

Smes are based on size finance essay

[Finance](#)



2. 1 Introduction

This chapter follows from chapter 1 as a review of the literature on financial accounting practices. Chapter 1 provided an overview of the research problem under study. Chapter 2 reviews financial accounting practices, accounting information and financial performance measurement in SMEs around the world, especially in economies such as the United States of America (USA), the United Kingdom (UK), Australia, Middle East and some African countries. It emphasizes the use of accounting information in financial performance measurement among SMEs. The objectives of this chapter are to review previous research related to the areas of financial accounting practices, accounting information, and financial performance measurement in SMEs and to build a model of the use of accounting information in financial performance measurement in SMEs. This chapter is structured into three main sections. Section 2. 1 introduces the general purpose and objectives of the chapter. Section 2. 2 discusses theoretical framework which indicates variables and relationships relevant to the research study. This includes reviews of definitions of SMEs, roles of SMEs, the concepts and principles of accounting as espoused in IFRS for SMEs, record keeping practices, accounting information and usage in financial performance measurement among SMEs. Section 2. 3 reviews the previous studies on financial accounting practices, accounting information and financial performance measurement in SMEs conducted by previous researchers in the other economies, justification (research gap) and develops a model of the impact of financial accounting practices, accounting

information and financial performance measurement in SMEs. . Lastly, section 2. 4 gives a summary of the literature.

2. 2 Theoretical Literature Review

2. 2. 1 SMEs in Zimbabwe

Definition of SMEs

There are several ways of defining a small and medium scale business.

Mbroh and Attom (2012: 30) contend that, regardless of their differences, all the definitions agree on the common views that small or micro businesses employ few persons and are characterized by a relatively small amount of capital and turnover. Zindiye (2008) agrees and states that, most definitions of SMEs are based on size and they use fundamental bases such as number of employees, financial position or annual turnover. However, none of these bases are pegged at the same level across disciplines and national boundaries due to differences in currencies and level of development. The International Accounting Standards Committee Foundation (IASCF) (2007) defines an SME as an entity that does not have public accountability and thus publishes general purpose financial statements for external users. SMEs are therefore entities which do not have the onerous requirement of filing their financial statements with any regulatory body for the purpose of issuing financial instruments. These entities do not hold assets in any fiduciary capacity for a group of outside investors (banks, insurance entities, security brokers, funds, etc) but the owners, who usually are also managers. In Zimbabwe, the Small Enterprises Development Corporation (SEDCO) (2010) defines a small and medium enterprise as a firm that has not more than 100 employees with maximum annual sales of up to US\$830 000. However, Sian <https://assignbuster.com/smes-are-based-on-size-finance-essay/>

and Roberts (2006) went further to differentiate a micro entity from an SME. They defined micro-entities as the smallest entities within the SME spectrum and that these entities have less than 10 employees (including those that do not have any employees). The UNCTAD (2000), defines a micro enterprise as " a business involving one to five persons (typical a sole trader)". Mbroh and Attom (2012: 30) went further to describe its characteristics. Its character would be such that its activities are simple enough to be managed directly on a person-to-person basis and the scale of the operations means it is unlikely to need or be able to afford to devote significant staff time to accounting. Its operations are likely to concern a single product, service or type of operations. Only basic accounting is needed to record turnover, control expenses and profitability, and if necessary, compute profits for tax purposes. It is unlikely to have extensive credit transactions. Enterprises employing up to 10 persons has been adopted as defining a micro enterprise for the purpose of this study. Similarly, Mbroh and Attom's description of a micro enterprise has been adopted for the same purpose.

Role of SMEs in the Zimbabwean economy

According to Zindiye (2008: 15) the primary importance of the SME sector in Zimbabwe is the creation of employment which contributes to an individual's disposable income. This implies that if people have disposable income they will spend more on goods and services. The consumption of goods and services contributes significantly to economic growth in Zimbabwe. Currently many researchers stipulate that the SME sector is the answer to the alleviation of poverty and creation of jobs in Zimbabwe. The Zimbabwean government and corporate institutions have assigned funds to develop and

empower communities through entrepreneurship (Mawadza, 2006). Small businesses are seen to be imperative in stimulating entrepreneurial development, contributing to the transformation of the traditional sector into a modern one, creation of employment, reducing rural and urban migration and serving as a training ground for managerial skill acquisition, as concluded by Akande (2011: 376). Small businesses are active and dominant in the economies of many developing countries including Zimbabwe. For this reason, they have been high on the developmental agenda of many African countries. The SME sector offers employment opportunities to a large section of the labour market (SIRDC, 2001: 12). SMEs therefore represent an important sector of the economy, which has the capacity to absorb the bulk of the unemployed if they produce both for the domestic and export markets, thus contributing to the sustainable development dimension. Ndoro (2012) adds that, SMEs in Zimbabwe contribute approximately 90% to the growth of the country as per a report in 2011. This implies that SMEs support a bigger part of the Zimbabwean population and contribute largely to Zimbabwe's Gross Domestic Product (GDP). This support can be seen in the form of income (salaries and wages) as most people are employed in the SME sector and they earn a living through SMEs. The Rural Banking (2007: 8) concludes that the SME sector plays a significant role in economic growth and improving the standard of living of the people of Zimbabwe. Mwangi (2011) adds that the SME sector is often an ignored sector although it plays a highly significant role individually and collectively in poverty reduction. He argues that this sector makes a major contribution to poverty reduction and a significant contribution to economic growth, an outcome all development programs aspire to achieve, hence its contribution can be seen through the <https://assignbuster.com/smes-are-based-on-size-finance-essay/>

creation of small businesses, the raising of household incomes and the creation of markets for locally produced goods. Small and micro enterprises are embedded in the economic sector and serve a given clientele. This clientele has consumer needs not catered for by the medium and large enterprises. SMEs therefore play an important role in a nation's economy. It is estimated that up to 30% of the working population in sub-Saharan Africa is employed in this sector (Mensah, J. V., Tribe, M & Weiss, J., 2007: 67). They also play an important role as efficient providers of intermediate goods and services to large firms. Not much attention has been paid to this sector of the economy involving small and micro-enterprises, which on one hand is claimed to significantly contribute to economic growth and reduction of employment, and on the other hand is a sector left out when recording official statistics relating to trade in Zimbabwe. It is therefore difficult to concretely determine the monetary value of their contribution to the economy. The result therefore is that little is known about their operations and especially the nature of the accounting systems that exist in these enterprises (Mwangi, 2011: 80). It is imperative that researches should be carried out concerning the accounting systems of micro entities so that it is possible to gather statistical data about them, which is vital in national policy formulation. Against this background it is necessary to discuss the factors that affect the growth of SMEs in developing countries such as Zimbabwe. This is an important area which should be addressed if the full potential of SMEs as a vehicle for economic growth, improvement of standards of living and employment creation is to be realised (Mawadza, 2006). Abor and Quartey (2010: 224) point out that SME development is hampered by a number of factors, including finance, lack of managerial skills, equipment

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and technology, regulatory issues, and access to international markets, emphasizing that " the lack of managerial know-how places significant constraints on SME development". Baoba (2011: 17) add that, this lack of education and business skills results in a limited number of small business owners equipped with the skills necessary to develop a sound business plan with realistic financial statements. This study will focus on the availability of accounting information of SMEs as a hindrance to their decision making process. The next section will focus the accounting concepts, principles and bases which should be adopted by SMEs in their accounting practices if they are to contribute immensely to the economy.

2. 2. 2 Accounting concepts, principles and bases

Accounting systems

In small enterprises there can be different kinds of accounting systems such as internal, external and tax accounting (EU, 2008). Internal accounting, according to EU (2008) is also called management accounting It is based on the enterprise's internal accounting procedures and recorded accounting information. Internal accounting is intended for managers within organizations, to provide them with the economic basis to make informed business decisions that would allow them to be better equipped in their management and control functions. For example, managers may want to be able to assess the contribution or the profitability of different products or services that they supply by comparing the revenues and costs that they generate. External accounting, also called financial accounting is concerned with the preparation of financial statements for decision makers, such as the owners, suppliers, banks, governments and its agencies, customers and

other stakeholders outside the enterprise (EU, 2008). External accounting makes use of the accounting information from the internal accounting system. In the preparation of the external accounting, the small enterprise may be governed by IFRS and local GAAP. Some countries in the EU have introduced external accounting rules for small enterprises, while others have no accounting rules in place and leave it to the enterprises themselves to decide which accounting systems they consider to be appropriate for their particular circumstances and business environment (EU, 2008). This lack of regulation could be the reason for informal accounting systems most prevalent in micro entities in Zimbabwe. Tax accounting is normally based on the financial accounting system (EU, 2008). There may be differences between the profits for tax purposes and the profits per the accounts. Tax authorities often ask for additional adjustments to be made to the profits per the accounts and these are captured in a "tax computation". Some examples of adjustments which are quite common between profits per accounts and tax profits are: depreciation differences, accruals, expenses which are disallowed for tax purposes and non-taxable income. In Zimbabwe, taxation is carried out on a cash basis accounting system, in which case further adjustments (when the enterprise uses accrual basis accounting) like accruals, unrealised income and unrealised expenses are to be made to the enterprise's results before the tax computation (Paradza, 2004).

