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Role of Financial Management Practices on the Financial Performance of Small and Medium Enterprises in Albania

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Abstract: Small and medium enterprises (SME) comprise 99.9% of the enterprises, playing the engine of Albanian economy, employing 52.2% of active population (INSTAT 2018). Previous studies in Albania related to SME show problems related to the environment in which SMEs operate, the obstacles faced by SMEs in maintaining their market position, such as poor management, low funding opportunities, lack of specialization as well as measures to be taken at the macro level to stimulate SME development. In our paper we want to identify the main financial management tools that allow the SME to reach the profitability. The purpose of this paper is to determine the role of financial management on profitability of SME. For this aim, the financial statements and financial reporting of 100 small and medium enterprises in Tirana published by firms on National Business Center were reviewed for information and data. The study used secondary data retrieved for a five-year period covering year 2013-2017 to establish the relationship between financial practices and financial performance of SMEs. The linear regression model used to determine the relationship between ROA ratio (measures financial performance) and Liquidity management, Capital budgeting, Debt management (independent variables used to define financial management practices). In this study we will show how financial analysis as a financial management tool helps a firm achieve profitability objectives. The study was faced by certain limitations which hindered the effectiveness of data collection. The study was also limited to two financial management practices in the SMEs. This includes liquidity management and profitability management. The panel regression results revealed that Capital budgeting (ROCE) had a high positive significant effect on performance as measured using ROA. Liquidity management had a negative insignificant effect on financial performance of SMEs. Debt management had a negative significant effect on financial performance of SMEs in Tirana. The results of the study may also be limited by time and financial constraints.

Keywords: Financial Management, SMEs, Profitability, Liquidity, Debt Management

1. Introduction

Small and medium Enterprises (SMEs) are seen as a driving force for the promotion of an economy and they contribute immensely to the economic development of any country. SMEs play an essential role in the Albanian economy and they are a source of entrepreneurial skills, innovation and job creation. Small and medium enterprises (SME) comprise 99.9% of the enterprises, employing 52.2% of active population [5].

Previous studies in Albania related to SME show problems related to the environment in which SMEs operate, the obstacles faced by SMEs in maintaining their market position, such as poor management, low funding opportunities, lack of specialization as well as measures to be taken at the macro level to stimulate SME development. Thus, financial management practices (working capital, management, financing, investment, financial reporting and accounting information systems) which have been largely ignored among SMEs) since majority of the SMEs are

individually owned, family owned may be advanced as a standing solution to the performance problems of SMEs in Albania.

Financial management practices can be defined as planning, organizing directions as well as controlling activities including procurement and the adequate use of funds of the enterprise [9]. Saramasivan and Subramanian [13] argued that financial management helps to the profitability position of business organizations with the help of strong financial control devices such as budgetary control and ratio analysis.

We have used two theories to make the relation between concepts and variables. The theories are: "Pecking Order Theory" and "Trade off Theory".

The pecking order theory suggests that firms have a particular preference order for capital used to finance their businesses [10].

The trade-off theory suggests that firms target an optimal level of liquidity to balance the benefit and cost of holding cash. Therefore, this study is important not because it fills the gap, but also it set out to address this gap of knowledge. The purpose of the study was to establish the relationship between financial management practices and finance performance of SMEs in Albania with a view of obtaining an appropriate model for improving business performance in Albania.

2. Literature Review

2.1. Theoretical Review

2.1.1. Pecking Order Theory

The pecking order theory suggests that firms have a particular preference order for capital used to finance their businesses [10]. Owing to the information asymmetries between the firm and potential investors, the firm will prefer retained earnings to debt, short-term debt over long-term debt and debt over equity. The managers have more inside information than investors and act in favor of old shareholders [10]. They are forced to rely on noisy signals such as the firm's level of capital structure to determine the risk of their investment and firm's value may be under-priced by the market [10]. An organization's need to plan and consider how to confront future potential risks and opportunities by establishing an efficient system of control, a detector of variances between organizational objectives and performance [2]. This theory instigates the second research hypotheses: Capital budgeting has no significant effect on the financial performance of SME-s in Albania.

2.1.2. Trade off Theory

The trade-off theory suggests that firms target an optimal level of liquidity to balance the benefit and cost of holding cash. The cost of holding cash includes low rate of return of these assets because of liquidity premium and possibly tax disadvantage [10], [11]. The benefits of holding cash are in twofold: First, the firms save transaction costs to raise funds and do not need to liquidate assets to make payments.

