

## **An Alternative Approach to Conventional Financing- The Lived Experience of the Iranian Capital Market**

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### **Abstract**

The development of businesses and entrepreneurship is today recognized to contribute to economic growth and capital market expansion in Iran. Entrepreneurship development requires purchasing machinery and equipment to provide working capital and complete development-oriented projects, enhancing the profitability and liquidity of corporations. Financing in organizations to implement profitable activities is of great concern to CEOs, business owners, and entrepreneurs, with multiple economic factors imposing challenges regarding enterprise financing. The most effective approach to financing businesses can be identified by analyzing their financial statuses, and enterprises can be financed through several methods, such as bank loans and issuing debt and equity securities in the capital market. Traditional financing is a frequent approach in financing economic institutions performed by issuing securities. Despite its advantages for business owners, traditional financing has multiple challenges. In light of online developments, social media platforms have opened new doors to financing, with alternative financing methods emerging to replace traditional processes. A public campaign is released on online platforms to collect individual capital, and such campaigns have been of interest to many investors and business owners since they offer several advantages, driving entrepreneurship and capital market growth. This study sought to elaborate on the advantages and disadvantages of crowdfunding as an innovative financing approach and identify the factors that have shifted financing from traditional instruments to crowdfunding.

### **Keywords**

Financing, Traditional financing, Crowdfunding

## 1. Introduction

Economic institutions require major investments to implement and develop their activities and ensure survival. They also heavily depend on financial markets to provide working capital. The identification of an effective financing mechanism to secure financial resources and continue activities is of great concern to the CEOs of economic institutions. Financing is a crucial aspect in financial management for financial managers, and CEOs' awareness of financing instruments and their consequences helps enterprises continue their operations and facilitates their activity flows. CEOs' strategies would lead to effective financing with minimal costs for economic development of activities in enterprises, increase profitability, and maximize the investors' wealth. Nowadays, the success of a business is dependent on financial resources, and some scholars believe that capital is the largest determinant of success (Kamalloo et al., 2022). Traditional financing methods are popular in companies. Despite its advantages, e.g., return predictability, support from well-known financial firms, financial stability, lower risk, income tax exemption, transparent information, and access to major capital, traditional financing organizations can no longer meet the demands of the manufacturing sector, particularly, new, innovative, and small businesses with high risk levels. Several methods have thus emerged to fill this gap, mostly based on crowdsourcing. As a result, crowdfunding has been of interest to economic entities as an outcome in recent years (Shahidi & Keivani, 2021; Zarandi, 2016). Crowdfunding is a different approach from traditional financing, and individuals and fundraisers play a key role in it. Crowdfunding is primarily aimed at collecting sufficient financial resources to launch a profitable project and, ultimately, ensure profitability, economic development, and capital market growth (Liu et al., 2023). Collecting adequate financial resources to implement a specific project, utilizing the Internet and the Web for online project financing, innovation and creativity, increased user awareness, and easy and rapid financing processes are major explanations for the superiority of crowdfunding over traditional financing. Despite its challenges and negative consequences, crowdfunding offers new opportunities for the capital market and economic growth. Thus, entrepreneurs and business owners are to analyze the advantages and disadvantages of traditional financing and crowdfunding and choose the

most optimal financing mechanism to maximize the production growth and profitability of industries.

## Literature Review

### Financing

Financing refers to providing funds for business activities, purchasing, or investment. It is the art and science of cash management. Financing is aimed at investment, profitability, risk minimization, and meeting the socio-economic demands of companies (Etemadi et al., 2014).

**Extra-organizational financing:** Extra-organizational financing refers to obtaining funds from external sources. These sources may include bank facilities, venture capital, or even financing through the capital market. Borrowing and issuing stocks are the major extra-organizational financing methods.

**Intra-organizational financing:** Intra-organizational financing refers to using the internal resources of a firm to continue its operations with minimal capital costs. Operation-derived cash flows, fixed asset sales, retained earnings, and savings are major intra-organizational financing methods. Given the limitations/challenges of traditional financing, crowdfunding is today recognized as an alternative financing approach for economic and capital market growth.

### Traditional financing

Traditional financing encompasses well-known methods that have long been used to meet the financial requirements of projects and businesses. Diversity and support from financial firms are the key advantages of traditional financing, while the high initial capital required, the supervision and strict standards of regulatory organizations, and the limitations and complexities of the financing process remain major disadvantages. Many studies reported that limitations such as the multiplicity of pillars, high financing costs, time-consuming process, regulatory instructions, the requirement for transparent financial reporting, and credible guarantees impose several challenges on traditional financing.

