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**An Analysis of Financial Health and the Provision of Financial Management Services  
in South Africa's Previously Disadvantaged SME Community – Implications for  
Sustainability and Creditworthiness**

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A minor dissertation submitted in partial fulfillment of the requirements for the award of the degree  
of Masters of Philosophy in Politics, Philosophy and Economics

Faculty of the Humanities

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2007

**COMPULSORY DECLARATION**

This work has not been previously submitted in whole, or in part, for the award of any degree. It is my own work. Each significant contribution to, and quotation in, this dissertation from the work, or works, of other people has been attributed, and has been cited and referenced.

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**Abstract:**

The following research builds on previous literature concerning the financial health and financial practices of South Africa's previously disadvantaged SMEs; it seeks in particular to better understand the impact which external financial management provision has on financial health.

Two research methodologies have been employed in separate sections of the analysis. A quantitative component utilizes several data sets to measure the level of financial distress among previously disadvantaged SMEs in South Africa. A series of financial distress metrics are then used to measure the effects of external financial service provision, creating a layered evaluation of the impacts of external financial procedures. Overall, the findings suggest that external financial management services are not associated with a decreased rate of financial distress, and that they have a mixed impact on a firm's eligibility for finance. These trends are somewhat surprising. Past research has proven that the implementation of sound financial management procedures has a positive impact on financial health. It would be a logical inference to expect businesses that employ external financial service providers to be better off than those that do not employ external expertise.

A subsequent qualitative component is based on 8 semi-structured interviews with financial service providers (accountants). It seeks a deeper understanding of the relationship between the service providers and the previously disadvantaged SMEs they cater to. The findings suggest that a number of barriers exist within these relationships – on both the side of previously disadvantaged SMEs and that of the accountants – which limit the effective transfer of valuable services. Moreover, co-dependent barriers are often exacerbated by existing conditions within the previously disadvantaged community, further decreasing the likelihood that the exchange will be valuable.

The combined findings reveal a “catch twenty-two” for previously disadvantaged SME owners with limited financial education. Poor financial administration skills lead to poor financial health and reduced cash flows. Yet upon seeking help from external services, these SME owners are often forced to pay more – in the form of extended sessions – to build their basic knowledge base, despite their constricted financial positions. And despite prolonged billing sessions, they are often unable to leverage the more sophisticated skills of accounting professionals. In order to break this cycle, increased public provision of financial education is needed. The paper concludes with recommendations for increased education, and with suggestions for the way in which previously disadvantaged SMEs and external service providers can increase the likelihood of ensuring valuable exchanges.

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**Keywords:** South Africa, previously disadvantaged SMEs, business development services (BDS), financial service providers, accountant

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My advisors displayed considerable patience as I stumbled my way through the analysis that follows. Reza Daniels signed on to co-supervise a project that he knew to be a fairly ambitious undertaking, and one which fell somewhat outside his own field of expertise. Insistent at times that pertained to methodology and deferential with regards to subject matter, his flexibility was hugely helpful as the research unfolded.

Eric Wood has played the role of advisor since well before this project began. Time and again, he has steered me back to earlier conversations about the fundamentals (and politics) of small business development in South Africa. When my aspirations grew too large or too broad, he tempered them without smothering my enthusiasm for the subject. He has been insightful, resourceful, and unwaveringly honest in his assessment of my work. I hope his efforts are reflected in these pages.

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## 1. Introduction

Current opinion concerning South Africa's market for finance for small and medium sized enterprises (SMEs) is largely divided into two groupings: those who believe that business owners generally need further skills in order to be more likely to qualify for finance; and those who believe that obstacles to raising money from within the formal financial system are unreasonably prejudiced against applicants with previously disadvantaged backgrounds. Among the first grouping, it has been suggested that increased financial administration skills are sorely needed, especially within the previously disadvantaged business community. The following research builds on previous literature concerning the financial health and financial practices of South Africa's previously disadvantaged SMEs; and seeks in particular to better understand the impact which external financial management provision has on financial health.

In order to build a comprehensive analysis, two research methodologies have been employed. The first section of this research is quantitative. It utilizes several data sets to measure the level of financial distress among previously disadvantaged SMEs in South Africa, as well as the effects of external financial service provision on this community. Because financial health should not be interpreted one dimensionally, a cross section of measurements – including exhausted overdraft, ability to pay wages, cash to cover costs, and profitability – has been used. When these metrics are employed to measure the effect of external financial service procedures, it creates a layered evaluation of the impacts of external financial management.

The second component of the study is qualitative in nature. It seeks a deeper understanding of the relationship between previously disadvantaged SMEs and financial service providers (accountants), from the perspective of the financial management providers themselves. It reveals a number of barriers which are currently mitigating the effective provision of financial management services. Moreover, it offers a more substantive explanation for many of the trends exposed in the quantitative analysis. When evaluated together, the quantitative and qualitative analyses allow for a more sophisticated and multidimensional analysis of financial health and the effects of external financial management.

## 1.1 Why is this study important?

The bulk of relevant literature has been included in the subsections to follow.<sup>1</sup> But a brief mention of the historical research available provides an important context for this study. Upon a review of the available literature, it becomes clear that SMEs can make significant contributions to developing economies. When supported by stable macroeconomic conditions and sound policy, SMEs act as powerful forces for economic and social development<sup>2</sup> (Reinecke & White, 2004; Barry et al, 2002; World Bank, 2006). The South African government has recognized the importance of small and medium enterprises, and has sought consciously to include them in the state's larger economic strategy.

Contrary to some suggestions, SMEs are unlikely to be a panacea for South Africa's economic problems. And the degree to which SMEs are capable of fulfilling all of the government's prescribed roles has been questioned in the past (Kesper, 2000; GEM 2003 & 2005). However, achieving real and sustained SME growth is a core component of economic health. Further, SMEs are capable of playing important roles in job creation and upgrading human capital (Barry et al., 2002). Given South Africa's history of high unemployment and unequal educational provision, these functions are critically important. Unfortunately, despite the government's efforts, South African SMEs have achieved limited growth since 1994. A plethora of reasons have emerged in an attempt to explain the disappointing progress: South Africa's "highly dualistic" economy is divided along racial lines; there are ongoing structural inequalities in the educational system; increased crime and political uncertainty exist; and the transition towards a liberal market economy has destabilized the business environment (Barry et al. 2002).

Some academics have suggested that South Africa's sluggish SME growth is largely attributable to failures in the financial marketplace – more specifically, that South Africa's financial system fails to cater adequately to the needs of many SMEs (Schoombee, 2004). Barriers such as high interest rates, exorbitant fees, insufficient collateral, and lack of proximity to loan centers have deterred entrepreneurs from accessing finance (Bonti-Ankomah, 2000). It has been noted that these barriers are particularly high for businesses owned by previously disadvantaged individuals. Critics of this

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<sup>1</sup> Because this research covers a range of topics – access to finance, financial distress, business development services (BDS), and financial service providers – separate literature reviews have been included. Relevant literature for each analysis can be found in the sections labeled "Background."

<sup>2</sup> The size criterion for SMEs varies internationally. This study will use the same size specifications as those of the World Bank and the Global Entrepreneurship Monitor whereby "small" refers to firms with 10-49 employees, and "medium" refers to firms with between 50 and 99 employees.

theory on the other hand, point to evidence that South African banks have taken considerable efforts to facilitate greater access to financing, but have been hamstrung by a dearth of capable entrepreneurs to lend money to (Levy, 1996). Beyond an entrepreneur's collateral or a small business's ability to pay back interest, banks often lament the insufficient business skills which applicants display, or their lack of educational experience (Cook, 2001).

These arguments are not mutually incompatible. It is possible, and likely, that banks often struggle to find capable entrepreneurs in which to invest, and also that some degree of apartheid-era prejudice continues. Furthermore, it has been argued that while many banks maintain high standards of loan qualification, relaxing these standards would be neither wise nor helpful. Mention of these arguments serves to highlight the complexities of the debate, and the need for further research.

In 2003, the Global Entrepreneurship Monitor (GEM) conducted a study in an effort to shed further light on the difficulties which previously disadvantaged entrepreneurs encounter when applying for finance.<sup>3</sup> The report aimed to better understand the financial management practices of South African entrepreneurs; and, in turn, to identify whether good financial management practices have a positive effect on an entrepreneur's ability to secure a loan. The study concluded that there is a worrying dearth of financial administration skills amongst previously disadvantaged entrepreneurs. Further, it identified a positive relationship between firms that adopted sound financial management practices, and their ability to procure financing – “Banks evidently prefer to channel finance, via term loans, to entrepreneurs that adopt good financial practices: more than 70% of entrepreneurs that had implemented the four essential financial management practices were successful in applications for loan finance (2003: 48).” The report calls for further financial management support, which caters specifically to the financial administration needs of SMEs.

The international consensus on effective BDS provision is that it must come from the private sector (Tanburn et al., 2000). In 2000, Tarnburn et al. published *Business Development Services for Small Enterprises: Guidelines for Donor Intervention*. Following an extensive analysis of past development-assisted efforts to improve BDS markets, they conclude the following: “The public sector generally should not get involved in the direct provision of BDS to SMEs. The view is that publicly-funded development assistance is better used to promote markets for services – markets

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<sup>3</sup> The findings of this report are depicted in the fifth chapter of the 2003 GEM report (Fisher and Wood, 2003).

which ensure that a diversity of appropriate services can be developed and provided to SMEs, driven by demand and shaped by competition” (2000: 3)

Although there may be instances of financial service support through public sector programs on the Western Cape, those services fall outside the realm of this study. Meaningful conclusions are more likely to derive from a study of private service providers, which supply the bulk of financial service support and are likely to continue to do so in the future. Further, the focus should be on accountants rather than bookkeepers. It is widely acknowledged that where bookkeepers are capable of compiling daily and monthly records, accountants have the ability to interpret these records and provide managerial advice. The latter capacity allows for a more substantive value addition and is critical to effective financial service.

