Identification of strengths and barriers among Pakistani SMEs: A financial management viewpoint

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ABSTRACT

In Pakistan, Small and Medium Enterprises (SMEs) are considered as key indicators of the status of the national economy through contributing 90% in total businesses establishments and 80% employments in the non-agriculture sector. Pakistani government with the assistance of Small and Medium Enterprise Development Authority (SMEDA) and other associated organizations are undertaking multiple activities to boost awareness and importance of adopting prudent financial management practices by SMEs. This research endeavor aimed at exploring the strengths and barriers faced by SMEs in planning and undertaking sound financial management practices. Keeping in view the exploratory nature of this research, based on qualitative research paradigm, semi-structured interviews were conducted with managers/owners of thirty SMEs. The study findings demonstrated that the component of capital found to act as strength and barrier among SMEs. On one side, the absence of external capital (loan) appeared beneficial for SMEs due to minimizing financial risk for the business and offering more freedom to managers in their decision making without having any fear regarding any restrictions imposed by external finance. However, on the other side, lack of financial resources due to having difficulty in acquiring external capital (loan) might restrict SMEs capability to undertake viable business opportunities. This study highlights the crucial role of adopting appropriate financial management practices in developing a sound capital structure for SMEs. This study finding could provide useful insight to SMEs pertinent to dealing with multiple business challenges and acquiring sustainable profitability.

Keywords: SMEs, Pakistan, Financial Management, Capital, National Economy

1. INTRODUCTION

The contribution of Small and Medium Enterprises (SMEs) are getting prominence in measuring the progress of any country (Veskaisri, Chan, & Pollard, 2007). In developing countries like Pakistan, Small and Medium Enterprises (SMEs) could be conceptualized as a core component of national economy due to their notable share across multiple dimensions. Overall, the SME sector has great potential to offer a wide

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range of employment opportunities to the skilled and semi-skilled labor force and particularly, the potential and development of SMEs could offer a foundation to the progress of large scale businesses as well (Madrid-Guijarro, Garcia, & Van Auken, 2009). Notably, the extant literature documents a number of studies covering different management issues of SMEs in general (Van Dyck, Frese, Baer, & Sonnentag, 2005), (Salikin, Ab Wahab, & Muhammad, 2014), (Garengo, Biazzo, & Bititci, 2005), (Kamalian, Rashki, & Arbabi, 2011), however, less emphasis has been given to identification of key financial management issues faced by SMEs in developing countries (Al-Hyari, 2013). In a current scenario, Pakistan has been referred as an emerging economy that is expected to progress well in future (Shahbaz, Javed, Dar, & Sattar, 2014). This necessitates that SMEs should work as a springboard to support large scale businesses to gain the momentum of progress in all sectors. No doubt, this calls for adequate attention by SMEs to sort out their management and operational issues in a best possible manner (Khattak et al., 2011).

Although, SMEs are considered as the backbone of the national economy of Pakistan, however, SMEs have been facing multiple challenges at national and international level (Khalique, Isa, Shaari, & Abdul, 2011). This situation restricts the sustainable development of SME sector in parallel with other sectors of the economy. It is pertinent to mention that the long term success of SMEs has always been linked with sustainable profitability and that could be achieved through sound financial management (Okpara and Kabongo, 2009). Primarily, financial management is concerned with the optimal use of the financial resource to generate a maximum return and in the case of SMEs, the acquisition and utilization of the limited financial resource are the key challenges faced by managers. A number of studies conducted across different countries have highlighted financial concerns as major problems faced by SMEs (N. R. Khan, Awang, & Zulkifli, 2013) and (Kamalian et al., 2011). The extant literature in this regard is mostly descriptive in nature and just focused on ranking or ordering of potential strengths and problems of SMEs. Since, various issues have been debated in relation to the adoption of sound financial management practices by SMEs; consequently, it necessitates in-depth research to ascertain the financial management issues of SMEs. Keeping in view this

perspective, this research aims to address research question pertinent to exploring the main strengths and barriers faced by SMEs concerning the adoption of financial management practices in the Pakistani context. In this regard, after offering brief background information, this paper throws light on the underlying notion of SMEs in respect of financial management aspects. The next section elaborates research methodology used, followed by study findings with a key focus on financial strengths and financial barriers. The last section concludes this study with future research direction.

