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Effect of Financial Management Practices on Financial Performance of Small and Medium Enterprises in Pudhucherry, India

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ABSTRACT

Financial management is an important element of the management of any business. This study was therefore,designed to establish the effect of financial management practices on financial performance of small and medium enterprises in pudhucherry, India. Three variables namely (i)Working Capital Management,(ii) Investment decisions and (iii)financing decisions [independent variables] were used to measure financial performance [dependent variable]. The study used descriptive research design utilizing qualitative data captured using a self-administered questionnaire. The study showed that considered individually, there is a positive relationship between working capital management; investment decisions; financial decisions and financial performance. The study showed that the combined effect of financial management practices [working capital management, investment decision and financial decision] have a moderate positive relationship between financial management practices and financial performance. The study recommends that to enhance financial performance, the organizations [SMEs] should adopt credit policies to guide credit sales. The policies should create a balance between customer retention and adequate the cash flow. Secondly the study recommends that the government should ensure creation of favourable policy and economic environment through legislation that facilitate access to affordable sources of funding for SMEs and attract venture capitalist. Third, developing appropriate strategies and policies that enhance financial decisions will be critical for the SMEs in enhancing their financial performance. Fourth, a study that covers other parts of the country with unique business environments would be welcome.

Keywords: Financial Management practices, Financial Performance, (SMEs).

INTRODUCTION:

Background to the Study:

Financial management is an important element of the management of any business. It is a key part of the management function focusing on the management of a business' assets. In the long term, the type of assets owned by a business charts out the direction of that business during the life of these assets. A business might not see its long term if it cannot carefully plan and lay out a policy to effectively manage its finances. As a result, ineffective financial management altogether is the main cause of the underlying problems facing Small and Medium Enterprises (SME) financial management (Jindrichovska, 2003).
Many, if not all of those who start a business do not engage themselves in financial matters. This is because they do not have enough knowledge about recording transactions, preparation and analysis of financial statements. Sometimes they get deeply engrossed in other aspects of business like managing people, sales purchasing and production to have any interest in carefully managing finances. Such entrepreneurs end up relying on their accountants to run the financial side of their business. Otherwise, they decide to do the management themselves making the business vulnerable to collapse (Atic, 2010).

Financial Management is about planning, organizing, directing and controlling the financial activities in a firm. Such activities involve the procurement and utilization of funds of the enterprise. Financial management refers to the application of general management principles to financial resources of the enterprise (Weston and Brigham, 1996).

According to (Gitman, 2000), other than application of management principles to financial resources, financial management deals with financing decisions and investment decisions. Financing decisions relate to whether a firm needs financing and how the financing will be done. Financial management is about identifying various sources of finance and how much needs to be raised from each of the sources. The sourcing will depend on the type of source, period of financing, cost of financing and the expected returns. Investment decisions are also called capital budgeting and include investment in fixed assets. Investment in current assets is also a part of investment decisions called as working capital decisions. The finance manager of any firm has the responsibility of carefully selecting the best investment alternatives in order to achieve reasonable and stable returns. The finance manager has to concentrate on safety, liquidity and profitability while investing capital. This is also to be done with the aim of wealth maximization (Singh, 2007).

In Europe, despite the sometimes challenging economic conditions, SMEs have retained their position as the backbone of the European economy. By 2012, there were some 20.7 million SMEs accounting for more than 98 per cent of all enterprises. 92.2 per cent of the SMEs were the small ones with less than ten employees. These SMEs accounted for 67 per cent of total employment (Wymenga et al., 2012).

In the East Asian region there is the dominance of the SMEs sector all the region's economies. Despite the different levels of development in the countries, the broad challenges faced by these East Asian SMEs are similar. Other than financial management challenges, the SMEs face other challenges like globalization, technological innovation, demographic and social change, as well as limited financial support (Chia, Fu and Lee, 2007).

According to Ong'olo and Odhiambo (2013) SMEs have the capacity to spur rapid economic growth and create employment opportunities in Kenya. It is estimated that SMEs create about 85 percent of Kenya's employment. However, the sector contributes only about 20 percent of the total Gross Domestic Product. This means the SME subsector is recording dismal performance. For the sector to realize higher success levels, there has to be effective financial management or else the dismal performance and the frequent collapse of SMEs will persist. SMEs in Kenya operate in all sectors of the economy, that is, manufacturing, trade and service subsectors. The SMEs range from those unregistered, known as Jua Kali enterprises, to those formally registered small-scale businesses, such as supermarkets, wholesale shops and transport companies. The capital invested in SMEs varies from as little as ten thousand Kenyan shillings to about 5 million Kenyan shillings. Almost two-thirds of all SMEs in Kenya are located in the rural areas with only one-third found in the urban areas (Central Bureau of Statistics, 2009).

STATEMENT OF THE PROBLEM:

The Small and Medium Enterprises (SMEs) play an important role in the Indian Economy. This sub-sector contributed over 50 percent of new jobs created in the year 2005 (The Economic Survey, 2006) and contributes about 20% of GDP. Despite their significance, past statistics indicate that three out of five SMEs fail within the first few years of operation (Kenya National Bureau of Statistics, 2007). According to Ong'olo and Odhiambo (2013) the subsector is still performing dismally. Because of their small size, simple management mistakes lead to the collapse of SMEs. Lack of proper financial management is one of the issues that easily lead to the collapse of SMEs despite improved access to financing (Longenecker, et al., 2006).

