

## The Practice of Preparing and Using Financial Information in Financial Decisions: A Survey of SMEs in Tanzania

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### Abstract

A large number of SMEs' managers in Tanzania are said to have neglected an important role of preparing and using financial information in decision making. As a result, they have been pursuing poor financial decisions which are regarded to be the main cause for poor performances and increase in failure rates of their undertakings. Specifically, the study analysed the purpose and practice of preparing financial information, its utilization and, perceived importance in the day-to-day management of SMEs. The study adopted a survey design where SMEs falling under service industry (*i.e. tourism, marketing and advertising, transportation, health and insurance*) were randomly selected to compose a total sample of 140 enterprises. The study used both primary and secondary information; where primary information was collected through survey questionnaires. Statistics and descriptive analysis were applied to explain the survey phenomena. The results of the study show that very few SMEs internally prepare and utilize financial information; most these information are prepared purposely to meet the requirements of financiers, business registration and revenue authorities. Moreover, most of SMEs prepare financial information by using external financial experts; they do not have enough internal resources. Conclusively, SMEs' managers do not consider financial information to be important towards their decision making.

**Keywords:** Financial information, Financial decisions, SMEs and Tanzania

### 1. Introduction

In recent decades, SMEs have been increasing in different economies including Tanzania. They account for more than 95 percent of all firms in many countries in the world (Yu, 2006). In Tanzania SMEs contribute 30 to 35 percent to the annual Gross Domestic Product (GDP) and employ about 95 percent of the workforce (SIDO, 2007; UNIDO, 1999). Undoubtedly, from the above statistics we can acknowledge that SMEs in Tanzania are business entities that could enhance and sustain the wealth of the economy in many years to come.

It must be remembered that these businesses do have potential to grow and become large enterprises in future despite many challenges they encounter. Challenges encountered by these enterprises include lack of demand for their products/services, poor management and/or administrative skills of the owner/manager. In addition, inexperience in the industry, insufficient capital, poor record keeping and the use of accounting and financial information in financial decisions are other major challenges. Poor or (no) record keeping and inefficient use of accounting and financial information are some of the critical management problems within these enterprises. It is evidenced that the poor performances of many SMEs are originated from the improper or (no) use of accounting and financial information. They have poor access to capital and sometimes these entities are charged with high interest rates because financial institutions e.g. commercial banks cannot assess their credit worthiness (credit risk). This is due to the fact that they have failed to provide accurate and timely accounting and financial information (World Bank, 1978). The poor or (no) use of accounting and financial information leads to failure of SMEs to assess their financial status and subsequently make poor financial choices (Bryon & Friedlob 1984; Miller & Rojas, 2004).

Proper accounting and financial system is said to be the engine for sound financial and economic decisions and a key determinant for small business success (Stice, 1994). The high failure rate of small business in Tanzania is partially propelled by this problem. The failure to provide accurate accounting and financial records to financial institutions will impede their access to capital in later stages and eventually may cease to operate.

There are number of studies concerning SMEs' problems in Tanzania but very few related to this area have been conducted. Acknowledging the importance of financial information in financial decisions of these businesses; this study assesses the practice of preparing and using financial information in financial decisions of SMEs in Tanzania.

It is from this general objective the following specific research questions were formulated: i. What is the purpose of preparing financial information? ii. How financial information are prepared? iii. How often SMEs monitoring financial information for decision making? iv. How important are financial information to the SMEs management?

## 2. Literature Review

### 2.1 Small and Medium Enterprises (SMEs)

The issue of what constitutes small and medium enterprises (SME) is a major concern in the literature. Different authors have given different definitions; however, there is no single universally agreed definition. Storey (1994) tries to sum up the danger of using the size to define status of the firm by stating that in some sector all the firms may be regarded as small, whilst in other sectors there are possibly no firms which are small

Meredith, (1994) suggested that, any definition of SME must include a quantitative component that takes into account staff levels, turnover and, assets together with financial and non-financial measurements. The description must also include a qualitative component that reflects how the business is organized and operated.

