

CHAPTER 2: SMALLER ENTERPRISES, GROWTH AND PERFORMANCE

2.1 Introduction

This second chapter of the thesis is concerned with the process of growth as experienced by small and medium-sized enterprises; with emphasis being placed, wherever possible, on businesses engaged in manufacturing and legally organised as proprietary companies. Of particular interest are the dynamics in smaller enterprises of the business development process; as well as the challenges and problems, especially those of a financial nature, to which it may give rise. Also of interest are any relationships that might exist between enterprise size and age on the one hand and business growth and performance on the other.

The chapter first presents alternative conceptualisations of growth in smaller enterprises which have appeared in the literature, and that seem to have some empirical support, are presented. The financial dimensions and implications of SME growth are then explored. Subsequently, consideration is given to problems associated with measuring smaller enterprise growth and performance in research such as this. Finally, evidence on any apparent relationships between enterprise size, age, growth and performance is reviewed.

2.2 Smaller Enterprises and Growth

2.2.1 Defining Smaller Growth Enterprise

A serious complication to the problem of specifying what is meant by smaller enterprises is that this sector of the economy is far from homogeneous (Scott, 1989; McMahon *et al.* 1993a). McMahon *et al.* (1993c, p. 14) indicate that:

- ... when studying small enterprises it is useful, in view of their diversity, to recognise two broad categories of such business concerns:
- Those that are small because the nature of the activity undertaken and the industry in which they operate dictates that small enterprises are more effective and efficient than larger ones. Enterprises in this category have been variously referred to in the literature as traditional small enterprises . . . , micro-enterprises, mom and pop enterprises, income substitution enterprises and self-employment enterprises.
 - Those that are small only because they are new enterprises – entrants either to established industries or to new industries. The essential point here is that such enterprises might presently be small, but they may have the inherent potential to become large. Enterprises in this category have been referred to in the literature as growth enterprises . . . or entrepreneurial small enterprises. Where new technologies are employed, businesses in this category are often called hi-tech or sunrise enterprises.

Following Bygrave & Petty (1991) and Petty & Bygrave (1993), McMahon *et al.* (1993a) go on to point out that scholarship in smaller enterprise finance/financial management has far less to offer on traditional smaller enterprises than on smaller growth enterprises. The reasons for this become apparent as the thesis progresses.

In Chapter 1 of the thesis, the following broad definition of smaller growth enterprise adopted by McMahon *et al.* (1993a, p. 15) is presented:

In general terms, a smaller growth enterprise is considered to be an owner-managed concern experiencing on-going, significant and often rapid increases in some or all of the usual indicators of size such as sales revenues, assets, profits (possibly) and number of employees; and which may also be moving towards greater product, geographical or technological diversity.

Having critically reviewed much of the relevant literature, Hanks & Chandler (1992, p. 2) believe that 'Organization growth refers to the creation of an organization and its subsequent development in terms of age, size, value, sophistication, and complexity'. The definition of smaller growth enterprise adopted here is not inconsistent with this view, and it is more specific to the present context.

It is important to emphasise the point that enterprise growth is not, nor should it necessarily be, the ultimate goal of all smaller business concerns. Obviously, life-style enterprises place very low emphasis on growth. And even in more progressive SMEs, strategic possibilities such as no growth or a managed/controlled growth rate or limited/capped growth must sometimes be realistically considered. McKenna & Oritt (1981, p.27) argue that SME owner-managers should be careful not to automatically associate enterprise size and growth with performance, and the authors observe:

From time to time it may be necessary for the business owner to consciously slow down, or even stop the growth of the enterprise in order to do the 'fine tuning' which will result in better performance and ultimately greater profitability.

and:

It should also be recognized that the growth of a small business may actually turn the enterprise into a form of organization which is no longer desirable to the owner or force the owner/manager into becoming someone he/she is equally unhappy with.

McKenna & Oritt (1981) go on to detail some of the problems that may be created by uncontrolled growth of smaller enterprises, and they emphasise the need for longer-term growth planning by owner-managers which includes contemplation of no growth and reduced or capped growth scenarios. To assist with such planning, the following questions bearing on growth are posed by McKenna & Oritt (1981, pp. 25-27) for owner-managers to answer:

- Why is growth of the business important?
- What should the business ultimately become?
- Is current management capable of growing the business?
- At what rate should the business grow?
- What types of resources and commitments will be required by the growth process?

In a recent comprehensive review of the literature on the distinguishing characteristics of growth and non-growth small enterprises, Holmes & Zimmer (1994, p. 107) propose that:

. . . a small non-growth firm [be] defined as an entity that acts to avoid agency relationships, with such entities incurring minimal levels of agency costs. Inversely, growth firms will seek out agency relationships which will enhance business growth, provided the benefits are positive.

Thus, a small enterprise owner-manager who is concerned to maintain tight control of his or her business, and to minimise his or her accountability to others, is likely to limit or cap the business's growth potential by being unwilling to seek external debt and/or equity funds to finance growth. Such funding inevitably establishes agency relationships, with their attendant monetary and non-monetary costs. An owner-manager who is willing to enter financing agency relationships, and to bear their costs, is more likely to reap the benefits that may come with growth of the business.

The definitions proposed by Holmes & Zimmer (1994) are closely aligned with views on the nature of the small enterprise financial objective function expressed by Osteryoung *et al.* (1992), McMahon & Stanger (1995) and LeCornu *et al.* (1996). And Holmes & Zimmer (1994) have found the definitions to be robust in an exploratory study undertaken by them. The definitions are helpful to the present study for two reasons. First, the concept of capped growth in smaller enterprises is important to conceptualisations of business growth reviewed later in the chapter. Second, the definitions support an agency perspective on financial reporting practices in smaller enterprises which is presented in Chapter 3 of the thesis.

It is indicated in Chapter 1 of the thesis that the emphasis in the present research is internally-generated growth through development and expansion of a business's financial, physical and human resources, product or service lines, target markets and customer bases, geographical spread of facilities and markets, etc. As it is not common amongst smaller enterprises, and because it represents a special case of growth with quite unique characteristics, external growth through acquisition of other businesses is not contemplated in this research. Romano (1990) and Romano & Ratnatunga (1992, 1994, 1995), amongst other researchers, have similarly excluded external growth through acquisitions from their studies of smaller enterprise growth. This is not to say, of course, that such external growth is not legitimate and justifiable for small and medium enterprises in particular circumstances. For example, this might be the only feasible means of accessing a new technology or scarce expertise in some field. Extending or leveraging a smaller enterprise's reach and influence through strategic alliances and networking with other businesses, or through other forms of inter-business collaboration, is similarly excluded from the concept of growth employed in this study. Again, such activities are frequently important to expanding SMEs; but, strictly speaking, they do not represent internally-generated growth of the businesses concerned. These exclusions are not taken to preclude consideration of fully- or partly-owned subsidiaries, and also joint ventures which are formally established as part of a smaller enterprise's growth strategy.

2.2.2 Explaining Smaller Enterprise Growth

Ideally, the intention in this sub section of the chapter would be to seek for a theoretically sound and empirically validated explanation of smaller enterprise growth to serve as a broad conceptual framework for the study described in the thesis. Such a framework would need to capture, in a rigorous and consensual manner, the current state of scholarly understanding of the dynamics of smaller enterprise growth, including the distinguishing characteristics, problems and requirements of growing SMEs.

An extensive literature search has been undertaken which has revealed this to be frequently trodden ground for researchers in a variety of business-related fields. However, in many respects, knowledge acquisition has not been cumulative and there is much that is yet to be settled. In their review of the relevant literature, O'Farrell & Hitchens (1988, p. 1380) conclude that 'At present an adequate explanatory framework within which to analyse the growth of the small owner-managed manufacturing enterprise has not been developed'. On the basis of their review, Gibb & Davies (1990, p. 26) are of the opinion that 'The production of such a theory and explanation in the near future is unlikely'. The review of Holmes & Zimmer (1994, p. 97) expresses the belief that 'an operational framework that distinguishes growth from non-growth small businesses does not exist'.

Wider scholarly thought on business growth in the literature of economics may be found in works by Marris & Ward (1971), Lindgren & Aislabie (1976), Casson (1982), Brock & Evans (1986), Johns *et al.* (1989), Acs & Audretsch (1990), Keasey & Watson (1993), McMahon *et al.* (1993a), Reid (1993) and Acs (1995). The most useful recent review articles found on the growth process of small and medium-sized enterprises are those of Chell & Haworth (1988), O'Farrell & Hitchens (1988), Gibb & Davies (1989, 1990, 1991), Hanks & Chandler (1992) and Holmes & Zimmer (1994). These are all substantial and critical published reviews of prior research which has attempted to explain the dynamics of growth in smaller enterprises. In addition, Birley & Westhead (1990) provide a general review of the relevant literature as a precursor to reporting empirical findings on growth and performance contrasts in smaller enterprises. Importantly, these reviews are broad in scope and comprehensive; and, by and large, they are not confined to the perspective of a particular academic discipline or to a single explanatory paradigm for growth. The most significant conclusions of the general reviews are summarised below.

In their review of alternative conceptual frameworks for explaining smaller enterprise growth, O'Farrell & Hitchens (1988) classify available business growth theories into four main groups:

- Mostly static equilibrium theories derived from the field of industrial economics that are insufficiently concerned with the dynamics of growth, and which tend to be preoccupied with attainment of economies of scale and minimisation of long-run unit costs. Many are considered to overemphasise the large firm as the

ultimate stable outcome of growth, there being no perceived limit to the size that a business might achieve (Perry, 1982; O'Farrell & Hitchens, 1988). As far as the present research is concerned, Penrose's (1959) views on the availability of managerial time and expertise, and its impact on the achievable growth rate for a business, are most significant. These are addressed later in this chapter.

- Stochastic models of firm growth, developed mainly in the field of economics, which, in summary, suggest that 'many factors affect growth and, therefore, there is no dominant theory' (O'Farrell & Hitchens, 1988, p. 1370). From the viewpoint of the present research, it is important to be aware of Gibrat's (1931) law of proportionate effect which proposes that business growth rates are independent of enterprise size. O'Farrell & Hitchens (1988) cite empirical evidence which upholds Gibrat's law for small manufacturing enterprises; and they also allude to empirical support for the proposition that the variability of growth rate decreases with increasing enterprise size.
- What are referred to as strategic management perspectives on smaller enterprise growth which, according to O'Farrell & Hitchens (1988, p. 1373), have:

. . . focused attention upon the strategic dimension of achieving sustained growth and the way in which the owner-manager responds to business and personal environmental indicators. Hence, they concentrate upon the identification of the owner-manager's policies and strategies for the conduct and development of the business and their subsequent translation into managerial action that will lead to sustained business development. These business strategies are thought to be determined by perceptions of what the owner-manager wishes to, or thinks he can, achieve through his business, in the light of the opportunities and constraints he sees. In turn, these aspirations and perceptions will be partly determined by personal characteristics.

Sandberg (1992) undertakes a useful review of the literature on strategic management and its potential contribution to understanding of smaller enterprise. Insights into smaller enterprise financial management provided by a strategic management perspective are presented by Barton & Matthews (1989).

As far as the present research is concerned, an extremely important message emanating from the strategic management literature is that not all smaller enterprise owner-managers have the desire, or indeed the capability in terms of resources and expertise, to grow their business (Stanworth & Curran, 1976, 1986; Perry, 1982; Perry *et al.*, 1986; O'Farrell & Hitchens (1988); Perry *et al.*, 1988; Storey *et al.*, 1988; Davidsson, 1989; Birley & Westhead, 1990; Frank *et al.*, 1991; Turok, 1991; Hanks & Chandler, 1992; Hay & Kamshad, 1994). Marginal to comfortable survival at the present enterprise size, rather than growth, is most often the overriding strategic objective. The reasons for this are myriad, ranging from personal wishes regarding life-style to a disinclination to surrender control and/or be accountable to others within and without the business in order that it may grow (McKenna & Oritt, 1981; O'Farrell & Hitchens (1988); Davidsson, 1989;

Osteryoung *et al.*, 1992; Hay & Kamshad, 1994; Holmes & Zimmer, 1994; McMahon & Stanger, 1995; LeCornu *et al.*, 1996).

