

**FINANCIAL MANAGEMENT PRACTICES EMPLOYED  
BY SMALL AND MEDIUM ENTERPRISES (SMEs) IN  
THE BUFFALO CITY METROPOLITAN  
MUNICIPALITY, EASTERN CAPE**

**A DISSERTATION SUBMITTED IN FULFILMENT OF  
THE REQUIREMENTS FOR THE MASTERS  
PROGRAMME IN  
BUSINESS MANAGEMENT**

**BY**

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## **ABSTRACT**

This study examined how financial management decisions are made by small and medium enterprises (SMEs) in the Buffalo City Metropolitan in Eastern Cape, South Africa. The study aimed at discovering SME awareness on financial management practices. The financial management practices address issues on capital budgeting, working capital management, capital structure, financial reporting and analysis. The study, therefore, hypothesised that SMEs were not aware of the sound financial management practices. It was also intended in this study to examine the relationship between employment of sound financial management practices and firm financial performance. Subsequently, the study hypothesised that the employment of sound financial management practices by SMEs did not significantly affect their financial performance. The results obtained in this study revealed that SMEs were aware of the sound financial management practices that could be employed to yield high financial performance. However, the results also revealed that most SMEs were not employing qualified personnel and this in turn had an effect on the effectiveness of the financial management practices that the SMEs utilised. The findings also indicated that the employment of sound financial management practices did significantly and positively affect the financial performance of SMEs. The study recommended that SMEs could increase their chances of financial survival if they employ sound financial management practices. The study also gave recommendations to the South African Government to provide effective facilities and services to SMEs and help sustain them because they are important in the economy. Lastly, the study recommended financial institutions to relax their credit granting policies so that SMEs could access funds.

**KEY WORDS:** SMEs, financial management practices, financial performance, awareness.

## DECLARATION

I, the undersigned, Mathew Marembo, hereby declare that this dissertation is my own original work and it has not been submitted, and will not be presented at any other University or institution for a similar or any other degree award.

Signature: \_\_\_\_\_

Date: \_\_\_\_\_

## **PLAGIARISM DECLARATION**

I, the undersigned, Mathew Marembo, hereby declare that this dissertation is my own original work and any literature used has been acknowledged.

Signature: \_\_\_\_\_

Date: \_\_\_\_\_

## **ETHICAL DECLARATION**

I do hereby declare that this study was conducted in the explicit observation of research ethics and data collection. The data collected will not be used for any other purpose than this academic work. Respondents were not deceived and data was collected at their convenience

Signature: .....

Date: .....

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This project is dedicated to my Master Jesus Christ who has blessed me in all things that pertain to life and righteousness. It was a long journey but it was worth a ride with Jesus by my side.

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## LIST OF FIGURES

Figure 2.1 Income Distributions on Adult Population.....	27
Figure 2.2 Below Summarises the Challenges that are Faced by SMEs. ....	34
Figure 3.1 Central Role of Financial Management .....	41
Figure 3.2 Financial Management Objectives .....	49
Figure 5.1 Respondents' Level of Education.....	101
Figure 5.2 SME Industry.....	103
Figure 5.3 Age of Business .....	104
Figure 5.4 Preparation of Financial Budgets .....	107
Figure 5.5 Problems on Capital Budgeting.....	112
Figure 5.6 Internal or External Funds.....	121
Figure 5.7 Reasons for the Choice of Funds.....	122
Figure 5.8 Financial Analysis Techniques.....	127



## LIST OF TABLES

Table 2.1 Definition of SMEs in Developed Countries.....	19
Table 2.2 Definition of SMEs in Developing Countries.....	20
Table 2.3 Definition of SMEs in South Africa.....	21
Table 2.4 Contribution of SMEs in Selected Countries .....	24
Table 3.1 Performance factors .....	58
Table 3.2 Performance Indicators .....	59
Table 4.1 Cronbach's Results .....	90
Table 5.1 Response Rate.....	99
Table 5.2 Respondents' Position in Business .....	100
Table 5.3 Respondents' level of education.....	101
Table 5.4 SME Industry.....	102
Table 5.5 Number of Employees in Business.....	105
Table 5.6 Capital Budgeting Practices .....	106
Table 5.7 Preparation of Financial Budgets .....	107
Table 5.8 Capital Budgeting Techniques.....	108
Table 5.9 Use of Computers .....	109
Table 5.10 Areas of Computer Application.....	110
Table 5.11 Efficiency of Capital Budgeting.....	110
Table 5.12 Problems on Capital Budgeting.....	111
Table 5.13 Current Assets.....	113
Table 5.14 Current Liabilities.....	114
Table 5.15 Review of Working Capital .....	115
Table 5.16 Application of Computers in Working Capital .....	116
Table 5.17 Efficiency of Working Capital.....	117
Table 5.18 Source of Funds .....	119
Table 5.19 Rank in Order of Preference.....	120

Table 5.20 Internal or External Funds .....	121
Table 5.21 Who Chooses the Source of Funds.....	123
Table 5.22 Challenges in Accessing Funds .....	124
Table 5.23 Preparations of Financial Statements.....	125
Table 5.24 Who Prepares Financial Statements .....	125
Table 5.25 How often are Financial Statements Prepared .....	126
Table 5.26 Financial Analysis Techniques .....	127
Table 5.27 Application of Computers in Financial Reporting.....	128
Table 5.28 Areas of Computer Application.....	129
Table 5.29 Efficiency of Financial Reporting and Analysis .....	130
Table 5.30 Financial Management versus Firm Performance.....	131
Table 5.31 ANOVA on Financial Management Practices.....	133
Table 5.32 Capital Budgeting Practices .....	134
Table 5.33 Capital Budgeting Techniques.....	134
Table 5.34 Chi-Square on Capital Budgeting.....	135
Table 5.34 Chi-Square on Capital Budgeting .....	136
Table 5.36 Financial Reporting and Analysis .....	136
Table 5.37 ANOVA on Financial Reporting and Analysis.....	137
Table 5.38 Regression Model Summary .....	138
Table 5.39 Regression ANOVA.....	138
.....	

## TABLE OF CONTENTS

ABSTRACT .....	i
DECLARATION.....	ii
PLAGIARISM DECLARATION .....	iii
ETHICAL DECLARATION .....	iv
ACKNOWLEDGEMENTS .....	iv
DEDICATION .....	vi
LIST OF FIGURES .....	vii
LIST OF TABLES .....	viii
CHAPTER ONE .....	1
INTRODUCTION AND BACKGROUND.....	1
1.1 INTRODUCTION AND BACKGROUND.....	2
1.2 PROBLEM STATEMENT .....	4
1.3 RESEARCH OBJECTIVES .....	5
1.3.1 Primary Objective.....	5
1.3.2 Secondary objectives .....	5
1.4 RESEARCH HYPOTHESES .....	6
1.4.1 Primary Hypothesis .....	6
1.4.2 Secondary Hypotheses .....	6
1.5 SIGNIFICANCE OF THE STUDY.....	6
1.6 LITERATURE REVIEW .....	7
1.6.1 Definition of Financial Management.....	7
1.6.2 Theories on Financial Management.....	8
1.6.3 Using Accounting Principles in Small Businesses.....	9
1.6.4 Financial Management and Business Success.....	9
1.7 METHODOLOGY OF THE STUDY.....	9
1.7.1 Research Instrument.....	10
1.7.2 Research Technique .....	10
1.7.3 Secondary Data .....	11

1.7.4 Survey Area .....	11
1.7.5 Population .....	11
1.7.6 Sample Size .....	12
1.7.8 Sampling Technique .....	12
1.7.9 Data Analysis Procedure.....	12
1.8 RELIABILITY AND VALIDITY.....	12
1.9 ETHICAL CONSIDERATIONS .....	13
1.10 DELIMITATIONS AND LIMITATIONS OF THE STUDY.....	14
1.11 RESEARCH ORGANISATION.....	14
CHAPTER TWO.....	16
AN OVERVIEW OF SMALL AND MEDIUM ENTERPRISES (SMES) IN SOUTH AFRICA .....	16
2.1 INTRODUCTION.....	17
2.2 DEFINITION OF SMES.....	17
2.2.1 Defining SMEs in developed nations .....	18
2.2.2 Defining SMEs in Developing Nations.....	19
2.2.3 Defining SME in the South African Context.....	20
2.3 IMPORTANCE OF SMES .....	22
2.3.1 Contribution of SMEs to Developed Economies .....	23
2.3.2 Contribution to Developing Economies .....	24
2.3.2 Contribution to the South African Economy .....	25
2.3.2.1 The South African Government .....	25
2.3.2.2 Income Distribution .....	26
2.3.2.3 Employment.....	27
2.3.2.4 The Gross Domestic Product.....	28
2.3.2.5 The community .....	28
2.3.2.6 The financial sector.....	29
2.3.2.7 Large organisations .....	29
2.4 CHALLENGES FACED BY SMES IN SOUTH AFRICA.....	29

2.4.1 Financial Problems.....	30
2.4.2 Marketing Problems .....	30
2.4.3 Access to Skills and Training .....	31
2.4.4 A Non-Conducive Business Legislation .....	32
2.4.5 Information and Other Technological Problems .....	33
2.5 FAILURE RATE OF SMES IN SOUTH AFRICA .....	35
2.6 CONDITIONS FOR THE MAXIMIZATION OF THE SME CONTRIBUTION .....	36
2.7 CHAPTER SUMMARY .....	38
CHAPTER 3 .....	39
FINANCIAL MANAGEMENT PRACTICES .....	39
3.1 INTRODUCTION.....	40
3.2 FINANCIAL MANAGEMENT DEFINITION.....	40
3.2.1 Capital Budgeting.....	42
3.2.2 Working Capital.....	43
3.2.3 Capital Structure .....	45
3.2.4 Financial Planning and Control .....	46
3.2.5 Financial Accounting and Analysis.....	47
3.2.6 The Objectives of Financial Management .....	48
3.3 THE SME FINANCE FUNCTION .....	49
3.4 THEORETICAL REVIEW OF FINANCIAL MANAGEMENT .....	50
3.4.1 Pecking Order Theory .....	51
3.4.2 Signalling Theory .....	52
3.4.3 Agency Theory.....	54
3.4.4 The Relevancy Argument.....	56
3.4.5 The Owner/Manager Capability Argument .....	56
3.5 FIRM PERFORMANCE.....	58
3.6 FINANCIAL MANAGEMENT PRACTICES AND SME PERFORMANCE .....	60
3.6.1 The Context of Financial Management Practices.....	60
3.6.2 Capital Budgeting Vs Firm Performance .....	61
3.6.3 Working Capital Management Vs Firm Performance .....	61
3.6.4 Capital Structure Decisions Vs Firm Performance .....	62

3.6.5 Financial Planning and Control Vs Performance.....	63
3.6.6 Financial Accounting and Analysis Vs Firm Performance .....	63
3.7 GOVERNMENT INTERVENTION ON SME FINANCE .....	64
3.7.1 Small Enterprise Development Agency (SEDA).....	64
3.7.2 Khula Enterprise Finance.....	65
3.7.3 Eastern Cape Development Corporation (ECDC).....	65
3.7.4 Business Partners.....	66
3.8 CHAPTER SUMMARY.....	66
CHAPTER FOUR.....	68
THE RESEARCH METHODOLOGY .....	68
4.1 INTRODUCTION.....	69
4.2 FOCUS OF THE STUDY .....	70
4.3 SCOPE OF THE STUDY .....	70
4.3.1 Survey Area .....	71
4.3.2 Study Unit .....	71
4.3.3 Study Population .....	71
4.4 RESEARCH DESIGN.....	72
4.4.1 Research Method.....	72
4.4.2 Research Technique .....	72
4.5 RESEARCH INSTRUMENT .....	74
4.6 THE SAMPLING PROCEDURE.....	75
4.6.1 Description of the Population and Sampling Frame .....	75
4.6.2 Sampling method .....	76
4.6.3 Sampling technique.....	77
4.6.4 Sample size .....	77
4.7 RESEARCH TECHNIQUE .....	79
4.7.1 Questionnaire design .....	80
4.7.1.1 Open - ended Questions.....	80
4.7.1.2 Close-ended Questions .....	81
4.8 SECONDARY DATA.....	83

4.9 DATA PREPARATION .....	84
4.9.1 Data Editing .....	84
4.9.2 Data Coding .....	85
4.9.3 Data Entry .....	85
4.9.4 Data Validation.....	85
4.9.5 Data Cleaning .....	86
4.10 DATA ANALYSIS AND STATISTICAL TECHNIQUES.....	87
4.9.1 Descriptive Statistics .....	87
4.9.2 Inferential Statistics .....	88
4.9.2.1 Chi-Square Test.....	88
4.9.2.2 Analysis of Variance (ANOVA) .....	88
4.9.2.3 Simple regression analysis .....	89
4.10 RELIABILITY AND VALIDITY .....	89
4.10.1 Reliability.....	89
4.10.2 Validity .....	91
4.10.2.1 Content validity .....	91
4.10.2.2 Construct validity .....	91
4.10.2.3 Internal validity .....	91
4.10.2.4 External validity.....	92
4.10.2.5 Statistical validity .....	92
4.11 SAMPLING AND NON-SAMPLING ERRORS .....	92
4.11.1 Response error .....	93
4.11.2 Non-response errors .....	93
4.11.3 Non sampling errors.....	93
4.11.4 Selection errors.....	94
4.11.5 Measurement errors.....	94
4.11.6 Surrogated information errors .....	94
4.12 ETHICAL CONSIDERATIONS.....	94
4.13 LIMITATIONS AND DELIMITATIONS OF THE STUDY.....	95
4.14 SUMMARY .....	96

CHAPTER FIVE .....	97
ANALYSIS OF DATA .....	97
5.1 INTRODUCTION.....	98
5.1.1 Normality of data.....	98
5.1.2 Missing Values.....	99
5.1.3 Response Rate Survey Results .....	99
5.2 SURVEY RESULTS ON A QUESTION TO QUESTION BASIS.....	100
5.2.1 Section A: Business Details .....	100
5.2.2 Section B: Financial Management Practices.....	105
5.2.2.1 Capital Budgeting .....	105
5.2.2.2 Working capital management .....	112
5.2.2.3 Capital Structure .....	118
5.2.2.4 Financial reporting and analysis .....	124
5.2.3 Section C: Financial Management Versus Firm Performance.....	131
5.3 HYPOTHESIS TESTING AND INTERPRETATION .....	132
5.3.1 Primary Hypothesis:.....	132
5.3.2 Secondary Hypotheses:.....	133
5.4 CHAPTER SUMMARY.....	139
CHAPTER SIX .....	140
CONCLUSIONS AND RECOMMENDATIONS .....	140
6.1 INTRODUCTION.....	141
6.2 OVERVIEW OF LITERATURE.....	141
6.3 RESEARCH OBJECTIVES REVISITED .....	143
6.3.1 Primary Objective.....	143
6.3.2 Secondary objectives .....	143
6.4 CONCLUSIONS ON RESEARCH RESULTS .....	144
6.5 RECOMMENDATIONS .....	145
6.6 AREAS OF FURTHER RESEARCH .....	148
6.7 CONCLUSION .....	148



LIST OF REFERENCES .....	150
ADDENDUM 1 .....	162
ADDENDUM 2 .....	169
ADDENDUM 3 .....	170
ADDENDUM 4 .....	172

## **CHAPTER ONE**

### **INTRODUCTION AND BACKGROUND**

## 1.1 INTRODUCTION AND BACKGROUND

Brink, Cant and Ligthelm (2003) state that in many countries, in the closing decades of the last century, a new industry of enterprise promotion and support was developed. This was done through government departments, local economic and enterprise agencies, private organisations, academic institutions and community initiatives to enhance small business enterprise start-ups, growth and success. Petrus (2009) points out that the small and medium enterprises (SMEs) are vital in today's economy because many of the revenues obtained by the government are from business taxes. In times of economic crisis the existence of small and medium enterprises can stimulate the economy and hopefully improve the economies all around the world. According to Whonderr-Arthur (2009) when the best small firms become bigger, they spread good ideas across the entire economy and create lots of jobs through expansion.

Luiz (2002) states that governments worldwide support small and medium enterprises (SMEs) for various reasons which are:

- ❖ SMEs have shown remarkable capacity to absorb labour
- ❖ Assistance to SMEs displays sensitivity to poverty mitigation and therefore it becomes a political necessity.
- ❖ SMEs ensure a more equitable distribution of employment opportunities and are scattered around the country.
- ❖ SMEs usually utilise local technology which make use of local raw materials and equipment and this saves on foreign exchange.
- ❖ SMEs provide a nursery and proving ground for entrepreneurship and innovation.
- ❖ SMEs are resilient to depression and can provide a steadier level of employment than larger firms.

According to Das and Dey (2005) increasing the small and medium enterprise sector of the economy would strengthen the backbone of the society and also curb social unrest in the economy.

With millions of South Africans unemployed and underemployed the government has no option but to give its full attention to the task of job creation, and generating

sustainable and equitable growth. In South Africa small business sector is of importance in employment creation and poverty reduction. Nicolaides (2011) points out that the creation of new business activities especially smaller firms has grown to be a significant driver of the South African economy. According to Statistics South Africa, SMEs have moved from employing 18% in 1998 to 60% of the employable population in 2010. They also contribute more than 36% to the gross domestic product (GDP) of South Africa. Statistics SA also reported unemployment rate to have risen to 25.2% in the first quarter of 2012, causing anxiety not only to the South African government but also to role players in the private sector. The government of South Africa has placed importance on the small and medium enterprise sector and has put support services in place like Small Business Development Agency (SEDA), Khula Enterprise Finance and Business Partners, just to mention a few. In institutions of high learning separate courses on small business management and entrepreneurship have been added to the curricula in order to breed students with a mind of developing the future economy by creating sustainable businesses.

Despite all the contribution the government and the private sector make towards economic and social stability, SMEs are suffering a lot of challenges leading to their failures. Petrus (2009) points out that the failure rate of small business initiatives in South Africa is phenomenal and much is needed to unravel the causes contributing to such failures. According to Rungani and Fatoki (2010) more than 90% of SMEs fail in the first few years after start-up. Literature has repeatedly cited deficiencies in financial management, among others, as a root cause of small business failure (Berry, Sweeting, Goto and Taylor, 2002).

Firer, Ross, Westerfield and Jordan (2004: 3) state that financial management involves making decisions about investment opportunities, working capital management and type of funds to use as well as how to obtain them. Recourse to the above, Brink, Cant and Ligthelm (2003) highlight that sound financial management practices can play a very important role in a firm's success. According to Hunjira, Iqbal, Batool and Niazi (2012) the business environment is characterised by economic fluctuations. In order to perform well in any economic situation firms try to adopt the financial practices that can lead to a greater performance. Financial practices involve adoption of methods that give a firm the edge to effectively control external and internal financial resources in accordance with economic fluctuations.

Success of SMEs and their continued survival is a concern for all the economies around the globe. Despite the importance of sound financial management, Das and Dey (2005) report that much of SMEs failure has been linked to financial problems, thus inaccessibility and poor management of funds. It was therefore the purpose of this study to investigate into the financial management practices employed by small and medium enterprises in general and how this can affect firm growth, success and survival.

## **1.2 PROBLEM STATEMENT**

According to Petrus (2009) financial management enables a firm to identify its strengths, weaknesses, opportunities and threats. Liu (2010) and Das and Dey (2005) add that the implementation of sound financial management practices and good accounting practices enables firms to remain profitable and to survive in the competitive business world. This is because, according to Ahmad (2012), sound financial management practices help corporate ventures to have effective control on their cash flows, inventories, accounts receivables and accounts payables as well as meeting business financial reporting requirements. Firms become able to execute sound capital budgeting, set up good capital structure and make financial analysis decisions also. According to Kehinde (2011), Liu (2010) and Harif and Osman (2008) the employment of financial management practices helps build a foundation for long term financial survival and sustainability.

However, SMEs struggle to effectively implement sound financial management practices because their profiles are characterised by inadequate infrastructural resources, unqualified personnel and a limited capital base (Ackar and Vuyor, 2011 and Das and Dey, 2005). According to Fatoki and Garwe (2010) in South Africa the SME sector is very important because it contributes towards the mitigation of poverty by creating sustainable job opportunities for the community in the shortest possible time than large businesses do. Seeing the challenges that SMEs face, the South African government has initiated state-run facilities and boards to help SMEs start-up and grow. Ackar and Vuyor (2011) agree that many SMEs have benefitted especially on the issue of accessing financial assistance. Nonetheless, Rungani and Fatoki (2010) observe that SMEs in South Africa are still failing with the majority ceasing operations in the first year of operation. Many studies like Kehinde (2011), Fatoki

and Garwe (2010) as well as Rungani and Fatoki (2010), have attached the failures to deficiencies in financial management of these SMEs. Rungani and Fatoki (2010) focused on the working capital aspect of SMEs whereas Frank and Goyal (2003) centred their research on capital structure decisions. This leaves the other areas of financial management, namely investment appraisal, financial reporting and analysis as well as financial planning, of SMEs unexplored. Agyei-Mensah (2011) conducted a study in Ghana on SME financial management; however, this study lacks the South African context. The current study therefore sought to add to the existing literature on the already explored areas of financial management and also to give more insight to on the financial management function of SMEs in the South African perspective.

## **1.3 RESEARCH OBJECTIVES**

### **1.3.1 Primary Objective**

- To evaluate into the financial management practices employed by SMEs in the Buffalo City Metropolitan.

### **1.3.2 Secondary objectives**

- To ascertain how small and medium enterprises make investment decisions (capital budgeting)
- To identify the sources of finance used by the small and medium enterprises (capital structure)
- To ascertain how small and medium enterprises manage their everyday financial activities (working capital management)
- To ascertain how small and medium enterprises report their financial progress (accounting practice)
- To ascertain the relationship between financial management practices and business growth/success
- To identify factors that promote/hinder the implementation of sound financial management practices
- To add and provide more information on the financial management techniques used by SMEs in order to provide an appropriate and effective financial management instrument relevant to the success of SMEs.

## **1.4 RESEARCH HYPOTHESES**

### **1.4.1 Primary Hypothesis**

H<sub>0</sub>: Small and medium enterprises do not make use of sound financial management practices

H<sub>1</sub>: Small and medium enterprises do make use of sound financial management practices

### **1.4.2 Secondary Hypotheses**

H<sub>0</sub>: SMEs do not employ capital budgeting techniques in evaluating investment alternatives

H<sub>2</sub>: SMEs do employ sound capital budgeting techniques in evaluating investment alternatives

H<sub>0</sub>: SMEs do not properly manage their everyday financial activities (working capital)

H<sub>3</sub>: SMEs properly manage their everyday financial activities (working capital)

H<sub>0</sub>: SMEs do not employ proper financial reporting systems (accounting practice)

H<sub>4</sub>: SMEs do employ proper financial reporting systems (accounting practice)

H<sub>0</sub>: Employing sound financial management practices does not significantly affect the firm's growth/success

H<sub>5</sub>: Employing sound financial management practices significantly affect the firm's growth/success

## **1.5 SIGNIFICANCE OF THE STUDY**

Small business sector is able to create more jobs and eliminate poverty among the people in the society. The success of these small and medium enterprises is very important. This study seeks to help SMEs in South Africa succeed by making use of sound financial management practices. In other words the study seeks to add and

provide more information on the financial management techniques used by SMEs in order to provide an appropriate financial management tool for SMEs.

Debate still exists in the literature of successful SMEs management. The findings of this study will contribute to the literature on this debate.

This research was thus important for the development and success of the small business sector in South Africa. The findings could be used by the government, other policy makers as well as owners/managers of the small and medium enterprises to improve on the successful and sustainable management of businesses. Findings from the study could be useful to stimulate future research as well.

## **1.6 LITERATURE REVIEW**

### **1.6.1 Definition of Financial Management**

According to Firer, Ross, Westerfield and Jordan (2004: 3) financial management answers three questions. The first question concerns long term investments decisions by the firm. The process of planning and managing a firm's long term investments is called capital budgeting. Here the manager tries to identify investment opportunities that can generate more value than they cost to acquire. Many methods can be used to make investment appraisal which include payback method, accounting rate of return and the net present value method.

The second question is about how a firm obtains and manages the long term financing that is needed to support the above mentioned investments. The manager must decide the best mixture of debt and equity by determining how much to borrow. This is known as the capital structure of the firm.

The third question answers the working capital decisions of the firm. Working capital management is a day-to-day activity that ensures that the firm has adequate resources to continue operations without interruptions. Issues addressed here are on how much cash and inventory to keep, credit policy and how to obtain any needed short term financing.



If a firm's finance matters are managed properly then the firm will be able to survive, beat competition, avoid bankruptcy and financial distress, minimize costs, maximize profits and maintain a steady growth of the firm's returns (Agyei-Mensah, 2011).

### **1.6.2 Theories on Financial Management**

Modern theories that explain the implementation of financial management decisions include the agency theory, signalling theory and the Pecking order theory (Whonderr-Arthur, 2009).

Agency theory was developed by Jensen and Meckling (1976) and it deals with the people who own the business and those that are interested in it. The theory postulates that everyday operations of a business are monitored by managers as agents who have been engaged by the owners. The notion of this theory is based on the principle of two-sided transactions where financial transactions involve two parties who both act in their own interests but with different expectations. Usually problems of information asymmetry, moral hazard and adverse selection are a consequent. Due to the risks faced in the agency theory, researchers on SMEs financial management contend that many small and medium enterprises agency relationship between owners and managers may be absent because many a time owners are also managers.

The seminar work of Spence (1973) resulted in the development of the signalling theory in financial sense. The signalling theory rests on the transfer and interpretation of information at hand about a business to the capital market and the impounding of the resulting perceptions into the terms on which finance is made available to the firm. Flow of funds between an enterprise and the capital market is dependent on the flow of information between the two. According to Whonderr-Arthur (2009) small and medium enterprises signal their value to potential investors and lenders of money. Owing to its characteristics this theory may be insignificant for some aspects of small business financial management.

The Pecking order framework was first suggested by Donaldson in 1961 and then modified by Myers and Majluf (1984). It postulates that management prefer to finance first from retained earnings then with debt followed by hybrid forms of finance such as convertible loans and lastly using externally issued equity. From a study by

Fatoki and Rungani (2010), small and medium enterprises mostly prefer internal followed by debt and external equity being the last preference. This shows that most of small firms follow the hierarchical or Pecking order way of funding.

### **1.6.3 Using Accounting Principles in Small Businesses**

According to Berry et al. (2002) there are two main explanations of accounting use in SMEs. Firstly is the relevance argument which says that accounting practice is based upon the needs of larger businesses which are complex for small businesses to integrate into their systems. Secondly there is the owner/manager capability argument which is based on the level of understanding of the manager to make use of the accounting principles.

### **1.6.4 Financial Management and Business Success**

According to Hunjira *et al.* (2012), a firm's performance and wealth is largely affected by the financial practices it adopts. In addition, if the financial practices are well managed then the firm can operate efficiently. The key aspects of financial management evolve around working capital, credit management, cash flow management as well as bookkeeping principles. A study by Garcia-Teruel and Martinez-Solano (2007) reports that working capital management is particularly crucial for SMEs. It is because most of their assets are in the form of current assets. Working capital also affects a firm's profitability and risk and consequently the firm's value. Poor financial management practices may increase the firm's risk of failure. Brink, Cant and Ligthelm (2003) state that contributing to major SMEs' problems are inadequate credit management, insufficient knowledge of bookkeeping, failure to do financial planning and poor cash flow management.

## **1.7 METHODOLOGY OF THE STUDY**

According to Cooper and Schindler (2006: 192), research design is the plan and structure of investigation so conceived as to obtain answers to research questions. Cooper and Schindler (2006: 71) point out that a research design provides the glue that holds a research project together. It includes an outline of what the investigator will do from writing hypotheses and their operational implications to the final analysis

of data. It is research design that helps the researcher to allocate both time and financial resources for the successful conduction of the research.

This study made use of quantitative research design. Quantitative research design is described by Ghauri and Gronhaug (2005: 120) as studies whose findings are mainly the product of statistical summary and analysis. The objective was to generalise about a specific population based on the results of a representative sample of that population. The researcher collected data from a large number of small and medium enterprises using structured questionnaires and data analysis was done by use of statistical methods like the T-test and Anova.

### **1.7.1 Research Instrument**

This study employed the questionnaire as a data collection instrument. A questionnaire is a research instrument consisting of a series of questions and other prompts for the purpose of gathering information from respondents. For the purposes of this research the questionnaire was designed for statistical analysis. The questionnaire consisted of both open-ended and closed-ended questions. An open-ended question is a question in a questionnaire that allows respondents to answer questions in their own words whilst a closed ended question provides the respondents with different alternatives. For purposes of validity and reliability, the questionnaire was pre-tested before it was used for the actual data collection.

### **1.7.2 Research Technique**

This study made use of self-administered questionnaires as an instruments to collect data. Cooper & Schindler (2006: 256) define self-administered questionnaires as those that are completed by respondents on their own without an interviewer. Advantages accruing to the use of self-administered questionnaires are that they ensure anonymity and privacy of respondents thereby encouraging honest responses. In addition, they also proved to have a higher response rate than other data gathering techniques and they are less expensive than other methods where the researcher must be with respondents at all times like personal interviews (Cooper & Schindler, 2006: 256). The use of self-administered questionnaires is also intended to reduce interviewer bias. Scaled questions are to be included as part of the questionnaire so that the analysis on the relationship between financial

management practices employed and firm success can be made easier. The questions asked were developed from questionnaires from other studies which are tried and tested. Most of the questions will be adopted from the research by Agyei-Mensah (2011) who focused on financial reporting, working capital, capital budgeting and accounting systems.

### **1.7.3 Secondary Data**

Secondary data is the data that have already been collected by and readily available from other sources. Common sources of secondary data are journals, internet sources, text books and other scholarly work. The above mentioned sources that are relevant to financial management practices in the small business sector were consulted. Dissertations in the similar field were also made use of. The information obtained from the secondary data sources was evaluated on the basis of relevance, accuracy and up-datedness.

### **1.7.4 Survey Area**

The research was conducted in the Buffalo City Metropolitan Municipality. It is situated on the east coast of Eastern Cape Province, South Africa and it includes the towns of East London, Bhisho and King William's Town, as well as the large townships of Mdantsane and Zwelitsha. For the purposes of this study, small and medium enterprises in the East London and King Williams Town were chosen for data collection because of their proximity to the researcher and also due to budgetary constraints.

### **1.7.5 Population**

Cooper and Schindler (2006: 441) define population as the study object, which may be individuals, groups, organisations, human products and events, that is, the subject of the research interest or the conditions to which they are exposed. In this study, the population consisted of all the small and medium enterprises in the King Williams Town and East London regions. The study focused on the SMEs in general. According to a contact in the Eastern Cape Development Corporation (ECDC) there are approximately 420 small and medium enterprises in the described area.

### **1.7.6 Sample Size**

The sample size to be used for data collection was calculated using the Raosoft Calculator at a confidence level of 95%, a margin of error of 5%, a response distribution of 50% and a population of 420. The sample size amounted to 201 respondents. The researcher made use of other people to collect data so that all the sample elements could be reached with ease.

### **1.7.8 Sampling Technique**

The researcher intended to select the sample elements by the use of a simple random sampling technique. A simple random sample is a subset of individuals chosen from a larger set where each individual is chosen randomly and entirely by chance, such that each individual has the same probability of being chosen at any stage during the sampling process. Every SME that was included was chosen entirely by chance.

### **1.7.9 Data Analysis Procedure**

The statistical package used was the Statistical Software for Social Analysis System V8 (SAS). The packages Statistical and Statistical Package for Social Sciences (SPSS) was used for the analysis of graphs. Data analysis was done using the Pearson Chi-square, T-test and simple linear regression. The Chi-square test for independence was used to test for association while cross tabulation was used to determine the distribution of respondents. Simple linear regression was used to test for relationships. The correlation test was also used to analyse the relationships as well as descriptive statistics such as the mean, mode, median and the frequency distribution graphs. The researcher also needed the help of the University of Fort Hare Statistics Department for results analysis.