The Notion of SMEs in Pakistan

Basically, there is no universally accepted definition that could be used to elaborate the basic notion of SMEs. Across different countries, SMEs have been defined in multiple ways, drawn from demographic and business related attributes, such as a number of employees, location, size, age, ownership structure, sales volume, the scale of innovation and technology (Zeinalnezhad, Mukhtar, & Sahran, 2011). Drawn from the strength of employees and scale of sales volume, Pakistan applies to a large extent the similar definition, as being also adopted by Malaysia, China, Korea, Japan, United Kingdom, and United States of America (Norailis, 2013).

The Small and Medium Enterprise Development Authority (SMEDA), an apex body that is responsible for the development and progress of SMEs sector in Pakistan differentiate between small and medium enterprises on the basis of a number of employees and size of productive assets (excluding land and building). According to this conceptualization, an entity is defined as a small business having 10-35 employees and productive assets of worth Rs. 2-20 million (SMEDA, 2017). Whereas, an entity is defined as medium size business having 36 – 99 employees, and productive assets of worth 20-40 million (SMEDA 2017). The role of SMEs in national development and sustainable economic progress of Pakistan is of utmost significance because SMEs are contributing a significant share in the national economy. Primarily, in Pakistan SMEs constitute nearly 90% of all business establishments, offer 80% non-agriculture employment and its contribution to annual GDP is 40% (SMEDA, 2017).

In Pakistan, SMEDA is aimed at offering a variety of services to SMEs. This

refers that lot could be done if appropriate actions are taking timely. Primarily, there is a need for SMEs to identify key areas, where they could improve their performance by polishing their skills and updating their knowledge to remain competitive in the ever-changing business environment (Shahbaz et al., 2014). It is pertinent to mention that many entrepreneurs manage their business activities without undertaking formal training and sometimes due to lack of practical know how they encounter multiple problems and could not continue their business in the long run (Shabaz et al., 2014). One of the common obstacle faced by SMEs is related to improper financial management (Hashim and Wafa, 2002, (M. W. J. Khan & Khalique, 2014).

SMEs and Financial Management:

Financial management is concerned with the acquisition and utilization of financial resources in terms of enhancing the long term profitability of the business enterprise (Saunders & Cornett, 2003). Mainly, decision making is involved in financial management and decisions regarding working capital, capital budgeting, dividend policy and capital structure formulate key aspects of financial management practices. Notably, there is no large difference between financial management of large scale businesses and SMEs, however, SMEs only get engage in decisions concerning working capital, capital budgeting and capital structure, but do not focus on dividend issues due to the absence of shareholders' capital (Agyei-Mensah, 2010).

(Hoe, 2010) based on the thorough literature review of relevant studies pointed out that the financial management is comprised of six basic elements namely, financial accounting, financial analysis, financial planning and control, working capital management, capital budgeting, and management accounting. Notably, the adoption of financial management tools appeared less common among SMEs, because although, SMEs were frequently involved in adopting various practices concerning financial planning and control, working capital management and financial accounting, however, SMEs were found to put less emphasis on key components of financial management namely, financial analysis, capital budgeting and management accounting (Azhar et al., 2010). In this regard, Agyei-Mensah (2010) stressed that funds providers and external

accountant are the prime forces that could compel SMEs to get engaged in sound management practices, but the lack of qualified internal accounting personnel appeared key obstacle among SMEs to maintain a proper financial record and practice financial management in the true sense.

2. Research Methodology

Keeping in view the exploratory nature of this research, the semi-structured interviews were conducted with 30 managers/owners of different SMEs based on convenience sampling approach. The sample of research participants was drawn from different sectors, such as Food and Beverages, Wholesale and Trading, ICT etc. Initially, participants were given a short briefing about the nature and purpose of underlying research and later on their voluntary participation was sought. The whole data collection process took two months period and in order to increase the trustworthiness of data, the semi-structured interviews were audio-recorded with the consent of research participants. Each research participant was ensured of maintaining the anonymity and confidentiality of the responses provided by them. The interview questions were categorized into two main sections. In section A, participants were asked about demographic details and in section B, questions pertinent to strengths and barriers of adopting sound financial management practices in SMEs were asked. The responses received concerning section A were summarized, whereas, the data collated pertinent to section B were analyzed by thematic analysis and participants' responses were categorized under the themes of strengths and obstacles in implementing sound financial management practices in SMEs.

