



THE PECULIARITIES OF FINANCIAL MANAGEMENT PRACTICES IN SMALL BUSINESSES

Artūrs Prauliņš, Valda Bratka

Latvian State Institute of Agrarian Economics

Annotation

Small and medium enterprises play an important role in the development of national economies both in developed and developing countries. Consequently, effective financial and business management of these companies could be considered a prerequisite of sustainable economy. In comparison with large corporations, small businesses have different financial goals and characteristics resulting in the need for different financial techniques and sources of funds. The study aims to explore financial management practices in small businesses and to contrast them with techniques used by large companies. The research object is financial management practices in small companies, changes of and main trends in their development. It has been revealed that usually financial management practices in small companies depend on the stage of their development. Small businesses are inclined to preparing capital budgets by necessity unlike large companies which have annual budgets. Traditionally, small companies are reluctant to use newer and more sophisticated financial management techniques and practices. Although over the years the popularity of such methods as discounted cash flow has increased, the percentage of small companies using them is lower compared with large companies. Few small companies adopt traditional formal approach to working capital management. Instead, they give preference to subjective working capital decision-making. The majority of small businesses concentrate just on one area of working capital management (cash, stock or debtors) and the minority do not manage any area. The maximization principle of available amounts of cash instead of its skilful short-term investment as well as poor control over receivables are believed to be a really acute problem. In comparison with large companies, cash balances of small businesses are proportionately higher. Many small companies still use manual methods of stock control and the majority does not adopt any stock optimization methods at all.

KEY WORDS: small business, financial management, capital budgeting, working capital

Introduction

Small and medium enterprises (hereinafter - SMEs) play an important role in the future economic progress of developed and developing countries. They are considered the backbone of business innovations and modern sustainable knowledge-based economic development. Nowadays, SMEs make up about 99 % of all European businesses, provide two thirds of the private sector jobs and contribute to more than 50 % of the total value-added created by businesses in the EU (Fact...). In the ASEAN region SMEs account for over 96 % of all enterprises and provide 50 % to 85 % of domestic employment. Their contribution to GDP varies in the range from 30 % to 53 % whereas the contribution to exports is between 19 % and 31 %. (Small...) In China and India their part in total exports is even higher, 68 % and 40 % respectively (Economic... 2013). In OECD countries approximately 95 % of enterprises are SMEs and they create more than a half of working places in the private sector (Lukács 2005). Therefore, it would not be an overstatement to say that an effective business management of the SMEs is a prerequisite of stable economy in any country. Consequently, internal and external problems which SMEs face have been gradually becoming the subject of increasing interest.

For Gitman (2007), financial management is the area of business management, which deals with a judicious use of capital and a careful selection of its sources with the aim to achieve company goals. Usually, it involves investment decisions (capital budgeting techniques),

capital structure and working capital management. Some managers claim that small businesses should follow the same financial management principles as large companies because small businesses are believed to be similar to large companies with the exception of smaller sales and assets, and fewer employees. However, the incorrectness of this approach is obvious and it is discussed in detail further in this paper. The development of small companies is different from the mature companies because the former are more profitable, less liquid and highly geared whereas they have a lower percentage of long-term liabilities (Walker *et al.* 1978; McMahon 2004).

The study aims to explore financial management practices in small businesses and to contrast them with techniques used by large companies. The following research tasks have been set:

- 1) to study the peculiarities of financial management at different stages of small business development;
- 2) to highlight trends in the financial management practices in small businesses;
- 3) to identify capital budgeting techniques and approaches to working capital management in small businesses and to compare them with those used by large companies.

The research object is financial management practices in small companies, changes of and main trends in their development. The following research methods have been used: analysis, synthesis, monographic research and logical reasoning.

Recently there has been an increase in the number of educational and support programmes sponsored by the

government which are targeted at assisting the small business sector to remove obstacles to the successful development of established companies with growth potential and to overcome typical difficulties at the initial stages of evolution. Nevertheless, there is some reluctance to launch new policies and establish new favourable tax regimes without full information on actual state of small businesses. Therefore, the results of this study could be of particular interest to policy-makers because they could help to raise awareness of the specific problems of effective financial management in a small business and to provide a valuable insight into differences between practices in small and large companies.