Until now, there has been little research conducted on the effects or provision of financial management services for previously disadvantaged business owners. Given the importance of these services to the financial health of SMEs, and the proven relationship between sound financial management skills and the increased likelihood of obtaining finance, further investigation seems warranted. The following research contains two original contributions to the academic discourse on previously disadvantaged SMEs in South Africa. The first is a quantitative analysis of the effects of external financial management provision on previously disadvantaged SMEs, and the second is a qualitative analysis of the barriers which mitigate the transfer of effective services between financial service providers and previously disadvantaged SMEs.

The remaining sections of this document proceed as follows: a methodological overview of complementary research techniques; a quantitative analysis – featuring World Bank findings on access to finance, GEM findings on financial distress, and findings on the impact of external service providers; a qualitative analysis on the barriers between previously disadvantaged SMEs and financial service providers; and finally, a section on complementary conclusions.

## 2. Methodological Overview

Detailed descriptions of methodology are provided under each of the major research sections of this study, and make up the substantive bulk of the methodological detail in this analysis. The simultaneous use of quantitative and qualitative methodologies, however, requires some degree of qualification from the outset. The value of combining quantitative and qualitative research methods has been well documented by Justine Brannen (2004). If employed in context of one another, the combination allows for a sophisticated and multi-dimensional investigation. Brannen describes three ways in which qualitative and quantitative research may be interpreted: triangulation, facilitation, and complementarity. The research proposed herein will utilize the process of complementarity, in which “two different sets of data are employed to address different but *complementary* aspects of an investigation” (2004: 314).

In reference to the subject matter at hand, a combined methodological approach was deemed necessary for three reasons. First, the findings of the quantitative study ran somewhat contrary to initial assumptions. The early expectation was that the provision of external accounting services would help bolster an SME’s financial health. Despite several logical rationalizations for this assumption, the data from the quantitative study did not support it. In many cases, the provision of external accounting was actually associated with an *increased* rate of financial distress. Although these conclusions are noteworthy on their own, a qualitative assessment allows for further insight into how and why these trends have occurred; and, in turn, allows for suggested remedies.

Second, in the analysis of external financial management, the manner in which the data was evaluated whittled the total number of firms down to relatively small sample sizes. Where large divergences in the data were discovered, Mann Whitney non parametric tests were used to test for statistical significance. However, due to the small sample sizes, statistical significance was found to be rare.<sup>4</sup> Effectively, when dealing with small sample sizes, the assumptions behind standard statistical tests are violated. Standard errors increase due to the high variance associated with a small sample rather than due to true variation in the population, resulting in a lack of statistically significant findings.

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<sup>4</sup> The noteworthy exception to this was in regards to the external preparation of VAT documentation.

Regardless, due to the fact that the data sets represent surveys from firms, (where small numbers of firms can still, theoretically, have significant market shares), it is somewhat acceptable to place lower weight on statistical significance. However, while many of the conclusions remain compelling in spite of the small sample sizes, the qualitative component lends further credibility.

The third reason for the qualitative analysis is the unique value of the qualitative research on its own. Despite a growing wealth of literature on South Africa's previously disadvantaged SMEs, there has been no research to date which includes the insights of private sector financial service providers who cater to these entities. Given their close and long term interactions with previously disadvantaged clients, this is unfortunate; these financial service providers are in a position to provide versed commentary, and their contributions to this study proved invaluable. Future research should recognize their capacity to contribute to this dialogue and seek to involve them further.

Finally, although it may be clear from the sample sizes and analyses in the studies below, it is worth mentioning that this research paints an indicative picture rather than an authoritative one. The final chapter does not conclude, "And so it is for all previously disadvantaged SMEs in South Africa." Until a national study of financial practices among all SMEs becomes available, an authoritative analysis, complete with categorical concluding remarks, will have to wait. However, supported by the comprehensive cross-sectional measurements used in the quantitative component of this study, and the detailed questioning involved in the qualitative component, the following analysis offers a nuanced but penetrating insight into the financial problems facing previously disadvantaged SMEs.

## **2.1 Data Sets**

Three data sets have been used to construct the following analysis; two in the quantitative research section, and one in the qualitative section.

The quantitative portion of this study contains an analysis of data sets directly related to South African SMEs: the 2006 World Bank Investment Climate Survey; and a 2003 Global Entrepreneurship Monitor survey. The 2006 World Bank Investment Climate Report on South Africa was compiled from a survey of 603 firms in four major metropolitan areas of South Africa. Although the data available covers only firms within the manufacturing sector, the results provide an important context for this study. The data regarding access to finance among SMEs is of

particular importance. An analysis of responses among this sub group, when compared to the overall average and non-previously disadvantaged respondents, allows for an assessment of the difficulties that may be unique to previously disadvantaged SMEs.

The 2003 GEM survey investigated the overall financial health of 224 previously disadvantaged SMEs. It sought to better understand the effects of several financial administration practices. Of relevance to this research is the component of the GEM survey which explored the propensity of businesses to seek external financial management support. Following mention of several financial administration procedures, respondents were asked whether or not they sought support from external accountants or bookkeepers with the procedure. They were also asked to indicate how much money was spent on financial services per annum. These responses, when correlated against output variables regarding overall financial health, enable an in-depth analysis of the effects of external financial service provision.

The qualitative portion of this study contains an analysis of interviews with 8 financial service providers located in the Western Cape Province. Because the study is qualitative, the sampling methodology was purposive rather than random. Respondents were chosen based on the following criteria: registration as a CA, and ability to perform the roles of an accountant; offices located within the Western Cape. These individuals are in a unique position to offer penetrating insights into the relationships between previously disadvantaged SMEs and external service providers on the Western Cape.

Once again, detailed descriptions of sampling methodology, as well as further information on the individual sample groups are provided in the sections to come.

### 3. Quantitative Analysis

The quantitative analysis is based on two data sets directly related to South African SMEs: the 2006 World Bank Investment Climate Survey; and a 2003 Global Entrepreneurship Monitor survey.

The basic intention of the quantitative study is two-fold. First, it aims to evaluate the difficulties faced by previously disadvantaged SMEs, including difficulties in reported access to finance and the overall rate of financial distress. Aspects of both of these subjects have been tackled in previous literature, as is depicted in the background sections to come. This analysis revisits some of the claims which have been made and, where necessary, re-evaluates them in a manner that is applicable to the previously disadvantaged SME community.

The second intention of the quantitative study is to measure the effect of external financial service provision on previously disadvantaged SMEs. If, in fact, the previously disadvantaged SME community continues to encounter difficulty with financial distress and when trying to access finance, the question should then become, "how can this group begin to alleviate these difficulties?" In 2003, a GEM study led by Fisher and Wood concluded that financial administration skills were sorely lacking within the previously disadvantaged community; and that this dearth of skills was adversely impacting the financial health of a significant number of SMEs. For those suffering from inadequate financial understanding and poor record keeping, external financial service providers are one possible point of support. Given their experience and expertise, these service providers are in a unique position to offer value.

To clarify, the intention of this research is not to measure the importance of individual financial procedures on a firm's propensity for financial distress. Such ground has been well traveled already, and has produced valuable findings (Wood and Fisher, 2003). Instead, this research aims to understand the specific contribution of external service providers. The larger intention also being to understand how these providers may increase financial knowledge and reduce financial distress within the previously disadvantaged SME community.

In summary, the quantitative portion of the study seeks to answer the following research questions with regards to previously disadvantaged SMEs:

- Do previously disadvantaged SMEs continue to struggle with access to loan finance?

- Does there appear to be a widespread tendency for financial distress within the previously disadvantaged SME community?
- What indicators exist, if any, to suggest that existing external financial management services help previously disadvantaged SMEs to avoid financial distress?
- Does the provision of such support lead, in turn, to a greater probability of qualifying for finance?

### 3.1 Access to Finance

Research Question: Do previously disadvantaged SMEs continue to struggle with access to loan finance?

#### 3.1.1 Background

Some academics have suggested that South Africa's sluggish SME growth is largely attributable to failures in the financial marketplace – more specifically, that South Africa's financial system fails to cater adequately to the needs of many SMEs (Schoombee, 2004). Barriers such as high interest rates, exorbitant fees, insufficient collateral, and a lack of proximity to loan centers have deterred entrepreneurs from accessing finance (Bonti-Ankomah, 2000).<sup>5</sup> It has been noted that these barriers are particularly high for businesses owned by previously disadvantaged individuals. Chris Rogerson, in 1999, reported that as many as 85 percent of emerging SMMEs complained about lack of access to credit.<sup>6</sup> In 2003, the work of the Global Entrepreneurship Monitor, lead by Fisher and Wood, buttressed these findings:

“Despite increased endeavours by government and banks to increase access to finance to this sector, a finding of GEM 2002 was that only one third of historically disadvantaged entrepreneurs (HDEs) with registered businesses were successful when applying for bank finance. This finding is particularly pertinent in the current environment where it is recognised that support of the SME sector is critical to

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<sup>5</sup> The barrier regarding unreasonable proximity to loan centers is particularly true in rural communities, and has been well documented by Bonti-Ankomah and Chamba in 2000.

<sup>6</sup> SMMEs are “Small Medium and Micro Enterprises.”

economic growth and development, when considering that formal entrepreneurs are key drivers of job creation and revenue generation.” (2003: 8).

Critics of this theory, on the other hand, point to evidence that South African banks have taken considerable efforts to facilitate greater access to financing, but have been hamstrung by a dearth of capable entrepreneurs to lend money to (Levy, 1996). Rogerson’s conclusions for example (cited above), were questioned by Orford in 2004, who showed that by international standards, a relatively high proportion of entrepreneurs in SA expect to obtain bank finance (GEM, 2004). Beyond an entrepreneur’s collateral or a small business’s ability to pay back interest, banks often lament the insufficient business skills which applicants display, or their lack of educational experience.