### Types of traditional financing

Companies may choose internal and/or external financing sources in financial decision-making. Financing methods and the utilization of their proceeds impact the future stock return, financial risk, and shareholders' degree of ownership.

**External financing sources**

Internal financing may be impossible in many key projects of economic institutions. In such cases, companies tend to utilize external financing to acquire financial resources to invest, secure working capital, and ensure further product sales.

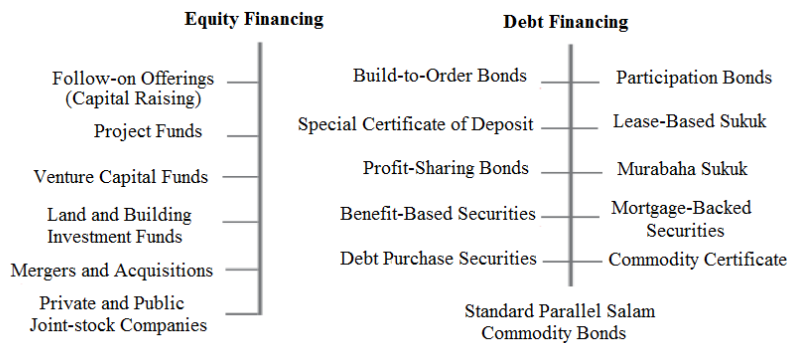
The capital market is the largest and most commonly used external source for financing. A variety of methods and instruments can be used to finance the purchase of equipment and implement working capital in industrial, mineral, and construction projects through the capital market. They are classified into (1) debt financing and (2) equity financing (Fig. 1).

Capital market financing offers many advantages, including:

- Large finances
- Long-term finances
- Principal payment at maturity
- Tax exemption on bond yields for investors

- Participation of retail investors in financing companies
- Liquidity management for financial institutions and banks
- Diversity of financing instruments for institutions
- The Securities and Exchange Organization’s rigorous supervision over the issuance of securities

In debt financing, the financing institution issues securities in the capital market. Financing through securities is currently available. Equity financing, on the other hand, refers to some instruments such as follow-on offerings, establishing public joint-stock companies aimed at investing in the original market (including the project company), and land and building investment funds.



**Fig. 1. Financing through the capital market**

**Traditional financing pillars**

Finance through debt securities: Many stakeholders interact with each other in issuing debt securities in the capital market. They manage advantages and challenges and finance large corporations through effective, purposeful interactions. The traditional financing pillars are described below.

**Issuer:** The issuer is the entity that issues securities. It is the first to issue securities, and only the issuer of securities can be the intermediate.

**Guarantor:** The guarantor guarantees the principal and the entire or a portion of the profit up to a certain level. In general, banks, investment firms, financing

institutions, insurance companies, and holdings can be guarantors upon permission from the Central Bank. Adequate credit ratings and the finance recipient’s share pledging can be a replacement for banks, provided that certain requirements are met.

**Payment agent:** The paying agent is the Central Securities Depository of Iran in the Iranian capital market.

**Paying agent:** The paying agent is the agent that issues securities for the first time.

**Underwriter:** The underwriter commits to purchase the unsold securities at a predefined price.

**Market maker:** The market maker guarantees market liquidity. It helps with the liquidity of markets that are shallow or do not have high trading rates.

**Financing by issuing equity securities:** Equity security issuance pillars in the financing of companies through capital raising are described below.

**Originator:** It is the company that requires finances and issues stocks.

**Issuer:** It is the company that issues stocks and is responsible for providing accurate and updated information on the company and issued stocks.

**Market maker:** It is the firm that increases stock liquidity and prevents severe volatility by selling and buying stocks in the market. The market maker plays a vital role in stabilizing the market and assuring investors.

**Guarantor:** In the issuance of stocks, the guarantor or underwriter commits to purchase the entire or a portion of unsold stocks. This assures the investors that their stocks will be bought.

**Advisory sponsor:** It helps the issuer with the listing of the stocks on the stock exchange. The advisory sponsor plays a vital role in providing information and advice on the listing process.

Auditors, brokers, and regulatory organizations are also pillars involved in the process of issuing stocks.

### **Advantages and challenges of traditional financing**

As mentioned, traditional financing is an effective strategy to obtain financial resources to develop businesses; however, it has advantages and challenges. Although decision-makers and CEOs often choose traditional financing in light of its advantages, they have recently preferred crowdfunding to fund businesses, particularly startups, as traditional financing has challenges. The key advantages and challenges of traditional financing are described below.