‘A small business is not a little big business’¹

In comparison with large corporations small businesses have different financial goals and characteristics resulting in the need for different financial techniques and sources of funds. Some fundamental financial differences between these two groups were revealed and explored several decades ago (see, for example, Walker *et al.* 1978). Firstly, small companies have a higher variability in profitability and consequently a larger business risk. It is due to the lack of geographical and investment diversification which increases the volatility of small company profits. Secondly, a small company has a lower proportion of long-term debt to total assets as it uses short-term credits more intensively. These peculiarities could implicitly determine those areas of financial management small companies are mostly concerned about.

Welsh *et al.* (1981: 1) argue that company size is a reason for ‘resource poverty’ and a necessity to apply management methods different from those used by large corporations. Resource poverty is a consequence of such various factors as an extremely stiff price competition in industries dominated by SMEs (wholesaling, retailing, service, job-shop manufacturing), a high percentage of salaries in revenues, inability to pay for accounting services of high quality as well as a more significant susceptibility to changes in governmental regulation (for example, tax and labour law) compared with large companies.

Barton *et al.* (1989) are of the opinion that financing decisions of small businesses are influenced by managerial choice which is complemented or constrained by external threats and opportunities as well as internal strengths and weaknesses. As a result, the traditional finance model applied to large companies can not be used to explain the decisions about capital structure in SME. Deakins *et al.* (2001) concur with this view and maintain that the process of making this kind of decisions is more intricate than initially was suggested by the theory of pecking order hypothesis. Both the willingness to dilute equity and necessity to find suitable equity investors are important.

Generally, the background and attitude of the owner-manager in SMEs are recognised as one of the main contingent factors in adopting new accounting

procedures, including methods and approaches to financial management (Berry *et al.* 2002; McChlery *et al.* 2004). The innovation, business “shocks” (product failure or liquidity crisis) and pressure from supply chain partners (large companies) or providers of finance to adopt methods used by mature enterprises also play a crucial role in the process of adoption. Among other factors computerised accounting systems, qualified internal and proactive external accounting staff have been mentioned (McChlery *et al.* 2004). Another study (Deakins *et al.* 2001) argues that internal management issues and external environmental issues are responsible for the choice of financial management methods in small enterprises. Evolutionary changes and learning have a considerable impact on the adoption of new and more advanced methods.

Nevertheless, most owners-managers of SMEs demonstrate complete ignorance of effective accounting systems and use of accounting information for decision making and financial management (Fadhil *et al.* 2011). Sian *et al.* (2009) maintain that the majority of managers do not realize the importance of financial information in achieving business goals. Consequently, they ignore the need for a complex and regular financial management. Moreover, Xu *et al.* (2003) have reported that small companies do not rely on accounting information obtained from their accounting systems as they realize its incompleteness for thorough decision making. In addition, it has been noticed that SMEs ignore the importance of strategic environment in implementing financial strategy. The SME managers lack knowledge of financial management theory, for instance, time value, risk value, marginal and opportunity cost (Hu *et al.* 2008; Liu 2010). Another surprising fact is that “best practices” supported by academic literature are not necessarily considered as suitable for SMEs. Alternative methods determined by covert motivation of managers are used in practice despite being heavily criticized or considered as lagging behind by scholars (Grablowsky 1976; McMahon *et al.* 1991; Jarvis *et al.* 1996). Ignorance of the opportunity cost of trade discounts forgone could be a case in point (Panikkos *et al.*, 2005).

Poor or careless financial management is stated to be the most important cause of small business failure in the UK (Berryman 1983; Chittenden *et al.* 2000). According to Dodge *et al.* (1994), inadequate capital, cash flow management and inventory control are amongst the most significant internal problems which cause the failure of SMEs. The similar results are obtained from the research done by the Chartered Institute of Management Accountants in 1994 in the UK. The research has revealed that one fifth of the bankruptcies were because of bad debts or ineffective management of receivables (CIMA... 1994). The same problem has been identified by Tung *et al.* (2008) in emerging economies where failure factors of SMEs include poor skills in business and financial management.

Financial management at different stages of small business development

Specific features of financial management practices in small companies could depend on the stage of its

¹ It is the title of a seminal paper published by J. A. Welsh and J. F. White in *Harvard Business Review* in 1981.

development (Peacock 1977; Bhaird 2010). For Berger *et al.* (1998: 622), “Small business may be thought of as having a financial growth cycle in which financial needs and options change as the business grows, gains further experience, and becomes less informationally opaque”.

