

# **Financial management practices and performance of SMEs in Sri Lanka: evidence from Jaffna District**

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## **Abstract**

*Efficient financial management practices is essential for small and medium enterprises to reach growth stage of the firm as it has major effect on performance. The aim of this study is to find out the financial management practices among small and medium sized enterprises in Jaffna district and also examine the impact of financial management practices on performance of SMEs. Financial management practices have been measured by working capital management, investment appraisal, capital structure management, financial reporting and analysis and accounting information system. Performance has been measured by perceptions on performance of owner of SMEs. Stratified random sampling method was used to select the participants from registered SMEs in Jaffna district. Data was collected through the self administered questionnaire from 60 SMEs functioning in Jaffna district. Descriptive and inferential statistics were used to analyze the data using SPSS. Cronbach's Alpha was used to check the reliability of the data. Results of the study revealed that there is a significant difference in the application of financial management practices between small and medium enterprises. Financial management practices of working capital management, investment appraisal, capital structure management, financial reporting and analysis and accounting information system are highly applied by medium sized enterprises than small enterprises. Working capital management and capital structure management have significant impact on SMEs performance. Outcome of the study may be useful to the practitioners to focus the financial management practices in order to enhance their business performance.*

**Keywords:** Financial management practices, performance, SMEs.

## **01. Introduction**

The small & medium enterprises are considered as driving engines of a country's economy. Growth dynamic is coming from SMEs as 98% of enterprises in Sri Lanka are micro, small and medium enterprises (Central bank annual report, 2014). Contribution of SMEs to economic growth is much more than the large scale companies in Sri Lanka as the scope of large scale companies is not materialized due to the post

war and other environmental factors. SMEs are facing many types of challenges since their development stage in terms of finance, marketing, global competition, availability of raw materials, talented human resources and technological changes. But major reason to fail small and medium enterprises is running out of cash due to the poor management of finance. Financial management is a process of planning, organizing, monitoring and controlling

money to achieve organisational goal efficiently and effectively. It is a basic function needed to be practiced in every organization for their success. The most owners of small and medium enterprises may not have proper knowledge in managing money. They rely on their accountant or assistant for managing money.

Over the years SMEs are considered as a major source of employment, poverty alleviation income generation and regional development (White Paper, 2002, p. 01). The Federation of Chambers of Commerce and industries of Sri Lanka (FCCISL) is continuously playing major part to provide a wide range of services for the SMEs to be competitive, socially responsible and environmentally friendly and conducting a program called "Enterprise Sri Lanka" is commenced to provide support services to SMEs. Many government and private organisations are conducting development programs for SMEs in the form of training, funding, marketing and infrastructure facilities.

Small and medium-sized enterprises (SMEs) a backbone of Sri Lankan economy, is expected to play a greater role in the development of economy. Successive governments in Sri Lanka have taken various steps towards developing the SME sector by improving access to finance, technology support, more access to information, support for skills development, better infrastructure, SME networking opportunities, linkage formation, improvement of advisory services and business development drives to support the growth of the SME sector. Yet, one of the

main challenges that SMEs still face is easy access to financing and working capital and also their inability to attract good skills (Dinesh , 2015). In order to solve this problem few studies have been conducted in Sri Lanka. However, the studies conducted have not shown that how all components in financial management practices improve the overall business performance of SMEs. Gamage (2014) emphasized that policy makers, practitioners and researchers in all relevant institutions have a huge responsibility to grow small businesses in order to become a large scale export firms which is essential for economic development in Sri Lanka. Butt, Hunjra and Rehman, (2010) reorganized that the financial management system is necessary to ensure that the SMEs economic resources are used effectively and efficiently in search of its goals. Karunanada and Jeyamaha (2010) expressed their view that poor record-keeping, inefficient use of accounting information to support their financial decision making and the low quality and reliability of financial data are part of the main problems in financial management concerns of SMEs. Therefore, it is utmost important to examine the financial management practices and performance of SMES in Sri Lanka as SMEs are contributing much to economic growth of the country. Therefore present study tries to identify the financial management practices adopted by SMEs in Sri Lanka and to assess the financial management practices have an impact on the performance of SMEs. Specially, current study focusing

on SMEs in Jaffna district as after ended the civil war in 2009, government concerns much more contributions to economy from North.

The aim of this study is to find out the financial management practices among small and medium sized enterprises and also to investigate the impact of those practices on performance of SMEs in Sri Lanka.

