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## Financial performance adopted by sme's in the import sector of Ghana

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### Abstract

The main objective of the study is to examine the financial performance by describing the financial measures adopted by SME's in the import sector of Ghana. The study adopted a mixed method approach (that is quantitative and qualitative). The units of analysis were the members or elements of the population, and are Small and Medium Enterprises in the import Sector of Ghana. It was revealed that, poor accounting records keeping is a major challenge to the management SMEs, lack the resources to manage their trade debtors (receivables) effectively, lack proper debt procedures, such as prompt invoicing and sending out regular statements, lack of market power which leads to weak position when negotiating credit terms with large businesses, lack of financial management skills which often create problems in managing stock in an efficient and effective way was also revealed by majority of the respondents as a major problem. The study found that most of the SMEs used financial ratios to measure their financial performance, but to a very limited extent. Very few ratios were used by individual SMEs and most of the ratios used were not the best indicators as mentioned in the literature. The study is the first of its kind as it concentrates on import sector SMEs in Ghana.

**Keywords:** SME, import sector, financial performance, financial

### 1. Introduction

Small and medium-sized enterprises (SMEs) play a vital role in the economic development of nations. The contribution of Small and Medium Enterprises (SMEs) around the globe is unquestionable and especially in developing countries, where development in this sector is seen as a key strategy for economic growth, job generation and poverty reduction (Agupusi, 2007:2) <sup>[7]</sup>. According to Mutezo (2005:1) <sup>[19]</sup>, Japan's SME sector accounts for the bulk of the country's business establishment, providing vital support for employment, for regional economies and by extension for the day-to-day life of the Japanese people. In Taiwan the SME sector generates 98 percent of the economy's GDP. Abor and Quartey (2010:218) for example points out the importance of SMEs stating that "it is estimated that 91% of the formal business entities are SMEs. They also contribute between 52 to 57% to GDP and provide about 61% of employment". Financial performance management forms an important part of the business management field and financial measurement is also crucial for the survival of businesses. Successful financial performance in SMEs has a positive association with the capacity to manage financial issues effectively. There is evidence of a positive association between financially related activities such as planning, maintenance of financial records, obtaining external finance and professional finance advice, and the successful performance of an SME (Jacobs, 2001) <sup>[13]</sup>.

Several studies (Twala & Phaladi, 2009:534-539; Al Berry, Magali, Rashad, Kesper, Rajaratnam & Dirk, 2002:39; Mbonyane, 2006:18) <sup>[7, 17]</sup> reveals that obstacles to access to finance by SMEs is the main cause of their failure, but it appears that not enough studies on how these businesses measure and manage their financial performance have been undertaken. The problem may become more acute when it comes to the specific financial performance management used in the SME sector, and whether SMEs are using the available tools (financial ratio analyses and bankruptcy prediction models mentioned earlier) for the purposes of performance management. The study will specifically deal with financial performance measurements for SMEs in the import sectors which are also part of the general performance management of organizations, and whether these businesses are using the available tools. It must be noted though that financial measures alone are not enough to

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measure companies' performance since a number of non-financial performance measures also play an important role in their overall performance. However, this study will focus on financial measures only. The specific objectives of the study are: to examine financial tools used by import sector SME's in measuring their financial performance; and to examine the challenges faced by SME's in the import sector of Ghana.

## 2. The Definition of SMEs & Importance of SMEs

By and large small and medium enterprises are becoming or are the back bone of most economies especially developing countries like Ghana, since the large corporate bodies mostly spring up from these small firms. Thus Cook and Nixson (2005) <sup>[9]</sup> commented that in majority of cases, these small enterprises are initially informal but gradually some of them survive and become formal businesses, thereby providing the foundation of modern private companies. Hence, the growth of these enterprises is part and parcel of a dynamic growth process in the corporate sector, as argued by Liedholm *et al.* (1994) and Prasad *et al.* (2005). Fisher and Reuber (2000) <sup>[11]</sup> enumerate a number of characteristics of small and medium enterprises in developing countries under the broad headings: labor characteristics, sectors of activity, gender of owner and efficiency. According to Abor and Quartey (2010) <sup>[14]</sup> given that most small and medium enterprises are one-person businesses; the largest employment category is working proprietors. This group according to them makes up more than half the small and medium enterprises workforce in most developing countries; their families, who tend to be unpaid but active in the enterprise, make up roughly another quarter.

