

The use of financial management practices by small, medium and micro enterprises: a perspective from South Africa

Pradeep Brijlal, Samuel Enow and Eslyn B.H. Isaacs

Abstract:

This paper reports on an investigation of financial management practices used by small, medium-sized and micro-enterprises (SMMEs) in South Africa. It was found that more than half the SMMEs examined use external accounting staff to prepare accounting reports and more than 60% rely on external accounting staff to interpret and use accounting information. A majority of the SMME owners were found to lack interpretation skills and an awareness of how to use information from financial statements. An implication of this study therefore is that policy makers, business support organizations, banks and academic institutions need to focus on educating SMMEs more effectively in financial management, thereby mitigating the risk of cash flow problems and business failure.

According to the Organisation for Economic Cooperation and Development (OECD, 2006), small, medium-sized and micro-enterprises (SMMEs) and entrepreneurship are now recognized worldwide as key sources of dynamism, innovation and flexibility. SMMEs are responsible for most net job creation, making an important contribution to productivity and economic growth; they are the logical 'kick-start' mechanism for job creation and future prosperity in the country (FaLOki, 2012) and alleviation of poverty (Berry *et al*, 2002).

Since 1996, SMMEs in South Africa have been actively promoted through the implementation of the National Strategy for the Development and Promotion of Small Business in South Africa to redress income redistribution, generation of employment and economic growth and ultimately alleviate poverty (Bruwer, 2010, Department of Trade and Industry, 2003). Many new SMMEs have been started in South Africa, contributing significantly to the economic growth of the country, to the extent of between 27% and 34% of the gross domestic product (GDP) and 72% of all jobs in South Africa (Department of Trade and Industry, 2003, Department of Trade and Industry, 2008).

According to Sha (2006) the failure rate of SMMEs is very high during the first two years of the new start-up. Research by Petrus (2009), Tung and Aycan (2008) and Herrington and Wood ((2004) indicated that SMMEs fail because of lack of education and training, shortage of management skills, lack of access to finance and lack of financial management competences. A

shortage of financial management skills as a root cause of business failure is not a new phenomenon (Nayak and Greenfield, 1994), such a shortage being typical of SMMEs, in contrast to large and multi-national business enterprises where specialists are employed and modern technology is used to provide up-to-date data and information.

SMMEs, often owned and managed by the same person, have been found to be flexible in decision-making but lacking in internal expertise (Berry *et al*, 2006). The informality of bookkeeping and the accounting information in SMMEs can complicate and prolong decision-making (Perren and Grant, 2000). SMME owners are often seen as a 'jacks of all trades', involved in all the key business functions such as marketing, human resource management, operations, public relations and financial management. While these functions are all equally important, this study focuses on financial management.

Proper financial management is one of the deciding factors with regard to the survival of SMMEs (Jayansankaran, 1999, Harif *et al*, 2010, Abdullah *et al*, 2009). A study by the International Finance Corporation (IFC, 2006) revealed that those involved with the management of SMMEs are aware of the importance of accounting information and when it is available they use it for a variety of purposes.

According to Padachi (2010) financial management has both internal and external aspects. Internally, it is concerned with (i) implementing and managing an accounting system and (ii) generating information for decision-making purposes. Externally, it is concerned with the ability to attract adequate financial resources. Efficient financial management practices are vital in SMMEs: they provide a historical analysis of the performance of the business, which can then be used to project potential future performance. Vijayakumar (2001) tares that optimal utilization of financial management practices could enhance the growth of SMMEs and contribute to improving the South African economy in general and to the realization of the objectives identified in the development and promotion strategy of the government (Department of Trade and Industry. 1995)

Table 1. SMME classification in South Africa.

Category	Generic description
Micro-enterprise	1–5 employees. Mainly informal, untaxed and unregistered businesses.
Small enterprise	6–50 employees. At least one management layer.
Medium-sized enterprise	51–200 employees

Source: Adapted from The Small Business Act of 1996 and DT1 (2008) Annual National SMME Summit.