Micro companies and those small companies which do not pursue permanent growth continually use equity provided by founders, members of their family and friends, venture capitalists and business angels as well as debt capital either in the form of trade credit or supplied by banks (Grablowsky *et al.* 1980; Mullen 2012). On average, 93 % of British SMEs use trade credit and 25 % of them buy inputs only on trade credit (Panikkos *et al.* 2005). According to Berger *et al.* (1998) these limitations are imposed mainly by information opacity, in other words, smaller and more informationally opaque companies are destined to rely on insider financing or short-term loans.

Nevertheless, small enterprises which are determined to expand usually go through four stages, namely, start-up, early growth, take-off and maturity. At the first stage the main sources of finance are similar to those mentioned above. At the second stage the retained earnings are added to the list. As almost all the assets are pledged as collateral for short-term and medium-term debt, the availability of long-term debt is limited. In Atrill's (2009: 310) opinion, SMEs face the following major problems with finding sources of long-term finance: a lack of financial management skills resulting in inability to prepare a sound business plan; a lack of knowledge about available sources of finance; insufficient security for obtaining loans, inability to satisfy strict assessment criteria (for instance, positive credit history) and an extremely bureaucratic screening process.

At this stage, small businesses spend much time trying to obtain finance from more effective management of working capital, for example, acceleration of invoices, good management of inventories and delay of payments to suppliers and employees. This is confirmed by empirical studies. For instance, 62 % of British SMEs have admitted that they regularly delay payments to their suppliers (Panikkos *et al.* 2005). The popularity of financial and operating leases is high, too. The next stage is characterized by obtaining and managing long-term debt which becomes vitally important to financing working capital due to imbalance between rapidly growing sales and incoming cash flows. The opportunity of using traditional sources like bank credits is still limited because of the insufficient amount of collateral. Therefore, at this stage of growth unskilful financial management can easily lead to a liquidity crisis and an inevitable bankrupt. If a company overcomes these obstacles, they enter the last stage of development and gain an access to stock markets. Finally, their approach to financial management becomes similar to those adopted by large and mature companies.

The limited availability of short-term and long-term loans to SMEs has been confirmed by numerous recent studies (Liu 2010; Sunday 2011; Mullen 2012; Abanis *et al.* 2013). The results of analysis (Mateev *et al.* 2013) of 3175 SMEs from seven CEE countries over the years 2001–2005 have stated a heavy dependence of these

companies on internally generated funds for investments and growth due to difficulty in raising funds externally. However, it has been found that micro- and small companies use mostly short-term debt and trade credit whereas medium-sized companies rely rather on long-term loans obtained from banks. In addition, it has been recognized (Garcia-Teruel *et al.* 2007) that in the “continental model” countries without well-developed capital markets SMEs have limitation on the number of available alternative sources of external finance and, consequently, are more dependent on short-term loans, particularly, on trade credit.

Break-even analysis and capital budgeting

A remarkable difference between break-even analyses done by large companies and small businesses is identified (Welsh *et al.* 1981: 7). Generally, in large companies the new projects are relatively small compared to all the business operations. Teams of qualified economists, financiers, analysts and designers are involved in their development. An access to historical information on indirect expenses and their behaviour (for instance, growth step-by-step instead of being constant) improves the quality of prediction. It has been emphasised that “Older firms would have more time to learn about their costs, and so will have more accurate estimates of their costs. Again, unpleasant surprises in their costs, and concomitant future output levels, will prove less likely as the firm gains in age.” (Hall 1995: 10)

On the contrary, the planning of small business growth is superficial due to the lack of stable operations which could serve as the main source of finance to support new activities. Sometimes, the unsuccessful launch of a new project can even endanger the existence of a small business. The number of people employed by a small business is smaller and the experience in predicting the behaviour of indirect expenses is limited. For example, a study based on small businesses in central and northern parts of Scotland has shown that 17% of the companies did not employ any accounting staff and of those that did, 37.5 % of the accounting staff did not have any form of qualification. Consequently, qualified staff was employed just by 45.7 % of companies (McChlery 2004). Therefore, instead of precise calculations the subjective analysis is often based on inkling, necessity or desire. Moreover, it has been reported that carrying out cost-volume-profit analysis and applying such related techniques as contribution analysis, flexible budgeting and marginal analysis could be hindered by difficulty experienced by SMEs in separating variable and fixed costs (McMahon *et al.* 1991).

For Brigham (1992), capital budgeting decisions are crucially important to prosperity and sustainable development of any company. As decisions usually lead to significant outlays of financial resources on acquiring fixed assets, undertaking financial obligations is one of possible outcomes for a company. Capital budgeting is argued to be of greater importance to a small company because it suffers from a limited access to public markets for funding and inherent lack of diversification. In other words, failure of one project could remain uncompensated by success in another.

