Effects of Financial Statement on the Performance and Growth of SME's: A Survey of SME's in Eldoret Langas Area

George Omondi Mumbo[1*]
1. Department of Agricultural Economics and Resource Management, Moi University, PO box 3900-30100, Eldoret, Kenya
* E-mail of the corresponding author: mumbo.ge@gmail.com

Abstract

The study investigates the effects of financial management statements on performance and sustainable growth of SME's. It engaged a robust OLS econometric model to empirically analyze performance levels alongside the determining variables in this case the profit loss, incomplete records and balance sheet being the main explanatory variables. The findings revealed that performance of SME's is significantly pegged on decisions based on the statements since, entrepreneurs who registered high profit levels, appreciated the positive and significant contribution of profit loss, incomplete records and the Balance sheet. However, entrepreneurs who registered Average, Low and Breakeven profit levels attributed the negatively significant and reversal effect of financial statement on the undesirable profitability rating. In addition, higher education level seemed to have had an insignificant impact on improving performance level but rather, a neutralization effect of sustaining the prevailing performance level from deteriorating. Hence, without an appropriate adoption of these statements in accordance with the business management ethics, growth and subsequent progress of SME's in this region remains stifled at the start-up and Life-style development stages prescribed in the enterprise life-cycle model.

Keywords: Growth, SME's, Profitability, Financial Statement

1. Introduction

In my view SME growth is intertwined in a series of stages of development through which the business may pass in an enterprise life-cycle. Having its genesis in the literature of economics (Marshall, 1890; Penrose, 1952, 1959; Rostow, 1960), reliance on this paradigm in the SME literature is most frequently claimed to date back to (Steinmetz, 1969).Kimberly & Miles (1980:ix) draws attention to the cyclical quality of organizational existence. Such, that Organizations are born, grow, and decline, in the context of reawakening, and sometimes disappearing into oblivion (McMahon, 1998:7).

Furthermore, Hanks *et al*. (1993) reviewed the strength of a taxonomic approach in identifying and specifying stages of an enterprise life-cycle model as derived from the use of multivariate analysis of empirical data to reveal common patterns and relationships in the data. They only acknowledge Smith *et al*. (1985) as having previously employed a taxonomic approach to developing an enterprise life-cycle model, but noted that that research had a very small sample size and various other weaknesses (McMahon, 1998:9).

2. Statement of the Problem

Incidentally, bookkeeping as a practice is a necessary pointer of strength and weakness in a business entity, however, the level of business management expertise and financial reporting skills necessary for sound decision making has been way below the conventional standards expected. Besides, most S.M.Es complying with the bookkeeping principals have fallen short of living up to the laid down standards, but to satisfy the mandatory and statutory requirement. Subsequently, this has further raised the urgency to provide technical support and management training needs to the operators in this sector to cope with the ever growing demand for new and existing players in the industry as a result of competition, creativity and innovation.

Therefore, a significant bundle of challenges threaten the survival of S.M.Es in a rather competitive market environment, which makes it an issue for local operators and investors to keep track of the progress of enterprises for the purposes of registering desirable performance and meaningful sustainable growth. Hence, the fundamental financial statements hold the potential of unraveling the future of S.M.E's as an integral driver of economic growth and development in low income economies.

2.1 Objectives

The study was centered on specific objectives that directly unraveled the role of financial management reports in appraisal of the performance and growth potential of S.M.Es in a low income economy.
  i.   To find out the role of financial statements in assessing performance
  ii.   To find out the role education level plays in determining profitability performance.
  iii. To find out the growth potential of SME's from the performance indicators.

2.2 Hypotheses

Financial statements are essential instruments for a sustainable growth pattern of SME's in low-income economies.

2.3 Stage Models of SME Growth

Hanks *et al*. (1993) derived a life-cycle model with four development stages and two disengagement (arrested development) stages. The development configurations or a stage in their taxonomic life-cycle model is described as follows:

2.3.1 Start-up

A relatively young and small enterprise with simple organisational structure that is highly centralised and quite informal characterizing little functional specialisation, with Product development that appears to be the priority, and has a Mean sales revenues growth of 90% per annum, and a mean employment growth of 30% per annum.

