

## An Investigation into the Financial Management Practices of New Micro-enterprises in South Africa

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**ABSTRACT** The research investigated the financial management practices of new micro-enterprises in South Africa. The research focused on six financial management practices namely financial planning and control, financial analysis, accounting information, management accounting, investment appraisal and working capital management. Data was gathered through the use of structured face-to-face interview in a survey. A combination of dichotomous and Likert scale questions were used for the survey. Statistical analysis was descriptive statistics in nature. The findings indicated that most new micro-enterprises do not engage in financial planning and control, financial analysis and investment appraisal. For accounting information most new micro-enterprises keep certain accounting books such as sales book and purchases book but do not keep other books such as drawings book indicating a mixed result. The pricing strategy of new micro-enterprises is mainly cost plus and pricing similar to competitors. Recommendations to improve financial management practices include training of the owners of new micro-enterprises.

### INTRODUCTION

Small and medium and micro-enterprises (SMMEs) are increasingly seen as playing an important role in the economies of many countries. Thus, governments throughout the world focus on the development of the SMME sector to promote economic growth. Micro, very small and small enterprises contribute between 27-34% of the Gross Domestic Product and 72% of all jobs in South Africa (Department of Trade and Industry 2003, 2008). South Africa suffers from high unemployment with an official unemployment rate of estimate of 23.9% (Statistics South Africa 2012). One of the best ways to address unemployment is to leverage the employment creation potential of SMME (FinMark Trust 2006). SMMEs are expected to be an important vehicle to address the challenges of job creation, sustainable economic growth, equitable distribution of income and the overall stimulation of economic development in South Africa (Maas and Herrington 2006).

According to the Parliament of the Republic of South Africa (1995), a micro-enterprise is a business with (1) total full-time equivalent of paid employee of less than 5 (2) total annual turnover of less than R150,000 and (3) total gross asset value (fixed property excluded) of less than R100,000. The South African Revenue Service (2011) defines a micro enterprise as a business

with annual turnover below one million rand. Munoz (2010) points out that micro-enterprises comprise the smallest end (by size) of the small business sector and constitute the vast majority of the small business sector in both developed and developing countries. Micro-enterprises add value to a country's economy by creating jobs, enhancing income, strengthening purchasing power, lowering costs and adding business convenience. Rolfe et al. (2010) observe that micro-enterprise activity (especially in retail trade) is the most pervasive entrepreneurial activity in the informal sector of Africa. This sector generates a lot of employment and has thus been identified by the government as a priority. According to Timm (2011), the total number of small businesses in South Africa in 2006 was 2.4m. Informal businesses and mainly micro-enterprises were 1.4m. Samujh (2011) points out that despite the importance of micro-enterprises, their entrepreneurial role in building communities has not often been given adequate consideration. Micro-enterprises tend to be overlooked, intentionally or unintentionally in small business research. The lack of participation by micro-enterprises in small business research places them in a category of the "silent (or silenced) majority" (Samujh 2011).

Maas and Herrington (2006) observe that the creation of a new small firm is a two-stage process. The first phase is the start-up phase, a

three month period during which individuals identify the products or services that the firm will trade in, access resources and put in place the necessary infrastructure such as staff. The next phase, a period of 3-42 months, is when the small firm begins to trade and compete with other firms in the market place. Therefore, a new micro- enterprise can be described as a business that has been in existence for a period not longer than forty- two months. Once a firm has successfully existed for more than 42 months, it becomes an established firm.

SMMEs in South Africa suffer from a high failure rate. According to Brink et al. (2003) and Ligthelm (2011), 75% of new SMMEs created in South Africa fail within the first two years of operation. Von Broembsen et al. (2005) state that the probability of a new SMME surviving beyond 42 months and becoming an established firm is less likely in South Africa than in any other Global Entrepreneurship Monitor (GEM) country sampled in 2004. Adcorp (2012) reveals that around 440,000 small businesses have closed in the last five years in South Africa. In addition, the number of new business start-ups is at an all-time low. The number of small businesses in South Africa has stagnated over the past decade. Small businesses offer the only real prospect of large-scale job creation in South Africa, yet conditions for small businesses have deteriorated markedly. Sha (2006) notes that given this high failure rate, it becomes vital to research the factors that are required to enable the SMMEs to survive and grow. According to Tung and Aycan (2008), Petrus (2009) and Naqvi (2011) failure factors of SMMEs include poor business and financial management competencies. Sound financial management is crucial to the survival and well-being of small enterprises of all types. In the light of the high failure rate of SMMEs, it is significant to investigate the financial management practices of new micro-enterprises in South Africa. A review of the literature on financial management and SMMEs revealed that no study has investigated the financial management practices of micro-enterprises in South Africa. In addition, as pointed out by Samujh (2011) studies on the SMME sector have tended to focus on small and medium enterprises, thus neglecting micro-enterprises despite their important contribution.