If interventions regarding how these SMEs conduct financial management is not addressed, their collapse will not only threaten job creation and entrepreneurship, but will impede economic growth and development. This research sought to find out how the SMEs conduct their financial management and how the practices affect their financial performance. This enabled provision of recommendations on remedial measures. To achieve this, the researcher conducted a survey focusing on SMEs located in Pudhucherry in India County.

PURPOSE OF THE STUDY:

To establish the effect of financial management practices on financial performance of small and medium enterprises in Pudhucherry in India.

OBJECTIVES OF THE STUDY:

The following were the objectives of this research regarding Small and Medium Enterprises in Pudhucherry in India.

i. To assess the effect of working capital management on the financial performance of Small and Medium Enterprises in Pudhucherry.
ii. To find out how investment decisions contributes to financial performance of Small and Medium Enterprises in Pudhucherry.
iii. To examine the effect of financing decisions on the financial performance of Small and Medium Enterprises in Pudhucherry.

Research Questions:
The following are the research questions this study sought to answer.

i. What is the effect of working capital management on the financial performance of Small and Medium Enterprises in Pudhucherry in India?
ii. What is the contribution of investment decisions towards the financial performance of Small and Medium Enterprises in Pudhucherry in India?
iii. How does financing decisions affect the financial performance of Small and Medium Enterprises in Pudhucherry in India?

Significance of the Study:
This research is significant to the owners of SMEs in Pudhucherry, policy makers in the government of India and financial management researchers. The owners of SMEs in Pudhucherry and elsewhere will get information concerning how best to finances in their businesses to improve the financial performance of their businesses. This is an input that can be used to come up with methods of improving the financial efficiency and profitability of the SMEs. Policy makers will use the information obtained from this research for their policy formulation concerning financial management of SMEs. The research highlighted the relationship between the financial management and financial performance of SMEs. This relationship indicated the importance of financial management as a contributor to financial performance of SMEs. Research concerning the contribution of financial management on financial performance of SMEs in Pudhucherry is rare, if available at all. This research provides a scholarly contribution to the effect of financial management in SMEs with focus on Pudhucherry in India. Future researchers will, therefore, use the findings of this study to further arguments and future research projects that will find this research relevant.

Scope of the Study:
First this research did not cover all the SMEs in India in their varied nature. It only focused on SMEs in Pudhucherry in India. The study limited itself to finding out the effects of working capital management, investment and financing on financial performance of the SMEs in Pudhucherry.

Limitations of the Study:
This research was expected to have several limitations. Being a survey, the findings would be as true as the time when the data was collected. Therefore, findings may not be applicable to later times. Secondly, the data required for the research was qualitative indicating the possible influence of opinions and attitudes of the respondents. Focusing on SMEs in Pudhucherry only, the findings may not be applicable to the whole country. To address limitations the study had three approaches. First, the sampling was as much as possible to replicate the distribution of SMEs in Pudhucherry according to the industries they serve and the sizes. Secondly, to address the issue of opinions, the researcher only focused on the owners of the SMEs which are likely to give the most accurate information concerning their businesses. Finally, the construction of the questionnaire was such that it was not only simplified, but there was reduced variation of the responses from the respondents by applying closed ended questions.

Assumptions of the Study:
This research assumed that financial management practices significantly contribute to the financial performance of SMEs in Pudhucherry. It also assumed that the owners of SMEs have strategies they use to manage finances in their businesses. Further, the researcher assumed that the owners of the SMEs in Pudhucherry would be willing to provide the information required for this study and that the information they provided would be accurate.

LITERATURE REVIEW:

Financial management in SMEs can be explained using various theories. Further, research findings on how various aspects of financial management affect a firm's financial performance vary. This chapter discusses three theories on financial management and reviews literature on how working capital management, investment decisions and financing decisions affect the financial performance of a firm. The chapter also identifies the research gap.

The main focus of WCM is steering the firm through challenges such as disconnected supply chains processes, excessive stocks caused by non-bridged interfaces, inadequate trade credit terms, and suboptimal loan decisions. While inadequate trade credit terms and suboptimal loan decisions originate from the financial area, connecting supply chain activities and reducing stock and inventory belong to the operating area. Organizations tend to try as much as possible to have less capital tied up in non-productive stocks, try to shorten the collection period for account receivables, and stretch cash payments for accounts payable as far as possible (Hofman, 2010).

Effective WCM is, therefore, a key role in maintaining the financial health of a firm. Management of Short-term finance is an essential part of working capital management. This is because Working capital is the only investment a company makes without expecting a defined return. If a firm over-invests in working capital it is likely to run into cash flow problems and may collapse (Hofman, 2010).

Financing decisions is about deciding on the capital structure of a firm. The owner of a firm has to decide when, where and how to acquire funds to meet investment needs. The key issue is determining the proportion of equity and debt. The mix of debt and equity is known as the firm’s capital structure. The financial manager must obtain the best financing mix for the firm, that is, the mix where the market value of the firm is maximized. Once the financial manager has determined the best combination of debt and equity, the appropriate amounts should be raised through the best available sources (Baker and Martin, 2011).

Financial performance is the act of performing a financial activity. It refers to the degree to which financial objectives of an organization are being or have been met. Financial performance is also used to measure a firm's overall financial health over a given period of time. Financial performance is done with the help of financial analysis of a firm (Horngren, et. all. 2011).

The dimension of the mode of operation involves horizontal or vertical analysis. Horizontal analysis involves analyzing and reviewing financial statements for a number of years. Current figures are compared with those of a base year. In the vertical analysis quantitative relationship of the various items of financial statements on a particular date form the basis of analysis are used to compare with other organizations of the same type (Schonbohm, 2013).

