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Abstract
The objective of this research is to find out the financial practices among Small & Medium-sized Enterprises (SMEs) in Sri Lanka. Further, it finds out the impact of financial practices upon business performance amongst SMEs in Sri Lanka. The SME sector has become a crucial segment and a major section of private sector in developing countries. Therefore, for the developing countries, it is important to accelerate the growth of SMEs in order to gain sustainable development. However, 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, through this research an attempt is made to ascertain the comprehensiveness of financial practices adopted by SMEs in Sri Lanka and evaluate whether financial practices have an impact on performance of these organizations.

The data and information required for the study are obtained through a questionnaire survey conducted. The primary concern is with the various financial practices within cooperating SMEs. Here, financial systems and their review, financial audit, historical and future-oriented financial reporting practices and historical financial statement analysis practices are all considered. Secondly, the study is able to establish some associations exist between the comprehensiveness of financial practices adopted by SMEs in the study sample and measures of SME performance and the relationship were evaluated by using correlation coefficients.
The findings suggest a significant difference in comprehensiveness of financial practices between small enterprises and medium-sized enterprises in study sample, with these practices being more extensive in medium-sized concern. Further, the findings establish that the comprehensiveness of financial practices may have some potential as an explanatory factor for business performances in SMEs. Overall, findings seem that SMEs who are complying with financial practices are performing well than the SMEs, who are not complying with financial practices.


1. Introduction
Small and Medium-sized Enterprises (SMEs) play an important role in any economy through generation of employments, contributing to the growth of Gross Domestic Production (GDP), embarking on innovations and stimulating of other economic activities (Gamage, 2000). Therefore, for the developing countries, it is important to accelerate the growth of SMEs in order to gain sustainable development. The numbers of SMEs in Sri Lanka tend to increase continuously. In the context of 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 (Mitchell et al., 2000, Son et al. 2006).

Thus, financial reporting system is necessary to ensure that the SMEs’ economic resources are used effectively and efficiently in pursuit of its goals. It also follows that there is a particular need in growing SMEs for the skills of financial analysis which will allow financial statements to be read and understood, whether they contain historical or forecast information (McMahon, 1995). Therefore, through this research an attempt is made to ascertain the comprehensiveness of financial practices adopted by SMEs in Sri Lanka and evaluate whether financial practices have an impact on performance of these organizations.

2. SMEs in Sri Lanka
Small and Medium-sized Enterprises (SMEs) have been identified as an important strategic sector for promoting growth and social development of Sri Lanka. Over the years SMEs have gained wide recognition as a major source of employment, income generation, poverty
alleviation and regional development (White Paper, 2002, p 01). According to the Annual report of the Central Bank of Sri Lanka (2009) SMEs sector plays an important role in economic development and therefore, institutional facilities for SMEs development continued in year 2009. Asian SME summit 2009 was held to identify the issues and challenges faced by the SMEs and to make recommendations for the development of SME sector. The Federation of Chambers of Commerce and industries of Sri Lanka (FCCISL) continued to provide a wide range of services for the SMEs to be competitive, socially responsible and environmentally friendly and a program named ‘Enterprise Sri Lanka’ is launched to provide support services to SMEs through one-stop-shops in Colombo and outstations. Having understood the positive impact of SMEs development and economic growth, governments in Sri Lanka, have taken various steps to develop this vital sector (Gamage, 2000, p134).

3. Accounting information

Many studies suggest that large and small firms differ in terms of strategies they pursue. That is while large firm model assume that firms’ objective is maximize wealth of share holders SMEs often place a value on autonomy, survival, stability or financial growth. Scase and Goffee, (1980); Hussey and Hussey, (1994) and Carsberg, et al. (1985) founds that an external auditor required by SMEs usually prepares the statutory accounts and provides management advice. Nayak and Greenfield (1994) founds that micro-business owner-managers are not keeping sufficient records to aid them in their decision-making.

Pugh, et al. (1969) and Chapman (1997) suggest that the sophistication of accounting systems is correlated with size and age of the firms and level of uncertainty as there is no effective capital market for SMEs; banks are general source of finance for SMEs (Chittenden, et al., 1980; Javis et.al., 1996). The implication of this can be that the SMEs monitor their cash position closely in order to maintain good relationship with banks as their lenders. According to McMahon (1999), the more sophisticated financial reporting system is necessarily prepared to ensure that an SME’s economic resources are used effectively and efficiently. He also claims that there is a particular need in growing SMEs for the skills of financial analysis which will allow financial statements to be read and understood.