## **1.8 RELIABILITY AND VALIDITY**

According to Babbie and Mouton (2001: 15), the level of an instrument's reliability is dependent on its ability to produce the same results when used repeatedly. The researcher consulted a statistician in constructing the questionnaire to be used to collect data. This ensured questionnaire reliability because the statistician helped in phrasing and sequencing as well as formulating questions that can be statistically

analysed. A pilot study was done as a way to pre-test the questionnaire to see whether it measured whatever it was meant to measure consistently. The pre-testing was conducted using 20 respondents that were not part of the sample and the data collected from the pilot test was analysed using SPSS (Statistical Package for Social Sciences).

Validity refers to whether an instrument actually measures what it is supposed to measure, given the context in which it is applied (Babbie & Mouton, 2001: 17). The following steps were taken to ensure validity. Content validity was enhanced by consulting a panel of experts (statistician and supervisor) to review the items and commented on whether the items cover a representative sample of the behaviour domain. For Internal validity which refers to the confidence that is placed in the cause-and-effect relationship, the researcher made use of the linear regression model to measure the strength and relationship between the dependent variables and independent variables. The chi-Square test was also used to determine whether an association (or relationship) between two categorical variables in a sample is likely to reflect a real association between these two variables in the population.

In order to guarantee external validity, the researcher used a margin of error of 5% and a confidence level of 95% to select a big sample. Random sampling was also used to select the respondents in order to minimize the bias that could have arisen due to the selection process. Statistical validity which means the degree of statistical significance of a result was enhanced by testing the efficiency of the model construct using a hypothesised data set to check for effectiveness of the regression model, choosing a low significance value (p value) of less than 5%.

## **1.9 ETHICAL CONSIDERATIONS**

Ethics involves the development of moral standards that can be applied to situations in which there can be actual or potential harm to an individual or a group. According to Roberts-Lombard (2002: 19), ethics are of particular concern to research practitioners because their profession is based on consumer or public cooperation. Researchers have some general obligations to people who provide data in research studies. According to Tustin, Ligthelm, Martins and Van Wyk (2005: 46), their obligations include the obligation not to harm, force or deceive participants.

Participants should be willing and need to be informed. The data that respondents provide must be held in utmost confidentiality.

This study was carried cautious of all the rules that govern academic research conduct institutionally, nationally and internationally. In the collection of data the researcher was aware to observe the rights of respondents and not to cause any respondents' mental or physical discomfort through harm, risks and danger. Respondents were encouraged to answer questions freely without any pressure. The data provided by respondents was treated with confidentiality in order to protect and ensure the dignity and welfare of the participants, as well as those who might be affected by the results.

## **1.10 DELIMITATIONS AND LIMITATIONS OF THE STUDY**

This study focused only on the financial variables as they relate to SMEs' success. Other non-financial variables like marketing, corporate social responsibility, motivation and values also affect SMEs' success but they were not the centre of this study. The research also focused on the SME sector in general. SMEs may employ different financial practices depending on their type of business. Only SMEs in the Buffalo City Metropolitan were considered and therefore care was exercised in generalising the findings obtained from this study to the entire small business sector in South Africa.

Time and budgetary constraints caused this research to be conducted in the Buffalo City Metropolitan. The research was intended to begin in August 2012 stretching to November 2013. The budget for doing the research was estimated to be R10 000. It was also anticipated that some elements of the described sample might not be able or willing to respond and this could compromise the quality of the data collected. The sample was drawn from SMEs in general.

## **1.11 RESEARCH ORGANISATION**

### **• CHAPTER ONE: INTRODUCTION AND BACKGROUND OF THE STUDY**

An introduction and background to the study was covered in the chapter. The research problem was discussed and a brief literature review was given. Research

objectives and the significance of the study were also reflected. Perceived delimitations and brief methodology were highlighted in this chapter

- **CHAPTER TWO: AN OVERVIEW OF SMALL AND MEDIUM ENTERPRISES IN SOUTH AFRICA**

This chapter gave an overview and contribution of the small and medium enterprises in South Africa. SMEs definition was given together with the success factors for SMEs. Problems and failures associated with the small business sector in South Africa are discussed. Importance and contribution of the small firm sector to the economy of South Africa and in general formulated the other sections of this chapter.

- **CHAPTER THREE: FINANCIAL MANAGEMENT DECISIONS OF SMALL BUSINESSES**

A literature study on financial management was discussed in this chapter. Explicit explanation and definition of financial management formulated the introductory part of this chapter. Theoretical and empirical review followed as well as the importance of sound financial management practices towards firm performance.

- **CHAPTER FOUR: RESEARCH METHODOLOGY**

This chapter reflected on the research design, research instrument, research technique, population and sample size, sampling procedure, data collection procedure and also data analysis procedure. A detailed explanation of the above was given in this chapter.

- **CHAPTER FIVE: RESEARCH FINDINGS AND ANALYSIS**

The main focus of this chapter was data analysis. Firstly the research findings were presented in graphical and tabular form. Analysis of the findings was now done using the laid down procedure in the preceding chapter. Lastly a discussion on the research findings was reflected.

- **CHAPTER SIX: CONCLUSIONS AND RECOMMENDATIONS**

This was the final chapter of the study. Conclusions were made in comparison with previous literature. Recommendations were also given to the managers/owners and to policy makers. Lastly areas of further research were highlighted in this chapter.



## **CHAPTER TWO**

### **AN OVERVIEW OF SMALL AND MEDIUM ENTERPRISES (SMES) IN SOUTH AFRICA**

## **2.1 INTRODUCTION**

According to Ackar and Vuyor (2011) SMEs formulate a substantial part of the business world and are the driving engines of almost all economies worldwide. This is all attributed to the SMEs ability to create many jobs in a short period of time and their considerable attempt to equally distribute income among citizens of an economy (Agyei-Mensah, 2011). Fatai (2011) points out that many governments believe that SMEs absorb more labour whilst utilising a small share of capital. It is in this light that SMEs are receiving much attention and consideration by both the governments and the private sector. The previous chapter provided an overview of why it is important to carry out this study. It also highlighted on the roadmap by which this research was carried out. In this chapter (chapter two) the focus is on the characteristic definitions of SMEs in the South African context as well as in the developed and developing countries. The contribution made by SMEs both to the global economies (developed and developing) and to the South African economy is also discussed in this chapter. Challenges faced by SMEs are highlighted in this chapter as well as the failure rate of SMEs in South Africa and the major causes thereof. Several studies have shown that SMEs are failing, the concluding section in this chapter explores the conditions that are necessary for SMEs to succeed and to maximise their contribution to the economy and the community. Section 2.2 focuses on the definition of SMEs on an international basis of developed and developing nations and then taking the South African perspective.

## **2.2 DEFINITION OF SMES**

While the importance of small and medium scale enterprises has not been doubted, classifying businesses into large and medium scale is subjective and premised on different value judgment (Fatai, 2011). According to Kushnir (2011), there are a number of challenges surrounding the definition of a small and medium enterprise and therefore there is no universally accepted definition. According to Monks (2010), in almost every country around the globe, there is a different criterion to define an SME. Even within an individual country, the definition may vary according to industry or sector. However, some common elements can be mentioned when defining an SME. The definition should include one or more of the following factors (Anon, 2009):

- Minimum/maximum number of employees
- Minimum/maximum turnover
- Minimum/maximum balance sheet total
- Minimum/maximum amount of capital.

### **2.2.1 Defining SMEs in developed nations**

In general, SMEs are defined according to a low maximum of 200 employees in Australia up to a high maximum of 500 employees for the majority of the developed countries (Nenzhelele, 2009). This category will cover small and medium enterprises. According to the Small Business Act of 1953 (amended 2008) in the United States of America, an SME is defined as one that is independently owned and operated, which is not dominant in its field of operation. The business should be employing not more than 500 people.

The Companies Act of 2006 in the United Kingdom defines an SME as one that satisfies certain quantitative and qualitative requirements. The quantitative requirements stipulate that the turnover of the firm should not be more than twenty two million eight hundred thousand (22.8m) British Pounds Sterling, a balance sheet total of not more than eleven million four hundred thousand (11.4m) British Pounds Sterling and the number of employees should not be more than two hundred and fifty (250). The qualitative factors require the SME to have a relatively small share of its market, be independent and not be a subsidiary of a larger firm and the management should have close personal involvement in most of the aspects of decision making

In the European Union, a similar system is used to define small and medium enterprises. An SME is defined as a business with a number of employees fewer than 250. The maximum annual turnover is fifty (50) million Euros with a balance sheet total of forty three (43) million Euros. The financial ceilings of turnover and the balance sheet total of the SMEs were raised to these new levels after taking into consideration that productivity increased within the Union since 1996 (European Union, 2004). Table 2.1 gives a summary on how SMEs are defined by the different developed economies.

**Table 2.1 Definition of SMEs in Developed Countries**

Country	Type of Business	Number of Employees
Australia	Small	< 20
	Medium	< 100
Canada	Manufacturing	< 500
	Services	< 50
Denmark		< 500
Portugal	Small	< 100
	Medium	< 500
Spain	Small	< 200
	Medium	< 500
Switzerland	Small	< 50
	Medium	< 500

Source: Monks (2011)

### **2.2.2 Defining SMEs in Developing Nations**

It is actually clear that developing nations use a substantially lower criterion in defining SMEs. According to Monks (2010), the generic maximum number of employees must not exceed 300 and a turnover of less than R55 million. In addition, the balance sheet total needs to be less than R45 million. If the SMEs are managed properly and assume a normal growth curve, then these enterprises will quickly move out of the SME category. According to Ndagu and Obuobi (2010), this will result in them not contributing to the SMEs' concessions and simultaneously, result in a low SME total contribution to the economies in the developing countries. Generally, large businesses in the developing countries might not be as large as large businesses in developed countries. This, therefore, proves the lower criterion to give a more relative size insofar as SME definition in developing nations is

concerned. Table 2.2 summarises how some selected developing nations define SMEs.

**Table 2.1 Definition of SMEs in Developing Countries**

Country	SME criteria
Brazil	Varies with industry; less than 500 employees
Egypt	Less than 100 employees
Indonesia	Less than 100 employees
Korea	Manufacture industry: less than 300 employees Service industry: less than 300 employees
Malaysia	Varies; turnover: less than RM 25 million (R55.75mil) and 150 employees
Mexico	Less than employees

Source: Monks (2010)

### 2.2.3 Defining SME in the South African Context

Two sources are utilised to define SMEs in the South African perspective, thus; the South African Revenue Service (SARS) and the National Small Business Act 102 of 1996 as amended in 2003.

SARS (2007) define SMEs in different ways according to the certain concessions on which the definition is based on. SARS define an SME as follows:

- For Amnesty purposes, a small business is any business with a maximum turnover of R10m.
- For Income Tax purposes, an SME has a turnover of less than R14m.
- For Capital Gains Tax, an SME has total net assets of under R5m.

According to the National Small Business Act 102 of South Africa, 1996, as amended in 2003, a small business is; “a separate and distinct business entity, including cooperative enterprises and non-governmental organisations, managed by

one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or subsector of the economy mentioned in column 1 of the Schedule”. The act goes on to classify small businesses as micro-, very small, small and medium. However, for the purposes of this study the researcher only focuses on small and medium classes. Table 2.3 shows the definition of small and medium enterprises according to industry or sector.

**Table 2.1 Definition of SMEs in South Africa**

<b>Sector according to standard industrial classification</b>	<b>Size of class</b>	<b>Equivalent full time employees</b>	<b>Total turnover</b>	<b>Total gross asset value</b>
Agriculture	Medium	100	R5m	R5m
	Small	50	R3m	R3m
Mining and quarrying	Medium	200	R39m	R23m
	Small	50	R10m	R6m
Manufacturing	Medium	200	R51m	R19m
	Small	50	R13m	R5m
Electricity, gas and water	Medium	200	R51m	R19m
	Small	50	R13m	R5m
Construction	Medium	200	R26m	R5m
	Small	50	R6m	R1m
Retail and motor trade	Medium	200	R39m	R6m

	Small	50	R19m	R3m
Wholesale and commercial agents	Medium	200	R64m	R10m
	Small	50	R32m	R5m
Catering and accommodation	Medium	200	R13m	R3m
	Small	50	R6m	R1m
Finance and business services	Medium	200	R26m	R6m
	Small	50	R13m	R3m
Community, social and personal services	Medium	200	R13m	R6m
	Small	50	R6m	R3m

Source: Smit and Walkins (2012)

## 2.3 IMPORTANCE OF SMES

According to Vedera and Kulshreshtha (2010), there is no doubt that the SMEs drive today's world economies and societies' well-being. Below are some key economic factors that exhibit the contribution of SMEs to a country's economy (Anon, 2009).

- SMEs are the growth engine that drives most economies. Small and medium enterprises have the ability to create new job opportunities. In addition, they can generate revenue for the government in terms of tax payments. Technical innovation is very necessary for economic growth and as such, SMEs act as catalysts to innovations and creativity. It follows that the SME sector can be a breaking ground for new product developments.
- SMEs enhance market competitiveness and effectiveness. SMEs possess the ability to adapt in times of boom or recession and this can consequently remove regional and sector imbalances. Easy of entry and exit of SMEs into

business make economies more flexible. Numerous numbers of SMEs enhance competition in the economy. SMEs can be subcontractors in downsizing, privatisation and restructuring of large companies.

- SMEs are necessary for poverty reduction. According to Abor and Quartey (2010), SMEs are an essential panacea to increasing the standards of living in a society and the stability of a country because they have the ability to eradicate poverty. Fatai (2011) points out that these SMEs are usually dispersed and can reach to the remotest rural places and as such employ poor and low income workers. Self employment may be the only income of many poor people especially in developing countries where poverty is severe (Monks, 2010).

From the key factors discussed above, SMEs are definitely important to the national economy. It is of interest to know how SMEs are contributing to the developed economies in comparison to developing ones. Therefore, selected developed and developing countries are discussed in the following section.

### **2.3.1 Contribution of SMEs to Developed Economies**

Most of the developed countries have managed to develop programs that successfully breed SMEs and these SMEs now constitute the majority percentage of formal businesses.

#### **United Kingdom**

According to Anon (2009), small businesses constitute 99.3% and medium enterprises constitute 0.6% of all businesses in the United Kingdom. Therefore SMEs contribute about 99.9% of all businesses. SMEs have a high survival rate such that about 80.7% of new businesses will still be in operation after two years and 54.7% after four years.

#### **United States**

In the United States, 99.7% of all firms are categorised as SMEs (Monks, 2010). These SMEs employ more than 50% of the private sector employees and create between 60-80% of all new jobs. More than five hundred thousand small and medium businesses are started every year and 66 percent of these can last to two years and 50% last up to four years.



### 2.3.2 Contribution to Developing Economies

With particular reference to developing countries, SMEs are useful for the creation of employment in the shortest time possible. Mahembe (2011), states that SMEs represent about 91% of formal businesses, employ more than 60% of the workforce and contribute more than 57% to the gross domestic product.

#### China

In China, export activity has boomed and SMEs account for 68% of these exports. According to Mahembe (2011), SMEs employ more than 78% of the employable population, contribute more than 60% of GDP and account for about 40% of all tax payments. Of all new jobs created in the urban areas, 75% of them are directly linked to SMEs. There are now approximately forty million SMEs in China, ten times more than they were in 2004.

#### India

According to Vedera and Kulshreshtha (2010) state that SMEs play a significant role in the emerging Indian economy. SMEs contribute about 35% to the country's GDP and account for more than 40% of exports. In 2008, the nation recorded approximately thirteen million SME units and these happen to employ more than 32 million Indian people.

Below is a table that summarises how SMEs contribute to some selected developed and developing nations.

**Table 2.4 Contribution of SMEs in Selected Countries**

Country name	Number of SMEs	SMEs per 1000 people	SMEs employment (%)
United Kingdom	4 415 260	73.8	39.6
United States	5 868 737	20.0	50.6
China	8 000 000	6.3	78.0
Russia	6 891 300	48.8	50.5

Brazil	4 903 268	27.4	67.0
Mexico	2 891 300	27.9	71.9
Egypt	1 649 794	26.8	73.5
Ghana	25 679	1.2	66.0
Malawi	747 396	72.5	38.0
South Africa	900 683	22.0	39.0

Source: Monks (2011)

### **2.3.2 Contribution to the South African Economy**

In South Africa, SMEs are as important as they are to other developing economies in the world. According to Agyei-Mensah (2011), Monks (2010) and Rungani and Fatoki (2010), SMEs are essential for social and economic development of the country in the light that they enhance competitiveness in the market and mobilise idle funds to more productive areas. They added that equal distribution of economic powers can be aided by SMEs. It is of interest to discover how the different parts of the South African economy are affected and hence the following sections give a detailed discussion to that effect.

#### **2.3.2.1 The South African Government**

The South African government is in the quest to make sure that the economy achieve higher values of the gross domestic product (GDP) every year, reduce unemployment by creating jobs as well as increasing the investment spending (Smit and Watkins, 2012). SMEs provide stimulation in the economy, and almost without exception, countries have sought ways and means to encourage an increase in their number. The South African government has put in place some support services like Small Enterprise Development Agency (SEDA). SEDA was established in December 2004, through the National Small Business Amendment Act, Act 29 of 2004 (President's Office, 2004). There is also Khula Enterprise Finance formulated in 1996 which is a wholesale finance institution and operates across the public and private sectors, through a network of channels to supply the much-needed funding to small businesses. Ntsika Enterprise Promotion Agency was established in 1996 and has, among others, a core function to expand, coordinate and monitor the provision

of training, advice, counselling and any other non-financial services to small businesses. All these and other unmentioned branches of the government serve the purpose of stimulating start-ups and successful running of SMEs in the country.

### **2.3.2.2 Income Distribution**

According to Malan (2010), the contribution made by SMEs towards equality in income distribution can be better explained theoretically. Here we will assume an economy which is dualistic in nature, on the one hand having a very few large firms that are capital intensive and absorbs little labour and on the other hand, having numerous micro firms that uses very little capital but are labour intensive. Malan (2010) emphasises that the large firms are able to offer very high income incentives because of the high per unit labour productivity. In the micro enterprise the unit productivity of labour is very low, causing the jobs to offer very low levels of income. The SMEs are a better alternative to such dualistic economies because they utilise a moderate share of capital and are able to offer a fair income than the micro sector. Van Scheers (2011) adds that the economies with larger SME sectors have high probabilities of reducing the income distribution inequalities.

The Bureau of Market Research (2010) released a report which shows a 3.8% of the adult population of South Africa to be earning about 39.4% of total personal income. This leaves 61.6% of the total income to be scrambled for by the remaining 96.2% of adult population. the report also shows that 20.8% of this adult population are in the R50 000-R300 000 per annum income groups (middle class), whilst 75.4% are earning less than R50 000 per annum. The figure below summarises the income distribution among the adult population of South Africa.

**Figure 2.1 Income Distributions on Adult Population**

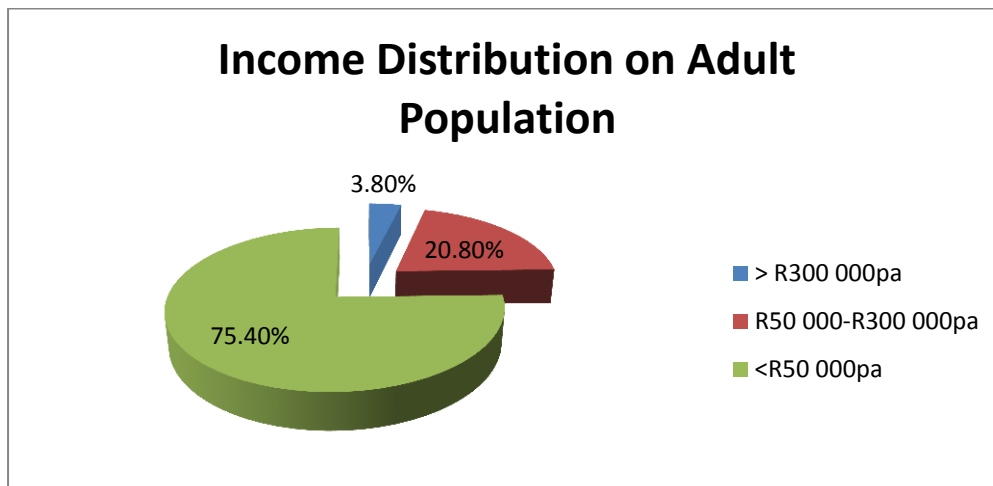


Figure 2.1 exposes the extent of the inequalities surrounding the distribution of income. SMEs having an intermediary role have the ability to neutralise the two extremes of low labour intensity with very high income and high labour intensity with very low income to moderated income and moderated use of capital (Nenzhelele, 2009).

### **2.3.2.3 Employment**

Gabriel (2005) states that SMEs are important to almost all economies in the world, especially to developing countries where there are major employment and income distribution challenges. In the first quarter of 2012, the South African economy recorded a 25.2% rate of unemployment which also increased to 25.5% in the third quarter. Some of the unemployed people are qualified for formal jobs and one way or another, they have a chance of getting employed. The challenge still remains to the lowly educated, some women, children, the elderly as well as the handicapped. Monks (2010) and Rungani and Fatoki (2010) agree that SMEs have that ability to create new jobs in the shortest time possible and they can be able to absorb the above mentioned unprivileged groups. It is reported that the SME sector employs more than 60% of the employable population in South Africa and that has been made possible by the SMEs' ability to reach out to the remotest places where the low income and poor people live. This is significant and as such, the government has to support these SMEs in the best way possible.

On another perspective, as mentioned earlier, is that SMEs have an intermediate role and can generate adequate and decent jobs for the majority poor population. In

the microenterprise sector, there is substantially low labour productivity and hence low income. This means that job opportunities in the microenterprise sector are available but do not provide a decent income to sustain households. Nenzhelele (2009) states that SMEs on the other hand can be substantially more productive than the micro sector and hence can offer a higher income which to some extent is decent and can, *ceteris paribus*, sustain some households. Unlike large firms which can generate job opportunities at a high share of capital than is available for the economy, Fatai (2011) points out that SMEs have the potential to generate jobs at a modest share of capital. If the SME sector is enhanced, it possess the potential to absorb people previously employed and those engaged in low productivity informal sector jobs (Mahembe, 2011).

#### **2.3.2.4 The Gross Domestic Product**

According to Abor and Quartey (2010), SMEs can be described as agents of change. This is mainly because mainly they have the ability to restructure existing markets and create new ones. SMEs are also the testing laboratory for new business ideas. They diffuse technology and are able to challenge the already existing established ways and methods of carrying out business. It is to the credit of these reasons that SMEs can help the economy to increase the total factor productivity and ultimately increase the GDP. According to Fatoki and Garwe (2010), SMEs contribute about 36% to the national GDP of the South African economy. Though this is lower than other developed economies, the contribution can still be labelled significant. However, for SMEs to increase their contribution to the GDP, they should operate at their full capacity and this is made possible if there are adequate resources for their operations (Monks, 2010).

#### **2.3.2.5 The community**

Agyei-Mensah (2011) points out that the SMEs are local and therefore depend upon the community for people to work in their firms. People in the society will get employed and have a source of income to sustain themselves and their families. According to Green and Martines-Sloano (2011), SMEs have the talent of dispersal and are able to reach out to the remote places therefore they can employ the low-skilled, the poor and poverty-stricken. The SMEs make goods and services accessible. The goods and services provided by these SMEs are affordable and tailored to meet local needs. This helps in increasing the standards of living and

ultimately alleviating poverty. People employed by SMEs may become less vulnerable to unemployment. This is because they assume multiple roles when they are working due to the flat management structures employed by SMEs (Smit and Watkins, 2012).

#### **2.3.2.6 The financial sector**

SMEs need funding for start-up and for expansion and growth. In this light, they (SMEs) can become major and profitable clients to the financial sector because they usually pursue credit. According to Agyei-Mensah (2011), a large number of SMEs are being planted and most of them are looking for funding. Therefore, this may give rise to a situation of more lenders and more borrowers, making the financial market effective and efficient.

#### **2.3.2.7 Large organisations**

SMEs can be a source of local cheap supplies and service provision to large corporations. This is because SMEs have knowledge on local resources and supply patterns as well as purchasing trends. In other words, some SMEs complement large firms, introducing the advantages of flexibility, lower transaction costs due to close contact with customers and quicker decision-making while large enterprises exploit the economies of scale (Gabriel, 2005). Some small companies grow into large ones, while some of the large ones may either fail or decide to shed activities and develop smaller new companies. This process of entry and exit, and growth decline, creates a healthy turbulence and implies a constant search for more productive use of resources (Monks, 2010). Competitiveness is thus a question of having the right mix of small and large firms and a sufficient division of labour that combines economies of scale with flexibility and the advantages of specialisation (Ntsika, 2002).

### **2.4 CHALLENGES FACED BY SMES IN SOUTH AFRICA**

According to Rungani and Fatoki (2010), SMEs face a lot of challenges which include inaccessibility of funds, managerial constraints, marketing related challenges, technological problems and a non-conducive legal environment as well as lack of skills and training. The challenges are discussed in the following sections

### **2.4.1 Financial Problems**

The most principal challenge that any business can face is the issue of finance and the SME sector is no exception. According to Agyei-Mensah (2010), the limited access to finance and the high cost of finance top the list of constraints affecting SMEs. For South African firms in the SME sector to be sources of sustainable income and employment, it depends on whether they have the financial capacity to attract new investment (Van Scheers, 2011). Consequently, they invariably resort to borrowing from financial institutions to start and expand their businesses. A substantial portion of the SME sector may neither have the security required for conventional collateral-based bank lending, nor high enough returns to attract formal venture capitalists and other risk investors. In addition, Malan (2002), states that financial markets may be characterized by deficient information (limiting the effectiveness of financial statement-based lending and credit scoring). The main obstacles to funding here appear to be on the demand (SMEs) rather than the supply (financial institutions) side of the business finance market. According to Naude and Havenga (2004: 112), this is mainly in the form of:

- Lack of satisfactory business plans, accounting and other information
- Inadequate assets for use as security
- Insufficiently high levels of profitability, gearing, liquidity, stability, and other business-financial performance criteria on the part of funding applicants

From the discussion above, it can be concluded that SMEs, in general, have a weak financial base and are regarded as high-risk areas and as such, do not succeed to attract loans to pursue their operations. It follows that many of them may be declared insolvent and are closed down (Naude and Havenga, 2004: 112).

### **2.4.2 Marketing Problems**

According to Smit and Watkins (2012) and Murphy (2006: 13-14), marketing is a very important task for SMEs in South Africa and it is the market related factors that exerts the most negative influence on enterprise success. The factors include increased competition, limited market size, low demand, poor competitor understanding, poor location and inability to identify the target market. South African

SMEs are hampered by a structural problem, in that, South African SMEs, contrary to SMEs in other developing countries, do not complement larger organisations with specialised products or services, but they compete with larger enterprises in the same product markets (Rogerson, 2004).

Most SMEs, both locally and globally, are still experiencing the challenge of accessing markets (both local and foreign). In South Africa, according to van Scheers (2011), some SMEs fail to successfully penetrate into markets due to insufficient marketing budgets. Inadequate marketing budget make it impossible to carry out objective marketing research. It follows then that these SMEs will not have sufficient information and intelligence on market opportunities and market trends (Anon, 2009). Access to foreign markets is made difficult because of too much paperwork, red tape and bureaucracy. Another drawback to successful marketing is that many SMEs employ a reactive approach to marketing and this does not have long term marketing considerations. Murphy (2006: 13) emphasises that it is the long term marketing strategy that determines whether a firm will succeed or not.

Monks (2010) states that it is altogether a new and dynamic business world today and the way marketing is done is changing rapidly to accommodate the new trends. SMEs are at a disadvantage usually due to resource constraints. Vedera and Kulshreshtha (2010) and Anon (2009) agree that SMEs cannot quickly adapt to new methods and processes because they might lack capital and funding to pursue the opportunities. In addition, most SMEs do not have a clear marketing function, marketing plan and they have poor marketing skills. The marketing risk is even increased by the fact that SMEs usually have a small product line. A question can now be asked: What happens when consumer preferences, tastes and demands change?

### **2.4.3 Access to Skills and Training**

Workforce training and development is critical to improving business performance and local economic development. This issue is especially critical in respect of small and medium size enterprises (SMEs) which in spite of making up much of most local economies but are often seen as less likely to participate in workforce development, thus compromising their own and their local economy's futures (Green and Martinez-



Solano, 2011). SMEs in South Africa lack appropriate general management skills, marketing skills, financial management skills and human resources skills. This has a negative effect on the growth of these SMEs.

According to Green and Martinez-Solano (2011), a possible solution to this challenge of insufficient skills for SMEs is to recruit experienced hands on management and mentors locally or internationally who are able to mentor and train their staff so that they can build skills throughout their businesses. However, this is not possible for most SMEs due to their financial struggles, and cannot afford high-caliber interim management who can assist with skills transfer and development. The accessibility to skills and training depends on the financial background of the firm. Government must therefore initiate consulting and training service programmes.

#### **2.4.4 A Non-Conducive Business Legislation**

There are a number of laws, regulations and by-laws that govern business operations in South Africa. It is this legal framework that is unfavourable as far as starting up an SME is concerned because, for example, the laws relating to commerce and industry have proven barriers. To obtain a licence, there are some capital requirements. However, the capital requirements are way too high to afford and this result in many SMEs not obtaining their business licences. According to SME South Africa (2012), on their first round report on about SMEs, the major regulatory barriers are the inflexibility of labour laws, Broad Based Black Economic Empowerment (BBBEE) and South African Revenue Services (SARS) inefficiencies.

Other constraints experienced relate to the areas of taxation, labour law, business trade, property, land ownership and access to credit.

SMEs are facing problems in accessing global markets. According to Bank SETA (2010), the policy of globalisation is that of being able to supply products adhering to the international standards. Furthermore, the international standards are so high that SMEs with their limited financial capacity will not be able to compete at this level. With all these conditions and complex requirements both in the local and foreign markets, most SMEs are finding it difficult to become competitive. This calls for government intervention to try and create a better and conducive legal environment for SMEs to easily operate. With unemployment rising to 25.5% in the third quarter of

2012 (Statistics South Africa, 2012), the economy needs job creators and so SMEs are important in this issue because they can create job opportunities in the shortest possible time.

#### **2.4.5 Information and Other Technological Problems**

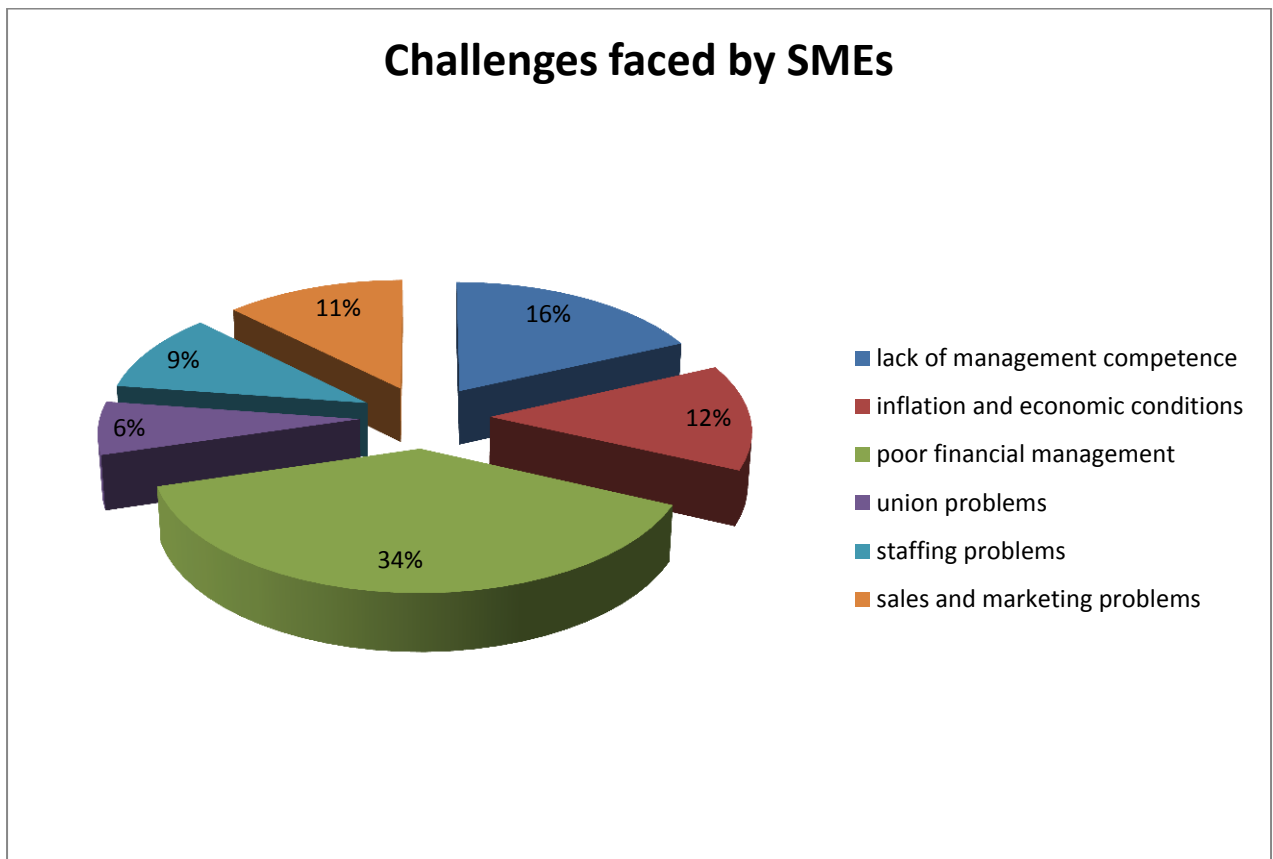
Smit and Watkins (2012), Agyei-Mensah (2011) and Monks (2010) all agree that technological innovations and improvements are important in today's business because proper implementation of this technology will probably reduce total production costs. SMEs are unable to identify technologies that can fit best into their operations because of lack of knowledge.