2.3.2 Expansion

The Enterprise is slightly older and larger with more complex organisational structures that is centralised and a little more formal than in the start-up stage. Functional specialisation is generally focused on Product commercialisation being the prime priority. Mean sales revenues growth of 300 % per annum, and a mean employment growth of 90% per annum is the target.

2.3.3 Maturity

Although, not necessarily older, on average, than in the expansion stage, enterprises in these stage is typically more than twice as large. Organisational structures are more complex, Centralisation is declining and formalisation increasing. In addition, the   Mean sales revenues growth of 100% per annum, and mean employment growth of 30% per annum (as quoted by McMahon**,**1998:14)

2.3.4 Diversification

Enterprises are generally medium-sized with increasing tendency to have divisionalized structures. Centralisation is relatively low, and formality is highest for any stage in the life-cycle model Mean sales revenues growth of 40 % per annum, and mean employment growth of 60 % p.a. Particularly note that generally increasing size and age of enterprises when reading down this list of life-cycle stages provides some evidence that businesses may, in some sense, progress sequentially through the stages as they evolve and develop.

Hanks *et al*. (1993) further describe the two apparently stable and sustainable disengagement configurations or stages in their taxonomic life-cycle model as follows:

2.3.5 Life-**style** – these enterprises are slightly larger than those in the start-up stage, but are generally much older. They are organisationally like start-up businesses. Mean sales revenues growth is in the range of 30 per cent per annum, but there is no growth in employment. These enterprises appear to have disengaged from the growth process after establishing their viability at relatively small size following start-up.

Hanks *et al*. (1993) assert that life-style firms, thrive where owners have consciously chosen to keep their firms small. Davidsson (1989), in his study of Swedish firms, found that for many small business managers, the negative effects of growth appeared to outweigh the positive outcomes once the firm had reached the size of five to nine employees. This arrangement may also reflect firms whose growth is limited because they operate in very small market niches.

2.3.6 Capped growth – these enterprises are relatively larger than those in the expansion stage, but are by and large much older. Organisationally, they are somewhat less intricate than typical businesses in the expansion stage. Their Mean sales revenues growth of 40% p.a, but mean employment growth of about 4% p.a. These enterprises appear to have disengaged from the growth process after successfully expanding to modest size following start-up.

Figure 1: Hanks *et al*. (1993) Enterprise Life-Cycle Model
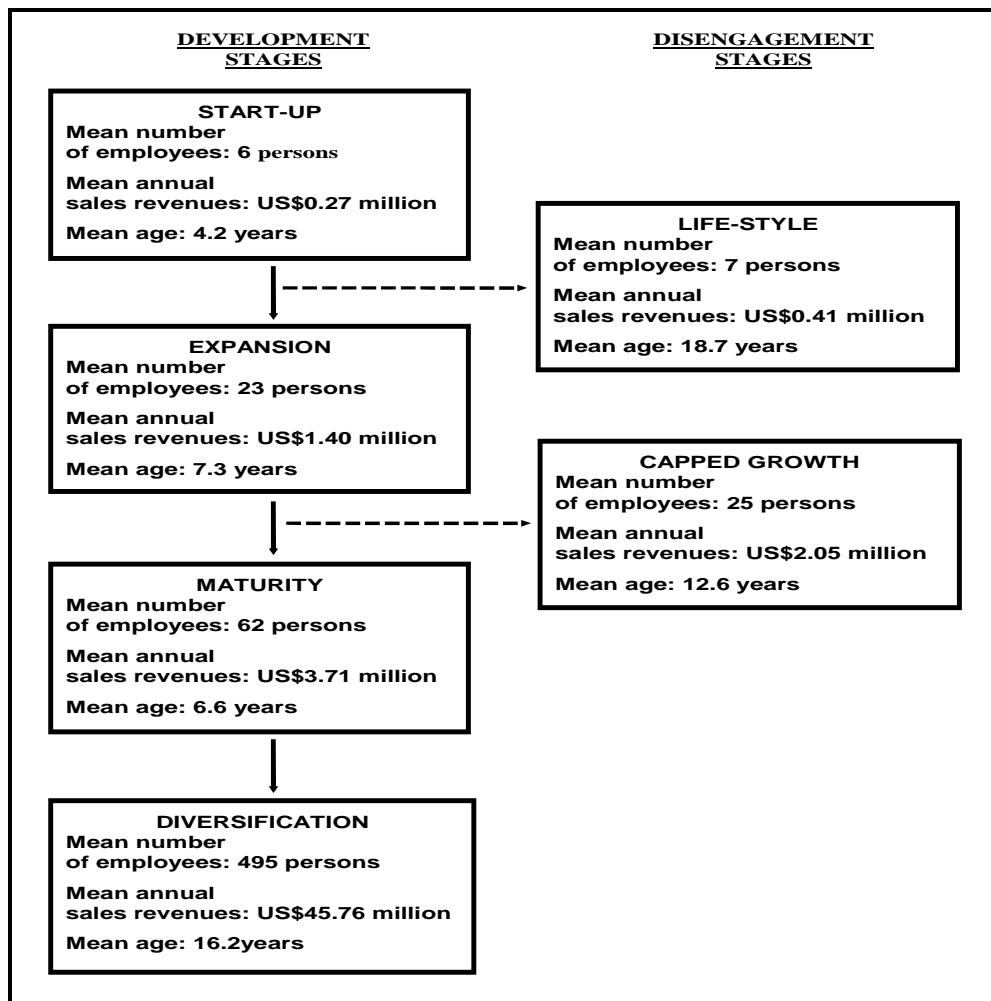
Churchill & Lewis' (1983:34) asserts that for a company to attain true economic health it must have a relatively sufficient size and product-market penetration to ensure economic success, and to earn an average or above-average profits as witnessed in the study. The enterprise can stay at this stage indefinitely, provided the environmental challenge does not destroy its market niche or an apparent ineffective management reduce its competitive abilities, since, according to Wanjohi & Mugure(2008),business environment is among the key factors that affects the growth of SME's significantly.