SME owner/managers are crucial players as searcher and assimilator of information and what extent use of information sources is influenced by the education of the SME owner/ manager (Holmes and Nicholls 1989; Lybaert 1998). The managerial style that most enterprises
emphasize is owners’ decisions. If their owners/ managers lack one or more of technical, managerial, and financial skills, the possibility to failure is higher (Gaskill and Hyland, 1989).

In addition to the above, in Sri Lanka, SMEs’ needs for financial disclosures are not significant especially to those whose form of legal registration is sole proprietorships. Concerning Sri Lankan law and regulation, sole proprietorships and partnerships are not obliged to file audited financial report. This has reduced the amount of financial information and the need of financial management for SMEs.

4. Financial Practices
Holmes and Nicholls (1989) summarize that management accounting information is associated with success and failure in SMEs depending upon how they are produced and utilized in their companies. However, Horngren (1995) argues that cost accounting or management accounting concepts and techniques are neutral instruments. It is not the cause of poor management but primarily symptoms since it may be used wisely or stupidly by managers of the firms.
Drury and Tayles (1995) concludes that the same rules and procedures established for external reporting (financial accounting) are likely also to be applied to internal reporting (management accounting) even some rules, referred to theory, are inappropriate for management accounting. Though external and internal reporting tend to employ the same rules, it does not mean that management accounting is subservient to financial accounting. The reason that most companies adopt the identical practices for both reporting systems is that firms prefer their internal profit to be reported consistently with external financial accounting requirements in order that they will be comparable with outsiders’ assessments of overall company performance. In the other words, companies would like to be ensured that internal accounting system do not have any conflicts with external financial accounting requirements.
The other issue in management accounting practices is budgeting. Referred to the study in Poland, the sampling companies, mainly large manufacturing and service enterprises, prepare annual operating financial budgets for the whole enterprises. Also a complete or nearly complete master budget is prepared by a much smaller proportion of enterprises. The rest of them prepare sales, production and cost budgets (Szychta, 2002). Unlike Polish companies, Japanese firms are less extensive use financial budgeting (Yoshikawa, et al., 1989). The key
issues in internal reporting are addressed in monthly and annual reports. However, the inadequately related budgeting and reporting system indicated that many companies failed to use accounting information systematically for clearly defined and useful purposes (Haldma and Laats, 2002). For performance measurement and evaluation, most companies based the measurement on different functions and product groups, to somewhat lesser extent on client groups and sales regions (Haldma and Laats, 2002). Net profit, rather than controllable profit, is widely used to evaluate the performance of divisional managers (Drury and Tayles, 1995) since it could be apparently measured in monetary value and, sometimes, it is not possible to allocate and designate which costs are controllable or uncontrollable for particular manager.

5. Financial Practices and Business Performance

There have been a number of empirical studies conducted in other countries investigating the types of financial reports produced by SMEs, the frequency of their preparation, and their perceived usefulness for management for management purposes. Comprehensive reviews of this empirical evidence, and the findings of comparable research conducted internationally, up to the early 1990s are provided by McMahon & Holmes (1989,1990), Holmes & Nicholls (1990), McMahon & Davies (1991a, 1991b), McMahon & Holmes (1991), McMahon & Davies (1992a, 1992b), McMahon & Holmes (1992), McMahon et al. (1992a, 1992b, 1992c), McMahon et al. (1993a, 1993b), McMahon & Davies (1994) and McMahon et al. (1994a, 1994b).

The studies attempted to extent the limited prior research with a similar objective, especially that of McMahon & Davies (1991a, 1991b, 1992a, 1992b, 1994). The broad concern is the extent to which, if at all, improved financial practices appear to pay-off in terms of enhanced business performances in the SMEs investigated.

Moores & Mula (1993) study the role of managerial control systems, including financial reporting, in survival and successful growth of nearly 300 Australian family businesses. Moores & Mula’s (1993) results clearly indicate increasing emphasis on financial reporting as businesses grow in employment terms and progress through the earlier stages (including a growth stage) of a business life-cycle model.