A study by Charitou et. al.(2010) investigated the effect of working capital management on firm’s financial performance in an emerging market. The hypothesis of the study was that working capital management leads to improved profitability. They used data of companies listed in the Cyprus Stock Exchange for the period 1998-2007. They used multivariate regression analysis to conduct data analysis. From the analysis they confirmed the hypothesis that working capital management leads to improved profitability. Specifically they found that the cash conversion cycle and all its major components such as days in inventory, day’s sales outstanding and creditors payment period were closely linked to the firms’ profitability.

Kirui(2013) also conducted a study to investigate how working capital management practices effect financial performance of sugarcane out-grower companies in Kenya. The research employed a descriptive approach. From ten sugarcane out-grower companies, a total of 30 managerial staff responded to a standardized semistructured questionnaire. Descriptive statistics and correlation analysis were used to analyze the responses. It was established that most sugarcane out-grower companies more conservative in WCM and this weakened the companies’ financial performance. For instance, the companies’ receivables were concentrated on loans advanced to members and accruing interests. However, trade receivables period was longer than payables period, indicating that the companies did not accelerate receivable periods to secure profitability.

In another study Mwangi et al. (2014) investigated the effect of working capital management on the performance of non-financial companies listed in the Nairobi Securities Exchange (NSE) in Kenya. This was an exploratory research. It was done on all the 42 listed non-financial companies. Secondary panel data from the annual audited reports and financial statements of the listed non-financial companies for the perio d 2006-2012 were used. The Feasible Generalized Least Square (FGLS) model was used to analyze the data and revealed that an aggressive financing policy had a significant positive effect on return on assets and return on equity. A conservative financing policy also had a significant positive effect on financial performance. The study recommended adoption of either aggressive or conservative financing policy to enhance the performance of the listed non-financial companies.

RESEARCH DESIGN AND METHODOLOGY:

Introduction:

This chapter presents the methods and procedures that was used to carry out this study. Specifically, the chapter spells out the research design, the population studied, the sampling strategy, the data collection process and how data will be analyzed and findings presented.

Research Methodology:

Research Design:

This research was a descriptive study using descriptive research design method. This method is similar to the method used by Burbank (2005) who conducted a survey to investigate the client poverty and participation in Kenyan NGOs' small enterprise programs. Just like in this research Burbank's research also focused on SMEs. A descriptive research design describes or defines a subject, through creating a profile of a group of problems, people, or events, through the collection of data, the tabulation of the frequencies on research variables and the analysis of their interaction, (Cooper and Schindler, 2006).

This research approach was appropriate for this study based on the fact that the researcher intended to collect detailed and current information that would enable identifying and describing the current situation concerning financial management in SME'S in Pudhucherry. The survey enabled a comparative analysis of the variation of financial management from one small enterprise to another.

Location of the Study:

The research was done on SMEs located in Pudhucherry of India Country. Pudhucherry is the commercial and administrative capital of Pudhucherry Union Territory.

