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COULD IT BE A CASE OF FINANCIAL MANAGEMENT IGNORANCE? AN ANALYSIS OF FINANCIAL STRATEGIES EMPLOYED BY SMES IN ZIMBABWE

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Abstract

SMEs have great potential to serve as engines for economic growth particularly in developing countries like Zimbabwe. However, SMEs face a number of constraints, which include financial, technical, raw materials, managerial, legal, regulation and competitive policies that hinder their development. According to many researches carried out about the challenges faced by SMEs, the major obstacle faced by this sector is finance. This paper is meant to analyse the effectiveness of financial strategies applied by the Zimbabwean SMEs as well as to evaluate their performance and contribution towards economic developments. Research has been carried out through administering questionnaires to the SMEs owners and managers and conducting interviews with the interested stakeholders like SEDCO, Micro King and Economic executives of Reserve Bank of Zimbabwe to gather information on the financing and investment issues of the SMEs. The study revealed that most SMEs in Zimbabwe have very limited sources of finance, inadequate access to loans, poor working capital management techniques and ineffective financial risk management policies. Recommendations had been given in this study on how to manipulate these variables in order to come up with the financial strategies that would boost the growth of this sector and the Zimbabwean economy as a whole.

Key Terms: *Small and Medium Enterprises (SMEs), financial ignorance, financial strategy.*

Introduction and Background

Black empowerment and indigenisation policies in Zimbabwe resulted in setups of many Small to Medium enterprises (SMEs). These enterprises were greatly supported by the government with the belief that increase in the number of businesses will facilitate the economic growth and development. Furthermore the implementation of Economic Structural Adjustment Programme (ESAP) in 1990 and Zimbabwe Programme for Economic and Social Transformation (ZIMPREST) led to a negative impact on the economy and this resulted in major retrenchment of employees, leaving the majority of Zimbabweans jobless with no income for survival. This stimulated many individuals to engage in income earning projects in the informal sector which had become a very lucrative source of income for many Zimbabweans.

SMEs which are believed to be outside the formal sector had managed to harness the talents in the informal sector bringing them into the formal sector to generate increased revenues through taxation. This also stimulated the government to recognize the potential of revenue in this sector and decided to implement policies for supporting the sector. According to the Small, Micro and Medium Enterprises Policy and Strategy Framework (July 2002) by Minister Sithembiso G.C. Nyoni , the objectives of supporting this sector is to generate sustainable jobs, alleviate poverty, stimulate growth and generate foreign currency earnings of which all this contributes to the economic growth of the country.

The downturn of the Zimbabwean economy has prompted a number of stakeholders to focus on SMEs for economic development. The government of Zimbabwe, Reserve Bank of Zimbabwe and some other Non-Governmental Organizations has managed to support the SMEs financially with the expectation of improved economic growth in the country. All this support has not yielded any feasible economic gains suggesting that the financial strategies applied by the Small to Medium enterprises are not effective.

The support providers are also considering reducing the gap of income distribution between urban and rural through supporting SMEs in rural areas. The owners of small enterprises in rural areas are lacking knowledge of investment and financial strategies. The small businesses in Zimbabwe are generally not growing into larger corporations and the opportunities of growing into multinational companies are slim yet this sector is also expected to generate foreign currency that is mostly needed in the country. The potential for them to grow will depend on its global competitiveness in their performances. The concern at hand now is the performance of the SMEs resulting from the financial strategies they apply.

The financial institutions in Zimbabwe are reluctant to provide financial assistance to SMEs because there is a strong belief that there is high financial risks particularly credit risks in smaller firms. Unlike larger firms, small firms do not have adequate collateral security to secure their loans hence they are unable to obtain loans from the private financial institutions. Failure to access funds hinders the growth and development of small firms but at the same time it is risky for financial institutions to provide finance to a firm which they have already assessed its inability to settle its obligations as they fall due. For the purposes of developing the economy through this sector, two parties that are, private financial institutions and SMEs sector must come into compromise on how the firms can be helped without throwing the other party out of business or with reduced risks. This paper is structured as follows: it starts with presentation on objectives of the study, followed by review of related literature subsequently followed by explanation of financial variables and presentation and analysis of results and findings. The paper closes with recommendations and conclusion.