### **The Objective of the Study**

The objective of the study is to investigate the financial management practices of new micro- enterprises in South Africa. The study will focus on six financial management practices namely financial planning and control, accounting information, financial analysis, management accounting, working capital management and investment decision.

### **Financial Management**

Gitman (2007) defines financial management as the area of business management, devoted to a judicious use of capital and a careful selection of sources of capital, in order to enable an organisation to move in the direction of reaching its goals. This definition points to certain essential aspects of financial management namely prudent or rational use of capital resource and achieving the goal of the firm. According to Oduware (2011), financial management entails planning for the future of a business enterprise to ensure a positive cash flow. Brinckmann et al. (2011) and Management Study Guide (2012) define financial management as managerial activities that concern the acquisition of financial resources and the assurance of their effective and efficient use. Financial management involves planning, organising, directing and controlling the financial activities such as the procurement and the utilisation of funds of the enterprise.

According to Firer et al. (2004) and Gitman (2007), financial management decisions include: (1) Investment decision (capital budgeting decision). Investment decision refers to the process of planning and managing a firm's long-term investments. Capital budgeting is used to evaluate whether investments in fixed assets such as new machinery, new plants, new products, and research development projects are worth pursuing. Capital budgeting techniques include non-discounted cash flow techniques (payback period and the accounting rate of return) and the discounted cash flow techniques (net present value, internal rate of return, profitability index and discounted payback period). (2) Working capital management involves managing the short-term assets and liabilities of a firm. Working capital management ensures that a firm has sufficient cash flow in order to meet its short-term debt obligations and operating expenses.

(3) Financial decision (capital structure). This relates to the raising of finance from various sources depending on the type of source, period of financing, cost of financing and the returns. Capital structure refers to the way a company finances its assets through some combination of equity, debt, or hybrid securities. (4) Dividend decision. This involves the decision with regards to the net profit distribution (dividend payment to shareholders and retained earnings).

### **The Goal of the Firm**

According to Firer et al. (2004), the goal of financial management is to maximise the wealth of the owners of the firm. The goal of the firm is to maximize its value to its shareholders. Value is represented by the market price of the company's common stock, which, in turn, is a reflection of the firm's investment, financing, and dividend decisions. The market price of a firm's stock represents the focal judgment of all market participants as to what the value is of the particular firm. It takes into account present and prospective future earnings per share, the timing, duration, and risk of these earnings, and any other factors that bear upon the market price of stock. The market price serves as a performance index or report card of the firm's progress.

Osteryoung et al. (1997) argues that it is important to note that firms have stated or unstated objectives. Corporate finance theory assumes that the objective of the firm is to maximise shareholder's wealth. This is, however, usually not the case with SMMEs who often do not participate in the capital markets. Small business enterprises often exhibit differences in their objectives for running their businesses well away from the traditional shareholder wealth maximisation concept. The objectives of small businesses include just having a job, enjoying a particular lifestyle associated with getting involved in a particular business, providing income to the owner-manager; and growing the business in terms of earnings through sales.

According to Kuratko et al. (1997), Woodliff et al. (1999) and Newby et al. (2003), the goal of SME owners can be measured quantitatively (financial) and qualitatively (non-financial). Financial return includes to earn as much profit as possible, to have as much disposable income as possible, to achieve financial security, to build

family wealth for the future. Non-financial factors include (1) personal satisfaction (2) independence/autonomy (3) intrinsic rewards (4) employment opportunities for owner's family (5) family security ((6) time flexibility and (7) staff and customer relations Osteryoung et al. (1997) declare that regardless of the goals and objectives that a small business may have, it is significant that there is an identification and implementation of the firm's objectives in order to make financial management of the small business relevant. Effective financial management strategy is crucial to the growth of a small business.