## **2. Literature review**

Financial management practices are the central to the success of any small business (Meredith, 1986). Financial literature suggests that optimum application and commitment towards financial management practices result in an increased firm's performance. The financially well-managed firms are operationally efficient (Butt et al., 2010). The ability of SMEs to develop, grow, sustain and strengthen themselves is heavily determined by their capacity to access and manage finance (Abe, Troilo and Batsaikhan, 2015). Inefficiencies in financial management practices result in poor financial performance and eventually lead to failure of SMEs (Jennifer and Dennis, 2015). Most important financial management practices emphasized in finance literature have been expressed following paragraphs.

### ***2.1 Working capital management***

Working capital management consists of managing working capital components; including cash, receivable, payable and inventory management in SMEs and working capital policy used to maintain level

of investment in current assets for attaining their targeted sales. Previous studies emphasizing on working capital management in SMEs have been conducted by many researchers. Rathnasiri (2015) examined working capital management in SMEs in Sri Lanka using 60 samples selected from western province in Sri Lanka. Researcher used the adoption of cash, receivable and inventory management practices of SMEs for measuring the working capital management. The findings revealed that SMEs practice on recording of cash, inventory and accounts receivable but not conducted in a formal manner. Study conducted by Kasiran and Mohamadb (2016) to analyze the efficiency of working capital management in the selected small medium enterprise companies in Malaysia using three indexes named, performance index of working capital management, utilization index of working capital management, and efficiency index of working capital management. Finding of the study was less efficient in managing their working capital. Czarnitzki and Hottenrott (2011) examined the relation between working capital management and profitability of small and medium-sized enterprises in Germany by controlling for unobservable differences. The result indicates that SMEs have an optimal working capital level that maximizes their profitability. Inefficient working capital management among SMEs was found in the study done by Masocha and Dzomonda (2016) in South Africa with 50 selected SMEs owners.

## ***2.2 Investment appraisal***

Brigham (1995) suggested that Capital budgeting should be practiced more by a smaller firm than larger organizations because of the lack of access to the public markets for funding. Graham et al. (2001) conducted survey in the USA and Canada. The main conclusion of the study was that the present value techniques had been used by most of the samples firms for evaluating new investments. However, when choosing an investment source, they emphasize more on size of the company as the main indicator influencing the company's choice. Soldofsky's (1964) study results shows that payback period is used by 58 percent of respondents whereas only 4.1 percent employed accounting rate of return technique

## ***2.3 Capital structure management***

Small and medium enterprises are usually operated using capital provided by their owners, venture capitalists and angel investors as they are unable to use external fund with higher cost of capital in the early stages. Therefore, questions asked from participants related to know how SMEs determine sources of finance in such difficult circumstance. The study done by Thevaruban (2009) investigates small scale industries and its financial problems in Sri Lanka. She concluded that SMEs of small scale industries in Sri Lanka are difficult to get credit from external parties because the cash inflow and savings of the SMEs in the small scale sector is very low. SMEs depends on bank loans as compared to their

larger counterparts as they require higher amount of cost due to the higher risk in SMEs (Berger et al., 2001; Bracker et al., 2006). Poland (Klapper et al., 2006) Vietnam (Nguyen and Ramachandran, 2006) and Ghana (Abor and Biekpe, 2007) conducted several studies on capital structure of SMEs. They argues that theories of capital structure and funding decisions are not applicable in SMEs and they concluded that there is significant institutional differences between developing countries and developed countries.

## ***2.4 Financial reporting and analysis***

Charles Ezeagba (2017) has done a survey to analyze financial reporting in Small and Medium Enterprises (SMEs) in Nigeria using time series data. The study found that inadequate accounting books and records, manpower and accounting system are considered as the challenges facing SMEs in preparation and presentation of financial reports. McMahon and Adelaide (1995) engaged in a study to examine the impact of financial reporting practices upon business growth and performance outcomes amongst small and medium-sized enterprises (SMEs) in manufacturing in Australia. They argued that improved financial reporting lead to more effective and efficient management of SMEs and significantly improve their prospects. Moores and Mula (1993) conducted a study on the role of managerial control systems, consists financial reporting, in survival and successful growth of Australian family businesses. The results clearly shows improving practices of

financial reporting as businesses grow in employment terms and progress through the earlier stages of a business life-cycle model.

### **2.5 Accounting information system**

Accounting information is information provided by accountants and accounting systems. This information is usually presented in financial statements such as the income statement and the balance sheet. It also includes any financial ratios extracted from these financial statements. Azize and Esmeray (2013) carried out a study on the 'Impact of Accounting Information Systems on Firm Performance: Empirical Evidence in Turkish Small and Medium Sized Enterprises' using primary data. The result of the study revealed that accounting information system has a positive effect on the performance of the SMEs. Another study has been done by Belal (2013) to investigate the Use of Accounting Information by Small and Medium Enterprises in South District of Jordan. This study recommended that good accounting practices will improve the effective operations of small and medium scale enterprises and even sole proprietors.

