The Financial Management of the Small Enterprise

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The Council of The Association of Chartered Certified Accountants and the members of the Research Committee consider this study to be a worthwhile contribution to discussion but do not necessarily share the views expressed, which are those of the authors alone. No responsibility for loss occasioned to any person acting or refraining from acting as a result of any material in this publication can be accepted by the authors or publisher.
Published by Certified Accountants Educational Trust for The Association of Chartered Certified Accountants, 29 Lincoln's Inn Fields, London WC2A 3EE.

ACKNOWLEDGEMENTS

We are grateful for the following assistance in completing this study and research report:

- a research award from the Association of Chartered Certified Accountants
- participating small business owners, some of whom gave up considerable time in order to participate in the research project

  and

- we are indebted to a colleague, Alana Morrison, who has provided comments on the draft report and suggested the application of the Balanced Scorecard model for financial management practices in small firms. Further work is being conducted into this approach.

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ISBN: 1 85908 337 4

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Executive summary

Small and micro firms are important for future economic development and for the continued evolution of a modern, knowledge-based economy. An important key to the successful development and survival of small and micro firms is the role of financial management, which has been recognised by the Bank of England in its annual reports on the *Finance of Small Firms* (Bank of England, 1997; 1998; 1999a; and 1999b). Our report, however, diverge from most previous studies in taking a dynamic, process-based view of financial management. It is important to understand how changes in financial management practices in small firms occur. We argue that it is only through the qualitative methods adopted in the report that such understanding is possible. Policy interventions and the role of professionals can then be better informed: an issue on which we comment. The dynamics of financial management processes and decision making are influenced by many factors, including both internal management issues and external environmental issues. This summary is based upon the findings from a case-based study on financial management practice by owner-managers in small firms; our main conclusions reflect the importance of process issues.

The study involved four main case studies with owner-managers in small firms. In addition, we have completed a programme of 30 face-to-face interviews with firms that were not investigated in full case study detail. In the case study firms, additional information was collected through financial accounts and several interviews in each business have been completed over the time period. The study was undertaken over a period of 12 months, although for the case study firms we have retrospective information that covers a longer time period. The research centre, Paisley Enterprise Research Centre (PERC), had maintained contact with three of the four case study firms over a number of years, enabling a rich source of data to be established. This methodology has allowed us to examine process and dynamic issues in financial management. It is arguable that previous research into financial management practices in small firms has been static and survey-based. In this report we provide evidence on change over time and process issues in financial management practices by owner-managers in small firms.

We suggest that the management decisions of the small firm owner-managers are based on a rationality that is grounded in the particular contextual environment in which they operate. Change makes an evolutionary modelling approach suitable for financial management in small firms. Entrepreneurial learning is an important part of this process, with experiential learning being critical, but there is also considerable scope for intervention to ensure that such learning is efficient. The importance of learning and innovation in small firms' financial management leads us to suggest that the concept of the Balanced Scorecard approach is appropriate to understanding financial management practices in small firms. In our report we suggest that the adoption of this concept, in the context of small firms, would be beneficial.

We found that financial management practices of small firm owners described in previous literature have often been characterised as fire-fighting; dealing with problems as they arise on a day-to-day basis. Consideration of these owner-managers' practices over a prolonged period, however, would reveal that behaviour occurs in a more evolutionary fashion, with the role of critical events in small firms being important for determining the learning of owner-managers. This gives rise to an evolutionary approach to decision making. Critical events could change behaviour leading to (less) gradual change in management practices. Again, the holistic approach suggested by the Balanced Scorecard method, we suggest, has benefits in terms of producing a closer model of what actually happens in small firms in practice. Financial management practices in small firms are far from static; the owner-manager learns to alter behaviour and change practice with experience. Our case study evidence shows that strategies alter and change with learning, innovation and experience; this supports a Balanced Scorecard approach.

We argue that evolutionary change and learning are interlinked and this in turn has an important effect on the dynamics of financial management. Our evidence suggests that the learning process in small firms is a crucial part of their evolution. The entrepreneur learns through experience. Rarely is this learning process planned, but is in fact the result of a series of reactions to events and opportunities in which the entrepreneur learns to process information, adjust strategy and take financial management decisions.

In terms of decisions concerning capital structure, our evidence suggests that process and behaviour of owner-managers in this area is more complex than theories such as the Pecking Order Hypothesis (POH) might suggest. The POH suggests that owner-managers in small firms have a preference for sources of capital that lead to a distinct and characteristic capital structure, with the major proportion as personal equity, followed by debt and then, lastly, venture finance. The argument is based on the premise that owner-managers will be reluctant to cede control. Some willingness to take venture capital (equity) was expressed by most of the owner-managers interviewed, but a more important constraint (than owner-managers' attitude) was locating suitable equity investors. This finding adds to the complexity and variety of practice in financial management that exist in small firms.

Relationships established between owner-managers and external advisers, whether accountants, bank managers or other professionals were very important. Our evidence suggests that these relationships are crucial during the early stage of development of a business, especially in reducing the isolation and self-dependency of the owner-manager, which is particularly high during the early years of trading. The embeddedness of the owner-manager in networks involving advisers, we conclude, is an important factor that

influences financial management practices. Policy makers have a role in facilitating such networks. The role of accountants could be particularly important in these networks and in ensuring that the transfer of knowledge and learning takes place.

The issue of late payment was highly variable in importance both between small firms and in the same same firm at different times. In terms of process, however, it was clear that owner-managers adjust behaviour through their experience in dealing with customers and in dealing with late payers. The related issues of invoice discounting and factoring also vary considerably from one small firm to another. The evidence from interviews regarding the importance of factoring was variable, although there was some evidence to support the increasing importance of factoring to some small firms. We suggest that for many small firms, however, factoring will only have a minor importance. Thus, like late payment this is an issue that varies, reflecting the diversity of small firms and the different practices in financial management.

Other issues considered included leasing, hire-purchase and business planning. Leasing was only used by a small minority of our respondents. In terms of business planning, again, evidence of practices was mixed. Issues discussed above in terms of evolutionary learning were also important for planning procedures. Some owner-managers could be considered to have sophisticated approaches, whereas others had a more *ad hoc* approach. Planning was used and was important in those firms undergoing growth and periods of rapid change.

In terms of policy, our study suggests that short-term episodic solutions are inappropriate. It is important to build long-term relationships so that advice can match evolutionary change and behaviour of small firms in the UK. Despite the inconsistency of approach to the small firms sector, the current review of business support in England, Scotland and Wales gives an opportunity to review the role of advisers and professionals such as accountants. An opportunity exists to recognise the role of accountants, who can help to support bodies that enhance evolutionary change in small firms. Indeed, the accountant performs two basic functions: that of an agent in the preparation and audit of external reports; and that of a business consultant advising on the internal management planning, decision making and control reports that will assist the owner-manager in the management of the small firm. The accountant hired to perform one of these functions will not necessarily be able, or be needed, to perform the other. Unless the owner-manager understands the difference between the two basic functions he or she may not even be able to identify the necessity for both.

1. Introduction

1.1 THE STUDY IN CONTEXT

The importance of small (fewer than 250 employees) and micro (fewer than 10 employees) firms for future economic development has been reflected upon in a number of recent policy papers. These papers have focused attention on the role of entrepreneurship, owner-managers and the small firm sector, at the European, UK and regional policy levels. Examples include recent policy papers from the SME forum Prodi Commission (EC, 1999a); EU policy on sustainability (EC, 1999b); the Competitiveness White Paper (DTI, 1998); the Small Business Service (DTI, 1999); and at a regional/ devolved level, the Network Strategy for Scottish Enterprise (SE, 1999a). The importance of the role of financial management in small firms, as necessary for their successful survival and development in the modern economy, has also been recognised by a number of these statements (e.g. DTI, 1998) and by the Bank of England in their recent reports on *The Finance of Small Firms* (Bank of England 1997; 1998 and 1999).

It is also noticeable that we have the welcome coming together of previously diverse strands of policy. For example, enterprise and entrepreneurial development are now an important parts of the social inclusion agenda. A recent 'key drivers' document by Scottish Enterprise (1999b) placed the following themes as central to the next decade of economic development: enterprise, learning, economic inclusion and infrastructure. The new network strategy of Scottish Enterprise promoted similar key themes on enterprise, learning, economic inclusion, competitive places and innovative far-sighted organisations. At the European level as well, it is noticeable that sustainability includes economic, environmental and social strands (EC 1999b).

Despite the increased attention paid to owner-managers in the small firms sector, we know comparatively little about the process of financial management and decision making in small firms and about the entrepreneurship process. We have increased our understanding with regard to the overall numbers of small firms, their characteristics, the importance of different constraints in their formation; yet our knowledge of process issues, such as financial management decisions, remains something of a '*black box*'. This is because of the nature of the research agenda, which, with small firm entrepreneurs, has tended to be concerned with quantitative findings. For example, research has tended to focus on regional and sectoral *comparisons*, the performance of and job-creation by small firms, the *numbers* of small firms concerned with the take-up and use of support schemes, the *numbers* of firms that are using different forms of finance, the *numbers* of growing small firms and so on (for example, see Storey, 1994, who attempts to synthesise much of small business research in the UK). We do not attempt to argue with that research agenda, yet this research emphasis has naturally

revealed more information about questions such as *how many* and *what type* rather than questions about *why* and *how* such firm formation and entrepreneurial development occurs.

Longitudinal research inside the organisation has been noticeable only by its absence in the small firm sector. In this report, we attempt to shed some light on the process issues within small firms from qualitative evidence collected as part of a programme of case study research with entrepreneurs and owner-managers. We concentrate on case evidence drawn from research with small firms and focus on how owner-managers reach financial management decisions, how they learn and how they adjust their behaviour within the entrepreneurship process.