### **Financial Management Practices and Firm Performance**

Literature on financial management of small firms identifies the components of financial management practices crucial to the performance of small firms as financial planning and control, financial analysis, accounting information, management accounting (pricing and costing), capital budgeting and working capital management (Nguyen 2001; Osman 2007; Azhar et al. 2010; Agyei-Mensah 2011; Maseko and Manyani 2011).

According to Maseko and Manyani (2011), accounting systems provide a source of information to owners and managers of small businesses operating in any industry for use in the measurement of financial performance. It is crucial therefore that the accounting practices of small businesses supply complete and relevant financial information needed to improve economic decisions made by entrepreneurs. Ismail and Zin (2009) note that business strategy is one of main components that contributes towards growth among small firms. Padachi (2010) points out that the main factors that contribute to success or failure of small business are categorised as internal and external factors. The external factors include financing (such as the availability of attractive financing), economic conditions, competition, government regulations, technology and environmental factors. The internal factors are managerial skills, workforce and the accounting systems. This is consistent with the views of Ismail and Zin (2009) and Nandan (2010) that in the context of small business, accounting information is important as it can help the firms manage their short-term problems in criti-

cal areas like costing, expenditure and cash flow, by providing information to support monitoring and control. Ismail and King (2005), Son et al. (2006), and Shahwan and Al-Ain (2008) point out that accounting information is also useful for firms operating in a dynamic and competitive environment as it can help them integrate operational initiatives within long-term strategic plans. Sarapaivanich (2003) find that SMEs lack of access to capital and high interest rates charges are partially the result of incomplete (or no) accounting records, and the inefficient use of accounting information. Poor record keeping and accounting information make it difficult for financial institutions to evaluate potential risks and returns making them unwilling to lend to SMEs.

Peel and Bridge (1998) note that capital budgeting and planning positively impact on the performance of small businesses. SMEs engaged in detailed strategic planning are more likely to use formal capital budgeting techniques, including the net present value method, which is consistent with maximisation of firm value. Perceived profitability and success in achieving organisational objectives are positively associated with planning detail, suggesting that strategic planning is a key component in improving performance. Planning is very important because of the constantly changing and volatile business environment. Sarapaivanich (2003) notes that due to inaccessibility to the capital markets, the allocation of capital in small firms is very important. Capital assets involve a large amount of money. The result of capital budgeting decisions continues to impact on the firm for many years. Effective capital budgeting can improve asset acquisitions. Frankly (2000) points out that the appraisal of new and existing capital investment projects is fundamental to the success of the small firm. In a perfect market, the value of the firm is maximized when the projects with the highest net present value are selected. In addition, planning and control positively impact on the performance of SMEs. Through planning, goals are set. It is important to compare a firm's actual performance with the goal through the control process (Wijewardena et al. 2004; Veskaisri et al. 2007).

Gill et al. (2010) and Agyei-Mensah (2012) point out that there exists a direct relationship between working capital management and firm liquidity. Effective working capital management

provides the firm with adequate liquidity both to pay its short-term maturing obligations as they fall due and to conduct the firm's day to day operations. Inability to manage working capital efficiently is a major cause of SME failure. According to Osman (2007), management accounting from the perspective of SMEs include pricing strategy and pricing objectives. Avlonitis and Indounas (2005) point out that a pricing strategy includes the explicit steps or procedures by which firms arrive at pricing decisions. Pricing methods fall into three main categories: (1) Cost-based methods. These include cost plus method, target return pricing, contribution analysis and marginal pricing. (2) Competition-based methods: These include pricing similar to competitors, pricing above competitors, pricing below competitors and pricing according to the dominant price in the market. (3) Demand-based pricing methods: These include perceived-value, value pricing and pricing according to the customers' needs. In addition, pricing objectives include sales maximization, profit maximization and increase in market share. Small firms face severe competitive pressures from other small firms and large firms. The pricing strategy of a small business can ultimately determine its fate (Julien and Ramangalahy 2003; Shigang 2010).