The research reported by McMahon & Davies (1991a, 1991b, 1992a, 1992b, 1994) is part of a two-year investigation of the essential growth characteristics of a non-random convenience sample of just over 100 growing SMEs from a variety of industries situated in North-East England. On the basis of their investigation of correlates with the historical financial practices
of these SMEs, McMahon & Davies (1991a, 1991b, 1992a, 1992b, 1994) believe comprehensive historical financial reporting is more likely to be undertaken by SMEs which *(inter alia)* are larger in size. McMahon & Davies (1991a, 1991b, 1992a, 1992b, 1994) believe financial ratio analysis based on historical financial statements is more likely to be undertaken by SMEs which *(inter alia)* are larger in size and undertake more comprehensive financial reporting.

According to the findings for the growing SMEs in the McMahon & Davies (1991a, 1991b, 1992a, 1992b, 1994) study, there do not appear to be any substantial associations between undertaking more comprehensive financial reporting and use of financial ratio analysis on the one hand and achieved rates of growth and financial performance on the other.

6. **Methodology for assessing Accounting practices**

This research determines the soundness of reporting practices in SMEs, using the identified five reporting practices. A total of 100 SMEs were assessed to determine the extent of their compliance with these practices. They are:

- Financial Systems
- Financial Audit
- Historical financial practices
- Future-oriented financial practices
- Financial statement analysis practices

7. **Hypothesis**

The main research hypotheses in this study are;

H$_1$ – There is a difference in financial practices among *small enterprises and medium enterprises*.

H$_2$ - There is an impact of financial practices upon *business performance* amongst Small and Medium scale Enterprises (SMEs) in Sri Lanka.

8. **Data & data collection**

The data and information required for the study obtains through a questionnaire survey and this study examines the financial practices and relationship between financial practices and the performance of the SMEs in Sri Lanka. The survey uses a semi-structured questionnaire
containing 25 questions focused on enterprise characteristics and performance and financial management characteristics and practices.

9. **Sample & sample selection**

The population of this study consists of SMEs operating their businesses in Sri Lanka. Due to the absence of a nationally accepted definition for the SMEs and the unavailability of information this study defines the SMEs as follows (Thrikawala S.S., 2009, page 335).

The study uses the definition for SMEs, which is appeared in White Paper, 2002. i.e. *Enterprises with assets values not exceeding Rs. 50 Million excluding land and buildings.*

The White Paper also agreed to give a demarcation between Small and Medium scale enterprises; (a) *Small scale enterprises* – assets values not exceeding Rs. 20 Million excluding land and buildings and (b) *Medium scale enterprises* – assets values not exceeding Rs. 50 Million excluding land and buildings.

It is considered as appropriate to use the purposive sampling technique which is a non-probability sample method. Based on that, sample is 100 SMEs established in Gampaha district, Colombo district and Kurunegala district.

10. **Data analysis method**

As a first part, this study aims to present new empirical evidence on the financial practices of Small and Medium-sized Enterprises in Sri Lanka. Distributive statistics are use to analyze the data, gathered from questionnaire. Second part describes whether an association appears to exist between the comprehensiveness of financial practices adopted by SMEs in the study sample and the achieved business performances of these concerns. All variables used in this research are categorical (nominal or ordinal) in nature and/or have irregular distributional properties. Therefore, non-parametric/distribution free techniques of statistical analysis are employed exclusively and Statistical Package for Social Science (SPSS), version 17 for Windows was used.

11. **Findings**

**Test of Normality**

To test normality, Kolmogorov-Smirnov Test and the Shapiro-Wilk Test are used the results show that the data is not normally distributed. Since, all the variables are used in this research are categorical (Normal or Ordinal) in nature and have non-normal distributional properties; non-parametric/distribution free techniques of statistical analysis are employed.
11.1 Financial Practices

11.2.1 Financial Systems

The modal response category (35.6%) in the study sample is ‘manually prepared by internal accounting division’ indicating a manual ledger accounting system by the owner, member of the owner’s family or internal accounts division of the organization. Further, 28.9 per cent of the respondents use commercially available accounting software like QuickBooks, MYOB, etc... Small-sized enterprises seem more likely to have an in-house general ledger accounting system, and this system is most likely to be manual (39%). Most of the medium-sized enterprises (32%) are using commercially available, standard accounting software. Therefore, medium-sized enterprises seem more likely to have an in-house general ledger accounting system, and this system is most likely to be computerized and use standard software.

Based on the rating scheme, financial systems are scored and ranked. As per the Figure - 1, ten SMEs in the sample are not having accounting systems. However, thirty-two SMEs in the study sample are having manual accounting system. Another 22 SMEs are also having manual accounting system with the help of expertise in the field. Balance 36 SMEs are having computerized accounting packages.