A lot is happening in the way that businesses are carried out nowadays and one major happening is the incorporation of technological changes into business. According to Nenzhelele (2009), most information technology (IT) has come into play and large businesses can adapt quickly because they have the financial capacity to do so. Nenzhelele (2009) also highlighted that the first challenge for SMEs is to identify technology that is appropriate and relevant to their operations. Literature (Green and Martinez-Solano, 2011; Ndagu and Obuobi, 2010 and Nenzhelele, 2009) shows that many SMEs are not able to identify the technology that is cost-effective for their businesses. Most of the times some give the reason that they did not know that a certain kind of technology is available. In the case that SMEs are able to identify the technology that is relevant for them (of which a few will do), the next challenge is to purchase and invest into such technology. The unfortunate part of it is that many SMEs do not have the financial capacity to do so. Some of the technologies that are relevant and cost effective to SME operations can be obtained from other countries. However, according to Ndagu and Obuobi (2010), SMEs have limited access to these technologies because of the tax and import tariffs associated with buying from outside. These tariffs and other policies are not usually differentiated from those that affect large firms. Financial bases for SMEs are too weak to compete with large businesses.

The other difficulty is the lack of IT literacy and support. Monks (2010) states that many SME owners and managers might have started their businesses out of need to have a sustainable source of income and might not possess all the necessary skills in running the business. According to Nenzhelele (2009) when change like

technology comes, they are usually resistant because they lack the skills and literacy to go with it and this places them in a state where they are not comfortable. Lack of IT skills within the SMEs will force them to look for IT personnel externally. Most of the highly qualified IT personnel are highly demanded and often, are attracted to large businesses where there are better offers. It is very difficult for SMEs to attract good IT personnel because it will be very expensive to hire and retain them (Smit and Watkins, 2012). IT has been proven to be a catalyst in carrying out some things in an organisation. An example can be that IT eliminates the idea of spending the whole day updating and taking stock because all that work is done through bar-coding and auto updates in computer systems. It is therefore advisable for SMEs to take up training so that they can have skilful personnel to handle change and jobs to do with IT (Green and Martinez-Solano, 2011).

**Figure 2.2 Below Summarises the Challenges that are Faced by SMEs.**



*Adopted from: NEDBANK (2011)*

## **2.5 FAILURE RATE OF SMES IN SOUTH AFRICA**

Most SMEs in South Africa fail annually either due to one or a combination of some of the problems and challenges mentioned above. When firms are said to have failed, it is either voluntary or compulsory liquidation. Voluntary liquidation takes place outside the court and the proprietor(s) decides to settle debts with creditors and ultimately close down all business operations. On the other hand, compulsory liquidation can be described as the legal court proceedings against a firm by its creditors leading to liquidation and ultimate business close down.

According to Rungani and Fatoki (2010), more than 90% of small businesses fail in their first year of operation. According to the Head of ABSA's Small Business unit, small business failure rates are as high as 63% in South Africa within the first two years of trading (Rocketlab, 2012). Willemse (2010) points out that an average of 71% of SMEs is not able to make it to a fifth year in operation. This means that less than 5% will still be in operation five years after they have been established. In a study by Willemse (2010), 14 sources were investigated and while eight ascribed the key reason for failure to quality of management, six ascribed it to a lack of access to finance. The financial challenge does not end on the issue of inaccessibility of funds only but it extends to the lack of financial know-how. Some SMEs do not know how to convince lenders and investors to invest in their businesses and others lack the ability to manage the funds that are available to them. In most of these cases, SMEs fail to plan and this testifies to the high failure rate. Planning helps to ensure the viability of the proprietor(s) and their business through being able to identify and mitigate risks as well as realising the business's financial need. This is critical if the success rate of SME has to increase.

According to Rocketlab (2012), a major reason for SME failure is the pride taken in pointing fingers at others when things are not working well. Some SME owners/managers tend to blame the banks, the government, their partners or even customers for the ultimate failure of their businesses. Only a few are able to acknowledge that they themselves may be the cause of their firms' downfall. If responsibility is taken by those who are supposed to, regrets might be limited. Below are the summarised reasons why some SMEs tend to fail to make it into the second, third or fifth year of operation:

- Not accepting reality in the business environment. Some owners tend to be risk adverse, conflict adverse, perfectionists, greedy, self-righteous, paranoid, indignant, or insecure
- Over-expansion, not being able to manage growth
- Not enough demand for a product/service at a profitable price
- Lack of a succession plan
- Poor accounting, lack of cash cushion/guard
- Operational mediocrity and inefficiencies
- Dysfunctional management

Failure means that the procedures, steps and support towards success were not taken or done adequately. The next section highlights on some of the conditions that can enhance the success of SMEs in order for them to consistently and sustainably perform their role in the economy.

## **2.6 CONDITIONS FOR THE MAXIMIZATION OF THE SME CONTRIBUTION**

After realising the high SME failure rate in South Africa, the most interesting question to be asked is: What conditions are necessary to make SMEs reach their biggest potential contribution to a healthy economy? A generic view to this issue is that SMEs must have the chance to develop and grow (Nenzhelele, 2009). The growth and success of SMEs can be measured by considering the firm's profitability, customer base, customer satisfaction, employee satisfaction and owner satisfaction.

According to Monks (2010) one ideal condition for SMEs to operate successfully at full capacity is the well-functioning of markets. In an economy where there are imperfections, say in the capital market, capital and the income from it is concentrated in the larger firms and labour unions are able to bargain for wages much higher than elsewhere in the economy (Ndagu and Obuobi, 2010). With the economy's capital stock almost completely used up by the large firms, there is little remaining capital to be distributed among the many workers not hired by large firms; this produces a large micro enterprise sector that is labour-intensive and the SME sector squeezed out for lack of capital.

On the one hand, large firms as stated earlier, usually make use of very capital intensive technologies, creating jobs only for a few highly paid individuals. On the other extreme end, micro enterprises employ a lot of labour at a very insignificant value of income. SMEs as intermediaries create decent jobs at a reasonable level of capital. According to the UN/ECE Secretariat (2007), tax and import tariffs make the relevant technologies that SMEs want to use to become very expensive. Other policies are created only mindful of large firms and at other times, borrowing ideas from countries of origin (Monks. 2010). All this does not really consider the development of SMEs to the extent that some of these policies impede the conception, growth and expansion of these SMEs.

SMEs in South Africa are at a disadvantage when comparing the same sector with the developed countries. According to Biggs (2008), the SME sectors in developed countries like the United States of America complement large firms or have large firms as their market. In South Africa, SMEs have to compete with large firms for the market of the same product and the result of this is the outwitting of the smaller firms from business. Policies like tax policy need to be revised. Many large firms who have roots/headquarters in developed countries influence legislation because they borrow their ideas from those developed industries. The micro enterprises are normally sympathised with by many governments in developing economies and ultimately will not be affected by the tax and other labour legislation policies. SMEs with their intermediate role in the economy are facing the axe of huge taxes and this usually creates a wedge between gross and net income. According to OECD (2006), one thing to be noted is that SMEs, unlike large firms, struggle to fund their research and development (R&D) costs (with an ultimate impact on gross income). It is therefore important to consider SMEs when drafting the tax policy and other legislative laws that govern business operation.

An example of SME consideration is the stance that was taken by the International Accounting Standards Board (IASB) on 9 July 2009. The IASB issued the International Financial Reporting Standards (IFRS) for SMEs and apparently it is the first 'stand alone' set of accounting standards prepared specifically for the development of SMEs. This IFRS for SMEs was simplified to reflect on the needs of SMEs' financial statements users and also on the cost-benefit considerations. The simplifications in the standard involve:

- Omitting topics that are not relevant for SMEs
- Significantly limited disclosure is required
- The standards are written explicitly in ease-to-translate format and language.
- Simplified principles for identifying and quantifying assets, liabilities, income and expenses.
- Allows the use of an easier option than purely accounting standards.

Some comprehensive training materials are being developed by the IASB Foundation in order to support and enhance the implementation of the IFRS for SMEs. The Foundation and other international development agencies are working together to provide facilitators and instructors to train other trainers on the use of the training material, especially in developing and emerging economies. The training material (initially done in English) will be published in a number of languages to enhance its comprehension.

## **2.7 CHAPTER SUMMARY**

This chapter reviewed literature about SMEs in South Africa. The definition of SMEs in the South African context was given in comparison with other developing and developed economies. Some sections explained the importance of SMEs and how they contribute to the GDP, employment, income distribution, other businesses, and financial markets as well as to the community. The chapter also discussed the challenges that SMEs face in their operations. These were summarised to be financial problems, marketing challenges, technological struggles, non-conducive legal environment and lack of training and support. If these and other challenges are not dealt with properly, they can lead to SME failure. The statistics for such failures in South Africa were given in this chapter. The concluding section in this chapter explained that SMEs can improve and enhance their valuable contribution to the economy if they are exposed to viable conditions and environments. The following chapter (Chapter 3) discusses one of the major challenges faced by SMEs in South Africa; financial management.

## **CHAPTER 3**

### **FINANCIAL MANAGEMENT PRACTICES**



### **3.1 INTRODUCTION**

The previous chapter gave an overview of SMEs in South Africa and also discussed on the challenges that SMEs face and that probably lead to business failure. The challenges included marketing problems, non-conducive legal environment and financial problems among others. Financial problems extend from just the inaccessibility of funds to the deficiency in the management thereof. In other words SMEs are not only in the quest to access funds to finance their operations, but are also struggling to be responsible for the appropriate use of these funds and align the respective efforts and actions to the ultimate goal of maximising the value of the firm. In this chapter the main aim is to explore fully the concept of financial management and its practice in small and medium enterprises.

The early sections of this chapter will focus on the definition of financial management and the many different areas it entails. A perspective on SME financial characteristics is briefly explained. Modern theories that relate to financial management decision-making in SMEs are outlined in this chapter. These theories are: The Pecking Order Theory, The Signalling Theory, The Agency Theory, Relevance Argument and the Owner/manager Capability Argument. Each of these theories is explained and its relevance to SMEs finance is highlighted. This chapter also the financial management practices and how they respectively relate to firm performance. The bases of firm performance are also highlighted. The chapter concludes by exemplifying the government initiatives that help SMEs to enhance their contribution to the economy and to the community. Section 3.2 is centred on defining financial management.

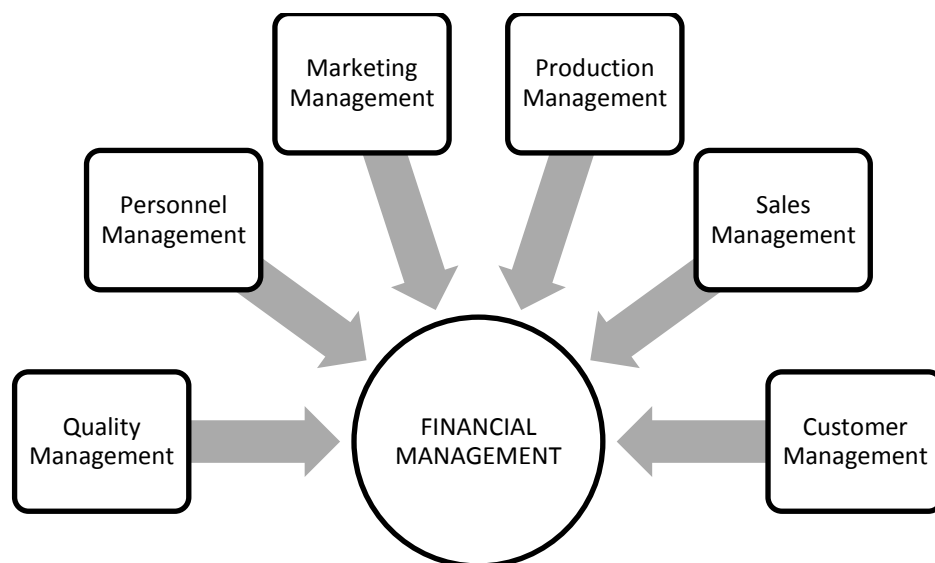
### **3.2 FINANCIAL MANAGEMENT DEFINITION**

The purpose of this study is to investigate into how financial management is practiced among SMEs and how it affects firm performance. It is therefore important to first analyse the concept of financial management. Nieman, Hough and Nieuwenhuizen (2006: 95) define financial management as a function responsible for putting together the necessary financial resources of a firm to ensure that the most beneficial results over both the short and the long term are obtained and to make sure that the firm channels these financial resources to the best of use. According to Odaware and Deloitte (2010), financial management is a careful, informed planning

for the future to ensure the generation of positive cash flows. It also involves the administration and maintenance of the financial assets of a firm as well as identification and management of risk. The ultimate goal of financial management is to maximise the value of shareholders' wealth. In other words it is to maximise the current value of the existing stock. This stock/share value is affected by projected cash flows to shareholders, timing of the cash flows and the risk of generating the cash flows. It is therefore the duty of the financial manager to ensure that the financial resources are managed properly to achieve the goal of financial management.

According to Firer *et al.* (2004: 3), financial management answers three questions. The first one is the making of investment decisions by appraising each alternative (capital budgeting). Secondly, financial management answers the question on how to fund the day to day operations of the firm (working capital management). Lastly, the firm need to plan on the type of funds to be used (finance mix/capital structure). Harif and Osman (2006) added that apart from capital budgeting, working capital management and capital structure, financial management also involves financial planning and control as well as financial accounting and analysis. Before the various areas of financial management can be discussed, it is important to note that financial management plays a very central role in relation to other functional areas of a business (Nguyen, 2001). This role is summarised by figure 3.1 below.

**Figure 3.1 Central Role of Financial Management**



Adopted from Nguyen (2001)

The different aspects that financial management addresses are discussed in the following sections. Section 3.2.1 discusses capital budgeting.

### **3.2.1 Capital Budgeting**

According to Agyei-Mensah (2011), capital budgeting is one of the most important responsibilities of owners and managers of SMEs. Capital budgeting (also known as investment appraisal) according to Oduware and Deloitte (2010) is the process of planning and managing a firm's long term investment. It can also be described as the planning process that is used to determine whether a firm's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects are worth pursuing. Capital budgeting processes require that the relevant cash flows that will rise as a result of investment be measured and the appropriate capital budgeting techniques are applied to decide whether or not the investment project should be accepted (Gitman, 2010: 376). There are a number of techniques that can be used in capital budgeting which can be categorised into non-discounted cash flow techniques and the discounted cash flow technique.

According to Firer et al. (2004: 5) the non-discounted cash flow techniques are the payback period technique, the profitability index and the accounting rate of return. When using the payback period, each project under evaluation will be considered according to how quick it can return the value of the investment (CIMA, 2000). Precisely, it is important to consider the time it takes for the cash flows generated from each investment to equal the cost of the investment. When making the investment decision, the investment with the shortest payback time is accepted. Investors usually consider payback as the first screening method. The profitability index identifies the relationship between investment and its payoff on every proposed project. It is also referred to as the benefit cost ratio where the present value of each investment alternative is divided by the estimated cost of making such an investment. An investment proposal is acceptable if its profitability index is greater than one. Accounting rate of return measures each alternative project on its after-tax income in relation to its average book value. This method ranks alternative

investments proposals based on average income and accounting data rather than the projected cash flows.

On the other hand, the discounted cash flow analysis gives the opportunity to evaluate an investment by estimating its future cash flows and taking into account the time value of money (Brigham and Daves, 2004: 22). The discounted cash flow techniques are the discounted payback, the net present value (NPV) and the internal rate of return. The discounted payback period considers the time it takes for a project to pay off the equivalence of the investment after subjecting the cash flows to the discount factor (cost of capital). Just like the non discounted payback method, the project with the shortest payback time is accepted. When evaluating each proposed project using the net present value, the present value of cash flows is discounted at the cost of capital and less the initial outlay. The project with the positive net present value is chosen and in the case where all alternatives have positive NPV, the one with the highest positive NPV is chosen.

The internal rate of return (IRR) can be defined as the discounting rate that gives an NPV of zero. In fact, the method equates the present value of the future cash flows to the present value of the cash flows. In other words, it measures the investment efficiency. This is a capital budgeting method which uses discounted cash flows in order to decide on the viability of long term investments. If the IRR is greater than the project's cost of capital or hurdle rate, (the required rate of return in a discounted cash flow analysis) the project will add value to the company.

Long term investment decisions can be made and best projects to pursue can be executed, as explained in capital budgeting, but it is the day to day operations that complement the success of these investment decisions and projects. It is therefore the aim of section 3.2.2 to explore the issues around the day to day running of the business, working capital management.

### **3.2.2 Working Capital**

Phenya (2011) defines working capital as the investment in short-term assets like cash, inventory and accounts receivable. The management of working capital therefore involves decisions to determine the extent to which the current liabilities should be used to finance the firm's current assets (Marx *et al.* 2010: 183–184).

According to Odaware and Deloitte (2010), working capital management are decisions that involve managing the relationship between a firm's short term assets and its short term liabilities. The major goal of working capital management is to ensure that the firm is able to continue and sustain its operations and that it has adequate cash flow to satisfy both maturing short-term debt and upcoming operational expenses. Working capital management involves making decisions on cash management, inventory management, debtor management and short term financing.

Phenya (2011) states that cash management involves identifying the cash balance necessary for the business to meet its day to day expenses but at the same time reducing the cash holding costs. Under inventory management the same procedure should happen. The decision is made on the level of inventory that must be available to meet the day to day uninterrupted production and this reduces the investment in raw materials as well as minimising the re-ordering costs. A process like this will definitely amount to the increase in cash flow. Debtor management involves the identification of the appropriate credit policy which will attract more customers. Here the belief is that any impact on the cash flow will automatically be set off by the increase in revenue. Short term financing decisions are made on identifying the most appropriate source to finance the current assets given the cash conversion cycle. For example, inventory can be financed by credit from suppliers. However, it may be necessary to utilise a bank loan/overdraft or through debt factoring.

In managing working capital, firms usually adopt two policies, the aggressive policy and the conservative policy. On the one hand, adopting the aggressive policy of minimising working capital investment would positively enhance the profitability of the firm by reducing the ratio of its total assets in the form of net current assets (Wang, 2002). However, excessive reduced inventory levels risks the firm losing increases in sales. The same applies to a significant reduction of trade credit granting where the firm may lose sales from customers requiring credit. Prolonged delay in paying up debts from suppliers may risk losing out on early payments discounts.

On the other hand, adoption of the conservative policy of investing intensively in working capital may also result in increased profitability. The maintenance of high inventory level:

- guards against production hiccups and possible loss of business due to product unavailability
- reduces supply costs
- Protects against price dynamics.

Lenient trade credit terms can be an effective price cut and can incentivise customers to buy more hence increasing profitability through increase in sales. However, the heavy investment in working capital may tie down a lot of cash in inventory and in debtors. This might reduce the firm's real profitability.

### **3.2.3 Capital Structure**

According to Odaware and Deloitte (2010) capital structure can be described as the way a firm funds its assets through some combination of equity, debt or hybrid securities. In other words, the firm's capital structure is the composition of its liabilities. Rungani and Fatoki (2010) emphasise that capital structure is the specific mix of debt and equity a firm uses to finance its operations and activities. These sources of finance are used to acquire the resources most needed for business and projects continuity.

Basically, capital structure consists of long-term debt, preferred stock, and net worth. It can be quantified on the basis of how much of each type of financing a company holds as a ratio of all its financing. It can also comprise of short-term debt, accounts payable, and other liabilities. Most firms raise their funds by equity or debt. Equity is the residual claim or interest of the most junior class of investors in assets, after all liabilities have been paid. There are a number of sources of equity. Firstly, there are the owner's funds that the owner invest to enable the commencement of operations and this creates liability for the business since the business is usually a separate entity (Baker and Wurgler, 2002). The other sources of equity are the retained earnings, venture capital and business angel finance.

Debt is any financing medium that has a contractual claim, tax deductible payment, fixed life and has priority on cash flow in both operating and bankruptcy periods.

Sources of debt finance include bank overdrafts, term loans, leasing, factoring, hire purchase, trade credit and credit cards. Both the financing has advantages and disadvantages over each other. The founders maintain their ownership rights and control of the firm if they raise capital by debt. However, the firm has to pay the principal and interest to the concerned debt holders. This privilege of ownership rights will be lost in equity, as the shareholders become an integral part of the company. Debt financing is easier and less expensive for SMEs. The payment of interest on a regular basis creates a burden for the firm and reduces their earnings. There is no obligation in equity financing to repay the principal. Shareholders take a chance on good ideas for better growth opportunities of the firm.

### **3.2.4 Financial Planning and Control**

According to Kieso, Weygandt and Warfield (2007: 1320), financial planning involves a business taking a series of steps or goals which their progressive and cumulative attainment are designed to ultimately achieve the firm's financial goal or circumstance. This usually includes a financial budget and an operational budget. A financial budget organises the firm's finances including setting goals of spending and saving future income. An operating budget is the annual budget of an activity stated in terms of functional/sub functional categories and cost accounts. It provides estimates of the total value of resources required for the performance of the operation including services for other operations. It also includes estimates of workload in terms of total work units identified by cost accounts.

This financial plan distributes future income or the expected funds to various types of expenditure and also reserves some income for short-term and long-term savings and investments. A financial plan sometimes refers to an investment plan, which allocates some funds to various assets or projects expected to produce future income, such as a new business or product line. A financial plan can also be an estimation of cash needs and a decision on how to raise the cash, such as through borrowing or issuing additional shares in a company (Sealy and Hooley, 2009). The Financial Planning activity involves the following tasks;-

- Assess the business environment
- Confirm the business vision and objectives

- Identify the types of resources needed to achieve these objectives
- Quantify the amount of resources
- Calculate the total cost of each type of resource
- Summarize the costs to create a budget
- Identify any risks associated with the budget

### **3.2.5 Financial Accounting and Analysis**

Kieso *et al.* (2007: 1320) state that financial accounting involves the preparation of income statement, balance sheet and cash flow statement. These financial statements are prepared to be used by stockholders/owners, suppliers, banks, employees, government agencies and other firm stakeholders. The fundamental need for financial accounting is to reduce the principal–agent problem by measuring and monitoring agents' performance and reporting the results to interested users. Financial accountancy is regulated by both local and international accounting standards. The objectives of financial accounting are:

- To know the results of the business
- To ascertain the financial position of the business
- To ensure control over the assets
- To facilitate proper management of cash
- To provide requisite information

According to Ehrhardt and Brigham (2008: 131), financial analysis (also referred to as financial statement analysis) involves the assessment of the viability, stability and profitability of a business, sub-business or project. It is done through preparing reports using ratios that make use of information taken from financial statements and other reports. These reports are usually presented to top management as one of their bases in making business decisions. The ratios are categorised into determining the profitability, solvency, liquidity and stability of the firm. Profitability refers to the firm's ability to earn income and sustain itself both in the short and long run. Solvency refers to the ability to pay obligations to creditors and other parties in the long term. Liquidity is the ability of a firm to maintain a positive cash flow, while satisfying immediate obligations. Stability of the firm refers to its ability to remain in



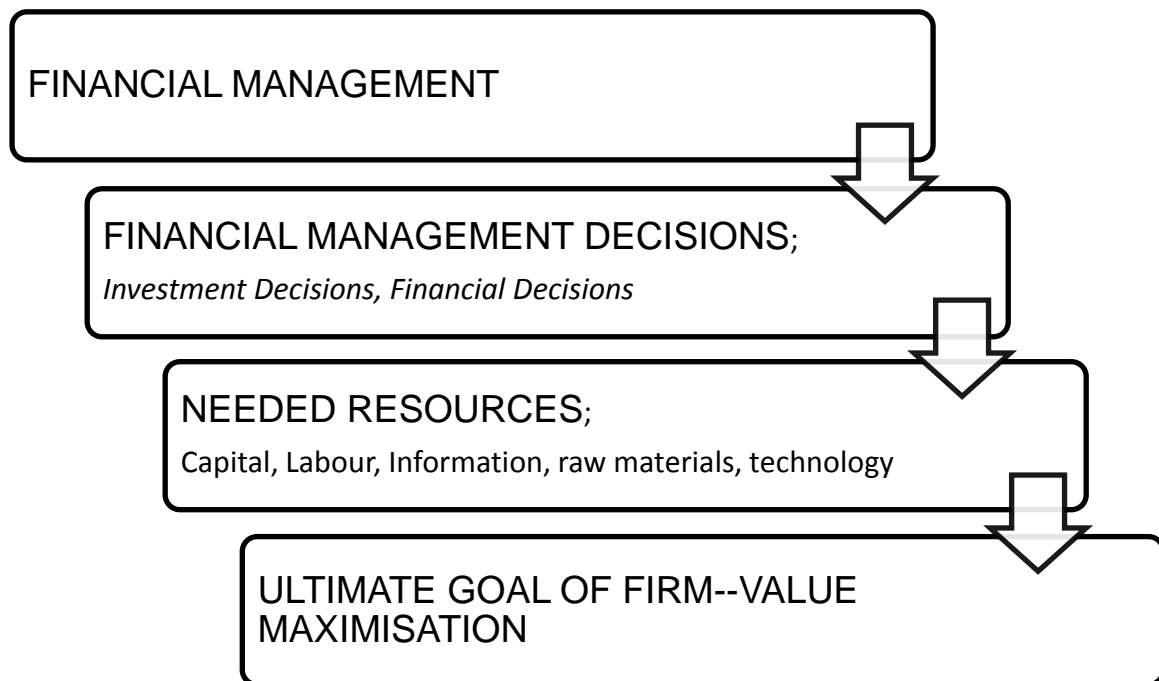
business in the long run, without having to sustain significant losses in the conduct of its business. Assessing a company's stability requires the use of the income statement and the balance sheet, as well as other financial and non-financial indicators.

### **3.2.6 The Objectives of Financial Management**

Financial management, as eluded by Nguyen (2001), is a management science and therefore goals and objectives must be set for this management science so that they act as foundations for easy evaluation on efficiency and effectiveness of financial management. The general or ultimate goal of financial management is to maximise the value of the firm. This goal can be described in the line of stock value where ultimately shareholder or owner value has to appreciate thereby increasing the total value of shareholder/owner wealth (Ahmad, 2012). Some specific objectives can be set in order to help achieve this ultimate goal. The specific objectives that are usually quoted among others are: profitability and liquidity. Profitability refers to the ability to maintain and increase a firm's earnings by focusing on cost control, pricing policy, sales volume and capital expenditure. This objective is usually based on the recorded accounting information and therefore may not be reliable enough, hence, it can be considered together with the liquidity of the firm. Liquidity as an objective refers to the ability to pay maturing short term and long term obligations. A business might be profitable but unable to pay up maturing debts because of liquidity problems. It is therefore important to analyse the profitability objective in light of how liquid a firm is. Liquidity also emphasises on the minimisation of idle cash balances.

In the making of financial management decisions, SMEs then, need therefore to put into consideration these objectives and balance between profitability and liquidity so that ultimately, the major goal of financial management can be achieved. It is also important to note that for the effective attainment of financial management goals and objectives, resources necessary for its implementation must be available. The resources include capital, labour, raw materials, technology and information. The figure (3.2) below summarises the whole process of attaining the ultimate goal of financial management by making the right decisions and making use of the appropriate resources.

**Figure 3.1 Financial Management Objectives**



Source: Developed for this Study

### **3.3 THE SME FINANCE FUNCTION**

Previous studies such as by Ahmad (2012), Agyei-Mensah (2010) and Whonderr-Arthur (2009) have concurred that differences exist between large firms and SMEs' financial characteristics. Generally, in large companies, the main goal of financial management is that of maximising the value of the firm as reinforced by two specific objectives of profitability and liquidity. However, the case might be different for SME finance. Here, the goal is not entirely channelled to the maximisation of firm value but rather, it is for both the firm and the owner. This is because literature has it that in SMEs managers are usually owners. Zoppa and McMahon (2003) argue that SMEs view the issue of survival as important as to supercede the goals related to the ideal financial practices. This is usually because of the capital rationing and the liquidity problems that are prominent in SME operations.

In the instance of large firms, there are different functions that are operated by different people with respective expertise. Large firms also possess the resources to employ the sophisticated systems and techniques in the quest to achieve the

ultimate goal of value maximisation. In SME finance, however, it is the owner manager who is responsible for the running of every function of the business including the finance function. Unfortunately, the SME owner/manager might not be well acquainted with all areas and hence end up improvising to get things done. To this end, SMEs might not make use the sophisticated methods to execute the ideal financial management practices. There are a lot of other characteristics of SMEs that makes them different from the larger firms. Some of the characteristics include the following:

- SME owner-managers may have strong inclination for finance sources that minimise the idea of business intrusion.
- There is generally strong willingness to take up financial risk among SMEs.
- SME capital structure may constitute more of debt especially short-term debt because they usually rely on current liabilities to fund their operations.
- The financial profile of SMEs is dependent on its stage of development in the context of the business cycle.

After explaining the meaning of financial management and the financial characteristics of SMEs, it is important to know how it (financial management) is practised among businesses. The theoretical background usually gives a reflection on how something can occur in practice. Hence, section 3.4 gives an overview of the theories that govern the making of financial management decisions in the business environment. The relevance of each theory to the SME sector finance is also explained.

### **3.4 THEORETICAL REVIEW OF FINANCIAL MANAGEMENT**

The theories that are used in this study explain generally how the task of financial management is carried out in the firm. However, the relevance of each theory to the financial management functions of SMEs is also explored. The Pecking Order Theory, the Signalling Theory and the Agency Theory are used to describe the behaviour of firms in dealing with their finance tasks. Section 3.4.1 explains the Pecking Order theory and how it applies to SME finance.

### 3.4.1 Pecking Order Theory

The Pecking Order Theory as proposed by Myers (1984) states that firms prefer to finance new investment; first, internally with retained earnings, then with debt, followed by hybrid forms of finance such as convertible loans, and finally with an issue of new external equity; bankruptcy costs, agency costs and information asymmetry playing a very minute role in affecting the capital structure policy. Myers argues that an optimal capital structure is difficult to define as equity appears at the top and the bottom of the capital composition hierarchy.

Internal funds are more preferable because they incur no flotation costs and require no disclosure of the firm's financial information (Whonderr-Arthur, 2009). This information may consist of the firm's potential investment opportunities and the expected respective cash flows to accrue as a result of taking up such investment projects. The Pecking Order Theory tries to explain why most profitable firms use internal financing. The obvious reason for this is that they do not need to make use of external funding. However, the other extreme, which are businesses with less profit, do not possess enough internal capital and have to seek for external funding (Myers, 1984: 592).