There is an extensive literature on the use of financial management practices by large companies (Pullen and Cooley, 1979, Lee and Filbeck, 2000). However, research on the application of financial management by SMMEs is scarce, especially in a developing nation such as South Africa. This study therefore investigates the usefulness and application of these techniques by SMMEs in South Africa.

The paper is organized as follows. First, by means of a literature review, we define SMMEs and financial management and provide an overview of financial management practices. We then summarize the research methodology and present the research results. In the final sections of the paper we discuss the findings and offer concluding remarks and suggestions for future research.

Literature review

The World Bank defines South African SMMEs by number of employees, in accordance with the National Small Business Act of 1995 and amendments introduced in 2003 through the Small Business Amendment Bill. The categories, as listed in Table I, were reviewed at the 2008 Annual National SMME Summit. The table combines small and very small enterprises into one category (labelled 'small enterprise') and does not include survivalist enterprises.

Definition of financial management

Financial management is the management of the finances of a business in order to achieve the financial objectives of the business. McMahon and Davies (1994) define financial management as the function concerned with raising the funds needed to finance the enterprise's assets and activities, the allocation of these scarce funds between competing uses, and ensuring that the funds are used effectively and efficiently in achieving the enterprise's goals. According to Armstrong (1986), financial management is concerned with planning, budgeting and control techniques. Oduware (2011) adds that financial management entails planning for the future of a business enterprise. Brinckmann *et al* (2011) define financial management as including managerial activities that concern the acquisition of financial resources and the assurance of their effective and efficient use to ensure a positive cash flow. Armstrong (2001) posits that financial management is further concerned with the activities within a business that contribute to profit maximization. According to Firer *et al* (2004), the goal of financial management is to maximize the wealth of the firm's owners. This notion is supported by Keown *et al* (2002), who argue that financial management contributes to creating and maintaining the economic value of a business.

Financial management principles

Armstrong (2001) identifies five principles of financial management: financial planning, financial accounting, financial analysis, management accounting and capital budgeting. Harif *et al* (2010) include working capital as a sixth financial management practice. In the same way that financial management practices are important to large and multinational enterprises, they are also important for SMMEs (Fatoki, 2012).

Financial management can occupy the major part of a financial manager's time and attention (Gitman, 2003) and many business failures have been attributed to the inability of financial managers to plan and control properly the current assets and the current liabilities of their respective firms (Dodge and Robbins, 1992, Ooghe, 1998).

This study focuses on financial planning and control, financial accounting and financial analysis. These broad categories of practices are defined in the following sections.

Financial planning. According to Armstrong (2001) financial planning predicts the overall financial performance of a business and alerts management to the funds required, when they will be required and how much will be needed. The primary financial planning activities are: income forecasting, cash flow forecasting, determining financial resource requirements, and profit and dividend planning.

Financial accounting. According to Weygandt *et al* (2000), financial accounting is the process of identifying, recording and communicating the economic events of a business in order to communicate this information to interested parties. Armstrong (2001) asserts that financial accounting records the financial transactions that have taken place in a business. The information recorded is then communicated through accounting reports in the form of financial statements – a balance sheet, an income statement and a flow of funds statement, deemed to be the primary data sources for financial analysis.

Financial analysis. According to Nguyen (2001), financial analysis is the process of evaluating the performance of a business and other projects using tools such as ratio analysis, payback period, net present value and internal rate of return. Investment in projects requires risk analysis and sensitivity analysis. Typical tools such as cost-benefit analysis, cost-effectiveness, sales mix analysis and cost-volume analysis can be useful. Financial analysis includes ratios such as current ratio, quick ratio, return on sales, debt ratio, inventory turnover and return on equity.

Financial practices of SMMEs and external advice. In a dynamic environment where businesses are growing, SMMEs tend to seek business and financial advice from external sources – for example, accountants. The market for advice, and in particular with regard to the regulations that affect SMMEs, is constantly changing, and this change in the market conditions for advice has led many accountants to provide a wider range of services to SMMEs. This has major implications for those accountancy practices seeking to engage with SMMEs (Blackburn *et al*, 2006, Blackburn *et al*, 2010). Over time, the amount and type of advice from accountants has evolved according to both the needs of SMMEs and the strategic intent of accountants (Doving and Gooderham, 2008).