3. Findings and Discussion

The information concerning the demographic details of participated SMEs is summarized in Table 1.

Table 1: Demographic Attributes of the Participating SMEs

Demographic Attributes	Categories	Frequency	Percent
Ownership Structure	Sole proprietorship	20	67
	Partnership	8	27
	Company	2	6
	Total	30	100
	Boutiques and Salons	10	33

Nature of Business	Food and Beverages	6	20
	Wholesale and Trading	3	10
	ICT	5	17
	Professional Services	6	20
	Total	30	100
Age of Business	0-5 years	8	27
	6-10 years	6	20
	11-15 years	9	30
	Above 15 years	7	23
	Total	30	100

As summarized in Table 1, more than one fourth of the participating SMEs having age between 0 to 5 years (27%), followed by 6-10 years (20%), 11-15 years (30%), and above 15 years (23%) respectively. It is pertinent to mention that majority of the research participants' mentioned that they don't have fixed working hours and they are generally involved in multiple tasks simultaneously and most of the time the larger share of their working time is spent on ongoing business activities rather than planning for long term. This reflects that unlike big scale businesses, there is a lack of strategic management approach among SMEs and this deficiency is more apparent in financial management issues due to its technical nature.

During interview conversation, it also became apparent that the educational background of the manager/owner of the SMEs is also critical in developing and boosting their willingness and enthusiasm to seek new knowledge and strategies through interactive activities, such as workshops, training, and seminars. In, Pakistan, SMEDA offers multiple programs to increase SMEs awareness concerning updated management practices. Similarly, National Vocational and Technical Training Commission of Pakistan (NVATTC, 2017) also offers a variety of programs for skill development of new entrants to business and youth in general. One of the key objectives of SMEDA, NVATTC, and other related organizations is to help SMEs to improve their management practices and adoption of sound financial management practices as a key consideration of all these programs.

Financial Strengths of SMEs

The findings drawn from this study are consistent with the prior literature (Al-Hyari, 2013; (Okpara & Kabongo, 2009). Pertinent to exploring the financial strengths of SMEs, the data collated from semi-structured interviews were categorized into different themes as presented in Table 2. Notably, out of 30 research participants, only 9 (30%) participants explicitly mentioned financial strengths of their SMEs, whereas, rest of the participants could not clearly identify financial strengths of their SMEs, because either they don't have any or they were unable to elaborate financial strengths properly because of the lack of relevant knowledge.

Table 2: Study Findings Concerning Financial Strengths of SMEs

Types of Financial Strengths	Elaboration
Personal Capital	<ul style="list-style-type: none"> • Self-finance/ No borrowing
Financial Sustainability	<ul style="list-style-type: none"> • Higher profit ratio • Adequate profit retained in the business
External Financial Support	<ul style="list-style-type: none"> • Financial support provided by Govt. • Financial support provided by NGOs
Record Keeping	<ul style="list-style-type: none"> • Systematic record keeping • Qualified accounting personnel • Proper financial management
Adequate liquidity	<ul style="list-style-type: none"> • No debtors
Financial Control	<ul style="list-style-type: none"> • Self-regulated/personal supervision
Reasonable Pricing	<ul style="list-style-type: none"> • Lower prices than competitors
Others	<ul style="list-style-type: none"> • Effective filing system • Cost/benefit analysis • Proactive management

It is pertinent to mention that majority of the participants identified personal capital and absence of external borrowings as key financial strengths of their SMEs because it exposes them to the minimum risk. However, this position in the long term can't be referred to sound financial management practice, because it could restrict SMEs scope to get engage in viable and profitable business opportunities in future due to lack of required funding. The sound financial management embedded in maintaining a trade-off between risk and return, thus, SMEs by getting external financing from Government and Non-Government Organizations (NGOs) at a reasonable cost might undertake profitable

projects and could enhance their financial strengths. In the similar vein, financial stability in terms of earning adequate profits, acquisition of funds from Government and NGOs, proper record management system, adequate liquidity due to cash basis transactions, financial control due to personal monitoring of financial transaction, and ability to offer discounts to customers were some of the aspects identified as financial strengths of SMEs by research participants. Moreover, participants perceive effective filing system, application of cost/benefit analysis as well as proactive management as indicators of financial strengths of their SMEs.