Second, the firm can use liquid assets to finance its activities and investment if other sources of funding are not available or are extremely expensive. As theory, the use of trade off model cannot be ignored, as it explains that, firms with high leverage attracts high cost of servicing the debt thereby affecting its financial performance and it becomes difficult for them to raise funds through other sources. The tradeoff theory indicates the exposure of the firm to bankruptcy and agency cost against tax benefits associated with debt use. Bankruptcy cost is a cost directly incurred when the perceived probability that the firm will default on financing is greater than zero. One of the bankruptcy costs is liquidation cost, which represents the loss of value as a result of liquidating the net assets of the firm. According to trade off theory, companies are expected to look for a target debt ratio [7]. This theory instigates the first and third research hypotheses: Liquidity management has no significant effect on the financial performance of SME-s in Albania; Debt Management has no significant effect on the financial performance of SME-s in Albania.

2.2. Empirical Review

2.2.1. Liquidity Management and Financial Performance

To measure the liquidity management efficiency of Indian steel companies, authors [3] use a sample of 230 companies for 9 years period (2002-2010) and found a petite association between the indicators of liquidity and profitability.

About liquidity and profitability trade – off: an empirical investigation in an emerging market, found a negative relationship between profitability and liquidity indicators. In his study, he used current ratio and cash gap (cash conversion cycle) as liquidity indicator and net operating income as a profitability indicator [4]. Those variables were tested using Pearson Correlation analysis and regression analysis. Author also found that current ratio was more important as liquidity measure that affect profitability, however, within sector, cash gap was found to be more important than current ratio in affecting profitability.

in his A study about evaluation of profitability and liquidity relationship through multivariate working capital analysis, found that liquidity and profitability were vital and contradictory aspect of life of business [15]. Also was found a positive relationship about the relationship between liquidity and profitability of listed banks in Ghana [8], even though the relationship was weak. The profitability indicator used in this study was return on asset (ROA), while the liquidity indicator used was temporary investment ratio (TIR). To conclude, the studies that found a negative relationship between liquidity and profitability but also found a positive relationship between liquidity and profitability [1].

2.2.2. Capital Budgeting and Financial Performance

To study the relationship between capital budgeting techniques and financial performance of companies, was used multiple regression analysis. The findings of the study indicated that there is a significant relationship between capital budgeting techniques and the financial performance

of the companies registered in the Nairobi Stock Exchange method [12]. Another study concluded that there was no significant relationship between the capital budgeting techniques employed and the financial performance of companies [6].

2.2.3. Debt Management and Financial Performance

Empirical evidence on the relation between Debt Management and performance is mixed; that is, the effect of Debt Management on performance has been found to be positive, negative, or insignificant.

A study conduct in Ghana argues that debt management is any approach that is adopted to guide an individual or business organization to manage its debt. This definition includes debt settlement, bankruptcy, debt consolidation, personal loans as well as other techniques that assist businesses to service outstanding debts [14]. Another study showed that total debt ratio had a negative impact on fixed investment in Chinese listed companies. This implies that high proportion of debt in the capital structure of a firm can harm investment using internal funds [16].

3. Methods and Procedures

3.1. Research Hypothesis

H1: Liquidity management has no significant impact on financial performance of SME-s in Tirana. Liquidity management will be measured by current ratio.

H2: Capital budgeting has no significant impact on financial performance of SME-s in Tirana. Capital budgeting will be measured using ROCE ratio.

H3: Debt management has no significant impact on financial performance of SME-s in Tirana. Debt management will be measured by debt ratio.

3.2. Operationalization and Measurement of Study Variables

Table 1 below shows the variables operationalization. It summarizes the indicators, measures and scale of dependent (Financial performance) and independent variables, namely Liquidity management, Capital budgeting and Debt management.

Table 1. Measurement of study variables.

	Variable	Operationalization	Measurement	Hypothese
Dependent variable	Financial Performance	Return on Assets	EBIT/Average total assets	Positive/Negative
	Liquidity management	Current ratio	Current assets/current liabilities	Positive/Negative
Independent variables	Capital budgeting	ROCE ratio	EBIT/(Total assets-current liabilities)	Positive/Negative
	Debt management	Debt ratio	Total liabilities/ Total assets	Positive/Negative

Source**:** Author (s) illustration.

3.3. Empirical Model

The study used fixed generalized least squares regression analysis to test the significance of the various independent variables (Liquidity management, Capital budgeting and Debt management). Financial performance was measured by ROA ratio. Gretl statistical package was used for data analysis and presentation of study findings. The model of the effect of financial management practices on financial performance was formulated as follows:

$$ROA= f (LM, FCB, DM)$$

Where:
ROA= Return on assets;
LM= Liquidity Management;
FCB = Capital budgeting;
DM = Debt management.

$$ROA_{it} = \beta_0 + \beta_{1it}LM + \beta_{2it}FCB + \beta_{3it}MD + \varepsilon$$

Where:
β_0, β_1 and β_2 are the coefficients, ε is the error variable;
LM, FCB, MD are independent variables related to financial management practices;
i is Number of SMEs (100 small and medium enterprise);
t is time, year 2013, 2014, 2015, 2016, 2017.