Figure 1: Map of Pudhucherry

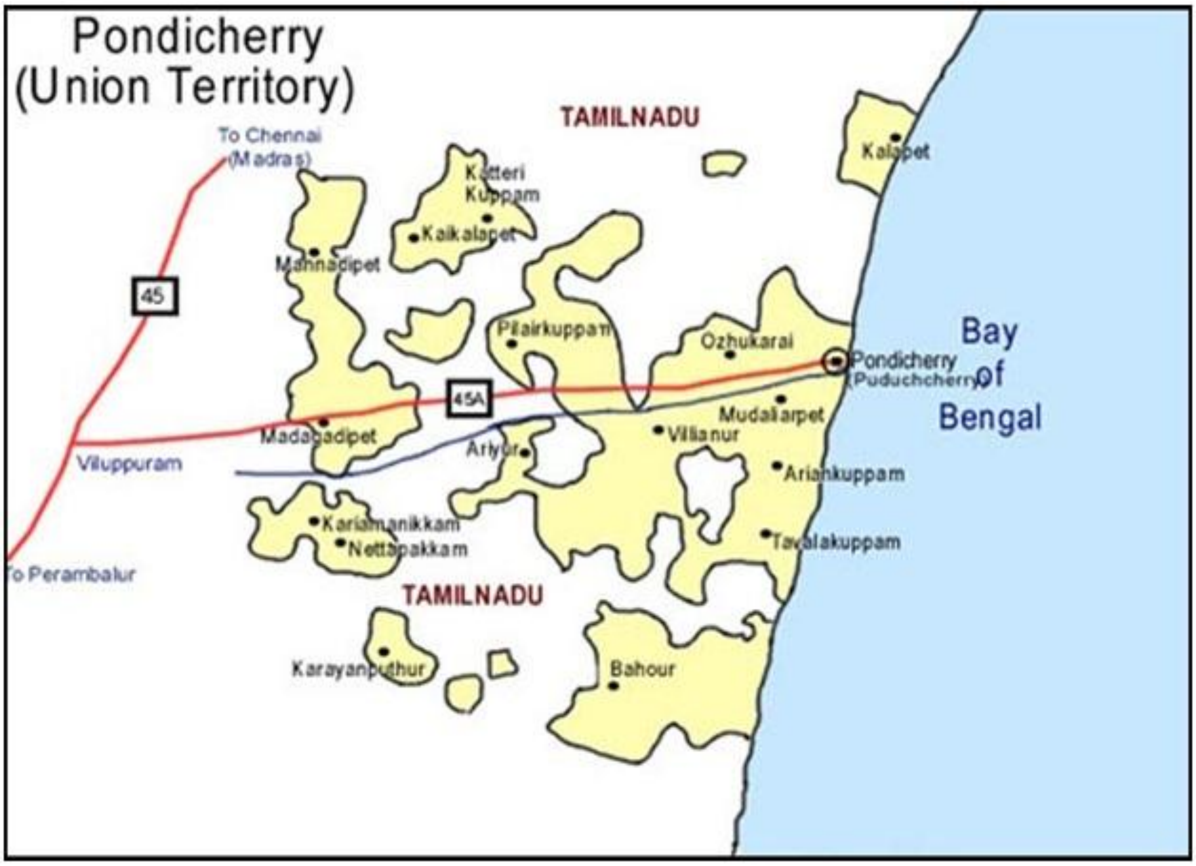
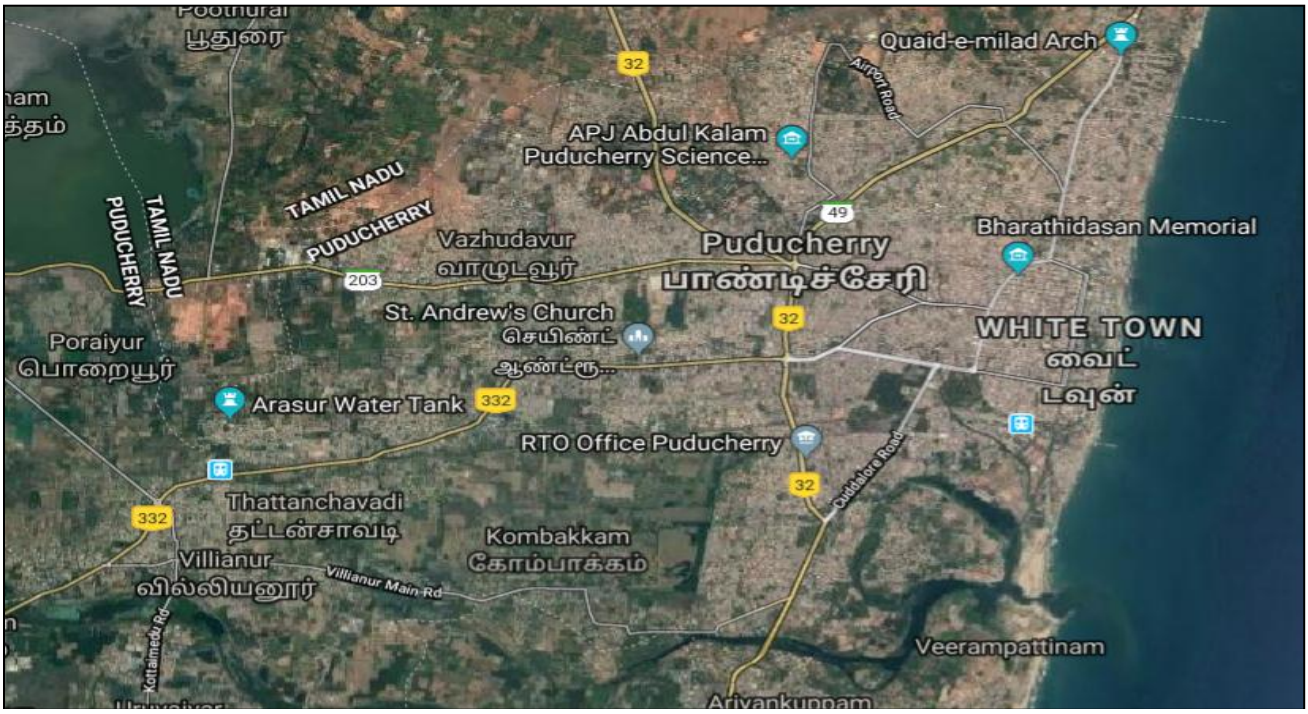


Figure 2: Google Map of Pudhucherry



Puducherry district, formerly Pondicherry district is one of the four districts of the union territory of Puducherry in southern India. The district occupies an area of 290 square kilometres, spread over 11 non-contiguous enclaves lying on or near the Bay of Bengal within a compact area in the state of Tamil Nadu.

Target Population:

Target population in statistics is the specific population about which information is desired. According to Ngechu (2004), a population is a well-defined or set of people, services, elements, and events, group of things or households that are being investigated. This definition ensures that the population of interest is homogeneous and by population the researcher means the complete census of the sampling frames. Population studies also called census are more representative because everyone has an equal chance to be included in the final sample that is drawn according to Mugenda and Mugenda (2003). The target population of this study comprised of 2,307 registered SMEs operating in Pudhucherry. The unit of analysis for this study is an individual organization.

Samples Technique and Sample Size:

According to The Central Limit Theorem any random sample size greater than 30 is approximately normally distributed irrespective of the population size and can be an accurate representative of the population. The theorem, therefore, allows a researcher to select any sample greater than 30. The study used a sample of 100 SMEs located within Pudhucherry selected by simple random sampling. The manager or owners of each SME responded to the questionnaire.

Research Instrument:

A self-administered questionnaire was used to collect data from the owners or managers of the identified SMEs in Pudhucherry. The questionnaire used mainly the closed ended questions with few open ended questions. The questionnaire was divided into five sections. Section A captures the demographic information about the respondent. Section B captures information concerning working capital management. Section C focuses on investment decisions while Section D focuses on financing decisions. Section E captures information on financial performance.