**Advantages:** Lower risk, predictable returns, access to major investors and large financial resources, higher transparency, support from financial organizations, high liquidity, diverse investment instruments, tax shield, and flexibility.

**Challenges:** Time-consuming bureaucracy and financing processes, high financing costs due to the multiplicity of pillars, requirements for transparent financial reporting, credible guarantors, strict and complicated rules and regulations, requirements for the

profitability of the fund recipient, and the requirement for an SEO-trusted auditor.

### **Crowdfunding**

Crowdfunding is an innovative approach for collecting financial resources from retail investors. Supported by Iran Fara Bourse Company (publicly held organization), this is performed using crowdfunding platforms and infrastructure, helping many entrepreneurs and contributing to the expansion of social activities. Crowdfunding is a relatively emerging phenomenon where corporations and individuals post online public requests for funding ideas, projects, and new businesses. It is based on four theories, i.e., stakeholder theory, crowdsourcing theory, crowdfunding theory, and signaling theory.

Online platforms collect funds online and provide an opportunity for non-governmental organizations (NGOs) to easily tackle their financing challenges. Crowdfunding platforms enable innovative entrepreneurs to request initial capital from a large group of supporters who are willing to fund projects (Al-Rashidi, 2024; Malik, 2014).

### **Types of crowdfunding**

There are various types of crowdfunding to be used depending on the goals of the recipient and provider of funds. All types of crowdfunding are aimed at providing financial resources to expand businesses, in particular startups, and develop the Iranian capital market and economy.

**Donation-based crowdfunding:** Investors support a project or idea and do not expect returns/rewards. This model is mainly applicable to charitable projects.

**Reward-based crowdfunding:** Investors receive a reward or non-financial benefits in return for their investment. The reward may be commodities, services, or early access to products.

**Equity-based crowdfunding:** Investors obtain stocks or partial ownership of a company in return for their investment.

**Debt-based crowdfunding:** Investors offer loans to a business and receive the principal and interest over a defined period. Debt-based crowdfunding is similar to bank loans, except that the funds are provided by various individuals (Shahidi and Keivani, 2021; Haji-Gholam Saryazdi, 2020; Malik, 2014).

### **Crowdfunding pillars**

Investors (a huge group of contributors), fund receivers, and platforms are the pillars of crowdfunding (Liu et al., 2022; Kouti, 2014; Jafari & Poorzanjani, 2022; Shafaei et al., 2021). The three main parties of crowdfunding projects hope that crowdfunding is successful. The creators hope that they will achieve the financing goals to obtain funds for their businesses. The supporters hope that they will get material/moral benefits. Crowdfunding platforms can receive costs and payments from successful projects and boost their reputation in the crowdfunding market.

### **Advantages and challenges of crowdfunding**

The popularity of crowdfunding is mainly explained by not only reducing financing costs but also the fact that crowdfunding is a direct business model in which manufacturers and consumers interact, and a three-party chain between supporters, manufacturers, and the platform is organized through crowdfunding. Potential losses would be distributed since a large number of investors are involved in crowdfunding projects. As charity foundations, decision-making organizations, and investors are involved in crowdfunding, such projects experience enhanced effectiveness and can be up-scaled (Saadabadi et al., 2022). Apart from the advantages, crowdfunding encounters growth and development challenges, such as narrow debt repayment space due to limitations (e.g., non-uniform distributions), risks, accumulation of bank accounts and lack of transparency in equipment and credit allocation, lack of interaction and links between the credit sector and the real economy sector, non-use of individual capacities, lack of effective and continuous regulatory mechanisms, and lack of intermediation roles in banks and financial institutions (Shahabi-Shojaei, 2022). Risk is a crucial factor that has been studied in the crowdfunding literature, reporting that crowdfunding contributors are more risk-tolerant than other types of investors.

### **Crowdfunding consequences**

Production declines and/or economic austerity are a critical phenomenon in economies, and the entire population shares the consequences since nearly every citizen experiences difficulties. In such conditions, economists recommend the reduction of consumption costs and emphasize production in order to overcome

economic difficulties. Crowdfunding is an effective strategy to involve citizens with small assets in the production ideas of small and fast-return enterprises. Crowdfunding not only enhances the economy and helps overcome recessions but also improves small industries. Not only is crowdfunding advantageous to startups and retail investors, but governments can also enjoy various advantages. In fact, governmental administrations require growth, and enhancing the number of profitable and cost-effective economic projects is a major task in an administration. Crowdfunding helps citizens to participate in construction, knowledge-based, and economic projects. Moreover, it substantially accelerates the implementation of economic, production, and knowledge-based projects and does not require piecemeal governmental funds. Apart from these two advantages, crowdfunding helps governments direct and implement economically feasible production schemes to improve the national economy, contributing to economic growth.