After the literature surveys following hypotheses have been formulated to carry out the study

### **2.6 Formulation of hypotheses**

**H<sub>1</sub>:** There is a significant difference in applying financial management practices between small and medium enterprises.

**H<sub>2</sub>:** There is a significant influence of financial management practices on

performance of SMES. This hypothesis has been divided as five sub hypotheses according to the variables considered in this study.

### **3. Methodology**

The sample consists of 60 firms from the SMEs operating their business in Jaffna District through a stratified random procedure from different sectors for the year ended 2016. A survey with a structured and self-reported questionnaire with 5 point likert-scale ranging from never to always is administered to garner data. Five variables have been considered as financial management practices; working capital management (WCM), investment appraisal (INA), capital structure management (CSM), financial reporting and analysis (FRA) and accounting information system (AIS) whereas perceived effectiveness by owners is used as the proxy for the firm performance. A multiple linear regression model attempts to investigate the influence of selected financial management practices on SMEs performance

$$Performance = \alpha + \beta_1 WCM + \beta_2 INA + \beta_3 CSM + \beta_4 FRA + \beta_5 AIS + \epsilon \dots \dots \dots (1)$$

The study uses the definition for SMEs, which is cited in Ponnampuma (2000). The Department of Small Industries (DSI) classifies enterprises with capital investment of less than Rs.5 million (US\$ 52500) is small and above Rs.5 million (less than Rs. 10 M is medium sized Enterprises (Ponnampuma, 2000).

#### 4. Data analysis

##### Demographic characteristics and business profile of respondents

In order to carry out this study, the data has been collected from 60 small and medium

enterprises in Jaffna district, Sri Lanka. A summary of findings on demographic characteristics and business profile of respondents is given in the table below.

Table 1: Demographic characteristics and business profile of respondents

Variable	Values	Frequency	Percentage
Gender	Male	56	93.3%
	Female	4	6.7%
Education	School Level	48	80.0%
	Graduate	6	10.0%
Form of business	Professional	6	10.0%
	Sole Proprietorship	54	90.0%
Number of years in business	Limited Liability Company	6	10.0%
	up to 5	13	21.7%
	11 to 15	22	36.7%
Nature of business	Over 15	25	41.7%
	Manufacturing	11	18.3%
	Trading	31	51.7%
	Beauty Care/Hairstyling	6	10.0%
Number of employees	Transporting	2	3.3%
	Other	10	16.7%
	Up to 10	45	75.0%
	10 to 20	4	6.7%
	30 to 40	6	10.0%
Size of enterprises	Over 50	5	8.3%
	Small Enterprises		
	(capital investment less than Rs.5 M)	43	71.7%
Level of Capital Investment	Medium Size Enterprises	17	28.3%
	Below Rs.1,000,000	16	26.7%
	Rs.1,000,000 – Rs.5,000,000	27	45.0%
	Rs.5,000,000 – Rs.50,000,000	11	18.3%
	Above Rs.50,000,000	6	10.0%

Since stratified random sampling method has been used to collect the data for this study, higher percentages (93.3%) of enterprises' owners were males engaging with manufacturing (18.3%) and trading (51.7%) while females were only 6.7%. Majority of respondents (80%) were with only school level education and other respondents were at graduate level (10%) and professionally educated (10%). Researcher can conclude that most of the people who are with low

background in education wish to become as an entrepreneur. Well educated people are working for the government or for other private organisations.

Most of the respondents (90%) were engaged in sole proprietorship. Others (10%) were limited liability companies. Majority of enterprises consists of 1 to 10 employees (75%) as higher respondents are from sole proprietorship.

Higher percentages (41.7%) of enterprises

have reached 15 years in their business operations; therefore they could have been maintained proper financial records and practiced financial management for their success. The data has been collected from 43 (71.7%) small size enterprises and 17 (28.3%) medium size enterprises. 45% of Enterprises are running with maximum Rs.5,000,000 capital and Only 18.3% of enterprises are operating with capital above Rs.5,000,000 as they may be as limited liability companies.

### Testing the reliability

A reliability analysis of the item-scales was

performed using SPSS. Cronbach's alpha ( $\alpha$ ) values were assessed for each variable with item-scales. The reliability of the test is reported in table 2. The reliability of the measures was well above the minimum threshold of 0.60 in every case (Gliner and Morgan, 2000). Thus, it can be concluded that all of the measures were generally reliable.