1.2 RECEIVED WISDOM ON FINANCIAL MANAGEMENT AND SMALL FIRMS

There are pre conceived notions of the financial management ability of such entrepreneurs, which have been ‘received views’ yet are now being challenged by the adoption of alternative research techniques. For example, a commonly expressed view of small firm owners is that they are assumed to be naive about planning and the development of strategy. Also expressed is the view that such firms lack financial skills and understanding of financial information (Lawson, 1995). It is only recently that such views are being challenged, as different pedagogic approaches are taken in business courses and greater appreciation is made of the environment in which small firms and entrepreneurs operate. In addition, ethnographic and qualitative research methods are revealing that small firm owners and entrepreneurs do have a greater sophistication of knowledge and understanding of strategic decision making than they have previously been given credit for. For example, Jarvis, *et al,* (1996) challenge the assumption of financial management weaknesses in small firms and argue that decisions made by small firm owners can be better understood through approaches grounded in using the reality of the environment in which they operate. Also, using ‘grounded theory’ and an ethnographic approach, Shaw (1997) has revealed the importance of bartering in small firm networks as well as sophisticated financial exchanges and the exchange of knowledge by such entrepreneurs.

1.3 STRATEGY AND FINANCIAL PLANNING IN SMALL FIRMS

The development of strategy within small firms and by small firm owner-managers has often been portrayed as limited, operations managed on a day-to-day fire-fighting basis. This rather traditional and black box view does not allow for the learning process that leads entrepreneurs to modify behaviour and develop strategy. This process happens rapidly; entrepreneurs learn to adjust, take decisions and develop a strategy that may not match pre conceived notions of financial management and business planning.

The literature specifically concerning financial management and small firms is limited, but we review this literature before turning to the remaining sections of this report, which are concerned with our methodology, the cases studied and a discussion of the main findings. We provide a final section that contains our main conclusions, based on the qualitative evidence presented.

2. Small business and financial management

In this section we review some of the issues and previous research on financial management and small businesses. We consider first issues concerning control of the owner-manager and access to financial information. Later we consider the nature of previous studies and literature.

2.1 FINANCIAL CONTROL IN SMALL AND MICRO BUSINESSES

The growth of small businesses in the 1980s and 90s; is the result of the major restructuring of the British economy, the growth in the service sector and positive government policies. This has lead to an increasing interest in how a small business monitors and controls its finance. It is a commonly held belief that better financial information means better control and therefore an improved chance of success. It can be conjectured that recent developments in the technologies applied in e-commerce will make the small business an integral part of the most rapidly expanding part of the economy and add to the difficulties of financial control. Certainly, in employment terms, the importance of small businesses will increase in significance and thus how these companies 'gather, record and use information' will raise important issues for all those who advise, train and provide funding to the small firm sector.

One of the basic questions to be resolved is whether good record keeping, the types of records and management's understanding of the information in them can be correlated with business success on one hand or resistance to failure on the other. The use of 'Z' scores to predict company failure includes insufficient management, cash flow planning, and costing systems as contributors to predicting failure. Nonetheless, in the weighting of the scoring system these defects rank below the 'mistakes' such as high gearing, over trading and the failure of big projects.

It could be argued strongly that better information can mean better credit control, will support day-to-day monitoring of performance, and will support production, pricing, marketing and capital expenditure decisions. In small and micro businesses resource constraints mean that the imperative of expediency in selling products or services will dominate the development and use of an information system. It is also reasonable to suggest that if the small business is successful, the development of the information system will inevitably lag behind other developments in the business.

These issues were addressed by Nayak and Greenfield (1991) in their survey of West Midlands companies. This survey analysed what information small and micro firms use to control their business and how they use this information. Nayak and Greenfield investigated the difficulty of keeping accounts, gathering information and bookkeeping.

They concluded that:

> *'advice was needed on keeping debtor records and chasing up debts; at start up, to develop simple information gathering systems to prevent failure and mean that systems were in place should the business grow rapidly; a well designed pro-forma for budgets; and, for manufacturers, assistance on weekly profit calculations and help with business monitoring'.*

Turner (1997) has suggested that owner-managers should change from a task focus to a behavioural focus, from a passive record keeping focus to an active control of finance, with greater skills needs for advisers and owner-managers of businesses.

A potential paradox small business is that owner-managers may agree to seek advice or to establish systems, but in practice fail to use the advice or the system. The use of the case methodology in this paper is an example of these issues. This can be achieved by examining the attitudes of various owner-managers to their financial control problems, including: whose advice they would accept, sources of advice, and the nature of information systems used. Thus the case methodology can be justified in providing the behavioural data required to allow the findings of surveys to be put into an appropriate context.

The importance of behavioural issues is indicated by Poutziouris *et al* (1998) in family companies. They also raise the issue of agency cost, 'the conflict of interest between owner-managers…and lenders…is relatively more expensive to small companies, due to the higher transaction costs involved in the provision of information and the compliance to conditions [of lenders]'. Asymmetry of information can occur where there is a difference in access to information between insiders and outsiders (Pettit *et al.* 1985). Owner-managers have the current information to run the business but the external adviser requires the information in a structured conventional form.

Poutziouris *et al.* (1998), although commenting specifically on family companies, identify issues that would affect the need and perceived need for good information systems. These include situations of high ratios of fixed assets to total assets, low investment in intangible assets, high investment in stocks and work-in-progress and low trade creditors' repayment periods. These could indicate a lack of confidence in, or a limited perceived need for, financial control systems, or a lack of understanding of how a modern system might be used to aid decisions rather than remaining a static source of data. This could also indicate the importance of the attitude and characteristics of a small firm owner-manager in investing time and money in a better financial control system that would allow secure growth of the company in the medium term.

In a US survey on the differences between large and small companies, Walker and Petty (1978) reached the conclusion that the liquidity of small companies was much lower than that of larger businesses. Thus cash management must be of great concern in small firms. Nayak and Greenfield (1991) indicate that the cash book is the most typical form of financial record but a key issue was the use of this information made by the owner-managers. Wilson *et al.* (1996) indicated 'a strong connection between good credit management practice and aspects of company performance', specifically 'efficiencies in managing the cash cycle and profitability'.

Another example of an area where good information would improve a business' financial position could be stock control, as identified by Poutziouris, *et al*. (1998). Grablowsky (1984) identified the differences in stock control techniques between large and small companies. The large companies used statistical methods and the smaller companies used judgement (6%); anticipation (32%); past experience (15%); with no method (27%) and he concludes that SMEs are 'a long way from a reliable system to control inventory' (Grablowski 1984, p. 64).

External financial support could also provide a motivation for robust information systems to justify borrowing. There is a consensus that small growing companies will face liquidity problems (Wilson, *et al*. 1996, p. 3). They will also be 'over-reliant on short-term funding', often find themselves in a hole between the bank, their creditors, and their debtors' with 70% of small businesses indicating that banks give them insufficient support.

Returning to a more behavioural approach to capital structure, Poutziouris *et al* (1998) propose a relationship between gearing and demographic and behavioural factors either positively or negatively in terms of their attitude towards gearing levels. The positive factors include risk-taking propensity; openness to external equity; growth orientation; and educational attainment. The negative factors include business control; personal net worth; negative experience with debt; and age of directors.

This study explores some of the process and behavioural issues surrounding the actions of the small firm owner-manager, such as factors affecting learning ability, on information processing by the owner-manager, the influence of external advisers and relationships with lenders, the credibility and skill of advisers and how advice is used. The surveys of Nayak and Greenfield (1991), Poutziouris *et al.* (1998) and others suggest a contingency approach by owner-managers in relationship to their decision making. Therefore the case style of investigation, involving longitudinal analysis, offers an effective approach to this study. The dynamism of the small firm sector requires the business to be constantly changing and adapting. How small firm owners react to financial management and change practices in such dynamic environments will form the focus of this study.

2.2 THE NATURE OF PREVIOUS LITERATURE AND RESEARCH

The limited literature on financial management and small firms could be considered to contain less than favourable assumptions about financial management practices and small firms. For example, Chittenden *et al*. (1999, p. 5) comment 'Studies of the reasons for small business failure inevitably show poor or careless financial management to be the most important cause.' Yet most studies use survey methods to obtain data on financial management practices in small firms. In the UK serious academic studies on financial management practices are rare; examples include Nayak and Greenfield (1991); Chittenden *et al*. (1999). These studies, however, rely upon postal questionnaire survey methodology and hence are remote, static in nature and limited in depth of insights. Although such surveys may reveal some evidence on general practice, owing to their nature such research studies will give limited insights into the actual attitudes and approaches of small firm owner-managers. Formal survey based methodologies contrast with informal qualitative-data based methodologies used by the alternative studies discussed below. Perren *et al*. (1999) argue that this has produced a dichotomous approach to the investigation of decision making in small firms, which they argue has produced some conflicting findings and results. For example, Chittenden *et al*. (1999) conclude that 'credit management in small firms falls behind best practice' (p 24). The approach of Jarvis, *et al*. (1996), on the other hand, has been to assume an approach grounded in the reality of the environment in which small firms operate and hence they conclude that financial management practices are more sophisticated than previous studies have indicated.

A previous qualitative study on financial management practices in small firms in the UK was conducted by Jarvis *et al*. (1996). They used a framework provided by different types of rationality (Hargreaves Heap *et al*. 1992) as an approach to understanding owner-managers' practice in financial management. They found that management of cash flow was used to achieve survival objectives rather than growth. Jarvis *et al*. (1996) conducted qualitative interviews with owner-managers in small firms and argued that alternative definitions of rationality, compared with previous studies (which assumed an instrumental form of rationality), gave valuable insights into financial management decision making by owner-managers in small firms. They adopted procedural and expressive forms of rationality and they concluded that these were more important than procedural rationality for owner-managers' decision-making in small firms. They conclude that:

> *'Owner-managers' desire for control was argued to be shaped, in part, by expressive forms of rationality because of the fluid and indeterminate nature of control. It is difficult to say that control can be defined in terms of some fixed end*

which can clearly be articulated by individual owner-managers and therefore it is difficult to interpret purely in terms of instrumental rationality.'
(Jarvis *et al.* 1996, p. 42).