3.4. Target Population

Population is therefore the entire group of individuals, events or objects having a common observable characteristic. The population of this study consisted on 100 small and medium enterprises in Tirana.

The study made use of secondary data obtained from the financial statements (balance sheets and income statements) of the firms for a five-year period covering years 2013 to 2017, published by firms on National Business Center.

3.5. Data Collection Instruments and Procedure

The study used panel secondary data to test hypotheses. The secondary data was contained in the financial statements of SME-s. A work plan was drawn to extract data relating to financial performance, debt, liquidity and capital budgeting for a period of five years covering 2013 to 2017 from 100 SME-s in Tirana.

Financial statements were used to provide data on performance as measured using ROA, Capital budgeting as measured using ROCE, Liquidity as measured using liquidity ratio (current assets and current liabilities), and debt management as measured using debt ratio. In order to calculate the ratios, raw data was required. The data extracted from the financial statements included earnings before interest and tax, Total assets, Current assets, current liabilities, short term debt, long term debt. To enhance quality

and quantity of data adequacy, a combination of both time series and cross section data was used.

4. Empiric Findings

Background information

The industry in which the SMEs belong highly determines its profibility and strategies adopted, due to the fact that some industries are more competitive and demanding than others. This section sought to establish the industry in which the SMEs belonged to and the findings optained are shown by Figure 1.

As shown, the majority were in the trading industry (51%), followed by 29% in the manufacturing industry while the remaining 20% in the service industry.
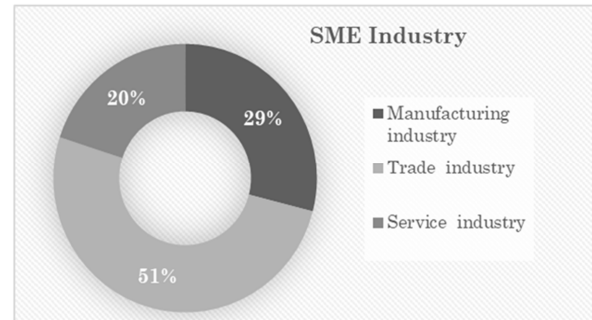

Figure 1. SME Industry.

This section sought at determining the years in which the SMEs had operation. This was used in determining the age of the firms. The findings obtained are shown in Figure 2.
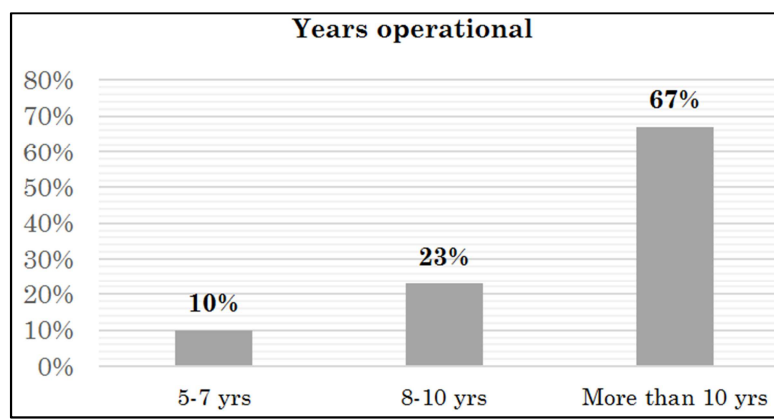

Figure 2. Years of operation of SMEs.

The results obtained show that 67% of the SMEs were operational for more than 10 years, 23% for 8-10 years and the remaining 10% for 5-7 years.