Berry et al. investigate these conclusions further. Despite earlier work indicating that small and new firms have relatively good access to South African banks, Berry et al. report that these findings tended to “conceal a much more gloomy picture among ‘African businesses,’ which represent only 7% of Levy’s sample and *all complained about prejudices of banks against them.* (Berry et al. 2002, 74 – emphasis added).<sup>7</sup> The piece goes on to describe the difficult dichotomy involved in assessing the financial predicaments of South African entrepreneurs. “There is still a lack of evidence,” they explain, “on whether this higher mortality is a cause or a consequence of the higher credit rejections, and whether the higher risks of these segments can be made up for on an accordingly higher return” (2002: 70). This is an important clarification. Judging from failure rates alone, it is difficult to know why previously disadvantaged SMEs struggle to access finance – the literature depicted above suggests that it could be the result of several phenomenon, including: unreasonably high standards on the part of banks (Bonti-Ankomah, 2000); lack of skills on the part of the entrepreneur (GEM, 2005); prejudice; or a combination of all of the above.

It is worth noting that these arguments are not mutually incompatible. It is possible, and likely, that banks often struggle to find capable entrepreneurs in which to invest, and that some degree of apartheid-era prejudice continues. Furthermore, it has been argued that although many banks maintain high standards of loan qualification, relaxing these standards would be neither wise nor helpful. Mention of these arguments serves to highlight the complexities of the debate, and the need for further research.

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<sup>7</sup> The earlier work referred to here was performed by Levy (1996).

The analysis in the following section is intended to provide a contextual basis for the remainder of this study. For the sake of simplicity, descriptions of methodology (i.e. question choice and tests of statistical significance) have been included in the findings themselves.

### 3.1.2 Sample

In 2006, the World Bank issued an assessment of the overall investment climate in South Africa. The objective of the report was to “evaluate the investment climate in South Africa in all its operational dimensions and promote policies to strengthen the private sector” (2006: 5). The analysis covers some of the largest obstacles facing the nation’s businesses, and documents results on the accessibility of finance for black businesses.<sup>8</sup> Further analysis of this data set allows for a deeper quantitative assessment of the difficulties which previously disadvantaged SMEs face in obtaining finance.

The World Bank data utilized herein is based on survey responses from 603 firms in South Africa’s manufacturing sector.<sup>9</sup> Respondents were questioned on issues such as crime, the regulatory environment, access to finance, and overall costs of doing business, among others. Only registered formal enterprises were selected for questioning. Although the data contains information related only to firms in the manufacturing sector, it provides an interesting depiction of the obstacles that South African firms face in today’s operating environment. Of particular salience to this research are the responses from business-owners within the previously disadvantaged SME community.

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<sup>8</sup> An additional survey of microenterprise and small business has been conducted by the World Bank, although a report had yet to be compiled as of the date of this analysis.

<sup>9</sup> Several attempts were made to access the full data set (beyond the manufacturing sector) through faculty at the UCT Graduate School of Business. However, no response was received from the World Bank.

### 3.1.3 Findings

Approximately 20% of firms reported that they were owned by individuals from previously disadvantaged backgrounds.<sup>10</sup> Of this group, 36 met the size criterion of SMEs.

Access to financing has been evaluated using both subjective and objective measurements from the World Bank data set. The subjective measurements are derived from questions which tested respondents' perceptions regarding financing. Respondents' were asked to rank various business issues by the degree to which they felt the issue posed a problem for the operation and growth of the business. Among these obstacles were the following categories: "Access to Financing (e.g. collateral)" and "Cost of Financing (e.g. interest rates)".

Just over 12% of respondents from the total sample group ranked access to financing as either a major or severe problem. Responses among the SME sub group were not found to be noticeably different, indicating that businesses in this category are not more prone to feel that access to or the cost of financing are prohibitive barriers to business success.<sup>11</sup>

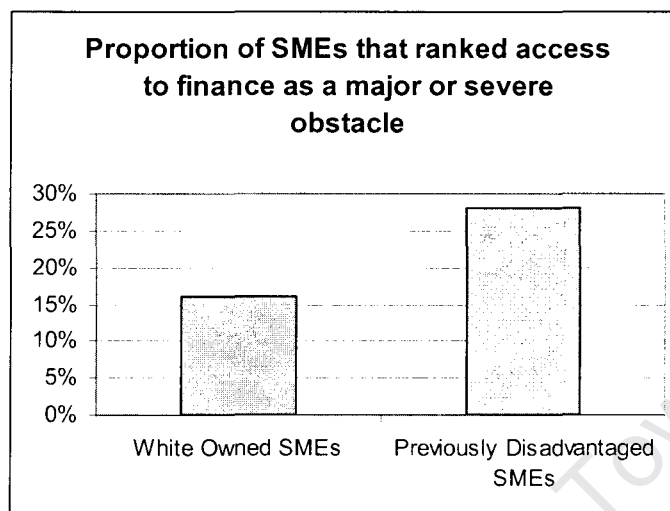
However, when the SME group is divided between previously disadvantaged SMEs and non-previously disadvantaged SMEs (i.e. white owned businesses), a large divergence in the data emerges. While 17% of non-previously disadvantaged SMEs indicated that access to finance was a major or severe problem, this statistic climbs to almost 28% among previously disadvantaged SMEs. These findings are depicted in Figure 3.1-1.

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<sup>10</sup> The data separated ethnicity into the following categories: African, European/Caucasian, Asian, Colored and Other. The respective proportions were 5.9%, 79.94%, 11.21%, 1.77% and 1.18%.

<sup>11</sup> Some of the data from the previously disadvantaged SME community may appear incongruous when compared to that of the sample group as a whole. The reason is that not all respondents answered the questions regarding ethnicity; therefore, the sample group for this response is smaller, changing the proportion of responses among SMEs. Misleading conclusions have been avoided by taking data from the SME sample group as a whole (before it has been divided into ethnic groupings) and comparing it to that of the total sample group.

Figure 3.1-1: Proportion of SMEs that ranked access to finance as a major or severe obstacle by ethnicity of ownership<sup>12</sup>



Interestingly, concerns regarding cost of financing among previously disadvantaged businesses were not found to be substantially different from those of their white owner counterparts. Seventeen percent of previously disadvantaged SMEs ranked cost of financing as a major or severe problem, compared to 16% among the overall population.

These findings are in keeping with the conclusions of the World Bank Investment Climate Report which suggested that black owned firms in particular reported greater concern in accessing financing than their white owned counterparts:

“African owned firms were far more concerned about access to credit and the cost of financing than European/Caucasian owned firms. This remains true even after controlling for other observable differences that might affect perceptions about access to financing such as enterprise size, sector of operation, and age.” (2005: 13).

The analysis herein suggests that comparable conclusions can be made regarding the concerns of previously disadvantaged SMEs.

<sup>12</sup> The proportions depicted were based on the following data: 10 out of 36 previously disadvantaged SMEs ranked access to finance as a major or severe problem, whereas only 22 out of 130 white owned SMEs ranked access to finance as a major or severe problem.

Objective measurements of access to financing were based on a series of questions regarding the business's history of success in applying for loans, and the details of how the loan was procured (i.e. collateral, fee structure, etc.). Two questions are particularly helpful for measuring the obstacles faced by the previously disadvantaged sector: "Has the business ever applied for a loan?" And, "Has the business ever been rejected for a loan?"

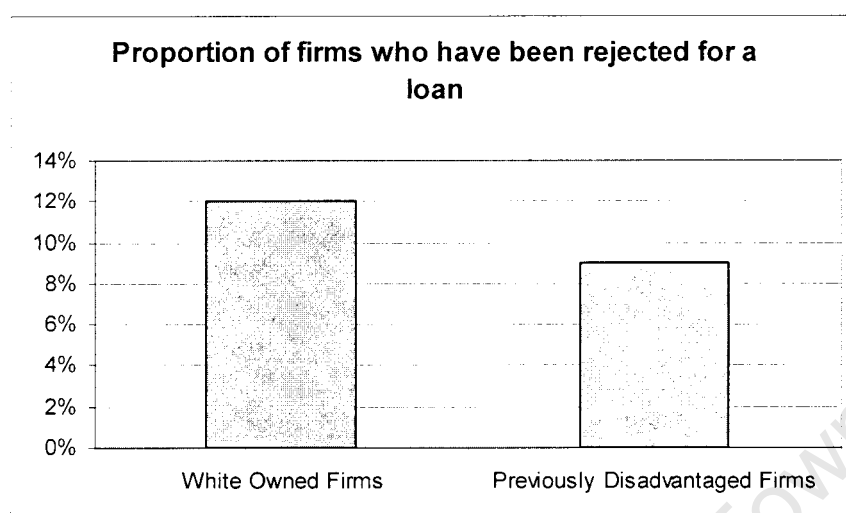
Overall, previously disadvantaged businesses were less likely to have applied for loans than white owned businesses. Eighty four percent of white owned businesses reported that they had applied for a loan at some point in the past, whereas only 78% of previously disadvantaged businesses had done so. This gap widens slightly with regards to SMEs. The probability of white owned SMEs having applied for a loan rested at 84%, but the probability of previously disadvantaged SMEs having applied for a loan fell to 75%.

Finally, of businesses that had applied for loans, previously disadvantaged business owners were more likely to report that they had been rejected for a loan (approximately 12% of previously disadvantaged businesses reported having been rejected, compared to 9% among white owned businesses). These findings are displayed in Figure 3.1-2.<sup>13</sup>

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<sup>13</sup> Interestingly, in contrast to the findings on the propensity to apply for a loan, the discrepancy regarding success in financing converged slightly within the SME sub grouping. Once again, this is likely attributable to differences between the overall number of respondents within the SME category and the number of businesses who responded to ethnicity questions.

