

# Financial Management Practices and Performance of Small and Medium Enterprises in Sri Lanka

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**Abstract—** This research was conducted to recognize the relationship between financial management practices and performances of Small and Medium Enterprises (SMEs) in Sri Lanka. In order to support the findings of the research, the reasons for not using financial management practices by SMEs have been discovered in this study. The primary objective of this study is to identify the relationship between financial management practices and performance of SMEs in Sri Lanka. As the sample of the study eight SMEs have been selected in Colombo district. The sample was selected based on the convenience sampling method. Under the financial management practices, this study has considered financial audit, accounting information system, investment decision and working capital management. Primary data required for the study obtained through distributing questionnaire and conducting interviews with the owner managers of SMEs. Secondary data collected for the study by examining the financial statements and annual reports of the SMEs. In order to analyse the data and present the findings, Statistical Package for Social Science (SPSS) software has been used. Findings of the study states that, there is a positive relationship between financial management practices and performance of SMEs in Sri Lanka. All four concepts used in the study which are financial audit, investment decisions, accounting information system and working capital management positively influence the financial performance of the firm. Further the study has found reasons which limit the SMEs from using financial management practices and they are financial instability of the SMEs, lack of knowledge regarding accounting and financial practices and owners are not interested to undertake financial management practices since it is not a mandatory requirement by the law of the state to carry out financial management practices when operating the business. By considering the research findings, the researcher concludes that, financial management practices such as financial audit, investment decision, accounting information system and working capital management enhance the financial performance of SMEs in Sri Lanka.

**Keywords—** Financial Management Practices, Small and Medium Enterprises, Financial Performances

SMEs greatly contribute to the Sri Lankan economy since it is a developing country and when having more SMEs in the economy, overall production in the economy goes up and ultimately it increases the Gross Domestic Production of the country. This leads to the growth in per capita income and it leads to the development of the country. SMEs are engaged in risky and innovative activities which gives more contribution to the economy.

Economy can be divided into 3 main sectors which are namely primary, secondary and tertiary. Primary sector engaged in raw material production and the secondary sector convert the raw material into finished goods and finally the tertiary sector will engage in supplying the final products to the business organizations and final customers. However, the contribution from SMEs to all the three sectors can be seen by undertaking business activities in all three segments.

SMEs provide significant benefits to the economy of a country. SMEs increase the country's overall production therefore the Gross Domestic Production (GDP) is also going up. On the other hand, the problem of unemployment can be minimized by having SMEs in the economy since it provides employment opportunities (Thuryahewwa et al, 2013). Further it leads to the economic development of the country by having the chance to increase the export earnings.

When considering about the issues faced by the SMEs, financial constraints can be recognized as the main issue (Amoako, 2013). Most SMEs don't have enough finance to expand or grow their operations. And the high interest rates in the financial market can also be an issue (USAID'S DCA Ghana Impact Brief, 2009). Further SMEs won't be able to focus on external financing like bank loans since their poor financial record keeping and not maintaining the accounts. When applying for a loan. Audited financial statements should be provided with collateral. As a result of not maintaining the records, obtaining a credit has been a challenge (Amoako, 2013). Furthermore, lack of technical financial and management skills and competencies of the owners of SMEs can be identified as the issues.