The SMME-accountant / bookkeeper relationship is regarded by many as a necessity, because SMMEs are required to produce documentation – such as audited financial reports – to comply with government regulations; and SMMEs are obliged to engage accountants or accounting officers to produce these statements. Research has also

demonstrated that the SMME-accountant relationship, established as a result of compliance work, has the potential to become a source of business advice and support (Blackburn *et al*, 2010) through the interpretation and analysis of financial statements.

According to a study by Nguyen (2001) on the financial management practices and profitability of small and medium-sized enterprises (SMEs) in Australia, 77% of SMEs apply financial planning practices such as financial, operational, sales and cash budgets; whilst 83% frequently compare budgeted and actual results. All the 150 SMEs in Nguyen's study (2001) used accounting information systems to monitor and execute their accounting operations while 70% prepared and analysed their financial statements. According to Maseko and Manyani (2011), accounting systems provide a source of information to owners and managers of small businesses operating in any industry for use in the measurement of financial performance in areas such as costing, expenditure and cash flow, by providing information to support monitoring and control.

Ismail and Zin (2009) investigated the use of accounting information among Malaysian small and medium-sized non-manufacturing firms using a sample of 136 firms. They found that half the SMEs that prepared accounting information used computerized accounting systems and just over half sought financial advice from accounting firms. In addition, they found that 40% of the SMEs did not prepare a balance sheet.

Maseko and Manyani (2011) investigated the record-keeping practices for performance measurement and improving the financial management practices of SMEs in Zimbabwe. They found that due to a lack of accounting knowledge the majority of SMEs did not keep complete accounting records and concluded that there was inefficient use of accounting information. An earlier study by McMahon (1999) found that most SMEs did not prepare a complete set of financial statements; and some did not prepare any financial statements.

The need to prepare a complete set of financial statements increases as an entity progresses from small to medium size. It is at the medium-size stage that financial performance reporting will be useful to internal and external users. External users include lenders and suppliers of raw material or finished goods. In most cases owner-managers prepare financial statements in SMMEs and many are not financially literate: it is possible that they resort to this practice to avoid the cost of hiring accountants (Everaert *et al*, 2006).

Based on this literature review and given the scarcity of South African literature in the field of financial management, investigation of the financial management practices used by SMMEs in South Africa was regarded as important and this study therefore set out to determine the extent to which financial management practices are used by SMMEs in the Western Cape. In particular, the following were investigated:

1. The importance of the financial planning practices used by SMMEs;
2. The importance of the accounting information system used in SMMEs; and

3. The extent to which financial analysis and reporting is used in SMMEs.

Research methodology

An exploratory study was conducted, mindful of the fact that financial information on SMMEs is not freely available in South Africa, unlike the case in developed nations. According to Babbie (2007) and Babbie and Mouton (2001), exploratory research is used to make preliminary investigations when few or no studies exist, with the aim of developing new ideas, seeking new insights and examining phenomena in a new light that will form the basis for further research. Descriptive research is aimed at observing and then classifying the elements being observed, to provide an accurate profile of the situation (Robson, 2002).

Primary data were obtained using a structured questionnaire with four sections:

1. Biographical information about the business and business owner-manager responsible for the financial management matters;
2. Assessment of the importance of financial planning practices;
3. Assessment of the importance of the accounting information system; and
4. The extent to which financial analysis and reporting was used in the SMME.

Questions were answered using a 3-point Likert scale (some of the secondary questions required 'yes' or 'no' responses).

The selection of cases was based on the purposive sampling method. This resulted in the selection of participants that best fitted the objectives of the study. Due to cost and other factors, 100 SMMEs in the main trading areas of the city of Cape Town were contacted: in the event, 59 business owners-managers agreed to participate. The data retrieved from the questionnaires were analysed using descriptive and inferential statistics.

The following were implemented, to ensure reliability and validity.

- The questionnaire was adopted and adapted to the South African context from previous studies, such as those of Nguyen (2001) and Harif *et al* (2010).
- The content of the questionnaire included the most relevant financial management practices discussed in financial management textbooks.