The following points give a summarised overview of the Pecking Order Theory as provided by Myers (1984, 581):

- Firms prefer internal finance.
- Unpredictable fluctuations in profitability and investment opportunities mean that internally generated cash-flow may be more or less than investment initial outlays. When it is less, the firm first utilises its cash balance or marketable securities portfolio.
- If external finance is required, firms first issue the safest and less risky security. That is, they start with debt, then possibly hybrid securities such as convertible bonds, and perhaps external equity as a last resort. However, there is no well-defined target debt-equity ratio, because there are two kinds of equity, internal and external, internal at the top of the pecking order and external at the bottom. Each firm's observed debt ratio reflects its cumulative requirements for external finance.

### *Relevance to SMEs*

According to Zoppa and McMahon (2003) business firms of all sizes select their financial structure depending on the cost, nature and availability of the type of finance. In fact capital structure is a function of the characteristics of the firm and its owners or managers' attitude towards risk. Lopez-Garcia and Sogorb-Mira (2008) concluded that compared to large firms, most SMEs are not listed on the national or state stock market and therefore are prone to information asymmetry. It is consequential to this that transaction costs for SMEs become very high when they seek financing.

In most circumstances, SME owners are usually the managers and they are very unwilling to share the control of their enterprises. Due to their unwillingness to share control, the owner-managers would prefer to finance their operations and activities using those sources of finance that are less likely to dilute their control and ownership. Thus, they generally prefer internal equity and then external debt which does not give less control of the firm. The costs of information asymmetry that arise between owner managers and external investors are very crucial to SMEs because they pronounce the differences in costs of internal equity, debt and external equity to be greater. According to Ghatak (2012) the Pecking Order Theory now provide for new or additional investments/contributions by owners to fund new projects and other business activities. Ghatak (2012) also adds that the relationship between the debt ratio and firm liquidity is negative and therefore SME capital structure follows the Pecking Order Theory because they prefer to have excess cash to fund discontinuities in operations.

Section 3.4.2 explains the Signalling Theory and how it is relevant to SME finance.

#### **3.4.2 Signalling Theory**

The seminal work of Spence (1973) resulted in the development of the signalling theory in the financial sense. According to the Finance Dictionary (2012) the signalling theory is based on the assumption that information has a cost and is not equally available to all parties at the same time. This is the reason why the markets are rarely in equilibrium. Hence there is need to transfer and interpret information at hand about the firm to the capital market. The theory states that corporate financial

decisions are signals that are sent by the firm managers to investors in order to undo all the information asymmetries. These signals are very vital for the creation and implementation of financial communication policy. Financial communication is a very key determinant of the cost of capital and therefore the firms must disclose full, timely and relevant information concerning their financial circumstances. Precisely, the flow of funds from the capital market to the business enterprise depends on the flow of information between them.

The underlying assumption of signalling is that when a firm changes its capital structure or any other thing that formulates the financial function, its market value is likely to change accordingly, resulting in the change of the firm's degree of systematic risk (Eldomiatry, Ju Choi and Cheng, 2007). An aggressive borrowing strategy sends a positive signal to the market. In this case, managers are believed to be showing their belief that the future cash flow of the firm will be sufficient to meet the firm's financial commitments. If managers are wrong the firm suffers the risk of going bankrupt and the costs thereof.

#### *Relevance to SMEs*

The emerging literature and evidence on the relevance of signalling theory to SME financial management is showing mixed perspectives. Most SMEs are not listed on the stock exchange and therefore they do not have compulsory signalling to the investors and other stakeholders. The SMEs have to choose to signal some information to stakeholders depending on what they desire to do at a particular time as well as what the stakeholders wish to know. SMEs are able to signal their earnings forecasts because these forecasts are significantly related to enterprise value. Nowadays investors and creditors like financial institutions require business plans that are particularly prepared for specific requests. It is through this process that the outside stakeholders in the capital market are able to detect signals and know some information about a firm. It is only now that the signalling theory is considered to be more insightful for some aspects of SME financial management as much as other theories do.

The Agency Theory and its applicability to SME finance is discussed in section 3.4.3.

### **3.4.3 Agency Theory**

Agency theory was developed by Jensen and Meckling (1976) and it deals with the people who own the business and those that are interested in it. Sealy and Hooley (2009) explain that this theory was developed from the law of agency which deals with a set of contractual, quasi-contractual and non-contractual relationships that involves a person/agent who is authorised to act on behalf of another person (principal) to create a legally binding relationship with a third party. According to Whonderr-Arthur (2009), the agency theory deals with the owners of the business and all those who have interests in it, for example, managers, employees, suppliers and other creditors. The agency theory explains that managers are appointed as agency to take care of the day-to-day running of the firm on behalf of their principals, the owners. It is also based on the notion of two-sided transactions whereby two parties act in the best of their interests but have different expectations. This arrangement works well when the agent is an expert on the things he/she is supposed to do and really understands the interests of the principal. According to Bergo and Bonaccorsi di Patti (2006), the separation of ownership and control may lead to managers exerting insufficient work effort, indulging in perquisites and choosing operation strategies that satisfy their interests and ego. This deviation from the principal's interest by the agent is called agency costs. These problems are a result from information asymmetry, moral hazard and adverse selection.

Information asymmetry exists when agents possess information on the financial status and prospects that principals know not of (Whonderr-Arthur, 2009). Consequently, managers take advantage and redistribute wealth to their utility. It is advised in this theory that agents should not mislead or misinform owners about the firm and its financial circumstances. Moral hazard occurs when agents knowingly or deliberately redistribute wealth and financial resources among themselves in a subtle manner that is detrimental to the principals. Adverse selection arises when agents misrepresent the skills and abilities they bring to the firm. In other words, adverse selection occurs when the principal is unable to verify that the agent is as qualified as he/she represents (Mole, 2002). This, then, leads to agents not achieving the goal of maximising shareholders' wealth. Another problem is that known as hold up. This is when an agent tries to renegotiate the contract after other parties (principal) have already made investments basing on the existing relationship.

In order to reduce the inherent risk posed by agents to the disadvantage of their principals, principals/stakeholders resort to various mechanisms to align the interests of the agents with those of the principals. Mole (2002) suggests that contractual methods may be used to overcome the adverse selection and agency problems. The contract can be specified to bring the incentive for the principal to try and manage their interests in line with those of the agent. If the principal and agent work together often, then the drive for the agent to act as an opportunist is mitigated, because opportunistic behaviour threatens the credibility of the agent to be considered for future contracts. Some stakeholders increase the rewards they expect as return to their investments and involvement with the firm. Creditors may increase the interest rates on their funds that are tied down by the firm. This causes agents/managers to work effectively to generate more cash flow in fear of liquidation. In the case of employment, employers may use piece rates or commissions and performance measurement through financial statements review. Monitoring and bonding may be used to increase the principal's access to reliable information.

#### *Relevance to SMEs*

In many SMEs around South Africa and the globe at large, owners are usually managers usually due to the size and financial situation of their businesses. Given such a background, the agency relationship between managers and owners may not entirely exist rendering the agency theory to be more applicable to large firms where the separation of ownership and control exist. In the case where there is divorce of ownership and control, the mechanisms to solve agency problems like bonding and monitoring become very expensive thereby increasing the cost of transactions between various stakeholders. On the positive side, the agency theory provides valuable information on how SME financial management function can be handled and this ultimately helps sustain SMEs.

As has been stated earlier, financial management also focuses on how firms report their financial progress; maybe by using financial statements. Sections 3.4.4 and 3.4.5 discuss the Relevance Argument and the Owner/manager capability Argument. These two describes how financial accounting is handled in SMEs.



#### **3.4.4 The Relevancy Argument**

According to the relevancy argument, cost information plays a primary role in a range of business issues and related business processes. These business processes incorporate the determination of long term business plans, short term plans, performance monitoring and assessment of both business projects and the managers. Cost reduction is aimed at increasing the firm's competitiveness. In enhancing cost reduction, some accounting practices have been adopted by businesses and some accounting boards have set some accounting practice standards. However, research has it that these accounting practices have been set more suitably for the context of large firms with well defined management hierarchy.

Some researchers recommend the modification of these accounting practices and transfer them from larger businesses until they become relevant to the SME context. The International Accounting Standards Board (IASB) issued the International Financial Reporting Standards (IFRS) for SMEs and apparently it is the first 'stand alone' set of accounting standards prepared specifically for the development of SMEs. This IFRS for SMEs was simplified to reflect on the needs of SMEs' financial statements users and also the cost-benefit considerations.

Most SMEs end up adopting some methods of reporting their financial information depending on how the methods apply to the situation of their businesses. This is the reason why some SMEs have been reported to be deviating from sound financial reporting systems. Other reasons may be that the SMEs might not be in possession of the rightful resources to implement the standardised practices, thus they lack highly skilled personnel and even the funds to invest into accounting software. According to Berry (2002), the problem is that some SMEs still cannot prepare the basic financial statements to help them make decisions.

The next two sections (3.4.5 and 3.4.6) discuss the arguments on how financial accounting is implemented in the firm with special reference to SMEs.

#### **3.4.5 The Owner/Manager Capability Argument**

According to Berry (2002), the way that firms practice certain behaviour and put up certain systems into action may depend on the skills, preferences and ability of the owners/managers. Managers and/or owners sometimes implement certain actions

and policies only because they are able to do thus far. The owner/manager argument is based on the notion that there are levels of ability starting from the manager who does not have clear understanding, followed by the competent manager and lastly the sophisticated manager.

The manager who lacks understanding causes a gap to exist between accounting theory and practice. This is due to the fact that the manager rejects or snubs the sophisticated accounting techniques because of he/she is unable to comprehend their applicability and usefulness. There is evidence of managerial lapses even when it comes to financial analysis. In addition, the manager tends to listen more to what is happening around rather than the implementing the right practices in reporting financial progress. The manager also ignores new techniques and sticks to those traditions that could have worked in the time past. Becoming aware of the things that are important to the cost effectiveness of a business at a very late stage is sheer risking the success of the business.

The transition from being unaware to becoming competent is problematic. What needs to be explored and understood here is how managers handle new ideas and techniques. The competent manager is aware of the sound ways and practices that can help in the decision making and sustainability of the business. The manager, in this case maps the different types of practices according to the business life cycle. When the manager makes use of the techniques he has understanding and knows the relevance of each technique.

Lastly, there is the sophisticated manager who is perceptive about the business and is very aware about the use of accounting techniques and how they help in decision making and action. This kind of manager does have awareness, understanding and competence.

The current study has the objective of aligning financial management to firm performance. It is therefore necessary to discuss the basics of firm performance and the indicators that can help measure it for the purposes of this study. Section 3.5 explains firm performance.

### 3.5 FIRM PERFORMANCE

Firm performance maybe described as the profitability that a firm can attain in a certain period of time given the human, financial, capital and other resources the firm has in possession. The basis of performance in most firms is the consideration of some of the factors that are exhibited in the table 3.1 below.

**Table 3.1 Performance factors**

<b>FACTOR</b>	<b>FACTOR ATTRIBUTES</b>
<b>Quality</b>	Product quality, process quality, defects scrap suppliers
<b>Time</b>	Work in progress, output lead time, delivery time
<b>Finance</b>	Profit, costs, cash flow, productivity expenditure
<b>Customer Satisfaction</b>	Product usage, service, returns complaints, user problems
<b>Human Resource</b>	Staff safety, staff turnover, personnel quality

Source: Ahmad (2012).

According to Ahmad (2012), financial performance is very crucial to the overall performance of the firm because for the other non-financial functions to produce excellent quality output there has to be the financial resource to do so. It is therefore the duty of the financial management function to make sure that the appropriate and adequate budgets are available for other non-financial functions to perform well (Anon, 2009).

Many businesses usually measure their performance for different reasons. Performance measurement can be defined as the process of quantifying the efficiency and effectiveness of the different actions that the firm would have taken. Businesses do performance measurement in order to:

- To monitor and control
- To drive improvement

- To maximise the effectiveness of the improvement effort
- To achieve alignment with organisational goals and objectives
- To reward and to discipline

The general performance of the firm can be measured using different performance indicators. The Table 3.2 below shows some different indicators across industries.

**Table 3.1 Performance Indicators**

<b>Retail</b>	<b>Service</b>	<b>Banking</b>	<b>Mining</b>
Capital expenditure,	New customer attraction,	Customer retention,	Capital expenditure,
Store portfolio changes	Customer retention,	Customer penetration,	Exploration success rate,
Return on new stores,	Service portfolio change,	Asset quality,	Mineral deposit discovery,
Customer satisfaction	Customer satisfaction	Capital adequacy, Loan loss	Customer retention

Source: Adapted from Pricewaterhousecoopers (2007)

Financial performance measurement can specifically be done to level out discrepancies on profit, growth and control as well as to achieve a balance between liabilities payouts and revenue income. When measuring a firm's financial performance, the most common indicators include turnover: cash flow, revenue, return on assets, return on equity as well as payments of liabilities. The financial performance is very important and hence the next section assesses how the financial management practices influence SME performance.

Section 3.6 below gives the review of literature on the relationship between financial management and firm performance.

## 3.6 FINANCIAL MANAGEMENT PRACTICES AND SME PERFORMANCE

### 3.6.1 The Context of Financial Management Practices

Financial management practices, especially of the SME sector, have become central in many research contexts. Ahmad (2012) and Nguyen (2001) summarised financial management practices among SMEs in USA, Malaysia and Australia and the practices include the following

- *Accounting information system*- involves the nature of record keeping system especially use of computer systems in today's businesses
- *Financial reporting and analysis*- the frequency and purpose of financial reports preparation, analysis and interpretation of financial information that is reported
- *Working capital management*- management of day to day financial needs
- *Capital structure*- financial leverage and gearing, sources and uses of funds
- *Financial planning and control*- cost-benefit analysis, pricing, financial budgeting and control
- *Financial advice*- used of both internal and external advice, public accounting service
- *Investment or capital expenditure*- budgeting for bigger expenditure, decision making using appropriate techniques
- *Financial management expertise*- relevant training in financial management both formal and informal education.

However, in this study, the purpose was not to analyse all financial practices as indicated above but only selected practices are explored according to their relevance to the South African SME operation. The selected practices for this study are capital budgeting, working capital management, capital structure, financial reporting analysis and interpretation. According to Agyei-Mensah (2011), most business firms, especially large ones, employ the sophisticated practices of financial management. SMEs also employ these financial management practices be it consciously or unconsciously. A vast body of literature like Agyei-Mensah (2011), Ciuhureanu, Baltas and Brezai (2008), Harif and Osman (2006) and Deakens, Morrison and

Galloway (2002) posits that the implementation of sound financial management practices enhances the performance of a firm. For the reason that deficiencies in financial management cause failure, it is common knowledge that sound financial management practices may increase the probability of a firm's success. This is because financial management offers the possibility to plan the way to achieve the firm's objectives, to cover a well-defined path and to take advantage of new opportunities.

It is important to relate each component of financial management to a firm's performance so that the role of financial management in enhancing the firm's performance can be fully explored. Section 3.6.2 starts by reviewing capital budgeting.

### **3.6.2 Capital Budgeting Vs Firm Performance**

According to Fatoki, Okubena and Herbst (2010), capital budgeting is a process that is modelled to achieve the greatest firm profitability and cost effectiveness. Agyei-Mensah (2011) agrees and asserts that the ultimate success of the firm is enabled by the use of sound capital budgeting techniques. Literature has it that some SME owner-managers agree that the use of investment appraisal techniques has a significant positive impact on their firms' profitability. SME owners must therefore get more training and skill development in order to use the techniques accurately.

However, some studies contend with the idea that use of sophisticated capital budgeting techniques enhances a firm's performance. Ekanem (2005) states that sophisticated capital budgeting techniques are neo-classical and are more relevant to the larger firms. Employment of these techniques will result in losses because the SMEs have to hire expensive skilled personnel or spend more funds on getting training and consultation. SMEs' way is to adapt to their situation and use past experience and advice from peers to get the most out of the funds they have to dispose in terms of investment.

### **3.6.3 Working Capital Management Vs Firm Performance**

Working capital management is a significant area of financial management, and its administration or management has a significant impact on the profitability and liquidity of the firm (Garcia-Teruel and Martinez-Solano 2007). Literature review like Agyei-Mensah (2012) and Azam and Haider (2011) shows that working capital

management has significant impact on SMEs performance and it is concluded in the study by Kahinde (2012) that owner-managers can increase the value of their wealth and return on asset by reducing their inventory size, cash conversion cycle and net trading cycle. Increase in liquidity and the time period to pay up suppliers will also lead to firms' overall performance. Kehinde (2011) also posits that the effective management of working capital in SMEs is very pivotal to their solvency and liquidity.

Despite the importance of working capital management in enhancing SME performance, some SMEs are still failing. Literature has consistently referenced inadequate working capital decisions and accounting information as causes of SME failures. Agyei-Mensah (2012) asserts that some firms do not manage their working capital as expected and this has affected the viability of their businesses. Firms fail because they do not maintain sufficient liquidity. SMEs rely on manual methods of inventory and the majority do not know anything about economic order quantity. Credit management in some SMEs falls beyond best practice. Poor working capital flow precludes SMEs from competing effectively.

#### **3.6.4 Capital Structure Decisions Vs Firm Performance**

Berger and di Patti (2004) point out that leverage affects agency costs and thereby influencing a firm's performance. The choice of capital structure mitigates agency costs. Higher leverage mitigates conflicts between shareholders and managers concerning the choice of investment and the amount of risk to take. Margaritis and Psillaki (2010) state that high debt ratios also help increase the value of the firm by exerting pressure on managers to generate more cash flow in order to service the debts in terms of interest payments.

Abor and Bielpel (2009) argue that on the contrary highly profitable firms tend to rely more on internal funds than external debt and hence have a low debt ratio. In addition, Berger and Di Patti (2004) affirm that relatively high leverage may impound on the firm's financial stability because conflicts may arise between debt holders and shareholders. In the end, managers reduce efforts to control risk, resulting in higher expected costs of financial distress, bankruptcy or liquidation. Other studies like Stock (2010) and Baker and Wurgler (2002) have shown that an increase in the issue of external equity reduces the value of the firm's shares causing the reduction of shareholders' or owners' wealth.

SMEs are usually characterised by using their retained earnings and owners funds (internal equity) and short-term debt. As much as this is less costly than other sources of capital, SMEs usually face the challenge of having inadequate funds to finance their existing operations and the potential proven-to-be-profitable new projects. Owners and managers will have to therefore make the decision on the proper finance mix to take. From a survey of 398 small and medium-sized enterprises by Baker and Wurgler (2002), it was observed that the growth of SMEs depends mainly on access to finance and firm size. Access to finance for SMEs is captured through access to overdraft facilities, line of credit and self reported measures of access to finance.

### **3.6.5 Financial Planning and Control Vs Performance**

Augustine, Bhasi and Madhu (2012) describe a strategic plan and a strategic planning process to have the ability to offer competitive advantage to the firm. They added that formal planners, especially large firms, are better performing than informal planners. SME profitability and goal accomplishment are positively related with planning detail and formal budgeting techniques. Kraus *et al.* (2006) is of the opinion that the higher the degree of planning horizon, the more successful is the SME. Many research findings indicate the positive relationship between planning and firm performance. Financial planning and control provides internal guidance in planning, steering and monitoring, value creation and external guidance in supplying stakeholders with key corporate information.

SMEs on the other hand prefer informal procedures, comparatively lesser amount of written documentation and use of simple measures of planning intensity. The findings of the study by Geiss (2003) show that there is no correlation between the level of planning activities carried out by a firm and the performance of the firm as measured by the Return on Assets, the Return on Equity, and the Net Interest Margin. The findings also show no correlation between the level of planning carried out and the size of the firm.

### **3.6.6 Financial Accounting and Analysis Vs Firm Performance**

Financial analysis is an instrument to evaluate the firm's financial performance in light of its competitors and determine how the firm might improve its operations.



Financial ratios can be used as an analytical tool to help managers to identify strengths and weaknesses of the firm. Quality of financial accounting information utilised within the small business sector has a positive relationship with an entity's performance. Accurate analysis indicates whether the firm has enough cash to meet its obligations, a sound inventory management system and a reasonable credit policy-all of which contribute to the achievement of the ultimate goal of the firm of maximising its value. Financial analysis can be used as a monitoring device and it plays an effective role in planning.

SMEs' importance or role to mitigate poverty and unemployment has been discovered and appreciated by governments all over the globe. The South African government has also taken steps and initiatives to support the continued existence of these SMEs. Discussed in the following section 3.7 is the government intervention in helping SMEs to succeed.

### **3.7 GOVERNMENT INTERVENTION ON SME FINANCE**

SMEs are playing a very crucial role in the South African economy because they help the government in its quest to reduce unemployment and alleviate poverty. It is in this light that the government has initiated some agencies and boards especially through the Department of Trade and Industry. These organisations are aimed at helping SMEs to start-up, access funds and grow as well as sustain themselves in this competitive business environment and in the process simultaneously creating employment opportunities for the South African citizens. The sections below mention some of the agencies that operate in South Africa and actually help SMEs.

#### **3.7.1 Small Enterprise Development Agency (SEDA)**

Small Enterprise Development Agency (SEDA) was established in December 2004 as an agency under the Department of Trade and Industry. The agency was formulated by merging three organisations namely the Ntsika Enterprise Promotion Agency, National Manufacturing Advisory Centre (NAMAC), and Community Public Private Partnership Programme (CPPP). SEDA is responsible for providing non-financial services to SMEs like marketing, training programmes, procurement advice, technology assistance and mentoring to business. A major responsibility of SEDA is to provide some information to SMEs and prospective entrepreneurs that will help

and encourage them to start and build sustainable businesses. A variety of channels are used and they aim to reach as many South Africans as possible with guidance and discussion on crucial business issues.

### **3.7.2 Khula Enterprise Finance**

Established in 1996 under the Companies Act, Khula Enterprise Finance is an independent agency which was a result of the Department of Trade and Industry initiative. It is focused much on the development and sustainability of SMEs in South Africa, something it has done for the past 15 years. The company is a wholesale finance institution which operates across the public and private sectors, through a network of channels to supply the much-needed funding to small business. Khula Enterprise Finance products and services involve the 1) Khula Property Portfolio which intends to provide business premises to business start-ups by even highly subsidising the rental payments, 2) Pre and Post Mentorship Programmes which gives pre and post loan counselling to SMEs and 3) Loans from Joint Venture funds, Loans for Agriculture, Mining and credit guarantees. The agency has its head office in Pretoria and many regional branches in other provinces. In April 2011, about R102 billion was invested to unlock the job market and in May the same year a programme was set aside to finance women-owned SMEs.

### **3.7.3 Eastern Cape Development Corporation (ECDC)**

The Eastern Cape Development Corporation (ECDC) was established in 1996 by an Act of the Eastern Cape legislature to plan, finance, coordinate and promote development in the Eastern Cape in its industry, commerce, transport and finance. The ECDC is a development and investment agency that is wholly owned by the Eastern Cape government. It offers plenty of services tailored for SMEs, such as Investment Promotion, Export Promotion, Business development Service, and Strategy Project Development. The agency works hand in hand with the national and other provincial offices with the aims to attract new investment opportunities, stimulate exports, facilitate economic progress, build existing businesses and facilitate new start-ups.

### **3.7.4 Business Partners**

Business Partners is a limited company that has operations in other countries. It works through the South African government and is a specialist investment company which provides customised and integrated investment, mentorship and property management services for small and medium enterprises in South Africa. The company supports entrepreneurship and creativity through financing and providing specialist sector intelligence to enable viability of SMEs. The core product of Business Partners is to provide enterprise finance for formal SMEs inclusive of other unique financial solutions. When considering applications for finance, two things are of importance namely the business and the proprietor/entrepreneur. Business evaluation involves issues such as the potential to grow, viability, product line and its history. The proprietor is evaluated on the basis of his ability to run the business successfully using sound business principles and appropriate experience. This evaluation process creates a motive or drive to want to do better and this usually may be a positive attitude towards achieving higher firm performance.

### **3.8 CHAPTER SUMMARY**

The conducting of sound financial management practice is really a challenge to SMEs especially that most of the techniques and processes were more aligned to large businesses with clear organisational structures. The issue is further complicated when resources needed for proper execution are mentioned. In this chapter, the whole function of financial management was described and its objectives were given. Some theoretical background on financial management was discussed with special reference to the applicability to SMEs. It is important to note that the researcher linked the theories to SME finance upon the foundations of limited literature. The relevance of financial management to firms' performance was discussed and a bit of literature review on the subject was also highlighted. The South African government is particular about the success of SMEs considering their contribution to the economy through creation of employment opportunities and alleviation of poverty. It is in this light that the chapter concludes by highlighting on the government initiatives and innovations to enhance the success of SMEs. These initiatives are responsible for different functions of a business despite the fact that

most of them relate to SME financial needs. It is the purpose of the next chapter (Chapter 4) to discuss the methodology used to carry out this study.

**CHAPTER FOUR**

**THE RESEARCH METHODOLOGY**

## 4.1 INTRODUCTION

According to Burns and Burns (2008: 14) research methodology is a collective term for the structured process of carrying out a research. This process is used to collect information and data which is necessary to answer questions about a specific subject of concern and make conclusive decisions. Research methodology can also be seen as the blueprint for the collection of data, measurement and analysis of the same. Thomas (2004: 34) adds that the methods, procedures and techniques to be used in carrying out the research must be of proven validity and reliability. Maintaining validity and reliability in research is necessary for the achievement of objective and unbiased research output. Research is important especially to inform action and therefore data or information obtained from it should be able to have implications that go beyond the research setting and the particular subject (or group of people) studied. Many a time, gaps exist between researchers and those who implement the research findings only because the way the data would have been produced might have compromised on quality, validity and reliability of the data.

There are components in the research methodology that enable a researcher to generate reliable information. One of the components under research methodology is the sampling design. In sampling design, according to Cooper and Schindler (2003: 366), the target population and the sampling method are explicitly explained and defined. The researcher also provides the motivation for choosing a specific sampling method. Secondly, the researcher has to identify the data collection method to use and the reasons for choosing such a method. Data collection methods may include self-administered questionnaires, postal surveys, or interviews. When data is collected, research methodology has it that the data must be analysed to make meanings out of it. This therefore calls for the researcher to identify methods of analysing the data and of course laying out the rationale for the use of such methodology. Encompassed also by research methodology are the limitations of the study. The researcher identifies significant methodology or implementation problems such as sampling errors, response and non-response errors and the constraints of cost and time (Cooper & Schindler, 2003: 366).

It is the purpose of this chapter to explain in detail the methodology used in carrying out this study. Included in this chapter is the focus of the study, the survey area, the

target population and the sampling procedure. The sampling procedure will help identify the sampling method and technique used to select the sample. Discussed also in this chapter are the data collection and the data analysis methods. The reliability and validity of the data collected was also discussed to establish the validity of the results as well as the limitations faced in the collection of data. The chapter went on to explain the ethical consideration taken up in carrying out the research on every stage of the process. Discussed in section 4.2 is the focus of the study.

## **4.2 FOCUS OF THE STUDY**

The focus of the study can be described as the main aims or objectives to be achieved by carrying out a study (Gill and Johnson, 2010: 126). In this study the main objective was to evaluate the financial management practices employed by the small and medium enterprises in the Buffalo City Metropolitan. Financial management is a broad concept with several areas of interest which include capital budgeting, working capital management, capital structure, financial reporting and analysis as well as financial planning and control. This study examined how SMEs make decisions associated with each of the above mentioned factors. It was also the aim of the study to determine if there was a significant relationship that exists between financial management and firm performance. Factors that enhance or hinder the effective implementation of sound financial management practices were also included as an objective of the study. Section 4.3 discusses the scope of the research.

## **4.3 SCOPE OF THE STUDY**

According to Cant *et al.* (2005: 45) the scope of the study refers to the physical borders and boundaries of the location and source of elements which formulates the sample frame of the study from which the data is collected. In simple terms the scope of the study may refer to where the study was conducted, the subject researched and the elements from whom the data was collected. The survey area, study unit and the survey population for this study are discussed in the following sections.

#### **4.3.1 Survey Area**

The study area in this context refers to the physical boundaries and borders that demarcate the location in which the subject(s) of study can be found. This research was carried out on the SMEs in the Buffalo City Metropolitan in the Eastern Cape Province of South Africa. The Buffalo City Metropolitan area includes the East London town, King Williams Town and Bhisho as well as the big townships of Mdantsane and Zwelitsha. However, for the purposes of the study and other foreseen constraints (time and budget) the study focused on East London and King Williams Town only.

#### **4.3.2 Study Unit**

The study unit or unit of analysis is the major entity that is of interest and stands to be analysed in the study (Thomas, 2004: 21). It is the 'what' or 'whom' that is being studied. Typical units of analysis in research include individuals (most common), groups, organizations and entities. In this study the focus was on all registered or recognised SMEs in the Buffalo City Metropolitan irrespective of their type of business and industry. These were chosen for this research for the sake of convenience to the researcher considering the scope of the study. As stated earlier, the main aim of this study was to evaluate the financial management practices exhibited by SMEs. It follows therefore that SMEs in all sectors were of concern because financial management is a universally important issue to all business entities regardless of the kind of business.

#### **4.3.3 Study Population**

Cooper and Schindler (2006: 441) define population as the study object, which may be individuals, groups, organisations, human products and events, that is the subject of the research interest or the conditions to which they are exposed. A population is the total collection of elements about which we want to make some inferences. This target population needs to be explicitly defined in order to draw an accurate sample. To identify the target population the researcher contacted some sources from Eastern Cape Development Corporation (ECDC). In this study the target population include all the SMEs located in East London and King Williams Town. The ECDC source confirmed that there are 420 registered SMEs in East London and King Williams Town. It is from these that the sample was drawn.



The following section 4.2 explains the research design.

## **4.4 RESEARCH DESIGN**

According to Kumar (2005: 84), a research design is a plan, structure or strategy that is employed to ensure the answering of set research questions and problems. Researcher design can also be described as the overall plan for linking conceptual research problems to the relevant and achievable empirical research. Explained under research design include the type of data wanted, methods of collecting and analysing the data as well as how the data is going to answer the research question(s). The research question must be answered accurately, validly, objectively and economically. It therefore follows that in research design there is an arrangement of the conditions for data collection and analysis.

### **4.4.1 Research Method**

In this study the researcher employed the quantitative research method. According to Brynard and Hanekom (2006) a quantitative research method derives empirical generalisations which may be used to determine future courses of action. Burns and Burns (2008: 14) and Tustin (2005: 90) add that in quantitative research variables are explained in a way that they become measurable and it also require statistical summarisation. It follows that in quantitative research data can be collected from a large group of respondents and in descriptive studies it is quantified to project the results from the sample to the population of interest. This study intended to evaluate the financial management practices employed by SMEs in general and hence required the use of statistical summarisation. It follows therefore that this research adopted the quantitative research method in order to accomplish the set out study objectives.

### **4.4.2 Research Technique**

According to Cooper and Schindler (2006: 390) there are three primary data collection method namely observation, experiment and survey. Brynard and Hanekom (2006) define an observation is a research technique that involves observing the research subject in the natural set-up. It is advantageous in that it is flexible and the research questions can be changed to suit the problem at hand. However, it is only relevant when a study is focused on behavioural aspects of the

study subject. An experimental research involves the creation of an artificial environment that is fit for the purpose of the study and having the study subject observed in it (Gill and Johnson, 2010: 126). In this research the survey methods was used. Cooper and Schindler (2006: 390) state that survey research encompasses any measurement procedures that involve asking questions from respondents. A survey will ask a series of questions that require answers from respondents which are then analysed at the end of the survey when the participant level has been reached. In survey research, the researcher selects a sample of respondents from a population and administers a standardized questionnaire to them. A survey was conducted because the researcher found out that it is relatively inexpensive especially when making use of self-administered surveys and also because surveys can explicitly describe the characteristics of a large population.