This section sought to establish the legal formations of the SMEs. The findings obtained are shown in Figure 3.
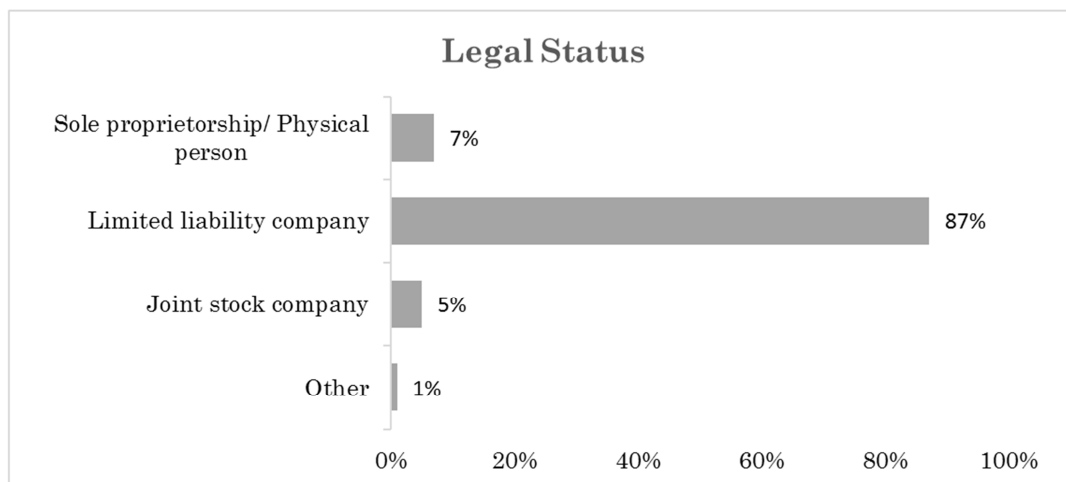

Figure 3. Legal status of SMEs.

The results obtained indicate that most of the SMEs (87%) had been formed as limited companies, followed by 7% which had been formed through sole proprietorship and the remaining 5% as Partnerships and 1% Other.

Results of panel regression and interpretation.

Table 2. The econometric model of return on assets for SMEs.

Dependent variable: ROA					
Method: Panel Fixed-effects					
Sample: 2013-2017					
Cross-sectionas Included: 100					
Total Panel (Balanced) Observations: 500					
^ROA = 0,366 - 0,00151*LM + 0,0160*ROCE - 0,385*DM					
	Coefficient	Std. Error	t-ratio	p-value	
const	0.366343	0.0420526	8.7115	0.00001	***
LM	-0.00150507	0.00212626	-0.7078	0.47946	
ROCE	0.0159528	0.00273884	5.8247	0.00001	***
DM	-0.385244	0.0598246	-6.4396	0.00001	***

Mean dependent var	0.108203	S. D. dependent var	0.247827
Sum squared resid	13.06132	S. E. of regression	0.181384
R-squared	0.573825	Adjusted R-squared	0.464329
F (102, 397)	5.240609	P-value (F)	3.06e-33
Log-likelihood	201.7690	Akaike criterion	-197.5380
Schwarz criterion	236.5666	Hannan-Quinn	-27.19608
rho	0.127817	Durbin-Watson	1.299673

Source: Research data 2019.

The summarized regression results from the above table show that the multiple regression model is significant (R-squared = 0.57), meaning that 57% of the variation in the return on assets is explained by the independent variables, while 43% is explained by variables outside the model. The value of F =5.24, is large enough to conclude that the set of independent variables as a whole were contributing to the variance of financial performance as measured by return on assets and therefore, the model represents the actual performance of the firms under study.

The results indicate that there was a statistically significant positive relationship between capital budgeting with a coefficient of 0.0159528 and a probability of 0.000 which is less than significance level of 0.05, and performance of SME-s as measured by return on assets.

The coefficient for liquidity of -0.00150 was not statistically significant at 5% percent level with a P value of 0.47946. The results indicate that there was a statistically insignificant relationship between liquidity and performance of SME-s in Tirana as measured by return on assets. Debt management had a negative significant relationship to financial performance with a probability of 0.00001 which is less than 5% significant level. The regression estimation reveals a positive relationship exist between ROA, ROCE and a negative relationship between ROA, LM and DM.

5. Conclusions and Recommendations

In the present study conducted on 100 SMEs from three economic sectors, we tackled the characteristics of the competitive business environment in Albania. In this regard, we built econometric model estimating return on assets. We compared some panel models to choose the appropriate ones using some tests as LM test and Hausman test. The main focus of the study was to establish the effect of financial management practices on financial performance of SMEs in Albania.

The panel regression results revealed that Capital budgeting (ROCE) had a high positive significant effect on performance as measured using ROA. Liquidity management had a negative insignificant effect on financial performance of SMEs. Debt management had a negative significant effect on financial performance of SMEs in Tirana.

Based on the above conclusion, the study recommends that managers of SMEs in Albania should put more emphasis on capital budgeting since it has a bigger impact on profitability.

These companies should also come up with policies to improve on investment decisions so as to improve returns on equity. Therefore, more empirical investigations need to be conducted on this topic by replicating the current study and by including more specific variables to control for the effect of other equilibrium factors on SME performance.

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