The lack of a formal means of defining SME has led to diverse approaches by countries and organizations. Generally, these are very heterogeneous groups; they include wide variety of firms like handcrafts, small machine shops and small manufacturing industries. They possess wide range of sophistication and skills and, they operate in very different markets and social environments. They are normally managed by family members and operate in formal or informal sectors; most of them are said to have minimal chance of growing into larger-sized enterprises and have a short life span if not well managed (Hallberg, 2000).

However, the significant difference of SMEs from large-sized enterprises is that of resources, i.e. lack of finance, people and expertise (Baker, 2002). SMEs do have inadequacy finance, people and expertise. They lack technical expertise and capital to undertake technical enactments; they are popular in using poor technology. Their limited access to financial capital is because they lack collaterals, securities and accurate financial records e.g. cash flow statements which would support them to secure loans/credits from financial institutions (Baker, 2002; Barry 2002 and Wohlmuth, 2004).

SMEs are regarded to be riskier business entities compared to their large counterparts; (De Lone, 1988), they are branded as uncertain undertakings (Walker, 1975). They do operate under tight financial capacity which would inhibit their applications of innovation and become large business entities in the future. These businesses are managed by a single person (sole proprietor), family members or a group of individuals with common interests. Unlike other forms of business ownership, it is real difficult for the owner(s) to raise vast financial resources, and that is why most of these enterprises rely too much on borrowing from banks and non-banking institutions. Often, all decisions are from a single person (owner), and therefore, if he/she has poor managerial skills and techniques, the business is subjected to low performances and high failure rate.

In Tanzania SMEs refers to micro, small and medium enterprises, it is sometime known as MSMEs. The SME sector covers non-farm economic activities mainly manufacturing, mining, commerce and services (Ministry of Industry and Trade, 2002). Like other countries Tanzania also uses quantitative measurements to define an SME. The commonly used yardsticks are total number of employees, amount of capital investment and sales turnover. The following table shows how SMEs in Tanzania are categorized:

Table 1: Classification of SMEs

Category	Number of Employees	Capital Investment in machinery (Tshs.)
Micro Enterprise	1-4	Up to 5 mil
Small Enterprise	5-49	Above 5 mil to 200 mil
Medium Enterprise	50-99	Above 200 mil to 800 mil

**Source:** (Ministry of Industry and Trade, 2002)

**Note:** Current exchange rate 1 US dollar= 1634 Tshs.

### 2.2 Financial Information and their General Uses

Financial information are accounting and non-accounting information that are used for corporate governance. Bushman and Smith, (2001) defined the governance role of financial accounting information as the use of externally reported financial accounting data in control mechanisms that promote the efficient governance of corporations. Financial information includes; statements such as financial performance, statement of financial position, cash flow statements, statement of change in equity etc.

The general uses of financial information are decision making and control purposes. Control mechanisms are the means by which managers are disciplined to act in the investors' interest. Control mechanisms include both internal mechanisms, such as managerial incentive plans, director monitoring, and the internal labour market, and external mechanisms, such as outside shareholder or debt holder monitoring. Other uses of financial information include the following:

- i. They can be used in performance pricing and its heavy reliance of accounting-based ratios (Beatty and Weber, 2000),
- ii. They may also be used in financial contracting. This signifies that information from financial statement is very important and can be used in making decision.
- iii. Decision that investors are willing to part with their capital are a function of the informational efficiency and liquidity of the capital markets in which they will subsequently trade their claims (Sloan, 2001).
- iv. Moreover, they can be used in dividend, liquidity, investment and financing decisions.
- v. Furthermore, financial information are also used to measure the performance of the firm in terms of its profitability, liquidity, efficiency and, leverage. It can provide managers of small business with the alternative course of actions. As it is well known that finance is 'lifblood' of any business, indeed; the success of SME depends much on how financial information is prepared and utilized. For example, decisions on capital structures rely much on the financial information at hand. Different capital structures offer different degrees of risks, and in fact; the best alternative course of action must be employed to provide the business with high chance of success.

### 2.3 The Practice of Preparing and Using Financial Information by SMEs

SMEs and large enterprises do have different strategies to pursue because their objectives differ. Large enterprise's strategies mainly focus on maximization of wealth of shareholders while SMEs possess a number of objectives mainly autonomy, survival and financial growth (Hussy and Hussey, 1994).