Accounting framework

Maseko and Manyani (2011: 172) note that, profit can analogously be viewed as the life-blood of a business and hence the accounting bases, concepts and principles adopted ought to capture and report all the relevant accounting

information to ensure reliability in its measurement. The IFRS for SMEs (2009) lays down the concepts and principles that are the basis for preparing and presenting the external financial statements of a small enterprise. The EU (2008) stresses that; each enterprise needs to decide which principles it considers most important and applicable to its particular circumstances and business environment. Accordingly, this study examines the accounting principles, bases and conventions that micro entities in Zimbabwe could adopt so that they can produce adequate information for use in decision making.

(a) Cash basis accounting According to Mwangi (2011: 92) the accounting in micro enterprises is on cash basis and most proprietors have no bank accounts. A cash basis means that a cost or an income is accounted at the equivalent amount of cash paid or received for it. Mwangi (2011: 92) further argues that, perhaps this is due to stringent requirements to open bank accounts and besides they need every coin to plan and meet all the business and family expenses at the early stages of business operations. Accounting on a cash basis means the impact of transactions on the financial statements are recognized when cash is received or disbursed (European Commission, 2008: 16). It further states that, in cases when an enterprise is a micro or even a very small enterprise, it might be more appropriate to use cash basis accounting. In this case the accounting and the resulting financial statements are prepared on a cash basis. Mwangi (2011: 92) sums up by stating that, very small businesses often use the cash basis because it can be simpler and easier to manage. This could be the reason why most micro enterprises in Zimbabwe have an incomplete recording system.

(b) Accrual basis accounting According to Wood and Sangster (2005: 111), accounting on an accrual basis means recognizing the impact of transactions on financial

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statements in the period of time when expenses and revenues occur, not necessarily when cash exchanges hands. The European Commission (2008: 16) notes that, financial statements are often prepared on an accrual basis. Under the accrual basis accounting, income and expenses are recognized as follows: Income is recognized when income is earned (when products are delivered or services are provided) and when income is realised or realisable (when cash is received or when it is reasonable to expect that cash will be received in the future). Expense is recognized in the period in which the related product or service has been obtained. The European Commission (2008: 16) concludes that, there seems to be a general consensus that while cash is important, focusing on it creates a narrow and incomplete picture. Accrual basis accounting is a better measure for relating company efforts to its accomplishments. It produces a more complete picture of the company's value-producing efforts. Present micro entity owners/managers therefore need to consider using the accruals basis of accounting and make sure that they produce the complete picture of the firm's activities.

(c) The matching principle Under this principle, the expenses are matched with revenues (Wood and Sangster, 2005: 111). When expenses are matched with income, they are not recognized until the associated income is also recognized thus allowing greater evaluation of actual profitability and performance (shows how much was spent to earn revenue). The European Commission (2008: 16) gives the following examples: Depreciation: the cost of purchasing a fixed asset is spread over the period in which it is expected to generate revenue. Office salaries and other administrative expenses are charged as expenses to the current period.

(d) Materiality concept In accounting, the concept of materiality is a characteristic of information which helps to optimize the

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information presented in the financial statements (The European Commission 2008: 16). Materiality states that if information is of such magnitude that it has no influence on the user's judgment and decision-making, it can be left out.

(e) The true and fair view principle
The financial statements provide a true and fair view of the enterprise's assets, liabilities, financial position and income and expenses. To support the application of the true and fair view, accounting has adopted certain concepts and principles which help to ensure that accounting information is presented accurately and consistently (The European Commission 2008: 17).

(f) The going concern principle
Financial statements are prepared on the assumption that the entity is a going concern, meaning it will continue in operation for the foreseeable future and will be able to realize assets and discharge liabilities in the normal course of operations (Wood and Sangster, 2005: 110).

(g) The prudence principle
According to Wood and Sangster (2005: 111) the principle of prudence requires that: Only profits made (realised) at the balance sheet date are included. All liabilities of the financial year are included; even if the liabilities become apparent after the financial year but before the date the balance sheet is drawn up.

(h) The opening balance principle
The opening balance sheet for each financial year shall correspond to the closing balance sheet of the preceding financial year (The European Commission 2008: 17).

(i) The consistency principle
The methods of valuation and presentation are applied consistently from one financial year to another (Wood and Sangster, 2005: 111). The principle can also be defined as conformity to enforced rules and laws.

(j) The separate valuation principle
Asset and liability components are valued separately; i. e. netting is generally prohibited (Wood and Sangster, 2005: 111). One should show the

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full details of the financial information and not seek to net off a liability with an asset, an income with an expense, and so on. It is therefore imperative that all SMEs adopt all these accounting conventions so that they capture and report all the relevant accounting information to ensure reliability in its financial performance measurement.

2. 2. 3 Record keeping in SMEs

This section highlights meaning and purpose of book keeping. It also discusses the different types of book keeping available for SMEs to use in their businesses.

Meaning of record keeping

Book keeping is the analysis, classification and recording of the business transactions in the books of accounts (Saleemi, 2008: 103). This implies that, it is a mechanical process that records the routine economic activities of a business either manually or electronically. Aruwa (2005) and Reed (2005) cited in Ademola et al (2012: 60) described book or record keeping as the art of keeping record of figures of all transactions in a regular and systematic manner, such that the records kept will provide various books of account which would be in permanent form or for the purpose of providing means by which an enterprise can be conducted in an orderly manner. The accountant creates reports from the recorded financial transactions recorded by the bookkeeper (Okwena, Okioma, and Osongo (2011: 5). The prime purpose of record keeping is therefore to provide accounting information for decision making. This implies that record keeping is a must among any form of business.

History of record keeping

The importance of record keeping dates back to biblical times. In the book of Esther Chapter 6 Vs 1, it is written that the king could not sleep and he commanded to bring " the book of records" and it was found " written" in the Book, how Modecai saved the king Ahasuerus. That was how Modecai, already destined to be killed was honoured. In addition, Jesus Christ was able to overcome the temptations of Satan by replying, " it is written" (Mathew 4 Vs 4; 10). This goes to show the importance of written records at all times. According to Mwangi (2011: 86), people have kept records for as long as they have engaged in buying and selling. He further explains that accounts in some form or other go back at least as far as 2300B. C in Egypt and 10000 B. C in pre-Mesopotamia. In both cases these early accounts served mainly to assist the memory of the businessman. Names, dates and nature of transaction, the transacting parties and other details would be noted. Persons with long term obligations, complex transactions, or simply poor memory would use accounts as little more than mnemonic devises. This implies that, accounting records would help the proprietor of business determine what he owed and how much work had been done in monetary terms. However, according to Mwangi (2011: 86), the absence of accounting numbers in the small and micro trading business does not imply the absence of an accounting system. He further states that accounting numbers do not always capture all aspects of an enterprise. For a long time accountants ignored many economic activities which in their view could not be measured in financial terms. This is despite the fact that these activities were an important factor in the measurement of capital employed. Over time, accounting became increasingly important because it was now a primary

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source of information, for the growing business empires for early merchants (Ademola et al., 2012: 48). Consequently, accounts had to be more systematic and complete to do more than just fill the gaps in someone's memory and a standardized format was developed for accounting for transactions for businesses in various locations. They further state that for a trader, knowing how to keep good and orderly records teaches one to draw contracts, how to do business and how to obtain a profit. For this reason, a merchant must not rely upon memory, for such reliance has caused many persons to err. Mwangi (2011: 87) notes that, long ago living and trading were not separate spheres of activity, and the specific source of an expense or revenue was of little consequence. As a proprietor, one need not be concerned about making clear distinction between business affairs and private or personal ones. This distinction becomes problematic when more than one person has invested in a firm or a proprietor has more than one business premise, as is the case with most micro entities at present (Ademola et al., 2012: 48). This aspect of separation of business from private affairs is still a problematic issue in Zimbabwean entities.