Of course, the prerogative to make such personal choices and have them dictate business goals and activities is, for many, what is most attractive about smaller enterprise owner-management as an occupation (Bolton, 1971; Stanworth & Curran, 1976; Carland *et al.*, 1984; Gibb & Dyson, 1984; Gibb & Scott, 1985; 1986; Stanworth & Curran, 1986; Chell & Haworth, 1988; O'Farrell & Hitchens (1988); Gibb & Davies, 1989; Birlay & Westhead, 1990; Gibb & Davies, 1990, 1991; Bygrave & Petty, 1991; McMahon *et al.*, 1993a; Petty & Bygrave, 1993).

- Theories that have their origins in the field of economics according to which smaller enterprise growth is viewed as a series of phases or stages of development through which the business may pass in an enterprise life-cycle. As the literature cited later in this chapter indicates, these are the most prevalent explanatory devices for growth in SMEs employed by researchers, educators, policy-makers and support professionals. Unfortunately, over time there have been a great many stage models of growth proposed in the literature, and there is a bewildering range from which to choose for the purposes of research such as this. The number and nature of growth or development stages in these models vary widely from author to author, as do their emphases. For reasons which will soon become apparent, this broad approach to explaining growth of small and medium-sized enterprises is critically examined in the following sub-section of the chapter.

In concluding their literature review on smaller enterprise growth, O'Farrell & Hitchens (1988, p. 1379) acknowledge that 'As in so many aspects of the social sciences, it is easier to provide a critique of contemporary theories than to present a definitive new conceptual framework within which to study small-firm growth'. They go on to make some suggestions on modifications and extensions to the theories they have considered which would, they believe, make them more cognisant of the realities faced by smaller business concerns. Gibb & Davies (1989, 1990, 1991) are similarly unable to suggest an explanatory framework that is free from the many criticisms they direct at the theories of smaller enterprise growth reviewed by them. Like O'Farrell & Hitchens (1988), these authors are, however, liberal with their views on what such a theory should include, how it should be derived, etc.

All of this does not, of course, resolve the dilemma facing the present study. It could be argued that, if a good business growth model is not currently available through the efforts of others, then the present research should include development of such a model. However, the impression gained is that this could form a doctoral thesis in itself, and leave no scope for exploring the business performance and financial reporting dimensions of the stated research question. The fact is that knowledge is imperfect for

most aspects of the research question and realistic expectations must be held if at least an exploratory perspective on its answer is to be obtained. Given the emergent stage of scholarship in the area, it is believed that this exploratory perspective is worth having and hopefully is worthy of a doctoral award. Perforce, a degree of pragmatism about conceptualising smaller enterprise growth needs to prevail if this research is to have some prospect of meeting its objectives. A reasonable expectation would seem to be no more than a convenient explanation of smaller enterprise growth that is sufficiently supported by informed thought, empirical observation and business experience. It must, of course, be acceptably robust and parsimonious as to be operational; and it should not be unduly threatening to the internal and external validity of the study findings.

What McGrath *et al.* (1982) refer to as a research 'judgment call' appears to be required. An election is therefore made to seek an expedient explanatory framework amongst the many stage theories of business growth that abound in the literature – notwithstanding their numerous failings which are freely acknowledged and detailed below. Amongst the specific justifications it is possible to give for this decision are the following:

- While industrial economics and stochastic theories shed light on some phenomena of interest, they are far from full explanations of the growth process in smaller enterprises. They are useful adjuncts in the present context, but are less than adequate as a broad conceptual framework for the study, given their somewhat spartan and rationalistic/mechanistic features.
- To the extent that smaller enterprises are and must be managed in an holistic manner, and given evidence which suggests strategic awareness in owner-managers is a key factor in successful growth and development of such concerns (Gibb & Scott, 1985, 1986), a strong case can be made that strategic management perspectives on growth hold most promise as rich and context-sensitive explanatory frameworks. However, there are still serious questions about whether owner-managers are consciously or deliberately strategic in their management style. Even casual observation would suggest that crisis management on a day-to-day basis is a fact of life in many small and medium enterprises. The rejoinder would be that these are generally not the types of concerns which are successful in growing. However, for strategic management perspectives on growth to be sufficiently plausible to act as the main conceptual framework for enterprise growth in this study, it would seem essential to be able to demonstrate more substantial longer-term vision and strategic intent amongst owner-managers.
- Unfortunately, strategic management perspectives on smaller enterprise growth are rich to a fault in the explanations they attempt to provide. Well may Birley & Westhead (1990, p. 535), who clearly favour the strategic management paradigm, seek to provide evidence on 'the kaleidoscope of factors which describes firms of

different size'. Strategic management models of growth like those of Gibb & Dyson (1984) and Gibb & Scott (1985, 1986) tend to become so multidimensional as to cause one to lose the thread of the explanations given, full and rich as they are. Simplicity and parsimony are qualities which seem to be overlooked in the zeal to provide as comprehensive and nuance-replete an explanation as possible of growth phenomena. Sparser explanatory paradigms are dismissed as overly reductionist (Gibb & Davies, 1989, 1990, 1991).

- Despite justified claims that appropriate qualitative methods involving small samples and/or case studies have been employed in their initial formulation, it is true to say that adequate empirical support for strategic management perspectives on smaller enterprise growth is yet to be forthcoming. Until recently, empirical underpinnings or other explanatory frameworks have also been weak or missing; but there have been no obvious attempts to make a virtue of this fact. Strategic management explanations of smaller enterprise growth tend to employ such complex and difficult to measure concepts, and are so contingent in their specifications, as to make these theories almost untestable in any practical sense. Their proponents seem to see this as a small price to pay for rich insights. Others see it as a profound weakness.
- In the last decade or so, stage models of smaller enterprise growth have been scrutinised with much more scholarly rigour than hitherto has been the case. Sound attempts have been made to integrate the multiplicity of models, and to ground them with an empirical as well as an experiential base. The works of Kazanjian (1988), Kazanjian & Drazin (1989), Hanks (1990a, 1990b), Kazanjian & Drazin (1990), Hanks *et al.* (1991), Dodge & Robbins (1992), Hanks *et al.* (1993), and Hanks & Chandler (1994) are particularly useful in this respect. Relevant findings of these and some other recent studies are reviewed in the following two parts of the chapter. Much of this research has the added attraction of being well grounded in strategic management thought. Thus, strategic management perspectives on growth in small and medium-sized business concerns are not really disregarded.

2.2.3 Stage Models of Smaller Enterprise Growth

As indicated earlier, it has become very common amongst writers in the area to view smaller enterprise growth as a series of phases or stages of development through which the business may pass in an enterprise life-cycle. Having its origins in the literature of economics (Marshall, 1890; Perrowe, 1952, 1959; Rostow, 1960), reliance on this paradigm in the smaller enterprise literature is most frequently claimed to date back to Steinmetz (1969). In an often cited book of readings on the organisational life-cycle, Kimberly & Miles (1980, p. ix) draw attention to:

. . . the cyclical quality of organizational existence. Organizations are born, grow, and decline. Sometimes they reawaken, and sometimes they disappear.

This quotation invokes a biological metaphor for business organisations which has been the source of much controversy in the literature of economics, business and sociology (Penrose, 1952; Kimberly & Millis, 1980).

A number of published reviews were found in the literature which focus specifically on explanations of smaller enterprise growth based on life-cycle stages through which growing businesses might typically pass. These extend the coverage provided in the general reviews on business growth already identified. D'Amboise & Muldowney (1988) is a widely cited overview of management theory for small enterprise which includes consideration of stage models of growth. In addition, there are reviews – some of which form introductions to reports on empirical research in the area – by Perry (1982), Quinn & Cameron (1983), Miller & Friesen (1984a), Smith *et al.* (1985), Kazanjian (1988), Kazanjian & Drazin (1989), Hanks (1990a, 1990b), Kazanjian & Drazin (1990), Hanks *et al.* (1991), Dodge & Robbins (1992), Hanks & Chandler (1992), Hanks *et al.* (1993), Terpstra & Olson (1993), Dodge *et al.* (1994) and Hanks & Chandler (1994). Together, these reviews consider all the best known attempts to develop, mostly inductively but sometimes deductively, life-cycle or stage models of smaller enterprise growth. Not all of the reviews are fully supportive of this explanatory paradigm. Nevertheless, as already suggested, the growth and life-cycle stages framework has a substantial pedigree in the literature of economics and business generally, and in the literature focused specifically on small and medium-sized enterprise development.

An assessment can be made of the collective coverage of the reviews of stage models of smaller enterprise growth mentioned in the previous paragraph by noting that they undertake detailed analyses (including tabulations, comparisons and integrations) of models in prior research proposed by Collins *et al.* (1964), Buchele (1967), Downs (1967), Lippitt & Schmidt (1967), Steinmetz (1969), Scott (1971), Greiner (1972), Kroeger (1974), Torbert (1974), Lyden (1975), McGuire (1976), Thompson (1976), Hosmer *et al.* (1977), Parks (1977a, 1977b), Gervais (1978), Katz & Kahn (1978), Adizes (1979), Kimberly (1979), Vozikis & Glueck (1980), Naoum (1981), Galbraith (1982), Perry (1982), Churchill & Lewis (1983), Quinn & Cameron (1983), Miller & Friesen (1984a, 1984b), Vargas (1984), Smith *et al.* (1985), Flamholtz (1986), Scott & Bruce (1987), Kazanjian (1988), Adizes (1989), Kazanjian & Drazin (1989), Hanks (1990a, 1990b), Kazanjian & Drazin (1990), Hanks *et al.* (1991), Dodge & Robbins (1992), Hanks & Chandler (1992), Hanks *et al.* (1993), Terpstra & Olson (1993), Dodge *et al.* (1994) and Hanks & Chandler (1994).

In terms of usefulness to the present study, the works of Hanks (1990a, 1990b), Hanks *et al.* (1991), Hanks & Chandler (1992), Hanks *et al.* (1993) and Hanks & Chandler (1994) stand out in the literature cited above in a number of respects. First, they post-date a considerable number of other works identified. Second, they critically review virtually all significant prior writing and research on the enterprise life-cycle construct. Third, they represent a comprehensive attempt to ground stages of the

enterprise life-cycle in empirical observation. Conceptually and methodologically, these works stemming from Hanks' (1990a) doctoral research represent a worthwhile cumulation and advancement of knowledge in the area.