It is observed by many studies that, after complying with statutory requirements when they want to get business licences from the respective authorities, afterwards, SME owners/managers will no longer be interested in preparing financial statements for various financial decisions. In Tanzania, the provision of Companies Act No. 12 of 2002 does not oblige sole proprietors (small-business owners) to prepare and use audited financial statements regularly

because these businesses offer unlimited liability. This has so far reduced the importance of preparing financial information and the need to utilize them in the day-to-day management of SMEs.

They prepare financial statements when they want to borrow money from banks. Bankers always require audited financial statements to effect their lending decisions (Kitindi, 1997). The motive behind many SMEs to buy accounting and external auditing services is solely driven by their desire to acquire financial resources from banks. Bank is the only reliable source for SMEs capital financing, as it is well known that there is no effective capital markets for SMEs globally (Chittenden, et. al., 1980; Javis et .al. 1996).

Unlike large enterprises (companies) sole proprietors cannot raise vast financial resources to suffice the need of having adequate seed and growth capital.

It becomes difficult sometimes when SMEs managers want to prepare financial statements because of poor or insufficient records (Nayak and Greenfield, 1994). Even those enterprises which will be able to prepare financial statements may fail to use them in various decisions making (DeThomas and Fredenberger, 1985). This is because a huge number of SMEs' owners lack the knowledge of preparing and using financial statements. They believe that financial information offer marginal benefits to their businesses. They are even unaware that they can use them in various financial decisions that may lead to proper financial decision which eventually could enhance the high performance of the firm in the industry. Poorly prepared financial information may cause SMEs' managers to fail to evaluate their financial situation and subsequently make poor decisions. Thus, many SMEs may encounter low performances and high failure rates.

According to McMahon, (1999), sophisticated financial reporting system is necessary in order to ensure that SME's resources are used effectively and efficiently. However, the information must be accurate and reliable in order to provide a platform for timely and sound decisions.

The management of financial information affects the performance of SME directly (Holmes and Nicholls, 1989). The success or failure of these enterprises is determined by how the SME manager prepares and utilizes financial information. It is true; many people believe that the success or failure of business is always due to lack of product knowledge. More often it is not the understanding of financial information. Most of SME managers/owners use financial reports which have been prepared by an outsourced accounting and financial management professional, as a result; they fail to understand the financial implications and make poor decisions (Gill and Chatton, 1999). For example, the failure of these businesses may come from over-buying, over-trading, and over-expanding. These decisions are impossible because of neglecting the crucial roles which financial information can play to the enterprise.

### **3. Conceptual Framework**

This section conceptualizes the research model which explains the relationship between the variables i.e. independent and dependent variables. In this study, independent variables include preparation and utilization of financial information while dependent variable is the performance of the SME. Figure (1) shows the relationship between these variables;