Research results

Table 2 presents the biographical information on the SMMEs and owner-managers: as can be seen, the popular types of legal ownerships were sole proprietor (36%) and close corporation (31%). Forty-four per cent of the businesses were less than five years old. In South Africa, a partnership is not a popular form of business ownership, accounting for only 6% of the respondents in our survey. As of 2010, the Close Corporation Act became defunct and therefore no new close corporations could be established after that date. SMMEs that had been in operation for more than 10 years accounted for 34% of the

businesses studied. The highest qualification for most of the owners was Grade 12 (42%) and 58% had a post-Grade 12 qualification. Fifty-four per cent of the owners were responsible for the financial matters of the business and 64% had been exposed to some sort of financial management training.

Table 2. Biographical information.

	% of firms surveyed
<i>Status of the business</i>	
Sole proprietorship	36
Partnership	6
Close corporation	31
Private company	27
<i>Industry sector</i>	
Manufacturing	52
Retail/wholesale	48
<i>Age of the business</i>	
Less than 2 years	15
2–5 years	29
6–10 years	22
More than 10 years	34
<i>Person responsible for financial matters</i>	
Owner	54
Internal accounting staff	36
External accounting staff	10
<i>Educational qualifications</i>	
Secondary school	42
Bachelor's degree	26
Honours degree	12
Master's degree	3
Diploma	17
<i>Financial management training</i>	
Never	34
Yes	66

Financial planning

The respondents were required to indicate the relative importance of the various aspects of financial planning in their business, as shown in Table 3. Key results were that 80% of the owners felt that financial planning was very important; 59% prepared budgets; 69% were involved in the budgeting process and in interpretation of the budgets; and 63% compared actual payments with budgeted amounts. Only 59% applied financial planning techniques learnt in training and 64% used computerized financial reporting techniques.

The business owners were asked to indicate their business objectives. The results showed that:

1. 64% were interested in profit maximization;
2. 49% were interested in customer satisfaction;
3. 48% were interested in sales maximization;
4. 41% were interested in growth;
5. 36% were interested in cost minimization; and
6. 14% were interested in survival.

The typical types of budgets prepared in these SMMEs were: sales (41%); overhead costs (34%); labour (29%); cash (25%); and purchases (20%). Furthermore, more than 60% of the business owners were not involved in the actual production of the budget s. This is a matter of concern, because budgeting is one of the most important planning tools with regard to avoiding business failure. Herrington *et at* (2010) revealed that 75% of businesses fail during the first two years of operations and the lack of a budget was among the main reasons for this to occur.

Accounting information system

Accounting information reporting was divided into four categories: financial matters; recording transactions; preparation of accounting reports and interpretation and using accounting information. SMME owners were requested to indicate who was responsible for each of the categories listed under the accounting information system (Table 4). Fifty-four per cent of the SMME owners were responsible for financial matters and 44% for recording transactions; 54% used external accounting staff to prepare accounting reports; and 61% relied on such external staff to interpret and use the accounting information. A high percentage of the owners seemed to lack the ability to interpret and use information from financial statements.

Table 3. Financial planning practices.

	Rating scale* (%)		
	1	2	3
How important is financial planning?	15	5	80
How regularly does your business prepare its financial budgets?	25	15	59
How involved is the owner-manager in preparing financial budgets?	20	11	69
How involved is the owner-manager in interpreting and using financial budgets?	20	11	69
How important are the financial budgets in providing useful information for decision making purposes?	20	4	76
How regularly does your business compare budgeted and actual results?	24	13	63
How regularly are financial planning techniques applied in financial analysis in your business?	19	22	59
How computerized are financial reporting and analysis practices in your business?	29	7	64

*Note: 1=low importance; 2=not sure; 3=high importance.

Table 4. Accounting information system responsibilities.