Table 2: Testing the reliability

Dimensions of variables	No. of dimensions	Cronbach's Alpha ( $\alpha$ )
Working capital management	15	0.619
Investment Appraisal	6	0.719
Capital structure management	5	0.698
Financial reporting and analysis	11	0.876
Accounting information system	6	0.607
Performance	15	0.854

Table 3 : Size of enterprises and use of financial management practices

	Size of the Enterprises	N	df	Mean	SD	SE	t	sig
Working Capital Management	Small	43		3.89	.29	.04		
	Medium	17	58	4.12	.30	.07	-2.612	.014
Investment Appraisal	Small	43		2.82	.55	.08		
	Medium	17	58	4.08	.37	.08	-10.232	.000
Capital Structure Management	Small	43		3.13	.71	.10		
	Medium	17	58	3.65	.78	.19	-2.367	.025
Financial Reporting & Analysis	Small	43		3.21	.72	.11		
	Medium	17	58	3.69	.54	.13	-2.788	.008
Accounting Information System	Small	43		3.41	.63	.09		
	Medium	17	58	3.82	.49	.12	-2.735	.009

As can be seen in table 3, medium sized enterprises highly applied working capital management practices ( $M=4.12$ ,  $SE=.07$ ) than small enterprises ( $M=3.89$ ,  $SE=.04$ ). The difference was significant  $t(58) = -2.612$ ,  $p < 0.05$ . A similar pattern was observed in the application of investment appraisal, capital structure management, financial reporting & analysis and accounting information system that medium sized enterprises highly applied ( $M=4.08$ ,  $SE=.08$ ;

$M=3.65$ ,  $SE=.19$ ;  $M=3.69$ ,  $SE=.13$ ;  $M=3.82$ ,  $SE=.12$ ) than small enterprises ( $M=2.82$ ,  $SE=.08$ ;  $M=3.13$ ,  $SE=.10$ ;  $M=3.21$ ,  $SE=.11$ ;  $M=3.41$ ,  $SE=.09$ ) and the differences were also significant  $t(58) = -10.232$ ,  $p < 0.01$ ,  $t(58) = -2.367$ ,  $p < 0.05$ ,  $t(58) = -2.788$ ,  $p < 0.05$ , and  $t(58) = -2.735$ ,  $p < 0.05$  respectively. Therefore, it is fair to say that there is a significant difference between small and medium sized enterprises in applying financial management practices in

terms of working capital management, investment appraisal, capital structure management, financial reporting and analysis and accounting information system. Therefore, hypothesis (H<sub>1</sub>) one is supported with the results of the study that there is a significant differences between small and medium sized enterprises in applying financial management practices.

The Pearson correlation coefficient (known as the Pearson product-moment correlation coefficient) is determined in line with Hair et al. (2010), Pallant (2010) and Field (2013). This study employs a correlation analysis to discover the association, direction and magnitude of the variables, mainly: the variables of financial management practices and firm performance.

Table 4: Correlations analysis between variables

		(1)	(2)	(3)	(4)	(5)	(6)
(1) Working Capital Management	Pearson Correlation Sig. (2-tailed)	1					
(2) Investment Appraisal	Pearson Correlation Sig. (2-tailed)	.161	1				
(3) Capital Structure Management	Pearson Correlation Sig. (2-tailed)	.268*	.596**	1			
(4) Financial Reporting & Analysis	Pearson Correlation Sig. (2-tailed)	.244	.441**	.421**	1		
(5) Accounting Information System	Pearson Correlation Sig. (2-tailed)	.276*	.278*	.172	.624**	1	
(6) Performance	Pearson Correlation Sig. (2-tailed)	.373**	.120	.447**	.031	-.018	1

\* Correlation is significant at the 5% level (2 tailed)

\*\* Correlation is significant at the 1% level (2 tailed)

As can be seen in table 4, the working capital management and capital structure management have a positive association with performance at a 1% significant level respectively ( $r = .373, p < 0.01$  and  $r = .447, p < 0.01$ ). There is no significant relationship of Investment appraisal ( $r = .120, p > 0.05$ ) Financial Reporting & Analysis ( $r = .031, p > 0.05$ ) and accounting information system ( $r = -.018, p > 0.05$ ) with performance. Therefore, it can be concluded that there is a

significant positive relationship between working capital management and performance. Also, it can be concluded that capital structure management significantly positively associated with performance.

In order to examine the impact of financial management practices on firm performances, multiple regression analysis was performed in this study. Result of the multiple regression analysis presented in the table 3 below.