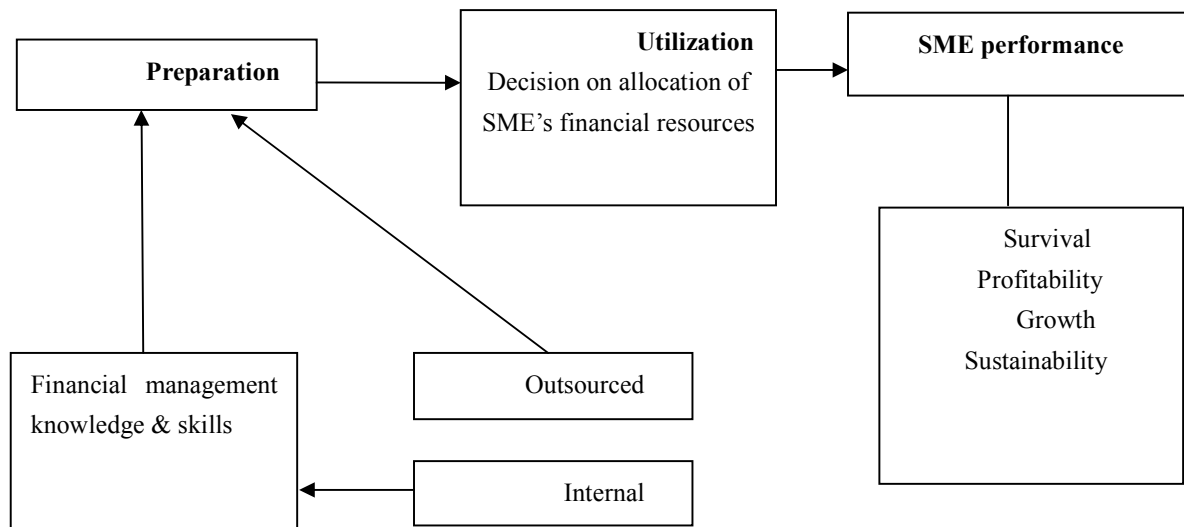


Figure1: Conceptual framework

From figure (1) above, the preparation of financial information by SMEs relies much on their financial management knowledge and skills. They may opt to prepare the information by outsourcing the financial management professionals or prepare them internally by SME managers/owners, if and only if they have the financial management knowledge and skills to do so. Sometime financial information can be prepared internally under the supervision of external financial management professionals.

Having the information is one thing and, utilizing them is something else. SMEs' managers may have the information at their disposal but fail to interpret and use them in a best way that could bring positive results to the firm. Often, SME managers who outsourced financial professionals may fail to interpret them and eventually give wrong financial decisions. If SMEs' managers have financial management knowledge and skills, the preparation of accurate and timely financial information, good interpretation and proper use can follow suit. These are massive determinants on how the firm can perform in the business environment. This process can determine firm's survival at first place, then profitability, growth and sustainability.

#### 4. Methodology

##### 4.1 Research Instruments

In order to understand the practice and use of financial information in financial and related decisions by Tanzania's SMEs, this study gathered data from both primary and secondary sources. The questionnaire in this regard was the major research instrument. The questionnaires were formulated basing on the research objectives of this study.

The questionnaires were both of open and close-ended nature. Open-ended questionnaires were used in order to allow respondents to explain more about the matter while close-ended was used when SMEs' managers were not required to give much information about the matter e.g. the age of SME etc. The questionnaires were distributed and returned via email, fax and postal mail. Statistics and descriptive analysis were applied in order to explain the survey phenomena. Most of the data were analysed by basic statistics e.g. frequency, percentages and mean values.

##### 4.2 Population and Sampling

The study population involved SMEs in service industry. The study chose this industry because most of entities have been registered by authorities in question; and therefore they could be easily accessed because they have physical and postal addresses. This composed of SMEs specifically falling under the following sectors; tourism, marketing & advertising, transportation, health and insurance. These entities were randomly selected in order to provide equal chances for these enterprises to participate in the study.

SMEs were selected from four major cities in Tanzania i.e. Dar es Salaam, Arusha, Mwanza and Mbeya. 7 SMEs were selected from each of the aforementioned sectors; and therefore a total of 35 SMEs were drawn from each city making a total sample of 140 SMEs. The total number of returned questionnaires was 125 which represent 89% of the targeted sample size. The table below shows the targeted sample against the number of responses:

Table 2: Target and Sample Size

CITY	Dar Es Salaam		Arusha		Mwanza		Mbeya		TOTAL	
SECTOR	Target	Response	Target	Response	Target	Response	Target	Response	Target	Response
Tourism	7	5	7	7	7	7	7	5	28	24
Marketing & Advertising	7	6	7	6	7	6	7	6	28	24
Transportation	7	6	7	7	7	6	7	7	28	26
Health	7	7	7	6	7	6	7	6	28	25
Insurance	7	7	7	7	7	6	7	6	28	26
TOTAL	35	31	25	33	35	31	35	30	140	125

## 5. Findings

This section presents the results from questionnaire analysis. Based on conceptual framework and research objectives, the questionnaire had to address the following major issues;

- (i) The purpose of preparing financial information.
- (ii) How financial information are prepared.
- (iii) How often SMEs monitoring the financial information for management.
- (iv) How important that they consider financial information in management of SMEs.