There are four types of surveys which are personal interviews, telephone surveys, mail and self-administered surveys. In this study the researcher made use of self administered questionnaires to gather the data by personally delivering the questionnaires to the SMEs in King Williams Town and East London. A self-administered questionnaire refers to a form of logically arranged questions that is given to a respondent to fill out in the absence of the researcher. The self-administered questionnaires were used for the following reasons (Cooper & Schindler, 2006: 369):

- Self-administered questionnaires are less expensive than other data gathering methods such as personal interviews where the researchers must be present with the respondents at all times.
- Self-administered questionnaires ensure anonymity and privacy of the respondents, thereby encouraging more sincere and honest responses.
- Self-administered questionnaires have proved to have a higher responses rate than other data gathering techniques such as mail surveys.

Having described the research design, the next important thing is to collect data. Section 4.5 is centred on discussing the instrument used to collect data.

## **4.5 RESEARCH INSTRUMENT**

According to Brynard and Hanekom (2006: 410) the research instrument is the tool or device used to gather information on the concept of interest or put simply, it is the device used to measure the concept of interest of a study. A good research instrument is one that is able to generate results that are relevant, accurate, objective, valid, reliable, sensitive and efficient. There are different types of research instruments including observation scales, questionnaires and interview schedules among others. All research instruments stand the test of validity and reliability to prove quality of their measurements. In the study the researcher made use of the questionnaire. The nature of this study was to collect data from a large group of people in a constrained timeline and therefore the use of a questionnaire was appropriate because it has the ability to collect data from a large group of people and data collection can happen quickly (Brynard and Hanekom, 2006: 410).

According to Martins (1999: 260) a questionnaire is a form that contains a set of logically arranged questions, addressed to a statistically significant number of subjects as a criterion of collecting information for a survey. The questionnaire was designed in a way that it consists of both open-ended and closed-ended questions. Open-ended questions are those that solicit for more information and may require a response that might need more than the simple one or two words. In the questionnaire for this study open-ended questions were used to find out about the challenges SMEs face in trying to implement sound financial management practices. Closed-ended questions are questions that limit respondents to a list of answers from which they will choose answers to the questions. These may be multiple choice questions, either with one answer or with check-all-that-apply, scaled questions and dichotomous questions. Scaled questions are those that ask respondents where they fit on a scale continuum and these include Likert scale and cumulative or Guttman scale. However, this study utilised the Likert scale to structure some of the questions. A Likert scale is a scale in which respondents indicate their level of agreement with statements that express a favourable or unfavourable attitude toward a concept being measured (Cooper & Schindler, 2003: 362). The questionnaire used for this study is attached in the Appendices section.

When collecting data from a large population, researchers usually resort to the use of a sample and hence section 4.6 discusses about the sampling procedure.

## **4.6 THE SAMPLING PROCEDURE**

According to Cooper & Schindler, (2003: 179) sampling is the procedure by which some elements of a given population are selected as representative of the entire population. Studying this part of the population (sample) will enable the researcher to generalise results back to the population from which the sample has been drawn. The following section examines the description of the population and sampling method selected by the researcher for the study, as well as the motivation for selecting the sampling method. It also examines the sample size used for the research study and, furthermore, explains how the sample size was calculated. Section 4.6.1 discusses the population and the sampling frame

### **4.6.1 Description of the Population and Sampling Frame**

The sampling frame is the source device from which a sample is drawn (Thomas, 2004: 90). Put simply, a sampling frame is a list of all units in a population of concern that are ready to be drawn out to become part of the sample. An ideal sampling frame should be characterised by some or all of the following:

- Contact information, map location and other relevant information should be present for all units
- Every element of the population should be present in the frame and should also be present only once
- Data about the population and the frame should be up-to-date
- All units must have a logical numerical identifier
- No elements outside the population should be present in the sampling frame.

The study covered the small and medium enterprises (SMEs) in King Williams Town and East London of the Buffalo City Metropolitan area in the Eastern Cape Province of South Africa. King Williams Town sits on the banks of Buffalo River and at the foot of Amatola Mountains. It is the second most populous town with approximately 100 000 inhabitants. On the other hand, East London is a city situated on the Indian Ocean coast, between the Buffalo River, and the Nahoon River, and is South Africa's only river port. East London today has a population of approximately 250,000, with

over 700,000 in the metropolitan area (South Africa Geography Information Systems Map, 2009). These two locations were chosen for their convenience because they are the centres for many business activities which are designed to attract both rural and urban market. The researcher also wanted to collect data from a large group of SMEs in order to infer the findings to the whole population of SMEs in the Buffalo City Metropolitan and even beyond. Many SMEs have their operations in these two towns (King Williams Town and East London). The sampling frame for this study therefore included all SMEs in the above mentioned area. The sampling method is discussed below in section 4.6.2.

#### **4.6.2 Sampling method**

There are two sampling methods namely probability sampling and non-probability sampling methods. Probability sampling is the one whereby every element or unit of the population has a known non-zero chance of being selected to become part of the sample (Weiers, 1988: 102). According to Roberts-Lombard (2002: 107) this method is relevant in the situation where the representativeness of sample is of essence especially when the statistics of the sample are needed to make generalisations about the population. The larger the number of elements to be chosen from the population, the more representative the sample will be. This would imply that the sample would set closer to a normal distribution. With probability sampling it is possible to estimate objectively the amount of sampling error present because each unit of the population has a known chance of inclusion in the sample. Probability sampling, however, has the disadvantage that it requires greater time and it involves higher costs and complexity.

On the other hand, non-probability sampling method happens when elements in a population are not exposed to a known chance of being selected. This method is applicable when the time resource is critical. Selection of elements is based on personal judgement and any statistical method cannot be used to infer from the sample (Cant *et al.*, 2003: 165). For the purposes of this study the researcher utilised the probability sampling method. The findings of this study are intended to be inferred to the population of SMEs in the Buffalo City Metropolitan and even beyond, hence the results must be accurate and the sample must be representative of the

population. This probability sampling method also mitigates the error accruing from selection bias and enhances the representativeness of the sample.

Section 4.6.3 discusses the sampling technique used in the research.

#### **4.6.3 Sampling technique**

The sample was selected using the simple random sampling method. Simple random sampling is the basic probability sampling technique where a group of subjects (a sample) is selected for study from a larger group (Cooper & Schindler, 2003: 164). It is given here that there is an equal chance for each unit of the population to be selected to be part of the sample. For this simple random sampling technique to be effective six steps must be followed. The researcher has to define the population, choose an appropriate sample size, list all units of the population, assign numbers to the units, find random numbers and finally select the sample units to be surveyed. The study adopted the simple random sampling technique because of the following reasons:

- Simple random sampling technique is an unbiased survey technique
- It allows to draw externally valid conclusions about the population
- It is free of classification error
- Its simplicity makes data interpretation easy.

The following section 4.6.4 is centred on the sample size.

#### **4.6.4 Sample size**

Sample size determination is the act of choosing the number of replicates or observations to include in a statistical sample. According to Martins, (1999: 262) the correct sample size in a study is dependent on the nature of the population and the purpose of the study. Sample size is an important factor in empirical surveys. Very large samples may waste time, money and other resources whilst very small samples may generate inaccurate results. Generally, sample sizes larger than 30 and less than 500 are appropriate for most research. However, in a multivariate study, the sample size should be several times as large as the number of variables in the study in order to achieve good results. The sample size usually depends on the population to be sampled, the level of precision, the level of confidence and the degree of variability although there are no general rules. Nevertheless, a balance must exist between or among these factors in determining the sample size.

The level of precision (the margin of error) is the amount of error which can be tolerated and it is selected by the researcher depending on the precision needed to make population estimates for a given sample. In other words it is the range in which the true population value is estimated to be. The margin of error in business generally ranges from three percent and seven percent (3% to 7%). The confidence level is the estimated probability that a population lies within a given margin of error. It is the amount of uncertainty that can be tolerated. According to Martins (1999: 263) the confidence level in business research ranges from ninety percent to hundred percent (90% to 100%)

When determining the sample size some strategies can be utilised. Firstly, some researchers make use of a census where all units of the population are surveyed. It is usually a strategy when the population is very small. Secondly, sample size may depend on the one used for a similar study. Other studies make use of some published sample size tables. The last and probably most common strategy is the use of formulae to calculate sample size. In this study the researcher used formulae to calculate the sample size. The Raosoft calculator was used in taking into account the margin of error of five percent (5%), a confidence level of ninety five percent (95%) and a response distribution of fifty percent (50%). Using this calculator with a population of 420 SMEs the sample size amounted to 201 SMEs.

To enhance accuracy the researcher also used a sample calculator formula (Roberts-Lombard, 2002: 87) and using this formula the sample size was calculated as follows;

**$n \geq \frac{N}{1 + N(d^2)}$**

**$n = \frac{N}{1 + N(d^2)}$**

**10 000**

**n = The sample size**

**N = The total population**

**d = Sample interval**

The sample size was calculated from a population of 420 SMEs giving a sample size of 201 SMEs. The sample size was similar to the one calculated using the formula by Raosoft (2007) which shows that the sample size was calculated accurately since

the results are the same. Section 4.7 discusses the research technique that was used in the research.

## **4.7 RESEARCH TECHNIQUE**

The research technique used to collect primary data was a self-administered questionnaire. According to Cooper and Schindler (2003: 369) a self-administered questionnaire is a form containing a set of questions and other prompts, usually presented to the respondent by an interviewer or a person in an official capacity that explains the purpose but does not actually complete the questionnaire. In fact, it is a questionnaire that the respondent gets to complete on his/her own. The interviewer or researcher might be present only to explain and clarify ambiguities. Accruing from the use of self-administered questionnaires are the following advantages:

- They are less expensive, no hiring and training costs
- They are efficient, can be distributed in large numbers all at once, involve less administration time
- Respondent is assured of anonymity
- Little or no interviewer bias is present
- Provide option for follow up research in the circumstance that the researcher wants to validate responses.

However, using a self-administered questionnaire may result in one or more of the following problems:

- Respondent error due to misinterpretation of questions, inaccurate responses
- Response rate might be low
- Peer pressure of embarrassment may cause people to not want to answer certain questions, or they may want to impress the researcher and fabricate the truth by filling in untrue answers, making questionnaires unreliable and sometimes invalid.

In this study the researcher collected data from a large number of respondents and in two different locations. This influenced the choice of self-administered questionnaire as a data collection instrument. Constrained with time and money resources, the researcher used the self-administered instrument to save time and money. In order to minimise the short comings of the self-administered questionnaire



the researcher kept the questionnaire layout and design simple and free of technical terms. The researcher also monitored the filling out of questionnaires in order to increase the response rate. The questionnaire design is discussed in section 4.7.1 below.

#### **4.7.1 Questionnaire design**

According to Loubser (1999: 287) care has to be taken when designing the questionnaire. One of the major factors that compromise the quality of research findings is non-response and therefore questionnaires should be designed in such a way as to encourage respondents to give honest and complete responses. Loubser (1999: 287) added that the appearance and layout of the questionnaire is of great importance in any survey whereby the respondent has to complete the questionnaire. Precisely, the questionnaire has to be highly structured in order to analyse data quantitatively and systematically. Two major objectives therefore can be highlighted about a questionnaire which are:

- To maximise the number of completed responses in a survey
- To gather as much relevant information as possible to answer the research question(s).

The construction of questions in the questionnaire used for this study was done after taking into account the research topic and objectives. The researcher conducted a small pilot on SMEs in 10 SMEs in Alice town, consulted the experts (supervisor and statistician) and also sent the questionnaire for ethical approval by the University Research Ethics Committee. In this study the researcher made sure that the layout of the questionnaire was kept very simple to encourage meaningful participation by the respondents. Wording and phrasing of questions was done in such a way as to avoid the semantic barriers. The researcher also made use of the relevant literature to the study to help construct questions that were concise and important for the achievement of research objectives. The questionnaire comprised of open-ended questions and closed-ended questions and these are discussed below.

##### **4.7.1.1 Open - ended Questions**

Open-ended questions are those questions in a questionnaire that probe the respondents to provide their own answers. In this case there are no pre-coded responses and respondents can express their thoughts freely. Open-ended

responses are very versatile and using these response types, various types of primary data can be collected, from demographic characteristics to opinions, attitudes and behaviour. Complex and variable subjects or topics can be better explored by use of open-ended questions. In this study the researcher used some open-ended questions to find information on the challenges that are faced by SMEs in implementing sound financial management practices. The open-ended questions were used for the reasons provided by Tustin *et al.* (2005: 396-97) and Cooper & Schindler, (2003: 375) which are:

- They encouraged full meaningful answers using the respondent's knowledge or feelings;
- They avoided bias that may result from suggesting responses to individuals;
- They do not allow respondents to just give answers without proper consideration and hence may increase the likelihood of honest responses.
- They allowed respondents to include more information, including feelings, attitudes and understanding of the subject. This allowed researchers to better access the respondents' true feelings on an issue (Cooper & Schindler, 2003: 362).

The subsequent section discusses the closed ended questions.

#### **4.7.1.2 Closed-ended Questions**

Closed-ended questions provide respondents with a list of answers where they select either one or multiple responses. The effectiveness of close-ended questions is dependent on the researcher's knowledge and ability to include relevant responses in the list. Some closed-ended questions require answers that fall along an implied continuum (rating scales), multiple choice and random lists. The researcher used scaled questions, multiple choice and dichotomous. In this study the researcher used these closed-ended questions in asking about the financial management practices employed by SMEs and the relationship between financial management practices and firms' performances. This was done to guide answers in order to fulfil the purpose of the study. Closed-ended questions were also used because of the following reasons:

- The questions provided uniform answers that were easy to analyse quantitatively and systematically

- The questions did not require explanation from respondents and hence encouraged more complete responses
- Increased chances of participation by respondents (Wheather & Cook, 2000: 142).

However, the use of closed-ended questions may cripple the idea of honest responses because respondents may not have the chance to express their feelings and opinions.

Discussed below are the different types of close-ended questions that were used in the questionnaire.

### **Dichotomous Questions**

A dichotomous question is a question which offers two alternative answers to choose from (Cooper & Schindler, 2003: 377). In other words it is a question to which there can only be one of two answers, often “yes” and “no”. Dichotomous questions were used because of the following reasons:

- Some questions in the questionnaire had only two possible answers. For example, questions relating to the gender of the respondents; and
- These questions simplified coding and data analysis, since the responses were predetermined.

Multiple choice questions are discussed in the section that follows.

### **Multiple-choice questions**

According to Cooper & Schindler (2003: 377-379) a multiple-choice question is a fixed question with more than two alternative answers. Some questions may require one response from more than two alternatives whilst others may require as many responses as are applicable. Multiple-choice questions were used for the study because of the following reasons:

- Non-response error was reduced especially that these type of questions were easy to answer
- They simplified coding and analyses of data since the responses were predetermined.

### **Five-point Likert Scale**

The researcher also made use of the five-point Likert scale. A Likert scale is a verbal scale which requires a respondent to indicate a degree of agreement or disagreement. The five response categories on the Likert scale represent an interval level of measurement. Five-point Likert scale questions were used by the researcher for the following reasons (Cant, Gerbel-nel & Kotze, 2003: 113):

- They eliminated the development of response bias amongst the respondents;
- They helped in assessing attitudes, beliefs, opinions and perception;
- Using a Likert scale made the response items standard and comparable amongst the respondents; and
- Responses from the Likert scale questions were easy to code and analyse directly from the questionnaires.

The combination of these different types of questions ensured the collection of complete information from the respondents. A combination of questions avoids the predictability of questions and makes the respondents to concentrate and provide correct information. Section 4.7 discusses secondary data used in the research.

### **4.8 SECONDARY DATA**

Secondary data is the information that was either gathered by someone else or for some purpose rather than the one at hand. It also can be a combination of the two. Secondary data is important to formulate proper research questions and plan on how to carry out the research. However, for secondary data to be deemed useful it has to pass the test of relevance and up datedness. Proper care and diligence in analysing secondary data helps in formulating proper research questions and constructs in a cost-effective way. Some few guidelines are used to evaluate the quality of data from different sources. The guidelines include:

- Determining original purpose of the data
- Ascertaining the credentials of the source or author of the data
- Date of publication
- Intended audience and report coverage
- Considering whether the document is well referenced

There are various sources of secondary data including journals and e-journals, text books and other publications. In this study the researcher utilised journals, e-journals and textbooks to do literature review and to formulate hypothesis as well as data collection and analysis planning. These various sources of secondary data were used to do literature review, hypothesis formulation and the research design. The researcher also used official statistics from Eastern Cape Development Corporation (ECDC) in order to find out about SMEs numerical information. Published data obtained from Statistics South Africa and other government boards was also assessed and deductively applied. Responses to the questionnaire were analysed and evaluated using techniques such as tabulation, correlation and statistical graphs.

## **4.9 DATA PREPARATION**

After data is collected, it needs to be prepared or processed in order to be analysed in a way that will yield objective results. Data preparation is a process of setting data in the right quality and format to get it ready for analysis and tabulation (Cooper and Schindler, 2003: 430). The process involves some steps that could be followed and these are discussed below.

### **4.9.1 Data Editing**

When data has been collected the first step to take is to edit the data. According to Brynard and Hanekom (2006: 238) data editing is done to achieve completeness, accuracy and uniformity of the data that would have been collected. This can be done when the survey is still being done and after it has been completed. The former is called field editing whilst the latter is known as central editing. Tustin *et al.* (2005: 114) state that field editing is done by the researcher when respondents are still filling in the questionnaires. In this study the researcher did field editing by advising respondents to complete partial responses, to enter proper responses and to check the meaning of abbreviations where they were used. Central editing is done after data has been collected but not in the place of data collection. A single expert editor must take up the job to edit so as to encourage consistency. Where two or more editors are to do the job, proper and clear cut guidelines should be given to maximise on data consistency. Alternatively, the task can be split into parts and an editor will be assigned to specialise on a single part (Tustin *et al.*, 2005: 114). The researcher made sure central editing was done by the statistician who would carry

out data analysis. All questionnaires from respondents had to pass the test of completeness, accuracy and uniformity. A questionnaire could only be totally excluded if all other ways were exhausted.

#### **4.9.2 Data Coding**

According to Gill and Johnson (2010: 187) coding is a procedure used to classify the responses to a question into meaningful and logical categories. In this case, symbols are used to represent the categories. Data coding is necessary to make tabulation and data analysis easier. In this study, most questions on the data collection instrument were structured (close-ended) and therefore the researcher just logically coded each possible response on the questionnaire. However, on Likert scaled questions care was taken to assign codes that give the same meaning about the concept of financial management. Open ended questions were not many and respondents gave fairly correlated responses; and this made the coding job easier for the researcher. According to Thomas (2004: 81) coding is very important because it gives structure to the data and prepares it for easy data entry. In very professional surveys and where large amounts of data are collected it is always important to develop a code book in order to construct data that is guarded against mistakes and other inconsistencies.

#### **4.9.3 Data Entry**

After data has been coded and edited into the right format, it needs to be entered into the computer system to be run through a programme for data analysis. The process of entering the data into the computer system is called data entry. The data can be entered manually by the researcher or a typist hired for the job. Here data is typed by carefully following its coded format so that it can be read well by data analysis programs. In data entry care should be taken to mitigate or reduce the chances of technical errors that can compromise the quality of results. The researcher personally coded and entered the data for the sake of consistency.

#### **4.9.4 Data Validation**

Data validation is the process that helps to ensure that the data that has been entered into the computer system or data base is clean, correct and useful before it is run through a data analysis program. When carrying out data validation, there are some rules that have to be followed. The data should be checked for its correctness,

meaningfulness and even the security of the data. Some researchers may use data dictionary to check for its validity. Data validation is very important because invalid data might lead to data corruption and security vulnerability. There are two data validation checks that can help improve the quality of the data namely validation check and post-check action.

Validation check involves several sub-checks. Firstly, there is allowed character checks where the researcher checks manually or through a computer system that only expected characters should be present in a particular field or class of data. Secondly, there is the batch totals check which allows checking for missing records. Other checks include data type checks, file existence checks, consistency checks and limit checks. In this study the researcher managed to do the allowed character checks and the consistency checks as well as the missing records check.

Post-check actions are actions that can be made to amend data and make it correct, clean and secure. The actions include enforcement action, advisory action and verification action. Enforcement action involves putting a data compliance system that instantly rejects the input of data that does not meet the required data format. Advisory action allows data to be entered but sends a message to the data input source on the validation issues concerned. Lastly, verification action is a special case of advisory action. In this case the data typist is asked to verify that the data is the one they really want to enter. In this study the researcher used some of the programmes on Excel and SPSS to make the post-check actions.

#### **4.9.5 Data Cleaning**

Data cleaning involves the detection, amendment and removal of errors from data to improve its quality. Most of the errors are data entry errors and these include:

- Misspellings
- Redundancy
- Duplication
- Contradictory values

These errors if not removed, they produce incorrect and misleading statistics. It is therefore important to amend data that is incorrect, incomplete, improperly formatted and duplicated. Data cleaning can be done by verification and data transformation. The researcher made verification and corrected all technical errors like spellings.

The subsequent section discusses the data analysis and statistical techniques.

## **4.10 DATA ANALYSIS AND STATISTICAL TECHNIQUES**

According to Barrow (1999: 222) data analysis consists of running various statistical procedures and tests on the data. It is the conversion of meaningless information into something which can easily be understood. The purpose of any research is not simply having data, but to deduce information from the data gathered. However, before data could be processed using the data analysis procedure, the researcher had to validate, code and edit data responses.

The data analysis was done by the Statistics department at the University of Fort Hare. The analysis type was descriptive through count. The statistical package which was used to analyse the data is the Statistical Package for Social Sciences V20 (SPSS V20). Statistical Analysis System V8 (SAS) and Statistica packages were used for the analysis of graphs. The researcher used descriptive statistical methods like the central limit theorem to examine the financial management practices employed by SMEs. Correlation was used to measure the relationship between financial management and firms' performance.

### **4.9.1 Descriptive Statistics**

Marshall and Rossman (1999: 185) define descriptive statistics as condensing large volumes of data into a few summary measures. According to Burns and Burns (2008: 15) descriptive statistics involves the collection, presentation, summarisation and description of data. It is very important in understanding patterns and trends because effective data presentation provides for effective analysis and the drawing of sound conclusions. This study made use of frequency distribution tables and graphs as well as mean scores and standard deviation. Frequencies were used for the first section of the questionnaire to describe the data that links to demographical characteristics of respondents and other appropriate areas. Frequencies can be explained, specifically for research, as the number of times a certain answer appears in the data.

Measure of central tendency can be used to aid descriptive analysis of data. The measure of central tendency is the point about which responses tend to cluster.



Such a measure is said to be the representative figure of the entire set of data. Statistical averages can be used to measure central tendency which are the mean, median and mode. The mean scores were used to aid in the measuring of variables as described by the questions on each section in the questionnaire. In other circumstances the mean scores were used to describe the data obtained from the 5-Point Likert scaled questions that were asking about the financial management practices as well as firm performance. Mellville & Goddard (1999: 37) elude that the mean calculates an average across a number of observations and the standard is the square root of the variance around the mean, in other words, how well the mean represents the data.

#### **4.9.2 Inferential Statistics**

Inferential statistics is the area of statistics which extends the information extracted from a sample to the actual environment in which the problem arises (Mellville & Goddard, 1999: 37). The real question is: Are the findings of a small group likely to be true for a larger group? Actually, inferential statistics seek to draw conclusions from datasets obtained from a system of random variation, random sampling and observational errors. The following inferential techniques were used.

The following section discusses the Chi-Square test.

##### **4.9.2.1 Chi-Square Test**

The Chi-Square test for independence was used to test for association between the predicting variable of financial management. The Chi-Square Test procedure tabulates a variable into categories and computes a chi-square statistic. The statistic obtained from the Chi-Square test compares the counts of responses (that are categorised) between two or more independent groups. This goodness-of-fit test compares the observed and expected frequencies in each category to test either that all categories contain the same proportion of values or that each category contains a user-specified proportion of values (SPSS, 2004: 5-11).

##### **4.9.2.2 Analysis of Variance (ANOVA)**

ANOVA provides a statistical test of whether or not the means of several groups are all equal, and therefore generalises t-test to more than two groups. According to Burns and Burns (2008: 14) analysis of variance is a hypothesis testing procedure that is used to determine if mean differences exist for two or more groups. The

purpose here is to decide whether the difference between means of observations is simply due to chance or whether there are significantly different from those in other groups. These inferences about the mean are made by analysing variances. In this study the researcher used the ANOVA test to analyse whether employing sound financial management practices has any impact on the performance of the firm. The ANOVA was used together with the causality test to prove the cause-and-effect relationship between financial management and a firm's performance. Causality is the relationship between a set of factors (causes) and a phenomenon (the effect). In this case the factors were all the financial management practices (capital budgeting, working capital management, capital structure policy, financial reporting and analysis) and the effect was the firm performance measured by turnover, sales and profit.

#### **4.9.2.3 Simple regression analysis**

According to Mellville and Goddard (1999: 37) simple regression analysis can be used to study the cause and effect relationship between and among variables. It follows therefore that the independent variable and the dependent variable should be defined. The independent variable is the one that causes the dependent variable to behave in a certain way. In this study the researcher defined the independent variable as the financial management practices which when practised can influence the performance of the firm. The performance of the firm was regarded as the dependent variable that was watched to see if it was influenced by the implementation of sound financial management practices.

### **4.10 RELIABILITY AND VALIDITY**

#### **4.10.1 Reliability**

Reliability is concerned with consistency of measures. Reliability can be measured taking into account three things which are as follows:

- **Stability.** According to Babbie and Morton (2001: 15) the level of an instrument's reliability is dependent on its ability to produce the same results when used repeatedly. In this case the test-retest technique comes into play and a question can be asked concerning the instrument of measurement, "If the measure is employed repeatedly on the same subjects will it yield similar

results?” in many cases stability over repeated measures is assessed with the Pearson’s coefficient.

- Equivalence. This is the ability of the measure to yield similar results even if it can be used by different investigators. Equivalence can also be explained in the context that one concept can be measured using different instruments and yielding highly correlated results.
- Homogeneity. This is reached when the results exhibit internal consistence. Internal consistency can be obtained by using the split-half correlation, the average inter-item correlation and the average item-total correlation.

In designing the questionnaire the researcher consulted with the University’s statistician and the researcher’s supervisor. The questionnaire was reviewed for question wording, phrasing, sequencing and structure; keeping open-ended questions to the minimum; devising response scales that are likely to increase the variability of responses thereby ensuring higher statistical value from the data and by using a large sample size. This was all done to enhance the reliability of the instrument and data collection method used for this study. Reliability was also improved by pre-testing the research instrument through a pilot study. The questionnaire was tested on 25 subjects which were later not included in the sample for final data collection. The researcher made use of the Cronbach’s alpha to test for the reliability of the instrument. When using the Cronbach’s alpha, reliability must be proven by an alpha value of between 0.7 and 0.9. The results obtained from the questionnaire are shown in the following Table 4.1.

**Table 4.1 Cronbach’s Results**

<b>SECTIONS</b>	<b>NUMBER OF MEASURED CASES</b>	<b>CRONBACH’S ALPHA</b>
Section A	5	0.811
Section B	48	0.8923
Section C	11	0.848

## **4.10.2 Validity**

According to Babbie and Morton (2001: 18) validity refers to the ability of the instrument to actually measure what it is supposed to measure given the context in which it is applied. In other words the researcher has to ask whether the research has measured what it intended to. The following steps were used to ensure validity. Section 4.9.1 discusses the content validity.

### **4.10.2.1 Content validity**

Content validity gives regard to sampling adequacy and representativeness of the measure. It determines whether any left out item should be considered in the measurement. Content validity is a non-statistical type of validity that systematically examines the test content and determines whether it covers a representative sample of the behaviour domain to be measured (Babbie & Mouton, 2001: 18). A panel of experts was used to review the items and comment on whether the items cover a representative sample of the behaviour domain.

### **4.10.2.2 Construct validity**

This can be described in three ways namely convergent, discrimination and hypothesis testing. Convergent is centred on the fact that when the same concept is measure in different ways it still yields similar results. Discrimination validity is the evidence that one concept is different from other closely related concepts. Lastly, hypothesis testing produces the evidence that a research hypothesis about the relationship between the measured concept and other concepts is supported.

### **4.10.2.3 Internal validity**

Internal validity describes the confidence that is placed on the cause-and-effect relationship. According to Babbie and Mouton (2001: 19) it answers the question that asks about the extent the research design permit the researcher to say that the independent variable causes a change in the dependent variable. To ensure internal validity the researcher used the linear regression model to measure the strength and relationship between the dependent variables and independent variables. The Chi Square test was used to determine whether an association (or relationship) between two categorical variables in a sample is likely to reflect a real association between these two variables in the population. The following section discusses external validity of the study.

#### **4.10.2.4 External validity**

External validity is an issue that arises in the process in the process of generalizing conclusions from a sample to a population, to other subject populations, to other settings, and/or to other time periods. In other words, research findings have to at least be projected to the whole population or other objects. External validity therefore is the extent to which research findings apply (or can be generalised) to persons, objects, settings, or times other than those that were the subject of study. A study that readily allows its findings to generalise to the population at large has high external validity (Babbie & Mouton, 2001: 20). To ensure this the researcher used a big sample size with a margin of error not more than five percent (5%) and a confidence level of ninety five percent (95%). Random sampling was used to select the sample units in order to minimise bias on selection. The subsequent section examines statistical validity.

#### **4.10.2.5 Statistical validity**

Statistical validity can be described as the degree to which an observed result, such as a difference between two measurements, can be relied upon and not attributed to random error in sampling and measurement. The degree of statistical significance of a result depends upon the number of sampled data points (e.g. the number of users in a test), the size of the effect, and the amount of variation between measurements (Babbie & Mouton, 2001: 22). Thus, statistical validity was enhanced by testing the efficiency of the model construct using a hypothesised dataset to check for effectiveness of the regression model, choosing a low significance value (p value) of less than five percent (5%). Section 4.10 discusses sampling errors.

### **4.11 SAMPLING AND NON-SAMPLING ERRORS**

Sampling errors occur especially when estimates of certain population characteristics are made by only examining a part of the population rather than the entire population. According to Loubser (1999: 289) the error that arise can be calculated as the difference between the estimates derived from a sample survey, and the true values that would result if the entire population was examined under the same conditions. Sampling errors were minimised in the survey by using a large sample size of approximately half the population. A large sample size is more

representative of the population. Section 4.10.1 discusses the response errors on the research instrument.

#### **4.11.1 Response error**

Response errors are the estimated inaccuracies that can be introduced potentially by the researcher or the respondents. The error may arise in the designing of the measurement instrument or where the researcher does not properly define the research problem and the relevant information required. According to Cooper and Schindler (2003: 332) response errors can also occur when the respondent deliberately or mistakenly provide incorrect answers to the survey questions. The measurement instrument (the questionnaire) was carefully constructed, designed and pretested in order to minimise the occurrence of response errors. Use of self-administered questionnaires gave the respondents convenience and freedom to honestly and accurately answer the questions.

#### **4.11.2 Non-response errors**

According to Loubser, (1999: 286) a non-response error arises when the researcher is unable to contact all members of the sample or when some contacted members of the sample fail to respond to a part or the whole of the questionnaire. The non-response errors occur because people who respond to the survey might not have characteristics similar to those who do not. Reasons for non-response include:

- Refusal to respond
- Lack of ability to respond
- Business closed
- Encroachment on privacy

The researcher mitigated the occurrence of the non-response error by employing self-administered questionnaires and personally delivering them to respondents' location. Follow-up calls were made to remind and monitor respondents. The researcher also replaced non-respondents with matched members of the sample or substituted non-respondents with other units of the sampling frame.

#### **4.11.3 Non sampling errors**

These represent the differences between the population and the sample that arise from such problems as poor questioning, poor wording or inconsistent processing of

data. The researcher pre-tested the questionnaire before collecting the final data so as to make sure that respondents would not be confused by poor questioning and other technical errors. Data was processed by using standard software such as the SPSS version 20 and analysis was done by an expert statistician.

#### **4.11.4 Selection errors**

When a sample is obtained through non-probability method, it is not representing the whole population and thus results in selection errors. In this case a probability sampling method (simple random sampling) was used and this minimised the chance of selection errors.

#### **4.11.5 Measurement errors**

These errors are ascribed to differences between information sought by a researcher for a study and information generated by a particular measurement procedure employed by the researcher. The instrument used for this study was pretested and questions were adjusted and edited in order to generate the kind of information intended by the researcher.