Table 5 : Result of multiple regression analysis

Variables	B	Std. Error	t	Sig.
(Constant)	1.569	.674	2.327	.024
Working capital management	.459	.178	2.583	.013
Investment Appraisal	-.100	.087	-1.147	.256
Capital Structure Management	.328	.089	3.703	.001
Financial Reporting & Analysis	-.114	.103	-1.105	.274
Accounting Information System	-.031	.110	-.283	.778
$R^2 = .333$	$Adj. R^2 = .272$	$F = 5.401$	$P ( F Statistic) = 0.000$	

Value of coefficient of determination for financial management practices ( $R^2$ ) is 0.333 whilst this result implied that 33 % percent of the total variance in performance could be explained by all five financial management practices. As the model revealed the remaining 67% of the variability was not explained in this model. An Analysis of Variance (ANOVA), indicated that;  $F= 5.401$ ,  $p < 0.01$ , that the model was significant. It means that the regression results were acceptable for this analysis.

Among the all five financial management practices considered in the analysis, only two financial management practices have significant impact on firm performance, which are working capital management and capital structure management. Working capital management significantly positively influenced on firm performance ( $B= .459$ ,  $p < 0.05$ ), similar pattern was observed in capital structure management that capital structure management has significant positive impact on firm performance ( $B = .328$ ,  $p < 0.01$ ).

In order to test the hypotheses, considering the probability of t test of working capital management was less than 5%. Hypothesis

( $H_{2,1}$ ) stated that there is a significant impact of working capital management on performance of SMEs. Since t test of p-value was  $.013 < .05$ , which illustrated that there was a significant positive impact of WCM on performance of SMEs as a result  $H_{2,1}$  was supported. The result is consistence with the findings of previous researchers (Butt et al., 2010; Niazi et al., 2011; Jennifer & Dennis, 2015).Hypothesis ( $H_{2,2}$ ) stated that there is a significant impact of investment appraisal on performance of SMEs. Since t test of p-value was  $.256 > .05$ , which illustrated that there was not significant impact of investment appraisal on performance of SMEs, as a result  $H_{2,2}$  was not supported. Hypothesis ( $H_{2,3}$ ) stated that there is a significant impact of capital structure management on performance of SMEs. Since t test of p-value was  $.001 < .01$ , which illustrated that there was a significant positive impact of capital structure management on performance of SMEs, as a result  $H_{2,3}$  was supported. Hypothesis ( $H_{2,4}$ ) stated that there is a significant impact of financial reporting and analysis on performance of SMEs. Since t test of p-value was  $.274 > .05$ , which illustrated that there was not significant

impact of financial reporting and analysis on performance of SMEs, as a result  $H_{2,4}$  was not supported. Hypothesis ( $H_{2,5}$ ) stated that there is a significant impact of accounting information system on performance of SMEs. Since t test of p-value was  $.778 > .05$ , which illustrated that there was not significant impact of accounting information system on performance of SMEs, as a result  $H_{2,5}$  also was not supported.

## 5. Conclusion

Having understood the importance of SMEs to the country and application of financial management practices to the performance of SMEs, present study has been carried out to find out the financial management practices among SMEs and to assess the impact of financial management practices on performance of SMEs. Current study specially focuses on Jaffna district as it has given more consideration by the Sri Lankan government in recent past. There are 60 SMEs were considered in this study by using stratified random sampling techniques. Independent sample t test has been performed to see the differences in applying the financial management practices between small and medium sized enterprises. Result of the study revealed that all the variables: WCM, INA, CSM, FRA and AIS are significantly differing in applying by small and medium sized enterprises. All the financial management practices are highly applied by medium sized enterprises than small enterprises. Among the five financial management practices, only WCM and CSM have significant positive influence on

performance of SMEs in Jaffna district.

After the post war in Sri Lanka, there were no studies conducted to analyze financial management practices in SMEs in Jaffna district. Therefore, this study extends the literature that what are the financial management practices are applying by the SMEs in Jaffna district and influence of the financial management practices on their business performance. Clearly this study identified which financial management practices influencing on business performance of SMEs. Thus, findings of the study may be useful to the practitioners to focus the financial management practices in order to enhance their business performance.

It is better to conduct survey in future using data collected from all district in Sri Lanka. This study identified to what extent financial management practices impact on performance of SMEs in Sri Lanka using limited factors. However there are many predictors on which performance of SMEs is depending. Therefore further research can be carried out to identify impact of other variables on efficiency and business growth of SMEs in Sri Lanka.

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