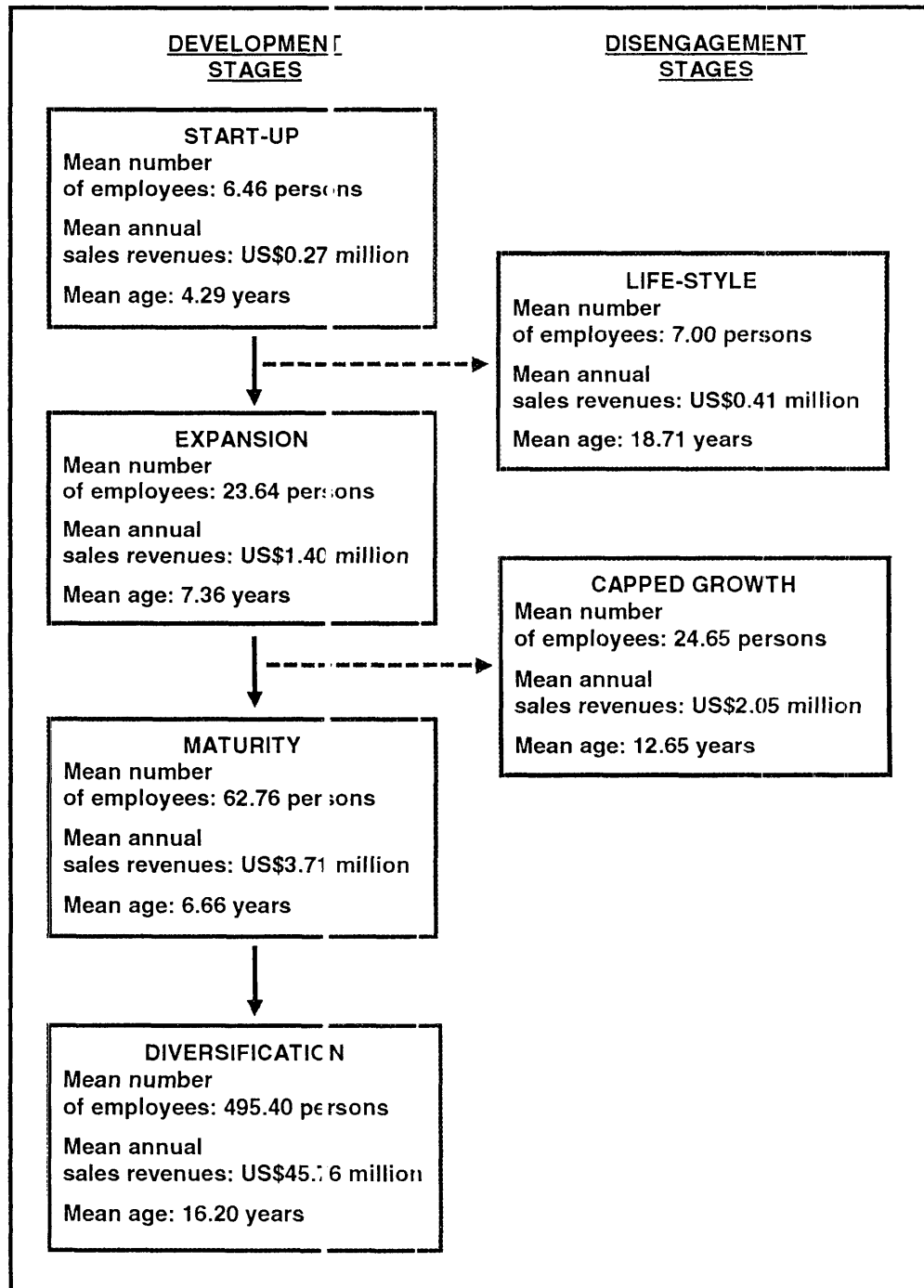
Before presenting the findings of their own empirical research, Hanks *et al.* (1993) review 10 enterprise life-cycle models described in the previous literature. Hanks *et al.* (1993, p. 6) indicate that models proposed by Quinn & Cameron (1983), Miller & Friesen (1984b) and Smith *et al.* (1985) are all 'summary models, developed to achieve some synthesis among competing life-cycle models'. Hanks *et al.* (1993) take these, along with models of Greiner (1972), Galbraith (1982), Churchill & Lewis (1983), Flamholtz (1986), Scott & Bruce (1987), Kazanjian (1988) and Adizes (1989) not otherwise considered, and compare and contrast them in terms of the number, nature and order of stages they entail, and the contextual and structural dimensions of business organisation they contemplate. Note that Hanks *et al.* (1993, p. 7) define a life-cycle or growth or development stage as 'a unique configuration of variables related to organization context or structure'. Contextual dimensions considered include enterprise size and age, growth rate, and focal tasks or challenges faced. Structural dimensions include structural form, formalisation, centralisation, vertical differentiation, and number of organisational levels.

Hanks *et al.* (1993) note that, at a superficial level, there are many commonalities between the life-cycle models they review. Nonetheless, commenting on wide differences in the specifics of prior life-cycle models (particularly inclusion of from 3 to 10 stages), Hanks *et al.* (1993, pp. 11-12) observe that:

In recent years, a few empirical studies of the organization life cycle have emerged, providing important contributions to life-cycle theory (Kazanjian, 1988; Kazanjian & Drazin, 1990; Miller & Friesen, 1984a; [Smith *et al.*, 1985]). However, most of these studies have defined growth stages a priori, using existing conceptualizations. The lack of specificity and empirical rigour in these typologies may account for unexpected intrastage variance found in some analyses. . . . It may be possible to address some of these difficulties by deriving taxonomic rather than typological models . . .

Hanks *et al.* (1993) see the strength of a taxonomic approach to identifying and specifying stages in an enterprise life-cycle model as deriving from use of multivariate analysis of empirical data to reveal common patterns and relationships in the data. They acknowledge only Smith *et al.* (1985) as having previously employed a taxonomic approach to developing an enterprise life-cycle model, but note that that research had a very small sample size and various other weaknesses.

Mainly using exploratory cluster analysis of cross-sectional data supplied via mailed questionnaire by 133 manufacturing SMEs from 'high technology' industries in the United States, Hanks *et al.* (1993) derive a life-cycle model with four development stages and two disengagement (or arrested development) stages as represented in Figure 2.1 on the next page.

Figure 2.1: Hanks *et al.* (1993) Enterprise Life-Cycle Model

Hanks *et al.* (1993) further describe the various development configurations or stages in their taxonomic life-cycle model as follows:

- Start-up – young, small enterprises with simple organisational structures and a mean of 2.20 organisational levels. The organisation is highly centralised and quite informal. There is little functional specialisation, with a mean of 1.50 specialised functions. Product development appears to be the focal priority. Mean

sales revenues growth is 91 per cent per annum, and mean employment growth is 29 per cent per annum.

- Expansion – slightly older and larger enterprises with more complex organisational structures and a mean of 3.18 organisational levels. The organisation is still very centralised and is a little more formal than in the start-up stage. Functional specialisation is generally adopted, with a mean of 3.4 specialised functions. Product commercialisation appears to be the focal priority. Mean sales revenues growth is 297 per cent per annum, and mean employment growth is 94 per cent per annum.
- Maturity – although not necessarily older, on average, than in the expansion stage, enterprises in this stage are typically more than twice as large. Organisational structures are more complex than hitherto, with a mean of 4.00 organisational levels. Centralisation is declining and formalisation increasing. There is a mean of 10.17 specialised functions. Mean sales revenues growth is 99 per cent per annum, and mean employment growth is 28 per cent per annum.
- Diversification – enterprises are generally medium-sized with increasing tendency to have divisionalised structures. There is a mean of 5.70 organisational levels. Centralisation is low, and formality is highest for any stage in the life-cycle model. There is a mean of 15.30 specialised functions. Mean sales revenues growth is 37 per cent per annum, and mean employment growth is 57 per cent per annum.

Particularly note that the increasing size and age of enterprises when reading down this list of life-cycle stages provides some evidence that businesses may, in some sense, progress sequentially through the stages as they evolve and develop. Kazanjian & Drazin (1989) make a similar point based on findings of their study of growth in technology-based concerns.

Hanks *et al.* (1993) further describe the two apparently stable and sustainable disengagement configurations or stages in their taxonomic life-cycle model as follows:

- Life-style – these enterprises are slightly larger than those in the start-up stage, but are generally much older. In most other respects, they are organisationally like start-up businesses. Mean sales revenues growth is 34 per cent per annum, but there is no growth in employment. These enterprises appear to have disengaged from the growth process after establishing their viability at relatively small size following start-up. Hanks *et al.* (1993) observe:

Perhaps they represent life-style firms, where owners have consciously chosen to keep their firms small. Davidsson (1989), in his study of Swedish firms, found that for many small business managers, the negative effects of growth appeared to outweigh the positive outcomes once the firm had reached the size of five to nine employees, roughly the size of firms in this cluster. This configuration may also reflect firms whose growth is limited because they operate in very small market niches.

- Capped growth – these enterprises are slightly larger than those in the expansion stage, but are generally much older. Organisationally, they are somewhat less

complex than typical businesses in the expansion stage. Mean sales revenues growth is 44 per cent per annum, but mean employment growth is only 4 per cent per annum. These enterprises appear to have disengaged from the growth process after successfully expanding to modest size following start-up. Hanks *et al.* (1993) observe that such businesses could be in Churchill & Lewis' (1983, p. 34) 'success-disengagement' sub-stage described as follows:

. . . the company has attained true economic health, has sufficient size and product-market penetration to ensure economic success, and earns average or above-average profits. The company can stay at this stage indefinitely, provided environmental change does not destroy its market niche or ineffective management reduce its competitive abilities.

As indicated earlier in this chapter, Holmes & Zimmer (1994) amongst others have also highlighted the possibility of capped growth in smaller enterprises. A detailed justification for SME owner-managers seriously considering this strategic option at some point is provided in a prescriptive article by McKenna & Oritt (1981).

Note that the term 'capped growth' is not specifically employed by Hanks *et al.* (1993) in depicting their taxonomic life-cycle model. However, based on their description of smaller enterprises in this disengagement/arrested development circumstance, its use appears entirely appropriate. Note also that the Hanks *et al.* (1993) model does not include a decline stage as in some other models such as those of Smith *et al.* (1985), Adizes (1979, 1989) and Kazanjian (1988). Hanks *et al.* (1993, pp. 9-10) comment on this as follows:

Exclusion of decline stages in the majority of models can most likely be attributed to two characteristics of organization decline. First, the impact of decline on organization structure and systems is far less predictable than changes associated with growth. Second, the onset of organization decline may actually occur at any stage of the organization life cycle (Hanks, 1990b; Miller & Friesen, 1984a).

On the compatibility of their taxonomic life-cycle model with the ten prior models reviewed by them, Hanks *et al.* (1993, p. 9) observe:

All of the models include one or more stages related to organization birth or start-up, expansion, and maturity. All but three . . . include one or more diversification . . . stages.

The main limitations of the SME growth model developed by Hanks *et al.* (1993) are acknowledged by the researchers as deriving from their use of an exploratory method and cross-sectional data, and due to potential sample specificity. On the possibility the model only has some validity for smaller high-technology concerns in the industries studied by Hanks *et al.* (1993), a point made by Kazanjian & Drazin (1989, p. 1499) regarding their stage-of-growth study of technology-based new ventures (TBNVs) may be relevant:

. . . even though the model presented . . . is theorized only to hold for TBNVs, the underlying structure of the theory has enough in common with general stage of growth models to lend some plausibility to a stage of growth progression occurring in a variety of growth situations.

Certainly, the work of Hanks *et al.* (1993) is very well grounded in prior research and writing on stage models of development in smaller enterprises of all types; and their findings appear to align reasonably well with those of earlier investigations. Furthermore, for one versed in smaller enterprise theory and research, their model does have intuitive appeal as a more or less general conceptualisation.

O'Farrell & Hitchens (1988) present a comprehensive critique of stage models of smaller enterprise development which acknowledges the following weaknesses of business growth conceptualisations of this type:

- Some stage models seem little more than heuristic classification schemes, rather than true conceptualisations of the growth process. The models are inclined to address the symptoms of growth, rather than reveal the underlying processes of the phenomenon.
- The body of literature underlying stage models is largely discursive and wisdom based. Furthermore, stage models and business life-cycle theory both tend to assume their own validity, rather than endeavouring to establish it in some rigorous manner.
- Where attempts are made to empirically validate stage models, most often this is done with relatively small samples and cross-sectional data. A strong argument can be made that longitudinal data are inherently appropriate to conceptualising growth of businesses over time.
- Stage models tend to assume all smaller enterprises pass inexorably through each stage, or fail in attempting to do so. It is usually unclear whether passage through all stages is necessary; or whether, in some circumstances, one or more stages may be omitted, and if variations in sequencing can occur. Stage models should be able to account for the rarity of growth; and for phenomena such as life-style and capped growth businesses in which owner-manager psychology and personal wishes may override strict business considerations. The possibility of regression through some stages should also be contemplated.
- Stage models typically fail to capture important early stages in the initiation of small enterprises, including prior to start-up. The focus of attention or emphasis is most often on those concerns well on the path to becoming medium-sized.
- Stage models usually measure enterprise size in terms of sales revenues or number of employees, and they usually disregard other measures of attainment or performance such as product mix, value added and rate of innovation.
- Stage models tend to focus on the internal dynamics of growing concerns, and typically pay insufficient attention to the impact of external factors in the social, economic and business environments. For example, stage models generally fail to take account of spatial dimensions of smaller enterprise development tied to advancement or decline of local, regional, national or international economies.

These points cover virtually all the substantial criticisms of stage models of smaller enterprise growth found in preambles to empirical studies already identified, and in specific reviews/critiques such as those of Penrose (1952), Perry (1982), Gibb & Davies (1989, 1990, 1991), Hay & Kamshad (1994) and Merz *et al.* (1994).