One of the first studies on the use of capital budgeting techniques by small enterprises was carried out by Soldofsky (1964). He interviewed 126 owners of small manufacturing businesses in Iowa and concluded that

about 56 % of respondents used payback period method and 3.9 % used accounting rate of return method. Over the following years the preferences varied significantly (Table 1).

Table 1. The results of early studies on the methods of investment analysis used by small companies (in percent)

	Payback period	ARR	Others	IRR	NPV	DCF ^d
Soldofsky (1964)	55,9	3,9	40,2	0	0	0
Luoma (1967) ^a	40,8	23,2	18,9	not individually broken out		17,1
Scott <i>et al.</i> (1972) ^b	30,0	51,0	9,0	8,0	2,0	10,0
Grablowky <i>et al.</i> (1980)	4,6	12,3	60,0	13,8	4,6	23,1 ^e
Runyan (1983) ^c	45,4	23,9	16,4	4,4	4,8	14,4 ^f

Source: Adopted from Block (1997: 295)

Abbreviations used in the table and in the further text: ARR – accounting rate of return; IRR – internal rate of return; NPV – net present value; DCF – discounted cash flow.

^a G. A. Luoma. Accounting information in managerial decision-making for small and medium manufacturers. New York: National Association of Accountants, 1967.

^b D. F. Scott, O. L. Gray, M. M. Bird. Investing and financial behaviour of small manufacturing firms. MSU Business Topics, 20, 1972, pp. 29-38.

^c L. R. Runyan. Capital budgeting decision making in small firms. Journal of Business Research, September 1983, pp. 389-397.

^d Is equal to the sum of IRR and NPV

^e Represents IRR, NPV or their combination

^f Represents IRR, NPV and probability index

Differences were also observed in preparing capital budgets. For example, according to the study carried out by Grablowky *et al.* (1980) just 30 % of 65 small companies prepared capital budget for each project and a similar percentage prepared annual capital budget. Only 3 companies prepared all the budgets, namely, annual capital budget, capital budget for each project, extended capital budget (over 1 year) and cash budget. Stoner (1983) obtained slightly different numbers, namely, 20 % of respondents in the sample prepared capital budget, 22 % prepared cash budget and 25 % prepared sales budget. In fact, these results are consistent with a conclusion made earlier by Soldofsky (1964) that small businesses tended to prepare budgets for capital outlays by necessity unlike large companies which traditionally had annual budgets. It was revealed (Grablowky *et al.* 1980) that owner's educational background played a part in determining the frequency of preparing capital budgets. Both larger companies and small companies managed by an owner with a higher level of education prepared capital budgets more often.

More recent studies evidence that over the decades the situation has slightly changed. However, the results of surveys are not consistent. In general, SMEs are still inclined to avoid newer and more sophisticated management techniques and practices related to financial

management. The results of the survey of 232 small businesses in the USA (Block 1997) have shown that payback period is strongly preferred by 42,7 % of respondents. It is followed by such methods as AAR (22,4 %), internal rate of return (16,4 %) and net present value (11,2 %). The popularity of payback period could also be attributed to the pressure of banks on small businesses. As credit institutions are primarily interested in borrowers' ability to repay loan within a certain period of time, payback period is the most suitable criterion for its quick assessment. Not surprisingly, it was short: 42,3 % of respondents indicated 2 years whereas 31,1 % of respondents mentioned 3 years as a minimum acceptable payout period.

The analysis of 42 manufacturing and 98 service SMEs located in Trafford Park industrial area (Manchester, UK) showed (Berry *et al.* 2002) that 39% of the respondents used break-even analysis. Payback period was used by 11 % of respondents. It was followed by NPV (7 %) and IRR (4 %). In addition, the results of quantitative analysis revealed that the majority of growing SMEs did not use financial measures. If they did, the users were older or had more employees.

Nowadays, there are still notable differences between methods for the appraisal of investments used by companies of different size (Table 2).

Table 2. Investment analysis methods used by companies of different size in the UK (in percent)

	Arnold <i>et al.</i> (2000)			Pike (1996) ^a				McIntyre <i>et al.</i> (1986) ^b
	Small	Medium	Large	Large				
				1992	1986	1980	1975	
Payback	71	75	66	94	92	81	73	82
ARR	62	50	55	50	56	49	51	33
IRR	76	83	84	81	75	57	44	28
NPV	62	79	97	74	68	39	32	36
DCF (IRR or NPV)	91	96	100	88	84	68	58	45
Non-financial criteria	32	17	39	-	-	-	7	4

Adopted from: Arnold *et al.* (2000: 605)

^a R. H. Pike. A longitudinal survey on capital budgeting practices. Journal of Business Finance and Accounting, 23(1), 1996, pp.79-92.