#### **4.11.6 Surrogated information errors**

When predictions of the future activities are involved, substitute information must often be accepted because of the respondent's inability to provide a good estimate (Kress, 1988: 158). The researcher edited the data before analysis to verify the validity of the responses provided by each respondent.

The ethical considerations are discussed in section 4.12.

### **4.12 ETHICAL CONSIDERATIONS**

According to Thomas (2004: 90) ethics are generally the moral principles that have the intention to guide a person's behaviour in society. In a professional context ethics regulate behaviour and conduct in a specific occupation. Carrying out research for academic purposes is guided by the ethical guide lines given by the university research body. The researcher took cognisance of respondents' rights as given by Burns and Burns (2008) which are the right to voluntary participation, informed consent, right to be safe and not to be harmed as well as the right to anonymity and confidentiality. The researcher informed the participants about the purpose of the

study and the use of the responses they provided. This was done explicitly and truthfully to clear any dust about deception. The results were also kept confidential as the respondents were not asked to fill in their names or give any identification. Appreciation to respondents was done through the communication on the cover letter.

#### **4.13 LIMITATIONS AND DELIMITATIONS OF THE STUDY**

The limitations are the challenges outside the control of the researcher and are the inherent design or methodology parameters that can compromise on the scope of the research outcome (Malhotra, 1991). These limitations or weaknesses arise especially when the optimum number of samples cannot be taken due to time/budgetary constraints. Therefore, these factors have the potential to reduce a study's validity of results (the credibility or believability of the findings). If after certain considerations, the findings of the study will still be valid and useful then the research can continue by appropriately reporting the limitations. In this study a sample less than the total number of SMEs in the East London and King Williams Town was selected after the consideration of time and budgetary constraints. However, the researcher selected the sample using a margin of error of 5% that was anticipated to affect the research outcome.

According to Proctor (2000) delimitations describe the population from which generalisations can be carefully made and are under the control of the researcher. The delimitations are actively chosen by the investigator. These include the choices of research question, objectives, variables, populations and methods of data analysis based on alternative theoretical perspectives which will determine how general the findings can be interpreted. The researcher tried to eliminate the chances of these delimitations by creating research questions and objectives based on relevant theoretical perspectives and also consulting with the supervisor. In choosing methods of analysis and instrument of data collection the researcher consulted with an expert statistician.



#### **4.14 SUMMARY**

In this chapter the focus was to examine the methodology used to carry out the study. The early sections of the chapter discussed the scope of the survey; the focus of the study and the research technique. The sampling method and the organisation of the survey were comprehensively discussed. The data gathering technique used for this research study was outlined. The chapter went on to give the rationale for choosing a self-administered questionnaire. After data was collected analysis had to take place. In this chapter the methods for processing the data and the statistical packages used were explained. The researcher used central limit methods to describe data and chi-square test as well as ANOVA to make inferences. The response and non-response errors that can affect the validity of the results and ways that were used by the researcher to minimise them were also discussed. Reliability and validity of measures are important in carrying out research. Issues of reliability and validity and how the two were enhanced were also discussed in this chapter. The ethical considerations, limitations and delimitations of the study formed the closing sections of the chapter.

The subsequent chapter focuses on analysing the data that was collected from respondents. The analysis was done using the laid out methods and techniques mentioned earlier in this chapter. Tables, pie charts and bar charts were used to aid the analysis of data. All the results obtained for each research hypothesis were compared with related empirical studies to confirm reliability and validity of measures.

**CHAPTER FIVE**

**ANALYSIS OF DATA**

## **5.1 INTRODUCTION**

The preceding chapter (Chapter Four) focused on the research methodology where the sampling procedure, data collection procedure and the data analysis methods were explicitly explained. This chapter focuses on analysing and interpreting the research results obtained for this study. According to Zindiye (2008: 146) data analysis is closely related to interpretation of the data in the sense that data analysis involves breaking the data into groups where it is examined separately to yield immediate results, whilst interpretation takes the immediate results and integrate them into general findings and conclusions. However, it is important to note that the findings must answer to the research objectives and hypotheses.

In this chapter, the researcher conducts a question by question analysis in order to fully explain and interpret all the responses associated with each question in the questionnaire. Tables, charts (pie and bar) and graphs were used to describe the data because they can help analyse trends and patterns. The hypotheses for this study were tested in this chapter and probability of rejecting or not rejecting a hypothesis was based on the statistical tests carried for each hypothesis. The researcher also made comprehensive comparison of the study's results with the findings of obtained in other related studies. The relationship between financial management practices and a firm's financial performance was analysed by employing linear regression and other inferential statistics like the test of variance and Anova. Interpretation of the obtained results was based on the analysis that was made using statistical enquiry in order to remain objective and at the same time fulfilling the requirements of the research objectives.

### **5.1.1 Normality of data**

In order to check if the data followed a normal distribution the researcher ran some normality tests. The researcher firstly used the Skewness and Kurtosis tests. The Skewness test is a measure of the symmetry of the data whilst Kurtosis measures whether data is peaked (Jordan, 2010). Zero values for both the Skewness and Kurtosis tests resemble an exact normal distribution of the data. In this study the value 0.106 was obtained for the Skewness test and it indicates a normal distribution that is slightly positively skilled. The value of 0.098 was obtained for the Kurtosis test and this means that the data is also slightly peaked. A further test was carried out

which is the Shapiro-Wilk's test and it calculates whether a random sample has been drawn from a normal distribution (Shapiro and Wilk, 1965). The test works using a chosen alpha level under the null hypothesis that data is from a normally distributed population. The study used an alpha-level of 0.05 (95% confidence level) and obtained a p-value that is greater than 0.05 to prove that the sample data is from a normally distributed population.

### 5.1.2 Missing Values

In the collection of data, the researcher experienced some missing values. The missing values were not very significant and therefore the researcher chose to do to include the cases with missing values. In carrying out data analysis the statistician used the option of pairwise deletion on the missing values. According to Graham (2009: 459) pairwise deletion is the exclusion of the particular missing values from the analysis but including all other available data on the case.

### 5.1.3 Response Rate Survey Results

In carrying out research, especially on business people, it must always be anticipated that some people might not be available to be interviewed. Table 5.1 gives a summary on the response rate for the study.

**Table 5.1 Response Rate**

Sample category	Count	Percentage (%)
Calculated sample	201	100
Unavailable elements	56	28
Usable sample	145	82

The table depicts that out of the 201 sample elements 28% of them were unavailable leaving 82% to be the usable sample. The researcher also encouraged high response rate by continuously calling the respondents as a reminder to fill up the questionnaire. Most respondents complained about their busy schedules and therefore the researcher dropped off questionnaires and collected them after some days. Using data obtained from the usable sample the survey results are discussed in section 5.2.

## 5.2 SURVEY RESULTS ON A QUESTION TO QUESTION BASIS

This section examines the survey data that was obtained from the self-administered questionnaires.

### 5.2.1 Section A: Business Details

The focus of this first part of the questionnaire was to gather details about each SME and its administration. There is a combination of questions to get business information and also about the manager and the owner.

#### Question 1

Please indicate your position in the business.

This question provided the researcher with information on who is responding and if the respondent has the relevant information to answer the questions. Table 5.2 shows the results.

**Table 5.2 Respondents' Position in Business**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Owner	97	66.9	66.9	66.9
Manager	35	24.1	24.1	91.0
Other	13	9.0	9.0	100.0
Total	145	100.0	100.0	

Source: Data Analysis

#### Comment:

The results show that more than 90 percent of respondents were owners and managers. Owners and managers of SMEs usually have the first hand information concerning their businesses, how they run and perform. The category of respondents labelled 'other' was represented by senior employees of the SMEs because the owner/manager was not available. These senior employees were only included because they showed that they have the knowledge about the business. Other studies like Agyei-Mensah (2011), Harif and Osman (2007) and Ekanem (2005) used the same set up of respondents citing reasons associated with accuracy of information.

## Question 2

What is your highest level of education?

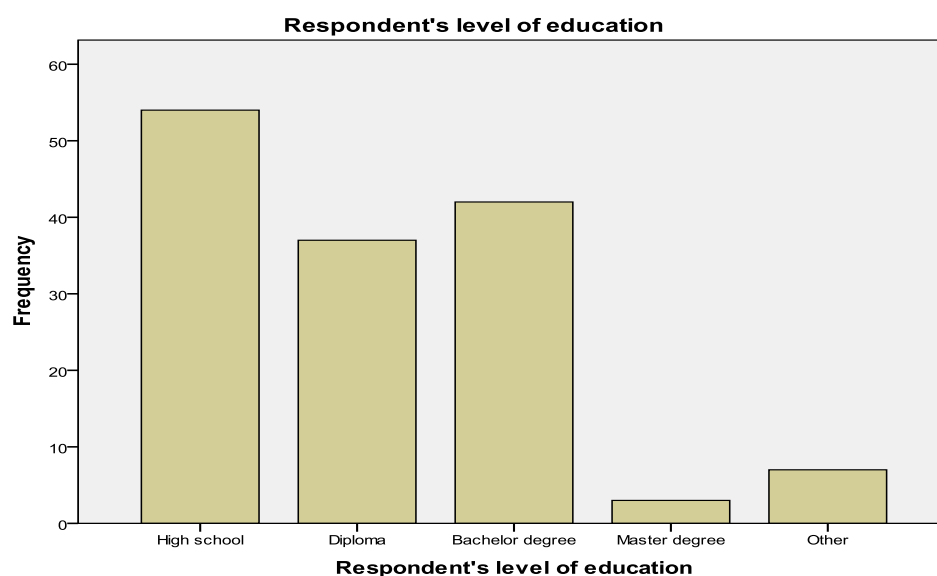
This question provided the researcher with an insight on the knowledge accumulation by the SME owners or managers. In a certain way, this knowledge might explain the financial management skills that are inherent in the SME owners or managers. The respondents' statistics to the question are presented in the Table 5.3.

**Table 5.3 Respondents' level of education**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	High school	54	37.2	37.8	37.8
	Diploma	37	25.5	25.9	63.6
	Bachelor degree	42	29.0	29.4	93.0
	Master degree	3	2.1	2.1	95.1
	Other	7	4.8	4.9	100.0
	Total	143	98.6	100.0	
Missing	System	2	1.4		
Total		145	100.0		

Source: Data Analysis

**Figure 5.1 Respondents' Level of Education**



**Comment:**

Most respondents (37.8%) indicated that they did not further their studies beyond high school and only just over 2% had done postgraduate studies. These results are consistent with a study by Agyei-Mensah (2011) which reported that the majority of SME owners do not have a real formal educational background and this might affect the way they do business as well as handling of their finances.

**Question 3**

Which industry does your business operate in?

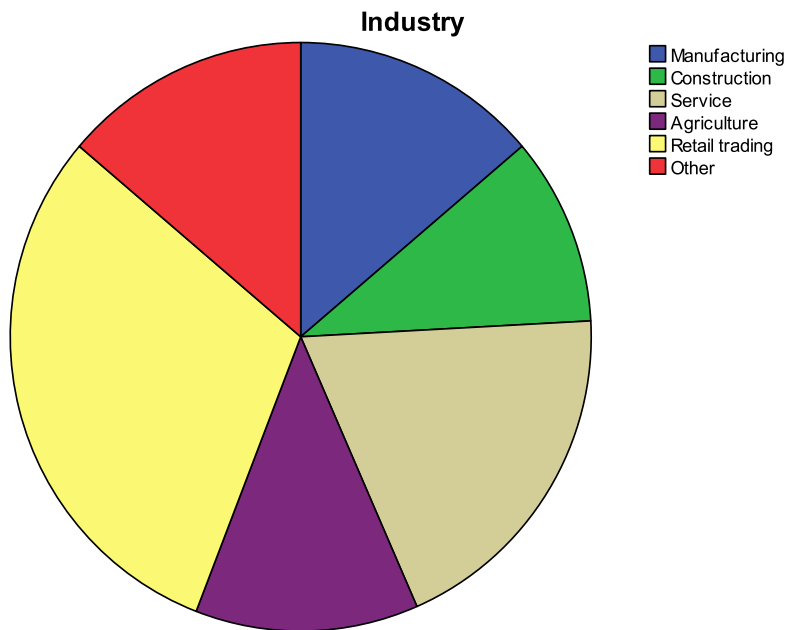
It was also important to know the type of business being carried out. The type of business can explain the kind of financial decisions that can be taken by the business firm. This is because sometimes financial decisions differ according to the type of business and this also helps in the interpretation of the results.

**Table 5.4 SME Industry**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Manufacturing	20	13.8	13.8	13.8
Construction	15	10.3	10.3	24.1
Service	28	19.3	19.3	43.4
Agriculture	18	12.4	12.4	55.9
Retail trading	44	30.3	30.3	86.2
Other	20	13.8	13.8	100.0
Total	145	100.0	100.0	

Source: Data Analysis

**Figure 5.1 SME Industry**



**Comment:**

In this question the researcher took into account SMEs in all areas of industry because of the fact that every business entity in any industry is bound to survive by its financial base. According to Njini (2003) financial management performs the heart function of all organisations be they small or big. However, the mode industry is the retail trading and this is representative of the SMEs in the Buffalo City Metropolitan Municipality where the research was conducted.

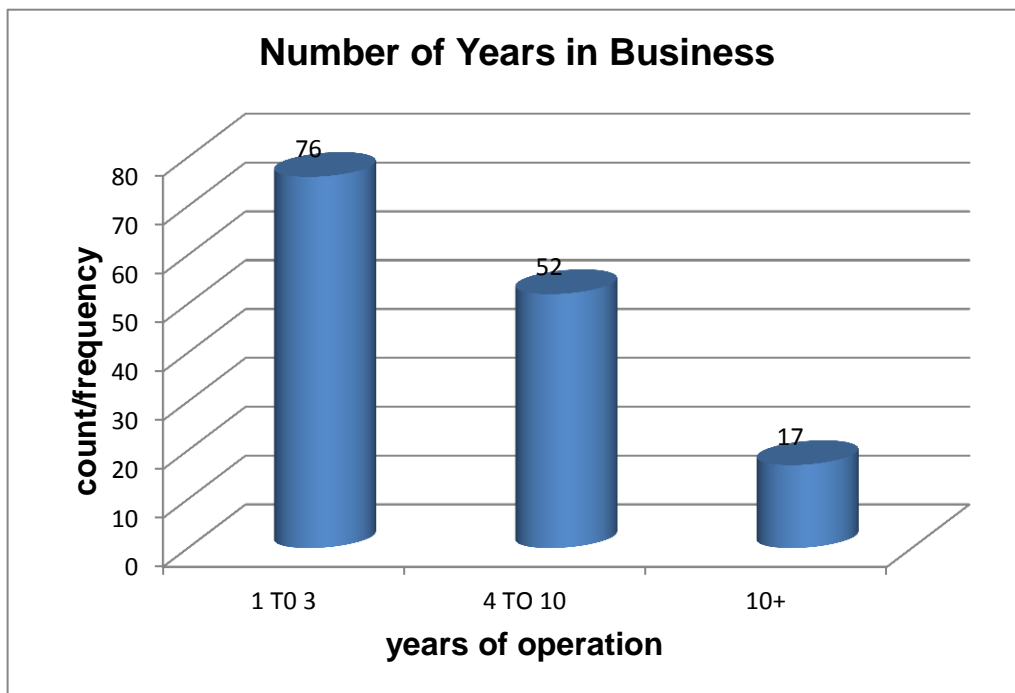
**Question 4**

How long has the business been established?

The early chapters of this study reviewed that many SMEs are failing in the preliminary years of operation and very few will make it to the fifth year. This question therefore sought to verify this literature by examining the SMEs under this study whether they follow the same trend. It was of importance to ask this question.



**Figure 5.1 Age of Business**



Source: Data Analysis

**Comment:**

The results in the figure above indicate that 76 out of 145 SMEs are in the 1 to 3 years category. The least count is in the 10+ year category which has less than 12% of the SMEs which were represented in this study. There is a negative relationship between the number of years in business and the number of SMEs. As the year category increases the count of SMEs decreases and this therefore leads the researcher to conclude that SMEs are struggling to sustain themselves in business for many years. Many survive the preliminary stages of operation but also many are failing to meet the pressure so as to survive beyond the first few years of commencement (Rungani and Fatoki, 2010).

**Question 5**

Please indicate the number of employees in your business.

The definition of SMEs can be premised on the number of employees because the number can testify on the size of the business operation. It was necessary to include this question because it is the simplest way of defining SMEs and the information is easy to get.

**Table 5.5 Number of Employees in Business**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid 0-20	66	45.5	45.5	45.5
20-50	44	30.3	30.3	75.9
50-60	22	15.2	15.2	91.0
60+	13	9.0	9.0	100.0
Total	145	100.0	100.0	

Source: Data Analysis

**Comment:**

Most business enterprises interviewed (76%) proved to be falling under the definition of being small because they had the total number of their employees less than 50. The enterprises with the number of employees totalling 50 and above had business operations in more than one place or were in the manufacturing and construction industries. Most businesses indicated that these were their permanent employees and only those in construction and other seasonal businesses indicated to have time on task employees. Rungani and Fatoki (2010) in their study on SMEs report that most SMEs have employees less than 50 because most of them lack resources and ability to grow.

**5.2.2 Section B: Financial Management Practices**

The study aims to examine the financial management practices being employed by SMEs. Financial management consists of capital budgeting, working capital management, capital structure decisions, financial reporting and financial analysis. This section of the questionnaire asked questions on each of the areas under financial management.

**5.2.2.1 Capital Budgeting**

Capital budgeting is usually done when huge money expenditure has to be done and it is common in construction and manufacturing operations. It is also a concept in other industries when businesses think of expansion, new product launches and other extra-ordinary expenditure. Questions number 6 to number 12 all intend to find out more on how these capital expenditure decisions are made among SMEs

### Question 6

Which of the following is done by your business when making big expenditure or capital decisions?

Preparation of financial budget is the basic start off for investment appraisal. This question intended to find out if the SMEs involve themselves in doing financial preparation. The question also probed to examine if SMEs when faced with capital budgeting issues do alternative project evaluations and cost benefit analysis.

**Table 5.6 Capital Budgeting Practices**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Making financial budgets	28	19.3	19.3	19.3
Evaluation of alternative projects	22	15.2	15.2	34.5
Possible income projections	15	10.3	10.3	44.8
Making financial budgets plus evaluation	21	14.5	14.5	59.3
Doing all three	33	22.8	22.8	82.1
Preparing financial budgets plus income projection	14	9.7	9.7	91.7
Evaluation plus income projection	12	8.3	8.3	100.0
Total	145	100.0	100.0	

Source: Data Analysis

**Comment:**

In this study, as evidenced in Table 5.6, all SMEs implement at least one of the three above mentioned practices. A considerable portion of the SMEs observed of almost 23% responded that they implement all three practices. These results are consistent with a study by Harif and Osman (2007) who indicated that almost all SMEs involve themselves in computing a working budget, making income possibility projections as well as evaluating investment alternatives.

### Question 7

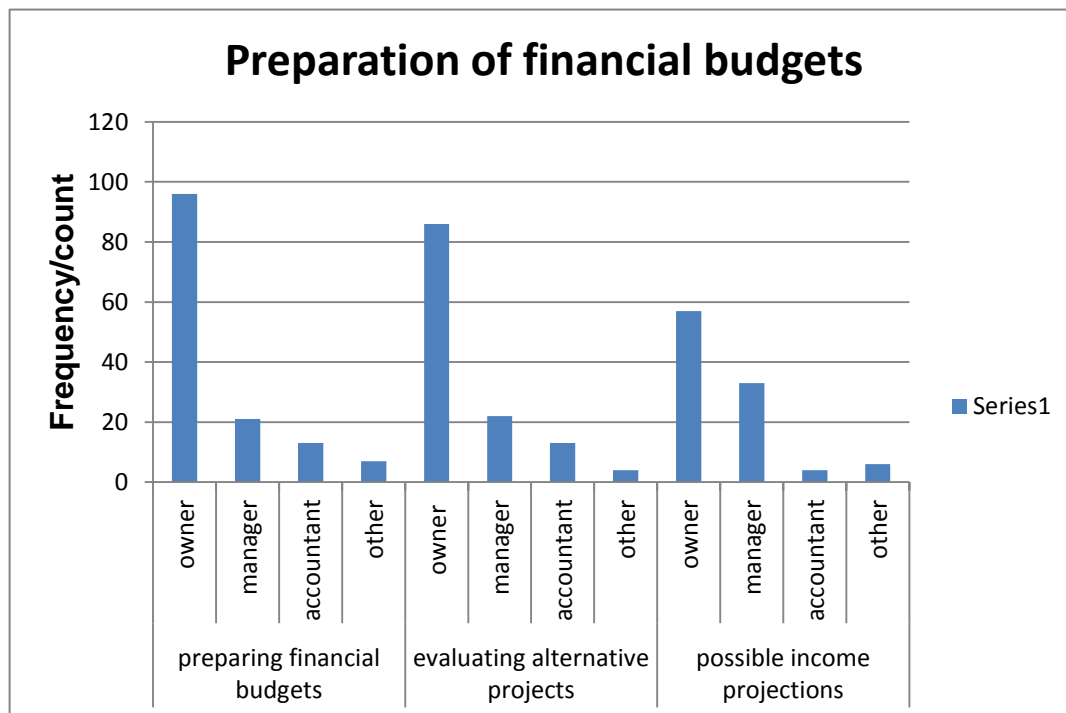
Who is responsible for carrying out the following?

The question intended to attach qualification, skills and capabilities to the jobs being done by the individuals in the SMEs.

**Table 5.7 Preparation of Financial Budgets**

Response	Owner	Manager	Accountant	Other	Total
Preparing financial budgets	96	21	13	7	137
Making income projections	86	32	19	4	125
Evaluation of investment projects	57	33	20	6	100

**Figure 5.1 Preparation of Financial Budgets**



Source: Data Analysis

**Comment:**

The results indicated that the owners take the bigger part in making capital expenditure decisions as indicated by 70%, 69% and 46% of SME owners being responsible for preparing financial budgets, evaluating alternative projects and making income projections respectively. The results also showed that just a small fraction of SMEs (less than 10%) made use of expert accountants to help prepare

financial budgets, evaluate big financial projects and make income projections. These findings are similar to studies by the European Association of Craft, Small and Medium-Sized Enterprises, (2010) and OECD (2004) which reported that SMEs have a shortage of qualified personnel because they have inadequate resources to hire them.

**Question 8:**

Please indicate the techniques your business use to evaluate capital expenditure projects.

The possible responses to this question included the techniques that are used in doing investment appraisal formally. It is a follow up question to question 6 which asked whether the SMEs do project evaluation before actually investing in the actual projects. The intention of the question is to find out whether SMEs make use of the known evaluation techniques when doing capital budgeting.

**Table 5.8 Capital Budgeting Techniques**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Payback	87	60.0	69.0	69.0
	Discounted payback	18	12.4	14.3	83.3
	NPV	21	14.5	16.7	100.0
	Total	126	86.9	100.0	
Missing	System	19	13.1		
Total		145	100.0		

Source: Data Analysis

**Comment:**

The findings on this question indicated a valid percent of 69% of SMEs to be using the payback period whilst the minority of them use net present value (NPV) and discounted payback. Harif and Osman (2007) gathered similar findings and they concluded that most SMEs put into practice the most obvious financial management techniques which are not on their own reliable. In a study by Agyei-Mensah (2011) SMEs commonly use the payback and the never used and are not aware of the internal rate of return, accounting rate of return and the profitability index.

### Question 9

Does your business apply computer systems in doing the process of capital budgeting?

As the world is becoming more advanced in technology, many methods and ways are being introduced that make doing work easier and at the same time less costly. Use of computer systems happens to be the common technology in today's business. The researcher asked this question to find out if SMEs are also making use of these computers and minimising on the related labour costs.

**Table 5.9 Use of Computers**

Response	Not at all	Rarely	Sometimes	Oftenly	Always	Mean score
Count	28	27	45	36	9	2.8

Source: Data Analysis

#### Comment:

There is a significant number of SMEs of about 20% who do not use computers at all and 19% who rarely uses computers. However, over 30% of SMEs in this study either uses computers oftenly or at all the times. It is important to note that the majority of SMEs are becoming more aware of the computer technology for business purposes even though they do not make use of it every day. These results of increased awareness in computer usage among SMEs are consistent with findings from a study by Chinomona (2013) who points out that SMEs are even integrating the use of Information Technology in their supply chain. Carvalho, Ribeiro, Araujo, Batista, Vilarinho and Castro (2012) also indicated that SMEs are integrating technology in their operations and many of them have recorded a number of IT assets.

### Question 10

Please indicate the areas you use the computer systems.

This question is a follow up to question 9 and intends to find out how the computer technology is being utilised in the business. It is important to note that the researcher in this study did not consider the use of tilling machine as computer technology.

**Table 5.10 Areas of Computer Application**

Area	Count/frequency
Making financial budget	17
Cost evaluation	21
Income analysis	43
Projects evaluation	17
Other	19
None	28

Source: Data Analysis

**Comment:**

Over 80% of SMEs indicated that they make use of the computer system in many areas of capital budgeting which include making financial budgets, cost evaluation income analysis and projects evaluation. However, the 13% who ticked on ‘other’ did not indicate for what they use computers for capital budgeting. The major result here is consistent with a study by Mboniyane (2006) who stated that all SMEs indicated to have the access to technology and they had the resources to invest in technology.

**Question 11**

The table 5.11 below contains statements that reflect on the efficiency of capital budgeting. Rank according to what happens in your business.

In this question, the researcher intended to examine how SMEs regard capital budgeting and how it is important to them.

**Table 5.11 Efficiency of Capital Budgeting**

How does your business regard capital budgeting?	Low regard				High regard			Mean score	
	7	6	4	21	43	43	11	4.9	
How often do you	Not regularly at all						Very regularly		

use investment appraisal techniques?	0	9	29	43	39	13	12	4.3	
How is the owner manager involved in this process of capital budgeting?	Low involvement						High involvement		
	8	23	14	7	28	34	31	4.7	

Source: Data Analysis

**Comment:**

On the question about how SMEs regard capital budgeting, a mean of 4.9 was obtained meaning that the general conclusion or perspective among SMEs is that they highly regard capital budgeting and it is important to them. A mean of 4.3 was obtained on the question about the number of times capital budgeting techniques are made use of. This represents a general perception of neutrality meaning that SMEs sometimes make use of capital budgeting techniques and at other times they do not. The last question was about owner/manager involvement in making capital budgeting decisions. The mean score of 4.7 shows that the owner manager is to a greater extent involved in making capital budgeting. In other words, among many SMEs the owner/manager is the one responsible for making major decisions like capital budgeting. Agyei-Mensah (2011) agrees that many SME owners do make major financial decisions and are responsible for handling the implementation because professional accountants are very expensive.

**Question 12**

In the implementation of the investment appraisal policies what problems do you face?

The questions asked earlier were focusing on the implementation of capital budgeting practices. From the responses provided, it is evident that challenges are present and this question seeks to find out these problems.

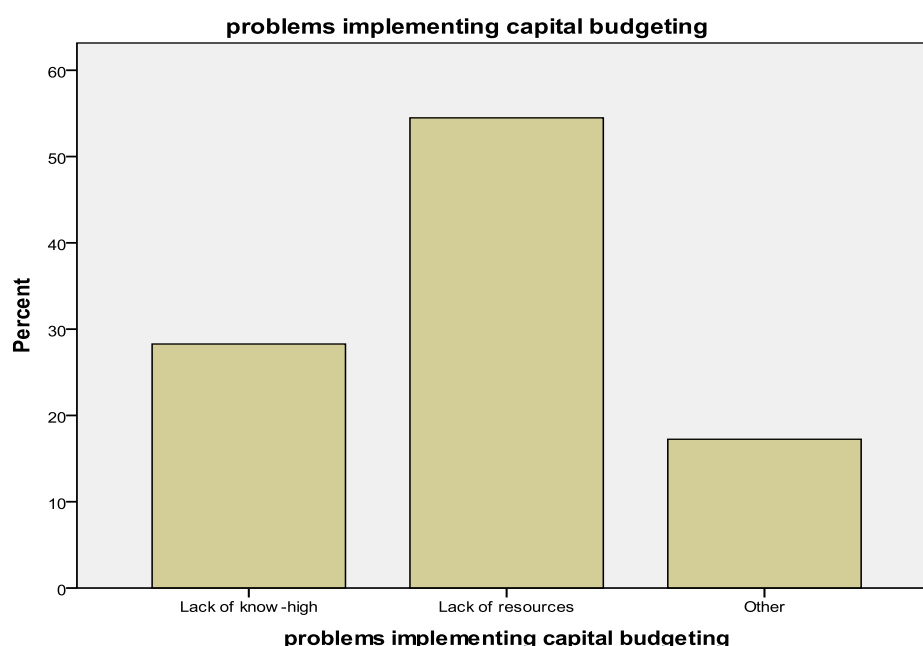
**Table 5.12 Problems on Capital Budgeting**

	Frequency	Percent	Valid Percent	Cumulative Percent
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Valid	Lack of know-high	41	28.3	28.3	28.3
	Lack of resources	79	54.5	54.5	82.8
	Other	25	17.2	17.2	100.0
	Total	145	100.0	100.0	

**Figure 5.1 Problems on Capital Budgeting**



Source: Data Analysis

**Comment:**

Almost 55% of respondents indicated that the major problems they face is lack of resources to implement sound capital budgeting practices. 28.3% confessed that they lack the know-how on how to put into practice some capital budgeting techniques. The 17% who responded as 'other' did not indicate the actual challenges they are facing. Consistently, Harif and Osman (2007) in their study concluded that the problems faced by SMEs include the lack of internal accounting staff, lack of technological facilities and the high cost of hiring and maintaining qualified accountants.

**5.2.2.2 Working capital management**

Working capital management is one of the major areas of financial management in any business regardless of the business size. Ekanem (2005) points out that working capital is a very essential aspect in the operations of SMEs because most of them do

not depend on long term sales investments but rather on the short term conversion of inventories into quick cash. In Question 13 up to Question 18 SMEs are asked on how they manage their working capital.

### Question 13

What kind of current assets does your business possess?

Current assets formulate a major portion of the working capital and this question intended to find out the kinds of current assets SMEs were in possession of. The results are represented in Table 5.13.

**Table 5.13 Current Assets**

		Responses		Percent of Cases
		N	Percent	
current assets <sup>a</sup>	Inventory	145	25.7%	100.0%
	cash	144	25.5%	99.3%
	receivables	131	23.2%	90.3%
	temporary investments	145	25.7%	100.0%
Total		565	100.0%	

a. Dichotomy group tabulated at value 1.

Source: Data Analysis

#### Comment:

All SMEs showed that they possess inventory and temporary investments. Exactly 100% of all cases indicated that they also possess cash and 90.3% indicated that they have receivables. The reason is that some SMEs said that they conduct all transactions on cash basis only. This is consistent with a study by Kehinde (2011) who postulates that SMEs usually worry about having a receipt of cash in their hands and a fat bank account balance. However, the same study indicated that some SMEs have little amounts of receivables given that they embark on debt factoring in order to have cash in their hands.

### Question 14

What kind of current liabilities does your business usually have?

Working capital management also involves taking into account current liabilities. This analysis of the short-term liabilities helps to know how much of a business' current assets will be funded by these short term liabilities. The main aim of this question is just to identify by name the short term liabilities that SMEs possess.

**Table 5.14 Current Liabilities**

		Responses		Percent of Cases
		N	Percent	
current liabilities	creditors	141	46.8%	97.9%
	bank overdraft	70	23.3%	48.6%
	Short term loans	90	29.9%	62.5%
Total		301	100.0%	

a. Dichotomy group tabulated at value 1.

Source: Data Analysis

**Comment:**

Table 5.14 above shows that almost 98% of SMEs studied here do have creditors and 48.6% showed that they have access to bank overdraft facilities. Some SMEs also indicated to be holding on to short term loans from friends, family and relatives. According to Nguyen and Ramachandran (2006) most SMEs hold low levels of liabilities because sometimes they hold poor records of reliability. Liabilities can help finance the short term assets but their low levels bring more financial stress to SMEs. On the contrary, Kehinde (2011) indicated that SMEs do have high amounts of liabilities because they usually focus on profit maximisation and when they get cash in their hands they forget to pay up their due accounts.