Importance of record keeping

From properly kept books a person can at any time ascertain: what property he possesses, what amounts he owes and to whom, what profit he has made or what loss he has sustained for any given period and the manner in which the profit and loss has risen, and the amount of his capital or deficiency (Okwena et al., 2011: 2). If no records are kept, it will be difficult to find accurate net profit. Under such circumstances, tax authorities may overestimate the profits and thus a trader will suffer for not having kept the

business records. Williams, Susan, Haila, Betrirel and Carcello (2008: 37) give more importance for record keeping by SMEs. They argue that, in the absence of proper business records, the trader will find it difficult to submit the true position to the court in case he becomes insolvent. Keeping of proper records helps the trader in framing future business plans and policies. Also it will be difficult to ascertain and fix the price of business to be sold or disposed off if no records are kept. Finally, they conclude that, in spite of the best memory it is beyond the capacity of a trader to remember all the business dealings with back references. This study therefore advocates for the full use of record keeping practices among SMEs. Many of SMEs would rather focus on making and selling their products and services than on keeping their books and records. However, according to Okpala (2012) book keeping is just as important as making and doing business. Many great businesses have failed due to a poor book keeping system. Apart from business owner's desire to stay in business, two reasons why book keeping is important are; legal requirement and book keeping records are an excellent business management tools (Okpala, 2012). Ademola et al (2012: 59) give a summary of the benefits of accounting record keeping as follows: 1. It helps to avoid business failure. 2. It is useful for financial management planning and control. 3. It helps to make sound decisions. 4. It gives background picture which helps organizational change. 5. It is critical to business survival. The benefits of record keeping cannot be over emphasised, so SMEs should engage in sound record keeping practices. Reed (2005) and Aruwa (2005) also emphasized that small scale businesses must keep proper and adequate records or books not only for the orderly conduct of the enterprise but also because it helps entrepreneurs reduce the possibilities of early

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failure, increase chance of business survival, serve as a basis for planning and controlling business operations, increases the chances of profitability and also helps to keep business in a sound and healthy state to face competition. They emphasized that small scale entrepreneurs must keep the following records, if they want to succeed; source documents (invoice, receipt, bank teller e. t. c.) which are recorded in subsidiary books (purchases and sales day books e. t. c.) and posted to different ledgers (debtors, creditors and the general ledgers), and is checked by trial balance and subsequently, the final financial reports (statement of comprehensive income and statement of financial position). This implies that, for every business, be it small, medium or large scale business, bookkeeping records is the lifeblood of its operations. The way it is handled may make or break the company. Therefore, it has to be done in a very orderly and smooth manner in order for the business to thrive.

Common methods of bookkeeping

Two common bookkeeping systems used by businesses and other organizations are the single entry and double entry systems.

Single-entry bookkeeping system

Under single entry book keeping system, no formal accounting records are maintained and records are kept mainly through memory and the records kept are those of debtors with dates indicating the date of borrowing and due date for likely payment (Mwangi, 2011: 92). This implies that, incomplete records are kept and the bookkeeping system does not use full double entry. Ademola et al (2012: 58) add that the primary book keeping record in single entry book keeping is the cash book which then allocates the

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income and expenses to various income and expense accounts. Separate account records are maintained for petty cash, accounts payable and receivable, and other relevant transactions such as inventory and travel expenses. Small scale businesses use a single book arrangement where only important notes have full records in logbooks and subsidiary books (Kurniawati and Hermawan, 2010: 3). They further say that, the transactions are recorded in logbooks which contain cash receipts, cash disbursements, sales ledger, buying ledger, and memorial ledger and those recorded in the subsidiary books pertain to receivables, payables and inventory. Wood and Sangster (2005: 423) concur and state that, therefore, many small firms, especially retail shops, can have all the information they want by merely keeping a cash book and having some form of record, not necessarily in double entry form, of their debtors and creditors. As a result, in an incomplete record system (Wood and Sangster, 2005):-the figures must be calculated, extrapolated, or extracted in the case of creditors and debtors. to arrive at the year-end profit and loss account and balance sheet will rely heavily on application of the concept of the accounting equation which is; $Assets = Proprietors\ capital + liabilities$. Thus the value of capital can be determined at any point in time. Kurniawati and Hermawan, (2010: 4) conclude that, using incomplete records cannot give an accurate picture of period end financial statements as they do not tell the whole story. There is no record of outstanding debtors or creditors, or of stock, or, without analysis, of for what receipts and payments have been received and paid, or, in some cases, of the split between revenue and capital items. However, the European Commission (2008) argues that, in some cases a single-entry

bookkeeping is justified when the enterprise is a micro and the transactions are not that many or complex.

Double-entry bookkeeping system

In double-entry bookkeeping, there are always two entries required for every transaction recorded (Wood and Sangster, 2005). They further say that, this is because any change in one account automatically results in a change in another account. Both changes must be recorded. The means by which these are recorded is by way of debit and credit entries. European Commission (2008) states that, in double-entry bookkeeping, accounting for each transaction means that the total debit amount must equal the total credit amount i. e. they must balance and at any time be equal. In Zimbabwe most micro entities do not keep adequate accounting records. This study therefore underscores the need for owners/managers of these firms to keep adequate records by employing double entry book keeping.

2. 2. 4 Financial reporting in SMEs

Karunananda and Jayamaha (2011: 2) write that, the financial reporting system is necessary to ensure that the SMEs' resources are used effectively and efficiently in pursuit of its goals, hence the new standard for SMEs. They further write that, in July 2009 the International Accounting Standards Board (IASB) published the International Finance Reporting Standard for Small and Medium sized Entities (IFRS for SMEs). For uniformity in practice and reporting financial information, the Standard sets out clearly, the content of financial statements in this order, that, a complete set of financial statements comprises: a statement financial Position; a statement of comprehensive income; a statement of changes in equity showing either: all

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changes in equity, or changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders; a statement of cash position; and notes, comprising a summary of significant accounting policies and other explanatory notes. In concurrence, Kurniawati and Hermawan (2010: 3) note that, small and medium enterprises use three financial measurements which include income statement, balance sheet and statement of cash flow. Statement of cash flow describes the inflow and the outflows of cash. The income statement reports revenue and expenses during a certain period of time. The balance sheet report the total assets, liabilities and owner's equity during a certain period of time. Accordingly, this study considers the use of a complete set of financial statements by Zimbabwean SMEs and goes a step further by examining the extent to which these statements are utilised in financial performance measurement. The objective of IFRS for SMEs was to enable similar SMEs across the world to produce comparable accounting information by taking into account the needs of SMEs in terms of costs involved in presentation of financial statements and the benefits provided to the users of these statements. According to Mwangi (2011: 88) the development of the IFRS for SMEs by the International Accounting Standards Board is welcome move to standardize financial reporting in this sector, the threshold for SME remains high thus excluding a significant majority of small and micro enterprises which when combined represent a high volume in financial and/or monetary terms. While it is a good starting point for a move towards accounting standard that include most business entities that contribute economic development, the impact and results of the implementation of this IFRS for SMEs in countries in sub-Saharan Africa might take the next couple of years (Bruce, 2011).

Mwangi (2011: 89) conclude that, the SME standard under the IFRS is a great step in incorporating all business players in all economies but a lot needs to be done by law making institutions relating to businesses that are important, yet excluded from statistics used in decision-making in areas directly affecting the small and micro enterprise sector. Mbroh and Attom (2012: 31) noted that, a good accounting system is not only judged by how well records are kept but by how well it is able to meet the information needs of both internal and external decision-makers. In their view, they maintained that it is common for qualified accountants to do a good job of keeping records up to date but they fail to provide information needed by decision-makers. Mbroh and Attom content that, an accounting system should be capable of providing the following information for a micro enterprise: Interim statements, quarterly or six-monthly that can provide information about the progress of the business. Such statements need not be detailed, but capable of addressing the special needs of the business. Such documents can also be circulated, if necessary, among external users such as lenders. An annual cash flow forecast, reviewed periodically, could indicate overall financial requirements. Such a statement can be prepared only with the help of a well-designated accounting system. An accounting system, in addition to providing financial statements, must be capable of generating other useful information in the form of reports, such as, aged accounts receivable, aged accounts payable, stock and bank balances.

2. 2. 5 Accounting information and its important roles

Accounting Information

Noor and Rosliza (2009) defines the accounting information as information about economic entities that are useful for making economic decisions in determining choices between alternative courses of action. He further notes that, accounting information is financial statements, consisting of balance sheet, income statement, cash flow statement, statement of changes in equity and notes to financial statements. Financial accounting information is more directed to parties outside the company, which mainly concerned are investors and creditors. For this reason, Prihatni et al., (2012: 31) argue that financial accounting information must be compiled according to the Financial Accounting Standards (IFRS's), because the accounting has many methods and concepts so that interested parties and the company has the same perception in interpreting the information.