Data collection:

Data from identified SMEs was collected by means of the self-administered questionnaire. The researcher delivered the questionnaire in person to the respondents and provided guidelines on the way to complete the questionnaire and picked the questionnaire after they had been filled on the spot. The questionnaires were completed by way of filling in blank spaces or ticking from a set of options in a five point Likert scale.

Data Analysis:

Collected data was first coded, sorted and organized for analysis. Summary statistics like the frequencies, percentages and means were used to analyze the data. Graphical presentations in form of pie charts, bar graphs, and tables were used to describe the nature of the distribution of the data obtained from respondents. To analyze the relationship between working capital management, investment decisions, financing decisions and financial performance a regression analysis and analysis of variance was conducted. The regression method was used since there are data collected by use of the Likert Scales concerning the dependent variable and independent variables in this research. The regression model took the following form.

To test the statistical significance of each of the regression variables and the the T-tests at 95 %
confidence level was used. The F-Test at 95 % was used to test the statistical significance of the whole regression. The F-test was used to test the significance of the effect of each variable on financial performance. The coefficient of determination and the adjusted was used to determine the strength at which the variation in the independent variables explains the variation in the dependent variable.

Logistical and Ethical Considerations:

The capture of information required was done using legally accepted ways. No respondent was coerced into giving out information either by force or by reward. The researcher first sort the permission to conduct the research the targeted SME. The respondents were assured of confidentiality and anonymity and that the information obtained was used specifically for research purposes and was not used in any manner detrimental to the well-being of the respondents.

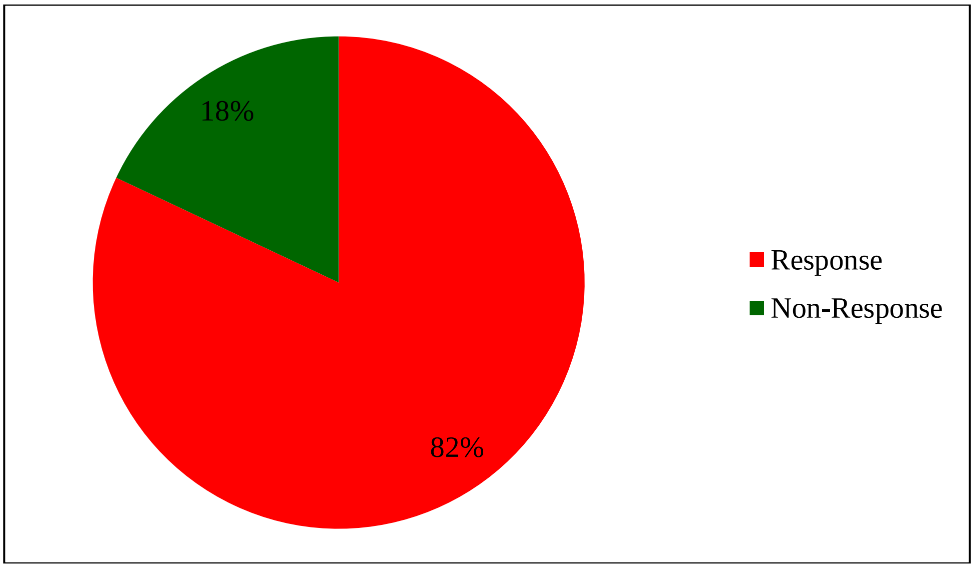
FINDINGS AND DISCUSSIONS:

Demographic Characteristics:

Response Rate:

The sample size for the study was 100 SMEs located within Pudhucherry. Figure 3 indicates 82% response rate.

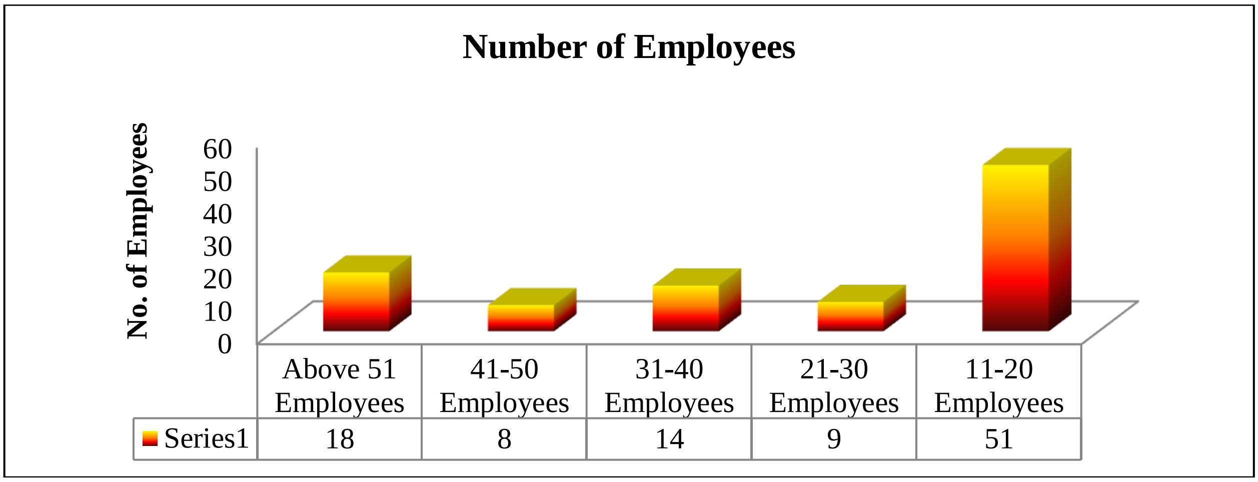
Figure 3 : Response Rate of SMEs



Number of Employees:

The study recorded 12 as the least number of employees and 98 as the highest number employed by the SMEs studied. Figure 4 illustrates that majority of the businesses at 51% employed between 11 and 20; 18% employed above 51; 14% employed between 31 and 40; 9% employed between 21 and 30; while 8% employed between 41 and 50 employees.