However, most of the SME's under study seemed to have exhibited characteristics similar to that of start-up development with a stagnated growth disposition at the life-style disengagement stage also referred to as arrested development circumstance, which appears an entirely appropriate safety zone for this category of entrepreneurs. Notably, Hanks *et al*. (1993) model does not include a decline stage as in some other models such as those of Smith *et al*. (1985), Adizes (1979, 1989) and Kazanjian (1988). Nonetheless, Hanks *et al*. (1993: 9-10) asserts that apparently, the Exclusion of decline stages in the majority of the models can be attributed to two characteristics of organization decline. Firstly, the impact of decline on organization structure and systems is far less expected than changes associated with growth. Secondly, the inception of organization decline may essentially occur at any stage of the organization's life cycle (Hanks, 1990b; Miller & Friesen, 1984a) (as quoted by McMahon**,** 1998:12).

In conclusion, Hanks *et al*. (1993: 9) reiterates that "All of the models include one or more stages related to organization birth or start-up, expansion, and maturity. However, all but three include one or more diversification stages".

3. Methodology

The survey design adopted drew a simple random sampling technique on a population of 17 business units in

Eldoret langas area out of a sample size of 20, the research instrument used was a questionnaire whose validity and reliability rested on open and closed ended questions.

Data collected was examined, categorized and tabulated and analyzed using an Econometric Economic Model with a Robust Ordinary Least Square Estimate in determining the relationship between the variables relative to the prescribed research objectives. In addressing heteroskedasticity, on the model a robust regression ensured that Variance ($\mu/X, X^2, X^3$ ....) $= \delta^2$, which means that the variance of μ given the explanatory variable X.... is equal.

3.1 Results, Discussion & Findings

The study concentrated on a cross section data collected within three month of January to march 2011 on gender, age, working capital, duration and length of experience in business, level of education, forms of financial statements maintained, decision making process and levels of profit margins. The questionnaire was administered to individual business owners to ascertain some confidentiality.

3.2 The model specification

A multivariate Robust Odinary Linear Square regression was adopted in this study for the reason that it appropriately describes the relationship between SME's performance and the role of financial management statements in predicting the determinants of sustainable growth in the sector. The regression model had the following components.

$$Y = \beta_0 + \beta_1 X + \beta_2 X^2 + \beta_3 X^3 + \mu$$

Where **Y** is the profitability variable (High profit, Average profit, Low profit & Breakeven levels respectively), β_0 is the constant and $\beta_1, \beta_2, \beta_3$.... are the coefficient parameters to be estimated in the model. Moreover, the **X, X^2, X^3** represent the variables that describe the levels of profitability in the model and μ represents the error term.