The Importance of Financial Accounting Information

Accounting information plays an important role in the business. The basic objectives of accounting are to provide financial information to the managers, owners and the stakeholders that are the parties who are interested in an organization, to help them reduce uncertainty in decision-making. This research investigates whether micro businesses in Zimbabwe see financial accounting information as an important aspect of their decision making process. For SMEs, accounting information is important as it can help firms manage their short-term problems in critical areas like costing, expenditure and cash flow by providing information to support monitoring and control (Karunananda and Jayamaha, 2011: 42). Accounting systems

provide a source of information to owners and managers of SMEs operating in any industry for use in the measurement of financial performance. The importance of financial performance measurement to any business entity, big or small, cannot be over-emphasized (Maseko and Manyani, 2011: 171). Sarapaivanich (2003: 4) add that, the misuse and inaccuracy of accounting information causes SMEs to inaccurately assess their financial situation, and make poor financial decisions, as well as leads them to face with the high failure rate. Relevant accounting information can help business, particularly SMEs to manage short-term problems and make wise decisions (Shazwan and Al-Ain, 2008; Yeunyoung, et al. 2009) in areas such as costing, expenditure and cash flow, by appropriate monitoring and control (Ismail and Mat Zin, 2009; Mitchell, Reid, and Smith et al., 2000; Son et al., 2006). It can also help SMEs operating in a dynamic and competitive environment, to integrate operational considerations within long-term strategic plans (Mitchell et al., 2000). This information can be obtained from proper financial statements which come from effective financial management (Mohd-Fadhil and Mohd-Fadhil, 2010). Accounting information is therefore used in deciding between different courses of action and results in informed decision making. It serves to reduce the uncertainty inherent in the business environment where decisions are made about the future. It further reduces entropy based on the assumption that chaos exists where there is no information. The provision of information that is useful to the decision-making process can be recognised as the main purpose of accounting information. Sarapaivanich (2003: 6) add that, accounting information is used to assess the profitability of alternative courses of action, measure performance, and evaluate the position of enterprises in term of profitability, liquidity, activity and leverage.

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This means that it can be used to improve SME performance, especially financial decisions. She further says that, different capital structures cause different degrees of financial risk. Different alternative financial plans affect SMEs' performance differently. Thus, proper accounting is a key to small business success. However, according to Senik et al. (2012), the usefulness of the accounting information has been jeopardised with the view that the information is prepared to meet a series of legal and bureaucratic demands only, such as for tax filing purposes, and not as a decision-making and control support tool for managers. They are only focusing on the sales and net income figures. Prihatni et al., (2012) stated that the lack of accounting information in corporate management can harm small companies. Despite this fact, Sarapaivanich, (2003) laments that, generally, the financial reports for SMEs are rarely prepared for control and decision making purposes but just for meeting the statutory and legal requirements. The objective of financial statements is to help develop the business by providing useful information to users. Therefore the financial statements should be designed to reflect users' needs. European Commission (2008: 13) describes the most likely needs of management as:

- To evaluate how the enterprise is performing
- To manage cash flow, collect money due from debtors etc.
- To find out possible financing needs
- To use the financial information for planning, forecasts etc.
- To propose to the owners the portion of profits to retain and distribute
- To propose to the owner a change in the range of products or business activities

Ademola et al (2012: 68) highlight several demerits of informal records. The lack of formal records means that the proprietor is unable to recognise when sales start slowing down, or costs start to rise unacceptably. Corrective measures cannot be taken in time if there is no

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timely recognition of problems, and this leads to poor, unguided decision-making and ultimately bankruptcy. Forward planning is also not feasible where current performance is unknown. Mwangi (2011: 92) says that the IFRS for SMEs were published by IASB in July 2009 providing an opportunity for small businesses to formalise their financial reporting processes, facilitate access to finance and loans, and benefit from long term savings in these less stringent IFRS reporting requirements. However, the challenges bedeviling the economy will pose serious challenges in the SME sector to be able to adopt the IFRS as some will not be able to meet the costs of training let alone implementing sound financial management systems for their businesses.

2. 2. 6 Challenges in use of accounting information by SMEs

SME owner or manager is a crucial player as a searcher and assimilator of information. As such, it is important for them to understand and get involved in the accounting figures produced (Senik, Said, and Khalili, (2012: 721). In concurrence, Maseko and Manyani, (2011) add that the better use of accounting information obviously takes place in situations where the SMEs have a certain level of accounting knowledge and technical qualifications, which does not tend to prevail in small companies. Lack of business knowledge could be the reason why most micro entities are not using accounting information to the maximum. Mutambanengwe (2012) says that, a critical weakness with the "informal" setup of SMEs is the fact that they do not keep proper accounting records of their activities. He adds that, keeping accounts is seen as a waste of time, money and effort, and is also avoided as a means of ensuring that there is no track record of what the proprietor

would have done, in the event that any government agency comes to visit. Bank accounts are also shunned for the same reason, with transactions occurring on a cash basis. According to Mutambanengwe (2012) the perception of owners/managers of micro entities seem to be a major limiting factor in the use of accounting information. Accounting skills are the totality of skills ranging from record keeping, attention directing, financial management and reporting skills that are expected to promote effective decision, performance evaluation and business reporting of any business enterprise. Although studies could not find record keeping skill as positive factor, financial management skill has been found to be contributory to business development (Akande 2011: 374). Attention directing skill enables the owner- manager to make vital decision on production and pricing issues while reporting skill describes the method and technique by which business information are reported to the stakeholders of the business. Therefore small business should start small but while starting small the aim of becoming big should not be jettison. Those important procedures that would be duly followed when the activities of such becomes big must be imbibed when the enterprise is operating as small enterprise. For instance, Oladejo (2008: 371) argued that accounting skill and procedure are necessary for successful entrepreneurial and small business development in Nigeria. This is because the inability to install a proper accounting system would disallow business monitoring, reporting, and performance evaluation that are germane to the business survival. Small business has failed in the past for ignoring this vital measurement apparatus. The literature suggests that after complying with statutory requirements there is no other use of financial statements by most SME owners/managers. The accounting regulatory framework is considered

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by most SMEs as something of a haphazard patchwork (Walton 2000). Although, most of small businesses prepare financial reports for statutory purpose, many fail to use these (Sarapaivanich 2003: 6) because SMEs owners/managers either lack the technique for using financial statements or simply are unaware that they can use them to support the financial decisions. This could suggest that, poorly prepared accounting information render most SMEs unable to evaluate their own financial situation, or to demonstrate viability, and/or to facilitate loan financing. This situation causes improper financial decisions and ends up with low performance and high failure rate.

2. 2. 7 Financial performance measurement in SMEs

It has been recognised that appropriate accounting information is important for a successful management of any business entity, whether large or small (European Commission, 2008). It is crucial therefore that the accounting practices of SMEs supply complete and relevant financial information needed to improve economic decisions made by entrepreneurs. The discussion in this subsection is on the financial performance of the micro enterprise and as such, focuses on financial measures and their usage. The success of enterprises is judged by their financial performance, hence the choice to study how SMEs measure financial performance. Taticchi, Balachandran, Botarelli and Cagnazzo (2008: 59) note that the significant majority of SMEs are family-run and they are characterized by lack of financial stability and face difficulty in resolving costly mistakes. They lack the resources to exploit advanced technology resulting in low efficiency, not following best practices, not collecting sufficient relevant data for analysis and face legal constraints

on their operations. For these reasons, they conclude that it is important for SMEs to measure and understand their own performances. However, according to Padachi (2012: 123) micro firms tend to focus their efforts to satisfying the requirements of external parties and little, if any focus is on using key performance indicators as a diagnosis tool to monitor business. From the literature available it is possible to collect information regarding how SMEs manage performance measure processes. In first instance, there is evidence that many SMEs already have some kind of accounting systems in place, and these constitute the base of their monitoring process. Even though this accounting system may be far from perfect, it nevertheless represents a useful basis for measuring various aspects of the financial performance of a company (Hvolby and Thorstenson, 2001). Given the limitations of traditional accounting systems there are significant barriers to the implementation of PMMS systems in the SME context (Manville, 2007). It is not surprising to find that studies on the use of performance measurement typically state that operational measures in SMEs are ad hoc and informal, with no real understanding of key performance drivers (Taticchi et al., 2008: 58). This evidence highlights the need to better understand SME characteristics, in order to point out their financial performance measurement needs and develop tailored solutions. Akande (2011: 375) stresses that; the concept of performance is used to determine the success of a business entity whether small or big. The International Accounting Standard Board (IASB) conceptual framework specifies that frequently, profit is used as measure of performance. Akande (2011: 375) further notes that this is confirmed by a study conducted by Cormie, Magnan and Zegahal (2000) on companies' financial performance. Five representative measures

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are pointed out as Net Income, Operating Income, Operating Cash flow, Residual Income and Added value. These elements are directly related to the measurement of profit for investors. Financial performance measurement generally looks at firms' financial ratios (derived from their financial statements) such as liquidity ratios, activity ratios, profitability ratios, and debt ratios (Ismaila, 2011: 14). Non-financial performance measurement is more subjective and may look at customer service, employee satisfaction, perceived growth in market share, perceived change in cash flow, and sales growth (Haber & Reichel, 2005: 260). However, these are not the focus of this study. Financial ratio analysis is defined by Lasher (2010: 80) as a general technique based on some relatively standard methods used to analyse information, and developed by people who make judgments about businesses by reading their financial statement. Enterprises measure their financial performance differently, but financial ratio analysis is the traditional approach to analysing and interpreting the financial position of an enterprise (Jacobs, 2001: 208). Ratios are derived from the financial statements of an enterprise and enable analysts to develop a picture of the financial position of an enterprise.