^b A. D. McIntyre, N. J. Coulthurst. Capital budgeting practices in medium-sized business - A survey. London: Chartered Institute of Management Accountants, 1986.

Although the popularity of such methods as DCF has increased, the percentage of small companies using them is lower compared with the proportion of large companies. Data presented in Table 3 have also revealed some insignificant differences in the frequency of use of investment analysis methods by companies of different

size in the UK. It means that if SMEs use a certain technique of financial analysis then generally it is applied almost as frequently as by large companies. In addition, there is evidence that small companies do not change their techniques more often than large companies (Arnold *et al.* 2000).

Table 3. Frequency of use of investment analysis methods by companies of different size in the UK (in percent)

	Rarely	Often	Mostly	Always
<i>Small companies</i>				
Payback	15	12	15	35
ARR	6	18	15	29
IRR	6	9	18	44
NPV	9	18	18	26
<i>Medium-sized companies</i>				
Payback	8	25	8	33
ARR	8	29	13	13
IRR	8	25	13	42
NPV	13	21	8	42
<i>Large companies</i>				
Payback	18	16	24	24
ARR	8	11	16	32
IRR	3	3	26	55
NPV	3	5	29	58

Adopted from: Arnold *et al.* (2000: 606)

An unexpectedly high proportion of small and large companies give preference to using such simple appraisal methods as payback or ARR (Arnold *et al.* 2000). Thus, it might be concluded that a tendency to simplify the process of analysis does not exclusively relate to small businesses. The comparative analysis of techniques used for the assessment of the risk of a major project has not revealed considerable differences either (Arnold *et al.* 2000). The majority of both small and large companies prefer sensitivity-scenario analysis (89 % and 82 % respectively) which is followed by the required rate of return (50 % and 42 % respectively) and subjective

assessment (55 % and 44 % respectively). However, if small companies apply sensitivity analysis as the only technique for the risk assessment (18 %) or combine it with subjective evaluation (15 %), large companies are likely to use the combination of sensitivity analysis and the raise of the required rate of return (Arnold *et al.* 2002: 613). The approaches to calculation of weighted average cost of capital demonstrate higher variability (Table 4). For instance, in comparison with large companies almost twice more small businesses ignore the basic rule and use balance sheet ratios of debt and equity as weights in the calculation of the abovementioned parameter.

Table 4. Appraisal of major capital investment by companies of different size in the UK (in percent)

	Small	Medium-sized	Large
<i>Derivation of the discount rate</i>			
Weighted average cost of capital	41	63	61
The cost of equity derived from the capital asset pricing model	0	8	16
Interest payable on debt capital	23	8	1
An arbitrarily chosen figure	12	4	3
Dividend yield on shares	0	0	3
Other	3	0	0
Earning yield on shares	12	8	11
<i>The definition of weights for the calculation of weighted average cost of capital</i>			
A long term target of debt and equity ratio	19	26	39
The present market values of debt and equity	44	47	42
Balance sheet ratios of debt and equity	37	26	19

Adopted from: Arnold *et al.* (2000: 619-620)

Working capital management practices

In general, working capital management is an extremely important component of financial management and corporate strategy of any company as it impacts on

profitability², creation of shareholders' value and

² After conducting analysis of collected data for 8,872 SMEs from 1996 to 2002 Garcia-Teruel *et al.* (2007) have reported a significant negative

liquidity (Shin *et al.* 1998). Because of various financial and non-financial factors, SMEs are forced to rely more heavily on short-term sources of funding which make them more susceptible to macro-economic fluctuations. Consequently, SMEs have to pay much more attention to the efficiency of working capital management. Particularly, it is relevant to managing accounts receivables and payables which account for a high proportion of working capital in any small business.

Thus, there are several disparities in the management of working capital in small and in large companies (Peel *et al.* 1996; Peel *et al.* 2000):

- 1) heavy dependence on trade credit and bank overdrafts as sources of short-term financing;
- 2) higher percentage of current assets;
- 3) lower level of liquidity and volatile cash flows;
- 4) tendency to grant lavish credit terms to obtain business, especially from large corporations;
- 5) rather weak procedures of control and absence of a well-developed policy of working capital management.