A comparative case study methodology was adopted by Perren *et al*. (1999) in a longitudinal study; they concluded that owner-managers in small firms move from informal methods of financial management and decision making to more formal methods as their businesses develop. With the exception of these two studies, work has been survey driven and static, which means that our understanding of how and why financial management practices are developed in small firms is limited; as commented by Chittenden *et al*. (1999, p. 6) 'there is a definite need for more information on the methods used by small firms to accumulate and allocate their scarce working capital resources.' This paper aims to meet that need by providing a dynamic view of changing financial management practices in small firms.

3. Methodology

3.1 INTRODUCTION

The present study aims:

1. to gain insights into practices of owner-managers of small firms over time, including management of cash flow, approach to liquidity, and stock control,

2. to compare the approaches of owner-managers in contrasting case studies drawn from different sectors,

3. to compare the approaches and experience of owner-managers in different growth phases,

4. to gain insight into the process and practices of owner managers,

   and

5. to gain insights into how approaches of the owner-managers affect the seeking of funding, especially venture capital.

To address these aims, case study methodology was used.

3.2 QUANTITATIVE RESEARCH

Quantitative (positivist) studies show trends that *explain* phenomena that occur generally. They count phenomena from within a sample that represents the wider population.

> *'the assumption behind the positivist paradigm is that there is an objective truth existing in the world which can be revealed,…measuring relationships between variables systematically and statistically'* (Cassell and Symon 1995, p. 2)

Turner (1994, p. 195-6) notes that 'we are obliged to categorise to some degree the events and phenomena which we encounter in the world if we are to bring any order to our experiences…', but 'what happens when the sample is not typical? This is particularly an issue…where the organisations can be very heterogeneous' (Hartley 1994, p. 225), such as in the case of SMEs. Added to this is the restriction of quantitative studies to that which is quantifiable, which precludes investigation into process. Therefore, quantitative research was rejected as an approach.

3.3 QUALITATIVE RESEARCH

Various methods can be used to achieve qualitative (phenomenological/interpretative) analysis, e.g. observation, biographic analysis, interviews. The aim is to 'describe and analyse the culture and behaviour of humans and their groups from the point of view of those being studied' (Bryman: 1988a, p. 46), and to collect and analyse data which is 'uncountable' (Cassell and Symon 1994, p. 4).

Qualitative research is used when we want to *understand* a circumstance in terms of *how* and *why* it occurs (Cassell and Symon 1994, p.5). Qualitative techniques can be used as a means of obtaining this kind of information because, rather than testing concepts in terms of fixed empirical referents, they afford us 'experiential *understanding*' (Stake 1995, p. 40), while still allowing for comparison (Yin 1994, p. 14).

3.4 CASE STUDIES

Case studies can be used to achieve a deeper, individualised understanding of process within context. Abramson (1992, p. 182) notes that, 'it is presumed that without measurement, scientific progress is impossible.' Case studies are subjective and do not lend themselves to generalisation, but the aim is not to 'expose' a general truth, but to facilitate understanding of process through studying a subject within the context of its existence. Often there will be contradictory findings, particularly in the case of SMEs as no two businesses, or owner-managers and their actions, will be the same. This does not render findings useless as 'the qualitative case researcher tries to preserve the multiple realities, the different and even contradictory views of what is happening' (Stake 1995, p. 8) because 'the uniqueness of individual cases and contexts is important to understanding' (Stake 1995, p. 39).

3.5 CASE STUDIES AS FACILITATORS OF CONTEXTUAL UNDERSTANDING

According to Yin (1994, p. 13), case studies are used when it is recognised that phenomena and context are inseparably linked. For example, in the present study a business context is affected by the behaviours of the owner-manager(s), and these, in turn, are determined by the context of the business itself and the business culture in which it is attempting to operate. Case studies can 'conceptualise the respondent as an active shaper of situation and events' (Cassell and Symon 1994, p. 5). As Hartley (1994, p. 208-9) puts it:

'Case study research consists of a detailed investigation, often with data collected over a period of time…with a view to providing an analysis of the context and process involved in the phenomenon under study. The phenomenon is of interest precisely because it is in relation to its context.'

One of the advantages of case studies is that they 'allow the detailed analysis of change' (Cassell and Symon 1994, p. 5). Hartley (1994, p. 211) claims that change over time occurs 'as a response to historical forces, contextual pressures and the dynamics of various stakeholders,' and this is highly applicable to small and micro firms.

3.6 INTERVIEWS

Quantitative interviews usually comprise responding to a questionnaire, where questions are written in a specific order and are mainly 'closed' (requiring a 'yes', 'no', or a tick). Answers are converted to numbers, which can be counted, compared etc. Indeed, such questionnaires commonly need no interviewer as they are self explanatory and require no support.

Conversely, case study interviews should be open-ended to allow for maximum interviewee contribution. There should be 'a low degree of structure…and a preponderance of open questions' (prompting detail, opinion etc.) (King 1994, p. 15). In the present study this latter tenet was followed and an 'interview guide' (King 1994, p. 19) comprising topics to be covered was used rather than an ordered questionnaire. This 'conversational' type of interview allows for relaxed conditions that are conducive to information elicitation (as is rapport, see section 3.8), and promotes the conditions where an interviewee can introduce research focuses not pre-considered by the researcher (see section 3.8).

All interviews were tape-recorded. The benefits of tape-recording are well documented (King 1994, p. 25, Buchanan *et al.* 1994, p. 61, but not Stake 1995, p. 66). Essentially, recordings eliminate the need for the researcher to rely on memory or to have to make notes throughout the interview, which can be distracting for both interviewer and interviewee. Recording also contributes to objective interpretation of data. No refusals to allow recording were encountered during the present study, as is the norm in formal research: 'A request to record a conversation should present no difficulty where the purpose of the study is appreciated, and where respondents know their conversations will be used in confidence and cited anonymously' (Buchanan *et al.* 1988, p. 61). Again, this suggests that trust is an important feature of research.

3.7 SELECTION OF CASES

A total of 21 businesses were studied for the present research, eight of which were examined in 'case study' detail. The eight companies chosen to be examined in depth pertain to a variety of business sectors broad enough to address (see aim 2, section 3.1). These eight businesses were also chosen because of the fact that they were apparently undergoing growth (aim 3, see section 3.1) or change. Hartley (1994, p. 213) cites Pettigrew *et al*. (1992), who focused on 'high change' in health authorities rather than 'average change' as 'high change' best illustrated changes in process and was observable and analysable. In this way, the focuses for Pettigrew did not represent the average health authority situation, but were exaggerations, or extreme examples of the processes he was attempting to observe for a research study. The eight businesses in the present study were focused on for very similar reasons i.e., they appeared to be undergoing, or were about to undergo, some form of change (usually growth-related) and this was observable within the research time frame (aims 1–5, see section 3.1).

The process of developing cases from interviews is illustrated in figure 1 below.

Figure 1: Interviews completed and selection of cases

Stage 1	Twenty first stage qualitative interviews	Background information/profile information and approach to financial management
Stage 2	Eight second stage interviews and development of 'mini-cases'	Changes undertaken since first interviews: detailed financial information, decision making
Stage 3	Four full cases and third stage interviews	Development of critical incident methodology, factors affecting changes to financial management
Stage 4	Additional interviews with case study firms	Follow-up issues, clarification of changes

3.8 TRUST AND RAPPORT

A good working relationship between a researcher and those being studied is an essential part of case study research, particularly if that research is to continue over a period of time. During an initial interview, a researcher should ask if it would be possible to return to follow up after a specified period (Buchanan *et al.* 1988, p. 66), and this practice was

followed with all the businesses visited for the present study. Indeed, upon initial contact, owner-managers were assured confidentiality and informed about the aims and recipients of the research.

To establish interviewee ease the present study started with simple 'factual and descriptive' questions (King 1994, p. 21), such as 'Can you give us some background to the business?' before moving on to more specific, 'sensitive' issues. This allowed each respondent to become familiar with the interview situation and develop trust in the researcher, thus minimising the chances of 'guarded' responses to sensitive questions, such as 'How do you deal with cashflow?' Trust is particularly important to research about the financial management practices of SMEs as, unless assured of confidentiality, owner-managers will not contribute sensitive financial or finance-related data. Also, a semi-formal, interactive relationship is useful in order to allow for any emergent insights into a topic by an interviewee, i.e. those that may have been 'missed' by the researcher. As most commentators acknowledge, e.g. Abramson (1992), King (1994), Bryman (1988a, p. 63), researchers 'are not always able to recognise everything that is important to their research'.

The present study also acknowledged that fostering a good relationship with respondents can also include 'managers being invited to contribute to university teaching and conference work' (Buchanan *et al.* 1988, p. 66).

3.9 MULTIPLE SOURCING

While interviews were the main source of data collection for the present study, other evidences were also included. This was to 'corroborate and augment' interviews (Yin 1994, p. 81), and is a well-documented technique (Cassell and Symon 1994, p. 4, Hartley 1994, p. 209, Stake 1995, pp. 115–6). For the present study documentary and archival evidence was used to complement data obtained through interviews, and also to validate findings by developing 'converging lines of enquiry and a process of triangulation' thus making the study more 'convincing and accurate' (Yin 1994, p. 92) in terms of objective interpretation.