Of the criticisms of stage-of-growth models identified in the previous paragraph, those grouped in the fourth point are most often voiced in the relevant literature. For example, in her seminal work *The Theory of the Growth of the Firm*, Penrose (1952, p. 806) expresses the following views:

The purpose of a life cycle theory of the firm would serve are obvious, yet the theory as a base undeveloped hypothesis has existed for a long time and nothing has been done to construct from it a consistent theoretical system with sufficient content to enable it to be used for any purpose whatsoever. . . . Although we have a respectable collection of information about firms, it has not stimulated economists even to suggest the further hypotheses necessary to the development of a life cycle theory of the firm. This, I think, is primarily because the available evidence does not support the theory that firms have a life cycle characterized by a consistent transition through recognizable stages of development similar to those of living organisms. Indeed, just the opposite conclusion must be drawn: the development of firms does not proceed according to the same 'grim' laws as does that of living organisms.

Gibb & Dyson (1984) claim that much small enterprise growth is topsy-turvy, and is reactive rather than pro-active. Fombrun & Wally (1989, p. 108) make the point that 'Growth . . . may be neither orderly nor sequential; it may occur in surges'. According to Miller & Friesen (1984a):

. . . while the stages of the life cycle are internally coherent and very different from one another they are by no means connected to each other in any deterministic sequence.

Finally, when commenting on published research into stages of growth in smaller enterprises, Merz (1994, p. 49) proclaim that:

These studies, while interesting and thought provoking, possess limited usefulness for the study of growth management since they are built upon the deterministic assumption that all firms grow linearly through a predictable series of preordained stages.

At least a partial rejoinder to many such commentaries on stages-of-growth models may be provided by Miller's (1981, 1987) suggestion that, rather than moving predictably through a sequence of developmental stages, businesses might instead 'attain gestalts or patterns of strategy, structure, and environment that may emerge for any number of reasons' (Kazanjian, 1988, p. 258). According to Miller & Friesen (1984b, p. 1) (*italics added for emphasis*):

Organisational structures, production systems, *information processing procedures*, strategies and environments all tend to influence each other. Our thesis is that they do so in such a manner that gives rise to a small number of extremely common configurations. . . . Configurations may represent common organizational structures, common scenarios of strategy making in context, and even *common developmental or transitional sequences*.

Kazanjian & Drazin (1989) point out that organisational *gestalts* are appropriate responses to imperatives facing businesses, and that movement from one *gestalt* to another would not necessarily follow any developmental pattern.

The most significant empirical research found which explicitly tests, for smaller enterprises, the validity of the alternative stages-of-growth and gestalt perspectives identified in the previous paragraph is a longitudinal study of technology-based new ventures (TBNVs) in the United States reported by Kazanjian & Drazin (1989). The research question addressed by Kazanjian & Drazin (1989, pp. 1492-1493) is:

. . . whether, over time, TBNVs progress according to a stage of growth model or if transitions in organizational form represent shifts in gestalts or configurations.

The authors cite only Miller & Friesen (1984a) as previous empirical research shedding some light on this question. Although the sample size is small, a stage-wise progression is claimed to be roughly present in Miller & Friesen's (1984a) data. On the outcome of their research, Kazanjian & Drazin (1989, pp. 1499) comment as follows:

To the best of our knowledge this paper provides the first statistical test of whether firms actually advance through stages over time. The modest support shown in the results confirms that some TBNVs do tend . . . to progress according to the predicted pattern.

Subsequently, Kazanjian & Drazin (1989, p. 1499) claim that the findings of their study provide 'only partial support for the stage of growth model, but point the way toward an interesting possible synthesis of the stage of growth and gestalt perspectives'.

Recall that Hanks *et al.* (1993, p. 7) define a life-cycle stage as 'a unique configuration of variables related to organization context or structure'. This definition, it could be argued, might equally well apply to *gestalts*. Furthermore, the taxonomic approach to deriving their model employed by Hanks *et al.* (1993) is a method one might use in identifying *gestalts* amongst business concerns. Commenting on the findings of their research, Hanks *et al.* (1993, p. 18) claim that:

While the cross-sectional nature of this study limits our ability to reach definitive conclusions as to the sequencing of stages, the derived taxonomy suggests a sequence of four developmental stages . . .

As pointed out earlier, a sequence of stages might be inferred from the enterprise size and age characteristics typical for concerns in each stage of the Hanks *et al.* (1993) study. However, later in their paper Hanks *et al.* (1993, p. 24) observe:

Although the cross-sectional approach taken in this study is suggestive of life-cycle stages, it is impossible to differentiate between configurations representative of life-cycle stages and those suggestive of firms simply choosing to do business in different ways.

This may be taken to suggest that what could be seen as life-cycle stages might alternatively be perceived as *gestalts* amongst the businesses studied.

The point is, then, that the Hanks *et al.* (1993) model described at some length in this sub-section of the chapter is not inconsistent with an alternative gestalt perspective; although, on balance, it favours a stages-of-growth perspective. Note also that a gestalt may, in fact, be a growth stage. The upshot for this study is that an election can be placed

some reliance on the Hanks *et al.* (1993) model in the knowledge that, as well as overcoming concerns that stages-of-growth models are frequently not empirically based, it can also be claimed to at least partially answer the most prevalent objections to such models in the literature (in particular those detailed earlier from Penrose, 1952; Gibb & Dyson, 1984; Fombrun & Wally, 1989; Miller & Friesen, 1984a and Merz, 1994). In the remainder of the thesis, reference will continue to be made to stages of smaller enterprise development. However, this is done with some caution and in full recognition of caveats stemming from the discussion of organisational *gestalts* immediately above.

In closing this sub-section of the chapter, it should be said that, while an election has been made to place reliance in this study on the stages-of-growth model devised and validated principally by Hanks *et al.* (1993), recognition is given to other stage models as the thesis progresses. For example, those of Kazanjian (1988), Kazanjian & Drazin (1989, 1990) and Dodge & Robbins (1992) receive attention in the subsequent section of this chapter. Furthermore, stage models proposed by Adizes (1979, 1989) and Quinn & Cameron (1983) are examined in the context of strategic management perspectives on financial reporting in Chapter 3 of the thesis.

2.3 Financial Dimensions of SME Growth

2.3.1 SME Financial Profiles

The purpose of this section of the chapter is to seek for evidence amongst recent conceptual and empirical studies that financial management, broadly defined to embrace dealing with financial challenges and undertaking recognised financial practices, changes in importance as smaller enterprises pass through successive stages of an organisational life-cycle. If such evidence can be found, then it might be argued that financial reporting practices of the type contemplated in this study may also change in their significance to successful management of growing SMEs. The nature and extent of such changes are, of course, the focus of this study.

A *prima facie* case may be established for an affirmative response to the implied question in the previous paragraph by closely examining what smaller enterprises look like from a financial perspective – that is, how they appear to the readers of their financial statements or reports. If it can be established that this financial appearance changes with enterprise growth and development, and that it differs from the financial appearance of larger enterprises, then the existence might be inferred of a financial dynamic which may drive changes in financial management, including financial reporting practices, as an enterprise progresses through the stages of its development. Hutchinson (1987, 1989) has studied this aspect of smaller enterprise by examining so-called 'financial profiles'. Hutchinson (1989, p. 6) describes a financial profile as 'that set of accounting ratios, available from the firm's profit and loss account and balance sheet, which usefully and efficiently summarises the financial aspects of the firm such as profitability, liquidity and gearing'. The financial context and condition of a business

enterprise are thus established against which its management practices may be appropriately seen and judged.

Based on the international theoretical and empirical literature extensively reviewed by him, and also on the findings of his own empirical research on the financial profiles of smaller enterprises in Australia, Hutchinson (1989, p. 155) concludes:

... there is a predictable relationship between stage of development of firms and their financial profiles; that the financial profile of small firms changes as they grow to maturity; and that the financial profile of growth small firms has features in common with bankrupt firms.

Expanding on the final point in this quotation, Hutchinson (1989, p. 154-155) indicates that:

Growth small firms were found to have a statistically significantly higher level of profitability than bankrupt firms but similar levels of liquidity and gearing. It was not found possible to accurately distinguish between growth small firms and bankrupt firms using multiple discriminant analysis.

Mature enterprises are reported to typically have more liquidity, lower gearing and higher profitability than other SMEs. Hutchinson's (1989) research stresses that it is the combined effect of small size and growth that produces a distinctive financial profile for smaller growth enterprises. They are reported to be more profitable, less liquid and more highly geared than large enterprises and other small enterprises.

It should be noted that Hutchinson (1989, p. 13) attributes much that is distinctive about the financial profile of smaller growth enterprises to the possible existence of a 'finance gap' for such concerns which represents their typically limited access to medium- to long-term debt and/or equity capital for development purposes:

If a finance gap does exist for growth small firms then it would help to explain why growth small firms are more profitable, less liquid and more highly geared than large (quoted) companies and other small firms. The argument is that a small growth firm would have to rely more on internally generated funds than a large firm and therefore there would be a greater correlation between profitability and growth in assets. Lack of long term finance would force reliance on short term sources of finance thereby reducing the liquidity position of growth small enterprises. Lack of equity finance, because of lack of access to the stock market, would result in higher overall levels of gearing for growth small firms, in other words not only would they substitute short term debt for long term debt but also substitute debt for unavailable equity. The finance gap also explains one of the few differences between the financial profiles of small and large firms upon which there is agreement in the literature, namely that small firms, whilst not necessarily having a higher or lower level of total debt to total assets than large firms, do have lower levels of long term debt to total assets than large firms.

This quotation does not, of course, recognise the widely acknowledged possibility, alluded to earlier in the chapter, that any finance gap which may exist for growth SMEs might be self-imposed. This could be so because of owner-managers' prejudicial, but in their view defensible, attitudes to use for development purposes of external debt and/or equity in place of, or to supplement, owner provided debt (that is, directors' loans) and/or undistributed profits (Osteryoung *et al.*, 1992; McMahon *et al.*, 1993a; Holmes & Zimmer, 1994; McMahon & Stanger, 1995; LeCornu *et al.*, 1996).

In Chapter 3 of the thesis a possible relationship is explored between the existence of a finance gap for smaller growth enterprises and the limited financial reporting they typically undertake to non-managing owners, creditors and lenders. The suggestion is made that improving their access to development finance might be facilitated by more timely and relevant financial reporting to finance providers, especially those which are external to the business. The fact that 'low liquidity' and 'high gearing' are adverse or problematic financial conditions that may be reflected in the financial profile of growth SMEs, and that this financial profile is apparently somewhat alike that of bankrupt businesses, highlights a problem focused theme which is common in the business growth literature and is developed in the following sub-section of the chapter.

2.3.2 Problematic SME Growth

As in biological organisms, growth in smaller enterprises can be a condition of stress, and it may be associated with a number of challenges which require special or advanced management skills. Building on this theme most notably promoted in the organisational literature by Greiner (1972) and in the small enterprise literature by Steinmetz (1969), there has emerged a series of conceptual, problem-oriented stage models with limited or no empirical backing such as those of Adizes (1979), Parks (1977a, 1977b), McKenna & Oritt (1981), Churchill (1983), Churchill & Lewis (1983), Flamholtz (1986) and Scott & Bruce (1987). Often of particular interest are the features of the rapid growth or take-off phase included as part of each model. According to Churchill (1983, p. 3), take-off is 'the most challenging stage with the most excitement and the most problems'. He underscores this by pointing out that certain key management factors become critical during rapid growth, including the following:

- Financial resources including cash and borrowing power – necessary to ensure that the business is able to finance the growth in stock, debtors, fixed assets, etc. that occurs. If sufficient financial resources are not available, the common spectre arises of a profitable, growing business experiencing a liquidity crisis and failing because employees, suppliers, creditors, etc. are no longer willing to wait for it to meet its short-term cash obligations to them. This adverse financial condition or problem is usually described as 'overtrading'.
- Systems resources in terms of the degree of sophistication of both information and planning and control systems – necessary to enable the owner-manager(s) to adopt a 'hands-off' management style more appropriate for the larger, more complex concern; and especially necessary to facilitate timely cash-flow planning in order to avoid the spectre of overtrading.

This overriding emphasis on financing and maintaining financial control during periods of significant enterprise growth is evident in the other SME growth models identified

above, although some anticipate the financial problem of overtrading arising in earlier stages than others (Scott & Bruce, 1987).