## I. INTRODUCTION

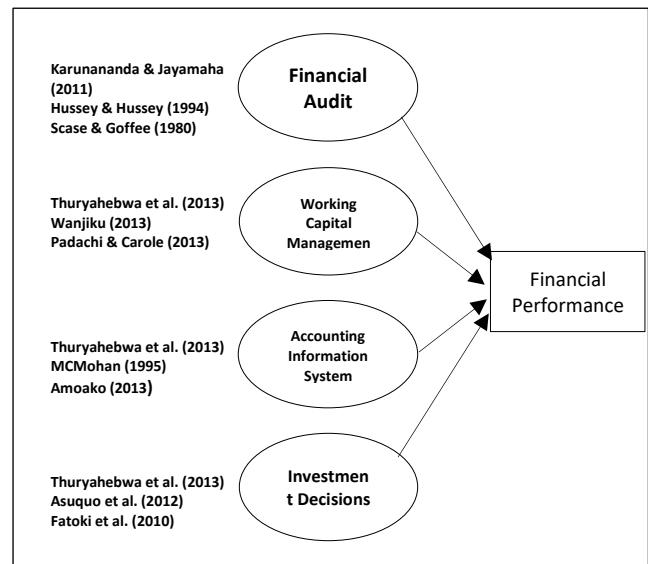
In order to minimize these issues, SMEs can adopt financial management practices which assist the company in obtaining loans and manage their firms in growing and expanding aspects. And the government should take steps to educate the SME owners regarding the importance of adhering to the financial management practices and implement financial management practices in the business. And also the benefits from using financial management practices including proper record keeping should be explained to the owners. Financial management practices assist in decision making, controlling unnecessary cost and expanding and growing the business by having the ability to easily get credits from the financial institutions.

This study focuses on financial practices which can be adopted by the SMEs in order to improve the financial performance and the degree to which the SMEs comply with these practices. And also this study identifies the constraints which limit the SMEs by using financial management practices and identifies the relationship between SME performance and financial management practices implemented by SMEs in Sri Lanka.

SMEs which do not undertake financial management practices are performing less effectively than the SMEs which uses financial management practices. (Karunanananda and Jayamaha, 2011). If the firm is not using financial management practices the issues arise when it comes to obtaining credit from a bank or any other financial institution which limits the growth and expansion of the SMEs (Amoako, 2013). SME owners make wrong investment decisions by not considering the financial feasibility of the investment which ends up incurring huge losses which cannot bear up by the SMEs and by not having proper financial management system SMEs are most likely to incur more bad debts which will damage the business operations heavily (Nguyen, 2001). It is worthwhile to address this problem because performances of SMEs significantly affect the development of the economy (Amoako, 2013) and standard of living of the people.

The primary objective of this study is to determine the relationship between financial management practices and performance of SMEs in Sri Lanka to enhance the performances of SMEs in terms of financial perspective and non-financial perspective. This study has conducted considering a hypothesis which is, there is a positive relationship between financial management practices a performance of SMEs in Sri Lanka.

## II. METHODOLOGY AND EXPERIMENTAL DESIGN



This study used financial audit, accounting information system, and working capital management and investment decisions as independent variables and financial performance as dependent variable. As the population of

Figure 1. Conceptual Framework

the study, all SMEs in Colombo District were considered. However, for the sample fifteen SMEs in Colombo District have been selected. Sample was selected based on the convenience sampling method. In order to collect data a questionnaire has been developed based on Likert scaling and distributed. Further interviews have been conducted in order to triangulate the findings. Mainly interviews were conducted to identify the constraints which limit the SMEs from using financial management practices. As the secondary sources, financial statements of SMEs have been examined in order to determine the financial performances of the firm. As the data analytical tool, statistical package for social science (SPSS) has been used.

## III. RESULTS



Figure 2. Relationship between Financial Audit and Financial Performances

The findings of this study explains the relationship between financial performances of SMEs which is the dependent variable with each independent variables namely financial audit, accounting information system, investment decision and working capital management system.

Assuming when all the other factors are constant, there is a positive relationship between financial audit and financial performances of SMEs in Sri Lanka can be seen in the figure 2. In other words, when the financial audits are carried out in SMEs efficiently, it improves the financial performances of the SMEs. The impact of financial audit to the financial performance is 52.06 percent.

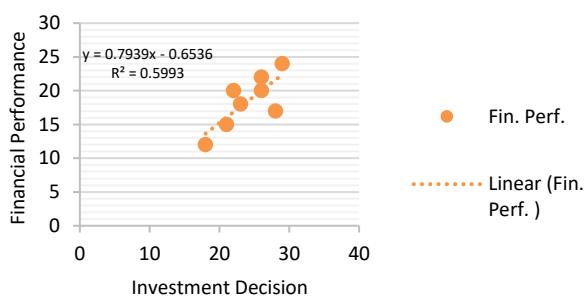


Figure 3. Relationship between Investment Decision and Financial Performance

According to the figure 3, assuming when all the other factors are constant, there is a positive relationship between Investment decisions and financial performances of SMEs. In other words, when SMEs use investment appraisal before making an investment, it enhances the financial performances of the firm. Positive relationship between investment decisions and financial performance is 59.93 percent.