Objective of the Study

The main objective of this study is to analyse the financial strategies applied by the SMEs in Zimbabwe and to evaluate the performance of SMEs in relation to financial strategies applied. The study consisted of SMEs in Bulawayo. SEDCO personnel, National Development department at the Reserve Bank of Zimbabwe and other commercial banks executives that provide loans to SMEs were consulted for information on policies and procedures of disbursement of loans to SMEs.

Review of Related Literature

Though SMEs are major players in the economy, there are major obstacles that hinder the effectiveness and efficiency in their performance. These include financial constraints, technological inefficiency and poor management skills. The major challenge in this sector is the access to funding. The conference on SMEs financing which was held in Lahore (May 2005) confirmed that the World Business Environment Survey 2005 was conducted covering four thousand (4000) firms in fifty four countries found that SMEs cited inadequate access to finance as their primary constraint to growth. Eckman K(2005) states that "SMEs need to be able to access credit in order to adopt new technologies, acquire productive assets, initiate other projects and investing on effective management policies. This indicates that if the problem of financial assistance is addressed other challenges like technological and managerial challenges will be automatically addressed. This is also confirmed by Binks M & C Ennew (1994) when stating that "Most people argue that financial assistance is the most critical support system of all for SMEs. Without it, other forms of support are of little use'.

According to A Hughes (1992) the problems of accessing finance are caused mainly by lack of security, inability to keep proper financial records and inadequate managerial skills which expose them to other financial risks. Availability of finance is not the final answer to the development of the SMEs. After acquiring finance, an SME has to apply the financial strategies that will enable the business to perform efficiently and effective. This involves making proper investment and financing decisions within the context of strategic plan. Micawber at David Copperfield (1989) also confirms that the success of any organization relies on managing finances effectively. Managing finances effectively involves sourcing of funds and application of funds effectively. Further on, Ilkova E. & Donnelly S. noted that financial management is an efficient use of economic resource capital. Efficient financial management also includes the ability to manage financial risk. According to C.T Ennew & M.R.Binks (1995:78) financial risk is the additional risk a shareholder bears when a company uses debt in addition to equity. This is also confirmed by Evans D.S & B. Joavanic (1989) who maintains that financial risk is the risk that arises from the financial structure of which if there were high debt ratio the financial risk would be high. Therefore, the companies that issue more debt instruments would have higher financial risks than the companies financed mostly or entirely by equity.

Sources of Finance

Sources of finance include debt funding thus acquisition of loans, equity financing, and venture capital and business angels. In developed countries there are some Stock Exchanges that are mainly for the SMEs because such companies are listed at lower cost. The requirements of these are very lenient to cater for smaller firms but at the same time compliance with the listing regulations are maintained. Examples of such Stock Exchanges are Bendigo and Newcastle Stock Exchange in Australia (A guide to SME Business Finance 2002).

The Zimbabwe government is also pressurized by the players in the SMEs sector to set up secondary Stock Exchange to enhance the financial position of the SMEs. (Zimbabwe Newsnet 04/04/07). This will create another source of funds to SMEs in Zimbabwe that are having problems of being shunned away by the financial institutions. Pecking order theory is also referred to as the information asymmetry theory and it states that the firms prefer to finance new investment first internally with retained earnings, then with debt and finally with equity. (F Buferna,K Bangassa & L Hodgkinson 2005).

Thirty seven percent (37%) of the SMEs that were being studied had access to government loans. The main sources of funds in the small and medium business sector are personal savings which constituted thirty four percent (34%) of the total sample. The source of the personal savings is mainly the retirement and retrenchment packages. Majority of SMEs being fifty five (55%) use retained profits and equity as their main source of finance and these are generally companies registered under Company Act and Private Business Corporation. From the total number of SMEs included in the sample, only four percent (4%) had access to loans from financial institutions.