There has also been a number of recent studies seeking empirical support for the proposition that businesses encounter different stresses or, indeed, crises at various stages of their development. These challenges and their resolution are believed to substantially influence the orientation, structure and management practices of the businesses affected. Examples of such studies from the smaller enterprise literature include those of Vozikis (1979), Vozikis & Glueck (1980), Vozikis (1984), Kazanjian (1988), Kazanjian & Drazin (1989, 1990), Dodge & Robbins (1992), Dodge *et al.* (1994) and Hanks & Chandler (1994). These works do not stop at mere description of the stages or phases in the organisational life-cycle; they also identify certain dominant problems, and suggest the prevalent orientation characterising the enterprise, at each stage. Necessary changes in the structure of the enterprise and the behaviour and *modus operandi* of its owner-manager(s) are also emphasised. Further empirical evidence on these matters, which does not examine dominant problems in all stages of some life-cycle model, is provided by Hunsdiek (1985), Kayser (1990) and Terpstra & Olson (1993).

Earlier in the chapter, an election was made to place some reliance in the present study on the stages-of-growth model devised and validated principally by Hanks *et al.* (1993). The work of Hanks & Chandler (1994) employs this model and extends that research to examine the changing pattern of functional specialisation in growing SMEs over successive life-cycle stages. The broad expectation in the study is that, as smaller enterprises move through the various life-cycle stages, they become increasingly more specialised in their functional management. It is argued that growth places a greater decision load on the owner-manager who, if he or she has the personal capability to do so, will delegate particular matters as appropriate to employed functional specialists. The main hypothesis tested is that 'The pattern of specialization in firms will reflect the dominant management problem associated with each stage of development' (Hanks & Chandler, 1994, p. 26). Prior work on this theme from Greiner (1972), Galbraith (1982), Smith *et al.* (1985), Flamholtz (1986), Scott & Bruce (1987), Kazanjian (1988), Kazanjian & Drazin (1990) and Dodge & Robbins (1992) is reviewed and found to collectively show a high level of consistency in the dominant problems identified with each life-cycle stage.

Hanks & Chandler's (1994) findings in relation to the functional specialisations of accounting and of finance are summarised in Table 2.1 on the next page which reports, for each development stage, the proportion of respondents to the study with at least one person employed full-time in the designated specialisations (adapted from Hanks & Chandler, 1994, p. 33, Table 3). Hanks & Chandler (1994) indicate that, for both accounting and for finance, a Chi-Square test indicates that there are statistically

Table 2.1: Functional Specialisations in Life-Cycle Stages

Functional Specialisation	Development Stages (from Hanks <i>et al.</i> , 1993)			
	Start-Up	Expansion	Maturity	Diversification
Accounting	0.10	0.52	0.97	1.00
Finance	0.00	0.21	0.86	0.88

significant differences in the extent of these specialisations between life-cycle development stages ($p < 0.01$). Based on consideration of dominant problems in the various stages, Hanks & Chandler (1994) predict that an accounting specialisation will emerge (that is, more than half of respondents report having this specialisation) in the expansion stage, which proves to be so. They are also correct in their prediction for the finance specialisation. Brief consideration should be given to the disengagement stages in the Hanks *et al.* (1993) model. Although Hanks & Chandler (1994) do not indicate this, it might be inferred that the accounting and finance functions in a life-style enterprise are most likely to be akin to those in the start-up stage. Similarly, the accounting and finance functions in capped growth enterprise may be most like those in the expansion stage.

These results from Hanks & Chandler (1994) are well underpinned by the earlier empirical work of Kazanjian (1988), Kazanjian & Drazin (1989, 1990), Dodge & Robbins (1992) and Dodge *et al.* (1994). In a principal components analysis of problem importance ratings gathered from respondents amongst growth SMEs in the United States, Kazanjian (1988, p. 265) reports that 'The first [component], which loads heavily with problems related to internal administrative systems and concerns – management information systems, cost control, financial information systems, and the general level of red tape – is an organizational-administrative construct'. The eigen value for this first component is 3.02. In an analysis of variance examining the level of six principal components over the four stages of the life-cycle model employed by Kazanjian (1988), it is clear that the organizational-administrative component increases in a statistically significant manner between the first two stages and the last two which include a growth stage. Kazanjian (1988, p. 275) indicates that this finding is 'consistent with a need for increased control in a large organization'. The highest ranking of the organizational-administrative component amongst the six components isolated is fourth behind sales/marketing, strategic positioning and people in the growth stage (that is, stage 3).

Amongst 849 major problems found in a sample of 364 small enterprises in the United States, Dodge & Robbins (1992) find that those of a financial nature amount to 16 per cent of the total. Financial problems are statistically significantly different ($p < 0.02$) over the four stages of the life-cycle model employed by Dodge & Robbins (1992); and financial problems are most pressing in the first (or formation) stage ($p < 0.01$). Financial problems are least numerous behind marketing and management problems in

all life-cycle stages. An analysis of particular financial problems over life-cycle stages is presented in the table below (adapted from Dodge & Robbins, 1992, p. 33, Table 5):

Table 2.2: Financial Problems in Life-Cycle Stages

Financial Problem	Per Cent of Financial Problems in Life-Cycle Stages			
	Formation	Early Growth	Late Growth	Stability
Poor financing arrangements	7	38	25	12
Poor accounting system	21	27	36	44
Poor cash-flow	4	35	39	44
Total	100	100	100	100

Poor financing arrangements, which include having to deal with undercapitalisation and difficulties with locating financing sources, amount to 42 per cent of all financial problems discovered over all life-cycle stages. Poor accounting system and poor cash-flow amount respectively to 31 per cent and 26 per cent of all financial problems discovered over all life-cycle stages. A Chi-Square test indicates that there are statistically significant differences in the incidences of these financial problems between life-cycle stages ($p < 0.01$). Note that having a poor accounting system becomes a more prevalent financial problem in later stages of development.

In another United States study of small enterprises, Dodge *et al.* (1994) examine (*inter alia*) the incidences of certain financial problems in light of the degree of competition being experienced by respondents (little/no competition vs intense competition), and their current life-cycle stage (early stages vs late stages). The findings of this research are summarised in Table 2.3 on the next page (adapted from Dodge *et al.*, 1994, p. 130, Table 3). Inadequate capital and poor cash-flow rank first and second respectively amongst eight types of internal problem reported in the study; whereas poor accounting system ranks eighth. It seems from the table that both degree of competition experienced and life-cycle stage influence the incidences of the financial problems identified. Note that having a poor accounting system becomes a more prevalent financial problem in later stages of development.

Table 2.3: Financial Problems, Degree of Competition and Life-Cycle Stages

Financial Problem	Per Cent Respondents Reporting Problem			
	Little/No Competition		Intense Competition	
	Early Stages	Late Stages	Early Stages	Late Stages
Inadequate capital	17.4	8.3	18.4	9.0
Poor cash-flow	16.3	10.0	12.7	12.5
Poor accounting system	7.0	11.7	7.4	10.6

Further empirical studies in which dominant problems of smaller enterprises are examined at two points of time – during start-up and during some later growth phase – are reported by Hunsdiek (1985), Kayser (1990) and Terpstra & Olson (1993). Table 2.4 on the next page presents the findings of Hunsdiek (1985) regarding financial problems in smaller growth enterprises in Germany (adapted from Hunsdiek, 1985, p. 18, Table 5). In Kayser's (1990) longitudinal study in Germany, the proportion of respondents reporting certain financial problems during start-up are as follows: accessing equity capital (42.4 per cent), having to provide personal guarantees to banks (27.2 per cent), obtaining information about financing alternatives (26.1 per cent) and slow payment by customers (0 per cent). During a later growth stage, the proportion of respondents reporting the same financial problems are as follows: accessing equity capital (38.8 per cent), having to provide personal guarantees to banks (23.4 per cent), obtaining information about financing alternatives (0 per cent) and slow payment by customers (42.3 per cent).

Terpstra & Olson (1993) indicate that, for the high-growth private companies in the United States responding to their survey, the second and third most prevalent problems experienced during their start-up phase are obtaining external financing and internal financial management (respectively, 17 and 16 per cent of all problems reported). Internal financial management problems include inadequate working capital, cash-flow difficulties, controlling margins, debtors' collections, etc. Sales/marketing problems are most prevalent during start-up (38 per cent of all problems reported). During a later growth stage, internal financial management is the second most prevalent problem (21 per cent of all problems reported); but obtaining external financing falls to 1 per cent of all problems reported. Sales/marketing problems just remain most prevalent during the later growth stage (22 per cent of all problems reported).

Table 2.4: Financial Problems in Smaller Growth Enterprises

Financial Problem	Per Cent Respondents Experiencing Problem During		
	Start-Up	Growth	Both Start-Up and Growth
Credit limits too low	15.6	13.1	11.9
Excessive collateral demands of banks	20.3	14.1	14.3
Insufficient bank financing alternatives	15.6	8.1	9.5
Insufficient information on financing alternatives	21.9	9.1	11.9
Insufficient cooperation from banks	12.5	6.1	4.8
Limited access to equity capital	15.6	13.1	9.5
Excessive debt to equity ratio	28.1	22.2	25.0
Cash-flow problems due credit arrangements	6.3	17.2	7.1
Insufficient information on financial assistance	17.2	11.1	15.5
Excessive debtors' balance	9.4	4.0	3.6

The only research study found which specifically suggests there are no statistically significant differences between life-cycle stages in financial problems experienced by smaller growth enterprises is that of Vozikis (1984) in the United States. Note, however, that the proportion of respondents reporting experience of financial problems in each of the three stages of the life-cycle model used is far from negligible (more than 30 per cent of respondents in each stage).

Overall, the empirical evidence reviewed in this sub-section of the chapter provides strong support for the proposition that, as a growing SME progresses through various life-cycle stages, the financial dimensions of its operations tend to become more problematic; and, as a rational response, it becomes more likely that the owner-manager will establish a functional specialisation in the accounting/finance domain. This function could involve employment, on a part- or full-time basis, of a bookkeeper or accountant; or it might involve more extensive use of the services of an external public accountant. In the following sub-section of the chapter, evidence is sought on possible concomitant

changes in financial management practices employed as the enterprise develops over time.

2.3.3 Financial Management Practices and SME Growth

It has so far been established that much of the literature on business development highlights the stresses, even crises, produced in a smaller enterprise by growth, and the need for changes in the way the concern is organised and managed if it is to cope with the stresses and survive to prosper. To the extent that improved financial management practices are intended to permit a business to handle more effectively and efficiently any financial problems which arise, it may be reasonably inferred that a changing pattern of financial problems over its life-cycle should, but may not, lead to changes in the manner in which financial management is carried out. The presumption is that the more problematic the financial circumstances of the enterprise, the more sophisticated will need to be financial management practices employed to deal with such difficulties. By extension, businesses that recognise the need to adapt financial management practices to changing circumstances, and then do so, are more likely to succeed in growth and/or performance terms. Those that do not see the need for changed financial management practices according to circumstances are more likely to suffer the problematic consequences of growth and/or underperform.

Earlier in the chapter it is indicated that O'Farrell & Hitchens (1988) classify available business growth theories into several groups, one of which is theories derived from the field of industrial economics. From the viewpoint of the present sub-section of the chapter, two aspects of the analysis of these theories are particularly important. Both relate to managerial constraints on growth which ring true for smaller enterprises. First, O'Farrell & Hitchens (1988, p. 1367) posit that perhaps there is a limit to enterprise size (*italics added for emphasis*):

Businessmen differ in the degree of interest that they take in different aspects of their functions (that is, production, *financial control*, marketing, etc.) and this may be important in influencing the size towards which a business is trying to grow.

Second, in summarising the views of Penrose (1959) on firm growth, O'Farrell & Hitchens' (1988, p. 1367) point out that she (*italics added for emphasis*):

... placed a major emphasis upon the managerial constraints on growth (subsequently known as the 'Penrose effect'), arguing that there are at any time limits to the expansion that existing managers can achieve, but limits also to the rate at which management can expand its numbers and thereby its managerial capacity. The core of Penrose's theory was the supply of managerial services to the firm. As the firm grows, obtaining new managers, *new abilities*, and *new information*, there are increases in the maximum services that the resources can generate. Any limit on the scale of possible operations recedes and the issue becomes one of determining the limits on the rate at which the firm ... can in fact grow.