## METHODOLOGY

The survey was conducted in Alice, Fort Beaufort and King Williams' Town. The three towns are in the Eastern Cape province of South Africa. The empirical approach consists of data collection through the use of structured face-to-face interviews. According to Cooper and Schindler (2003), structured face-to-face interviews involve trained interviewers visiting respondents to collect data. Interviewers ask fixed choice questions in a consistent format. Face-to-face interview method is a good approach for ensuring a high response rate to a sample survey. The method allows the interviewer to gather better quality data. In addition, face-to-face interview method allows the interviewer to establish rapport with the respondents. The method allows the interviewer to explain the questions to the respondents and so clarify any unclear question items.

Because of the difficulty in obtaining the population of micro-enterprises in the study area,

convenience sampling and the snowball sampling methods were used. According to Cooper and Schindler (2003), convenience sampling is a non-probability sampling technique where subjects are selected because of their convenient accessibility and proximity to the researcher. Snowball sampling method is a non-probability sampling technique where existing study subjects recruit future subjects from among their acquaintances. As the sample builds up enough data is gathered to be useful for research.

The number of years in operation was used to measure a new micro enterprise. According to Maas and Herrington (2006), a new micro-enterprise can be described as a business that has been in existence for a period not longer than forty two months. The questionnaire was divided into two sections: (1) biographical questions (2) questions related to financial management practices. A combination of dichotomous and Likert scale questions were used for the survey. Statistical analysis was mainly descriptive statistics in nature. This is consistent with similar empirical studies such as Agyei-Mensah (2011) and Maseko and Manyani (2011). A pilot study was conducted on the survey instrument used in this research with 10 owners of micro-enterprises in order to ensure face and content validity. The pilot study led to some modifications to the questionnaire. Owners were assured of confidentiality with regard to the data collected. The study focused on new micro-enterprises in the retail and service sectors. According to Rolfe et al. (2010), most of the micro-enterprises in South Africa are in the retail sector. Micro-enterprises focused upon are those with formal trading places.

## RESULTS

Table 1 depicts the biographical information of the respondents. 128 new micro-enterprises were contacted and 57 participated in the survey. The response rate was 44.5%.

Table 1 depicts the biographical information of the respondents. 53 out of the 57 respondents are sole proprietorships. Most of the respondents are male in the 31-40 age group in the retail sector and have been operating for three years and employing on the average two employees.

**Table 1: Biographical information**

<i>Biographical questions</i>	<i>Frequency</i>
<i>Status of the Business</i>	
Sole proprietorship	53
Partnership	4
<i>Age of the Respondents</i>	
Below 20	0
21-30	5
31-40	28
41-50	18
Above 50	6
<i>Level of Education</i>	
Matric	32
Post matric	25
<i>Gender</i>	
Male	39
Female	18
<i>Industry</i>	
Retail	33
Service	24
<i>Number of Employees</i>	
No employee	4
1 employee	15
2 employees	36
3 employees	2
4 employees	0
<i>Age of the Business</i>	
Less than 1year	5
1-2years	17
2-3 years	35

**Table 2: Financial planning, analysis and control**

<i>Questions</i>	<i>Never</i>	<i>Rarely</i>	<i>Some times</i>	<i>Often</i>	<i>Always</i>
<i>Financial Planning</i>					
Do you set financial objectives that you want to achieve within one year	55	0	0	1	1
Do you set financial objectives that you want to achieve within five to ten year	57	0	0	0	0
<i>Control</i>					
Do you compare your financial objectives with your performance	56	0	0	1	0
<i>Financial Analysis</i>					
Do you analyse the trend of your sales	52	0	0	3	2
Do you analyse the trend of your cost	52	0	0	3	2
Do you analyse the trend of your profit	52	0	0	3	2

The results as indicated by Table 2 indicate that 55 out of the 57 respondents do not set any financial short-term financial objectives. In ad-



dition, none of the respondents sets long-term financial objectives. In addition, 56 out of the 57 respondents do not compare objective with performance. Furthermore, 52 out of the 57 respondents do not undertake financial analysis to determine the trend in sales, cost and profit.