It is pointed out (Khouri *et al.* 1998) that few small companies adopt traditional formal approach to working capital management. Instead, they give preference to subjective working capital decision-making. Partly it could be explained by the concentration of ownership and control. As a company grows, the problems identified by agency theory require the introduction of formal systems and methods. Howorth *et al.* (2003) report that small companies are a heterogeneous group with regard to approaches to working capital management. The majority of small businesses concentrate just on one area of working capital management (cash, stock or debtors) and the minority do not manage any area. Other studies (Abanis *et al.* 2013; Sunday 2011; Yeboah 2012) have also confirmed the ignorance of working capital effective management by SMEs. The findings implicate the limitations of human and time resources for working capital management. In addition, it is noted that due to low-level financial skills the completion of specific tasks takes a longer time in comparison with a well-educated financial manager employed by a large corporation. However, companies which utilise fewer working capital management routines are not necessarily smaller ones. Management time constraints which limit the amount of time spent managing working capital are considered one of the most important problems for small companies. Therefore, it is not surprising that improvements in working capital management practices in small businesses would significantly decrease bankruptcy in this sector of national economy (Peel *et al.* 1996).

In large companies the rates of change and annual growth are usually small and short-term variances during the year are insignificant. Consequently, the borrowing capacity of the company is able to absorb them. It is not the case of a small business which could often suffer from seasonal fluctuations in sales resulting in periods of fast growth when the cash is consumed or periods of contraction when the payments are received. Actually, small companies can survive for an uncommonly long period of time without profit and be destroyed by not

making just a single payment. Therefore, these companies are recommended (Welsh *et al.* 1981) to devote special attention to the analysis of both income statement and statement of receipts and disbursements over the forthcoming periods of 6 to 12 months.

The conclusion can be made that the successful maintenance of liquidity and management of cash flows are of much greater importance to small companies than such a traditional indicator of success of large companies as profit and the efficiency of its generation measured by return on investment (Welsh *et al.* 1981). Jarvis *et al.* (1996) have found that in a small firm the management of cash flows was used just to obtain survival results and not growth. Other scholars (Deakins *et al.* 2001: 29) characterize micro business owners as naïve and unlikely to be actively involved in monitoring and management cash flows. Grablowsky (1978: 38) is convinced that “modern cash management methods, especially those usually presented in college textbooks and classrooms, are generally neither understood by most small-business managers nor applicable to the vast majority of their businesses”. As their cash flows depend on a limited number of clients and a few product lines, they are unstable and difficult to forecast. Grablowsky (1978) has showed that only 30 % of the 66 small businesses which filled in questionnaires prepared cash budget. Of companies which prepared cash budget, the smaller ones updated it more seldom than the large companies. If most small companies prepared a budget for a year, large companies did it just for 30 days. Only 5 small firms used quantitative techniques to determine the level of cash to be held and just 19 firms invested excess cash in earning securities or accounts. In one of his later publications, Grablowsky *et al.* (1980) made an extremely critical conclusion that cash management practices adopted by small businesses were inadequate.

The maximization principle of available amounts of cash instead of its skilful short-term investment as well as poor control over receivables and management of inventories are believed to be a really acute problem faced by most SMEs (Dodge *et al.* 1994; Hu *et al.* 2008; Liu 2010). It was revealed (Opler *et al.* 1999) that large companies with high credit ratings and an access to capital markets held lower ratios of cash to total non-cash assets. On the contrary, small firms held more cash than other companies.

The approach to stock control techniques also differs between large and small companies. According to Grablowsky (1984), the large companies apply statistical methods but small companies rely heavily on judgement (6 %), anticipation (32 %), past experience (15 %) or do not apply any method (27 %). A more recent study (Chittenden *et al.*, 2000) has shown that just 78 % of SMEs in the UK prepared sales budget and 63 % prepared cash budget. More than one third of respondents used manual methods of stock control and the majority of respondents did not adopt any stock optimization methods. In comparison with large companies cash balances of SMEs were proportionately higher. The results obtained from the research conducted by McChlery *et al.* (2004) are similar and show that just a small majority of respondents adopted budgeting (profit or cash) systems.

correlation between SME profitability and the number of days of accounts receivable and days of inventory.