### **Capital market experience**

The capital market is a constituent of financial markets and, in fact, a backbone component of financing in economies. Its contributions to cash flows and economic growth have been recently analyzed with an emphasis on the desirable growth of the Iranian capital market. The capital market has a strong effect on economic growth in countries since it plays a key role in collecting funds through savings and optimizing and directing financial resources toward investment demands in productive sectors. It is the most important long-term financing source and refers to a certain system and location where the mid- and long-term demands of economic enterprises are met. In economies with relatively advanced financial markets, the capital market increasingly contributes to the financing of enterprises. Thus, recognized as an innovative strategy to supply funds to businesses, crowdfunding is a financing instrument in the capital market, and its advantages over traditional financing have increased its popularity among entrepreneurs and investors. It is a process through which institutional and retail investors invest in various businesses/projects in the capital market. Iran Fara Bourse Company is a major financial organization that influences the growth of crowdfunding. It plays a key role in this area by deploying a legal and regulatory framework for crowdfunding. Aimed at improving

transparency, minimizing risks, and directing funds toward eligible projects, this framework proposes crowdfunding to be an efficient instrument to finance businesses and projects. Hence, Iran Fara Bourse Company has further increased the popularity of financing among users, investors, entrepreneurs, and other stakeholders by establishing a legal and regulatory system, enhancing public trust, and reducing risks, leading to capital market development and economic growth in Iran. **Table 1** shows some financial enterprises and their active platforms in crowdfunding reported on the Iran Fara Bourse Company website.

**Table 1. Financial enterprises and platforms**

No.	Platform	Enterprise	Start Date	Certificate Expiration Date
1	Dongi	Firouzeh Asset Management	May 13, 2020	Jul 22, 2025
2	KarenCrowd	Karafarin Bank Brokerage	May 13, 2020	Jul 22, 2025
3	HamAfarin	Fintech Investment Advisory Co.	Jun 10, 2020	Jun 22, 2026
4	IBcrowd	Tamin Sarmaye Tamadon (IBShop)	May 29, 2021	Jul 22, 2025
5	Halal Fund	Algorithm Asset Management	Jan 19, 2022	Jan 18, 2026

## Conclusion

Financial markets play a vital role in directing funds toward the production and economic sectors and, therefore, enhancing economic growth. It is essential to identify the interaction between the money market and capital market as the backbone components of financial markets in economic decision-making. Economic growth has been of concern to economists since the economics literature was developed, and capital is today a major determinant of economic growth since the world has been experiencing a new economic era. In western developed countries, financial activities are an essential characteristic of not only business economics but also political systems, well-being, social security, and public culture. In fact, business economics has long depended on funds to finance production and investment processes. Indeed, production cannot be boosted without investment. The

capital market is a crucial driver that, coupled with efficient and effective strategies to finance knowledge-based businesses, industries, and the production sector, accelerates domestic production growth and, ultimately, enhances economic growth. Growth, market development, stock exchange, and their factors influence businesses, economic activities, and the management of societies. Such factors have been well-recognized to contribute to well-being, excellence, and achieving strategic goals in countries, and it is necessary to further evaluate them due to the complexities of their environment, which have become even greater in the third millennium. Crowdfunding is an alternative to traditional financing and has been recently popular among many entrepreneurs and investors in light of its advantages. Apart from its advantages, crowdfunding encounters a number of challenges, e.g., default risk, enterprise and individual bankruptcy, entrepreneur bankruptcy, lack of liquidity guarantors, and the risk of its online nature (Kamaloo et al., 2022).

The fundamental threats perceived in this respect refer to aspects that arise due to product or project innovativeness and the lack of comparable products or information. Uncertainty in the launching of projects stems from the lack of funds for investment and the lack of crowdfunding assessments for a given project. Furthermore, information-related concerns involve users' concerns about threats associated with the online data of projects and users' reactions to admitting to information leaks and expected loss of results due to the misuse of information (Taghavifard et al. 2022). Given the significance of crowdfunding and its impacts on investors, fund recipients, platforms, and the supervision of the regulatory authority, it is necessary to comprehensively evaluate crowdfunding and identify its risks under risk management considerations. The use of risk management techniques and the minimization of challenges further increase the popularity of crowdfunding among users and stakeholders, and entrepreneurs' increased utilization of crowdfunding will develop the capital market and, therefore, enhance economic growth in Iran.

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