**Table 3: Accounting information**

<i>Accounting information</i>	<i>No</i>	<i>Yes</i>
Do you keep the following accounting books?		
Sales book	3	54
Purchases books	19	38
Expenses books	42	15
Do you make any provision for depreciation	57	0
Do you make drawings from your business	0	57
Do you record your drawings	32	21
Do you keep a fixed assets register	51	6
Do you keep a stock book	34	23
Do you keep a cash book	18	39
Do you have a debtors book	15	23
Do you keep a creditors book	4	18
Do you have a computer to record your transactions	50	7

The results as indicated by Table 3 show that most of the respondents keep sales books. A sales book allows a business to record sales. However, most of the respondents especially those in the service sector do not keep purchases book. None of the respondents makes provision for depreciation. In addition, most of the respondents do not record their drawings, do not keep a fixed assets register or a stock book. Only 7 respondents have computers to record their transactions. The results indicate that apart from sales book, most micro-enterprises do not keep other books that will allow them to extract useful accounting information. In addition, the results indicate that most micro-enterprises still usual manual method instead of computers for

The results as indicated by Table 4 reveal that most of the respondents (especially those in the retail sector use the cost-plus pricing method. In addition, some of the respondents (especially those in the service sector) use the pricing similar to competitors' method. Some respondents in the service sector also use the pricing below competitors' method. Most of the respondents use these pricing strategies to be able to maximise profit, sales and increase their market share record keeping.

**Table 4: Pricing strategy and objective**

<i>Pricing strategy</i>	<i>Frequency</i>
Cost plus method	33
Target return method	0
Break even analysis	0
Pricing similar to competitors	18
Pricing above competitors	0
Pricing below competitors	6
<i>Pricing Objective</i>	
Achievement of satisfactory profit	53
Achievement of satisfactory sales	51
Achievement of satisfactory market share	42

The results as indicated by Table 4 reveal that most of the respondents (especially those in the retail sector use the cost-plus pricing method. In addition, some of the respondents (especially those in the service sector) use the pricing similar to competitors' method. Some respondents in the service sector also use the pricing below competitors' method. Most of the respondents use these pricing strategies to be able to maximise profit, sales and increase their market share.

**Table 5: working capital management**

<i>Working capital management</i>	<i>Yes</i>	<i>No</i>
Do you bank your takings on a daily basis	22	35
Do you sell on credit	38	19
Do you have a number of days that you give your creditors to repay	23	15
Do you purchase on credit	22	35
Do you have a number of days that you use to pay your debt	19	3

The results as depicted in Table 5 show that out of the 57 respondents, only 22 bank their takings on a daily basis. This will easily enable their banks to develop deposit history and may facilitate the availability of credit to the macro businesses. 38 respondents mainly in the retail sector sell goods on credit and 19 do not sell on credit. In addition, some respondents in the service industry also sell goods (for instance, some saloons also sell hair products on credit to customers). 22 respondents purchase on credit of the respondents buy on credit and 35 do not purchase on credit

**Table 6: How often do you review your stock?**

<i>Daily</i>	<i>Weekly</i>	<i>Monthly</i>	<i>Do not review stock</i>
1	36	18	2

**Table 7: How do you decide to re-stock?**

Stock is down	35
Periodically	22
Consumer demand	0
Projected sales	0
Economic order quantity	0

The results as indicated in Tables 6 and 7 reveal that most of the respondents review their stock on a weekly basis and restocking is mainly done when stock is down. Some of the businesses in the service industry also sell goods related to their business. For instance, hair saloons also sell hair products and gyms also sell health products.

### Investment Decision

**Table 8: Did you do any evaluation of the feasibility of your business before starting?**

Yes	56
No	1

**Table 9: If your answer is yes, how did you evaluate your investment?**

<i>Payback</i>	<i>ARR</i>	<i>NPV</i>	<i>PI</i>	<i>IRR</i>	<i>DPB</i>
X					

The results as depicted in Tables 8 and 9 indicate that 56 out of the 57 respondents did not evaluate the feasibility of their business before commencing operations. Only one respondent evaluated the feasibility of the business before stating using the payback period method.