![Figure 1: Financial Systems in the study sample](image)

11.2.2 Financial Audit

Financial audits are undertaken or not, amongst respondents to this survey are revealed in Figure - 2.
Figure 2: Financial Audits in the study sample

Financial audits are apparently undertaken only for 45 per cent of the respondents. Majority of the study sample (55%) are not undertaking financial audits.

11.2.3 Historical Financial practices

Figure 3: Historical Financial practices of the study sample
As per the Figure -3, 16 SMEs in the study sample are not preparing financial statement like balance sheet, profit and loss accounts and cash-flow statements and they are not using them. Even though, twenty SMEs of the study sample preparing financial statements, they are not using them. Financial statements of another 14 SMEs are also prepared, but they are having less usage. Most probably those SMEs use only profit and loss account. Another 19 SMEs are also preparing financial statements, as well as they have considerable usage. Most probably, they use profit and loss account and cash flow statements. Balance thirty-one SMEs in the study sample are preparing and using their financial statements to the greater extent. They use all the statements in the set of financial statements.

11.2.4 Future-oriented financial practices

The budgeting system is in use or not, amongst and frequency of assessing future cash requirement are considered to evaluate the future-oriented financial practices as showed in the Figure - 4.

34 SMEs in the study sample are not involving future-oriented reporting practices, who got the less score. Then, another 17 of the study sample are involving future-oriented reporting practices, mostly in informal ways. However, 48 of the SMEs in the study sample are formally papering future-oriented reporting practices and they are having greater usage of it.
**11.2.5 Financial Statement Analysis Practices**

The comparisons of forecasts versus actual and the frequency with which budget comparisons of forecast versus actual results are carried out within collaborating SMEs, typically requiring historical and future-oriented financial statements being brought together, is shown in Figure - 5.

![Bar Chart](chart.png)

**Figure** Error! No text of specified style in document. Financial Statement Analysis Practices.

The amount of 15 SMEs in the study sample does not analyze their financial statement. However, 28 SMEs in the study sample are analyzing their financial statements, most probably on basis of annual or by-annual. Another 30 SMEs are also analyzing their financial statements mostly on the basis of quarterly or monthly. Balance 27 SMEs in the study sample are analyzing their financial statements on weekly basis or daily basis.

**11.2 Synthesis of the financial practices in SMEs and testing of hypothesis (H₁)**

To test the first hypothesis, findings of the Kruskal-Wallis one-way analysis of variance are used. Result reveals in the Table 1.

**Table 1: K-W Test results for financial practices.**

<table>
<thead>
<tr>
<th>Test Statistics</th>
<th>Financial Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chi-Square</td>
<td>1.372</td>
</tr>
<tr>
<td>df</td>
<td>1</td>
</tr>
</tbody>
</table>
A Kruskal-Wallis one-way analysis of variance reveals that financial practices, as reflect in the survey, are most comprehensive in medium-sized enterprises in asset value terms (n=90, H=1.372, df=1, P=0.241 (p<0.000)). This result suggests a significant difference in comprehensiveness of financial practices between small enterprises and medium-sized enterprises in study sample, with these practices being more extensive in medium-sized concerns. Therefore first hypothesis (H1) - there is a difference between financial practices amongst the small-sized enterprises and medium-sized enterprises, is accepted.

11.3 Financial practices in SMEs and performance - Testing of hypothesis (H₂)

One dependent variable issued to represent business performance for respondent firms; SALES represents current annual sales turnover, with six levels reflecting business performance in terms of sales revenues (over Rs. 50 million; Rs. 25 to 49 million; Rs. 10 to 24 million; Rs.5 to 9 million; Rs.1 to 4 million; under Rs. 1 million). Each and every accounting practice is evaluated to evaluate the second hypothesis.

11.3.1 Financial Systems

The results shows that significant positive correlation (ρ=0.524) between the financial systems and the enterprises’ performance. Therefore, the SMEs who are having appropriate financial systems are performing well than who are not having proper financial systems.

11.3.2 Financial Audit

The results shows that significant positive correlation (ρ=0.489) between the financial auditing and the enterprises’ performance. Therefore, the SMEs who are conducting financial audits are performing well than who are not conducting financial audits.

11.3.3 Historical financial reporting practices

The results shows that significant positive correlation (ρ=0.212) between the historical financial practices and the enterprises’ performance. Therefore, the SMEs who are complying with financial practices are performing well than who are not.
11.3.4 Future – oriented financial reporting practices
The results shows that significant positive correlation ($\rho=0.332$) between the future-oriented financial practices and the enterprises’ performance. Therefore, the SMEs who are complying with future-oriented financial practices are performing well than who are not.