Most of the SMEs do not incorporate leasing as part of financing. About thirteen percent (13%) of the sample incorporates the leasing and this is mainly the manufacturing and engineering sector. Retailing sector do not use heavy machinery hence there is no leasing of the equipment.

Many SMEs depend on their personal savings and ploughing back of profits for their capital. A number of SMEs were initiated as micro businesses and the retrenchment packages were the main sources of capital. Because of lack of collateral security most of them have problems in accessing loans from financial institutions except the government loans which are relatively cheaper. The repayment period of financial institution loans is a strain to many SMEs because it is so short.

Many organizations have access to government and Reserve Bank of Zimbabwe loans because of its low interest but the amount allocated to individual organizations is so small such that it is not enough to purchase the assets required for effective production. This leads to production of poor quality products that cannot withstand the global competition with other internationally produced goods. The SMEs are also failing to build brand loyalty because of the poor quality products. More funds are needed to advance the technology in the SME sector so as to improve the quality of products

Capital Structure

It has been revealed in the research that the financial structure of many SMEs in Zimbabwe consists of equity only which would be contributed by the owner only. Debt to equity ratio is too low and zero in some cases reflecting that the SMEs do not depend on debt financing. The reasons for low debt to equity ratio are that financial institutions are not willing provide loans or debt financing to SMEs through charging high interest rates which are not affordable to SMEs and making short repayment period. Some SMEs owners are not willing to engage external owners in their companies so as to maintain full control. The affordable loans which are provided by the government and the Reserve Bank of Zimbabwe are not enough to finance any project hence such funds do not yield any favorable results in the development of SMEs. The research revealed that the small firms in Zimbabwe are being managed by the owners and these owners do not have management skills hence they need to develop basic management skills. In addition to basic management skills, the investment and financial knowledge is important to the decision makers to enable them to utilize the financial resources effectively and efficiently.

Generally the debt to equity ratio is very low. Though SMEs have difficulties in accessing debt financing, most of them are not willing to include outside investors fearing loss of control and dilution of shareholding capacity and this has been the main contributor of having hundred percent 100% equity structure in many small businesses.

Working Capital Management

Working capital management involves the relationship between current assets and current liabilities. The goal of working capital management is to ensure smooth operations of a business and capability to meet short-term liabilities and operating expenses by managing cash, stock, debtors and creditors. Wood N. and Lord J. (2000) suggested that working capital management could be further analysed by examining the operating cycle and the cash cycle of the firm. Operating cycle is defined by E. Ilkova and S. Donnelly (2000) as a cycle which begins when the inventory is purchased and ends when the payment is collected from the customer. The cash cycle begins when the inventory is paid for and ends when the customer finally pays.

Cash management involves optimization of cash flows and investment of excess cash. Maneval E.(1999) concluded that a firm holds the cash so as to maximize the benefits from it and wait to pay out the cash being held until the last possible moment. In other words, one would rather invest cash and earn interest before clearing the debt.

Creditors' Management

This technique refers to the firms that purchase or acquire goods and services on credit. The goal of this technique is to ensure that the cash is with the firm as much as possible to benefit from it before transferring it to the creditor. In other words the firm is attempting to shorten the operating and cash cycle by keeping the suppliers waiting as long as possible without incurring penalty interest or losing the supplier due to late payment.

This research revealed that seventy six percent (76%) of the firms which were studied do not have any credit terms when making purchases but they offer credit terms to their customers. This means that they have more debtors and fewer creditors in their books. This operating system has a huge effect on cash management principle because cash is transferred to the supplier at the earliest time but collected from the debtor later.

Debtors Management

Though almost all the SMEs keep records of their debtors, the credit sale policy is not maintained; as a result the accounts receivables are not properly managed. Lack of effective management of debtors affects the profitability of a firm through bad debts as well as liquidity through failure in collection of cash from debtors. Because of poor accounting skills, small firms are failing to allow sufficient provision for contingencies like provision for bad debts resulting in failure to handle the risks. SMEs without proper accounting records have problems in managing their working capital. Poor management of cash results in liquidity problems and temporary closure of the SMEs.