Abor and Quartey (2010) <sup>[4]</sup> postulate that in Ghana, small and medium enterprises can be categorized into urban and rural enterprises; the former can be subdivided into "organized" and "unorganized" enterprises. Kayanula and Quartey (2000) <sup>[14]</sup> states that The organized ones mostly have paid employees with a registered office, whereas the unorganized category is mainly made up of artisans who work in open spaces, temporary wooden structures, or at home, and employ few or in some cases no salaried workers. Whilst Kayanula and Quartey, (2000) <sup>[14]</sup> builds on the fact that They rely mostly on family members or apprentices. Rural enterprises are largely made up of family groups, individual artisans, women engaged in food production from local crops. The major activities within this sector include:- soap and detergents, fabrics, clothing and tailoring, textile and leather, village blacksmiths, tin smiting, ceramics, timber and mining, bricks and cement, beverages, food processing, bakeries, wood furniture, electronic assembly, agro processing, chemical-based products and mechanics. The importance of SME's to the development of low- and middle-income economies is well documented (Snodgrass and Biggs, 1996; King and McGrath, 1999; Mead and Liedholm, 1998; McPherson, 1996; Vijverberg, 1992; Daniels and Mead, 1998; Daniels, 2003). Through the promotion of competition and dynamism, SME's can augment government efforts to achieve economic growth and poverty reduction in rural and urban areas (African Development Bank and Organization for Economic Co-operation and Development – AfDB and OECD, 2005). Indeed, there is a considerable literature

devoted to the constraints and policy conditions that mitigate SME growth (King and McGrath, 1999).

### 2.1 Contributions of SMEs to Economic Development

According to Abor and Quartey (2010) <sup>[4]</sup>, there is a general consensus that the performance of small and medium enterprises is important for both economic and social development of developing countries. From the economic perspective, Advani (1997) <sup>[5]</sup> comes up with the fact that small and medium enterprises provide a number of benefits, thus small and medium enterprises have been noted to be one of the major areas of concern to many policy makers in an attempt to accelerate the rate of growth in low-income countries. These enterprises have been recognized as the engines through which the growth objectives of developing countries can be achieved. They are thus potential sources of employment and income in many developing countries. In Ghana and South Africa, it is postulates that small and medium enterprises represent a vast portion of businesses. Economic perspective wise, it can be argues that small and medium enterprises are not just suppliers, but also consumers; and this plays an important role if they are able to position themselves in a market with purchasing power: their demand for industrial or consumer goods will stimulate the activity of their suppliers, just as their own activity is stimulated by the demands of their clients (Abor and Quartey 2010) <sup>[4]</sup>. Demand in the form of investment plays a dual role according to Berry *et al.* (2002) <sup>[7]</sup>, both from a demand-side (with regard to the suppliers of industrial goods) and on the supply-side (through the potential for new production arising from upgraded equipment) thus demand is important to the income-generation potential of small and medium enterprises and their ability to stimulate the demand for both consumer and capital goods (Abor and Quartey 2010) <sup>[14]</sup>.

### 2.2 Measuring Financial Performance of SMEs

Financial performance management forms an important part of the business management field; and it is also crucial for the survival of businesses. Important part of the business management field; and it is also crucial for the survival of businesses. The relevant question in this regard is using the available tools (*i.e.* financial ratio analysis) that have been used for years.