11.3.5 Historical financial statement analysis practices
The results shows that significant positive correlation ($\rho=0.375$) between the financial statement analysis practices and the enterprises’ performance. Therefore, the SMEs who are analyzing their financial statements are performing well than who do not.

11.4 Synthesis of the financial reporting and business performance
To evaluate the relationships between identified five financial practices and business performance, correlation coefficients are calculated. These correlation coefficients are summarized below.

<table>
<thead>
<tr>
<th>Table 2: Summary of the correlation coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting Practices</td>
</tr>
<tr>
<td>Performance</td>
</tr>
</tbody>
</table>

According to the Table 2, all correlation coefficients show significant positive correlations. Therefore, the study concludes that there is an impact of financial practices upon business performance amongst Small and Medium scale Enterprises (SMEs) in Sri Lanka. Therefore, second hypothesis ($H_2$) - There is an impact of financial practices upon business performance amongst Small and Medium scale Enterprises (SMEs) in Sri Lanka, is accepted.

12. Conclusion and Recommendations
11.1 Conclusion
The research findings described in the analysis chapter suggest that financial practices are more comprehensive in medium-sized concerns in assets value terms. Further there is
statistically difference between small enterprises and medium-sized enterprises, with theses practices being more extensive in medium-sized concerns. Furthermore, the comprehensiveness of financial practices is statistically greater amongst respondents that performing strongly in sales revenues terms. There is further evidence that the comprehensiveness of financial practices is statistically greater in responding SMEs that have higher annual sales revenues.

To evaluate the relationships between identified five financial practices and business performance, correlation coefficients are calculated. The correlations coefficients prove that the SMEs who are having appropriate financial systems are performing well than who are not having proper financial systems. Then, the SMEs who are conducting financial audits are performing well than who are not conducting financial audits. Further the results found that the SMEs who are complying with financial practices are performing well than the SMEs, who are not complying with financial practices. The SMEs who are complying with future-oriented financial practices are performing well than SMEs, who are not. Finally, results shows that the SMEs who are analyzing their financial statements are performing well than SMEs who do not analyzing their financial statements. All correlation coefficients show significant positive correlations. Therefore, the study concludes that there is an impact of financial practices upon business performance amongst Small and Medium scale Enterprises (SMEs) in Sri Lanka.

11.2 Contributions to the policy and recommendations

The empirical analysis demonstrates that financial practices have a direct impact on performance of SMEs in Sri Lanka. The absence of proper guidelines for the preparation and presentation of financial statements need to be rectified. Policy makers are advised to consider the following when framing guidelines for the preparation and presentation of financial statements of SMEs in Sri Lanka.

11.2.1 To have a clear legislative definition

At present there is no clear legislative definition for SMEs. Different institutions adopt different definition for their own programs. This situation has led to confusion in identifying SMEs for providing various concessions and programs. Also, this creates various problems in the implementation of government policy for promoting SMEs. Therefore, the government
should recognize the urgent need to develop a legislative definition for Micro, Small, Medium and Large enterprises.

11.2.2 To conduct a comprehensive industrial survey
There is no any recently conducted comprehensive industrial survey covering SMEs in Sri Lanka. Therefore, it is imperative to conduct a comprehensive industrial survey to understand the position and contribution of SMEs to the national economy.

11.2.3 To expand institutional support
At present there are various government, NGOs and private sector institutions that support for the promotion of SMEs. However, these institutions do not have a well spread network of information regarding SMEs. Therefore, it is recommended to have a well spread network of SMEs for Sri Lanka.

11.2.4 Introducing a separate accounting standard for SMEs
According to the present statutory requirements, it is not mandatory to prepare separate financial statements. Therefore, it has impact of business performance. It is recommended to introduce a separate accounting standard for SMEs, which will provide guidelines to prepare and present the financial statements of SMEs.

13. Future research
This study uses the definition in the White Paper (2000). It is important for future research to gather data using other definitions of SMEs. As well as this study find out the financial practices of SMEs and their impact on business performance amongst SMEs. However, future researchers can determine more relationship, such as business growth, efficiency. Further, it is recommended that future research study why these relationships exist. Case studies or in-depth interview with an appropriate number of respondents will enhance the understanding of SMEs and their utilization of financial information.

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