From the total number of SMEs studied only twenty four percent (24%) were having credit terms with their suppliers and eighty (80%) were providing credit terms to their customers. For the firms that sell their goods on credit forty six percent (46%) had a documented credit sale policy. Most of these firms that had a documented credit sale policy are firms that are registered under Company Act and Private Business Corporation and they apply professional accounting principles. The contents of the credit sale policies included the following:

- First installment (usually half of the total price) is paid before delivery and the balance is cleared later (after two weeks, after seven days or a month) after delivery.
- Payment due at the end of the month usually salary payday of the client. This is common with informal retail traders.
- Discount allowed to payments made before due dates.
- Failure to settle the credit on the due date then interest is charged.
- Breach of contract will lead to cancellation of credit terms, which is the customer would be required to buy on cash basis only.

Inventory Management

This technique is meant to avoid having cash being held up in stock that is illiquid. Such cash can be invested in marketable securities that can be liquidated to buy stock when needed. David Holt (1992) maintains that purchasing too much inventory increases the risk of low turnover and obsolescence.

This research revealed that most of the SMEs order their stock as per demand. They apply Just-In-Time inventory policy. Eight four percent (84%) applied Just-In-Time inventory policy and these are mainly in the retail sector. Ten percent (10%) of the SMEs use economic reorder level and most of these were found to be in the manufacturing sector.

Financial Risk Management

Many SMEs lack financial risk management policies. Effective policies and procedure should be implemented to reduce and eliminate avoidable risks. This will also improve their acceptance by the lenders and attract the potential investors. Many SMEs are exposed to different types of risks which include operational risks, market risks, credit risks, cultural risks, political and economic risks. Most of these risks are due to the following reasons:

- Lack of entrepreneurship skills
- Poor understanding of market dynamics.
- Poorly available consultancy services
- Failure to forecast future inflation rates changes
- Competition with other established companies
- Inadequate infrastructure

From the sample of SMEs considered for the purposes this research only twenty one percent (21%) were found having financial risk polices that were distinct from the overall risk management policy, while seventy nine percent (79%) of the SMEs had their risk management policies and procedures embedded in the overall risk management framework.

For those SMEs that had distinct financial risk management policy, the policies included the following:

- Separation of duties and responsibilities - for example a person who had authorised the order should not sign the cheques.
- Dual control and management which involves joint custodianship of keys of the safe or cheques.
- Internal auditing department with an independent opinion on the control of the business assets.

Performance Evaluation

Performance evaluation is part of a strategic plan process and is very important to all organizations. This can help the business to access whether the objectives are achieved or the standards previously set are met. The potential investors to make investment decisions (Mason C. and Harrison R.(1994) can also use performance evaluation results. As noted by D.H. Holt (2004) SMEs are having difficulties in attracting investors because they lack track records and proper financial statements analysis records. Financial performance evaluation can be done through use of techniques like financial ratios and budget variance reports.

Because of lack of accounting skills, small businesses fail to make budgets to forecast the adequate capital requirements and provide sufficient provisions for contingencies. With lack of budgets there are no variance reports or reports for comparisons to measure the performance of the business and comparison with other businesses in the same industry or with the performance of the previous year against.

Nineteen percent (19%) of the SMEs indicated that they do not prepare either budget variance report or financial statement analysis (ratio). Most of these SMEs who do not prepare budget variance report are SMEs that are not formally registered, do not have qualified accountant, are in retail sector and they mainly keep the records of debtors. This research revealed that most organisations (about thirty six percent) assess their performance on a monthly basis and thirty two percent (32%) on a quarterly basis.