#### Ratios Analysis

A ratio is the simplest mathematical expression of two magnitudes which are meaningfully related, and which are expressed in relation to each other as a quotient (Jacobs, 2001:208) <sup>[13]</sup>. Financial ratio analysis is defined by Lasher (2010:80) as a general technique based on some relatively standard methods used to analyses information, and developed by people who make judgments about businesses by reading their financial statement. Enterprises measure their financial performance differently, but financial ratio analysis is the traditional approach to analyzing and interpreting the financial position of an enterprise (Jacobs, 2001:208) <sup>[13]</sup>. Ratios are derived from the financial statements of an enterprise and enable analysts to develop a picture of the financial position of an enterprise. Financial ratios are generally classified into the categories discussed below: *Activity ratios*-They measure how quickly various

accounts are converted into money or sales, *Liquidity* -This is an enterprise's ability to pay its short term debts when they are due. It refers to the solvency of the enterprise's total financial position, *Debt/leverage ratios*-These measure the extent of debt in relation to total assets. They show the percentage of total funds obtained from creditors. Creditors would rather see a low debt ratio because there is a greater cushion for creditor losses if the firm goes bankrupt, *Cash flow ratios* -Cash flow analysis should not be overlooked when evaluating the liquidity of a company. Cash flow ratios need to be evaluated to determine a company's ability to satisfy its debts. They are useful in predicting financial distress (or even bankruptcy), *Profitability ratios* -The various criteria for measuring profit relate the enterprise's earnings to sales, assets, owner's equity and share value (Jacobs, 2001:209) [13]. Profitability refers to the ability of a company to earn income. Net income is the single most significant measure of profitability,

**3. Research Methodology & Data Discussion**

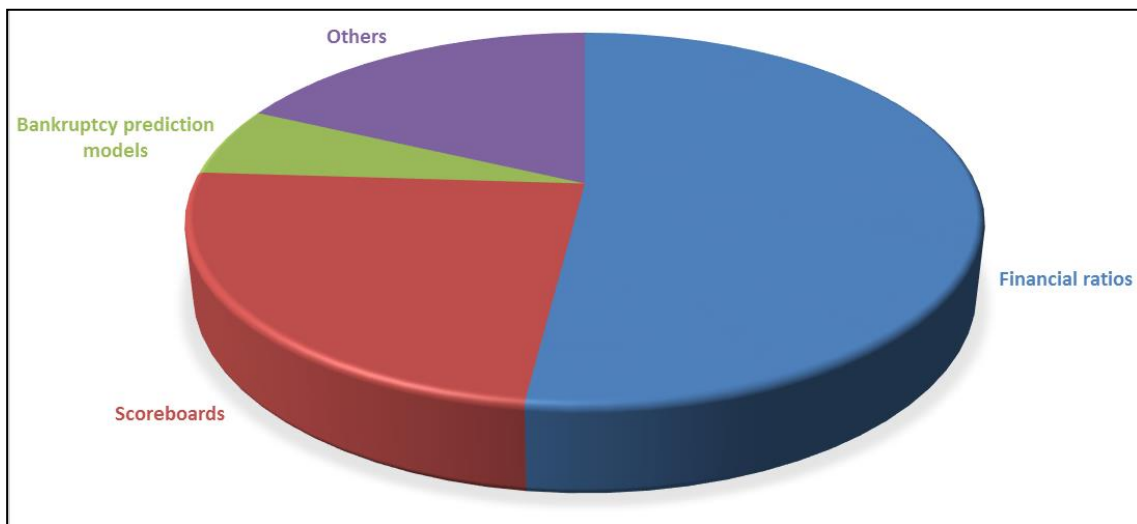
The study adopted a mixed method approach (that is quantitative and qualitative). The purpose of quantitative research is to evaluate objective data consisting of numbers while qualitative research deals with subjective data that are produced by the minds of respondents or interviewees *i.e.* human beings (Welman, 2001) [13]. The sampled population for the study was One Hundred (100) employees of selected import sector SMEs. Semi-structured questionnaires were used to collect data at the premises of the participant. The questionnaires were both closed and open ended. The questionnaires were self-administered.

