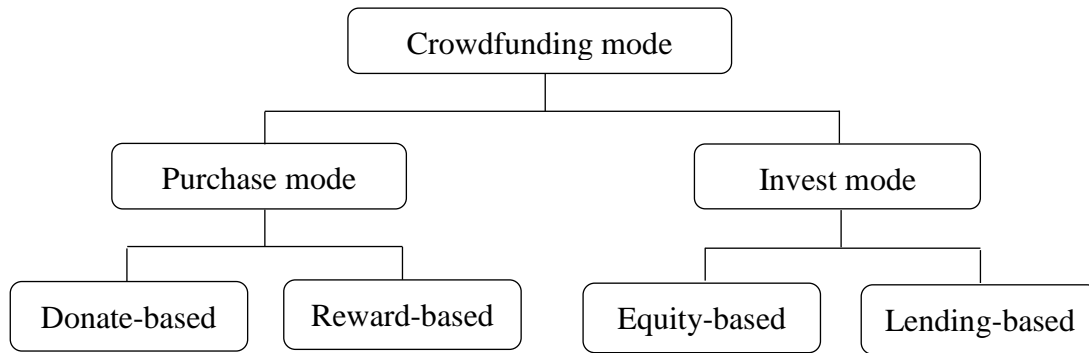


Figure 1. Crowdfunding modes classification

Crowdfunding financing includes creators, Crowdfunding platform and backers. The Creators formed project according to their own creative ideas, then submit the project to the platform if there is the need of fund. After that, the platform verifies the project and posts it in the website. The backers choose the project to invest. The crowdfunding is working as the Fig. 2 shows.

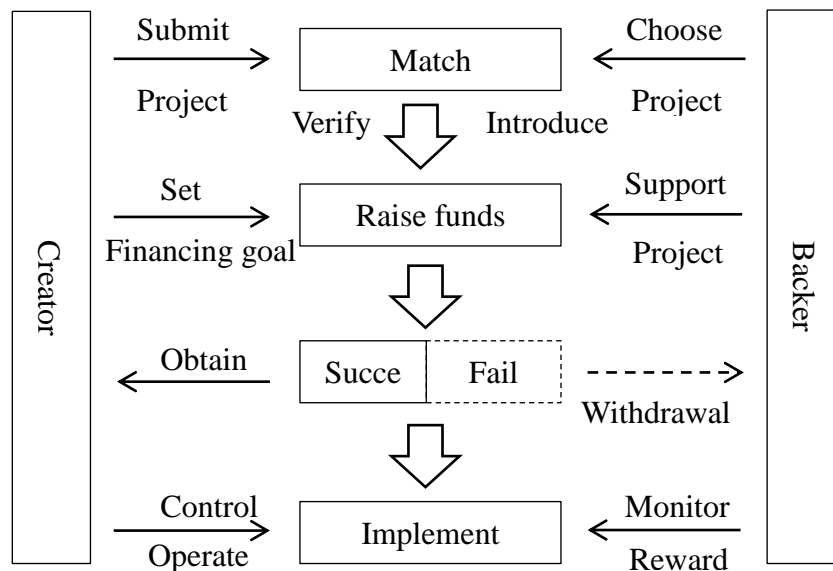


Figure 2. Process of Crowdfunding financing

### Development Status of Crowdfunding Financing

**Scale of Financing.** From 2015 statistical data, by the end of 2015, domestic crowdfunding platform has more than 365, covering 21 provinces and cities, the number of Equity crowdfunding platform is 185, commodity crowdfunding platform is 119, donated crowdfunding platform is 7, and another 39 is "Equity+Reward" multi-mode platform. By the end of 2015, reward-based crowdfunding fund-raising amounted to 3.07 billion yuan. Among them, the fund-raising amount of 2015 up to 2.7 billion yuan, is 10 times as much as last year (2.7 billion). The two leading platform are Taobao Crowdfunding and Jingdong Crowdfunding. The amount of fund both of them are over 100 million. Some other crowdfunding platforms also have outstanding performances.

**Trading Projects.** The crowdfunding industry is more concentrated in the types of culture or for public purpose. The rate of fund about cultural project raised is 65%, public project accounted for 27%, Intelligent Electronic Devices accounted for 6%. Besides, Crowdfunding is still providing much room for other areas. For example, the Real Estate Crowdfunding achieved great development in 2015.

**Platform Construction.** Whether crowdfunding project, successful fundraising amount, etc., Jingdong, Taobao crowdfunding performs outstanding. The participation of Taobao and Jingdong, on the one hand, is an extension of the scope of their own business, on the other hand, expands the crowdfunding visibility. It provides future development direction for the crowdfunding.

### **Risk Analysis of Crowdfunding Financing**

The very rapid development of Crowdfunding has been accompanied by risks. The creators, platform and the backers, they all faces different risks in different process.

**Risk of Matching Process.** The creative person bears the main risk in the project matching process. Take the reward-based crowdfunding for an example, the creators (fundraiser), put his product in the crowdfunding platform, on the one hand to test the market acceptance of the product by the reaction of supporters, but also use it as a sale to get money in advance to achieve mass production process. However, Creators is facing the risk of leakage of creativity in this process. Once the secret or main technology is leaked, it means that the whole project is failed [2].