**Question 15**

How often does your business review the following?

The number of times working capital elements are reviewed can contribute to the effective management thereof. It is in the light of this reason that the researcher asked the SMEs on the number of times they review their working capital elements.

**Table 5.15 Review of Working Capital**

	Not Regularly							Mean score
	1	2	3	4	5	6	7	
Cash account	0	0	0	7	46	66	26	<b>5.77</b>
Accounts receivable	0	4	10	18	48	35	30	<b>5.31</b>
Inventory	0	0	0	4	33	68	40	<b>5.99</b>
Accounts payable	0	7	22	40	48	13	15	<b>4.57</b>

Source: Data Analysis

**Comment:**

The majority of SMEs showed that they attach much importance to their cash flow. This is indicated by the high mean score of 5.77 and with a few cases deviating from this mean. Another important asset is the inventory with all respondents agreeing to be reviewing inventory very regularly. SMEs also showed that they regularly review their receivables and payables as indicated by mean scores of 5.31 and 4.57 respectively. The results from a study by Agyei-Mensah (2011) showed that SMEs paid much attention to their cash accounts, cash budgeting and cash flow. However, the same study also showed that more than 70% of SMEs rarely review their debtors, payables as well as policies associated with each. This is different from the results obtained from this study.

**Question 16**

Do you use any computer control system in managing the following assets and liabilities?

As stated earlier, computer technology is becoming common in business administration and management. This question intended to determine if SMEs are making use of this technology when managing their working capital. The results obtained are presented in Table 5.16

**Table 5.16 Application of Computers in Working Capital**

		Responses		Percent of Cases
		N	Percent	
areas where computer is applied <sup>a</sup>	computer for cash management	102	31.0%	76.1%
	computer for inventory management	100	30.4%	74.6%
	computer for managing receivables	72	21.9%	53.7%
	computer for managing payables	55	16.7%	41.0%
Total		329	100.0%	245.5%

a. Dichotomy group tabulated at value 1.

Source: Data Analysis

**Comment:**

The results in Table 5.16 indicate that the computer technology is being used by SMEs to specially manage cash and inventory with 76.1% and 74.6% of the respondents indicating that they use the computer to manage cash and inventory respectively. There is a relatively high usage for reviewing receivables and payables as evidenced by the 53.7% and 41% respectively. Liu (2010) and Harif and Osman (2005) agree that computer technology is now being highly considered among SMEs. However, results from a study by Agyei-Mensah (2011) showed that more than 70% of SMEs did not use any computer technology to help facilitate in the management of their finances.

**Question 17**

In the table 5.17 the intention is to evaluate the efficiency of working capital management in your business. Please rank each situation as appropriately as it applies to your business.

**Table 5.17 Efficiency of Working Capital**

How often do you experience cash shortage?	Very often						Not at all		Mean score
	44	35	21	17	21	7	0	2.7	
Do you experience cash surpluses?	Not at all						Very often		3.55
	11	22	57	14	27	14	0		
How long does it take to convert inventory into cash?	very long						Expected time		4.01
	23	14	19	10	50	19	10		
Have you ever experienced inventory shortages?	Not at all						A lot of time		4.24
	6	11	26	28	47	27	0		
When do you place orders to receive inventory?	Before stock finish						After stock finish		1.5
	89	40	16	0	0	0	0		
Do your debtors settle their accounts in time?	Not at all						Always in time		4.72
	0	17	17	19	50	20	22		
How do you rate the amount of bad debts you experience?	Very high						Not at all high		5.25
	0	7	7	19	47	40	25		
Do you settle your due accounts in time?	Always						Not in time		3.73
	16	22	23	24	44	16	0		
Which policy do you use in controlling the levels of your working capital?	Conservative						Aggressive		3.97
	18	21	27	14	24	29	12		
How do you regard the control system of your working capital?	Not effective						Very effective		5.19
	0	3	15	23	39	40	25		

Source: Data Analysis

**Comment:**

Some of the questions asked on this scale referred to individual elements (cash, inventory, debtors and creditors) of the working capital. About 69% and 62% of respondents indicated that they experienced shortages of cash and did not realise cash surplus respectively. The mean score for inventory days is 4.01 which skews to the neutral response and this is because 37% of SMEs responded to be having difficulties in selling their products whilst 48% indicated smooth running of their sales.

More than 51% of the respondents said that they experience inventory shortages for a considerable number of times. However, this is in contrast to the fact that 100% of SMEs responded that they make new orders before inventories have ran out. About 63% of SMEs confirmed that their debtors pay on time and 77% also confirmed that the amount of bad debts they incur is relatively low. The results show that 43% of the respondents under study did settle their due accounts on time whilst almost an equal proportion indicated to be struggling in settling their due accounts on time.

A high mean score of 5.19 was obtained on the question concerning the effectiveness of the system of control on working capital. This means that most SMEs believed that the ways they are managing their working capital are effective enough. Garcia-Teruel and Martinez-Solano (2007) also concluded that the SMEs they studied showed much confidence in the systems they apply in their business.

### **Question 18**

What problems do you face in the implementation of your working capital policy?

This question was designed as an open ended one with the aim to give SMEs the chance to clearly say out the challenges they face when they try to implement good ways of managing their working capital. Similar to the findings reported by Azam and Haider (2011), some SMEs indicated that they are constrained by the unreliability of suppliers and their own (SMEs) inability to settle their due accounts fully and on time.

### **5.2.2.3 Capital Structure**

According to Nguyen and Ramachandran (2006) accessing finance remains a major challenge among many SMEs. In this section the researcher intended to determine what constitute the capital structures of SMEs. The questions to be answered were: What sources of funds are being utilised by SMEs and in what proportion as well as for what reasons?

### **Question 19**

Which of the following sources do you make use of in your business?

In this question SMEs are asked to simply indicate the sources of funds that they make use of. Table 5.18 gives a summary of the results obtained.

**Table 5.18 Source of Funds**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Own capital	14	9.7	9.7	9.7
Bank loan	21	14.5	14.5	24.1
Retained profits	4	2.8	2.8	26.9
Combination of any two	68	46.9	46.9	73.8
Combination of any three	38	26.2	26.2	100.0
Total	145	100.0	100.0	

Source: Data Analysis

**Comment:**

The results show that the SMEs studied make use of three sources of funds namely, own capital, bank loan and retained profits. From the table 9.7% and 14.5% of the respondents indicated that their business makes use of their own capital and bank loans respectively, with only 2.8% relying entirely on their retained earnings. More than 46% indicated that they use a combination of any of the three sources with a high proportion combining own capital and retained earnings. Only 26% utilise all the three sources of funds. Consistently, Rayan (2008) and Frank and Goyal (2003) state that SMEs are struggling to finance their operation considering that they have a limited self-sponsoring capacity. These results also indicate that SMEs make use of combinations of sources of funds so as to 'make ends meet'. However, Rayan (2008) indicates a big reliance on debt finance by SMEs.

**Question 20**

Please rank the sources of funds according to your business preference where 1 is the most preferred one.

This question sought to bring to light the most preferred and probably most accessible source of funds available for SMEs. The question also probed for SMEs to indicate their next best alternative source of funding and this will indicate also a source of fund that is next in accessibility and less costly.



**Table 5.19 Rank in Order of Preference**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Own capital	93	64.1	64.1	64.1
Bank Loan	34	23.4	23.4	87.6
Other	18	12.4	12.4	100.0
Total	145	100.0	100.0	

Source: Data Analysis

**Comment:**

There is a high percentage of over 64% of SMEs who prefer to use their own capital than alternative sources of funds. Many SMEs probably lack the security to acquire bank loans and may not be earning enough to meet the costs of servicing the bank loans. The next preferred is bank loan with a frequency of over 23% of all respondents and this might be due to the fact that some SMEs might be in possession of valuable assets that can act as security in order to acquire bank loans. In a study by Shinozaki (2012) consistent results were obtained given that SMEs prefer to utilise their own capital so that they do remain in total control of their business. However, the OECD (2009) indicated that SMEs utilise debt finance more than their own capital because they do not have adequate funds to sponsor operations.

**Question 21**

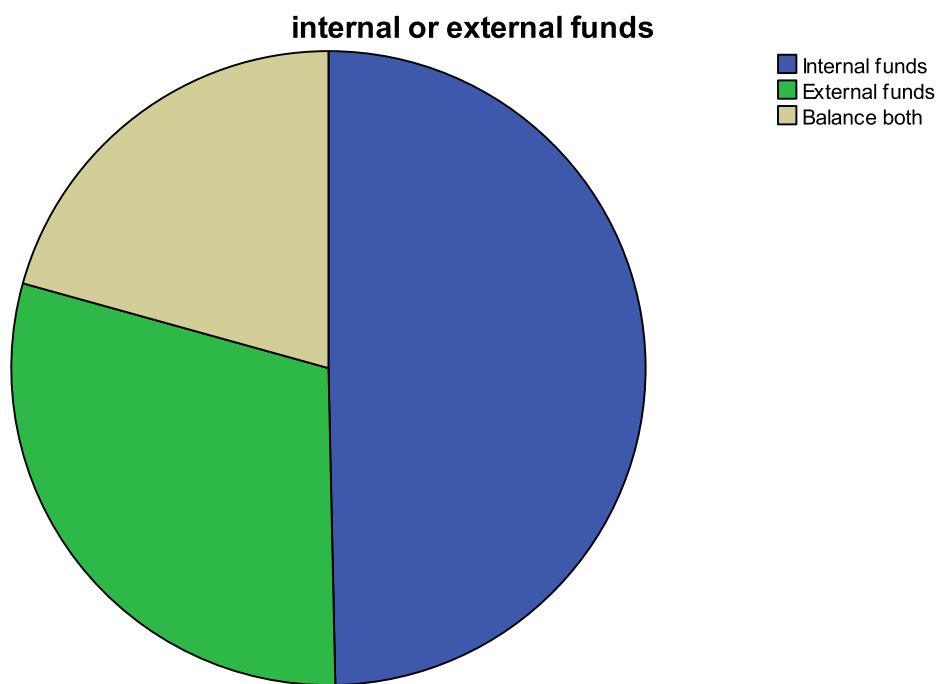
In terms of composition of your capital, do you use more internal or external funds?

The ratio of the capital sources has an impact on the profitability of a firm. Very high leveraged firms tend to highly use borrowed funds but face the financial risk of paying the cost of debt whether profits are made or not. In this question the researcher sought to find out how SMEs combine the sources of funds that they use be they external or internal funds.

**Table 5.10 Internal or External Funds**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Internal funds	72	49.7	49.7	49.7
	External funds	43	29.7	29.7	79.3
	Balance both	30	20.7	20.7	100.0
	Total	145	100.0	100.0	

**Figure 5.1 Internal or External Funds**



Source: Data Analysis

**Comment:**

Close to 50% of the studied SMEs indicated to be utilising internal funds more than external ones. Only 29.7% and 20.7% of the SMEs made use of external funds and balance between external and internal respectively. These results are consistent with the findings by Mazanai and Fatoki (2012) who state that SMEs fall victim to the credit rationing by financial service providers and this jeopardises their chances of getting bank loans and capital from other investors. The results are also consistent with a study by Nguyen and Ramachandran (2006) who in their study on Vietnam

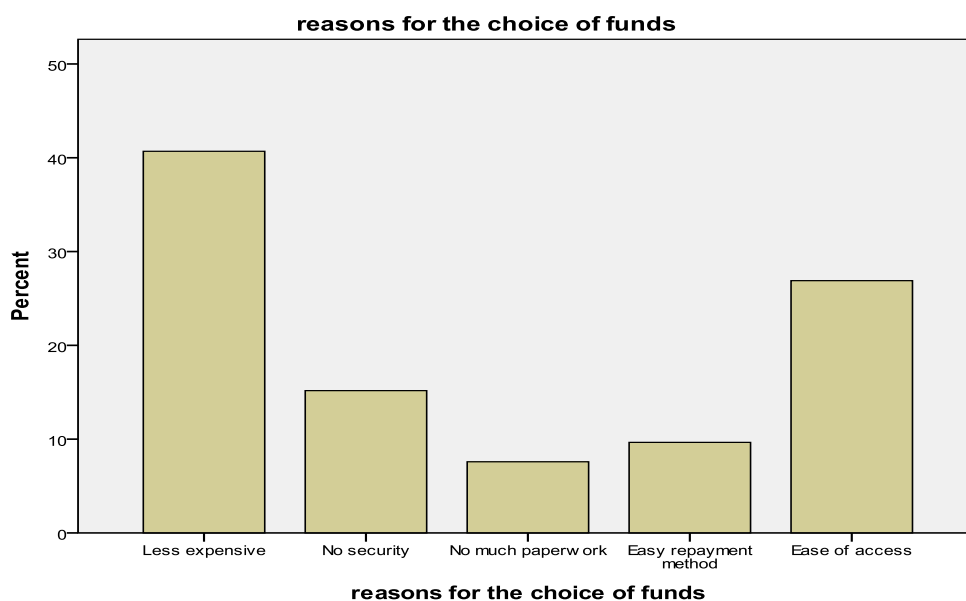
SMEs concluded that most SMEs debt ratio is below 50% and SMEs rarely use long term debt but rather use short term liabilities as additional source of capital.

### Question 21

Which of the following reasons make your business to use the sources of funds it uses?

The aim of the question was for SMEs to point out the factors that drove them to choose the type of funds they use. The reasons given on this question include the cost of securing the funds, accessibility and ease of repayment. Results on this question are displayed in Figure 5.7.

**Figure 5.1 Reasons for the Choice of Funds**



Source: Data Analysis

### Comment:

It is exhibited in Figure 5.7 that more than 40% of the studied SMEs chose the sources of funds they use due to the reason of being less expensive than other sources. Most of those who chose a source of fund as a result of it being less expensive did have internal funds as their main source. Some SMEs indicated that they lack the security needed to borrow funds and hence resort to other sources of funds that require little or no security at all. The results show that 30% of the SMEs

also responded that they choose to use certain sources of funds due to the reason of ease accessibility of these funds. According to Ackar and Voyoh (2011) and Bowen, Morara and Mureithi (2009) SMEs rely heavily on borrowed funds but they struggle to access these funds because they do not meet the credit terms demanded by the lenders and the number one reason being inadequate security to guarantee the loans. The SMEs therefore choose other sources of funds because they are less expensive and do not need security (Bowen *et al.*, 2009)

**Question 22**

Who is responsible for deciding the sources of funds to use?

The individual who secures the funds used in the SME indicates the quality of decisions that are taken in the business.

**Table 5.21 Who Chooses the Source of Funds**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Owner	90	62.1	62.1	62.1
Manager	37	25.5	25.5	87.6
Accountant	18	12.4	12.4	100.0
Total	145	100.0	100.0	

Source: Data Analysis

**Comment:**

As evidenced in Table 5.21, it is the owner that takes the responsibility to source funds in more than 60% of the SMEs under study. Only 12.4% make use of professional accountants to evaluate and make the capital sourcing decisions. The high percentage of owners making decisions is confirmed by Agyei-Mensah (2011) whereby SME owners were the ones taking responsibility on all important decisions. In other results on working capital and capital budgeting there is high involvement in decision making by the owners.

**Question 23**

What challenges do you face in sourcing funds?

SMEs have been reported to be faced with problems insofar as accessing funds is obtained. This question therefore intended to confirm this literature by having SMEs answer and indicate whether they face challenges in sourcing funds.

**Table 5.22 Challenges in Accessing Funds**

Challenge	Frequency	Valid percent
No required security	84	58
High borrowing costs	28	19
Improper business or project plan	33	23

**Comment:**

Most SMEs (58%) who desired to borrow from banks and other financial institutions indicated that they face the challenge of having insufficient security. Other challenges include high borrowing costs and improper business plans where each scored 19% and 23% of respondents respectively. These results are consistent with the findings by Nguyen and Ramachandran (2006) and Mazanai and Fatoki (2012) who agree that most SMEs bank loan applications are rejected because they lack evidence of adequate security to guarantee the repayment of the loans..

**5.2.2.4 Financial reporting and analysis**

Financial reporting involves the preparation of financial statements that are used to evaluate mainly the financial progress of a firm and also to help to make decisions for the future. Financial analysis is the in depth investigation of the financial statements in order to derive meaning and relevant assessment of the firm's performance. This also helps to make decisions for the future.

**Question 24**

What kinds of financial statements are regularly prepared in your business?

This question was intended for the SMEs to just indicate the financial statements they prepare.

**Table 5.23 Preparations of Financial Statements**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Balance sheet	2	1.4	1.4	1.4
Income statement + Balance sheet	64	44.1	44.1	45.5
Income statement + Balance sheet + cash flow	79	54.5	54.5	100.0
Total	145	100.0	100.0	

Source: Data Analysis

Given the three options of income statement, balance sheet and cash flow statement, 98.6% prepared more than just a single financial statement. 54.5% indicated to be preparing all the three whilst 44.1% are preparing only two. This shows that most SMEs are aware that there is need for continuous financial review which can be done through the preparation of financial accounts. Only 2 cases out of 145 answered that they prepare a balance sheet only. These results are even consistent with a paper by the European court of auditors (2012) which stated that SMEs are receiving training and development services from government and other well wishers. These training programmes are equipping owners with administration skills which include reporting financial status.

### Question 25

Who is responsible for the following duties in your business?

This question intended to identify the office(s) that prepares and analyses financial statements.

**Table 5.24 Who Prepares Financial Statements**

	Owner	Manager	Accountant
Preparing financial statements	77	47	21
Analysing financial statements	63	53	29

**Comment:**

As has been the case in other financial management decisions, there is high owner involvement in both the preparation and analysis of financial statements. The modal response was the “owner” with 53% and 43% for the preparation and the analysis of financial statements respectively. Only 14% and 20% of SMEs indicated that they make use of the services of professional accountants to prepare and analyse financial statements respectively. The rare use of professional accountants is confirmed by Agyei-Mensah (2011) who pointed out that SME owners are the ones who do the financial reporting and analysis because external accountants are expensive to maintain and also they lack internal accounting staff.

**Question 26**

How often are the financial statements of your business prepared and analysed? Please tick where appropriate.

This is a question of evaluation. Financial reporting and analysis need to be done with adequate understanding and this question is a kick-start to see the value that SMEs attach to financial reporting and analysis.

**Table 5.25 How often are Financial Statements Prepared**

	Monthly	Quarterly	Semi-annual	Annually	Never	Mean Score
Preparing financial statements	79	51	15	0	0	1.56
Analysing financial statements	67	48	30	0	0	1.74

Source: Data Analysis

**Comment:**

More than 50% and more than 46% of SMEs indicated that they prepare and analyse their financial statements on a monthly basis respectively. A considerable number do their reporting and analysis on a quarterly and semi-annual basis. All SMEs under the study do not do their reporting annually. The mean scores are 1.56 and 1.76 for reporting and analysis which are an indication that most SMEs prepare

and analyse their financial statements monthly and quarterly. Consistently, Sarapaivanich (2003) concluded that many SMEs do prepare financial statements but they have the challenge to effectively interpret these financials through analysis. Sarapaivanich (2003) also indicated that the few owners who do analysis of financial statements make use of consultancy services and do not regularly do so.

**Question 27**

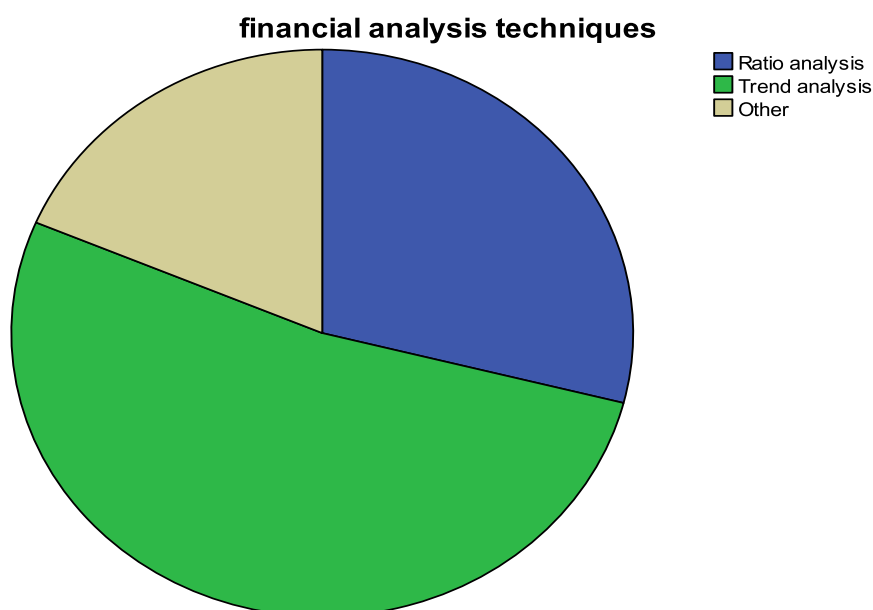
What kinds of financial analysis are currently used in your business (May circle more than one number)?

This is a question that intended to evaluate the financial analysis systems utilised by SMEs. The techniques available include ratio analysis and trend analysis. Table 5.25 gives the summary of the results obtained.

**Table 5.26 Financial Analysis Techniques**

Valid	Ratio analysis	42	29.0	29.0	29.0
	Trend analysis	76	52.4	52.4	81.4
	Other	27	18.6	18.6	100.0
	Total	145	100.0	100.0	

**Figure 5.1 Financial Analysis Techniques**





**Comment:**

Up to 81.4% of the respondents showed that their SMEs either used the ratio analysis or the trend analysis. Only 52% of all cases indicated to be making use of the trend analysis and 29% use the ratio analysis. However, the remaining 18.6% responded on the option 'other' but they did not indicate the techniques they make use of in financial analysis. These reported results corroborate the findings by Agyei-Mensah (2011) and Nguyen and Ramachandran (2006) who pointed out that SMEs sometimes do not do the sound financial analysis because they lack the understanding of techniques and they end up brushing them aside saying that the statements are too difficult to understand.

**Question 28**

Does your business ever apply computers in financial reporting and analysis?

The intention in this question was to discover the extent to which SMEs do make use of the computer technology which has proven to be modern and effective in a manager's life. The responses obtained are shown in Table 5.27.

**Table 5.27 Application of Computers in Financial Reporting**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Never	12	8.3	8.3	8.3
Rarely	39	26.9	26.9	35.2
Sometimes	52	35.9	35.9	71.0
Often	32	22.1	22.1	93.1
Always	10	6.9	6.9	100.0
Total	145	100.0	100.0	
<b>Mean Score</b>	<b>2.92</b>			

Source: Data Analysis

**Comment:**

On this question the mean score is 2.92 which is close the score 3 "sometimes". This means that most of the SMEs do sometimes apply computer technology in their analysis and preparation of financial statements. The result indicates that 26.9%

rarely use the computer system and 8.3% do not use the computer system at all. More than 22% make use of the computer system oftenly in the preparation and the analysis of financial statements. These results are inconsistent with studies by Liu (2010) and Harif and Osman (2005) who all postulated that SMEs are integrating computer technology in their operations and are becoming often users and even innovators to some of the technology. The difference in results could be that these studies are international and their SME sector might be different to the South African SME sector under study.

**Question 29**

If yes, what area is your computer applied?

**Table 5.28 Areas of Computer Application**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Financial reporting	35	24.1	24.1	24.1
Financial analysis	26	17.9	17.9	42.1
Both	84	57.9	57.9	100.0
Total	145	100.0	100.0	

Source: Analysis

**Comment:**

This question sought to validate the findings of the question 28. However, the SMEs who had indicated that they never make use of computer system responded to be using it in this question. Most SMEs (57.8%) indicated that they use the computer technology in doing both the preparation and analysis of financial statements. Chinomona (2013) produced similar results given that SMEs are utilising computer technology and IT to run their operations.

**Question 30**

The statements in the following table intend to evaluate the efficiency of accounting practice in your business.

In this question, the respondents were asked to respond on the scale as relevant as applicable to their businesses. The intention was to evaluate the efficiency of the financial reporting and analysis systems in SMEs. Table 5.29 gives a summary of the findings.

**Table 5.29 Efficiency of Financial Reporting and Analysis**

How does your business regard financial reporting and analysis	Low regard				high regard			Mean
	0	0	29	37	39	27	13	
How is the owner/manager involved in financial reporting and analysis	Low involvement				high involvement			5.04
	0	0	13	48	33	22	29	
How useful are the financial statements of your business in providing information for making decisions?	Not useful at all				very useful			5.64
	0	0	0	13	59	40	33	

Source: Data Analysis

**Comment:**

In the 7-point scaled question a mean score of 4.71 was obtained. This means that most SMEs give high regard to their financial reporting and analysis. However, 20% of the respondents indicated that their businesses do not give high regard to financial reporting and analysis. It is shown that 58% of respondents agreed that SME owners are highly involved in making decisions on financial reporting and analysis. Most owners as indicated by owners' educational details are not very qualified to be involved in financial reporting and analysis. However, all SMEs indicated that financial statements provide them with necessary information important to make decisions for their businesses. According to Kehinde (2011) SMEs do not highly regard financial reporting to be very important because they only want to have huge cash balances in their hands and they do not give much consideration to reviewing their progress. Kehinde (2011) also added that SME owners have the overall control of their business and as a result they only do what they can.

### 5.2.3 Section C: Financial Management Versus Firm Performance

Please indicate the level of your agreement on the situations given in the table below where 1= strongly disagree, 2= disagree, 3= neutral, 4= agree and 5= strongly agree.

The set of questions in this Likert scale sought to examine the relationship between financial management practices and SME performance. The respondents were expected to give their view taking into account the financial management practices they implement and the performance of their businesses. Table 5.30 gives a summary of the frequency and means of the responses for each question.

**Table 5.30 Financial Management versus Firm Performance**

ITEM	1	2	3	4	5	Mean
Investment appraisal techniques help in selection of profitable projects	0	0	16	89	40	4.17
Selection of sound investment projects increase ability to generate positive cash flows	0	0	30	69	46	4.11
Regular review of business accounts enhance the making of sound decisions	0	22	30	57	36	3.74
Owners wealth will be maximised if sound financial projects are executed	16	20	32	47	30	3.38
Good credit policy can help reduce bad debts	11	38	45	41	10	3.01
Financial planning is vital for business profitability	0	0	12	68	65	4.37
Poor inventory management can cause production hiccups	0	0	16	57	72	4.39
Use of internal funds can be less expensive	0	21	42	60	22	3.57
Financial reporting and analysis help in utilising monetary resources appropriately and profitably	0	0	20	73	52	4.22
Use of computer system can enhance efficiency in control and management	18	14	33	43	37	3.46
Offering discounts may help increase sales revenue	0	11	10	83	41	4.06

Source: Data Analysis

**Comment:**

Most SMEs confirmed that financial planning is vital for business profitability as evidenced by the fact that almost 92% of them responded agreeing and strongly agreeing. On the issue of investment appraisal most SMEs agreed that the use of sound appraisal techniques helps in choosing profitable projects as evidenced by a mean of 4.17. SMEs also agreed at a mean score of 4.11 that selection of sound investment projects helps business generate positive cash flows. Harif and Osman (2007) had similar findings that sound capital budgeting practices yield profitable investment.

The results show that poor inventory management can cause production problems and resultantly affect a firm's performance. However, on the question of reducing bad debts a mean score of 3.01 (neutral) was realised meaning that some SMEs agreed to the idea whilst others disagreed. Agyei-Mensah (2011) agrees that SMEs who had poor inventory management disappointed their customers as they failed to deliver adequate orders and on time.

### **5.3 HYPOTHESIS TESTING AND INTERPRETATION**

Hypothesis testing is the art of proving the acceptability of a statement made about a situation. Statistical tests are usually carried out to arrive at the decision. Hypothesis testing helps the researcher to measure how effectively the research objectives have been achieved.

#### **5.3.1 Primary Hypothesis:**

***Small and medium enterprises do not make use of sound financial management practices***

This hypothesis was tested by a close analysis of each area of financial management. The areas are capital budgeting, working capital management, financial reporting and analysis.

**Table 5.31 ANOVA on Financial Management Practices**

		Sum of Squares	df	Mean Square	F	Sig.
business's regard for capital budgeting	Between Groups	17.849	4	4.462	1.185	.320
	Within Groups	527.116	140	3.765		
	Total	544.966	144			
business's regard to working capital control	Between Groups	5.067	4	1.267	.740	.566
	Within Groups	239.526	140	1.711		
	Total	244.593	144			
business's regard for financial reporting and analysis	Between Groups	7.561	4	1.890	1.247	.294
	Within Groups	212.274	140	1.516		
	Total	219.834	144			

The F-values obtained in this analysis are greater than 1 for capital budgeting and financial reporting and analysis (1.185 and 1.247 respectively). The f-value for working capital (0.74) is less than but close to 1. This means that there is statistically significant evidence that is inconsistent with the null hypothesis. Therefore, the null hypothesis is rejected and a conclusion can be made that SMEs do make use of sound financial management practices. Similarly, Agyei-Mensah (2011) concludes that SMEs make use of good financial practices. However, they lack the relevant personnel to effectively implement these practices. Ekanem (2005) had contrasting results stating that SMEs do not employ sound financial management practices but they rather 'bootstrap' in order to fit their own ability and capacity.

### **5.3.2 Secondary Hypotheses:**

***No. 1: SMEs do not employ capital budgeting techniques in evaluating investment alternatives***

In testing this hypothesis the researcher used the questions on capital budgeting practices and capital budgeting techniques. The analysis yielded results as depicted in Table 5.32 and Table 5.33.

**Table 5.32 Capital Budgeting Practices**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Making financial budgets	28	19.3	19.3	19.3
	Evaluation of alternative projects	22	15.2	15.2	34.5
	Possible income projections	15	10.3	10.3	44.8
	Making financial budgets plus evaluation	21	14.5	14.5	59.3
	Doing all three	33	22.8	22.8	82.1
	Preparing financial budgets plus income projection	14	9.7	9.7	91.7
	Evaluation plus income projection	12	8.3	8.3	100.0
	Total	145	100.0	100.0	

Source: Data Analysis

**Table 5.33 Capital Budgeting Techniques**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Payback	87	60.0	69.0	69.0
	Discounted payback	18	12.4	14.3	83.3
	NPV	21	14.5	16.7	100.0
	Total	126	86.9	100.0	
Missing	System	19	13.1		
Total		145	100.0		

Source: Data Analysis

In Table 5.30 it is shown that 100% of the SMEs being studied employ at least one of the capital budgeting practices given in the question. From the responses, 55.2% of these SMEs indicated to be using at least a combination of two strategies whilst almost 23% make use of all three strategies. The Table 5.31 depicts results on the capital budgeting techniques that SMEs make use of. Net Present Value is made use of by a valid 69% with 19 cases having with missing answers. In the light of

these results SMEs seem to be aware of capital budgeting but probably lack the effective implementation of its techniques. However, a Chi-square test was carried to compare the results in the two categories above and the chi-square test results are tabulated in Table 5.34.

**Table 5.34 Chi-Square on Capital Budgeting**

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	22.088 <sup>a</sup>	30	.851
Likelihood Ratio	25.852	30	.683
Linear-by-Linear Association	.361	1	.548
N of Valid Cases	145		

a. 32 cells (76.2%) have expected count less than 5. The minimum expected count is .74.

Source: Data Analysis

The chi-square values are way above 0.05 meaning that there is little statistical evidence to reject the null hypothesis. Therefore, the null hypothesis that the SMEs are not employing capital budgeting techniques in evaluating investment alternatives is accepted and a conclusion can be made that SMEs do not employ sound capital budgeting techniques in evaluating investment alternatives. Consistently, Ekanem (2005) postulated that SMEs do not employ sound investment appraisal techniques because they lack the resources, skill and knowledge to do so.

***No. 2: SMEs do not properly manage their everyday financial activities (working capital management)***

In testing this hypothesis the researcher made use of the mean score on variables that answer the question on the regularity of review of everyday financial activities. The mean scores are tabulated below in Table 5.35.