**3.1 Financial tools used by import sector SME's**

The first objective of the study was to identify financial tools currently used by manufacturing SME's in measuring their financial performance. This objective of the study was achieved during the field study with semi-structured interviews at SME premises that helped gather information on the financial performance measures used by each. Respondents were first asked to indicate how often they measure their financial performance. Majority of the respondents (60%) stated that they measure their financial performance once every year, 25% said twice a year (six months) while the remaining (15%) said they do not have exact period. Respondents were once again asked to your current financial performance satisfying. The majority of respondents (65%) indicated that their current financial performance was satisfying; 18% said they could improve and 17% said that their current financial performance was not satisfying. Asked whether they employ a financial officer or use the services of an external consultant, majority of the respondents (52%) said they employ full time financial officers while the remaining 48% said they use or rely on external consultants.

**3.2 Financial performance measures used**

Eighty (80%) of the respondents indicated that they used financial ratios while the remaining, and two said that they do not use them, neither do they use any of the measures given to them as other options, as shown in percentages in figure 4.3 below. With respect to the tools used to measure their financial performance, the responses are presented in the figure 1.1. below



All the respondents unanimously indicated whether using financial ratios or not, were familiar with many of the ratios found and regularly used in the literature, namely: Current ratio (current assets to current liabilities); Net operating margin (net working capital to total assets); Earnings after tax to total assets; market value of equity to book value of total debt; cash flow to total debt; cash flow to total current liabilities; debt to equity ratio (total liabilities/stockholders' equity); equity to total assets ratio; inventory turnover (inventory to sales); quick assets to current liabilities; gross profit margin ratio (gross profit to net sales); and Return on equity (ROE) which is equal to net income/average

stockholders' equity. Respondents were quick to add that even though they know; they do not use all of them. Infact about 10% of them said they do not use them at all. For example only 9% of the respondents use cash flow to total debt; current ratio (used by 42%); working capital to total assets (used by 18%); cash flow to average total current liabilities (used by 8%); gross profit margin ratio (used by 7%); inventory turnover (used by 15%) and others. Some of the respondents said they use other ratios such as: solvency ratio (which is given as total assets to total debt); payable day's ratio [(accounts payable\*30\*period/cost of

sales)]; receivable day’s ratio [(accounts receivable \*30\*period/sales)]. Three out of the hundred respondents indicated that their firm uses software such as PASTEL as a financial measuring tool. The respondents were very confident about its use and its efficiency as well. They further indicated that everything is done with the software. The company uses virtually most of the ratios identified above, but computes these using PASTELS. Compared to the ratios indicated by various authors in the literature as best financial measures (Vallely, 2008:1), current ratio, networking capital to total assets, and cash flow to total debt are the only ratios that appeared to be the most widely used ratios by respondents. Compared to the ratios used in the presented bankruptcy prediction models, out of the five ratios in the Altman Z-score, only working capital to total assets, and sales to total assets were used by respondents. As for the five ratios used in the predictive accuracy for Daya’s second test, just cash flow to average total current liabilities and net income to total assets are used by the SMEs.

**3.3 Challenges faced by Import Sector SMEs**

SMEs particularly in developing countries face numerous problems including the management of finances. According to 45% of the respondents, poor accounting records keeping is a major challenge to the management of working capital by SMEs even though 55% disagree. This finding partly confirms the position of Marfo-Yiadom (2000) [16] who postulates that many SMEs do not keep accounting records on their operations. Thus, in the absence of proper accounting records and information, the SMEs in Ghana face the problem of differentiating clearly between their working capital and profits. According to Marfo-Yiadom

(2000) [16], SMEs tend to collapse few years after they have been established because of this problem. Majority of the respondents (29%) agreed, 25% disagreed, and 19% disagreed while 18% disagreed strongly. The remaining 7% were uncertain. The responses indicate that SMEs also lack proper debt procedures, such as prompt invoicing and sending out regular statements. This tends to increase the risks of late payment and defaulting debtors. These risks probably tend to increase where there is an exclusive concern for growth. In an attempt to increase sales, SMEs may be too willing to extend credit to customers that are of poor credit risks. While this kind of problem can occur in businesses of all sizes, SMEs seems particularly susceptible. Another problem is the lack of market power which leads to weak position when negotiating credit terms with large businesses. From the responses gathered 25% agreed strongly, 29% agreed, 19% disagreed while 18% disagreed strongly. The remaining 7% were uncertain. The findings are not surprising as Atrill (2006) [8] states that the lack of market power is another working capital management challenge of SMEs. Lack of financial management skills which often create problems in managing stock in an efficient and effective way was also revealed by 77% of the respondents as a major problem. On the other hand 16% disagreed while the remaining 7% were uncertain. There are costs involved both in holding too much or too little cash. In view of that, there is a need for careful planning and monitoring of cash flows over time (Atrill, 2006) [8]. Chittenden (1998) [18] found that 63% of the respondents prepared cash budget. It was also found that cash balance were generally proportionately higher for SMEs than for large businesses.