Financial Obstacles of SMEs

Pertinent to explore the financial obstacles of SMEs, the data collated through semi-structured interviews were categorized into different themes as presented in Table 3. Some of the study findings appeared consistent with the prior literature (Khan et al., 2013, Kamalian et al., 2011). Notably, out of 30 research participants, 15 (50%) participants explicitly mentioned financial obstacles of their SMEs, whereas, rest of the participants discussed various aspects that could also be conceptualized as financial obstacles. The financial obstacles of SMEs emerged from this study data are summarized in Table 3.

Table 3: Study Findings Concerning Financial Obstacles of SMEs

Types of Financial Obstacles	Elaboration
Inadequate Capital	<ul style="list-style-type: none"> • Lack of financial resources
Hurdles in borrowing external funding	<ul style="list-style-type: none"> • Strict requirements
	<ul style="list-style-type: none"> • Competition
	<ul style="list-style-type: none"> • High financial cost
Weak financial performance	<ul style="list-style-type: none"> • Insufficient profit
	<ul style="list-style-type: none"> • Continuous decline in return
Deficiencies in accounting record keeping	<ul style="list-style-type: none"> • Incomplete record keeping
	<ul style="list-style-type: none"> • Manual system
	<ul style="list-style-type: none"> • Less emphasis on financial planning
Insufficient liquidity	<ul style="list-style-type: none"> • Non collectible receivables
	<ul style="list-style-type: none"> • Delayed payment from debtors
High operating cost	<ul style="list-style-type: none"> • High cost of raw materials
	<ul style="list-style-type: none"> • High cost of overhead

Notably, inadequate capital emerged as a major financial obstacle of SMEs as highlighted by the majority of the participants. Participants expressed concern pertinent to facing multiple challenges in acquiring external funding, such as strict criteria for borrowing funds, tough competition, and high financial costs. It could be inferred that due to weak earning potential and high operating costs, SMEs financial position turns low, thus, SMEs face difficulty in terms of meeting required criteria to get a loan. Here, it is pertinent to mention that although government intuitions and some NGOs offer financial support to SMEs at subsidized rates, the amount of such funding is generally very limited. On the other hand, commercial banks and other commercial financial institutions charge very high interest rates and put strict conditions for loan borrowings and thus, SMEs generally did not get such expensive financing. It reflects that SMEs required being well versed with the different types of financing available to them. In this regard, recently Government of Pakistan has signed MoU with State Bank of Pakistan to undertake various initiatives pertinent to offering financial support to SMEs (Economic Survey of Pakistan 2014-15).

Moreover, deficiencies in accounting record keeping in terms of incomplete records, use of manual accounting system instead of the computerized accounting system and less emphasis on financial planning also emerged as financial obstacles faced by SMEs. The negative aspects of credit sale transactions pertinent to none receipt of cash from customers or delayed receipts jeopardize the liquidity of SMEs due to their limited working capital and any incident of non-receipt of any big amount poses a serious threat to the financial position of SMEs. This situation suggests that SMEs should be very vigilant of their credit policy and should adopt a proper mechanism to minimize bad debts. The rising inflation also emerged as a source of a financial obstacle for SMEs in relation to increasing cost of inputs, such as raw materials and overheads.

4. CONCLUSION

This study concludes that the availability of sufficient capital appeared as the most important financial element of SMEs' financial management in Pakistan. Notably, participants more often explicitly discussed the financial obstacles of SMEs as compared

to the financial strengths of SMEs. This suggests that SMEs in Pakistan are having multiple financial issues and most of them creating hindrances for them. Although, the personal capital was categorized as the key financial strength of SMEs due to the occurrence of less risk the sole reliance on personal capital might not be optimal financial management strategy in future. This refers that the policy of only using personal capital by SMEs at the cost of avoiding business growth in future might turn this financial strength into a financial obstacle. There is a need for SMEs to develop trade-off between risk and return, and getting external finance at a reasonable cost for sustainable growth and profitability is a fundamental element of sound financial management in SMEs. Moreover, the staff of SMEs should get engaged in updating their financial management skills and there is need to create awareness pertinent to the adoption of sound financial management in Pakistani SMEs. Overall, this research finding offers useful insight pertinent to understand the major challenges faced by SMEs in dealing with various financial issues and implementing financial management practice. Keeping in view the limitations of this study, to offer more comprehensive understanding, the future studies should include larger sample size and in-depth interviews for wider applicability.

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