3.3 Variables used in the model

High Profit represents a 75% profit Margin on average working capital, Average Profit represents a 50% profit margin on average working capital, Low profit represents a 25% profit margin on average working capital and Breakeven represents a 10% profit margin on average working capital which is the performance leverage in the study since, it captures the motivation of the entrepreneur to stay in business alongside other challenges. College/University/Secondary represents Owners level of Education, which in this case constitutes the intellectual entry disposition of the entrepreneur. profit Loss represents business maintaining a Profit& Loss account statement, Balsheet represents a balance sheet document and Incomplete represents incomplete records in the business at the time of the study which in case plays a key role in determining the future success or failure of the SME's sector. DecisionEndyr/Beginyr/Midyr represents Decision made at End/Beginning &Mid of year respectively based on the financial statements maintained in the business , Duration represent the lifetime of business, , Publicrelat represents owners public relation training skill, Manageskill represents owners managerial skills, Age represents Age of Owner and Capital represents the working capital in the business.

3.4 Findings

The results of the multivariate robust regression are tabulated below clearly depicting the relationship between the explained and explanatory variables of the study.

Table 1: Results on determinants of High Profit

Highprof	Coef	t-value	P>ItI
College	-89.9689	-3.24	0.023
Profitloss	107.7534	6	0.002
Incomplete	66.49343	2.21	0.078
DecideEnd	16.58195	0.97	0.377
Balsheet	162.4635	10.29	0
Capital	0.042944	3.72	0.014
Age	-3.5127	-3.98	0.011
Secondary	43.28462	2.53	0.052
Constant	27.76178	1.06	0.339
Prob>F	0.0001		
R-squared	0.9629		
Root MSE	20.034		

High Profit = 27.76 – 89.98 *College* + 107.75 *ProfitLoss* + 162.46 *Balsheet* + 66.49 *Incomplete* – 3.51 *Age* + 43.29 *Secondary* + 0.043 *Capital* + µ

Where

In the first model a robust OLS regression was run with the outcome on the above equation where the financial statements; profit &loss (107.7%), balance sheet (162.5%) and incomplete records (66.5%) depicting a positive and significant effect on high profitability, given that in one year of their application increases the profitability rating significantly with the absolute t-value above (1.96) and a P-value of 0.0001 depicting that the variables are significant at all levels. Notwithstanding, the positive effects of secondary education (43.3%) and working capital (0.043%) respectively, However, college education (-89.9%), and age of the owner (-3.5%) depicted a negative effect on high profitability.

In the second model

Table 2: Results on determinants of Average Profit

Averageprof	Coef	t-value	P>ItI
College	22.29626	2.31	0.046
Incomplete	-18.5043	-0.91	0.384
University	71.78713	4.77	0.001
Balsheet	-80.79149	-7.24	0
Capital	-0.0582511	-2.31	0.046
Duration	10.63635	3.66	0.005
Secondary	-68.50457	-1.09	0.303
Constant	79.69368	0.98	0.353
Prob>F	0		
R-squared	0.6803		
Root MSE	49.444		

Average Profit = 79.69 + 22.30 *College* – 68.51 *Secondary* – 80.79 *Balsheet* + 10.64 *Duration* + 71.79 *University* – 18.50 *Incomplete* - 0.058 *Capital* + µ

In this case one year application of College (22.3%), university (71.8%) education has a positive and significant effect on Average profitability performance, compared to Secondary (-68.5%) an indication that tertiary education is a necessary condition to sustain the business but not sufficient to improve the profitability level . An extra year Duration (10.6%) in business contributes positively to the prevailing condition. However, application of Documents such as the balance sheet (-80.79%), Incomplete records (-18.5%) for an extra year would have a significant and negative impact on the value of Average Profit, an implication that financial statements have a reversal effect of improving the profitability level. Nonetheless, working capital (-0.058%) insignificantly and negatively reverses the gains of average profitability.