In the light of the previous quotation from O'Farrell & Hitchens (1988), it seems plausible to include financial control skills amongst the new abilities referred to by Penrose (1959). O'Farrell & Hitchens (1988, p. 1367) claim that 'There are both theoretical and empirical

reasons for believing that the Penrose effect is a major determinant of the growth of a firm: both case study and econometric analyses support this view'. Thus, there may exist managerial diseconomies of scale in smaller enterprises related to the availability and abilities of senior managers (including owner-managers) who can undertake financial management.

Recent empirical evidence on the existence of a Penrose effect amongst a sample of over 400 SMEs in the software, printing and instrumentation industries in the United Kingdom is provided by Hay & Kamshad (1994). The researchers report that enterprise growth is an important objective amongst the respondents to their study whether they are owner-managers or employed managers. Furthermore, typical growth inducing strategies such as product innovation, broadening product range and geographical expansion (in the order of popularity) are pursued amongst those respondents intent on growth. However, realised growth rates amongst many growth seeking respondents are reported to be lower than might reasonably be expected. This is substantially attributed to external factors such as economic recession at the time of the study and the intensity of competition in the industries examined. However, internal limits on enterprise growth also seem to have been important amongst respondent enterprises, with limitations on the management team's ability to manage further growth being the most prominent. Hay & Kamshad (1994, p. 67) comment upon their findings as follows:

The limitations on SME management's ability to achieve sustained growth operates at many levels including: the pool of talent at management's disposal; the rate at which new management resources can be added and integrated; and the speed with which proven managerial experience can be shared. To this must be added the self-imposed limits on growth as reflected in managerial aspirations and objectives. More concretely, we would argue that a key reason why many SMEs do not grow is that their owner-managers eschew growth in favour of other objectives.

Hay & Kamshad (1994, p. 67) conclude that 'internal constraints stemming from managerial capacity and attitudes do play a significant role in limiting SME growth'.

Another group of business growth theories identified by O'Farrell & Hitchens (1988) is what they describe as strategic management perspectives on smaller enterprise growth. The work of Gibb & Scott (1985, 1986) is a frequently cited example of this *genre*. Significantly for the present study, these authors underscore the importance of adequate financial control within the holistic framework provided by strategic management for smaller growth enterprises. They emphasise the importance of establishing and monitoring an adequate 'performance base' for growth, and of implementing (*inter alia*) an appropriate financial 'control base' to sustain and manage growth. Moores (1990) and Moores & Mula (1993), amongst other strategic management writers referred to in Chapter 3 of the thesis, indicate that the appropriate design of managerial control systems is contingent upon a range of organisational variables such as environment, strategy, technology and structure, and including enterprise size and

rate of growth. As an enterprise develops it may outgrow its present financial control system (should one exist) and may come to require a much more sophisticated system in terms of the nature, quality and timeliness of information flows for planning, control and decision-making. This, of course, will require concomitantly greater sophistication on the part of the owner-manager(s) in the general area of financial management.

While there are a significant number of prescriptive works in the literature of smaller enterprise that broadly examine financial management practices and their role in facilitating SME growth (Grabovskiy & Flowell, 1980; Rausch, 1982; Carey & Olson, 1983; Wise, 1984; Flamholtz, 1986; Meredith, 1986; Price, 1986; Walker & Petty, 1986; Barrow, 1988; Ronstadt, 1988; Dewhurst & Burns, 1989; English, 1990; Dunn & Cheatham, 1993; McMahon *et al.*, 1993a; Ratnatunga *et al.*, 1993; McMahon, 1995; Osteryoung *et al.*, 1997), there are surprisingly few published empirical studies to underpin the prescriptions typically contained in such writings.

The most extensive research study found dealing with overall financial management in growth small enterprises is that reported by Hutchinson *et al.* (1975), Ray (1980a, 1980b), Hutchinson *et al.* (1981), Ray & Hutchinson (1983, 1985) and Hutchinson & Ray (1986). This is a substantial United Kingdom investigation of financing and financial control practices in small, rapidly growing enterprises up to and following flotation on the London Stock Exchange. Financial management practices of a sample of 33 'super-growth' businesses are examined for a period of ten years prior to their flotation between April, 1968 and March, 1973, and for four years after. To provide a benchmark, the financial management practices of a matched sample of small enterprises which did not grow, and that did not achieve flotation, are also examined. The businesses studied are from a variety of industries and are predominantly situated in the south of England. Hutchinson *et al.* (1975, 1981) report on the pilot study and Ray (1980a, 1980b) chiefly provide conceptual foundations for the research. The remainder of the works cited earlier in the paragraph deal with the main inquiry, with Ray & Hutchinson (1983) being the fullest published account.

By examining the financial profiles of the 33 super-growth businesses for the period of the study, and comparing these with profiles for other samples of smaller concerns, Ray & Hutchinson (1983) provide evidence that business enterprise growth results particularly in financial stresses such as incipient overtrading, low liquidity and high gearing. They go on to argue that, if the many financial pitfalls of growth are to be avoided, there is a critical need for improved financial control (that is, more sophisticated financial management). Table 2.5 on the next page summarises differences found by Ray & Hutchinson (1983, 1985) in business and financial control characteristics between the super-growth and non-growth enterprises in their research (adapted from Ray & Hutchinson, 1985, p. 231, Figure 3).

Table 2.5: Financial Control in Rapid Growth and Non-Growth Enterprises

Business and Financial Control Characteristics	Super-Growth Enterprises	Matched Non-Growth Enterprises
Objectives pursued	Maximise profits, increase turnover	Less emphasis on maximising profit, more on independence
Organisational structure used	'Tree' organisation, development of teams, 'clover leaf' emerging	'Tree' organisation in well established businesses
Style of management employed	Autocratic, becoming more consultative	Paternal
Structure used for internal accounting	Increasing movement to profit centres	Less emphasis on profit centres
Historical financial information provided	Monthly or weekly profit and loss and balance sheet items	Very similar to super-growth enterprises
Forecasted financial information provided	Trend to monthly data, particularly strong on cash-flow	Very little emphasis
Key variables monitored	Cash-flow, profitability, sales	More emphasis on supplier relationships

On the basis of these findings, Ray & Hutchinson (1983) go on to make an empirically supported case that improved financial control in smaller growth enterprises can and should come about through (*inter alia*) a significant upgrading of their financial reporting and analysis systems:

- In order to monitor financial position and performance, there is a need for timely and relevant financial statements reflecting what has been achieved.
- To effectively plan for the business's future, there is a need for regular forecasted financial statements.

Thus, a more sophisticated financial reporting system is necessary to ensure that the enterprise's economic resources are used effectively and efficiently in pursuit of its goals. It also follows that there is a particular need in the smaller growth enterprise for the skills of financial analysis which will allow financial statements to be read and understood, whether they contain historical or forecast information. As broadly indicated in the table above, the research study most fully reported by Ray & Hutchinson (1983) seeks evidence on the manner in which financial reporting systems and practices appear to change as a result of smaller enterprises experiencing rapid growth; and also attempts to contrast these circumstances with those in non-growth concerns with

otherwise similar characteristics. The detailed findings of the investigation on financial reporting practices are presented in Chapter 4 of this thesis.

This section of the chapter has attempted to establish support for the broad proposition that smaller enterprise growth results in increased financial challenges or problems, and that there is consequently a greater need for careful attention to financial management in general, and financial reporting in particular, if the growing concern is to succeed in survival and performance terms. As the core concern of this thesis, specific attention is paid to associations between smaller enterprise growth/development and financial reporting practices in Chapters 3 and 4, and from Chapter 6 onwards.

2.4 Smaller Enterprise Growth and Performance

2.4.1 Measuring Smaller Enterprise Growth and Performance

Matters relating to measurement of business enterprise growth and performance – the ultimate outcome variables in this research – are now to be addressed in some detail. This sub-section of the chapter presents broad guidelines, taken from recent scholarly writing and research, on measuring smaller enterprise growth and performance. In subsequent sub-sections, specific growth and performance measures available to SME research are described; and then possible empirical associations between enterprise size, age, growth and performance are examined. As pointed out in Chapter 1 of the thesis, the survey instrument for the AMC *Best Financial Practice* study relies heavily upon subjective assessments of business growth and performance from respondents. Hence, the measurement issues this raises receive particular attention at the close of this section of the chapter. Because it is the data collection method employed in the present research, the emphasis throughout is on methods of growth and performance measurement that can be employed in mailed questionnaires for self-completion by SME owner-managers.

Venkatraman & Ramanujam (1986) is an often cited article comparing various approaches to measuring growth and performance in research on strategic management of businesses of all sizes. The article holds that performance is a multidimensional construct, and therefore multiple measures should be simultaneously used in sound business research. Furthermore, it is argued that measures employed should not be restricted to only those of a financial nature, since to do so 'assumes the dominance and legitimacy of *financial* goals in a firm's system of goals' (Venkatraman & Ramanujam, 1986, p. 804). The possible existence and overriding nature in smaller enterprises of goals other than those which are strictly financial have already received comment in the thesis. Regarding measurement of SME success, Stevenson & Harmeling (1990, p. 11) point out that:

... success should be measurable in such a fashion that better and worse are clear and will be the same from observation to observation. This demand and the demands of analytical tractability lead us to one of two extremes. Either we choose a single measure of success such as shareholders' wealth or we retreat to

a tautological concept of utility function. Neither is adequate for the needs of management.

The two extremes identified in this quotation are, in fact, avoided in the present research.

The challenges in measuring growth and performance for smaller enterprises receive considerable attention in the research literature (Edmunds, 1979; Dess & Robinson, 1984; Madsen, 1987; Sapienza *et al.*, 1988; Miller *et al.*, 1988; Aaby & Slater, 1989; Walters & Samiee, 1990; Brush & Vanderwerf, 1990, 1992; Chandler & Hanks, 1993; Murphy *et al.*, 1996). Most recently, Murphy *et al.* (1996) have examined 71 approaches to measuring growth and performance found in 51 small enterprise and entrepreneurship research studies reported in the literature between 1987 and 1993. Arranged over 8 'performance dimensions', virtually all of the growth and performance measures identified are of a financial or monetary nature. Following their comprehensive review, Murphy *et al.* (1996, p. 15) comment as follows:

Little consistency in [growth and] performance measurement across studies was found; rather, a wide diversity of measures are relied upon. Moreover, 60% of the studies used only one or two dimensions of [growth and] performance, generally without justification for selecting.

Although not specifically identified by Murphy *et al.* (1996), minimally informative statements such as 'Performance is measured by the owner-manager's scoring of his firm's profit performance against the market' (Birley & Westhead, 1990, p. 539) are not uncommon, even in research published in reputable journals. Murphy *et al.* (1996) go on to conclude that research in the area would benefit from explicit statements of growth and performance measures employed, proper theoretical justification for these measures, use of multiple measures, and implementation of adequate controls for enterprise size, age, industry and risk in particular.

Finally, having elected in this research to place some reliance on a life-cycle perspective on smaller enterprise development, heed needs to be taken of Moores' (1990, p. 70) conclusion that 'measures of success are different for an organisation depending on where it is in the organisational life cycle'. He goes on to cite the National Association of Accountants (1986, p. 13) in the United States in its *Statement on Management Accounting No. 4D* as follows:

At each stage of growth in an entity's life cycle, different measures of financial performance take on varying degrees of importance. Therefore, neither growth nor net income nor cash flows nor return on investment should be emphasised to the exclusion of other meaningful measures.

Strong support for this position is provided by Quinn & Cameron (1983) in their article on measuring organisational effectiveness at various stages in the business enterprise life-cycle.