Variables	Strongly Agree %	Agree %	Neutral %	Disagree %	Strongly Disagree %	Total %
Poor accounting records keeping	30	20	30	20		100
The lack of resources to manage trade debtors (receivables) effectively	27	27	7	19	18	100
The lack of market power which leads to weak position when negotiating credit terms with large businesses	15	19	9	28	29	100
Lack of financial management skills which often creates problems in managing stock in an efficient and effective way	40	37	7	8	8	100
Lack of financial management skills which often leads to poor cash management	22	34	20	11	13	100
Lack of basic training in bookkeeping and accounting	4	6		50	40	100
The business is too small to adopt and implement financial management practices	46	33	4	9	8	100

Source: Field data, 2018

**Summary, Conclusion & Recommendations**

The main objective of the study is to examine the financial performance by describing the financial measures adopted by SME’s in the import sector of Ghana. The first objective of the study was to identify financial tools currently used by manufacturing SME’s in measuring their financial performance. This objective of the study was achieved during the field study with semi-structured interviews at SME premises that helped gather information on the financial performance measures used by each. Majority of the respondents (60%) stated that they measure their financial performance once every year, 25% said twice a year (six months) while the remaining (15%) said they do not have exact period. It was once again revealed by the majority that their financial performance satisfying. Again

most of the SMEs employ full time financial officers even though some use the services of an external consultant.

**4. Conclusion**

The use of ratios by the studied SMEs is limited, because only a few numbers of ratios are being used by the respondents. Yet again, out of the ratios used, few are among those in the literature that were found to be the best financial measures or good financial distress predictors. None of the respondents used any of the available bankruptcy prediction models. In fact, most of the respondents knew nothing or very little about the models. Some of the participants have opted for the use of computer software and are getting satisfying results from them. Although most of the respondents have performed fairly

well so far, to improve their financial performance, SMEs should use more of the recognized ratios identified in this study. SMEs need also to train their financial staff on other financial tools such as bankruptcy prediction models that are quite easy to use. It self-evident that ratio analysis and bankruptcy prediction models (since they consist of a group of ratios with variables of different weights) have their shortcomings as well. Therefore they should only be used as an indication. Compared with that in large organizations, the emphasis of financial performance measurement in SMEs is focused on only a few ratios and other tools. SMEs need to analyze internal and external factors, and deeply understand the industry and value chain so as appreciate fully the performance.

#### 4.1 Recommendations

First it is recommended that both employees and owners of SMEs participate in more training programs. In other words they should make themselves to take opportunity of the various training programs organized by government and other bodies like; National Board for Small Scale Industries (NBSSI), Ghana Regional Appropriate Technology and Industrial Service (GRATIS), Empretec Foundation, and Ghana Chamber of Commerce and Industries, to polish their knowledge in financial management and other managerial issues. This will help improve their performance. It is recommended that SMEs use more ratios, especially those in the literature study so as to improve their financial performance measures. SMEs should probably consider the use of most used ratios, since they seem to be working well not only for the majority of SMEs, but for businesses in general. It is also recommended that SMEs owners/managers request and enroll their financial staff for training on bankruptcy prediction models at relevant institutions such as universities. The few models presented in this study may be used by SMEs as well, since they are simple and cheap, and should not pose problems to trained financial staff. Again, for those SMEs that can afford it, to try the use of specialized financial accounting software such as PASTEL, PRO ACC5 etc, which were indicated as effective by some who use them. The SMEs would be able to use ratios that are computed from the software.

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