Ratio analysis

One of the most common means of analysing accounts is the use of financial ratios. According to Jacobs (2001: 208), a ratio is the simplest mathematical expression of two magnitudes which are meaningfully related, and which are expressed in relation to each other (as a quotient). Mosalakae (2007: 5) defines a financial ratio as " an expression of a relationship between any two figures or group of figures in the financial statements of an undertaking".

Ismaila (2011: 36) gives several reasons for using ratio analysis in financial performance measurement. Ratios can also be used to compare an enterprise's current position with its past positions. It is necessary to be able to assess whether or not a company has performed well over a certain period of time. From its profit and loss account, analysts can observe the profit it has generated. It is also necessary to know if a company is in a good short-term financial position, and if it is in a good financial position for long-term growth. Ratio analysis and interpretation can be used by many different stakeholders; especially those outside of the organisation who want to invest.

Jacobs (2001: 210-230) highlights commonly used ratios, which are classified into the following four main categories:

a. Liquidity: this is an enterprise's ability to pay its short term debts when they are due. It refers to the solvency of the enterprise's total financial position. This includes:

- Current ratio which is equal to $\text{current assets} / \text{current liabilities}$.
- Quick (acid-test) ratio which is equal to $(\text{current assets} - \text{inventory}) / \text{current liabilities}$.

b. Activity ratios: these measure how quickly various accounts are converted into money or sales.

- Accounts receivable turnover which is equal to $\text{net credit sales} / \text{average accounts receivable}$.
- Accounts receivable period (the number of days' purchases in receivables) which is equal to $360 \text{ days} / \text{accounts receivables turnover}$.
- Inventory turnover which is equal to $\text{Cost of goods sold} / \text{average inventory}$.
- Number of days inventory which is equal to $(\text{inventory} / \text{cost of goods sold}) * 360$.
- Accounts payable turnover which is equal to $\text{cost of goods sold} / \text{average accounts payable}$.
- Accounts payable period (the number of days' purchases is payables) which is equal to $360 \text{ days} / \text{accounts payable turnover}$.
- Assets turnover which is equal to $\text{net sales} / \text{average total assets}$.

c. Debt ratios: these measure the extent of debt in

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relation to total assets • Debt ratio which is equal to average total liabilities/average total assets. • Debt to equity ratio which is equal to total liabilities/stockholders' equity. • Equity to total assets which is equal to shareholders' equity/total assets. • Times interest earned which is equal to income before interest and taxes (EBIT)/interest expensed. Profitability: Profitability refers to the ability of a company to earn income. The various criteria for measuring profit relate the enterprise's earnings to sales, assets, owner's equity and share value (Jacobs, 2001: 209). • Gross profit margin which is equal to gross profit/net sales. • Net operating income which is equal to operating income/net sales. • Return on total assets (ROA) which is equal to net income/average total assets. • Return on equity (ROE) which is equal to net income/shareholders' equity. • Return on investment (ROI) which is equal to net income/average total assets.

e. Cash flow ratios

Cash flow analysis should be used when evaluating the liquidity of a company. Cash flow ratios need to be evaluated to determine a company's ability to satisfy its debts. (Ismaila 2011: 36) • Cash flow to average total current liabilities; • Cash flow and bank to total assets; • Cash flow and bank to current liability; • Cash flows from operating activities/operating income; • Cash flows from operating activities/net income; • Cash flow return on assets which is equal to (Cash flows from operating activities + interest paid + taxes paid)/average total assets; and • Cash flow return on equity which is equal to (Cash flows from operating activities - preferred dividends paid)/average common stockholders' equity Lasher (2010: 87) concludes that most of these ratios are put forward by different authors as the best

predictors of business failure, which is the interest of this study. Ismaila (2011: 36) suggest the use bankruptcy prediction models as a framework for ratio analysis and interpretation. He says that most of these models use a combination of a relatively smaller number of ratios found to be the most significant predictors of business failure to compute a single score. The interpretation of this score may be used by SMEs, as a financial measurement toll to assess how they are doing financially (i. e. are they financially sound, should they start worrying and take careful measures or are they facing imminent financial collapse?). The use of bankruptcy prediction models with fewer ratios will also make it easier for practical use by SMEs. While ratio analysis is an effective tool for assessing a business' financial condition, the following limitations must also recognised (Ismaila, 2011: 48):

- Accounting policies vary among companies and can inhibit useful comparisons. For example, the use of different depreciation methods (straight-line vs. double declining balance) will affect profitability and return ratios.
- A ratio is static and does not reveal future flows. For example, it will not answer questions such as " How much cash do you have in your pocket now?" or " Is that sufficient, considering your expenses and income over the next month?"
- A ratio does not indicate the quality of its components. For example, a high quick ratio may contain receivables that might never be collected.
- Reported liabilities may be undervalued. An example is a lawsuit on which the company is contingently liable.
- The company may have multiple lines of businesses, making it difficult to identify the industry group the company is a part of.
- Industry averages cited by financial advisory services are only approximations. Hence, you may have to compare a company's ratios to those of competing companies in the industry. The

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literature review has shown that ratios can be a valuable and effective tool for assessing a company's financial condition, and even for predicting failure of small businesses, but their limitations must also be recognised. Therefore they should be used cautiously. The present research used financial performance measurement through the use of financial ratios. In this thesis the relationship between accounting information and financial performance measurement was based on the nature of records, reports and ratio analysis practiced by micro entities. It is from this data that information relating to the existence of a relationship between accounting information and financial performance measurement in micro entities is obtained and statistical calculations in form of the chi-square model was used.

2. 3 Empirical Literature

2. 3. 1 Use of accounting principles and bases by SMEs

Maseko and Manyani (2012: 179) investigated accounting record keeping practices for performance measurement employed by SMEs in Zimbabwe, using Bindura as a case. The results reveal that the accounting bases adopted by an entity had a bearing on the accounting records kept. The study reveals that SMEs are more comfortable with the cash basis, suggesting the need for the adoption of cash basis accounting in SMEs. Cash accounting is easy and straight forward as compared to the accruals accounting, which is complex, as it requires understanding of double entry bookkeeping and accounting processes. In a study of company failures in South Australia, Okwena et al. (2011: 15) state that Peacock reviewed the bankruptcy reports of 418 unincorporated businesses for four years and found that 50. 5 percent of this used single entry system of bookkeeping, 32.

8 percent used bank and taxation records whereas only 2.1 percent utilized double entry systems. He recommended further research to be done on double entry systems of recording in companies. Okwena et al. (2011: 15) surveyed small and medium scale enterprises in Kisii Municipality, Kenya and found that majority of small and medium scale enterprises use single entry book keeping system. In a related survey centred on a study of accounting information requirements of 928 small enterprises operating in Sydney, Melbourne and Brisbane, Holmes, found out that 57% of the respondents used the journal/ledger (double entry) systems (Okwena, 2011: 16). This finding is rather in contrast to Peacock's findings of types of records maintained by failed enterprises, where only 2.1% of respondents were found to use double entry systems. He recommended for further research on challenges facing small enterprises in an economy.