In the third model

Table 3: Results on determinants of Low Profit

Lowprofit	Coef	t-value	P>ItI
College	28.52963	0.74	0.481
Profitloss	-90.7101	-3.14	0.014
University	36.33133	0.9	0.393
Balsheet	12.87918	0.42	0.688
DecisionEnd	-50.5361	-2.28	0.052
Duration	2.331796	0.7	0.502
Secondary	40.5952	1.11	0.298
Age	-2.39715	-2.93	0.019
Constant	81.85155	2.12	0.067
Prob>F	0.0006		
R-squared	0.6187		
Root MSE	42.893		

Low Profit = 81.85 + 28.53*College* – 90.71*ProfitLoss* – 50.53 *DecideEndYr* + 2.33 **Duration** +36.33 *University* + 75.58 *Incomplete* + 12.88 *Balsheet* - 2.40 *Age* + 40.60 *Secondary* + μ

In this case one year application of Profit& Loss(-90.7%),Decision made at the end of year(-50.5%) based on the statements in place has a negative and significant impact with a reversal effect on the low profitability overtime, Age(-2.4%)of the owner had a reversal impact on the explained variable, given that an extra year in business with the combined effort of Profit Loss & Decision End would sustain the business into the next level. however, the other variables were statistically significant at all levels in explaining low profitability.

BREAK-EVEN

Table 4: Results on determinants of Breakeven

BreakEven	Coef	t-value	P>ItI
College	139.3259	4.21	0.004
Profitloss	100.5914	3.1	0.017
Incomplete	81.03396	1.92	0.097
DecideBeg	111.5762	2.2	0.064
Balsheet	-191.19	-2.84	0.025
Capital	-0.04474	-1.01	0.348
Age	4.718205	2.31	0.054
Manageskill	-50.2948	-1.65	0.143
Publicrela	53.4688	1.47	0.184
Constant	-175.576	-2.55	0.038
Prob>F	0		
R-squared	0.7256		
Root MSE	40.912		

Break-Even = -175.58 + 139.33 *College* + 100.6 *ProfitLoss* + 111.58 *DecideBeginYr* + 81.03 *Incomplete* – 50.29 *Managskill* + 4.72 *Age* + 96.54 *Secondary* - 0.108 *Capital* + 53.47 *Publicrelat* + μ

Apparently, an extra year application of college (139.3%) education propagates the breakeven level significantly without improving the scales. Nonetheless, the profit loss (100.6%), Incomplete (81.03%) statements coupled with an annual Decision (111.6%) made at the beginning of the year based on the statements contributes positively and significantly towards breakeven profitability. However, the Balance sheet (-191.2%) has a negatively significant and a reversal effect on the breakeven profitability.

4. Conclusion

Precisely, the main objective of the study was to assess the impact of financial statements on the performance

and sustainable growth of SME's in a low income economy setting. It was to find out whether the adoption of conventional financial management statements and entrepreneurial practices has a sustainable impact on performance and meaningful growth in the sector.

Nonetheless, the empirical findings there is a strong evidence indicating that financial statements play a fundamental role towards sustainable performance and growth of the SME's. Basing on the result of this study it can concluded that financial statements affect performance significantly though in different magnitudes. In the realization of High profitability, Profit & Loss, Balance sheet and the Incomplete records had a strongly positive and significant role on the posting of performance rating relative to other variables.

 Average profitability level, the Balance sheet and Incomplete records played a negative and significant reversal effect on the posted performance rating, indicating a turnaround effect on an unfavorable results. On Low profitability, the Profit Loss and Decision made at the End of the year based on the statement over time is likely to have a strong reversal effect on the undesirable result. On Breakeven profitability, Profit Loss, Incomplete records substantially, occupies the decision making process at the beginning of the year. An indication that errors made in the statements are reflected on the performance, however, the balance sheet significantly reverses the performance ratings by reflecting the flaws that may have arisen from the initial documentation.

Essentially, higher education level of university and college entitlement is evidently a necessary condition to sustain desirable performance level and growth in the sector but not a sufficient condition for a higher and improved profitability performance and meaning growth compared to the role of ethical entrepreneurial practices. Nonetheless, the cross cutting perception is that the Enterprise Life-Cycle Model description clearly places SME's in this low income economy at the start-up and entirely on the Life-Style disengagement development stage. However, more research is required on the role of education and need based business skills that directly influence meaningful growth in the SME's sector.

References
Adizes, I., (1989), "Corporate Lifecycles: How and Why Corporations Grow and Die and What to Do About It." Prentice-Hall, Englewood Cliffs, New Jersey.