### 5.1 The Purpose of Preparing Financial Information

SMEs' managers were asked to rank (1-very important, 2- important, 3- somewhat important, 4-not important) of the four given reasons of preparing financial information. The results of the study showed that there are two main reasons which necessitate SMEs' managers to prepare financial information i.e. requirements by financiers and different authorities like the local government and revenue authorities as per table 3 below:

Table 3: The Purpose of Preparing Financial Information

	Purpose	Percentage (Score)	Level	Rank
1	Requirement by Financiers	41.6%	Very Important	1
2	Measure business growth & performance	8%	Not Important	4
3	Requirement by Authorities	38.4%	Important	2
4	Assess profitability & Financial Status	12%	Somewhat important	3

As per table 3 above, the highly ranked purposes of preparing financial information were requirements by financiers and authorities with the score of 41.6% and 38.4% respectively. This implies that only 20% of SMEs prepare financial information in order to make their financial and related decisions.

#### 5.2 How Financial Information are Prepared

The study observed that 58.2% of SMEs prepare financial information by outsourcing accounting expertise/professionals. And 28.3% are internally prepared under the supervision of an external advisor. Table 4 shows how financial information is prepared:

Table 4: Preparation of Financial Information

Preparation of Financial Information	Percentage
Externally prepared by financial accounting expertise	58.2
Internally prepared under outside advisor	28.3
Internally prepared	11.0
Prepared by computerized accounting systems	2.5
Total	100.0

Despite the introduction of computerized accounting systems; very few (2.5%) of SMEs could afford to buy the packages; they are considered to be expensive because of the installation and operation costs. In addition, it was found that (11.0%) of SMEs could employ competent financial accounting officers who would prepare these information.

Moreover, the study observed that it is only 2% of the externally prepared financial information can be well interpreted and utilized by SMEs managers/owners for various financial decisions. A huge number of SMEs might fail to utilize the information in the way that could bring positive and tangible results to the firm.

#### 5.3 How Often SMEs Monitoring the Financial Information for Decision Making

According to the question on how SMEs monitoring the financial information for management; as shown in table (5), SMEs rarely or almost never monitor and utilize the statement of change in financial position, financial ratio analysis and, Break-Even Analysis. Statement of cash flows, financial forecasting and budgeting and, cost-volume profit analyses are monthly monitored. Moreover, balance sheet and statement of profit and loss are yearly monitored.



Table 5: The frequency of utilizing financial information

Financial Information	Frequency
1. Balance Sheet	Yearly
2. Statement of profit and loss	Yearly
3. Statement of cash flow	Monthly
4. Statement of change in financial Position	Almost never
5. Financial Forecasting and Budgeting	Monthly
6. Bank Statements	Monthly
7. Financial ratio analysis	Almost never
8. Break-even analysis	Almost never
9. Cost-Volume-Profit analysis	Monthly
10. Published industries information and trends	Almost never

#### 5.4 How Important are Financial Information to the SMEs Management

The respondents were asked to rank different financial information in order of what they consider to be important. The ranking was from 1 (most important) to 10 (less important). The top three ranked financial information are statements of profit and loss, cash flow and balance sheet. The table below presents the importance of financial information according to mean value;

Table 6: The importance of financial information

Financial Information	Mean	Rank
1. Balance Sheet	2.87	3
2. Statement of profit and loss	3.40	1
3. Statement of cash flow	3.0	2
4. Statement of change in financial Position	1.97	8
5. Financial Forecasting and Budgeting	2.87	4
6. Bank Statements	2.80	5
7. Financial ratio analysis	1.60	10
8. Break-even analysis	2.66	7
9. Cost-Volume-Profit analysis	2.75	6
10. Published industries information and trends	1.65	9

## 6. Conclusion

The study showed that, a large number of SMEs prepare financial information in order to meet the requirements of financiers, business registration and revenue authorities. They are unaware that financial information can be used to measure performance, growth, financial position and effect the proper decisions. Also, a large number of these entities prepare financial information by using external financial experts; they consider it to be relatively cheaper than employing a staff on permanent or temporary bases. Unfortunately, most of the externally prepared information are not utilized properly because managers fail to understand and interpret them. Moreover, very few SMEs consider financial information as an important tool in the day-to-day management of their businesses. Conclusively, SMEs' managers believe that financial information add nothing of value to their entities. Therefore, this has been the main factor for high failure rates of SMEs in Tanzania. It is recommended that, SMEs' managers should always prepare and utilize financial information in the day-to-day management of their entities in order to have sound financial decisions that will take their entities to another level.



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