2.3.2 Accounting records kept by SMEs

Arkoh, Asamoah, Osei, Agyemang, Arku (2012) carried out a study to examine the book keeping practices among small scale business in the Kumasi metropolis. Both primary and secondary data were used. The instrument used for the gathering of data includes questionnaire, interview and observation. The questionnaires were administered to the various small scale business owners in the metropolis. Interview was used to obtain from the respondent on how their accounting records are kept. The findings revealed that, due to lack of knowledge in keeping books of account, improper records were kept by most small and medium enterprises in the metropolis. Again, the various business owners showed reluctance to be trained or attend further studies due to the cost involved in training and

education. The study recommended that financial statements of micro enterprises should be requested for approval of loans by banks. In addition, laws should be enacted in other to improve the record keeping practices of micro entities so that they have access to credit facilities from any financial institutions. Researching on accounting practices of SMEs in Zimbabwe, Maseko and Manyani (2012: 179) revealed that SMEs do not keep complete accounting records because of lack of accounting knowledge and the cost of hiring professional accountants. Most SMEs did keep subsidiary books of accounts, especially to capture sales and cost of sales. There was however little accounting information captured on operating expenses as evidenced by a few number of SMEs keeping books to record expenses. SMEs in the retail shops business were keeping sales day books for controlling inventory and those in the manufacturing sector keep records for non-current assets as owners try to safeguard their assets. Record keeping in SMEs was therefore not being done for the purpose of capturing accounting information for performance measurement but for security and control. This was supported by only 27% of SMEs preparing financial statements to report financial performance. As a result, there was inefficient use of accounting information to support financial performance measurement by SMEs in Zimbabwe. Mbroh and Attom (2012: 40) studied the accounting and control systems practiced by small and micro enterprise owners within the Cape Coast Metropolitan area of Ghana. They used a survey of two-hundred and seventeen business owners of micro and small enterprises which employed less than 29 workers. They found that most of the owners lacked basic working knowledge in accounting and therefore were unable to keep simple books of prime entry and ledgers. Mbroh and Attom (2012) concluded their research by proposing <https://assignbuster.com/smes-are-based-on-size-finance-essay/>

the following recommendations: Carefully organising training programmes might firstly target important aspects of book-keeping which may expose SMEOs to Cash Book preparation, Purchase and Expense records, Debtors and Creditors records, Costing and Pricing and Stock Management. The next level may look at basic accounting controls, the preparation of ledger accounts, bank reconciliation statements and the business final accounts in that order. The Micro Finance and Small Loans Centre (MASLOC) may have to come in to partner with the business schools in the tertiary institutions in the metropolis to broaden access to these urgent and all-important training programmes especially in the subject area of small business accounting. Tertiary institutions may initiate specific research policies in this direction aimed at championing the capacity-building drive with these SMEs. Research grants to tertiary institutions may consider inputs in the area of SMEs. Own their own micro entities need to form groups in order to discuss their challenges and short-comings so as to seek ways by which they can overcome and improve them for their desired growth. Okwena et al. (2011: 15) note that, Peacock investigated the effects and causes of 1, 000 proprietary company failures in South Australia during ten years and found that 4. 6 percent of failures had inadequate or no accounting records. Peacock concluded that there was a minimal effect of accounting records on the success or failure of businesses of the proprietary companies and recommended for further research on causes of business failures. According to Okwena et al (2012), an evaluation by Williams of the adequacy of accounting records for 10, 570 failed and surviving small enterprises operating throughout Australia found that a significant proportion of owner-managers kept inadequate accounting records. He recommended for further

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investigation on the record keeping practices in small enterprises in Australia. Okwena et al. (2011: 16) further note that, in a related study, Peacock found a significant element in the failure of many businesses to be the inefficient or absence of accounting records. More than half of the businesses failed were found to have no records or had only bank and taxation records. Peacock's overall research findings are very important in examining the impact of bookkeeping system practices on profitability of SMEs. He recommended for further research study on bookkeeping and performance of companies. This study intends to find out how accounting information from book keeping is used by micro entities in measuring their financial performance. Ademola et al (2012: 64) conducted a study on the roles of record keeping in the survival and growth of small scale enterprises in Ijumu Local Government area of Kogi State. The study reveals that, the majority (87%) of the small scale entrepreneurs interviewed did not keep proper written records. The majority (67%) of those who did not keep proper written records said it's because they did not know how to keep the records. Other reasons given for not keeping records were the fact that it is time consuming; they can keep the records of their sales in their heads and due also to the fact that they own their businesses. The researchers concluded that, in Kogi State, most SMEs failed in their first year of establishment majorly from management incompetence. The owners lacked elementary knowledge of bookkeeping and the people employed by them were not better either. In the same survey, Ademola et al (2012: 64) found that, out of the 80% of small businesses who had applied for a bank loan, only 15% were granted. The majority of the loan applications were rejected because the business organisations did not keep a record of their activities, there was no

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justification for the loan and the loan request were not properly prepared. This implies that small firms need to keep records needed by banks in making their decisions for the loan request. Entrepreneurs therefore need to acquire basic knowledge of book keeping enabling them to record their day to day transactions. In a related study, Okwena et al. (2011: 21) found that most of the small and medium scale enterprises use manual book keeping method with 63. 9%, followed by 24. 7% of the small and medium scale enterprises that use all the book keeping methods. The percentage of SMEs that use manual book keeping is big enough and can be used to explain the effect of proper book keeping on the financial performance since it may not be as accurate as computerized and online book keeping. Their result seem to imply that a computerised accounting system should be used by SMEs because it generates better information than a manual one. Efficient financial managers dwell on the past and present in order to predict the future and for proper evaluation and comparison of financial activities. To achieve this aim, proper book-keeping remains integral. It is equally acknowledged that by their nature, the owners'/managerss' relevant academic and accounting backgrounds are expected to influence the success or otherwise of this critical function. Mbroh and Attom (2012: 35) conducted a study on accounting and control systems practiced by small and micro enterprise owners within the Cape Coast Metropolitan Area of Ghana. They used a survey of two-hundred and seventeen business owners within the CCMA of Ghana. Findings revealed that basic book-keeping practices were not in operation in many of the enterprises with majority (52%) frequently seeking external assistance in their business accounting. They recommended for future research and policy directions in respect of training

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and capacity development targeting specifically business segment differences and needs. Similarly, in his study, Sathyamoorthi (2001: 103) found 6% of his respondent enterprises had maintained all the required ledger accounts, with 34% seeking assistance from accounting firms. Ademola et al. (2012: 57) note the result of a survey of causes of business failure in the USA by a credit rating company called Dun and Bradstreet. The result showed that finance accounted for 47.3%, economic factors 37.1%, disaster 6.3%, fraud 3.8%, strategy 1.0% and experience 0.6%. This implies that management of finances was the single most factors causing business failure in the USA. In a related study of management of business challenges among small and micro enterprises in Nairobi, Kenya, Bowen et al (2009: 21) note that disciplined finance management was cited as one of the challenges facing SMEs. This can be closely linked with non maintenance of a written record of all money transactions relating to business activities. The consequence being, that the proprietor is unable to trace all income and expenses. This may be due to poor memory or pilferage where one employs more than one worker without stringent record-keeping habits. According to Bowen et al (2009) only 47% of the respondents in their survey considered financial management knowledge as a hindrance to growth to the micro and small business trade. This implies that 53% did not consider financial management resulting from accounting record keeping as important for the success of their enterprise. In another Kenyan survey, Okwena et al (2011: 22) assessed the effect of proper bookkeeping practices on financial performance of SMEs in Kisii municipality to ascertain the cause of such failures. The study employed a cross-sectional survey research design. Both stratified and simple random sampling techniques were used in the study.

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The respondents were 97 owner-managers/managers of the sampled SMEs. Structured questionnaire was used to collect quantitative data from primary sources. Descriptive statistics and Pearson correlation coefficient and simple linear regression was used to analyze quantitative data. The study showed that book keeping practice was a challenge among SMEs in Kisii Municipality, the greatest challenge being little knowledge in book keeping. They concluded that records prepared are therefore inaccurate and therefore the decisions made would not be appropriate for effective operations of the SMEs. The study recommended the government in conjunction with national accountancy bodies to carry out sensitization programmes so to equip the owners and managers of the SMEs with proper knowledge in book keeping. This could be done through the means of exposure drafts, discussion papers, symposiums, conferences, and open forums. Research focusing on internal preparation seems to suggest that financial awareness amongst owner-managers of the smallest entities is quite low and that there is inadequate record-keeping (UNCTAD, 2002). For instance, in the UK, a survey of 200 businesses with fewer than ten employees found that while most respondents maintained business records, only 34% used any form of budgeting. They also noted that small enterprises that monitored their profits and undertook some form of budgeting also maintained the best records, while enterprises with more than one owner manager were more likely to keep better records (either on paper or on computer).