Figure 3.1-2: Proportion of firms who have been rejected for a loan by ethnicity of ownership<sup>14</sup>



Although the differences depicted in these findings is more subtle, they should be interpreted in context of the decreased number of previously disadvantaged firms that apply for a loan in the first place. The combination of both suggests that a significantly smaller percentage of previously disadvantaged firms have accessed financing at some point in the past.

Once again, these findings mirror those of the World Bank report.

“The objective measures of financing provide some support for the idea that access to credit is more difficult for African-owned firms. African owned firms were less likely to have ever applied for a loan, were less likely to have a loan, were less likely to have an overdraft facility [and] were more likely to have been rejected for a loan...” (2005: 13).

Given the limitations of the data, the analysis above does not provide a categorical assessment of the demand for finance within the previously disadvantaged SME community, nor does it uncover the reasons for why this group struggles to receive finance. Such an assessment would require a much larger cross sectional study of SME financing, as well as further investigation into the

<sup>14</sup> These differences were *not* found to be statistically significant using a Mann Whitney non parametric test. The proportions depicted were based on the following data: 8 out of 67 previously disadvantaged firms had been rejected for a loan at some point in the past, whereas only 24 out of 271 white owned firms had been rejected for a loan.

standards of formal loan institutions in South Africa. This analysis is, however, helpful in creating context for the remainder of this study. Despite efforts on the part of government to promote further lending to this sector, access to finance continues to be a difficult issue for many previously disadvantaged SMEs.

### **3.2 Financial Distress**

Research Question: Does there appear to be a widespread tendency for financial distress within the previously disadvantaged SME community?

#### **3.2.1 Background**

In 2003, the Global Entrepreneurship Monitor (GEM) pioneered research about the relationship between financial practices and financial health in the previously disadvantaged SME community. In attempt to understand the effects of good financial management practices, the study surveyed entrepreneurs' financial procedures across a range of business activities. The report determined that by implementing four procedures into their financial operating models, entrepreneurs could significantly enhance their financial health (Fisher and Wood, 2003). The procedures included: keeping a cash book; keeping an accounts receivable record; keeping a record of inventory; and performing proactive debtor management.

The study found that variations of other procedures, such as the frequency and manner in which purchase documentation was compiled, could also have a positive effect. However, the four "essential" procedures were singled out for emphasis because they had a significant and unambiguous effect on reducing financial distress. The study concludes as follows:

"Implementing any one of [the four essential financial practices] is associated with a minimum of 33% reduction in the probability of an exhausted overdraft.

Performing all four of these financial practices appears to reduce this probability by as much as 61%. Implementing the "four essential practices" is likely to have the additional benefit of significantly increasing the probability that a firm will succeed in an application for term loan finance." (Fisher and Wood, 2003: 50).

The report concludes, therefore, that “a few relatively simple changes to the administration practices of owner-managed firms have the potential to improve significantly their cash position and reduce the probability of their overdraft being exhausted. Over 60% of these entrepreneurs could potentially benefit from training in these practices.” Most importantly, “[t]he results demonstrate that nearly three-quarters of entrepreneurs who proactively manage cash flows are successful in applications for bank loan finance. This implies that banks channel finance to the majority of firms that adopt good management practices” (2003: 43). The logical inference here is that increased understanding of and emphasis on financial support for previously disadvantaged entrepreneurs is of critical importance.

### **3.2.2 Sample**

The GEM study was based on the financial management practices of 224 previously disadvantaged SMEs in South Africa. The study sought to answer the following questions regarding small and medium enterprises: What aspects of financial administration, if any, are deficient? How widespread are these deficiencies? What impact do these deficiencies have on the financial health of a business? Do these deficiencies influence an entrepreneur’s ability to secure external finance?

This GEM study and data set has been used as the cornerstone for this research. Although the survey focuses primarily on financial administration and financial distress, the data reveals information across a range of issues, including the respondent’s history of success in applying for finance, details of client base, and overall ownership structure. Like the World Bank Investment Climate Survey, the sample includes only formally registered businesses. Respondents were drawn from several geographic locations in South Africa; Johannesburg, Durban, Cape Town and Port Elizabeth. All businesses are more than 50% owned by black, colored or Indian individuals. Table 3.2-1 depicts the overall demographics of respondents.

Table 3.2-1: Demographic breakdown of firms in GEM sample <sup>15</sup>

N=224 Race	number of respondents %	gender		mean age of respondent Years	Mean age of firm Years
		%			
		Male	Female		
Indian	29	24	5	43	8
Black	37	30	7	43	6
Colored	33	28	5	44	8
White <sup>16</sup>	2	1	0	54	7

The sample avoids young start-up businesses. New businesses often experience high capital outlays and increased expenditure during the first year. Because it takes time to establish a client base, many do not produce profits until several months after operations begin. As a result, only businesses that had been operating for at least a year, and were producing a minimum of R 100,000 annual turnover were selected.

It is important to note that the sample is not intended to be representative of the entire previously disadvantaged SME community in South Africa. The sampling procedure utilized by the GEM surveying team was purposive, rather than random. And the focus on businesses that produce over R 100 000 in turnover each year excludes smaller firms. Given the high end sample group, the data produced is likely to depict an overly optimistic assessment of financial trends among previously disadvantaged SMEs.

The sample includes SMEs across a range of industries, including manufacturing, retail and personal services, construction, transport, and automotive. Business type also varied across registration. The majority operated as Close Corporations (CCs) followed by Pty companies and sole proprietorships/partnerships. This spread is featured in Table 3.2-2.

<sup>15</sup> Table sourced from GEM, 2003 – A study of financial health and administration in emerging SMEs.

<sup>16</sup> Although the owners interviewed were white in these cases, the companies were more than 50% black owned.

Table 3.2-2: Details and operating metrics across type of firm registration from GEM sample <sup>17</sup>

Type of registration	Percentage of firms %	Mean age of the firms	Mean Annual Turnover*	Mean number of employees
Sole proprietor/ partnership	14	9	R 1 330 000	8
CC	72	7	R 1 990 000	11
Pty Ltd.	15	7	R 5 540 000	21
<b>All</b>	<b>100</b>	<b>8</b>	<b>R 2 420 000</b>	<b>12</b>
		Std. deviation 6.7	Std. Deviation R3 591 229	Std. deviation 14

Finally, even though problems of financial administration are by no means limited to the formal sector – and, in all likelihood, are worse in the informal sector – a focus on formal businesses has been chosen based on the added job creation potential of this group (GEM, 2003 & 2005).

### 3.2.3 Measuring Financial Distress

Although conceptually clear, in practice financial distress can be difficult to identify. Many companies go bankrupt only to realize post-mortem where the source of their financial troubles was located. Clearly, an unsound operating methodology or a period of sluggish sales can lead a business quickly towards financial distress. But even with effective operational procedures in place, a business can encounter financial difficulty. Sub-optimal financial management can take place across a range of areas, all of which can lead a business towards a precarious state of financial well-being. Therefore, a careful analysis of the way in which financial health should be measured is critical.

In past research, several output variables have been used to operationalize and measure financial health, including credit card debt, exhaustion of overdraft accounts, and the ability to pay wages (Fisher and Wood, 2003). A number of interpretive issues were identified when deciding upon an appropriate measure for this study. Taken separately, the variables contained in the GEM survey

<sup>17</sup> Table sourced from GEM, 2003 – A study of financial health and administration in emerging SMEs.

data offer important but limited depictions of a company's financial situation.<sup>18</sup> Therefore, relying on any one of these measures alone can result in misleading conclusions.

In light of these interpretive ambiguities, the following analysis utilizes a cross-sectional approach. This allows for a more insightful investigation into the effects of external financial provision, and provides a comprehensive picture of a company's financial situation. The output variables used to measure financial distress are as follows:

- Exhaustion of overdraft in the last 6 months;
- Inability to pay wages in the last 12 months;
- No profitability in the last 3 months; and
- Insufficient cash on hand to cover costs over the past 6 months.

Where appropriate, greater emphasis has been given to exhaustion of overdraft within the last 6 months. This variable has been used effectively in past studies and was determined to be the least susceptible to interpretive ambiguities. It was also found to be an effective overall measure of financial distress – “Though by no means terminal, an exhausted overdraft is suggestive of a cash shortage. It could imply little margin for error should the business take a turn for the worse” (Fisher and Wood, 2003: 41).

Sixty-seven percent of the firms surveyed in the GEM study had access to an overdraft facility. For most, this was identified to be the result of choice, rather than access (overdraft financing is more accessible than long term finance). Therefore, this measure is less likely to exclude portions of the sample than other financing measures. However, it should be noted that due to the selection process involved in qualifying for overdraft financing, conclusions regarding this variable may represent a slightly optimistic assessment of the sample.

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<sup>18</sup> Although existing research has utilized a single metric to evaluate financial distress (GEM, 2003), these analyses are somewhat limited. A company's financial health is multifaceted and in ideal circumstances should not be measured comprehensively by one variable alone.

### 3.2.4 Analytical Limitations

The different timing periods of the variables makes it difficult to employ them simultaneously. For example, the combination of exhausted overdraft and inability to pay wages would be a useful measurement of severe financial distress. Unfortunately, one measurement stipulates a 6 month time period and the other a 12 month period. It is impossible to know, therefore, whether the exhaustion of overdraft and the inability to pay wages occurred simultaneously. Moreover, the timing variations make it difficult to exclude respondents who may have responded incorrectly, or who are acting unethically. Business owners who have not paid wages, for example, but have also not yet exhausted their overdraft accounts are withholding available funds from employees. Although such actions would be unethical – and likely illegal – the limits of the data leave such determinations outside the realm of this study.