2.4.2 Smaller Enterprise Growth Measures

Chapter 1 indicates that, most simply, growth could be said to have taken place if a small or medium-sized enterprise is perceived to have moved from one stage of

development to the next in some business life-cycle model. Growth can more definitively be considered to have occurred if either or both of the following specific conditions are met:

- Customary measures of business enterprise size such as employment, sales revenues or turnover, either fixed or total assets, paid-up capital, net profit, retained earnings, and shareholders' funds or net worth have increased in amount from one period to another. Simple or compound rates of increase in such measures over a prescribed period, possibly annualised, provide convenient means of operationalising growth in this sense. It must be borne in mind that 'precise definitions based on money measures like assets, turnover or profits are subject to the obvious erosion of inflation, as well as being riddled with statistical and accounting holes' (Boswell, 1973, pp. 14-15). In research such as this, growth measures are frequently transformed in some way (log, reciprocal, square root, etc.) in order to modify the distributional properties of these variables – thus permitting valid use of certain techniques of statistical analysis. Because more exact data are not available, or are considered to be confidential, categorical indications that some measures of enterprise size have increased, remained steady or decreased over a period may need to be used as alternatives to quantitative growth rates
- Relevant dimensions of business enterprise diversity such as products or services supplied, customers served, physical facilities and locations established, processing or value-chain stages undertaken, hierarchical levels and functional specialisations created, technologies employed, and end-use or geographical markets targeted have increased in number or range from one period to another. Counts on such dimensions, possibly using weightings for the relative importance of items, provide convenient means of operationalising growth in this sense.

At this point it may be helpful to briefly review the sub-section of Chapter 6 of the thesis which describes, in some detail, the manner in which enterprise growth has actually been measured in this research, using data from the *AMC Best Financial Practice* study. A general evaluation of the subjective methods employed is provided at the close of this section of Chapter 2.

2.4.3 Smaller Enterprise Performance Measures

Chapter 1 of the thesis points out that it is possible to measure performance for small and medium-sized enterprises in two broad senses – financial and non-financial.

Amongst the many financial performance measures which could be employed are key monetary amounts, percentages and ratios such as:

- Sales revenues or turnover.
- Gross profit or income.
- Gross profit or income as a percentage of sales.

- Individual or total expenses.
- Individual or total expenses as a percentage of sales (that is, expense ratios).
- Net operating profit or income
- Net operating profit or income as a percentage of sales.
- Net profit or income.
- Net profit or income as a percentage of sales.
- Individual or total assets.
- Sales or cost of sales related to individual or total assets (that is, asset turnover measures).
- Individual or total assets as a percentage of total assets (that is, asset structure measures).
- Individual or total liabilities.
- Individual liabilities as a percentage of total liabilities or total funds employed (that is, financial structure measures).
- Sales or purchases related to individual or total liabilities (that is, liability turnover measures).
- Owners equity.
- Owners equity related to total liabilities.
- Return on total assets or funds employed.
- Return on owners equity.
- Current assets related to current liabilities (that is, liquidity measures).
- Operating profit related to interest paid or other fixed financing charges (that is, earnings coverage measures).
- Cash-flow from operations.
- Cash-flow from operations as a percentage of all sources of cash.
- Total liabilities related to cash-flow from operations.
- Cash-flow from operations related to individual or total uses of cash (that is, cash-flow coverage measures).

Strictly speaking, some of the measures listed actually capture financial position rather than financial performance (for example, liquidity measures such as the current ratio and financial structure measures such as the debt-to-equity ratio). These are included because a broad interpretation can be given to financial performance which embraces improvement or deterioration in a business's financial position. Market-based financial performance measures, such as the price-earnings ratio and share price, are omitted because the small and medium-sized enterprises of concern in this thesis are not listed on the stock exchange. Differences in financial performance measures arising from the inclusion or otherwise of taxes, extraordinary items, etc. have been ignored.

A number of the overall financial performance measures identified above could be broken down by product or service or organisational unit in order to give a more

focused assessment of achievement. Generally speaking, relative measures such as gross margin or return on owners equity are likely to be more useful in assessing financial performance than absolute measures such as sales revenues or net profit. As with measures of growth, performance measures are frequently mathematically transformed in order to modify their distributional properties. The caution about use of monetary measures in inflationary times, given in the previous sub-section of the chapter, needs to be borne in mind when measuring financial performance in any of the ways indicated above.

Since owner-managers of smaller enterprises are frequently reluctant to divulge financial information on their businesses, and also that financial information for such concerns is often incomplete, non-standardised or unreliable, subjective assessments of financial performance relative to past performance, performance of key competitors or industry performance may need to be obtained from owner-managers, their employees or their advisers.

Chapter 1 of the thesis identifies non-financial measures of overall performance which could be employed for a smaller business enterprise as follows:

- Mere survival for another period, or the avoidance or amelioration of survival-threatening crises.
- Physical measures of input, output or activity in an absolute sense or relative to some scarce resource (for example, direct labour hours per unit or units of product per shift or customers served per day or sales per representative).
- Subjective assessments of the extent to which the concern has met the objectives of its owner-managers regarding business matters such as customer satisfaction, technological advancement, resource self-sufficiency, employee turnover and lost-time accidents; and regarding personal matters such as disposable income and preferred life-style.

At this point it may be helpful to briefly review the sub-section of Chapter 6 of the thesis which describes, in some detail, the manner in which enterprise performance has actually been measured in this research, using data from the *AMC Best Financial Practice* study. A general evaluation of the subjective methods employed is provided in the next sub-section of Chapter 2.

2.4.4 Subjective Measurement of Enterprise Growth and Performance

A brief reading of the relevant sub-sections of Chapter 5 of the thesis will confirm the indications given earlier that the survey instrument for the *AMC Best Financial Practice* study relies heavily upon subjective assessments of business growth and performance from respondent enterprises. The principal reasons that have been given for employing such methods are as follows:

- Financial information on smaller enterprises is frequently not available at all because of non-existent or poor accounting systems. When it is available, the

financial information is often incomplete, non-standardised (that is, not prepared according to generally accepted accounting principles) or unreliable in other respects. A particular problem in measuring SME financial performance is the many accounting treatments possible for compensation or rewards to owner-managers. Consequently, the quality of financial data collected from smaller enterprises is typically poor, as is the comparability of data between respondents.

- Even if it is available, owner-managers of smaller enterprises are frequently reluctant to accurately divulge financial information on their businesses – especially in mailed questionnaires and even when assurances of confidentiality are given. Deliberate distortion of any sensitive information that is released cannot be dismissed as a possibility. It is often the case, however, that if quantitative financial information is sought, either the relevant questions are not answered or the questionnaire as a whole is not completed and returned. Either way, the research suffers in terms of the diminished size and representivity of its sample and database.

To these reasons must be added the very real possibility that, because of many other demands on their time, smaller enterprise owner-managers may be reluctant to complete and return mailed questionnaires, whatever their content. Thus, the issue for the SME researcher is frequently not whether to use subjective methods for measuring enterprise growth and performance, but how much reliance can be placed on the data they produce. This is the matter to be considered now.

Employing the subjective approach, categorical or scale-based assessments of enterprise growth and performance are often sought. Questions may be framed in terms of owner-manager satisfaction with recent or prospective achievements of the business; or in terms of broad comparisons with past achievements, achievements of key competitors or industry achievements. While perhaps not strictly subjective, questions asking for growth or performance to be reported in defined ranges can also be included here. Whatever type of question is used, the level of measurement of the data obtained is nominal or ordinal, rather than ratio. Clearly, such data carry less information than quantitative measures of growth or performance; but, depending on the purpose of the research, it may be more desirable than no information or unreliable information.

Examples of subjective methods of performance measurement in SME research include recent use by Covin & Slevin (1988), Covin *et al.* (1990) and Covin (1991) of a modified version of an instrument developed by Gupta & Govindarajan (1984). With this instrument, respondents are first asked to indicate on a set of 5-point Likert scales, ranging from 'of little importance' to 'extremely important', the degree of importance attached by their enterprise to various financial performance measures (sales level, sales growth rate, cash-flow, return on shareholders equity, gross profit margin, net profit from operations, profit-to-sales ratio, return on investment, ability to fund business growth from profits, etc.). The importance scores are mathematically adjusted to sum

to one in order to minimise the impact of personal bias. Respondents are then asked to indicate on another set of 5-point Likert scales, ranging from 'highly dissatisfied' to 'highly satisfied', the degree to which top management of their enterprise is presently content with its achievements in terms of the various financial performance measures already identified. The 'satisfaction' scores are multiplied by the 'importance' scores in order to calculate a weighted average performance index for each enterprise. Covin & Slevin (1988) found a correlation of $r=0.82$ between their subjective measure and the sales growth rates of a sub-sample of their respondents. After rehearsing the arguments for use of the subjective approach given earlier, and noting the finding just mentioned, Covin (1991, p. 448) ventures that 'This information would seem to indicate that the subjective measure used in the current study is a reasonable substitute for "hard" data and possibly a superior measure'. A recent example of well-published research using subjective comparisons of performance relative to competitors is that reported by Lumpkin & Dess (1995, p. 1394) who simply asked participants to 'assess your organization's performance OVER THE PAST FIVE YEARS relative to your competitors'.

There have been a number of other empirical studies focused on smaller enterprises that provide some evidence on the reliability of a range of subjective growth and performance measures (Dess & Robinson, 1984; Sapienza *et al.*, 1988; Brush & Vanderwerf, 1990, 1992; Chandler & Hanks, 1993). Dess & Robinson (1984) examine associations between objective and subjective measures of both sales growth and return on assets in a small sample of private companies in one manufacturing sector of the United States economy. Associations between these objective and subjective measures and further subjective measures of overall enterprise performance are also investigated. The correlation coefficient for the association between objective and subjective measures of sales growth is $r=0.694$ and is significant ($p<0.001$). The correlation coefficient for the association between objective and subjective measures of return on assets is $r=0.611$ and is significant ($p<0.01$). A number of statistically significant ($p<0.05$) positive correlations between these objective and subjective measures and further subjective measures of overall enterprise performance are reported. Note that the subjective measures used in Dess & Robinson's (1984) research require respondents to compare their enterprise with its competitors. This is also the case for the two studies reported upon in the following paragraph.

Sapienza *et al.* (1988) seek to partially replicate and extend the Dess & Robinson (1984) study for another limited sample of United States small enterprises; but they substitute return on sales for the previously used return on assets performance measure. No statistically significant associations are reported between the objective and subjective growth and performance measures examined by Sapienza *et al.* (1988). The researchers suggest their findings may have arisen because of some differences in method between their study and that of Dess & Robinson (1984); and they go on to

provide guidelines for developing and using subjective growth and performance measures in small enterprise research. In a United States comparison of methods and sources for obtaining empirical estimates of new manufacturing venture performance in small enterprise research, Brusil & Vanderwerf (1990, 1992) report high reliability for subjective estimates of sales growth from respondents.

The most recent, and undoubtedly the most thorough, of the studies of growth and performance measurement in small enterprise research identified earlier is that of Chandler & Hanks (1993). This uses quite sophisticated multivariate statistical analysis (correlations, reliability analysis, factor analysis, multiple linear regression, etc.) to examine subjective growth and performance measurement in 120 smaller manufacturing enterprises legally organised as private companies in the United States. The findings of Chandler & Hanks' (1993) research are summarised in the table below (adapted from Chandler & Hanks, 1993, p. 405, Table 6):

Table 2.6: Comparison of Subjective Growth and Performance Measures

Variable Attribute	Defined Ranges of Enterprise Business Volume	Defined Ranges of Enterprise Growth Rate	Owner-Manager View on Enterprise Performance Relative to Competitors	Owner-Manager Satisfaction With Enterprise Performance
Relevance	very good	very good	very good	Unknown
Availability	very good	very good	acceptable	very good
Internal consistency	very good	good	very good	Good
Inter-rater reliability	very good	good	marginal	Acceptable
External validity	very good	very good	very good	Inadequate

No performance measure based on owner-managers' satisfaction with enterprise performance was used in the *AMC Best Financial Practice* study, and so no further comment is made here regarding the fourth measure in the table above (see fifth column). Results elsewhere in the table suggest that use of defined ranges for certain key enterprise size, growth and performance variables in the present investigation (number of employees, sales turnover, sales growth rate, etc.) is methodologically acceptable, providing the veracity of arguments for use of subjective measures in this type of SME research, presented earlier, is upheld.