3.10 FIELDWORK AND DATA ANALYSIS

As discussed above, a small number of cases were eventually selected for repeat interviews over the period of the study. With these cases, the research centre also had material from previous interviews. Interviews were repeated at intervals and carried out

with different people in the same firm where more than one owner-manager was involved. All interviews were transcribed and loaded in to a suitable computer software package for qualitative analysis. The package was used to code, categorise, cross reference and analyse data electronically on the basis of thematic issues suggested by the literature.

4. The case study businesses

4.1 INTRODUCTION AND SUMMARY DATA

The case study businesses are drawn from different sectors and are of different maturities and size. They provide examples of manufacturing, services, product innovation and distribution in order to provide contrasting examples of issues in financial management and how these issues were resolved by the small business owners. As discussed in the methodology section, four case study small businesses were eventually developed through a number of interviews undertaken with the small business owners, after being selected from a wider list and first stage interviews. Where there was more than one clearly identified business owner, all the business owners have been interviewed. In two of the four cases, business development has been tracked by the Paisley Enterprise Research Centre (PERC) for some time since they were included in the initial development of the cases. In all four cases, however, we have had access to additional information to verify the interview data, including business plans, financial records and media articles. Summary profile information is contained in table 1 below.

Table 1: The case study businesses – summary profile data

Case	No of owners	Age of businesses	Current level of turnover	No of employees – including owners	Sector/Product
A	4	6 years	£500,000	20	IT/Computing services
B	2	5 years	£200,000	3	Engineering
C	1	4 years	£1.3m	50	Packaging and distribution
D	1	2 years	£150,000	6	Manufacturing

Notes:

1. Interviews undertaken both retrospectively and concurrently with critical events in the development of the businesses.
2. All the owners of the case study businesses have been interviewed by the researchers.

A number of other businesses were taken to second stage interviews but not to further case development owing to a variety of reasons such as lack of access to background and additional financial information needed to validate interview data.

4.2 VIGNETTES

The purpose of the vignettes is give more depth to the research study and provide an opportunity to give some background to the development of each case so that the issues in financial management that are discussed can be placed in the context of the individual businesses and the owners.

Case A

Case A was started by two young Asian entrepreneurs as a publishing business. They were joined later by two further director-owners, one within the last year. The business has enjoyed substantial growth and has been transformed into a computing network service provider to other small businesses. The original publishing business has been largely run down to focus on the computing service. One of the founding business owners has become concerned directly with new software development that has attracted recent business angel investment. The fourth director has financial management as part of his remit and the business has undergone a number of changes in its approach to financial management, which are partly the result of external factors.

In terms of financial management, the case study demonstrated considerable change in behaviour by the owner-managers, as indeed in other forms of strategy. In terms of capital structure, there has been no outside, external investment and it corresponded to an introspective view of capital structure represented by the Pecking Order Hypothesis (preference for personal sources and re-investment of profits). Indeed, to begin with the owner-managers were reluctant even to draw sufficient salary and depended on their parents for their basic living expenses (being still young owner-managers). These attitudes have changed considerably during the development of the firm, which in a relatively short space of time has undergone significant change, both internally and in its target markets. The factors influencing such changed behaviour have been both internal and external, including the contact that the firm has had with outside advisers. The firm was brought into contact with outside advisers through a desire to become established in the public sector market. Some initial orders from development agencies such as Glasgow Development Agency and Scottish Enterprise led to contact with a specialist adviser (in ICT) who, in time, influenced the attitudes of the original owner-managers. The role of the accountant as a potential adviser was also important in this firm. This illustrates that accountants can influence learning, networks and the eventual development of small firms.

Case B

This business was started by two partners who had worked together previously for the same firm. Originally, the concentration was on general business services to other small

companies. The business, however, has undergone transformation from this to a niche engineering concern that involves R&D and production development. The main concern now is with new product development, for which it has taken some time to establish a market. One partner is concerned with design and R&D, while the other has responsibility for the approach to financial management, which has been influenced by internal and external factors.

This firm has also undergone considerable change, but this has not led to the rapid growth experienced by case A. Learning has also taken place, both internally and through external networks and contacts. This firm has had similar advisers (to case A), but the experience has been less beneficial. Greater change has taken place from internal experience and areas such as dealing with customers. Growth has been much more evolutionary, hence the firm has remained small. The firm, however, is dealing in markets in which it is much more difficult to make a breakthrough. The market is slow to change (being based on agriculture and aquaculture practices) and the dominance of large firms is difficult for the small firm to break. By contrast to case A, this firm has been much more self-reliant and this may have hindered the growth of the firm. Attitudes to external capital (Pecking Order Hypothesis) have not really shown any evidence of change whereas in the other cases there is greater evidence of a change of attitudes.

The role of accountants may help in introducing external networking influence. In case B, the owner-managers were less reliant on advice from accountants and this limited the extent to which they were able to make use of external networks.

Case C

Case C is a high growth company founded by a single highly motivated entrepreneur, who is still the owner-manager. Over four years the business has rapidly diversified into a number of related activities, but is centred on packaging, mailing and distribution. The owner has retained close control of financial management as the business has developed. The business recently moved into new premises to increase capacity and is seeking to further diversify into associated services such as the establishment of a call centre.

In this case, the owner-manager's background meant that he was able to apply his previous experience (in a large company) to quick effect. It is an example of a firm, however, in which growth became almost too rapid. The owner-manager in this case benefited considerably from early stage mentoring advice from a support agency. Later development left the owner-manager vulnerable to over-trading, however: something that he later admitted he was naive about. The case represents rapid dynamic change in a small firm environment and the reluctance of the owner-manager to delegate responsibility. For example, it is only recently that a specific finance manager has been appointed.

This case illustrates the important role of accountants when a firm is expanding rapidly: the owner-manager became very dependent on the accountant, but often decisions were being taken based on historical data that was no longer entirely relevant to the firms current trading position. The owner-manager had only recently introduced some cost control methods and admitted openly that often cost and efficiency were sacrificed in order to deal with current important issues and problems.

Case D

The fourth case evidences the development of an interest of the owner-manager in a niche market – tailor-made highland dancing shoes. This business is still in an early stage of development but has been carefully tracked over the period of this study. The owner-manager uses a number of innovative marketing methods; he was an early user of Internet marketing/mail order. The business is also directly concerned with manufacturing.

This case is a rare example of an owner-manager in a small firm that has successfully used the Internet to market the business. For example, the customers choose and order the products from the website. In other respects the firm is typical of small firm start-ups using limited capital. A difference, however, admitted by the owner-manager, was the award of some start-up grants and further special grants for marketing on the net. The case illustrates that start-up grants can help some firms, despite the inevitable 'deadweight' (non-beneficiaries) that such schemes carry. The role of external advisers and the accountant was again important in the early development of this business.

5. Discussion of findings

The dual qualitative methodology that has been adopted for this study means that the presentation of the findings will focus upon the process issues in financial management arising from some of the research issues identified in chapter 3. It will focus, primarily, on the comparative case studies, but will also present supplementary qualitative data from the additional interviews. Much of the material presented has been derived through the inductive approach. Issues have been identified using a qualitative analysis software package, which has provided a systematic and coherent method of analysis of the large amount of interview transcripts and other material that has been collected. Following the literature review of issues in chapter 2, the discussion of findings is organised around the following headings, which can be grouped subjectively into 'process issues' and 'specific issues'. 'Process issues' include cash flow management, critical events and financial management, learning and the small business owner, financial structures and investments, relationships with external advisers and professionals. 'Specific issues' are concerned with late payment, factoring, hire purchase, leasing and business planning. These issues are selective, rather than exhaustive, to give some focus to the discussion of the findings.

5.1 PROCESS ISSUES IN CASH FLOW MANAGEMENT

The literature review revealed an often preconceived view that the micro business owner is naive about monitoring cash flow and unlikely to manage cash flow on an active basis. Furthermore, the micro business owner is seen as having an unchanging attitude to the monitoring of cash flow, which assumes that there will be no changes in behaviour over practice with cash flow management. The Jarvis *et al*. (1996) study argued that the behaviour of small firm owner-managers is based upon procedural rationality (taking account of social and cultural norms) rather than the economic or technical rationality that is assumed by most writers. Our interview and case study research supports the view of Jarvis *et al*. and we also find that, in cash flow management, the micro business owner also changes behaviour, learning from dealing with customers and suppliers. This change in behaviour is a sophisticated and a (procedurally) rational response to critical events. It demonstrates that a small firm's development is an evolutionary one in which the path of development is influenced by both changes in external events and changes in behaviour of the business owner. This evolutionary change is usually accumulated from experience in dealing with customers and suppliers.

In case A, a situation had continued for some time where there was little formal monitoring of cash flow, creating an admitted fire-fighting financial management situation. In this case it was the introduction of a further director (previously a mentor) that brought about a change in the financial management system to one based on cash flow.

Case A: planned reaction to recognised problems in monitoring cash flow

> *'one of the weakest areas of the our business at the moment – because we have grown fast – is that we are very much a sales orientated company and our finances were always left to the very end – and ultimately we were actually fire fighting to make sure that there was enough money left in the bank at the end of the month. What we have done over the last four to five months is to put procedures into place to prevent these sort of situations. – But things like purchasing we've always done – I mean if anybody needed anything they'd just purchase it, but now we're actually putting all the different departments in to cost centres.'*

In this case, although learning had taken place so that change was recognised, the new systems were only put into place once the previously external mentor had been brought in as a director. The organic growth of the firm had created a situation where it was necessary to change behaviour and the operation of financial management procedures. A further external influence that brought about a change in financial management procedures was requirements from external funders. The business was seeking possible venture or bank finance to fund further growth. This led to some changes as the owner-managers realised that they had to adopt different practices to respond to the varying requirements of external funders.