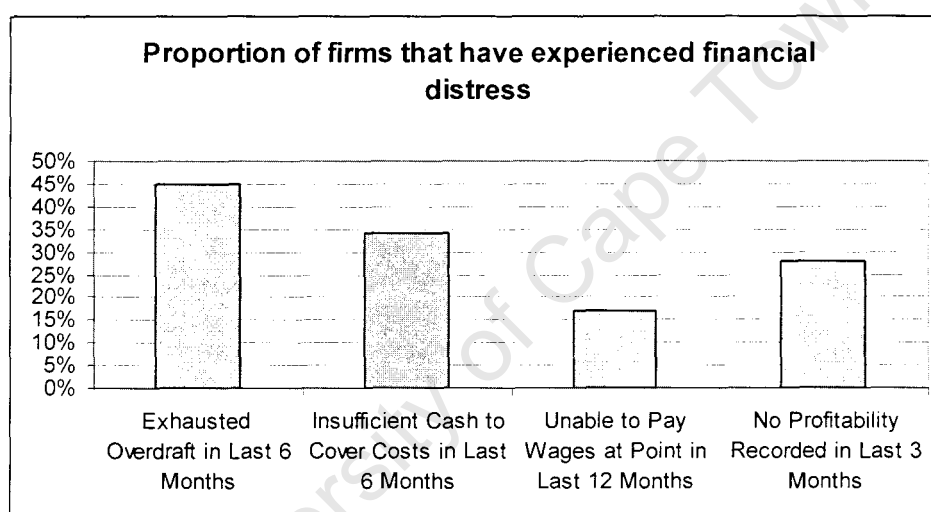
Furthermore, findings regarding profitability must be treated with particular care. There are instances in which external financial services were found to have a positive effect on profitability, but not on any of the other financial distress variables. Profitability is a measure of many things; of which sound financial management is only one. Therefore, the measurement's reflection on the influence of external financial services must be interpreted in light of this indirect relationship. In addition, seasonal variations in profitability must be taken into account. Overemphasis on this variable would make it easy to misinterpret businesses which are subject to high seasonal turnover but are otherwise financially healthy. Once again, as a result of these qualifications and others, a cross-sectional approach was deemed appropriate. Each of the four variables is listed separately in the analysis. But when interpreted together, they allow for a more complete picture of financial distress.

Finally, while the educational levels of business owners undoubtedly play some role in the performance of the businesses, the limits of this data set make it difficult to account for. Educational experience has been shown in the past to have a large impact on an entrepreneur's ability to steer a venture towards success, and also on an individual's propensity to begin a venture in the first place (GEM, 2005). However, even if information on the educational backgrounds of business owners were available, it is not necessarily appropriate to assume that this translates into some, or any, level of financial knowledge. Nonetheless, future studies would benefit from a heightened degree of information regarding the educational background of SME owners, particularly within the previously disadvantaged sector.

### 3.2.5 Findings

A deeper analysis of the data suggests a worrying tendency for financial distress across all four measurement variables. Of businesses that had access to an overdraft account, 45% had exhausted this facility in the last 6 months. Thirty-four percent of the businesses sampled did not have enough cash on hand to cover their costs at some point over the previous 6 months. Seventeen percent reported that they had been unable to pay wages at some point over the past 12 months, and 28% had not recorded a profit in the previous 3 months. These findings are displayed in Figure 3.2-1.<sup>19</sup>

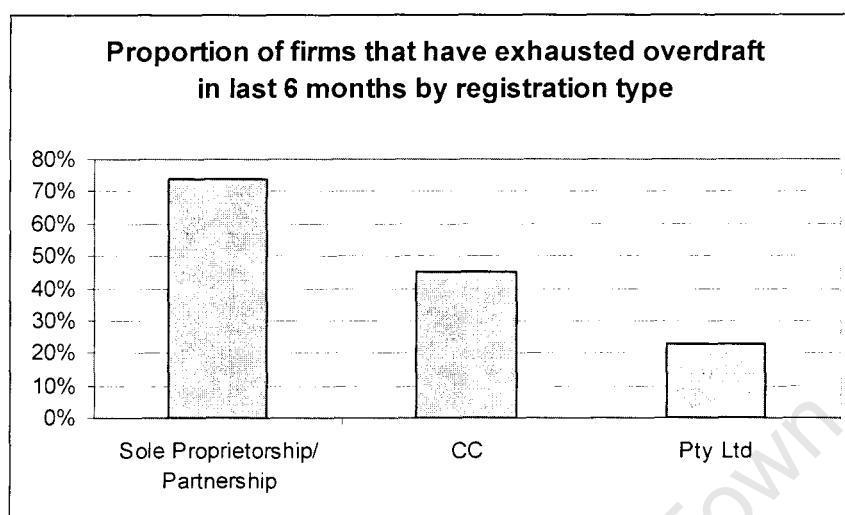
Figure 3.2-1: Proportion of firms that have experienced financial distress



Trends of financial distress differed somewhat across business types, and across business sector. Businesses registered as sole proprietorships and partnerships suffered in particular – almost three fourths (74%) of these businesses were found to have exhausted their overdraft in the previous 6 months. Figure 3.2-2 displays exhausted overdraft by type of business registration.

<sup>19</sup> It is important to note that the sample size for those with access to overdraft facilities is smaller than the others. Even though the figures are portrayed in the same graph as percentages, they are representative of different sample sizes.

Figure 3.2-2: Proportion of firms that have experienced financial distress<sup>20</sup>



The data indicates no difference between old or young firms, which has two important implications. First, it implies that old firms are not more likely to learn the importance of effective cash management over time, despite a possible history of close encounters with financial distress. Second, it is suggestive that older firms in the sample have sustainable operating methodologies and sufficient market demand for their products, without which, it is unlikely that they would have survived. The latter inference is especially pertinent. As mentioned, poor financial administration is only one contributing factor to financial distress. However, if many of the older businesses in the sample have been able to survive for years without effective financial administration practices, it implies that underlying operating methodologies and sufficient sales revenue have allowed them to do so. This indicates that a reformulation of financial practices could bring considerable benefits. More effective cash flow management leads to a more optimal use of funds, which has positive implications for growth and employment generation. Put simply, a better use of available funds through good financial management would allow businesses to make investment and employment decisions that they would have otherwise been unable to make.

<sup>20</sup> These differences were found to be statistically significant (Fisher and Wood, 2003). The proportions depicted were based on the following data: 14 out of 19 firms that were registered as sole proprietorships or partnerships and had access to an overdraft had exhausted this overdraft in the last 6 months; 46 out of 103 firms that were registered as Close Corporations and had access to an overdraft had exhausted this overdraft in the last 6 months; and 6 out of 26 firms that were registered as limited liability corporations and had access to an overdraft had exhausted this overdraft in the last 6 months.

Overall, these findings buttress the results of the GEM study. They indicate that a significant minority of previously disadvantaged SMEs are operating under financial distress. Unfortunately, the data set does not allow for an investigation of financial distress among non-previously disadvantaged SMEs. However, the severity of the findings is clear. A large number of businesses within the previously disadvantaged community are operating under precarious cash conditions. When operating with very little cash on hand, there is a low margin for error should businesses encounter some form of external shock. Even in the absence of such externalities, the financial position of many of the businesses sampled suggests that there is very limited room for growth or employment generation. This is important when considering the fact that many SMEs may well possess sound underlying operating methodologies and sales revenue (allowing them to sustain for many years despite precarious cash situations). Better financial management and a more optimal use of available resources could result in more efficient and profitable entities, which has positive implications for future growth potential.

### **3.3 External Financial Service Provision**

Research Question: What indicators exist, if any, to suggest that existing external financial management services help previously disadvantaged SMEs to avoid financial distress?

Research Question: Does the provision of such support lead, in turn, to a greater probability of qualifying for finance?

#### **3.3.1 Background**

Where financial management services have been tackled in the literature, it is typically within the context of a larger suite of business development services (BDS). Unfortunately, this pool of work is much smaller than that concerning SMEs. Early work has been performed by the International Labor Office in effort to assess markets for BDS (Miehlbradt, 2002; Sievers & Van den berg, 2004). While broad in nature, these pieces provide a number of insights into international BDS provision. Meihlbradt tests preconceived notions about developing BDS markets, refuting the idea that clients pick programs solely based on price, or that all BDS markets in developing countries are weak.

In South Africa, groundbreaking work on BDS has been performed by the German Development Corporation (GTZ). In 2004, they completed a pilot study of the BDS market in Nelspruit. The underlying assumption for the study echoes common perceptions regarding BDS provision; “Like many other agencies, The German Development Corporation, (GTZ) believes that addressing market failures to efficient and effective provision of BDS would have a higher chance of providing quality, affordable BDS to a large proportion of small enterprises than traditional, public sector driven highly subsidized service offers.” This is a logical approach. It has been noted that while governments may be able to play important roles in developing BDS markets through policy interventions and subsidy provision, the services themselves are best left to the private sector.

In 2000, Tarnburn et al. published *Business Development Services for Small Enterprises: Guidelines for Donor Intervention*. Following an extensive analysis of past development-assisted efforts to improve BDS markets, they conclude the following: “The public sector generally should not get involved in the direct provision of BDS to SMEs. The view is that publicly-funded development assistance is better used to promote markets for services – markets which ensure that a diversity of appropriate services can be developed and provided to SMEs, driven by demand and shaped by competition” (Hitchins, 2002: 3). The South African government has gradually begun to recognize the increased effectiveness of private sector BDS provision. This acknowledgement is well illustrated by the evolution of The RED Door Program. Created in the wake of the widespread failure of the “Local Business Support Centres,” these resource centers were designed to provide a wide range of direct support for local businesses. Entrepreneurs could seek advice and help with tax filing, legal documentation, overall business counseling, and some degree of financial administration training (RED Door, 2004). Following a series of scathing critiques regarding the quality of services delivered, however, these centers have since evolved into small outsourcing centers, linking entrepreneurs to a host of private sector business development providers. In hindsight, it has been noted that these public sector efforts to provide BDS failed to facilitate an effective market for BDS. Moreover, although these services are often of a very poor quality, the ability to procure them for free may confuse the market, and discourage users from paying for private services (Hitchins, 2002).