Cash Management

Some service providers like SEDCO request a business plan or proposal from the applicant of a loan at the same time they provide the service of drafting those business plans at a fee. This means that those business proposals submitted might not have a real organisational plan but would be meant for accessing funds. Project proposals that are used for applying for funds are not adhered to. Many applicants submit fake proposals that are only meant to be used for accessing funds that are later diverted to other illegal dealings in black markets for fast cash. Many SMEs admitted that they sometimes invest in other investments which are not core business. Business people have become more of speculators instead of investors. Speculation also distorts the development of SMEs because these investors tend to ignore the need to develop the SMEs and concentrate on the speculative dealings.

The research revealed that forty eight (48%) of the SMEs included in the sample were involved in investing in other investments other than the core business. Most investors were diverting from manufacturing to retailing and dealings in black market especially in foreign currency. Fifty two (52%) confirmed that they restrict their investment to their core business. Discussions with the Reserve Bank of Zimbabwe economists revealed that some resources which are meant to boost growth of SMEs are diverted to some other projects for example Fuel distributed to agricultural sector at the end of 2006 for farming was diverted by the recipients to the illegal markets for fast cash (Monetary Policy Statement – 31 January 2007) .

Many SMEs have access to short term finance hence this finance is used for both long and short term financing needs. Lack of proper accounting skills results in inability to make proper investments decisions associated with matching the right sources of funds with the proper applications. Many SMEs have access to only short term finance and these same funds are used to finance or acquire fixed assets resulting in constraining the working capital management or liquidity crisis. Most manufacturing SMEs make high investments in fixed assets (particularly in the start-up stage) straining the cash for day to day running of a business. The effect of investing too much capital in the fixed assets is that a lot of cash is unnecessarily tied up in the fixed assets.

By the virtue of being owner managed, small firms lack the principle of separating the legal personality of a firm from its owner. Failure to distinguish that the owner and the firm are two personalities encourages the owner to mismanage the business cash through unplanned withdrawals even for personal use which is not business related.

Recommendations

The study recommends that the following be adopted:

SMEs Owners or Managers

The owners of SMEs need to be advised and introduced to variety of sources of finance so as to avoid relying on personal funds only to finance businesses. If these owners are also trained on finance and investment skills, financial record keeping and proper management of working capital, they will be able to know the difference between short and long term financial needs and its sources. By so doing the problem of mismatching sources and its application would be avoided and the problem of illiquidity eliminated. Use of capital budgeting techniques should be encouraged to eliminate the problem of investing in unprofitable projects. SMEs should also consider leasing some of the equipment instead of buying the equipment as this will also help in improving liquidity.

In terms of managing risk, the policies and strategies should be put in place and if possible independent opinions from the professionals should be considered to maximize the effectiveness of financial risk management policy.

Financial Institutions

Financial sector should extend beyond urban areas so as to cater for the rural SMEs. Banking sector should also reconsider their requirements for accessing loans like collateral security should not be only physical asset but also consider other variables like financial performance and potential performance. When vetting and screening, the institution should not base on business proposal or plan only, but it should also conduct an adhoc field visit and assess financial records. The range of loans and repayment period advanced should reasonably enable the business to conduct its activities without too much pressure of closing down. Compulsory short courses should be enforced to improve the management skills.

Government

The government should take a lead to act as a guarantor to repayments of loans provided to the SMEs by the financial institutions. This will encourage the financial institutions to advance loans to the SMEs with less credit risks attached to it. Zimbabwe Secondary Stock Exchange can be opened and this should be lenient in terms of listing requirements but at the same time being compliant with the listing regulations. Venture capital market must be highly developed from both private and public sector. The government must also relax regulations on importation and exportation of small enterprises.

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Larger Companies

This sector can support the development of SMEs through transferring some of its factors of production or leasing out some of its equipment to SMEs. Larger companies can also sub-contract small firms thus including them into the system. SMEs can also make use of franchising as this will reduce the risk of failure since the brand is already known in the market and introduction costs would not be incurred.

Conclusion

This research had covered financial strategies of SMEs which incorporates financing and investment decisions that are being implemented by small firms in Zimbabwe. This discussion also touched on the financial risk which affects implementation of those decisions. For further research, other operational strategies can be researched on and the risks associated with implementation of such strategies which includes credit risks, market risks operational economic and technological risks.

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