Case A: changed financial management as result of requirements to obtain external funding

> *'Two reasons (for a different approach). The first reason was our bank. It was because our account was being… left to manage on its own. They wanted us to manage our account better in order to meet some of their criteria (for a loan). Secondly, when we go to the market to look for (venture) funding, then they are going to look at our financial situation very closely… so to look attractive to investors… we have put in a proper financial system.'*

In case B, the owner-managers had also altered procedures as a result of experience, but this had not required an external mentor or stimulus. It had occurred through internal change in management of cash flow and dealing with customers, as explained by one of the owner-managers below.

Case B: evolutionary change in cash management

> *'certainly as far as credit goes you become a lot harder… and it doesn't seem to have affected the business. Whether more and more organisations out there are getting used to the idea of offering them a certain discount, like an up-front discount… Certainly, that's helped a lot and it means that you've less to manage anyway, the cash is in the bank.'*

There was also some evidence of evolutionary change in cash flow management in case C, even though the business had undergone the rapid change associated with a high growth business. The MD of this business commented on a gradual change to monitoring cash flow.

Case C: evolutionary change in monitoring cash flow

> *'Mentally my approach is beginning to change, we have been so busy growing, I have had no time to spend on finance, which I know I should. Now the figures are getting bigger so I need to look at it more closely, and we are getting better at chasing (late payers).'*

Although external influences can be very important in determining the approach to financial management by a small firm owner-manager, it is more often a reaction to the experience of dealing with customers that may be a spur to using external agencies or training, which then leads to changes in practice. For example, Case D admitted that the experience of dealing with customers led to action being taken to improve the monitoring of cash flow through a Sage accounting system.

Case D: reaction to experience of dealing with customers

> *'I had learned (financial management) from operating the business in dribs and drabs and not very well, but having won an award (for a new start-up business) it has allowed me to go to Sage and say set me up with this… and having this package I can do courses at my local college.'*

These cases illustrate that learning occurs in an evolutionary way, but it can also result from an external stimulus or a reaction to an internal critical event, such as non-payment by an important customer.

The additional interview material also revealed an evolutionary learning approach to financial management. In some cases this may have been through pressure to conform with existing practices and was thus coercive. For example, the owner-manager of an early stage business comments:

> *'Because of our cash flow problems, we've had to delay payment probably longer than we would like because we had literally not been able to, but if we had the money we would pay. We tend to leave it 30 days… (because) …it seems to me that everyone does that. I mean we started out not doing that but now we're doing it.'*

The owner-manager of a more established, but still growing, business also commented on the evolutionary change in their approach to financial management.

> *'As you get bigger you've got to get harder. It's easy to manage five accounts, it's harder to manage ten, it's much harder to manage 500…and you've just got to adapt and put systems in place and stick to them…'*

Overall, the evolutionary change was evident in all owner-managers who were interviewed, even with the early stage businesses. There were, however, a number of factors affecting evolutionary change and these are discussed in more detail in the following sections.

5.2 CRITICAL EVENTS AND FINANCIAL MANAGEMENT

We have already seen from the discussion so far, that critical events are important in shaping the approach and behaviour of the owner-manager to financial management. For example, in case B, we have discussed how the owner-manager dealt with a situation of late payment by a large organisation. We have discussed how owner-managers may learn incrementally from experience in dealing with day-to-day situations, – as in case D 'in dribs and drabs'. This incremental learning is also supplemented by more fundamental changes in behaviour, perhaps utilising previous accumulated knowledge, through a fundamental review of financial management practices. A critical event need not be very important at first, it may just consist of a chance event, that may on its own be relatively insignificant, but which in the context of the business, becomes very significant. The result can still be considered evolutionary rather than revolutionary. This is illustrated in this section by the directors in case A, who altered their approach to seeking funding as a result of a critical meeting at an overseas exhibition.

Case A: changes in seeking funding

> *'the situation had evolved… the first time we thought about doing any of this was… at an event in Canada. We did a presentation, they became very interested in funding us… but since then we have spoken to a lot of people and we are now using this as a lever'.*

The meeting had acted as a catalyst, the changed approach was the result of the accumulation of small changes in thinking that had been apparent before, but the experience was still necessary to convert accumulated thinking and knowledge into changed behaviour.

A critical event then, may be seen as part of an evolutionary process, that acts as a catalyst for changed behaviour of the small firm owner-manager, but it also represents a small trigger, which opens a small 'dam,' behind which accumulated knowledge and experience has been built up, causing the introduction of changed management practices and systems. This may involve experience in dealing with a large firm that may have very different approaches to cash flow.

Case B: reaction to a critical event in dealing with a large firm.

> *'one of the very large organisations… a multinational… we decided to walk off site and left the equipment high and dry because we hadn't received their cheque – it was something like £15,000. They had decided that they hadn't had our invoice. We were told that our cheque is run at the end of the month, that there is no such thing as a mid-month cheque run. Fine, there'll be no such thing as a mid-month production at your facility then… and we walked off site. We had the MD deliver a cheque to us to get us to go back upon site.'*

Of course a critical event can be much more dramatic, perhaps leading to significant changes in the development of the business. As illustrated in the next example, a critical development in case B that was to lead to fundamental change in the business.

Case B: critical events and changes in business development

> *'there were a lot of enquiries but no firm interest and then… a chance meeting with a journalist produced an article… suddenly this magazine appeared on our desks and all this splurge about the company and what it could do… within about 10 minutes of that arriving on our desk, the fax machine kicked in to life.'*

Although this event did not directly change the behaviour of the owner-managers in case B, it did produce a lot of interest from funders and led eventually to changed behaviour when approaching external funders.

Case C, being a young rapid growth company, had experienced some problems associated with the dangers of over trading, the owner manager was experiencing problems with recruitment and retention of staff rather than with financial management. There was evidence, however, that the dangers of over trading were recognised.

Case C: reflective review of changes/events

> *'Without any shadow of doubt, a bigger turnover has meant less profitability. Making money and growing covers up inefficiencies and inefficiencies are left, we pick up the nearest thing (solution) rather than use the cheapest. Our move (into*

new premises) has been our major problem, with recruitment, only now can I reflect on changes.'

The additional interviews also contained some cases where the owner-manager had changed behaviour in financial management practices as a result of a critical event. In particular, one owner-manager involved in a family business, which had a history of crises involving receivership in the difficult textiles sector, referred to their ability to diversify from reliance on a small number of major customers:

'…it was very much phoning you up one day and wanting delivery that week… and you do not know where you are going, you are just led by your customer… it has been a very difficult market with some firms going to the wall… since then we have become more specialised with quite small businesses, where a customer wants a special job, we are less dependent on one customer and we are also confident of getting large contracts.'

5.3 LEARNING AND THE SMALL BUSINESS OWNER

We have mentioned that a commonly expressed view of small firm owners is that they are assumed to be naive about planning and the development of strategy and lack financial skills and understanding of financial information (Lawson, 1995). It is only recently that such views are being challenged, as different pedagogic approaches are taken in business courses and greater appreciation is made of the environment in which small firms and entrepreneurs operate. In addition, ethnographic and qualitative research methods are revealing that small firm owners and entrepreneurs do have a greater sophistication of knowledge and understanding of strategic decision-making than they have previously been given credit for. For example, Jarvis *et al.* (1996) challenge the assumption of financial management weaknesses in small firms and argue that decisions made by small firm owners can be better understood through grounded approaches using the reality of the environment in which they operate. Also using grounded theory and an ethnographic approach, Shaw (1997) has revealed the importance of bartering in small firm networks as well as sophisticated financial and knowledge exchanges by such entrepreneurs. The development of strategy within SMEs and by small firm entrepreneurs has often been portrayed as limited, operations being managed on a day-to-day fire-fighting basis. This rather traditional and black box view does not allow for the learning process that takes place as entrepreneurs, modify behaviour and develop strategy. This process happens rapidly: entrepreneurs learn to adjust, take decisions and develop a strategy that may not match preconceived notions of business planning.

Although the process of learning by owner-managers is still poorly understood, we can see from the case studies that small firm strategic development and change occur more as a result of a combination of knowledge and evolutionary reaction to critical events than through planned development. This indicates the importance of learning from experience for future development. We draw upon some examples below to illustrate the importance of learning in the evolutionary development of financial management in our cases of small firm owner-managers.

Case A: evolutionary learning

> *'The firm has evolved a structure over the last two or three years; we have wound down in a sector that we did not see any great value in being in... I think once you finalise the business plan, you've got a clearer understanding of the way to move forward.'*

The owner-managers with Case A had moved from a situation of proactive use of business planning, to understanding the importance of planning and the evolutionary change in learning on the part of the owners for strategic development of the firm.

Case B: learning to differentiate customers

> *'It's slightly difficult because the type of customer has changed. There are certain customers who we still give 90 days to. There's not a lot we can do about it... the larger organisations are like that. The smaller organisations are more flexible... There are so many organisations who have been up and down they're not used to having credit anyway, and couldn't get it if they tried, so they get used to it.'*

This case again illustrates the evolution of strategy. In this instance, owner-managers learn to take advantage of different credit terms given to different customers, thus allowing fairly creative approaches to the range of customers that they might have to deal with. It also illustrates the very different practices that are sometimes required for large and for small firms, partly reflecting different bargaining powers. We can see, however, that far from being naive, the owner-managers in this case have developed a sophisticated approach to differentiating between customers.

We have already indicated that, in case C, the owner-manager was evolving a strategy in cash flow management that had involved a gradual change and learning. This was also evident in the realisation by the owner-manager that he needed to establish a control structure in which he could delegate responsibility to a financial manager. He had learned that an owner-manager in a fast growth business may not necessarily be able to maintain close control of financial management.