2. 3. 3 Financial reports generated by SMEs

Mensah et al. (2007: 87) carried a survey on small-scale manufacturing sector in Ghana. The researchers found that a significant number of

enterprises in their survey kept no records pertaining to operations reports, financial reports, audited accounts, tax returns reports, and so on. Most enterprises did not prepare a complete set of financial statements with some not preparing any financial statement at all. An entity may fail to prepare financial statements even with well-maintained books of accounts because the preparation of financial statements requires accounting skills and this, as revealed by their results, was lacking in 62% of SMEs. Owner-managers dominated preparers of financial statements in SMEs and according to this survey, most of the owner-managers were not financially literate and they may have resorted to this practice to avoid the cost of hiring accountants, confirming the findings of Sathyamoorthi (2001: 103). Mwangi (2011: 87) cite the work of Aryeetey who assessed the financial statements of micro and small enterprises. They concluded that there were practical problems in deriving the records and figures that make up these statements. This was because for almost all enterprises the owners kept all the records in memory and hence the lack of records of all kinds – sales, marketing, accounting, credit borrowing from lending institutions, staff costs, and owners emoluments. Proprietors of micro and small enterprises kept no systematic records and were therefore unable to provide data over the period since their creation of their entities. Yström (2010: 96) carried out a study to sort out areas of financial reporting information that are likely to be of significance to managers of entrepreneurial SMEs in their provision of information to users. In order to fulfil this purpose data was collected through interviews with accounting experts. The major findings were that, financial reports make up an important tool mainly for informing external capital providers, among which bankers hold a prominent position. Managers

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were found to make use of financial reporting information not only in informing external users but in the internal management of their businesses as well. In addition to cash flow and intangible assets, financial ratios in general, and financial ratios measuring various aspects of growth in specific, i. e. growth ratios, has been sorted out as likely to be of specific importance to include in the financial reports of entrepreneurial SMEs. Yström's (2010: 96) study focused on interviews with accounting experts. However, accounting experts were not a true representative of the population, since they were not involved in the preparation of micro entities' accounting information and were also not the ultimate decision makers. The present research proposes to go beyond Yström's work through focusing on company documents, questionnaires and observations in addition to the interview and use owners/managers who do the actual recording and use of accounting information rather than accounting experts.

2. 3. 4 Use of accounting information in performance measurement

Previous researches demonstrate that most SMEs are still not aware of the importance of accounting information for their businesses, which lead them to neglect management of the financial aspect and use it at minimum. Accordingly, this section highlights the use of accounting information in performance measurement by micro entities. Maseko and Manyani (2012: 180) report that, the absence of statutory requirements to prepare financial statements, for example from tax authorities, SMEs in their survey could do without financial reporting because the chief users (owners) do not value financial reporting, basing on their perspectives of performance

measurement. They concluded that, owner-managers in SMEs do not value the use of profitability in measuring performance but are compelled to calculate profits for tax purposes. They therefore recommended that a micro entity should calculate profit as a measure to protect its capital from being depleted. Cash should not be mistaken for profit as an entity may have huge cash balances but having its asset base or productive capacity depleted by losses. This implies that accounting numbers should be used and interpreted correctly. A study in Kisii Municipality, Kenya by Okwena et al. (2011: 23) concluded that there is a direct relationship between book keeping and financial performance: poor book keeping would lead to poor financial performance and proper book keeping would lead to better financial performance of the SMEs. As such, there is need for the owners and managers of the SMEs to embrace proper book keeping practices in order to be successful in their financial performance. Ismaila (2011: 79) explored the financial measures that manufacturing SMEs in Pretoria use to measure their financial performance. Semi-structured interviews were conducted at the participant SMEs' premises in order to gather the information. The study found that most manufacturing SMEs used financial ratios to measure their financial performance, but to a very limited extent. Very few ratios were used by individual SMEs and most of the ratios used were not the best indicators mentioned in the literature. Though, some of the interviewees acknowledged that they need to use more ratios. The use of bankruptcy prediction models was totally absent among the participants. Ismaila (2011: 79) conclude by reinforcing that, it must be noted though that financial measures alone are not enough to measure companies' performance since a number of non-financial performance measures also play an important role

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in their overall performance. It has been recommended that SMEs use the six ratios that have worked well for some of the participants in the study (cash flow to debt, current ratio, working capital to assets, cash flow to average total current liabilities, gross profit margin ratio and inventory turnover). It is also recommended that SME owners enrol their financial staff for training in bankruptcy prediction models, and use financial software packages if they can afford them. Similarly, Mosalakae (2007: 232) made an exploratory investigation on financial performance measurement of South Africa's top companies. The researcher concluded that, top South African companies do not use the available arsenal (financial ratio analyses and bankruptcy prediction models) to measure their financial performance. Using the procedures stipulated by the grounded theory, Chong's (2008: 6) study reports the findings of in depth semi-structured interviews with five owners-managers of small and medium sized enterprises who hire twenty or less employees in Texas, USA. The findings reveal that the owners-managers place equal attentions on both the financial measures (profits before tax, turnover, profits per employees and revenue growth) and non-financial measures (customers' satisfactions, referral rates, and growth in customers' bases and revenues). Even though this study intended to focus on in-depth understanding of the behaviour and nature of the SMEs, the five selected respondents may not necessarily reflect the culture and approaches adopted by the owners-managers as a whole, or in other parts of the country and other industries. More empirical tests could help firm up the understanding and reasons for selecting or neglecting certain categories of measures. Repeated surveys help provide comparative observations of measures in a variety of settings on an industrial, national and international context. Hence <https://assignbuster.com/smes-are-based-on-size-finance-essay/>

this study focuses on the international context aspect. Mwangi (2011: 96) carried out a study on accounting systems in small and micro enterprises in Kenya. The results revealed that small and micro enterprises that extensively populate the informal sector are profitable operations just like the enterprises in the formal business sector. However, unlike in the formal business sector, the absence of accounting data makes it difficult to carry out financial ratio analysis. Mwangi (2011: 96) therefore recommended the calculation of various financial ratios among SMEs. This would provide a basis for gauging empirically the profitability level of the enterprises in the small and micro business sector. It would therefore be worthwhile to include this sector in economic statistical calculations in developing countries such as Zimbabwe. Sarapaivanich (2003) carried out an empirical study on the use of financial information in financial decisions of SMEs in Thailand's trading sector only. A total of 19, 798 SMEs owners/managers in the trading sector were used as the total population of this study. A systematic sample of 3, 959 enterprises was created by selecting every fifth enterprise. The study found that SMEs in Thailand made little use of accounting information in raising external funds and making long-term investments. Senik et al. (2012: 731) carried out a study on the accounting information needs, management and usage among Malaysian SMEs restaurants. The findings of this study revealed that small medium sized restaurants managers did not possess enough skill and qualifications to better utilize the accounting information. The small firm owner who are normally the one that manage the firms' account or hired account personnel, had limited skills and proficiency in managing and using accounting information. Besides, they were unaware of the advantages of outsourcing their accounting work to the professionals.

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They recommended the need of training for the restaurant's owner/manager on the importance of handling and using accounting information. The research employed qualitative research method of face-to-face interview using purposive sampling. The present research will use quantitative method. Researching on the impact of accounting information on management's decision-making process, Lengauer, Mayr and Parasote (2006: 54) used a case study of Wexiödisk AB, Scandinavian's leading supplier of dishwashing machines. They concluded that accounting information has an important role in decision making and is not only used for the planning but also for controlling phase. Profitability (gross and operating profit) was regarded as the most important accounting tool for the owners and also for the managers in addition to target and cost-plus pricing, a kind of benchmarking, working capital, and the payback method. The empirical data collection was primarily done by conducting two face to face interviews, one with the financial manager and another one with the managing director. However, the danger of interviews is their risk of being subjective. This present research proposes to go beyond Lengauer, Mayr and Parasote's work through focusing on 61 entities rather than one and use quantitative methodology rather than qualitative one. By using a research sample of 61 micro entities, such a research design allow the researcher t speak more authoritatively about the impact of accounting information on management's decision-making process. Akande (2011: 376) investigated the effect of accounting skill on entrepreneur performance for the success of small businesses in Nigeria. A simple random sampling technique was used to select a total of 140 small business owners in Ogun State of Nigeria. Chi-square was used to measure the discrepancies existing between the

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observed and expected frequency and to proof the level of significance in testing stated hypotheses. His findings revealed that most entrepreneurs of small businesses did not see the need to prepare financial statement which was regarded as waste of time since they were not obliged to do so either for tax assessment or as internal control measure being the sole stakeholders. This may be wrong in view of the fact that there are other interest groups that may have stake in the business such as banks, creditors and investors. Accounting skills was found to be highly contributory to entrepreneurial performance. Akande (2011) concluded by making the following suggestions: Owner entrepreneurs should embark on capacity building in accounting skill in the area of financial management and record keeping for better performance, since they do it alone. Government should make it mandatory for small business owners to prepare financial statement for performance monitoring so as to be able to assess their performance regardless of tax assessment motive. While there has been substantial research that examines accounting practices in SMEs (record keeping, reporting system and performance measurements), these studies do not measure the relationship among these practices. The present study therefore examines the extent to which accounting information is used in financial performance measurement, for decision making within micro entities.