	Financial matters (%)	Recording transactions (%)	Preparing accounting reports (%)	Interpreting and using accounting information (%)
Owner	54	44	27	27
Internal accounting staff	36	34	19	12
External accounting staff	10	22	54	61

The SMME owners were asked to indicate their view of the importance of the accounting information system (Table 5). Eighty-five per cent of the businesses had a formal accounting system and 71% used computers (limited to recording business transactions). Respondents were also asked to provide feedback on the importance of their accounting information systems. Eighty per cent indicated the importance of accounting information in making decisions that had led to the success of their business; 69% compiled and updated financial information on a monthly basis; 66% of the owners were involved in interpreting and using accounting information; 71% of the firms had computerized accounting systems; and 80% of the owners found the accounting systems to be useful in making decisions.

Financial reporting and analysis

Bookkeeping alone, without preparing financial reports, is unlikely to be a fundamental factor in aiding decision making. As such, the efficiency of financial planning is dependent on the type of accounting system used in a business. The balance sheet, income statement, cash flow statement and flow of fund statements are the most important documents for reporting and analysis. The present research revealed that an income statement was prepared in 85% of the businesses, a balance sheet and cash flow statement in 47%; and flow of funds in only 10%.

The study also sought to establish who was responsible for preparing and analysing financial statements. As noted in Table 6, 54% of SMME owners were responsible for the financial matters of the business and 64% obtained the services of external accountants for the interpretation, preparation and analysis of financial statements.

Table 5. Efficiency of accounting information system.

Efficiency practices	Rating scale* (%)		
	1	2	3
How important is your accounting information system to the success of the business?	8	12	80
How frequently does your business prepare its accounting reports?	19	12	69
How does an accounting information system in your business update the business transaction?	19	12	69
What is the owner-manager's involvement in preparing accounting information?	32	19	49
What is the owner-manager's involvement in interpreting and using accounting information?	22	12	66
How acceptable is your business's accounting information system?	19	12	69
Is your business's accounting information system useful in making decisions?	10	10	80
How computerized is your business's accounting information system?	24	5	71

*Note: 1=low; 2=undecided; 3=high.

Table 6. Responsibility for preparing and analysing financial statements.

	Financial matters	Interpreting and using accounting information	Preparing financial statements
Owner	54	24	24
Internal accounting staff	36	12	12
External accounting staff	10	64	64

Table 7. Efficiency of financial reporting and analysis.

	Rating scale* (%)		
	1	2	3
How does your business regard financial reporting and analysis?	22	7	71
How frequently does your business prepare financial statements?	20	17	63
How involved is the owner-manager in preparing financial statements?	27	19	54
How involved is the owner-manager in interpreting and using financial statements?	24	10	66
How useful are the financial statements of your business in providing information for decision making?	14	8	78
How frequently does your business analyse financial statements?	17	17	66
How useful are financial ratios applied in financial analysis of your business?	27	14	59
How computerized are the financial reporting and analysis practices in your business?	24	7	69

*Note: 1=low; 2=unsure; 3=high.

The SMME owners were asked to indicate the extent to which they undertook financial reporting and analysis, as shown in Table 7. It is clear that in a large number of the businesses financial reporting and analysis practices were rated highly. Seventy-one per cent attached high importance to financial analysis and reporting; 78% attached high importance to the use of financial statements for decision making; 60% were involved in interpreting and analysing financial statements; and 63% of the SMMEs prepared financial statements on a frequent basis. One means of analysing financial statements is through ratio analysis. The ratios most frequently used are: current, quick, debt, debt-to-equity, inventory turnover, return on sales, return on assets and return on equity. Respondents were asked to indicate the ratios they used to analyse their businesses (see Table 8): it can be seen that the SMME owners used ratios to a limited extent. The two main ratios used were the current ratio (36%) and return on sales (30%). These low percentages could be attributed to the lack of knowledge among SMME owners about the power of ratio analysis as a tool for assessing and improving business performance.

Table 8. Assessing financial statements using ratio analysis.