Case C: fast growth requires delegating responsibility

> *'Now as we get bigger, we will try to get the right calibre of person on board. I need to delegate, but the problem is finding someone you can develop and trust. The most important thing… is people and the single biggest problem (for this company) is recruitment.'*

In our other case, however, development and growth of the business was partly achieved by the resourcefulness of the owner-manager. The following extract refers to a resourceful approach developed by the owner-manager to obtain a website for the micro business.

Case D: being resourceful

> *'I was offered a grant to use a local training company to set up a website… it would have cost £1500 even after a grant… but I thought it was bit expensive. But I had a look at other websites and found a website designer in America and asked him what kind of charges he was asking, he offered to do the first two pages free and the rest for $550; so in other words, if you're working in an international community, you do not actually need to use local people who are ripping you off.'*

The owner-manager in case D has since become an expert in web design and won awards for his website. He also advises other businesses on developing their websites and on e-commerce. The resourcefulness of owner-managers reflects the importance of developing strategies that can exploit opportunities; such resourcefulness means that the approach to financial management is more sophisticated than is appreciated by many commentators.

An owner-manager from an early stage start-up business was able to reflect on the learning experience of business ownership-management in the following way:

> *'There's always been things that you never thought about when you were trying to set up… it's been good… it has been a good learning experience.'*

Our research has revealed that the learning process in SMEs is a crucial part of their evolution. The entrepreneur acquires the ability to learn through experience. Rarely is this learning process planned, but is the result of a series of reactions to events and opportunities in which the entrepreneur learns to process information, adjust strategy and take decisions. The implications for policy are that interventions must be based on helping the entrepreneur to learn rather than imposing prescribed solutions and consultancy.

These issues have been discussed in some detail in previous work using similar case study methodology and qualitative interviews (for example, see Deakins and Freel 1998) These issues were also illustrated by the interview material associated with this study. As commented by one respondent, much learning occurs experientially: 'it takes a long time… you learn as you go along'. This raises the issue of whether learning could be more efficient, an issue that we revisit in relation to the role of external advisers in section 5.5 below.

5.4 FINANCIAL STRUCTURE AND INVESTMENTS

The conventional wisdom in much of the literature on small firms' financing structures is based upon a perceived reluctance of the small firm owner-manager to relinquish equity to outside investors. Thus the small firm owner-manager is assumed to rely heavily on personal sources and reinvested capital in the capital structure of the business. Even applying for debt finance from banks is assumed to be undertaken with reluctance, with a preference for short-term debt such as overdrafts rather than bank loans (Cosh and Hughes, 1994). This assumption is based upon an acceptance of the Pecking Order Hypothesis (POH) of Myers (1984), who suggests that external sources of equity are only approached by owner-managers as a last resort, after personal sources of debt and equity are exhausted. Michaelos (1997), in a study of financing structures, suggests that the gearing declines as firms' profitability increases, which suggests that the capital structure used and developed may be more complicated than the POH suggests. Michaelos (1997), also indicates that this will vary over time and with the age of the firm, suggesting that preferences change. In addition, of course, equity investors require formal scrutiny of the owner-manager(s) and the business. Preferences may be immaterial if the owner-manager is unable to locate equity, an issue which is illustrated in more detail with case D below.

An analysis of this issue with our cases revealed that this issue is less straightforward, as we have indicated, than conventional wisdom might dictate. For example, with case D, rather than the owner being unwilling to give up equity, a more important constraint was locating suitable equity investors.

Case D: developing capital structure

> *'Question: would you have minded giving up equity?*
> *That wasn't an issue. I would have always wanted to retain control of the business and that would have not been an issue… I would have sold the company in order to retain a smaller investment as long as I had an income. But in the meantime that isn't on the cards and the investors wouldn't look at me (even though invited to*

training sessions). I'm a nothing company to them (formal venture capital companies (vcs)), unless I have the potential to do millions.'

The issue of raising venture capital was also discussed with case B. In this case the owner-managers had engaged in a search for private investors, but the high tech nature of the business meant that there were problems in attracting investment.

Case B: difficulties of technology-based firms and venture capital

'We had this piece of equipment and it worked. So we did what we were supposed to do, you know, go round the enterprise people and the venture capitalists. There was no way. Big lumpy orders… you're moving from a £50,000 turnover to trying to produce a £250,000 order… We had all the right buzzwords, we had innovation, we had manufacturing, we had job creation. This will be easy… but no, it wasn't interesting enough.'

In this case the owner-managers' difficulty lay in changing capital structure so that investment could be raised to fund an expansion of manufacturing capability. The difficulty lay not in the attitudes of the owner-managers but in the search procedure and in the nature of their technology-based business.

The owner-managers of Case A were also considering raising additional capital to fund expansion. This case also showed the resourcefulness referred to in our earlier discussion, since they were considering applying for the Small Firms' Loan Guarantee Scheme to improve their gearing structure. They discuss their need to raise substantial funding for further growth and development below.

Case A: developing an investment/funding strategy

'Obviously, we've got to put a lot of resources into this. We've spoken to people like… development agencies… SFLGS, SPUR, and we're having a meeting with 3i soon… What we plan to do is to get some short-term investment into the company to get a prototype soon… then we could attract some of the major funding, when we've got maybe a million, then we can go to 3i.'

Thus, case A had identified a strategy, although there was also some evidence that there were limits to the dilution of equity that they were prepared to accept in order to fund further growth. They also comment that:

'We would rather actually build the capital base of the company up so that if we do get a million in, say, a year's time, we only have to give away 20% or 30% of our

equity, rather than maybe 40 or 50%, which we would have to do to get the funding in soon.'

Case C's high growth had been organically funded, although a small overdraft facility had been used (which was about 4% of turnover). Nevertheless, the owner-manager did express a willingness to consider venture capital funding for future development. A similar sentiment was expressed over the desire to have a larger businesses, even if it meant having a smaller share: 'I would rather have a smaller share of a larger cake'.

As is continuously indicated by recent reports (e.g. Bank of England, 2000), venture capital, whether formal or informal, is only used by a small minority of small firms. Yet there was some interview evidence that small firm owner-managers would consider venture finance if additional expertise could be brought into the business. As one owner-manager from a successful growth business looking to diversify and expand commented:

'If they (vcs) are not adding anything, if they're not bringing anything to the party, then its expensive money. But sometimes it's the only way for people to get money and therefore it is a good tool to grow the business. The people we're talking to who will be buying into the business, have a wealth of expertise and bring something very very real to the party.'

5.5 RELATIONSHIPS WITH EXTERNAL ADVISERS AND PROFESSIONALS

We have noted previously in our discussion that relationships with external advisers or professionals can be important in the learning process and the evolution of financial management practices by the owner-managers. For example, in section 5.1 in the discussion of case A, were noted how a previous mentor had been brought into the firm and changed procedures concerned with financial management. Other relationships that are going to be influential in terms of financial management by owner-managers in small firms are those with external funders, the bank manager and the accountant. The importance of the relationship with the bank manager has also been discussed previously with case A, where the owner-manager had described how they had to alter practices to meet some of the requirements of the bank. Case A were involved in applying for the maximum amount, under the Small firms Loan Guarantee Fund, of £250,000 and were working with the bank to develop a business plan.

Case A: developing and evolving relationship with the bank

'Actually we approached our own bank… who are very with us at the moment (and)

they've bought into the concept they are going to be funding us. What they're doing is... we're going to get a business plan together for (application to SFLGS) £250,000.'

The relationship with external advice agencies, where they exist, can also be important in developing potential deals with funders such as business angels, where it may be important to have a third party that can act as a broker in terms of introductions and setting up deals. Again, this may be precipitated by a critical or significant event. For example, in Case A, one of the owner-managers had been selected for an innovative award, which triggered much interest from business angels and potential funders, providing a significant change to the prospects of the business.

Case B: relationship with enterprise agencies and credibility

'We had decided to go to the enterprise people and ask them: do they want to appoint a receiver or should I? And that's really how low we felt at that time... (but) about a week later the Scottish Office extremely interested in us from the credibility point of view (with Innovation Award). So they were interested in helping us, now that we'd established that kind of credibility. We had a range of business angels come to ask if they possibly could invest in our company, which was absolutely amazing—having spent so long trying to find them, they were coming to us now.'

The owner manager concerned with Case C, as a fast growth company, had received one-to-one mentoring advice from the local enterprise company (LEC). The role of this business mentor had been important during the early development of the company, illustrating that during early stage development the role of external advisers can be very important in influencing approaches to financial management and the use of accountants.

Case C: role of external business adviser in early stage development

'We were allocated a business adviser when we started by... (the LEC) and we still have a relationship with... (the LEC) ...he was like a sounding board, it was valuable to bounce developments off him.'

As discussed with Case C, the relationship with external agencies and advisers can be crucial during the early stage of development of a business, especially in reducing the isolation and self-dependency of the owner-manager, which is particularly high during the early years of trading. This was illustrated by the owner-manager of Case D during the early stage of development of his business.