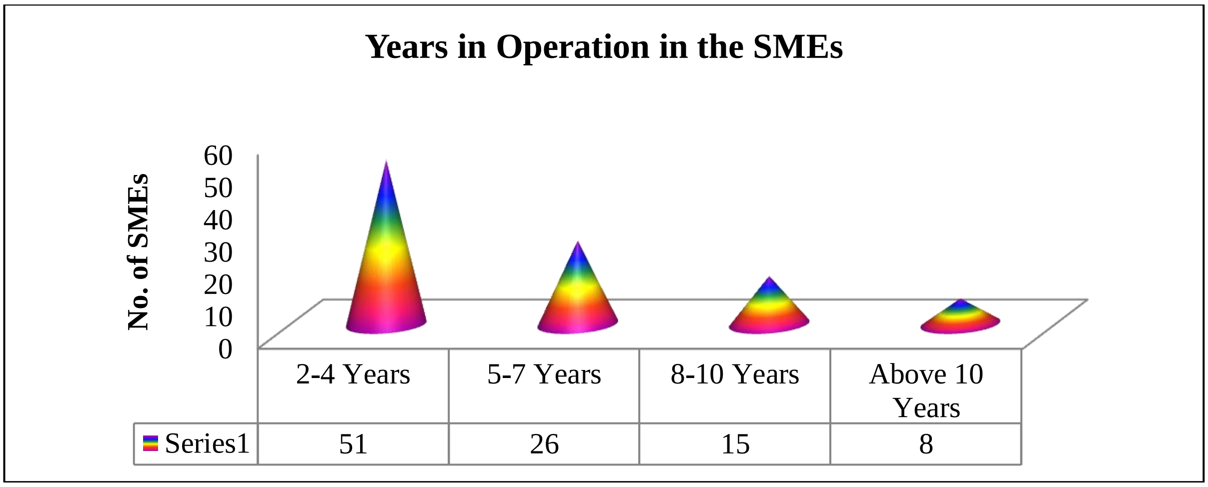
Figure 4: No. of Employees in the SMEs



Years in Operation:

Figure 5 illustrates that majority of the businesses at 47% had been in operation for 2 to 4 years; 39% for 6 to 10 years; and 14% for more than 10 years.

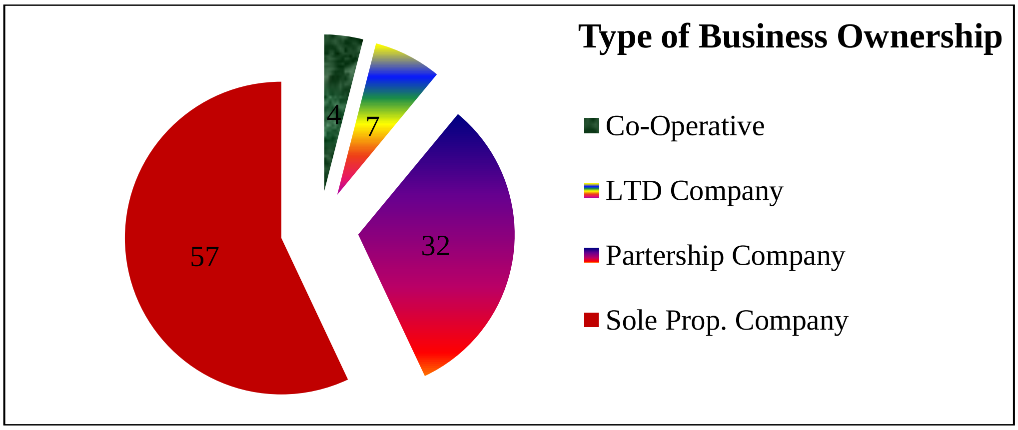
Figure 5: Years of Operation in the SMEs



Type of Business Ownership:

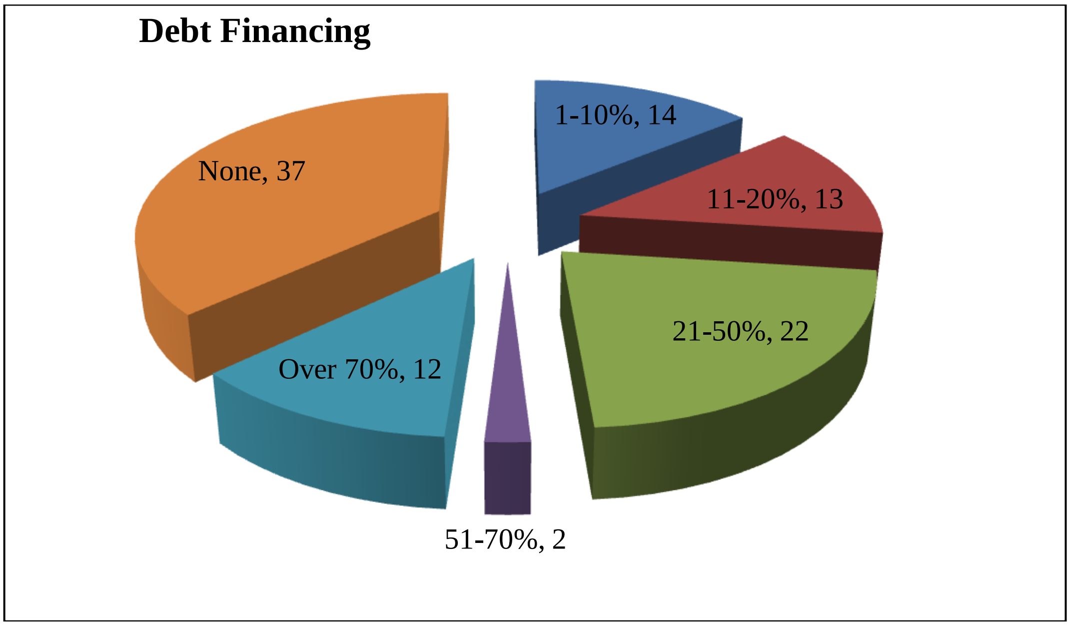
Figure 6 indicates that majority [57%] of the businesses were registered as sole proprietorship; 7% as limited companies; 32% as partnership; 4% were cooperatives.