2. 3. 5 Appropriate accounting practices for micro entities

According to Jefferson (2012) there have been so many ways of managing bookkeeping records - from manual to online or the use of bookkeeping software. He further says that though many companies prefer to use the manual method, it is still highly recommended that every business today use

online bookkeeping to make the processes more accurate, efficient and effective. On the basis of collected data from Member States, EU (2008: 21-23), on applied accounting systems in small enterprises, the experts of national administrations and the business organisations came forward with the following good practices for the accounting systems which may be considered appropriate for small enterprises according to their particular circumstances and needs.

- Keeping the most important financial records such as the sales day book, purchases day book, cash receipt book, cheque payments book, petty cash book, general journal, nominal ledger, debtors' ledger and creditors' ledger and a payroll system. This improves the accuracy and reliability of the accounting transactions which further provide the input to the financial statements for small enterprises;
- Doing double-entry bookkeeping, because it offers a much better control of the transactions being recorded properly;
- Using simplified formats for financial statements i. e. the balance sheet and the income statement presenting only the main headings;
- Preparing projected cash flow statements on a regular basis;
- Applying accrual basis accounting, because such an accounting method provides a more accurate and complete picture of the enterprise's financial position, performance and changes in its financial position than cash basis accounting;
- Applying the matching principle, because of the importance that revenues are matched with expenses to provide a truthful view of the enterprise's financial performance;
- Applying the true and fair view principle, because it is very important to ensure that accounting information is presented accurately and consistently;
- Using a standardised chart of accounts, because it removes some barriers when changing an accounting software package, but also because it facilitates the introduction

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of taxonomy to supply financial information, and• Applying the " only once" principle meaning an administrative simplification in the supplying of financial information to different or the same authorities for different or the same purposes (e. g. taxation, statistics, banks). It is therefore imperative that micro entities engage in the above good practices in the accounting systems, in order to generate and use accounting information in financial analysis.

2. 4 Model on use of accounting information in financial performance measurement

Based on the literature, this research chapter was seeking to provide an overview of the findings of financial management practices, financial characteristics and SME profitability. As such, the lack of empirical evidence from the emerging economies and the absence of examination of the impact of financial management practices and financial characteristics on SME profitability, are gaps that this review found from the literature. Based on these findings provided by previous researchers and these gaps, a model of the impact of financial management on SME is developed. Yin (2008: 90) suggests that where existing theory has been used to formulate research questions and objectives, theoretical propositions used by the researcher should be developed into a conceptual framework to help organize and direct data analysis. The framework will then be used to shape the research and to organize and direct data gathering and analysis (Gill and Johnson 2009: 15). Such a model is presented in Figures 2. 1. The model needs to be tested by the empirical data and this will be demonstrated in chapters 3 and 4. In this research project a conceptual framework will be used despite the argument

by Bryman (2008: 78) that introducing a conceptual framework in the earlier phases of the research project may create a premature closure on the issues to be investigated. A conceptual framework will be used in this research because the researcher believes it will help him to identify the main variables, components, themes and issues in the research project and generally guide it (Saunders et al 2008: 78). According to the literatures, this study constructs the research framework which is shown in 2. 1 below.

Accounting Information Performance Measurement
 D E C I S I O
 N PROFITABILITY BUSINESS ACTIVITY BUSINESS LIQUUIDITY GEARING
 A C C O U
 N T I N G P R A C T I C E ACCOUNTING RECORDS FINANCIAL REPORTS

Figure 2. 1 Use of accounting information in financial performance measurement

Source: Developed for the study

Figure 2. 1 describes the general model of the use of accounting information and financial performance measurement in financial decisions of SMEs. It shows the impact of financial accounting practices on SME decision making processes in which the components measuring financial accounting information such as accounting records, financial reporting, and components measuring financial performance measurement such as profitability, liquidity, financial leverage, and business activity are identified. Having come up with a conceptual framework which depicts the core relationship of the literature reviewed above, the researcher will link the causal relationship that exists in the conceptual framework above. The study therefore assumed that the utilisation of accounting information by SMEs in their performance measurements will result in improved decisions.

2. 5 Justification – gap

The findings of this paper indicate that very little research has been previously conducted looking specifically at micro-entities as these tend to be subsumed in the term SME. Furthermore much of the published literature is restricted to studies conducted in developed countries and does not reflect the very different environment in which micro-entities operate in developing, emerging or transition economies. This gap in the literature indicates that this is an area that is ripe for further in-depth examination and research. Based on the literature, this research chapter was seeking to provide an overview of the findings of financial accounting practices, accounting information and SME financial performance measurement. Related to financial accounting practices, most previous researchers from the literature concentrated on examining, investigating and describing the impact of accounting practices on the performance of SMEs. The specific areas of financial accounting practices including record keeping practices, adoption of IFRS for SMEs, accounting information system, financial reporting and analysis, working capital and small business profitability have attracted the attention of many researchers. Their findings are mainly related to exploring and describing behaviour of SMEs in financial accounting practices. Although they provided much descriptive statistical data and empirical evidence on SME financial accounting practices, it appears that there are some limitations in past research, which need to be addressed. Firstly, most empirical evidence comes from developed economies such as the USA, UK, Canada and Australia and the Middle East economies such as Malaysia and Thailand. India. The context is obviously different and the findings would most probably not applicable to the local context where institutional set up and

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economic development are different. Evidence seems to lack from emerging economies, especially from the developing countries such as those in the sub-Saharan Africa. Secondly, most researchers in the literature only focus on investigating and describing financial accounting practices, whereas few examine the use of accounting information in financial performance measurement. Thirdly, many authors have written on the subject of small scale business failure. Many reasons have been given for their failure. The problem however, remains that many of the authors did not link business failure to the lack of adequate record keeping and underutilisation of financial performance measures in decision making. Fourthly, to date, there is no study, which examines the relationship or the impact of two variables: financial records and financial reports on financial performance measurement variable. This lack of empirical evidence from emerging economies and the lack of examination of the impact of financial accounting practices on decision making in SMEs are major gaps in the knowledge of financial accounting practices and decision making in SMEs. It will be difficult to convince micro entity owners/managers of the importance of accounting information in decision making until evidence on the use of accounting information in financial performance measurement is provided and the relationship between the two variables are discovered. Based on previous research findings and recognition of these gaps, a study on the use of accounting information in financial performance measurement is justified and a suitable model should be developed and tested by using the empirical data from emerging economies. Zimbabwe is one of many appropriate countries to provide such data. Therefore, this study will extend previous studies by focusing on examining the use of accounting information in

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financial performance measurement in SMEs using the empirical evidence from Zimbabwe. It is suggested that SMEs performance is influenced by a number of factors which include 1) a lack of demand for product or service, 2) poor management and/or administrative skills of the owner/manager, 3) a lack of experience in the particular industry, 4) insufficient capital invested by the owner, 5) an over-reliance on external borrowings, 6) poor record-keeping, and etc. (Brooks, Collings & Gonzales 1990). It is also implied, in the literature, that a poor accounting record-keeping and inefficient use of accounting information cause poor financing decision of SMEs and high failure rate. The ineffective use of capital budgeting techniques also makes the SMEs' take of successful more difficult. Thus, the use of accounting records and financial performance measurement in financial decisions of SMEs has valuable implications for economic development, policy formulation, and program development, as SMEs are the foundation of Zimbabwe's economy. The overall performance of the SMEs is crucial to Zimbabwe's economic development. Moreover, since few SMEs studies have been done in Zimbabwe, this study will fill a gap in the literature.

2. 6 Summary

As indicated in the introduction, the objectives of this chapter were to review the literature, find gaps and build a model of the use of accounting information in financial performance measurement based on this review. These objectives could not be separated as different activities, and all are fulfilled when a model of the use of accounting information in financial performance measurement in SMEs was created (Figure 2. 1, page 47). Sections 2. 2, 2. 3, 2. 4 and 2. 5 respectively reviewed literature on

theoretical literature review, empirical literature review, justification of the study and model of the use of accounting information in financial performance measurement in SMEs. Generally, previous researchers provided valuable and detailed insights into accounting information and performance measurements in SMEs. However, it appears that no investigation has been undertaken of the relationship between accounting practices including many variables such as accounting principles and bases, financial records, financial reporting and financial performance measurement on decision making in SMEs. Finally in this chapter, a model of the use of accounting information in financial performance measurement in SMEs was developed. This model indicates that the objectives of this chapter have been satisfied. Collecting data for testing the model will be examined in chapter 4, which is designed to discuss aspects of research methodology, while chapter 5 will present the results of data analysis applied in this study.

Chapter summary