**Risk of Verifying Process.** Inadequate qualification examination may pose a risk to all the participants, including the creators, platform and backers. This can be seen from the illegal fund-raising concept. According to People's Bank of China promulgated the "ban on illegal financial institutions and illegal financial activities related to the issue of notice" provisions, "illegal fund-raising is the unit or individual is not in accordance with legal procedures approved by the relevant departments to issue shares, bonds, lottery, securities investment funds or other debt obligations to the public a way to raise money and commitment within a certain period of currency, in kind and other ways to reward the investor servicing or behavior. " The biggest feature of Illegal fund-raising is to raise funds from the public [3]. Therefore, the way of crowdfunding financing might be mistaken into Illegal fund-raising if there is no clear and specific regulation or principles.

**Risk of Introducing Process.** In this process, the backers (investors) bear the main risk. They might be trapped into the contract fraud situation. The investors cannot get enough information to distinguish the project [4]. Especially the medium and small investors, they often follow the leader investor. Once there is a kind of interest relationship or other relationship between the leader investors and creators, the investors' interests will be damaged [5].

**Risk of Financing Process.** In this section, different roles face different risks. As the creators, they will face time risk. It means that they must get enough funds in the financing period. If not, the project may be canceled by the platform. To the platform, financing process is generally a process that needs for a specific time to complete. Therefore, funds often need to be collected at designated locations. After reaching a certain amount, it is expected to be carried out. Therefore, it is likely to form the "capital pool" in the process.

**Risk of Operating and Monitoring Process.** In this part, the investors take the main risk. In the general corporate finance situation, enterprises will be in accordance with the requirements of the "enterprise accounting standards" for the disclosure of relevant information, and investors can read through a variety of reports to understand the operating conditions of the enterprise. However, there is no regulation about disclosure of crowdfunding, so the investors may not be able to accurately understand the operating status of the enterprise project. Therefore, the main risk is still the information disclosure risk. The description of the risk in different process can be seen in table 1.

Table 1 Description of crowdfunding financing

Source of risk	Risk bearing subject	Specific risk
Matching	Creators	Information disclosure risk
Verifying	Creators	Information disclosure risk
	Platform	Illegal fund-raising risk
	Backers	Illegal fund-raising risk
Introducing	Backers	Contract fraud risk
Financing	Creators	Time risk
	Platform	Capital flow risk; amount risk
	Backers	Amount risk
Operating	Backers	Information disclosure risk

### Risk Prevention Measures

**Prevention and Control of Business Information Leakage Risks.** Information Disclosure in the crowdfunding process, may result in the risk of business secrets leaking from the perspective of creator, but, if they do not disclose the information, it will increase the difficulty of financing. Besides, if the information disclosure is not enough, the investors cannot understand the operation status of enterprise project. They must bear the risk of information opacity. Thus, for entrepreneurs, they can emulate the practice of high-tech enterprises to protect their own interests [6]. Raise awareness of Intellectual Property Protection and register the Patent technology timely is very necessary [7].

**Prevention and Control of Illegal Fund-raising Risks.** Crowdfunding financing must be clear boundaries of illegal fund-raising, especially the Equity-based crowdfunding. Relying solely on the operation of the platform is difficult to completely prevent the risk of illegal fund-raising, it must strengthen external regulation to ensure equity crowdfunding operate stably within the framework of the law [8]. Therefore, the basic thing is to improve the information disclosure system. It needs the law to make clear definition.

**Prevention and Control of Contract Fraud Risks.** The development of the Internet makes information transmission convenient, but on the other hand its virtualization also improves the likelihood of fraud. Therefore, in order to prevent the risk of fraud in the recommendation process, the off-line interview is a good step. The face-to-face communication improves the understanding of the project and reduces the possibility of fraud but it will increase the cost at the same time, such as more information disclosure, including the financial status of the enterprise and so on [9].

**Prevention and Control of Capital Flow Risks.** The main role of the platform is to use the Internet to optimize the allocation of surplus capital between fund-raisers and investors, improve the utilization efficiency of the surplus capital, and solve the problem of capital resource waste caused by information asymmetry [10]. Therefore, considering the safety of funds, the platform is not handle or responsible for capital management, generally choose the third party platform or bank. The investors and fund raisers negotiate to agree to pay a management fee to the hosting party, and achieve the purpose of controlling capital flow risk.

**Prevention and Control of Time Risks and Amount Risks.** The platform should clearly define the financing period of the project in case of the time risk. Meanwhile, the amount of the investment shall be limited by the law in accordance with the actual investment ability of the investor and the state of the industry in which the investment is invested. On the one hand, the financing scale of the whole project can be controlled to prevent the potential risks that may exist in the market. On the

other hand, control the investment risk and control the risk of investment in a certain range. This is not only to ensure the healthy development of the crowdfunding platform, but also to maintain financial market order and social stability.

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