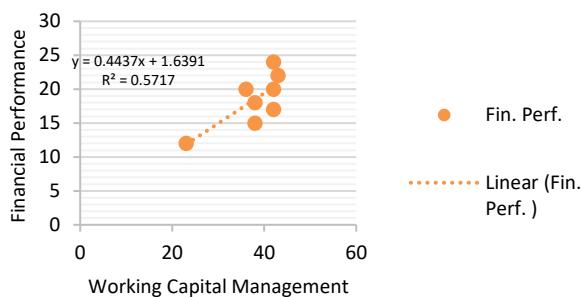
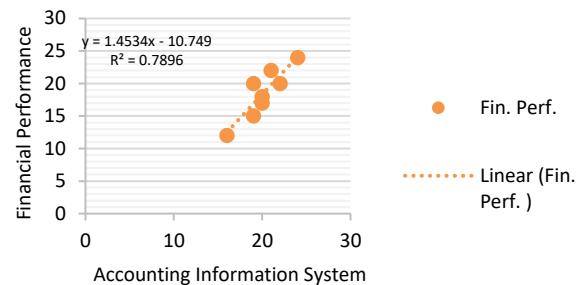


Figure 4. Relationship between Working Capital Management and Financial Performance

As shown in the figure 4, when assuming all the other factors are constant, there is a positive relationship between working capital management and financial performances of SMEs in Sri Lanka. In other words, when working capital management practices are properly



implemented by SMEs, it leads to improve financial performances. The impact to the financial performance by working capital management is 57.17 percent.

Figure 5. Relationship between Accounting Information System and Financial Performance

Assuming all the other factors are constant, positive relationship between accounting information system and financial performances can be indicated. In other words, when the firm is having an efficient accounting information system that leads to enhance the financial performances of the SMEs. It can be shown in the figure 5. There is a positive influence to the financial performance by having an accounting information system in the firm which is counted for 78.96 percent.

When considering about the findings, all four financial management practices namely financial audit, investment decisions, working capital management and accounting information system have positive influence on the financial performance of the SMEs.

Kaiser Meyer Olkin (KMO) and Bartlett's Test has been used to measure the adequacy of the sample. The sample adequacy of the study is 80.9% and it is considered to be good. In order to measure the fitness of the sample, Model summary has been used. Goodness of fitness of the sample is 82.3% which can be considered as good. This implies the influence which can be made by financial management practices on the financial performance is counted for 82.3%. Cronbach's Alpha measurement was used to measure the reliability of the variables. Reliability of financial audit and working capital management is 0.940 and 0.923 respectively which can be considered as reliable whereas reliability of investment decision is 0.862 which can be considered as good. Reliability of the accounting information system is 0.563 which can be considered as fairly reliable. Correlation test was used to identify the relationship between independent variables and dependent variable. There is a positive correlation between financial audit and financial performance and that relationship is significant at the 0.05 level. Positive correlation between investment decision and financial

performance can be found at the significant level of 0.05. There is a positive correlation between working capital management and financial performance which is counted for 0.756, showing a significant level of 0.05. There is a significant positive correlation between accounting information system and financial performance and that relationship is significant at the 0.01 level.

Findings obtained from the interviews explain the constraints which limit the SMEs from using financial management practices. The SMEs are not undertaking financial management practices because of not being strong financially to implement financial management practices, lack of knowledge and literacy regarding financial management practices and owners do not consider the use of financial management practices are essential for SMEs since it is not a legal requirement for the SMEs to undertake financial management practices.