Traditionally, the credit management of SMEs has been subjected to severe criticism and characterised by Chittenden *et al.* (2000: 24) as “fall[ing] behind best practice”. Unlike large companies, the vast majority of small businesses do not employ a full-time credit manager or even none at all (Grablowsky 1976). In economic sectors with high level of competition it is important to the seller to offer such terms of trade credit as comply with the general practice of the industry. This motive has been proved more crucial to small and less influential companies (64 %) rather than the large corporations (24 %) as the former can not be out of line with industry leaders which they compete with (Chenga *et al.* 2003: 424). Rafuse (1996)³ has emphasised that credit management “is essentially a Darwinian situation – the survival of the fittest. Large companies enforce their terms with smaller companies, who in turn enforce their terms with those smaller yet”. A postal survey of 236 privately held British companies with less than 250 employees (Panikkos *et al.* 1995) has shown that only 36 % of them have fully documented credit policy whereas 41 % have partially documented credit policy. Moreover, in 22 % of companies credit policy is either purely verbal or does not exist at all. Despite the fact that 84 % of respondents provide customers with credit terms and conditions, just 58 % ask them to complete a special credit application. Credit insurance is not popular with SMEs as only an average 23 % use it. However, its use has been reported to be more popular in larger companies. Actually, the popularity of credit applications notably increased in comparison with the situation 20 years ago when only some of the small retailing businesses in the sample required the completion of application (Grablowsky 1976). Nevertheless, 83 % of respondents still did not classify clients into different risk categories (Panikkos *et al.* 1995). This approach is consistent with previous practices when the “feel” of small business managers or owners for client credit-worthiness was the main determining factor in making a decision on granting trade credit (Grablowsky 1976). Unsurprisingly, intuition combined with a lack of adequate personnel and knowledge of appropriate collection procedures inevitably results in higher bad debt rates than those experienced by large companies. Analysis of case studies done by Howorth *et al.* (1998) has confirmed that late payments were indeed a typical and important problem faced by small companies.

Some researchers (Deakins *et al.* 2001) are convinced that in small businesses not all the factors influencing the choice of different financial management methods and techniques have been explored thus far. Therefore, the use of modified Balanced Scorecard has been proposed to examine the specific application of financial management methods.

Conclusions

SMEs play an important role in the development of national economies both in developed and developing countries. Consequently, effective business management

of these companies could be considered a prerequisite of sustainable economy. In comparison with large corporations, small businesses have different financial goals and characteristics resulting in the need for different financial techniques and sources of funds. The development of small companies is specific because they are more profitable, less liquid and highly geared. In small companies the professional and educational background of the owner or manager are among the main influencing factors in selecting approaches to financial management. Poor or careless financial management is stated to be the most important cause of small business failure.

Usually financial management practices in small companies depend on the stage of their development, namely, start-up, early growth, take-off and maturity. If initially an equity provided by founders, members of their family and friends, venture capitalists and business angels as well as trade credit are mostly used, later the retained earnings are added to this list. The availability of long-term debt is still limited due to insufficient amount of collateral. At this stage, small businesses spend much time trying to obtain finance from more effective management of working capital, for example, acceleration of invoices, good management of inventories and delay of payments. The next stage is characterized by obtaining and managing long-term debt which becomes vitally important to financing working capital due to imbalance between rapidly growing sales and incoming cash flows. Therefore, an unskilful financial management can easily lead to a liquidity crisis and an inevitable bankruptcy. If a company overcomes these obstacles, it enters the last stage of development and gains access to stock markets. Finally, its approach to financial management becomes similar to those adopted by large and mature companies.

Small businesses are inclined to preparing capital budgets by necessity unlike large companies which traditionally have annual budgets. Although the results of surveys are not consistent, typically small companies are reluctant to use newer and more sophisticated financial management techniques and practices. However, a tendency to simplify the process of analysis is also typical of large businesses. Although over the years the popularity of such methods as discounted cash flow (NPV and IRR) has increased, the percentage of small companies using them is lower compared with large companies. If a certain financial analysis technique is used, it is applied equally frequently both in small and large companies. In addition, there is empirical evidence that the frequency of change in applied techniques does not differ between small and large companies. However, carrying out cost-volume-profit analysis, contribution analysis, flexible budgeting and marginal analysis could be hindered due to the difficulty experienced by SMEs in separating variable and fixed costs.