Case D: role of external business adviser in early stage development

> *'I have a very good business plan, which has helped put together with… a local business adviser, Brian. Brian has a lot of experience of where to go and who to meet, what to say and all the rest of it, he was very keen on sitting down with me and actually discussing things with me because he knew that entrepreneurs live in an ivory tower, not of their own making but because of the situation they've got themselves into. They have got nobody to talk to, it's insular and you don't really know if you are making the right decisions.'*

The additional interviews also revealed that relationships with an adviser could be important for reducing isolation and changing financial management practices. One of the additional owner-managers commented, that it may just mean access to additional finance, such as grants, but also:

> *'the fact that you have access to a wealth of experience and knowledge… there are people who are just very good at helping and in business (sometimes) you can't see the wood for the trees, you're too close. You know, someone standing back can help you and we have drawn on their expertise a lot.'*

This indicates that external advisers can have an important role in assisting the experiential learning process, perhaps providing vicarious learning through their own experience or work with other small firm owner-managers. In fact, one firm had recruited their bank manager to bring financial management expertise directly into the firm:

> *'As regards the overall financial management, we've actually employed our bank manager to come away from the bank, he's left the bank and joined us.'*

The issues discussed so far have involved process and dynamic issues. They reveal that financial management practices in a small firm are not static, but changing and evolving. These evolutionary changes may reflect a number of factors that affect the process of financial management. Among those that we have discussed and illustrated from our research have been the resourcefulness and learning of the owner-manager, the influence and role of external advisers, accountants and bank managers, the impact of significant and critical events, and changing capital structures. In the remaining sections we turn to examine some specific issues within the dynamics of these processes. These are often seen as particular problems for small firm owner-managers (for example, late payment); however, the remaining sections examine these issues within the context of the dynamic processes that characterise the environment for small firm owner-managers.

5.6 LATE PAYMENT

It is generally accepted in the financial management literature that late payment is a particular problem for small firms, which may force the owner-manager to adopt particular financial management practices or to use special (and expensive) financing arrangements such as factoring or invoice financing and debt collection methods.

All our case study firms had some experience of late payment as a financial management problem; however, it was usually approached as an exceptional occurrence, rather than the norm. In previous research by the Centre at Paisley, late payment, contrary to popular wisdom has never rated as a very significant issue (PERC, 1997; PERC, 1999). The assumption that small firm owners are naive also applies to management of creditors and debtors, whereas in practice our evidence suggests that the owner-manager is more likely to take credit when it is available and manage or monitor debtors to ensure that cash flow is maintained. This issue is too important for owner-managers to ignore. The approach is illustrated in the following extract from an interview with case A.

Case A: managing debtors, creditors and late payment
Commenting on policy:

> *'We do have a standard contract which we issue with all our contracts, in terms of: we expect this invoice to be paid within seven days. That's our operating terms with our creditors. With our suppliers we tend to take 30 days and have a policy of trying to pay within 30 days if possible.'*

Commenting on late payment:

> *'(Printing) is the worst industry for that (late payment). A lot of businesses do go to the wall in that industry because the margins are very tight and the payments are very late. That's how we were pleased to get out of it when we did.'*

Thus Case A had removed a late payment problem through a diversification strategy so that late paying debtors were no longer involved. Case B illustrated that it is more likely to be large firms that are the late payers where this is a problem.

Case B: managing debtors, creditors and late payment

> *'Some of the larger organisations have taken 90 days to pay, and if I've paid for goods on credit card or got credit facilities from an organisation... They're the big lumpy orders so the purchases are bigger than our overheads and if we have to pay that supplier in 30 days or maybe 60 days and the revenue hasn't been received because it won't be till 90 days, we've got the option of stretching it out with that supplier to 90 days and falling out with them, and therefore they're not giving you*

any credit after that, or doing something else about it. Its not so bad – I find nowadays discussions with the creditors a lot more helpful – to actually say that was a big contract and the customer hasn't paid up, but he has promised to pay in six weeks time. In the meantime I can offer you so much payment. That's very well received. They'd rather be aware of the situation. They don't know what's happening. They just either assume that you're bust or whatever, but if they're aware that you're dealing with the situation…'

Case B: managing debtors, creditors and late payment

'My business is all credit cards. But indeed, there was one customer who was getting 30 days and he was complaining – he was buying a lot of stuff – and he was complaining why he wasn't getting regular deliveries and I had to admit to him that the reason why he wasn't getting regular deliveries was because he pays in thirty days, and if he paid up front or even within seven days he would get regular deliveries. And he said, "All you had to do was tell me", so I said, "Okay, I'm telling you now", and he said, "I'll pay in seven days"'.

Case C, our fast growth company, like others had not had particular difficulty with late payment, but there was evolutionary change in dealing with a small number of customers who had been identified as late payers.

Case C: managing debtors, creditors and late payment

'Late payment is a problem with some customers, we pester them… some people always say they did not receive our invoice, which can be part of a culture… we have started to do it (pester) because cash flow has become more of an issue.'

Overall, when examining both the case study and the interview evidence, the problem of late payment could be seen to be highly *variable* both from one small firm to another and within firms when dealing with different customers. In addition, as discussed below, practice with factoring varies considerably from one small firm to another. As commented by one of the owner-managers from the additional interviews, late payment, if it is an issue, tends to be a problem with a small number of customers.

'Well it (late payment) varies. People like… they tend to be reasonably good. Where it gets worse is with… and there is one company in particular that have a reputation for late payment.'

Thus the overall picture with late payment is more complicated than some of the more popular received views might suggest. There is little evidence of a 'late payment culture', although as an issue it can certainly be important for some owner-managers. We will

consider the use of factoring in section 5.7, the growth of which in small firms (see comment in the Bank of England Report, *Finance of Small Firms*, 2000), has helped to alleviate the problem of late payment for some of them.

5.7 FACTORING

Factoring has often been promoted as a form of short term finance for owner-managers and also as a desirable form of financial management, allowing the owner-manager to control debtors (Storey, 1994). The evidence from our study, however, was rather mixed as to the potential benefits of factoring as a form of short-term finance. None of our cases were using factoring, although some had considered it, but in general attitudes of owner-managers towards factoring were not favourable. Some owner-managers in our interview survey were using factoring as a method of managing their debtors and we discuss some evidence drawn from our interviews. We comment first of all, however, on some opinions and attitudes expressed by our case study owner-managers.

Case A, for example, did not wish to consider factoring because it was perceived to have negative connotations.

> *'I've heard both positive and negative things about it (factoring), but more negative rather than positive, so I've decided to stay away from that as a form of financing the business. What I do hear is that you get your money very quickly but at the end of about a three month period you are landed with a big bill.'*

Case B also commented on the suitability of their business for factoring as well.

> *'We've looked at factoring, …was involved in factoring at various companies. I've operated factoring for a customer… – the company I used to work for were factored, and some of the clients that I used to work for were factored as well. We've never considered it for this organisation and we wouldn't be accepted for it for this organisation because of the low numbers of customers that we have. The debtors ledger's not spread out enough. They're looking for hundreds of little invoices to lots of people rather than three or four – big chunky stuff. If you actually work out what happens with invoice factoring you end up with a black hole scenario where you cannot get any advance on your invoices going out. If I had, say three customers, one of which has 75% of a debtors' ledger and the other two were only 25%, if I invoiced to that big customer they wouldn't advance me any cash because they would constitute a higher percentage of the ledger – its much more risky if they go down. So although there's invoices going out and they're*

charging a fee on it, they're not advancing with any cash. Worse than that, when the other two customers pay up this existing debtor becomes a higher proportion of my ledger. They'll take money back off me as well, and there's the usual weighing up where they say that it's their professionalism which makes them get the cash in. Experience has shown that it's still the 90 days before they collect. I suppose an average collection's about 95 days. That allows them to have maximum charges against you for that invoice because you're charged 2% per month that its outstanding, and they've got the full lot. Then it gets reassigned because its more than 90 days so they take all the cash back off you again, charge you an extra percent, and give it all back to you. And it can be... Its brilliant when you've got lots of customers and they do pay reasonably well, but that's why you get into factoring in the first place – you thought they're not paying very well. I need the boost. It's a brilliant boost to start with if you're just getting 80% of your debtor's ledger in to the company – brilliant boost. Except that a lot of people fail to realise that its only 80% of anything that's up to 90 days old. It doesn't count anything older than that anyway.'

Our other cases also commented that factoring was not suitable for them and generally saw it more of a last resort nature than something that should be considered. The owner-manager of case D, expressed this as follows:

'I suppose it (factoring) must be good for some businesses, but I have the feeling that better management of finances in a company should not require the use of factoring. A lot of the time, its because they give too much credit, which is one of the reasons why they have to get factors in.'

The evidence from the additional interviews was more positive in terms of attitudes of owner-managers and factoring, but as indicated by the case study interviews factoring was suitable in a minority of small firms. In one additional firm that was dependent on public sector contract work, factoring was important to their cash flow management.

'We have a contract with the Social Work that we were to be paid within 28 days... we never get paid in 28 days and we couldn't survive without it (factoring).'

Another owner-manager admitted that factoring was expensive and that he had had to change factors, but it was still of value to his business:

'I do think that it is (worth it) but it isn't cheap. We pay a lot because we take the maximum amount, but we had problems with the service from our previous factors,

their service went out of the window—so we changed… it was expensive, because we had to pay commission and the termination fee as well.'

Another owner-manager from the additional interviews admitted that late payment was a problem for some of her customers and she had adopted a system of invoice financing, which was of particular value to her growing business.

'The old style of factoring was very expensive and inflexible. Factoring today is actually a superb business tool. I use it because if I'm trying to grow a business and expand a business, I've got to give credit…(but) …if I can raise the money to a reasonable percentage, I've then got working capital in the business that I can expand and sell through rather than going for pure overdraft.'

As with late payment, financial management practice with factoring or invoice financing is highly variable. As discussed by the Bank of England (2000), in their latest Report on small firms finance, the take up of factoring has dramatically increased in recent years; while there is still a perception by some owner-managers that factoring is expensive, improvements to the service offered by the commercial banks mean that more small firms are taking advantage of this form of financing, which can be valuable for some owner-managers.

5.8 OTHER ISSUES: HIRE PURCHASE/LEASING AND BUSINESS PLANNING

Other issues in financial management, such as the owner-manager's use of hire purchase and leasing, were not considered to be important for our cases and hence were not discussed with them in any depth. With microfirms, leasing is unlikely to be a significant part of their finance even though recent surveys have suggested that this is becoming a more important source of finance. As one of our case study owner-managers commented, however, microfirms are too small to utilise benefits of leasing.