While use of subjective comparisons of performance with that of competitors also looks acceptable, there would appear to be some weaknesses with this measure. First, it

seems inter-rater reliability is a significant problem. However, this may be partially ameliorated by pointing out that it is what the owner-manager thinks about enterprise performance that will drive decision-making in the business. Thus, it is his or her perception of performance, however accurate, which is of key interest. Second, only 78 per cent of participants in Chandler & Hanks' (1993) study responded to the question on this measure – the lowest level for any of the measures examined. Some non-respondents indicated that they simply were not aware of the performance of competitors. In this regard, it is worth noting the findings of the Australian federal government's 1995 Business Longitudinal Survey of employing businesses of various sizes which indicate that (Industry Commission & Department of Industry, Science and Tourism, 1997, p. xvii):

Just under one in five firms compare their performance, formally or informally, with other firms. The largest firms make these comparisons much more often (with over 60 per cent doing so) than the smallest firms (around 14 per cent).

and (on p. 17):

When firms do make these comparisons, the micro firms overwhelmingly tend to make informal comparisons whereas larger firms are much more likely to make formal comparisons.

Findings specifically for the manufacturing sector do not differ markedly from those reported in these quotations. Notwithstanding misgivings about a possible low response rate for a question seeking subjective comparisons of performance with that of competitors, such a measure was included in the AMC *Best Financial Practice* study. Further detail is provided in Chapter 5 of the thesis.

2.4.5 Relating Enterprise Size, Age, Growth and Performance

Clearly, there is some logical overlap between growth and performance in businesses, in that growth measures very often represent percentage changes over time in what may be considered performance measures such as sales turnover (which, of course, can also be seen as an enterprise size measure). In a meta-analysis conducted by Capon *et al.* (1990, p. 1144) of over 300 empirical studies of financial performance determinants, it is indicated that 'some studies use sales growth as a performance measure, others use it as an explanatory measure'. Furthermore, to the extent that reinvested profits are typically a major source of development capital for SMEs, a linkage between enterprise performance and achieved growth can obviously be anticipated. Thus, an important issue for a research study such as this is the extent to which enterprise growth and performance may be associated empirically. It is also interesting to consider whether growth and performance can be empirically associated with enterprise size and age. There is evidence to suggest that some growth and performance outcomes in smaller enterprises may be due more to their early age than to their size *per se*. These matters are briefly addressed now.

Earlier in this chapter it is reported that, after an extensive review of the international theoretical and empirical literature, Hutchinson (1989) reaches the following

conclusions on inter-relationships between enterprise size, age, growth and performance in smaller business concerns:

- It is the combined effect of small size and growth that produces a distinctive financial profile (including financial performance achievements) for smaller growth enterprises
- Smaller growth enterprises are typically more profitable (that is, have better financial performance) than other SMEs (including those that become bankrupt) and larger businesses.
- Mature enterprises are typically more profitable (that is, have better financial performance) than other smaller enterprises.

Hutchinson (1989) also indicates that one of only two differences in financial profiles between large and small businesses upon which most researchers internationally agree is that the variability of profitability (that is, variability of financial performance) is greater for smaller concerns than for their larger counterparts.

The meta-analysis conducted by Capon *et al.* (1990) of 320 empirical studies, published between 1921 and 1987, examining the relationship between environmental, strategic and organisational factors on the one hand and financial performance on the other, concludes that enterprise size appears to be unrelated to financial performance. Apparently, growth is consistently related to higher financial performance. Furthermore, growth in assets and growth in sales each seem to be positively related to financial performance.

Reporting on a large-scale United Kingdom study of SMEs, Reid (1993, p. 200) draws attention to a not unexpected interconnectedness between enterprise growth and profitability in his research:

The central idea . . . is that of two-way causation. Growth generates profits, and profits stimulate growth. Profits are themselves an important source of finance for expansion. Indeed, inside equity was used to the total exclusion of outside equity. When debt finance was used, it was typically a bank loan, and it was common . . . to get debt finance which at least matched (internal) equity finance: equity gearing ratios of around unity were common. Thus generating internal finance for expansion acts as a magnet for attracting external finance, which can also be put to the same purpose. Greater growth can in turn enhance profitability, for example if learning effects are significant.

Later, when reporting on modeling of growth and profitability determinants using his SME data, Reid (1993, p. 207) indicates that:

In determining growth, profitability is most important, followed by gearing, the degree of product differentiation, the market share, the extent of the market, and the importance of rivals' pricing policies. In determining profitability, growth is most important, followed by gearing, the form of business organization, and the importance of rivals' pricing policies.

Reid (1993) also reports supporting evidence for a Penrose effect, suggesting that growth leads to managerial challenges which, when not met effectively and efficiently, may actually erode enterprise performance as the business increases in size and complexity.

The research study found in the smaller enterprise literature that most extensively overlaps with the inquiry forming the basis of this thesis is that reported by McMahon & Davies (1991a, 1991b, 1992a, 1992b, 1994) and McMahon *et al.* (1992a, 1992b, 1994a). It was part of a two-year investigation of the essential growth characteristics of just over 100 smaller growth enterprises from a variety of industries situated in North-East England; and it fortunately provides some useful evidence on inter-relationships between enterprise size, age, growth and performance in a similar context to that of the present inquiry. For their research, McMahon & Davies (1992b) report finding that enterprise age has only weak, though statistically significant ($\alpha=0.01$) positive associations with enterprise size measured in terms of employee numbers ($r=0.289$) and sales turnover ($r=0.353$). This suggests that larger enterprises in the study are not necessarily those that have existed longer, although this is generally the case. Not unexpectedly, the enterprise size measures are strongly and positively correlated ($r=0.854$, $\alpha=0.01$).

McMahon & Davies (1992b) report that amongst respondents in their study the association between growth rate in employee numbers and growth rate in sales turnover is statistically significant and strongly positive ($r=0.686$, $\alpha=0.01$). Examining associations between these growth rate measures on the one hand and both size measures and enterprise age on the other, the only statistically significant ($\alpha=0.01$) associations reported by McMahon & Davies (1992b) are those between each of the growth measures and enterprise age. Both these associations are moderate and negative ($r=-0.411$ for employee growth and $r=-0.573$ for sales growth). Evidently, higher rates of growth have been achieved by younger enterprises in the sample. This finding is consistent with a view that enterprise age is likely to be a better explanation of growth in smaller enterprises than size. Thus, newly established enterprises might be expected to grow more quickly than older, established enterprises, at least until they achieve minimum economic size. Storey *et al.* (1987) come to the same conclusion after reviewing the extensive literature on this point and conducting tests themselves on a sample of smaller enterprises in the United Kingdom. Further recent support for this conclusion is provided by Reid's (1993) study in the same country.

The weakly negative, though not statistically significant associations between growth rates and enterprise size measures reported by McMahon & Davies' (1992b) lend support to the conclusion of Storey *et al.* (1987, p. 100), again reached after reviewing the relevant literature and conducting tests themselves, that:

. . . a weakly negative relationship exists between size and growth. It appears broadly true that the smallest sizes of company grow faster than the larger (small) companies. The relationship is, however, relatively weak because once the smallest size of company is omitted from the analysis no general relationship is apparent. Amongst small companies there appears little evidence of persistency of growth rates . . .

Although weak, these findings are somewhat inconsistent with Gibrat's (1931) law of proportionate effect which proposes that business growth rates are independent of

enterprise size. Earlier in this chapter, it is reported that O'Farrell & Hitchens (1988) cite empirical evidence which upholds Gibrat's law for small manufacturing enterprises. However, on balance, the limited evidence now available seems to suggest that smaller enterprises actually tend to grow more rapidly, if only because they begin from a smaller base. Further recent support for this proposition is provided by Reid's (1993) United Kingdom study. O'Farrell & Hitchens (1988) allude to empirical support for the proposition that the variability of growth rate decreases with increasing enterprise size; although Storey *et al.* (1987) find these variables to be independent.

Focusing on smaller enterprise performance, McMahon & Davies (1991a) report finding only two statistically significant ($\alpha=0.10$ or better) associations amongst three performance measures (improvement in net margin, improvement in net profit per employee and improvement in sales turnover per employee) on the one hand and both enterprise size measures and enterprise age on the other. Improvement in turnover per employee is weakly and negatively associated with both employee numbers ($r=-0.198$) and with enterprise age ($r=-0.255$). Unfortunately, findings on relationships between the performance measures above and growth rates in employee numbers and sales turnover are not reported. Another performance measure, growth rate in profit, is found to have no statistically significant associations with the enterprise size measures; but there appears to be a relationship with enterprise age ($r=-0.295$, $\alpha=0.05$). Growth rate in profit is reported to have a statistically significant ($\alpha=0.01$) positive association with both growth rate in employees ($r=0.388$) and with growth rate in sales turnover ($r=0.398$). On the basis of their research review and empirical investigation, Storey *et al.* (1987) find that profitability increases with enterprise size, while the variability of profitability decreases in a weak fashion.

Finally, McMahon & Davies (1992b, p. 23) report that, for the range of primary characteristics (legal structure, capital intensity and organisational formality) and management process characteristics (computer usage, financial reporting and analysis, managerial planning and control, strategic orientation, owner-manager role and experience, internal support staff, and external advisers) examined by them, 'enterprise size appears to be more influential and generally has greater power as an explanatory variable for differences between enterprises than age'. Thus, in examining influences on the financial reporting practices of SMEs in the present research, it seems possible that enterprise size will be a more important independent variable than enterprise age. Further empirical evidence on the significance or otherwise of enterprise age in explaining financial reporting practices undertaken by SMEs is presented in Chapter 4 of the thesis.

The evidence reviewed here does suggest that enterprise age could be an influential intervening variable when examining the relationship between financial reporting practices and achieved enterprise growth and performance. Storey *et al.* (1987, p. 130) claim that their study:

. . . clearly demonstrates that a small firm is not simply a scaled-down version of a large firm. Indeed it could even be argued that it is unwise to undertake comparisons of this type because they ignore the importance of factors such as age which have a significant effect on small firm performance and little impact on large firm performance. This [study] has shown that, *ceteris paribus*, young firms are both more profitable and grow faster than older firms. To ignore the age factor is to lose an important dimension of understanding.

Having thus established the potential explanatory importance of enterprise age in research such as the present study, it must be acknowledged that this variable is not included in the descriptive evidence and analysis presented in Chapters 6 and 7 of the thesis. As explained in Chapter 5, the question intended to establish enterprise age in the research instrument used in the *Best Financial Practices* survey is sufficiently flawed that responses to it are judged to be unusable. This, of course, becomes a significant limitation of the research.

2.4 Chapter Review

This chapter of the thesis has primarily sought to provide a well founded scholarly understanding of the process of growth as experienced by small and medium-sized enterprises. Of particular interest have been the dynamics in SMEs of the business development process; as well as the challenges and problems, especially those of a financial nature, to which growth and development inevitably seem to lead.

Alternative conceptualisations of growth in smaller enterprises that have appeared in the research literature have been examined, and an election has been made to place some reliance on a taxonomic representation of the business life-cycle recently developed by Hanks *et al.* (1993). This is done in the knowledge that, as well as overcoming concerns that stages-of-growth models are frequently not empirically based, this conceptualisation is claimed to at least partially answer the most prevalent objections to such models found in the literature. A particular attraction of the model selected is that, not only does it incorporate a sequence of four development stages that have much in common with other models proposed in the literature; but it also recognises two disengagement/arrested development stages corresponding to life-style enterprises and capped growth in business concerns – circumstances that are widely observed in SMEs.

The financial dimensions and implications of smaller enterprise growth are subsequently explored at some length. Reliable evidence has been presented from recent conceptual and empirical studies that financial management, broadly defined to embrace dealing with financial challenges and undertaking recognised financial practices, increases in importance as smaller enterprises pass through successive stages of an organisational life cycle. Imperatives for this are found in common problems of a financial nature to which growth typically gives rise – such as incipient overtrading, poor liquidity and excessive gearing. Again with empirical support, it has further been argued that financial reporting practices of the type contemplated in this

study also increase in their significance to successful management of growing SMEs. The nature and extent of such changes are, of course, the focus of this study.

Careful consideration has been given to problems associated with measuring smaller enterprise growth and performance in research such as this. It has been established that, if possible, multiple financial and non-financial measures should be used. Particular attention has been paid to subjective means for assessing business growth and performance in self report questionnaires. It would appear that the validity and reliability of some such measures are acceptable. Finally, evidence on any apparent relationships between enterprise size, age, growth and performance has been reviewed. Attention has been drawn to the importance of considering enterprise age, as well as size, as an explanatory variable in SME research.