Past studies have also noted the difficult capacity-related issues which small businesses encounter. In 1998, Barringer, Jones and Lewis performed a study on rapidly growing firms in the United States. The study concluded that firms often outsource managerial practices in order to free up

internal capacity to focus on critical aspects of the operation. In South Africa, these capacity issues are often exacerbated by the lack of educational background of business owners, particularly where financial record keeping is concerned (Fisher and Wood, 2003). These findings suggest that the effective provision of financial services from external providers could relieve capacity burdens as well as aid in financial sustainability, posing significant benefits for previously disadvantaged SMEs.

Despite the general consensus on the importance of the private sector in delivering financial administration services, little past research has been done on the effects of external service provision. The following section of the analysis constitutes an original contribution to the discourse on financial management and business development services within South Africa's previously disadvantaged business community. These elements of the GEM data set have not been evaluated before. They present unique insights into the effects of external financial management on previously disadvantaged SMEs.

### **3.3.2 Measuring External Service Provision**

The convincing nature of Fisher and Wood's findings in 2003 makes it tempting to intuit that a study of external financial management support should stem directly from this model (i.e. the study should identify which firms used external financial provision for the four essential financial practices, and evaluate the propensity of these firms to encounter financial distress accordingly.)

However, in an assessment of the effects of external financial provision, it is important to consider the limitations of external support. It would be unfair to suggest that accountants should, or could, be responsible for all of a business's financial activities. Documenting individual purchase records, for example, or tabulating inventory on a daily basis, are responsibilities that must fall predominantly upon employees inside the business. It is clear, therefore, that financial management cannot be outsourced completely. A well functioning business depends on an internal understanding of financial concepts. Insufficient understanding of these concepts is likely to lead to sub-optimal financial management and to increase the probability of financial distress.

However, external financial service providers can offer important contributions in a number of ways. Formal registered accountants, endowed with an understanding of financial measures and

concepts, are able to conduct sophisticated analyses of a company's financials. If performed effectively and to a high standard of quality, these services should add to the financial knowledge of a business owner. External service providers can offer significant value addition in the following ways: effective periodic analysis and review of a business's finances; helping a business to employ up-to-date and applicable systems of financial administration; conducting financial procedures for a business with greater proficiency; providing overall financial and regulatory guidance; and, most importantly, alerting business owners to current or future cash shortages.

The following analysis focuses on several aspects of external financial service provision which were documented in the GEM survey. These variables include:

- External preparation of VAT;
- External preparation of sales documentation;
- External preparation of purchase documentation;
- External preparation of cash flow records;
- External preparation of cash flow forecasting; and
- Overall expenditure on accountants and bookkeepers.<sup>21</sup>

Preparing VAT documents for a business gives an accountant an overall understanding of a company's finances. Armed with this understanding, an accountant should be able to offer some degree of helpful advice to the business owner. The area of cash flow records and cash flow forecasting necessitates an added degree of financial knowledge. As a result, these are areas in which it would be expected that accountants could offer significant value addition. Furthermore, cash flow practices were found by Fisher and Wood to have a significant affect on overall financial health and access to finance – conclusions in this section are therefore evaluated in light of these earlier findings.

Sales and purchase documentation, though critically important, do not necessarily require a sophisticated degree of accompanying managerial advice. While accountants should be able to perform these tasks with a greater degree of proficiency, the opportunity for value addition may be less. In addition, the data on overall expenditure on accountants and bookkeepers does not

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<sup>21</sup> While this study is intended to examine only accountants, it was not possible to separate this data section into bookkeepers and accountants. Nevertheless, the measurement provides a good indication of trends which result from expenditure on external financial professionals.

discriminate between external or internal services. Therefore, although these findings add to the overall theme of this study, they do not apply exclusively to accountants and therefore fall slightly outside the previously mentioned definition of external financial service provision.

The rates of financial distress are measured across two main groupings: those that used external accounting for the procedure, and those that performed the procedure internally. Once again, the financial distress variable of exhausted overdraft in the last 6 months was deemed to be the least susceptible to interpretive ambiguities. Particular attention has been paid to findings based on this metric.

### **3.3.3 Analytical Limitations**

To reiterate, it is important to recognize that sound financial management practices represent only one component of business success. If an SME holds no inherent competitive advantage, or employs insufficient operating methodologies (aside from poor financial practices) it is likely that the business will encounter some form of financial distress.

On the other hand, for those businesses that do possess sound operating methodologies but in which financial resources are not being optimally managed, the provision of external financial management services can result in significant value addition.<sup>22</sup> At a minimum, the employment of an external service provider to perform an accounting procedure implicitly reveals that the procedure is, in fact, being performed. Therefore, while it can be difficult to ascertain this information in a study of financial health alone, it is fair to assume that businesses who seek external financial management services should exhibit an overall decreased likelihood of encountering financial distress. Concurrently, given the proven relationship between sound financial management practices and a business's likelihood of obtaining financing, businesses who procure some form of external financial management services should also be more likely to obtain loan finance.

However, these assumptions are largely contingent upon the type of service being provided and the degree of accompanying managerial advice. If the provision of external financial services does not

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<sup>22</sup> It was noted in the GEM 2003 study that this problem, while important to acknowledge, is difficult to take into account empirically.

increase the financial health of a business, further investigation into the clients as well as the type of services being provided is warranted.

Tests for statistical significance were performed using Mann Whitney nonparametric tests. However, due to the small sample sizes of the data being analyzed, differences were not always found to be statistically significant.<sup>23</sup> The original sample size of 224 is quickly eroded when the parameters of the external financial procedures are applied. For this reason, the sample sizes have been clearly labeled in each section (rather than proportional figures alone). This is not to suggest that the findings herein do not present compelling conclusions; merely that they should be evaluated in context of the small sample from which they were derived. These circumstances lend further weight to the importance of the qualitative component of this study.

Finally, in South Africa, the regulations of accounting and auditing differ somewhat across firm type. A Close Corporation (CC) for example, is not required to conduct audits at the close of each financial year. A limited liability company (Pty Ltd.), on the other hand, must conduct annual audits, implying that it is likely to have a much more in-depth and prolonged interaction with an auditor. It is possible, therefore, that depending on the extent of the firms' interaction with auditors, it may be that the success of their experience with external service providers is driven by firm type. It should be noted, however, that by law, a limited liability company is not allowed to use the same service provider for both accounts preparation and for auditing; they must be separate individuals from separate legal entities. Therefore, while a limited liability corporation may have a strong legal imperative to employ an external service provider, this is unlikely to disproportionately affect the findings. The reality is that any company – CC or Pty Ltd. – that has not yet received extensive accounting training is likely to be motivated to employ the services of a financial service provider (whether it be externally or in-house).

The rules and regulations regarding VAT documentation also pose important implications for analysis. An intricate discussion of these details, however, has been left for the section on VAT preparation itself.

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<sup>23</sup> For this reason, mention of tests for statistical significance has largely been left out of the body of the findings. Information on these findings can be seen in the footnotes accompanying the graphs in each section. The Stata “do file” commands for these tests can be found in Appendices A and B. They are labelled by the syntax “\* -- MANN WHITNEY TEST-- .”

### 3.3.4 Findings

Overall, a review of the GEM data indicates that current financial service provision has not enabled previously-disadvantaged SMEs to deter the likelihood of encountering financial distress. Given Fisher and Wood's findings based on the 2003 GEM study, this trend is surprising. It would be logical to expect businesses that employ external financial providers to implement financial procedures to be better off than those businesses that do not employ external expertise to do so. Given the accountant's training and specialization, it is reasonable to expect a greater proficiency when performing financial procedures. An accountant should be capable of providing a degree of expert counseling which the businesses owner may not possess himself. Therefore, these findings, displayed below, are noteworthy. Possible explanations for these trends are featured in the conclusion of the quantitative analysis, and further explored in the qualitative research to follow.

#### VAT Preparation

The preparation of VAT (value added tax) documentation entails compiling a company's purchase and sales receipts for the tabulation and payment of VAT to the South African Revenue Service (SARS). Depending on the nature of the rebates being claimed in the process, VAT returns are due on either the 25<sup>th</sup> of each month, or the last working day of each month.

VAT preparation was by far the most commonly outsourced procedure. Eighty-seven percent of businesses sampled produced VAT records, and almost 30% of this group employed an external accountant to do so.<sup>24</sup> However, the provision of an external accountant to prepare VAT records had no impact on alleviating financial distress across any output variables. In most cases, SMEs who sought external help with VAT preparation were *more likely* to encounter financial distress.

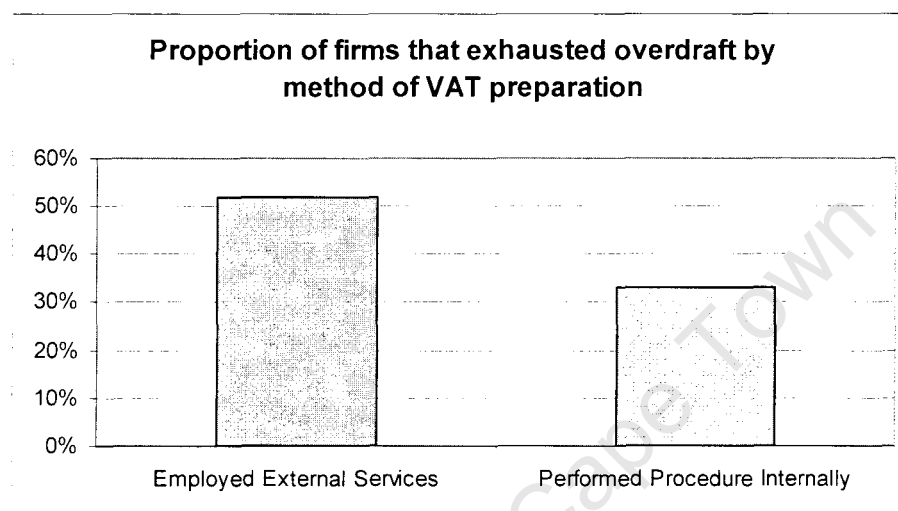
Fifty-two percent of businesses who employed an external accountant to prepare VAT records had exhausted their overdraft in the last 6 months. Of those that chose to perform VAT records internally, only 33% had exhausted their overdraft in the same time period – a margin of almost 20 percentage points less. These findings are displayed in Figure 3.3-1. Using a Mann Whitney non

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<sup>24</sup> Overall, businesses that produced VAT records were no more or less likely to encounter financial distress. Given the high percentage of businesses that complete VAT records, it is not surprising that the rate of financial distress among this group resembles that of the overall sample.

parametric test, the difference between those who prepared VAT internally versus those who used external service provision was found to be statistically significant.