'With being small, even the likes of welding equipment—you can hire that equipment, but by the time you've paid for all that, and its only a short period of time, you are just as well giving it to someone to do (subcontract).' (Case B)

The additional interviews with owner-managers also confirmed that leasing was an exceptional practice, only being extensively used by one of our respondents, whose business was concerned with media technology and required expensive equipment that dated rapidly, hence in this case both hire purchase (hp) and leasing were an important

source of finance, ‘we lease, probably half of it (equipment), and we’ve come to an arrangement to lease and pay h.p.’

The practice with business planning was also highly variable, both within our cases and with the selected additional interviews. As with factoring, there was evidence both of prejudicial views on the value of business planning, among some respondents and, among others, examples of business planning being part of their financial management forecasting and practice. There was evidence that business plans were used for more than just funding/bank applications. For example, one of the case businesses had established a formal planning procedure with a ‘strategy day’ built into the procedure.

Case A: formal planning procedure

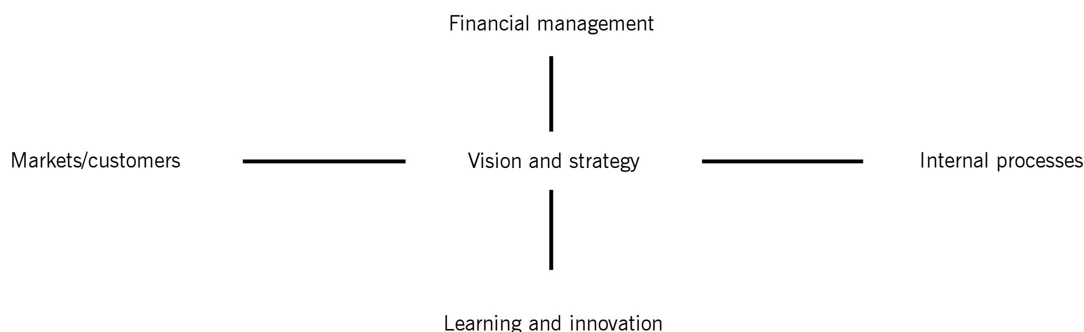
> *‘Over the last six weeks it’s been a whirlwind of meeting people and getting different ideas, different opinions, and it’s just to try to consolidate these into something that works best for us… we will actually have a strategy day… to bring everything together.’*

A comment on the usefulness of the process of writing business plans was provided by one of the owner-managers from the additional interviews as follows:

> *‘But it’s very worthwhile, not just plucking figures out of thin air, but concentrating on making a concerted effort to get as accurate a picture as you can… and you realise that spending many hours doing a business plan is a lot better than plucking figures out of thin air to impress a bank manager.’*

These comments (on the value of the process of business planning) need to be balanced by comments from other owner-managers who did not use business plans, or those who effectively had an *ad hoc* approach, as might be expected in small firms, to strategic and business planning. Such examples are worth highlighting because it reflects the importance of the process to some businesses. Both firms mentioned in this section were undergoing growth and a period of rapid change: circumstances in which planning was important.

Figure 2: Four perspectives of Balanced Scorecard to strategy and financial management



From Kaplan and Norton (1996)

5.9 TOWARDS A MODEL OF FINANCIAL MANAGEMENT BEHAVIOUR IN SMALL FIRMS: THE RELEVANCE OF THE 'BALANCED SCORECARD' APPROACH

The Balanced Scorecard is a well known concept applied to strategic management. As proposed by Kaplan and Norton (1993); it provides four perspectives on company measurement and performance, one of these perspectives being evolutionary learning and adaptation (innovation), as shown in figure 2.

The four perspectives of the model are intended to focus managers of companies on performance measurement. The four perspectives to be considered are as follows.

1. Financial – how do we look to shareholders?
2. Customers – how do customers see us?
3. Internal processes – what must we excel at?
4. Learning and innovation – can we continue to improve and create value?

It is suggested that the four perspectives will produce the 'Balanced Scorecard': translating the vision, communicating and linking, business planning and learning. Most of the work, of applying the Business Scorecard concept has, however, taken place within large companies, as envisaged by Kaplan and Norton (1996).

Chow, *et al*. (1997), however, have looked at the potential of the Balanced Scorecard for small firms. They used four case studies to assess the applicability of the Balanced Scorecard approach. They concluded that:

> 'across the four companies considered there is a clear indication that management is designing the goals and measures to fit the company's unique needs and perceived role. Further, these responses suggest that the Balanced Scorecard can be an effective management tool for small companies as well.' *(p.25)*

In the light of previous literature and research concerning small firms and financial management, it is argued that the Balanced Scorecard concept is relevant to the evolutionary nature of behavioural issues of owner-managers in small firms. One of the problems of survey-based studies is the lack of insight into the process of financial management. Our cases illustrate the evolutionary nature of learning as part of this process leading to changed behaviour in financial management by the owner-manager in the small firm. By incorporating learning, innovation and change, it is argued that such an approach is more relevant to the dynamic process of financial management in small firms than traditional financial approaches that focus on static task-based control measures.

6. Conclusions

The evidence presented in this report suggests that there exists considerable variety in financial management practices in small firms, with some owner-managers capable of adopting sophisticated approaches, including full strategic and financial planning methods. It is clear that the dynamics of financial management processes and decision-making are influenced by many factors, including both internal management issues and external environmental issues. Our main conclusions reflect the importance of factors that affect these issues and are organised around the main issues discussed in chapter 5: process and specific issues.

6.1 In terms of cash flow management, we agree with the argument of Jarvis, *et al* that owner managers operate a procedurally rational approach in reaching financial cash flow management decisions; that is, allowing for social and cultural norms. This procedural rationality is grounded in the particular contextual environment in which the businesses operate. Change is evolutionary, lending support to the value of an evolutionary modelling approach to financial management in small firms (Freel, 1997). Entrepreneurial learning is an important part of this process, with experiential learning being critical, but there is also considerable scope for intervention to ensure that such learning is efficient. We refer to the importance of the role of external advisers in 6.5 below, and some policy implications in 6.8.

6.2 As part of the dynamic process, in terms of changes in financial management practices, the role of critical events was important for determining the learning of owner-managers and their evolutionary approach to decision making. Critical events could change behaviour leading to (less) gradual change in management practices. This should not be mistaken for fire-fighting practice but more the accumulation of learned experience which leads to change once a trigger event happens. Critical events are not in themselves disasters, they act more as a confirmation to the owner-manager to change a practice or bring forward a planned change.

6.3 Evolutionary change and learning are interlinked and this in turn has an important effect on the dynamics of financial management. Our evidence suggests that the learning process in small firms is a crucial part of their evolution. The entrepreneur, through experience, acquires the ability to learn; rarely is this learning process planned, but is the result of a series of reactions to events and opportunities in which the entrepreneur learns to process information, adjust strategy and take financial management decisions.

6.4 In terms of decisions concerning capital structure, our evidence suggests that process and behaviour of owner-managers in this area is more complex than theories such as the Pecking Order Hypothesis might suggest. Some willingness to dilute equity was expressed by most of the owner-managers interviewed, but a more important constraint (than owner-managers' attitude) was locating suitable equity investors. This finding adds to the complexity and variety of practices in financial management that exist in small firms in practice.

6.5 Given our argument that financial management is based upon evolutionary change and dynamic processes, the relationships established between owner-managers and external advisers, whether accountants, bank managers or other professionals, were very important. Our evidence suggests that these relationships are crucial during the early stage development of a business, especially in reducing the isolation and self-dependency of the owner-manager, which is particularly high during the early years of trading. The embeddedness of the owner-manager in networks involving advisers, we conclude, is an important factor that influences financial management practices. Policy makers have a role in facilitating such networks.

6.6 Like some of the other specific issues, we conclude that late payment was highly variable in importance both between small firms and within the same firm over time. The related issue of invoice discounting and factoring also varies considerably from one small firm to another. The evidence from interviews was variable in terms of the importance of factoring, although there was some evidence to support the increasing importance of factoring to some small firms.

6.7 Other issues considered included leasing, h.p. and business planning. However, leasing was only used by a small minority of our respondents. In the case of business planning, again evidence of practices was mixed. Issues discussed above in terms of evolutionary learning were also important for planning procedures. Some owner-managers could be considered to have sophisticated approaches, whereas others had a more *ad hoc* approach. Planning was used and was important in those firms undergoing growth and a period of rapid change.

6.8 We have emphasised that it is important to take a dynamic view of financial management practices in small firms and that of such an approach has policy implications. The implications for policy are that interventions must be based on helping the entrepreneur to learn rather than imposing prescribed solutions and (top down) financial management consultancy.

6.9 In terms of policy, in the UK, the small firms sector is beset by inconsistency of approach, despite attempts to develop a one-stop shop approach to support via the Business Links in England and Wales. In Scotland, LECs have the ability to respond independently to local economy needs; yet this can also produce some large divergences in delivery of support. *The Small Business Service (SBS) Consultation Document* (DTI, 1999) promises to give small firms a voice in policy making. The apparent commitment to a greater role for small businesses in policy formulation may help to redefine the role of advisers in the context of evolutionary change. There are different approaches to interventions to support small firms in practices such as financial management. Our study suggests that short-term episodic solutions are inappropriate; it is important to build long term relationships so that advice can match evolutionary change and behaviour of small firms.

6.10 There is a need for more conceptual development to understand the process of financial management in small firms. We suggest that a modified version of the Balanced Scorecard approach can provide a framework for understanding owner-manager behaviour in the small firm. The Balanced Scorecard approach has previously only been applied to large firms. We argue that it has relevance for small firms; however, more research and work is called for to develop, test and apply this model to small firms.

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