Small businesses are forced to use intensively short-term sources of funding which make them more susceptible to macro-economic fluctuations. Thus, efficiency of working capital management, particularly, managing accounts receivables and payables, is crucial for their survival. Nevertheless, few small companies adopt traditional formal approach to working capital

³ Rafuse, M. E. (1996). Working capital management: an urgent need to refocus. *Management Decision*, 34(2), 59-63. [quoted from (Yeboah, 2012: 4)].

management. Instead, they give preference to ad hoc or subjective working capital decision-making. The majority of small businesses concentrate just on one area of working capital management (cash, stock or debtors) and the minority do not manage any area. As their cash flows depend on a limited number of clients and a few product lines, they are unstable and difficult to forecast. The maximization principle of available amounts of cash instead of its skilful short-term investment as well as poor control over receivables and management of inventories are believed to be a really acute problem. In comparison with large companies, cash balances of SMEs are proportionately higher. Many small companies still use manual methods of stock control and the majority does not adopt any stock optimization methods at all. Commonly large companies enforce their terms with smaller and less influential companies. In result, the latter are forced to offer the terms of trade credit which comply with the general practice of the industry. Most small businesses do not classify clients into different risk categories. Alternatively, “feel” of managers or owners for client credit-worthiness is the main determining factor in making a decision on granting trade credit. It leads to higher proportion of bad debts in comparison with large corporations.

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THE PECULIARITIES OF FINANCIAL MANAGEMENT PRACTICES IN SMALL BUSINESSES

Summary

The study aims to explore financial management practices in small businesses and to contrast them with techniques used by large companies. The results of this study could be of particular interest to policy-makers because they could help to raise awareness of the specific problems of effective financial management in a small business and to provide a valuable insight into differences between practices in small and large companies.

Small and medium enterprises play an important role in the development of national economies both in developed and developing countries. Consequently, effective financial and business management of these companies could be considered a prerequisite of sustainable economy. In comparison with large corporations, small businesses have different financial goals and characteristics resulting in the need for different financial techniques and sources of funds. The development of small companies is specific because they are more profitable, less liquid and highly geared. In small companies the professional and educational background of the owner or manager are among the main influencing factors in selecting approaches to financial management. Poor or careless financial management is stated to be the most important cause of small business failure.

It has been revealed that usually financial management practices in a small business depend on the stage of its development. Small businesses are inclined to preparing capital budgets by necessity unlike large companies which have annual budgets. Traditionally, small companies are reluctant to use newer and more sophisticated financial management techniques and practices. However, a tendency to simplify the process of analysis is also typical of large businesses. Although over the years the popularity of such methods as discounted cash flow has increased, the percentage of small businesses using them is lower compared with large companies. If a certain financial analysis technique is used, it is applied equally frequently both in small and large companies. However, carrying out cost-volume-profit analysis, contribution analysis, flexible budgeting and marginal analysis could be hindered by the difficulty experienced by small companies in separating variable and fixed costs.

Small businesses are forced to use intensively short-term sources of funding which make them more susceptible to macro-economic fluctuations. Thus, efficiency of working capital management, particularly, managing accounts receivables and payables, is crucial for their survival. Few small companies adopt traditional formal approach to working capital management. Instead, they give preference to subjective working capital decision-making. The majority of small businesses concentrate just on one area of working capital management (cash, stock or debtors) and the minority do not manage any area. The maximization principle of available amounts of cash instead of its skilful short-term investment as well as poor control over receivables are believed to be a really acute problem. In comparison with large companies, cash

balances of small businesses are proportionately higher. Many small companies still use manual methods of stock control and the majority does not adopt any stock optimization methods at all. Most small businesses do not classify clients into different risk categories. Alternatively, the “feel” of managers or owners

for client credit-worthiness is the main determining factor in making a decision on granting trade credit. It leads to higher proportion of bad debts in comparison with large corporations.

KEYWORDS: small business, financial management, capital budgeting, working capital

Artūrs Prauliņš, *Dr. oec.*, researcher at the Department of Agribusiness Information and Analysis, Latvian State Institute of Agrarian Economics. Scientific interests: financial and management accounting, analysis of farm performance, microeconomic analysis. Address: Struktoru Street 14, Riga, LV-1039, Latvia. Phone: (371) 67552786; fax: (371) 67541789; e-mail: arturs@lvaei.lv.

Valda Bratka, *Dr. oec.*, leading researcher, Head of the Department of Agribusiness Information and Analysis, Latvian State Institute of Agrarian Economics. Scientific interests: agrarian economics, econometrics, microeconomics. Address: Struktoru Street 14, Riga, LV-1039, Latvia. Phone: (371) 67167909; fax: (371) 67541789; e-mail: valda.bratka@lvaei.lv.