	Businesses using ratios as a means of analysis (%)
Current ratio	36
Return on sales	30
Debt-to-equity	14
Inventory turnover	13
Quick ratio	11
Return on equity	7

Discussion

It is widely accepted that a lack of proper financial management contributes to business failure, irrespective of whether it results from Jack of access to financial resources or lack of expertise. Two issues emerge from Table 2: (i) approximately 54% of the owners were responsible for financial matters, and (ii) 56% of the owners who were responsible for financial matters had attended some form of financial management training. Berry *et al* (2002) refer to relevance and competence as drivers of implementing and managing financial matters in a business. Some owners are often so engaged in trying to generate money through sales that they do not always understand the relevance (and importance) of financial matters; others might ignore financial management practices because they lack financial competence. Whilst 58% of the SMME owners surveyed had a post-Grade 12 qualification and could thus be regarded as educated, education in financial management seemed to be lacking. Educating SMME owners in small business financial management could improve financial management practices and thus contribute to business success. The importance of financial practices, the efficiency of generating accounting information and the efficiency of reporting and analysis all received high ratings in our survey, which correlates well with the findings of Abanis *et at* (2013).

As financial practices increase in complexity, the use of external expertise becomes more prevalent. In our study, about half of the owners were involved in reporting accounting information, fewer than half recorded business transactions and about a quarter prepared and interpreted accounting reports and these low proportions could be ascribed to a lack of financial management competence. More importantly, by relying on external individuals or companies for interpretation and analysis, owners may lose flexibility in decision making.

From this study, it is evident that SMMEs use ratios to a limited extent, with current ratios and return on sales as the two most commonly used. Initially, 13 ratios were included in the questionnaire, but only six were used by respondents (and those six to a limited extent

only). This limited use is a cause for concern, because the monitoring of financial ratios can provide an early warning of liquidity and profitability problems.

The results of the study are surprising, given the high-level educational background of the owners. SMME owners seem to lack knowledge and application of financial management practices, even though a high percentage indicated that they had attended financial management training. We can speculate that perhaps the particular training they had undertaken was not effective, or that the SMME owners had perhaps not applied the knowledge gained from the training to their businesses. It is the case that many higher educational institutions in South Africa focus on financial management in large corporations rather than in small businesses: very few institutions include financial management topics focusing on SMMEs.

We would argue that higher education institutions with faculties offering courses in economic and management sciences should place more emphasis on the application of financial management topics to SMMEs. Research by Wolmarans (1999) indicated a financial management education gap between academics and practitioners in large businesses in South Africa: this may also be the case with SMMEs. More consultations are needed between higher education institutions and business owners on action needed to close this gap, so that SMMEs can adopt the financial management practices that are most appropriate for the operation of their business.

Conclusions

In this study we examined the financial management practices of SMMEs, the perceived importance of the accounting information system and the use of financial analysis and reporting.

Most of the SMME owners had a post-Grade 12 qualification and most had been exposed to some financial management training but lacked the expertise or willingness to apply it to their business. With regard to financial planning, 80% of owners felt that this was very important. More than half the SMMEs used external accountants to prepare accounting reports and more than 60% relied on external accountants to interpret and use accounting information. This suggests that a high percentage of the owners lacked the ability to analyse and interpret financial statements, although 80% recognized the importance of accounting information in making decisions; and 64% used analyses of financial statements produced by external accountants when making their business decisions. Financial ratio analysis was used to a limited extent only by the SMMEs.

Recommendations

Based on our findings, we offer the following recommendations .

- (I) Courses offered by business support organizations should be developed and tailored to suit the needs of SMME owners in specific sectors.

- (II) There should be presentations or workshops on financial management organized by the Chambers of Commerce and SETAs (Sector Education and Training Authorities).
- (III) Higher education institutions offering entrepreneurship or business-related modules should place more emphasis on financial management topics targeted at SMMEs rather than large businesses.
- (IV) (4) For those higher education institutions offering financial management courses, the following topics in particular should receive more attention: the role of finance in the business; the income statement and balance sheet; cash budgets ; operating budgets; and understanding a d interpretation of financial statements.

Limitations and future research

This study is based on a small sample of 59 cases and was limited to the City of Cape Town in the Province of the Western Cape. It is an exploratory study, setting the stage for further rigorous research in the field, especially in South Africa where there is a scarcity of research on financial management. We suggest that future studies should include (i) more cases and (ii) other less researched practices, such as working capital budgeting , management accounting and financial analysis. This would then enable results to be generalized, to provide a better and more detailed picture of which practices are followed by SMMEs.

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