**Table 5.34 Chi-Square on Capital Budgeting**

	review of cash account	review of debtors/receivables	review of inventory	review of payables
Mean	5.77	5.31	5.99	4.57
N	145	145	145	145
Std. Deviation	.799	1.278	.786	1.284

Source: Data Analysis

The table above depicts that most SMEs do review their cash accounts, receivables, inventories and payables regularly as evidenced by the means that are generally above the score 5 out of a maximum score of 7. The summarised mean of these variables becomes 5.41 which is a high score resembling the regular review of the working capital elements. The high score means are evidence enough to reject the null hypothesis and conclude that SMEs do properly manage their everyday financial activities. Studies by Kehinde (2011) and Nguyen and Ramachandran (2006) had similar conclusions. Kehinde (2011) postulates that SMEs are very much concerned about their cash balances and they can do whatever possible to have huge balances in their accounts. However, Kehinde (2011) disregarded the fact that SMEs end up employing an improper credit policy forgetting to pay their debts.

***No. 3: SMEs do not employ proper financial reporting systems (accounting practice)***

The ANOVA test was implemented to properly analyse the way that SMEs handle the financial reporting and analysis function. The variables used and the results obtained are depicted in Table 5.36 and Table 5.37.

**Table 5.36 Financial Reporting and Analysis**

	business's regard for financial reporting	how often do you prepare financial statements	how often financial statements analysed	financial statements prepared
N Valid	145	145	145	145
Missing	0	0	0	0
Mean	4.71	1.56	1.74	4.50
Std. Deviation	1.236	.676	.780	.647

**Table 5.37 ANOVA on Financial Reporting and Analysis**

				Sum of Squares	df	Mean Square	F	Sig.
how often do you prepare financial statements	Between Groups	(Combined)		.047	2	.024	.051	.950
		Linear Term	Weighted	.010	1	.010	.022	.883
			Deviation	.037	1	.037	.081	.777
	Within Groups			65.704	142	.463		
	Total			65.752	144			
how often financial statements analysed	Between Groups	(Combined)		.690	2	.345	.564	.570
		Linear Term	Weighted	.115	1	.115	.187	.666
			Deviation	.575	1	.575	.940	.334
	Within Groups			86.869	142	.612		
	Total			87.559	144			
business's regard for financial reporting	Between Groups	(Combined)		.670	2	.335	.217	.805
		Linear Term	Weighted	.076	1	.076	.049	.824
			Deviation	.593	1	.593	.384	.536
	Within Groups			219.165	142	1.543		
	Total			219.834	144			

Source: Data Analysis

In the ANOVA table 5.37 most F-values are greater than the expected F-critical value meaning that the evidence is significantly inconsistent with the null hypothesis. The analysis of the mean scores also reflects on much evidence to reject the null hypothesis. It is therefore statistically significant to reject the null hypothesis and conclude that SMEs do employ proper financial reporting and analysis practices.

Agyei-Mensah (2011) obtained different results which state that SME owners lack accounting information and know-how to soundly report their financial status and progress. This therefore acts as a barrier to the implementation of sound financial systems. The results in this study are inconsistent with Agyei-Mensah conclusions because there are now available many support programmes available that are teaching SMEs to soundly report and manage their finances.

***No. 4: Employing sound financial management practices does not significantly affect the firm's growth/success***

The researcher employed the linear regression analysis to test the relationship that might exist between the employment of financial management practices and firm performance. Firm performance was the dependent variable whilst financial management practices (capital budgeting, working capital management, capital structure decisions and accounting practice) were the independent variables.

**Table 5.38 Regression Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.275 <sup>a</sup>	.076	.045	1.228

a. Predictors: (Constant), working capital management, capital budgeting techniques, financial reporting and analysis, capital structure decisions

b. Dependent Variable: firm performance

Source: Data Analysis

**Table 5.39 Regression ANOVA**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	14.924	4	3.731	2.473	.048 <sup>a</sup>
	Residual	182.544	121	1.509		
	Total	197.468	125			

Source: Data Analysis

From the regression ANOVA table above the p-value is 0.048 and this is significant. This means there is significant enough statistical evidence to reject the null hypothesis and conclude that the employment of sound financial management practices significantly affect firm performance. The correlation coefficient for each predictor variable was also found to be positive meaning that the employment of sound financial management practices significantly and positively affects firm performance. Similarly, Agyei-Mensah (2011), Harif and Osman (2007) and Ekanem (2005) concluded that the more SMEs adopt effective ways of managing their finance function, the high the probability of success.

## **5.4 CHAPTER SUMMARY**

This chapter mainly focused on the question by question analysis of responses and relating each finding to the existing literature. Hypothesis testing was done using the chi-square test, mean scores, ANOVA and simple-linear regression. It was concluded that there is evidence that SMEs do make use of sound financial management practices. It was also concluded that there is a significant and positive relationship between the employment of sound financial management practices and firm performance.

The following chapter (Chapter 6) gives conclusions and recommendations based on the findings of this study.

## **CHAPTER SIX**

### **CONCLUSIONS AND RECOMMENDATIONS**

## **6.1 INTRODUCTION**

This chapter focuses on providing a conclusive review of the whole study. The first sections give a brief recap of the research objectives, the literature relevant to the obtained results and also the research design. The chapter gives a summarised discussion on the obtained research results from the general study and the research hypotheses. Conclusions are then made on these findings. Recommendations for SMEs, government and other policy makers are given in this chapter with reference to the research findings. The chapter ends by suggesting areas of further research.

Section 6.2 gives an overview of the literature relevant to the main findings of the study.

## **6.2 OVERVIEW OF LITERATURE**

In the first chapter (Chapter 1) the researcher provided a background to the study. It was discovered that SMEs play a crucial role in the development of economies through the creation of employment and alleviation of poverty (Nenzhelele, 2010). However, many of these SMEs are failing in the first years of their operations. The South African government has been drawn to attention by the pivotal role that SMEs play and therefore has introduced some systems and policies to help SMEs perform. Despite these efforts and those from the private sector, SME failure rate is still high. Vast literature has highlighted finance as a major cause among many and this research is rested on the finance function of the SME as an inside challenge.

In consideration of the efforts exerted by the stakeholders in SME development, some SMEs did access funds and got mentoring but still they are failing. The finance function needs consideration since it is rested upon the allocation and management of funds either received from outside or generated inside the firm. Thus this study focused mainly on investigating how capital budgeting, working capital management, capital structure, financial reporting and financial analysis takes place in the SME finance function. The study also examined how these areas of financial management do affect the ultimate financial performance of the SME.

Chapter 2 was centred on describing the SME and how financials are handled therein. The chapter described the SME as an entity that can be defined by the minimum and maximum number of employees that it can employ, balance sheet

totals and revenue. In South Africa an SME is defined as one that employs between 50 and 250 people depending on the industry, is managed by one or more managers and has a maximum turnover of R10m. This definition helps to discover the contribution that SMEs make towards income distribution, employment and gross domestic product. SME sector was described to be important to almost every economy across the globe.

In this chapter the researcher also highlighted the challenges that SMEs face as much as they are a strategic sector for economic development. The challenges include financial, marketing, technological, legislative and training and development issues. It was discovered that the financial problems that SMEs face stretches from the inaccessibility of funds to the deficiencies in the management of the little available funds. These challenges eliminate the chances of sustainable finance status. In order for SMEs to sustainably and significantly contribute to economic development, governments need to offer or provide an effective helping hand. The South African government has in operation many boards, systems and policies that are assisting and supporting SMEs in terms of accessing financial assistance and consultants on how to manage the finance function.

Chapter 3 was premised on the theories of financial management. The Pecking Order Theory (Myers, 1984), the Agency theory (Jensen and Meckling, 1979), the Signalling theory (Spence, 1973), the Owner/manager capability argument and the Relevancy argument are the theories that were used in this study to predict how SMEs run their financial function. The pecking order theory predicts that firms first use the internally available funds before sourcing from outside. The agency theory states that a firm might employ a third party, a manager, to run the business on behalf of the owner(s). In SMEs the owner usually becomes the manager who does everything. The Signalling theory emphasises the idea of communicating financial information to the market in order for potential investors to know the ground of their investment. Owner/manager capability argument points out that the owner/manager can adopt and implement certain practices because the owner/manager is able and capable of doing so. Relevancy argument postulates that the SME can only adopt certain systems and practices insofar as they apply to the SME.

The chapter ends by discussing of the efforts and initiatives that the South African government have implemented as intervention strategy for SMEs to be enhanced in their financial performance.

Section 6.3 gives a brief overview of the objectives the study intended to achieve.

## **6.3 RESEARCH OBJECTIVES REVISITED**

The research objectives were categorised into primary and secondary objectives which are as follows:

### **6.3.1 Primary Objective**

- To investigate into the financial management practices employed by SMEs in the Buffalo City Metropolitan.

### **6.3.2 Secondary objectives**

- To examine how small and medium enterprises make investment decisions (capital budgeting)
- To identify the sources of finance used by the small and medium enterprises (capital structure)
- To examine how small and medium enterprises manage their everyday financial activities (working capital management)
- To examine how small and medium enterprises report their financial progress (accounting practice)
- To examine the relationship between financial management practices and business growth/success
- To identify factors that promote/hinder the implementation of sound financial management practices
- To add and provide more information on the financial management techniques used by SMEs in order to provide an appropriate and effective financial management instrument relevant to the success of SMEs.

Section 6.4 gives summarised conclusions on the results obtained from the study as well as from testing the research hypotheses.



## **6.4 CONCLUSIONS ON RESEARCH RESULTS**

The usable sample for the study was 145 respondents and out of 201 chosen elements. A self-administered questionnaire was used to collect data from the SMEs. The researcher used the mean scores, chi-square test, analysis of variance (ANOVA) and linear regression to analyse the findings and test hypotheses. Conclusions were made concerning the awareness of SMEs about sound financial management practices and how these practices affect firm performance.

- **Awareness of SMEs on financial management practices**

In testing the hypothesis on SME awareness of financial management practices, the researcher examined SMEs' take on capital budgeting, working capital management, capital structure, financial reporting and analysis. The results obtained showed that the SMEs studied did give high regard towards the above mentioned areas of financial management. All the SMEs indicated that they carry out one or more of the following: 1) evaluation of alternatives 2) making financial budgets and 3) possible income projections. In addition, the results reported the use of payback, discounted payback and net present value (NPV) by the same SMEs. The mean score test confirmed that SMEs did regularly review their cash, debtors, creditors and inventories accounts. The researcher used the ANOVA test to examine the financial reporting and analysis systems that were employed by the SMEs under study. A conclusion was made that the SMEs did employ proper financial accounting principles especially that they regularly prepare and analyse their financial statements. This was similar to studies by Nenzhelele, (2009) and Kehinde (2011). The SMEs also indicated that they highly regard the availability of financial information in decision-making. All these findings give an indication that the SMEs have an understanding and probably some knowledge on how to manage the financial part of their businesses.

- **Financial management practices versus firm performance**

The researcher formulated a hypothesis to test how the implementation of financial management practices by SMEs affects the financial performance of these SMEs. Simple linear regression was employed to test the related hypothesis. The results obtained indicated that for the most part the implementation of sound financial management practices did significantly predict the financial outcome of the SMEs. It

is also important that the relationship between the implementation of sound financial management practices and financial performance is positive. This means that those SMEs that utilise sound capital budgeting techniques, working capital management, financial reporting and analysis are likely to yield a positive financial status (Agyei-Mensah, 2011 and Ekanem, 2005).

- **Other findings**

One of the objectives of this study was to identify the challenges that hinder the implementation of sound financial management practices. As far as the results are concerned, most SMEs do not have professional staff to handle the financial issues of their firms. This is because they lack adequate resources to hire qualified personnel and ultimately the owner/manager who might not have full expertise and knowledge handles the management of finance. The results indicated that the majority of the owners have not furthered their education their education beyond high school. Business operations in the twenty-first century are influenced by the advancement in technology. Most of the SMEs in this study were reported not to be making use of computer systems and software. As a matter of discussion, the lack of standard capital resource and state-of-the-art technology might bring concern on how effectively the financial management practices are being implemented by the SMEs (Chinomona, 2013).

In section 6.5 recommendations are made based on the obtained results.

## **6.5 RECOMMENDATIONS**

This study was conducted on SMEs in the Buffalo City Metropole and results obtained specifically refer to these SMEs. In this section recommendations are given to the SMEs in general and also to policy makers like government and other private institutions based on the obtained results.

This study makes the following recommendation to the SMEs:

- The financial management practices including capital budgeting techniques and financial reporting systems are mostly made for large business context and might be difficult to implement for an SME context. It is therefore

recommended in this study that SMEs should adopt financial management methods and practices that fit their ability and context (Ekanem, 2005).

- According to the results obtained in this study, SMEs did not make use of relevant human resources to help handle their finance functions. It follows therefore that SMEs can be recommended to effectively implement financial management techniques by hiring qualified personnel or alternatively develop the available staff through training and development programmes. Having relevant personnel for certain tasks might help SMEs to actually set financial goals which they can aim to achieve. A stance like this can enhance the control process. The owner/manager will be in a position to control budgets by effectively controlling expenditure and other costs.
- Other studies have shown that SMEs usually tend to give much attention to what is happening in their internal operations whilst hardly considering other external pressures that can negatively or positively affect their business. The results of this study indicated that most SMEs are rarely using external sources to fund their operations because of the inaccessibility of these funds. A recommendation can therefore be made that SMEs should continuously enquire and analyse the requirements by the money lending institutions. Environmental scanning and analysis is the art of gathering information on the business surroundings and discover opportunities and threats to the business. An example is to check the viability of certain products in the market and adjust the current product line in order to boost sales revenue. The majority of SMEs reported not to be using computer technology and this means that SMEs need to take note of new technology and create ways of incorporating the particular technology in their business and benefit from it.
- According to Liu (2010) SMEs may develop by making their human capital participate in training and development set up by government or other promoters. Firstly, SMEs might consider creating their own system of training by inviting their learned friends and relatives to facilitate the learning process. Secondly, SMEs may need to identify and acquaint themselves with the training and supporting programmes that both the government and private sector are setting up. Examples of these can be workshops, entrepreneurship conferences and outreach programmes by academics and students. Finally,

SMEs may also make consultations since there are many government run facilities to support the SME sector.

The following recommendations are made to the Government and other policy makers:

- Government is known to be a policy maker. The South African government has appreciated the role that SMEs play in the well-doing of the economy and has been supporting SME by initiating support bodies like Business Partners, Khula Enterprise Finance and Umbomvu Youth Fund. These policies have proven to be helpful; however, they need proper management and control to see that they effectively serve the SME sector. One challenge that the study reported is the difficulty that SMEs face in borrowing money from financial institutions like banks because they lack adequate security. Government may establish an effective loan guarantee system in order for SMEs to get funding to expand and grow. Literature reviewed for this study has it that many SMEs fail in the first year of business commencement. Government may actually help by providing a special funding for those SMEs that have growth intention but lack the resources to expand.
- The business regulatory system may also give room for SMEs advocacy capacity and association services. This might propel SMEs to be more open about the challenges they face and as is said “a problem shared is a problem solved”. If SMEs make associations, they can help and learn from each other as well as increasing the networking capacity. The creation of SME advocacy freedom can help government set up policies that may effectively address SME problems and challenges.
- Government may also advertise the facilities that they have that are tailored for SME assistance. The more these facilities are known the higher the chance of equipping SME owners and managers with a recipe to succeed. Information and advice is very important in business decision making. Government may inform SMEs on how financial information is crucial for money lenders. Money lenders may also need to care for SME growth by providing to them the specific requirements to successfully qualify for a loan.

The following recommendations were made to the private sector and non-governmental organisations:

- The private sector and other non-governmental organisations are hereby recommended to develop support systems to help SMEs in their supply chain and distribution. They can also create support partnership for strategic positioning of SMEs.
- Partnerships could be developed by the private sector to work with SME representative organisations, development agencies and other government partners who support SMEs.

Many recommendations can be made to many stakeholders insofar as the SMEs are concerned. Section 6.6 gives suggestion for future research and study.

## **6.6 AREAS OF FURTHER RESEARCH**

This study concluded that SMEs are aware and are making use of sound financial management practices. Research may be done to examine the effectiveness of these practices that SMEs are implementing. This study discussed deficiencies in financial management as a cause of SME failure whilst other studies have highlighted factors such as the inaccessibility of funds, marketing challenges as well as a tight regulatory system to be causes of SME failure. Research can therefore be conducted to investigate which factors have the most effects on SME financial performance. A replication of the study may be done on other metropolitan and district areas in South Africa to confirm the findings obtained in this study.

## **6.7 CONCLUSION**

Very few studies have been conducted on how the SMEs handle and manage their finance function. SMEs do have a pivotal socio-economic role in many nations across the globe and hence their success is a concern. This study makes an important contribution to SME literature and on how SMEs can enhance their chances of survival in a competitive environment by examining the financial management function of the SME. Literature to this study introduced some important areas of financial management namely; capital budgeting, working capital management, capital structure, financial reporting and financial analysis. In this chapter the objectives were revisited and they were all achieved. The hypotheses to

the study were also re-stated and conclusions on whether they were rejected were given.

Major findings of this study indicated that SMEs are quite aware of their finance function and are also aware of some strategies that can be used to soundly manage this function. However, it was highlighted in the findings that SMEs could be aware of financial practices but they do not possess adequate resources and personnel to effectively implement these practices. The obvious indication to this challenge is that SME owners usually handle all these activities whilst they do not have enough competencies to effectively do so. It was also obtained in this study that the use of sound financial management practices can enhance the performance of SMEs. SMEs should continue to attach importance to financial information because this information can help access funds and make sound profitable decisions.

The issue of financial management is very important because even if the SMEs do get financial assistance they still must be able to allocate and utilise them effectively. This can be done through the financial management function of the firm. Policy can also be directed to training and teaching SME owners and personnel on how to effectively administer their businesses. It is with anticipation that the findings to this study can contribute to literature and also help SMEs to grow and succeed as they form a very important part of both the economy and society.

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September 2013.

## **ADDENDUM 1**

### **Questionnaire**

#### **Questionnaire for the Small and Medium Enterprises survey-Masters Studies**

**Department of Business Management**

**Faculty of Management and Commerce**

#### **DEAR RESPONDENT**

My name is Mathew Marembo and I am a Master of Commerce student at University of Fort Hare under the department of Business Management. I am carrying out a research on the Financial Management Practices by Small and Medium Enterprises in the Buffalo City Metropolitan. Literature has reviewed that a lot of small and medium enterprises fail in the first few years of operation and this failure is very much linked to deficiencies in financial management. A business might have all the funds it needs but might fail to get the most out of the funds. This is where financial management is important. This study will therefore investigate into how financial management decisions are made by SMEs and also to evaluate the relationship between financial management and firm performance. The objectives of the study are summarised below:

To investigate into the financial management practices employed by SMEs in the Buffalo City Metropolitan;

To examine the relationship between financial management practices and business growth/success;

To identify factors that promote/hinder the implementation of sound financial management practices

It will be highly appreciated if you, the owner and or manager of the business, would participate in answering the questions as thoroughly as possible. The data obtained from the study will be used to provide solutions to the problems that SMEs face.

All the information will be treated as **STRICTLY CONFIDENTIAL** and will only be used for academic purposes. Please feel free to contact the researcher or the supervisor in cases of any queries.

Researcher: Mr Mathew Marembo; Cell: 073 699 2162, email [200808191@ufh.ac.za](mailto:200808191@ufh.ac.za)

Supervisor: Ms E.C. Rungani; Tel 040 602 2074 email; [erungani@ufh.ac.za](mailto:erungani@ufh.ac.za)

## **SECTION A: BUSINESS DETAILS**

1. Please indicate your position in business

Owner [ ]    Manager [ ]    Other (please specify) \_\_\_\_\_

2. What is your highest level of education?

High school            [ ]            Bachelor degree        [ ]

Diploma                [ ]            Master degree         [ ]

Other (specify) \_\_\_\_\_

3. Which industry does your business operate in?

Manufacturing        [ ]            Agriculture             [ ]

Construction         [ ]            Retail trading         [ ]

Service                [ ]            Other (please specify) \_\_\_\_\_

4. How long has the business been established?

1-3 years                [ ]            4-10 year              [ ]

10 years and above [ ]

5. Please indicate the number of employees in your business

Full time \_\_\_\_\_            Part time \_\_\_\_\_

## **SECTION B: FINANCIAL MANAGEMENT PRACTICES**

### **Capital Budgeting**

6. Which of the following is done by your business when making big expenditure or capital decisions?

Making financial budgets            [ ]            Evaluation of alternative projects [ ]

Possible income projections        [ ]

7. Who is responsible for carrying out the following?

	Owner	Manager	Accountant	Other
Preparing financial budgets?				
Making income projections?				
Evaluation of investment projects?				

8. Please indicate the techniques your business use to evaluate capital expenditure projects.

Payback  Discounted payback

NPV  IRR

Other (specify) \_\_\_\_\_

9. Does your business apply computer systems in doing the process of capital budgeting?

Not at all  Rarely  Sometimes  Oftenly  Always

10. Please indicate the areas you use the computer systems.

Making financial budget  Income analysis

Costs evaluation  Selection of best project

Other (specify) \_\_\_\_\_ None

11. The table below contains statements that reflect on the efficiency of capital budgeting. Rank according to what happens in your business

How does your business regard capital budgeting?	Low regard							High regard
	1	2	3	4	5	6	7	
How often do you use investment appraisal techniques?	Not regularly at all							Very regularly
	1	2	3	4	5	6	7	
How is the owner manager involved in this process of capital budgeting?	Low involvement							High involvement
	1	2	3	4	5	6	7	

12. In the implementation of the investment appraisal policies what problems do you face?

Lack of know-how  Lack of resources

Other \_\_\_\_\_

### Working Capital Management

13. What kind of current assets does your business possess?

Inventory/stock  receivables

Cash at bank  cash in hand

Temporary investments  prepaid insurance

14. What kind of current liabilities does your business usually have?

Creditors  overdraft

Short term loans  dividends

15. How often does your business review the following?

	Not regularly						Regularly
	1	2	3	4	5	6	7
Cash account							
Accounts receivable							
Inventory							
Accounts payable							

16. Do you use any computer control system in managing the following assets and liabilities?

	Yes	No
Cash/Bank		
Inventory		
Receivables		
Payables		

17. In the table the intention is to evaluate the efficiency of working capital management in your business. Please rank each situation as appropriately as it applies to your business.

How often do you experience cash shortage?	Very often						Not at all
	1	2	3	4	5	6	7
Do you experience cash surpluses?	Not at all						Very often
	1	2	3	4	5	6	7
How long does it take to convert inventory into cash?	very long				Expected time		
	1	2	3	4	5	6	7
Have you ever experienced inventory shortages?	Not at all						A lot of time
	1	2	3	4	5	6	7
When do you place orders to receive inventory?	Before stock finish				After stock finish		
	1	2	3	4	5	6	7
Do your debtors settle their accounts in time?	Not at all						Always in time
	1	2	3	4	5	6	7



No much paperwork  easy repayment method   
 Ease of access  other (specify) \_\_\_\_\_

23. Who is responsible for deciding the sources of funds to use?

Owner  Manager  Accountant  Other \_\_\_\_\_

24. What challenges do you face in sourcing funds?

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### Financial reporting and analysis

25. What kinds of financial statements are regularly prepared in your business?

Balance sheet  Income statement (profit and loss)   
 Cash flow statement  other (specify) \_\_\_\_\_

26. Who is responsible for the following duties in your business?

	owner	manager	accountant
Preparing financial statements			
Analysing financial statements			

27. How often are the financial statements of your business prepared and analysed?

Please tick where appropriate.

	monthly	quarterly	Semi- annually	annually	never
Preparing financial statements					
Analysing financial statements					

28. What kinds of financial analysis are currently used in your business (May circle more than one number)?

Ratio analysis  Trend analysis  Other \_\_\_\_\_

29. Does your business ever apply computers in financial reporting and analysis?

Never  Rarely  Sometimes  Often  Always

30. If yes, what area is your computer applied?

Financial reporting  financial analysis



31. The statements in the following table intend to evaluate the efficiency of accounting practice in your business.

How does your business regard financial reporting and analysis	Low regard				high regard		
	1	2	3	4	5	6	7
How is the owner/manager involved in financial reporting and analysis	Low involvement				high involvement		
	1	2	3	4	5	6	7
How useful are the financial statements of your business in providing information for making decisions?	Not useful at all				very useful		
	1	2	3	4	5	6	7

**SECTION C: FINANCIAL MANAGEMENT VERSUS FIRM PERFORMANCE**

32. Please indicate the level of your agreement on the situations given in the table below where 1= strongly disagree, 2= disagree, 3= neutral, 4= agree and 5= strongly agree.

ITEM	1	2	3	4	5
Investment appraisal techniques help in selection of profitable projects					
Selection of sound investment projects increase ability to generate positive cash flows					
Regular review of business accounts enhance the making of sound decisions					
Owners wealth will be maximised if sound financial projects are executed					
Good credit policy can help reduce bad debts					
Financial planning is vital for business profitability					
Poor inventory management can cause production hiccups					
Use of internal funds can be less expensive					
Financial reporting and analysis help in utilising monetary resources appropriately and profitably					
Use of computer system can enhance efficiency in control and management					
Offering discounts may help increase sales revenue					

**END!!!!!!!!!!!!!!!!!!!!!!!**

**THANK YOU VERY MUCH FOR YOUR TIME**

**ADDENDUM 2**  
**English Editor's Letter**



**University of Fort Hare**  
*Together in Excellence*

University of Fort Hare

Private Bag X 1314

Alice

5700

2013/11/20

To whom it may concern

This note serves to inform whoever may be concerned that I, Rachel Moyo, from the department of Communication, at The University of Fort Hare, Alice campus, have edited the Masters Dissertation of Mathew Marembo, who is in the department of Business Management, in the faculty of Management and Commerce. I am available to assist if need arises.

Yours faithfully

R. Moyo

Lecturer (Department of Communication)

Cell: 0744382830

E-mail: moyorachel@gmail.com

## ADDENDUM 3

### Ethical Clearance Letter



**University of Fort Hare**  
*Together in Excellence*

#### ETHICAL CLEARANCE CERTIFICATE

Certificate Reference Number: RUN02 1SMAR01

Project title: **Financial management practices employed by SMEs in the Buffalo City Metropolitan Municipality, Eastern Cape, South Africa.**

Nature of Project: Masters

Principal Researcher: Mathew Marembo

Supervisor: Mrs EC Rungani

Co-supervisor:

On behalf of the University of Fort Hare's Research Ethics Committee (UREC) I hereby give ethical approval in respect of the undertakings contained in the above-mentioned project and research instrument(s). Should any other instruments be used, these require separate authorization. The Researcher may therefore commence with the research as from the date of this certificate, using the reference number indicated above.

Please note that the UREC must be informed immediately of

- Any material change in the conditions or undertakings mentioned in the document
- Any material breaches of ethical undertakings or events that impact upon the ethical conduct of the research

The Principal Research must report to the UREC in the prescribed format, where applicable, annually, and at the end of the project, in respect of ethical compliance.

The UREC retains the right to

- Withdraw or amend this Ethical Clearance Certificate if
  - Any unethical principal or practices are revealed or suspected
  - Relevant information has been withheld or misrepresented
  - Regulatory changes of whatsoever nature so require
  - The conditions contained in the Certificate have not been adhered to
- Request access to any information or data at any time during the course or after completion of the project.

The Ethics Committee wished you well in your research.

Yours sincerely



**Professor Gideon de Wet**  
**Dean of Research**

25 March 2013

## ADDENDUM 4

### DATA ANALYSIS

#### Frequency Tables

**Respondent's position in business**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Owner	97	66.9	66.9	66.9
	Manager	35	24.1	24.1	91.0
	Other	13	9.0	9.0	100.0
	Total	145	100.0	100.0	

**Respondent's level of education**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	High school	54	37.2	37.8	37.8
	Diploma	37	25.5	25.9	63.6
	Bachelor degree	42	29.0	29.4	93.0
	Master degree	3	2.1	2.1	95.1
	Other	7	4.8	4.9	100.0
	Total	143	98.6	100.0	
Missing	System	2	1.4		
	Total	145	100.0		

**Industry**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Manufacturing	20	13.8	13.8	13.8
	Construction	15	10.3	10.3	24.1
	Service	28	19.3	19.3	43.4
	Agriculture	18	12.4	12.4	55.9
	Retail trading	44	30.3	30.3	86.2
	Other	20	13.8	13.8	100.0
	Total	145	100.0	100.0	

**Age of business**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	1-3 years	76	52.4	52.4	52.4
	4-10 years	52	35.9	35.9	88.3
	10 years plus	17	11.7	11.7	100.0
	Total	145	100.0	100.0	

**number of employees**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0-20	66	45.5	45.5	45.5
	20-50	44	30.3	30.3	75.9
	50-60	22	15.2	15.2	91.0
	60+	13	9.0	9.0	100.0
	Total	145	100.0	100.0	

**application of computers**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Not at all	28	19.3	19.3	19.3
	Rarely	27	18.6	18.6	37.9
	Sometimes	45	31.0	31.0	69.0
	Oftenly	36	24.8	24.8	93.8
	Always	9	6.2	6.2	100.0
	Total	145	100.0	100.0	

**capital budgeting practices**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Making financial budgets	28	19.3	19.3	19.3
	Evaluation of alternative projects	22	15.2	15.2	34.5
	Possible income projections	15	10.3	10.3	44.8
	Making financial budgets plus evaluation	21	14.5	14.5	59.3

Doing all three	33	22.8	22.8	82.1
Preparing financial budgets plus income projection	14	9.7	9.7	91.7
Evaluation plus income projection	12	8.3	8.3	100.0
Total	145	100.0	100.0	

**problems implementing capital budgeting**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Lack of know-high	41	28.3	28.3	28.3
Lack of resources	79	54.5	54.5	82.8
Other	25	17.2	17.2	100.0
Total	145	100.0	100.0	

**business's regard to working capital control**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Not effective	3	2.1	2.1	2.1
Not effective	15	10.3	10.3	12.4
Neutral	23	15.9	15.9	28.3
Effective	39	26.9	26.9	55.2
Effective	40	27.6	27.6	82.8
Very effective	25	17.2	17.2	100.0
Total	145	100.0	100.0	

**sources of funds**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Own capital	14	9.7	9.7	9.7
Bank loan	21	14.5	14.5	24.1
Retained profits	4	2.8	2.8	26.9
Combination of any two	68	46.9	46.9	73.8
Combination of any three	38	26.2	26.2	100.0
Total	145	100.0	100.0	

**how often do you prepare financial statements**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Monthly	79	54.5	54.5	54.5
Quarterly	51	35.2	35.2	89.7
Semi-Annually	15	10.3	10.3	100.0
Total	145	100.0	100.0	

**Simple Linear Regression**

**Descriptive Statistics**

	Mean	Std. Deviation	N
owners wealth maximisation	3.38	1.264	145
how often business does capital budgeting	4.37	1.301	145
conversion of inventory to cash	4.01	1.860	145
internal or external funds	1.71	.790	145

**Correlations**

		owners wealth maximisation	how often business does capital budgeting	conversion of inventory to cash	internal or external funds
Pearson Correlation	owners wealth maximisation	1.000	-.103	-.041	-.007
	how often business does capital budgeting	-.103	1.000	.144	.011
	conversion of inventory to cash	-.041	.144	1.000	-.049
	internal or external funds	-.007	.011	-.049	1.000
Sig. (1-tailed)	owners wealth maximisation	.	.108	.314	.465
	how often business does capital budgeting	.108	.	.042	.447
	conversion of inventory to cash	.314	.042	.	.278
	internal or external funds	.465	.447	.278	.
N	owners wealth maximisation	145	145	145	145



how often business does capital budgeting	145	145	145	145
conversion of inventory to cash	145	145	145	145
internal or external funds	145	145	145	145

**Variables Entered/Removed<sup>b</sup>**

Model	Variables Entered	Variables Removed	Method
1	internal or external funds, how often business does capital budgeting, conversion of inventory to cash	.	Enter

- a. All requested variables entered.
- b. Dependent Variable: owners wealth maximisation

**Model Summary<sup>b</sup>**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.107 <sup>a</sup>	.011	-.010	1.270

- a. Predictors: (Constant), internal or external funds, how often business does capital budgeting, conversion of inventory to cash
- b. Dependent Variable: owners wealth maximisation