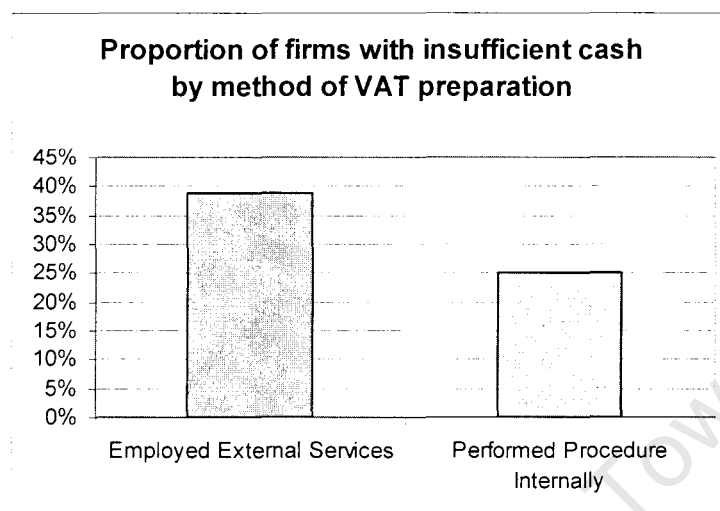
*Figure 3.3-1: Proportion of firms that exhausted overdraft in last 6 months by method of preparing VAT documentation*<sup>25</sup>



In addition, 39% of those who utilized external service provision did not have enough cash on hand to cover costs at some point in the prior 6 months; well higher than the 25% reported among those who performed VAT records internally. A visual comparison is featured in Figure 3.3-2.

<sup>25</sup> Once again, these differences were found to be statistically significant using a Mann Whitney non parametric test. The proportions depicted were based on the following data: 22 out of 42 firms that sought external service provision had exhausted their overdraft, whereas only 18 out of 55 of those that performed the procedure internally had exhausted their overdraft.

Figure 3.3-2: Proportion of firms with insufficient cash to cover costs in last 6 months by method of VAT documentation<sup>26</sup>



For those with external service providers, ability to pay wages over the last 12 months and measures of profitability over the last 3 months were 18% and 25%, respectively. Among firms that performed the procedure in house, however, the proportion experiencing no profitability dropped to 21% (ability to pay wages was found to be the same as that for external service provision). Again, this suggests that SMEs who employ external assistance with VAT preparation are more likely to experience financial distress than those who performed the procedure in house.

It is worth pausing briefly to note the specific rules and regulations that pertain to VAT preparation and their effect on this analysis. According to the South African Revenue Service (SARS), only entities with an annual turnover of 300,000 rand or more must include a full record of sales and purchase receipts in their VAT documentation – a process which leads many to seek external help.<sup>27</sup> Because the GEM sample group includes firms with annual turnover of 100,000 rand or greater, this portion of the analysis potentially excludes firms which report an annual turnover of between 100,000 and 299,999 rand. Therefore, it is possible that these findings are not representative of the

<sup>26</sup> These differences were *not* found to be statistically significant using a Mann Whitney non parametric test. The proportions depicted were based on the following data: 26 out of 67 firms that sought external service provision did not have enough cash to cover costs in the last 6 months, whereas only 19 out of 76 of those that performed the procedure internally did not have enough cash to cover costs at some point in the last 6 months.

<sup>27</sup> Those that make less than 300,000 rand per year are still expected to pay VAT, but the filling and compilation processes are not as complicated. The process for small firms is entitled “Small Retailers VAT Package.” Details can be found at [www.sars.gov.za](http://www.sars.gov.za).

sample group overall. However, Fisher and Wood found little difference in the rate of financial distress among firms which reported different annual returns -- "The probability of an exhausted overdraft in the last six months varied little by firm size, measured either by the number of employees or annual turnover" (2003: 42). This implies that firms with annual revenue of between 100 000 and 299 999 rand were not more inclined to experience financial distress, suggesting that the implicit bias that may result from the VAT analysis is unlikely to undermine the findings of this section.

Moving forward, the findings depicted above are noteworthy for several reasons. First, they imply that very little value addition is being transferred from the accountant to the SME. The preparation of VAT documents allows an accountant to gain a sound overall perception of a company's financial position. Beyond the mere preparation and filing of the documents, an accountant should possess the capacity to offer guidance on a business's overall financial position; and, in doing so, provide valuable information with which to make future operational decisions. Given the elevated propensity for those who outsourced this service to encounter financial distress, it seems that this needed value is not being transferred.

One possible explanation is, as suggested, that accountants are not highlighting critical information regarding cash shortages for their clientele. Another possibility is that the fees incurred in outsourcing VAT documentation further exacerbate the cash shortage of the business. Without any value addition in order to make up for this expenditure, businesses that seek external help end up worse-off than those that perform the procedure internally. In parallel, the fees charged for these services may be too high. Even if the quality of the services is high, an exorbitant price would mitigate any value transfer, rendering the exchange harmful to the SME owner.

From the side of the business owners, it is possible that they lack the skills necessary with which to act on the information presented to them. Or, if some form of advice has been delivered along with the VAT returns (i.e. the business owner should save sufficient funding for upcoming VAT payments), it may be that business owners are not diligent about implementing this advice. Finally, it may be that the expenditure on external VAT preparation is simply not in line with the value addition these services create (if in fact the services hold intrinsic value to begin with). In other words, the amount spent on external VAT services further exacerbates a precarious financial situation, rendering the expenditure harmful to the business in all cases, regardless of the quality of services provided or the degree of accompanying managerial advice. In this case, the problem

would lie with neither the SME owner nor the accountant, but rather with the transaction itself. This is the least likely possibility. Given the aforementioned value of VAT services, and the expertise which registered accountants have at their disposal, it is more probable that these transactions are overpriced or improperly completed – as opposed to the possibility that the transaction does not possess any intrinsic value. These concepts are further explored in the qualitative section below. But for now, they serve to highlight the web of possibilities which may explain why external accounting does not seem to be having a significant impact on financial health.<sup>28</sup>

### Sales Documentation

The GEM survey investigated the effects of two types of sales documentation: the day-to-day tracking of sales records, and the compilation of these records into a document which might be used for further analysis. A very small percentage of businesses employed external accountants to record day-to-day sales records. This finding is not surprising. The procedure is performed by almost all businesses, and should not require outside expertise.<sup>29</sup>

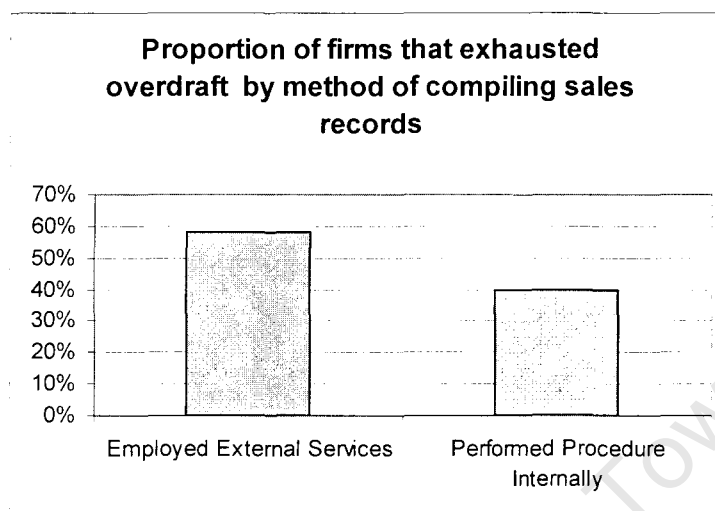
Of businesses who compiled sales records for further use (i.e. created a document that could be used for additional analysis and interpretation), 11% employed the services of an external accountant to do so. Of this group, 58% had exhausted their overdraft facility in the last 6 months. Once again, this is substantially higher than businesses that chose to perform this procedure in-house, which experienced only a 40% rate of overdraft exhaustion. Figure 3.3-3 depicts these trends.

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<sup>28</sup> It is also worth noting that businesses which perform VAT procedures internally have greater opportunity to under-report their income than those that employ an external service provider; this presents another possible explanation for the discrepancies in the data. It also raises serious questions of ethics and legality, many of which are beyond the realm of this study. Furthermore, while this option is important to note, it is limited given the other findings contained in this research. The degree of knowledge possessed by accountants should enable business owners to manage more cash effectively and to save on taxes, as is displayed in the coming section on external preparation of purchase documentation.

<sup>29</sup> Over 95% of the SMEs sampled produced some form of day-to-day sales records.