Adizes, I.,(1979), "*Organizational passages: diagnosing and treating life cycle problems in organizations*," Organizational Dynamics, Vol. 8, No. 1, pp. 3-25.

Churchill, N.C. & Lewis, V.L. (1983), "*The five stages of small business growth*," Harvard Business Review, Vol. 61, No. 3, pp. 30-50.

Davidsson, P. (1989), "*Entrepreneurship and after? A study of growth willingness in small firms,*" Journal of Business Venturing, Vol. 4, No. 3, pp. 211-226.

Hanks, S.H. (1990b), "*The organization life cycle: integrating content and process,*"Journal of Small Business Strategy, Vol. 1, No. 1, pp. 1-13.

Hanks, S.H., Watson, C.J., Jansen, E. & Chandler, G.N. (1993), "*Tightening the life-cycle construct: a taxonomic study of growth stage configurations in high-technology organizations,*" Entrepreneurship Theory and Practice, Vol. 18, No. 2, pp. 5-29.

Holmes, S. & Zimmer, I. (1994), "*The nature of the small firm: understanding the motivations of growth and non-growth oriented owners,*" Australian Journal of Management, Vol. 19, No. 1, pp. 97-120.

Kazanjian, R.K. & Drazin, R. (1989), "*An empirical test of stage of growth progression model,*" Management Science, Vol. 35, No. 12, pp. 1489-1503.

Kazanjian, R.K. (1988), "*Relation of dominant problems to stages of growth in technology-based new ventures,*" Academy of Management Journal, Vol. 31, No. 2, pp. 257-279.

Kimberly, J.R. & Miles, R.H. (1980), " *The Organizational Life Cycle: Issues in the Creation, Transformation, and Decline of Organizations*," Jossey-Bass, San Francisco, California, pp. ix-xiii.

Marshall, A. (1890), " *Principles of Economics*," Macmillan, London, England.

McKenna, J.F. & Oritt, P.L. (1981), "*Growth planning for small business,*" American Journal of Small Business, Vol. 5, No. 4, pp. 19-29.

 McMahon. R.G.P, (1998), "Stage Models of SME Growth Reconsidered," *Flinders University of South Australia, Research Paper Series: 98-5*

Rostow, W.W. (1960)**,** "*The Stages of Economic Growth,*" Cambridge University Press, Cambridge, England.

Smith, K.G., Mitchell, T.R. & Summer, C.E. (1985), "*Top level management priorities in different stages of the organizational life cycle*," Academy of Management Journal, Vol. 28, No. 4, pp. 799-820.

Steinmetz, L.L. (1969), "*Critical stages of small business growth: when they occur and how to survive them,*" Business Horizons, Vol. 12, No. 1, pp. 29-34.

Wanjohi, A.M. and Mugure, A. (2008), "*Factors affecting the growth of MSEs in rural areas of Kenya: A case of ICT firms in Kiserian Township, Kajiado District of Kenya,*"

This academic article was published by The International Institute for Science, Technology and Education (IISTE). The IISTE is a pioneer in the Open Access Publishing service based in the U.S. and Europe. The aim of the institute is Accelerating Global Knowledge Sharing.

More information about the publisher can be found in the IISTE's homepage:
http://www.iiste.org

CALL FOR JOURNAL PAPERS

The IISTE is currently hosting more than 30 peer-reviewed academic journals and collaborating with academic institutions around the world. There's no deadline for submission. **Prospective authors of IISTE journals can find the submission instruction on the following page:** http://www.iiste.org/journals/ The IISTE editorial team promises to the review and publish all the qualified submissions in a **fast** manner. All the journals articles are available online to the readers all over the world without financial, legal, or technical barriers other than those inseparable from gaining access to the internet itself. Printed version of the journals is also available upon request of readers and authors.

MORE RESOURCES

Book publication information: http://www.iiste.org/book/

Recent conferences: http://www.iiste.org/conference/

IISTE Knowledge Sharing Partners

EBSCO, Index Copernicus, Ulrich's Periodicals Directory, JournalTOCS, PKP Open Archives Harvester, Bielefeld Academic Search Engine, Elektronische Zeitschriftenbibliothek EZB, Open J-Gate, OCLC WorldCat, Universe Digtial Library , NewJour, Google Scholar