#### IV. DISCUSSION

According to Karunananda & Jayamaha (2011) there is a significant positive relationship between financial audit and financial performances of SMEs in Sri Lanka has and further the study has elaborated that the SMEs which carry out financial audit program efficiently achieve better performances compared to the SMEs which do not carry out financial audit programs. Further financial statements or accounting records prepared by SMEs should be audited by an external auditor and the opinion and the advices should be obtained in order to achieve better financial performances proving the positive impact to the financial performance by properly conducting a financial audit program (Scase & Goffee, 1980). These findings support the findings of this particular research since it also elaborates the positive relationship between financial audit and financial performance of SMEs in Sri Lanka. Therefore, the hypothesis considered in this study can be proved, which is there is a positive relationship between financial management practices and financial performance of SMEs in Sri Lanka.

Findings of this particular study tally with the findings of Wanjiku (2013) because the findings imply that the working capital management and financial performance are positively correlated. As per the findings of Thuryahebwa et al. (2013), consecutive relationship between working capital management and financial performance can be recognized and the findings also state that positive attitudes regarding financial management practices should be developed in the minds of owner managers of SMEs in order to enhance the financial performance of the SMEs. These findings also support the current discussion since the positive impact of financial

management practices on the financial performance has been elaborate by this particular study's findings. Hence the hypothesis considered in this study can be proved, which is there is a positive relationship between financial management practices and financial performance of SMEs in Sri Lanka.

The positive relationship between investment decision and financial performance have been illustrated by Thuryahebwa et al (2013) and Fatoki et al (2010) and as mentioned by Fatoki et al (2010), the use of investment decision leads to earn greater profits and maintenance of minimum cost level. These findings tally with the findings of this particular research since it also concludes the positive relationship between investment decision and financial performance of SMEs in Sri Lanka. Therefore, the hypothesis considered in this study can be proved, which is there is a positive relationship between financial management practices and financial performance of SMEs in Sri Lanka.

According to the findings of Karunananda & Jayamaha (2011), the positive relationship between accounting information system and financial performance can be recognized and it also tally with the findings of Thuryahebwa et al. (2013). According to Thuryahebwa et al. (2013), necessary steps should be taken to build positive attitudes towards maintenance of proper accounting records in order to achieve greater level of financial performance in SMEs. These findings tally with the findings of this particular research, since the consecutive relationship between accounting information system and financial performance of SMEs have been elaborated by this particular research. Hence the hypothesis considered in this study can be proved, which is there is a positive relationship between financial management practices and financial performance of SMEs in Sri Lanka.

#### V. CONCLUSION

SMEs play a crucial role in the economy by increasing the Gross Domestic Production and creating job opportunities. Karunananda & Jayamaha (2011) found that most SMEs do not undertake proper financial management practices in order to enhance the performance of the business. Therefore, the researcher has found this issue as the research problem and this study has done to identify the influence to the financial performance of SMEs in Sri Lanka by implementing financial management practices. Primary objective of this study is to identify the relationship between financial management practices and financial performance of SMEs in Sri Lanka in order to enhance the financial performances of SME in Sri Lanka. For this study, researcher has selected four concepts which are, financial

audit, investment decision, accounting information system and working capital management.

As the sample 8 SMEs located in Colombo District have been selected. In order to collect primary data questionnaire was distributed and interviews have been conducted. Furthermore, financial statements and annual reports of the SMEs have been analyzed to obtain the data required for the study. The sample has been selected based on the convenience sampling method considering about the easy access to get the information. Data has been analyzed with SPSS software and found that there is a positive relationship between financial management practices and financial performance of SMEs in Sri Lanka. Financial management practices consist of financial audit, investment decision, working capital management and accounting information system. All four variables show a positive influence to the financial performances. Research findings were sufficient to accept the research hypothesis, which is there is a positive relationship between financial management practices and financial performance of SMEs in Sri Lanka.

Further the findings of the study states the constraints which prevent the SMEs from using financial management practices. The SMEs which do not undertake financial management practices because of not being strong financially to implement financial management practices, lack of knowledge and literacy regarding financial management practices and owners do not consider the use of financial management practices are essential for SMEs since it is not a legal requirement for the SMEs to undertake financial management practices such as preparation of financial statements. Therefore, findings of this study was sufficient to successfully achieve the research objective that is there is a positive relationship between financial management practices and financial performance of SMEs in Sri Lanka.

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