Figure 6: Type of Business Ownership



Debt Financing:
Majority at Thirty seven percent indicated that they run their businesses entirely on internal funds [i.e. no debt financing]; 20% had between 21% and 50% level of debt financing; 12% had between 11% and 20% level of debt financing; 14% had between 1 and 10% debt financing; 12% had over 70% debt financing while 2% had between 51% and 70% debt financing as indicated in Figure 7.

Figure 7: Debt Financing

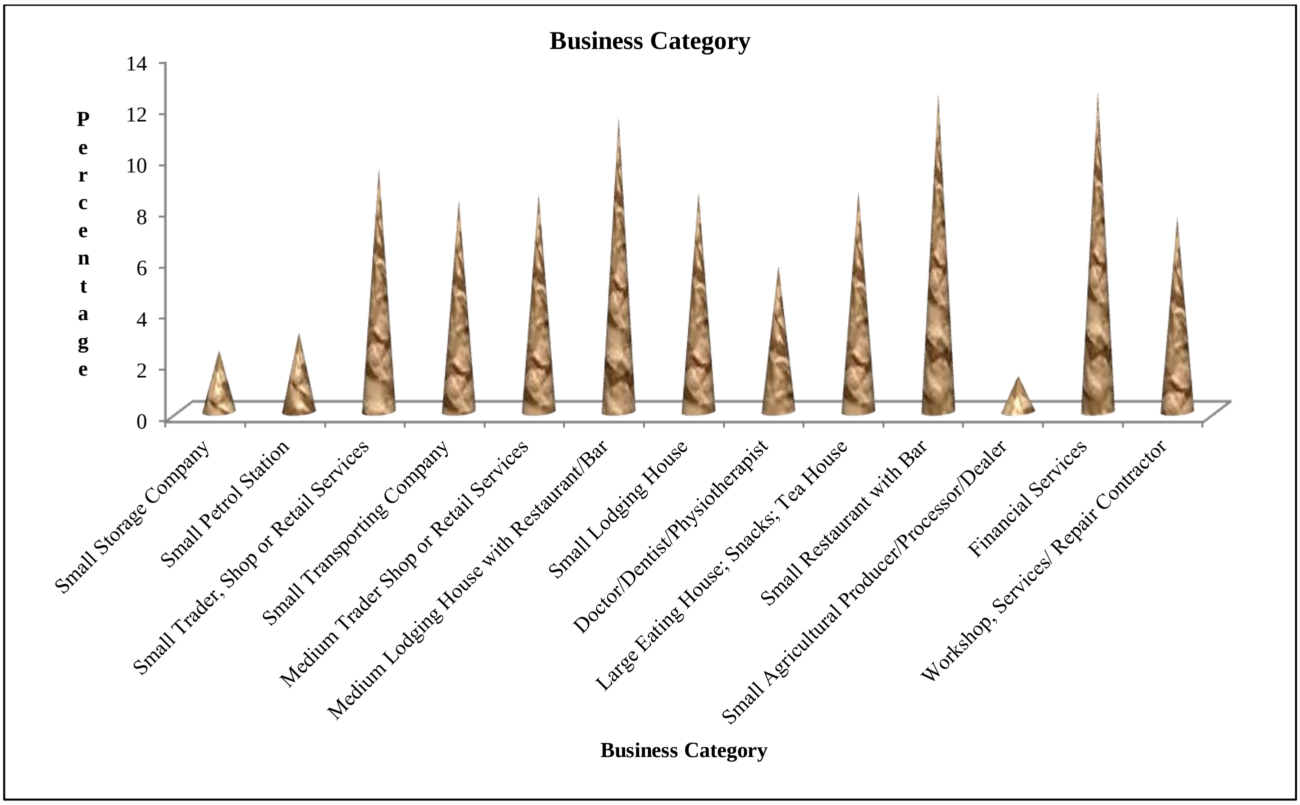


Business Category:
Table 1 indicates that 21 business categories were represented in the study with small restaurants with bars being the majority with 14% representation followed by Small transporting companies at 10%. The rest had between 1% and 9% representation.