### DISCUSSION

The results indicate that most micro-enterprises do not engage in financial planning, analysis and control. Most respondents do not set financial objectives, do not analyse the trend in sales, cost and profit. Because there is no plan, most micro-enterprises do not compare their

goals with performance. A plan allows a business to set certain goals for the business and to measure expectations against actual performance. This will enable the business to put in control measures to ensure that actual performance meets expectations (goals). Lack of financial analysis implies that micro-enterprises do not have an idea of how to enhance sales, reduce costs and maximise profitability. The results for the keeping of accounting information are mixed. Most of the respondents keep sales book and purchases books. However, most of the respondents do not keep expenses books, drawings books, fixed assets register, make provision for depreciation. Because of the absence of certain key books, it is difficult for micro-enterprises to be able to calculate their profitability and determine the real performance of their businesses. The results are consistent with the findings of Agyei-Mensah (2011) and Maseko and Manyani (2011) that the majority of small firms do not keep complete accounting records because of lack of accounting knowledge. As a result there is inefficient use of accounting information in financial performance measurement. This can negatively impact on the survival and growth of micro-enterprises. In addition, the use of computer by micro-enterprises is very limited as those that keep books still use the manual method. Amidu et al. (2011) find that the use of computers by small firms has the tendency to reduce cost, enhance clerical works, provide sufficient space to store data and process information for management decision in a timely manner.

The results under management accounting indicate that most of the respondents in the retail sector use the cost plus method for pricing while most of the respondents in the service sector use pricing similar to competitors. In addition, profit maximisation appears to be the most important pricing objective of micro-enterprises. The results are consistent with the findings of Carson et al. (1998), Avlonitis and Indounas (2005) and Obigbemi (2010) that profit maximization is the overriding pricing objective of small firms. With respect to working capital management, most of the respondents in the retail sector sell on credit. However, the banking of takings on a daily basis is limited. This could negatively impact on the deposit history of micro-enterprises with commercial banks and also limit access to credit. In addition, most of the respon-

dents did not evaluate the business before starting. Peel and Bridge (1998) point out that capital budgeting and planning positively impact on the performance of small businesses. This could be one of the major reasons for the high failure rates of micro-enterprises.

### CONCLUSION

This study investigated the financial management practices of new micro-enterprises. The study focused on six areas of financial management namely financial planning, analysis and control, accounting information, working capital management, investment management and management accounting. The results indicate that micro-enterprises do not engage in financial planning, analysis and control. In addition, under accounting information, most of micro-enterprises keep sales book and purchases book. However, the use of other accounting books such as drawings book is limited. Also, none of the micro-enterprises makes provision for depreciation. This makes it difficult to determine the profit and growth of micro-enterprises. Pricing decisions of micro-enterprises are mainly to realise the objective of maximising profit, sales and market share. The results for working capital management are mixed. Most micro-enterprises especially in the retail business do grant credit. However, there is a weakness in the banking of takings on a daily basis and most micro-enterprises still use the manual method instead of computers to record their transactions. In addition, micro-enterprises do not engage in any form of evaluation when making investment decisions. It can be concluded that the financial management practices of micro-enterprises are very weak in the areas of financial planning, analysis and control and investment decisions. However, micro-enterprises do engage in a limited level of accounting information and seem to have a pricing strategy.

### RECOMMENDATIONS

Owners of micro-enterprises need to take greater responsibility for their own learning. Therefore, they need to create a positive attitude towards entrepreneurship and training. They can attend training programs organised by universities on financial management for non-financial managers and training programs orga-

nised by government agencies such as the Small Enterprise Development Agency (SEDA). In addition, owners of micro-enterprises need to move from manual to computers for record keeping. Owners of micro-enterprises need to purchase computers and go for training on e-accounting.

In addition, owners of micro-enterprises should realise the importance of planning, analysis and control. Training on how to set goals, measure performance and institute the control process is very important to the survival of micro-enterprises. Evaluation of investment through the use of capital budgeting techniques is also important to the survival of micro-enterprises. Most universities offer training in this respect to small businesses. In addition, owners of micro-enterprises can use accountants and consultants to assist with investment evaluation.

Universities (especially the management department) should make it part of their community engagement to visit micro-enterprises and train the owners on how to keep books of account and the planning process. In addition, since micro-enterprises are the most dominant business in South Africa, organisations responsible for SMMEs in South Africa such as SEDA should have well trained field agents to visit and train micro-enterprises on a regular basis on how to keep books of accounts. The websites of government agencies such as SEDA should include information on how micro-enterprises can be engaged in financial management.

### Areas for Further Research

Other studies can investigate the impact of entrepreneurial characteristics on the financial management practices of micro-enterprises

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