Table 1: Business Category

S.No	Business Category	%
1.	Small Storage Company	2.4
2.	Small Petrol Station	3.1
3.	Small Trader, Shop or Retail Services	9.49
4.	Small Transporting Company	8.25
5.	Medium Trader Shop or Retail Services	8.5
6.	Medium Lodging House with Restaurant/Bar	11.5
7.	Small Lodging House	8.56
8.	Doctor/Dentist/Physiotherapist	5.7
9.	Large Eating House; Snacks; Tea House	8.6
10.	Small Restaurant with Bar	12.4
11.	Small Agricultural Producer/Processor/Dealer	1.4
12.	Financial Services	12.5
13.	Workshop, Services/ Repair Contractor	7.6
	Total	**100.00**

Figure 8: Business Category



SUMMARY OF FINDINGS:

The purpose of the study was to establish the effect of financial management practices on financial performance of small and medium enterprises in Pudhucherry. The study had three research questions. What is the effect of working capital management on the financial performance of Small and Medium Enterprises in Pudhucherry? What is the contribution of investment decisions towards the financial performance of Small and Medium Enterprises in Pudhucherry? How does financing decisions affect the financial performance of Small and Medium Enterprises in Pudhucherry?

The study was descriptive in nature. The scope of the study was limited to SMEs located in Pudhucherry. The target population of this study comprised of 2,307 registered SMEs operating in Pudhucherry. The unit of analysis for this study was individual organizations. The study used random sampling method to sample 100 SMEs located within the study area. A structured questionnaire was used to collect data from the owners or managers of the identified SMEs. Data analysis involved descriptive statistics [frequencies, percentages and means] and inferential statistics [regression analysis and analysis of variance]. The findings were presented in tables and figures. First, the study showed a weak but a positive relationship between working capital management and financial performance. This means that financial performance can be predicted by working capital management system adopted by the SME. Zero point five percent variance in financial performance was attributed to capital management alone. That is, an effective working capital management leads to an enhanced financial performance of the SME. Secondly, the study showed a weak positive relationship between investment decisions and financial performance. This means that financial performance can be predicted by investment decisions adopted the SME. Zero point two percent of variance on financial performance was attributed to investment decisions alone. That is, an effective investment decision leads to enhanced financial performance of the SME.

Thirdly, the study showed a moderate positive relationship between financial decisions and financial performance. The study indicated that considered individually, financial decisions contributed 16% variance in financial performance. This means that financial performance can be predicted by financial decisions adopted the SME. That is, an effective financial decision leads to enhanced financial performance of the SME. Finally, the study showed that the combined effect of financial management practices [working capital management, investment decision, financial decision] have a moderate positive relationship between financial management practices and financial performance. The study indicated that considered collectively, financial management practices contributes to 18.3% variance in financial performance. The other 81.7 % variance in financial performance would be attributed to other factors beyond the scope of the study.

CONCLUSIONS:

Relationship between Working Capital Management and Financial Performance:

The study showed that good working capital practices such as effective management of cash conversion cycle and all its major components such as days in inventory, day's sales outstanding and creditors payment period are closely linked to the firms' financial performance. That is, an effective working capital management leads to an enhanced financial performance of the SME.

Relationship between Investment Decision and Financial Performance:

This study showed that the investment decisions which inform the firm's asset portfolio used to generate the cash flows determines the firms' profitability, value, viability and overall financial performance. Hence, when a firm makes the right financial decisions, the prospects of enhanced financial performance is improved. That is, an effective investment decision leads to enhanced financial performance of the SME.

Relationship between Financial Decision and Financial Performance:

The study showed that majority agreed that the SMEs use internally generated cash sources and borrowed funds through bank loans. This means that the owners of these organizations have established the need to balance when, where, how much and how to acquire funds to meet their investment needs. They balance equity and debt proportions to maximize the value of the firm. That is, an effective investment decision leads to enhanced financial performance of the SME.

Relationship between Financial Management Practices and Financial Performance:

The study showed that financial management practices contributes to 18.3% variance in financial performance. Financial decision has the most positive significant influence on financial performance [a unit increase in financial decision will lead to a 0.519 increase in financial performance]. This was followed by working capital decisions [a unit increase in working capital decision will lead to a 0.140 increase in financial performance] and investment decisions [a unit increase in investment decision will lead to a 0.084 increase in financial performance].

RECOMMENDATIONS:

Recommendations for Improvement:

The study has shown a positive relationship between working capital management and financial performance. Further, it has shown that the SMEs have working capital management systems in place yet they do not have credit policies in place. This is a gap. Therefore to further enhance performance the credit policies should be crafted in these organizations to guide credit sales and enhance performance as credit improves on sales turnover. The policies will also be instrumental in guiding how much credit should be advanced at any given time without jeopardizing the cash flow.

Investment Decision:

The finding indicates a challenge with access to equity and credit facilities for the SMEs to aggressively invest. Thus aggressive investment decisions are slowed down by the fact that the SMEs lack cash for investment in long term projects; lack resources to invest in non-current assets; lack capacity to utilize fully the non-current assets; lack financial capacity to invest in real estate and stock market. They also lack financial capacity to effectively train their management on investment decision making. To address this, the government should ensure creation of favourable policy and economic environment through legislation that facilitate access to affordable sources of funding for SMEs and attract venture capitalists.

Financial Decision:

Among the three financial management practices studied, financial decisions appeared to be the most significant predictor of financial performance. Therefore developing appropriate strategies and policies that enhance this output will be critical for the SMEs in enhancing their financial performance.

Recommendations for Further Studies:

The scope of the study was only limited to Pudhucherry. Considering the fact that Pudhucherry sourrounded by

Tamilnadu state, Tamilnadu and they can comparatively easily access resources and facilities such as financial service compared to areas far flung from the city, generalizing the findings to other areas such as the whole frontiers may not be wholly accurate. A study that covers other areas of the country with unique characteristics would be welcome. Further the study was limited to only three variables of financial management practices. Broadening the study scope to cover other variables such as activity analysis would be welcome to offer more empirical evidence on the factors that affect financial performance of the SMEs.

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