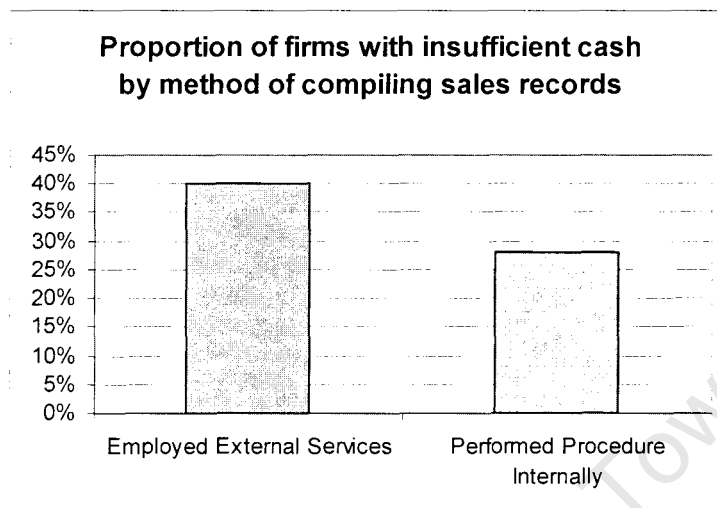
Figure 3.3-3: Proportion of firms that exhausted overdraft in last 6 months by method of preparing sales compilation documents<sup>30</sup>



Businesses that employed external help with sales documentation were also more likely to encounter cash flow shortages, and to experience difficulty in paying wages. Forty percent of these businesses had insufficient cash to cover costs at some point over the last 6 months, and 20% of these businesses were unable to pay wages at some point over the previous 12 months. These figures contrast with the respective proportions of 28% and 15% for those who performed the procedure in-house. The findings regarding cash to cover costs are portrayed in Figure 3.3-4.

<sup>30</sup> These differences were *not* found to be statistically significant using a Mann Whitney non parametric test. The proportions depicted were based on the following data: 7 out of 12 firms that sought external service provision had exhausted their overdraft, whereas only 40 out of 60 of those that performed the procedure internally had exhausted their overdraft.

Figure 3.3-4: Proportion of firms with insufficient cash on hand to cover costs in the last 6 months by method of preparing sales compilation documents<sup>31</sup>



The only area in which external provision of sales records was found to be helpful was profitability. Businesses who used an external provider to compile sales records reported a 15% rate of no profitability over the previous 3 months, compared to 24% for those who performed the procedure internally. However, as indicated earlier, inferences based on this indicator alone are limited and subject to seasonal variations.

Overall, these findings are again surprising. One would expect a trained accountant to perform sales documentation with a high level of proficiency, and to offer some form of valuable insight. Instead, as with external VAT documentation, businesses who sought outside help with this procedure were actually more likely to encounter financial difficulty.

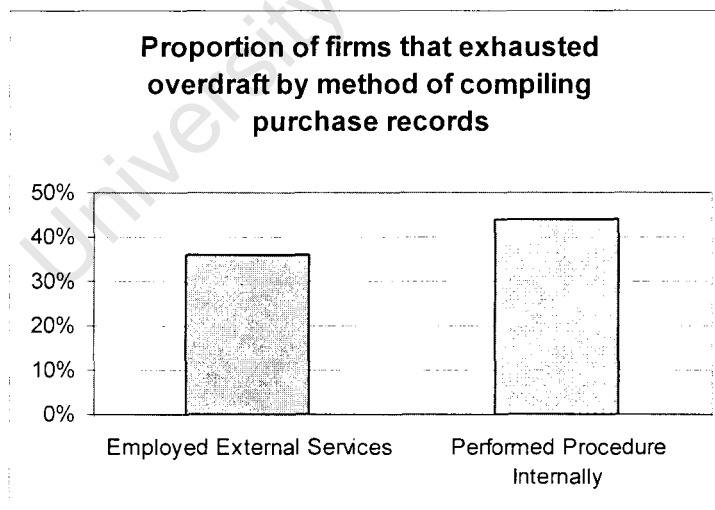
<sup>31</sup> These differences were *not* found to be statistically significant using a Mann Whitney non parametric test. The proportions depicted were based on the following data: 8 out of 20 firms that sought external service provision did not have enough cash to cover costs in the last 6 months, whereas only 42 out of 146 of those that performed the procedure internally did not have enough cash to cover costs at some point in the last 6 months.

### Purchase Documentation

The GEM data evaluates purchase documentation procedures in the same manner as that of sales documentation. Businesses were asked to describe two distinct aspects of their purchase documentation: the day-to-day tracking of purchase records, and the compilation of these records into a document which might be used for further analysis. Once again, the vast majority of businesses performed the daily tracking of purchase records internally. This is not surprising given the nature of the procedure.<sup>32</sup>

Of those who compiled purchase records for further analysis, approximately 22% employed an external accountant to do so. In contrast to the earlier findings regarding sales documentation, external support in compiling purchase records was found to have a positive effect on the financial health of businesses. Thirty-six percent of these businesses had exhausted their overdraft over the past 6 months, compared to 44% of those businesses that performed the procedure internally. This comparison is displayed in Figure 3.3-5.

*Figure 3.3-5: Proportion of firms that exhausted overdraft in the last 6 months by method of compiling purchase records*<sup>33</sup>



<sup>32</sup> Just over 93% of the SMEs sampled produced some form of day-to-day purchase records.

<sup>33</sup> These differences were *not* found to be statistically significant using a Mann Whitney non parametric test. The proportions depicted were based on the following data: 4 out of 11 firms that sought external service provision had exhausted their overdraft, whereas only 44 out of 100 of those that performed the procedure internally had exhausted their overdraft.

This trend continued with the remaining financial metrics. Only 19% of businesses who performed the procedure with external support had encountered cash shortages over the previous 6 months, and only 6% had experienced an inability to pay wages. Those reporting no profitability among this group dropped to 6%. By contrast, those who performed the procedure internally reported financial distress results as follows: 32% had insufficient cash to cover cost in the last 6 months; 18% were unable to pay wages at some point over the last 12 months; and 25% recorded no profits in the last 3 months.

These findings run contrary to the trends thus far. It seems that while businesses that compile purchase records internally do not benefit substantially from the procedure, those that outsourced this responsibility to external service providers reported superior performance across all four indicators of financial distress. One explanation for the difference between these findings and those of the sales documentation analysis is that purchase documentation is closely related to the process of claiming rebates on VAT returns. Therefore, it is possible that accountants who perform this function are in a better position to add direct value. This possibility is further explored in the qualitative research to follow.

### Cash Flow Records

The importance of optimal cash flow management cannot be underestimated. Although all of the procedures analyzed in this study have an effect on healthy cash flows, it is arguable that none are of more direct relevance – and therefore importance – than cash flow records. Essentially, keeping cash records entails tracking the cash that comes in and out of the business on a daily basis. Doing so allows for greater perception of the cash needs of the business, the effective tracking of bank accounts, and sound debtor and creditor management. If evaluated correctly, these records allow business owners to act with a heightened degree of foresight.

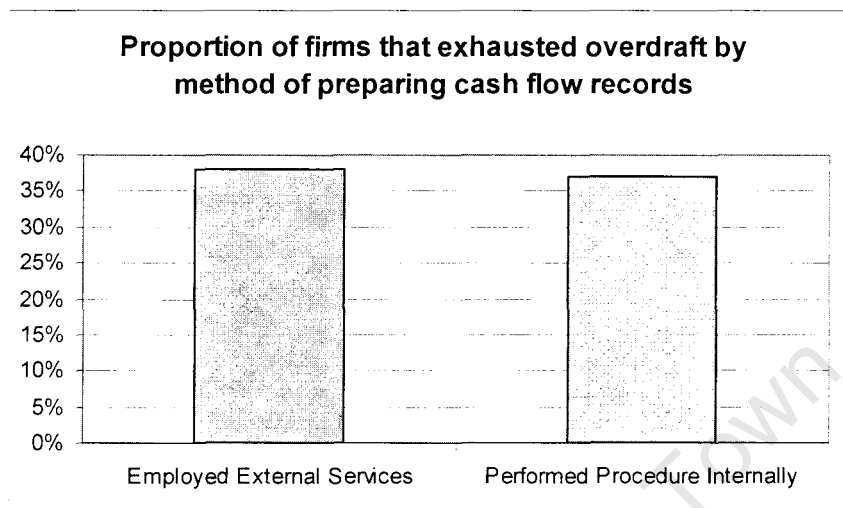
Of the sample, 58% produced some form of cash flow records whether in-house or with external support. Almost 50% of this group had exhausted their overdraft in the last 6 months. In light of Fisher and Wood's recommendations, this is an interesting and noteworthy finding. As mentioned earlier, keeping a cash book was identified as one of the four essential financial practices by GEM in 2003. The study reported as follows:

“While just over a third of businesses that do produce a cash book had exhausted their overdraft at some point in the last six months, 58% of firms that do not produce this record had exhausted their overdraft in the last six months... This suggests that making a relatively simple change to a firm’s administration could assist in helping some businesses improve their cash management, perhaps reducing the probability of an exhausted overdraft by as much as one third” (Fisher and Wood, 2003: 44).

It is therefore important to note that only when cash records are properly compiled in the form of a cash book do they become valuable to a business owner. Keeping cash records alone – as loose slips, for example, or filed records – is not sufficient to decrease the probability of financial distress.

Use of an external accountant to compile cash records was not found to be more beneficial than performing the procedure in house. Of firms that used external service providers, thirty-eight percent had exhausted their overdraft in the last 6 months, 30% had encountered insufficient cash to cover costs at one time over the past 6 months, and 10% had been unable to pay wages at some point over the last 12 months. Those who performed the procedure internally reported very similar results of 37%, 28%, and 16%, respectively. The findings regarding exhausted overdraft proportions are depicted in Figure 3.3-6.

Figure 3.3-6: Proportion of firms that exhausted overdraft in the last 6 months by method of preparing cash flow records <sup>34</sup>



The profitability variable was the only one that proved to be substantially different among the two groupings: 10% of those employing external services reported no profit in the last 3 months whereas 27% of those that performed cash flow procedures internally had experienced no profitability.

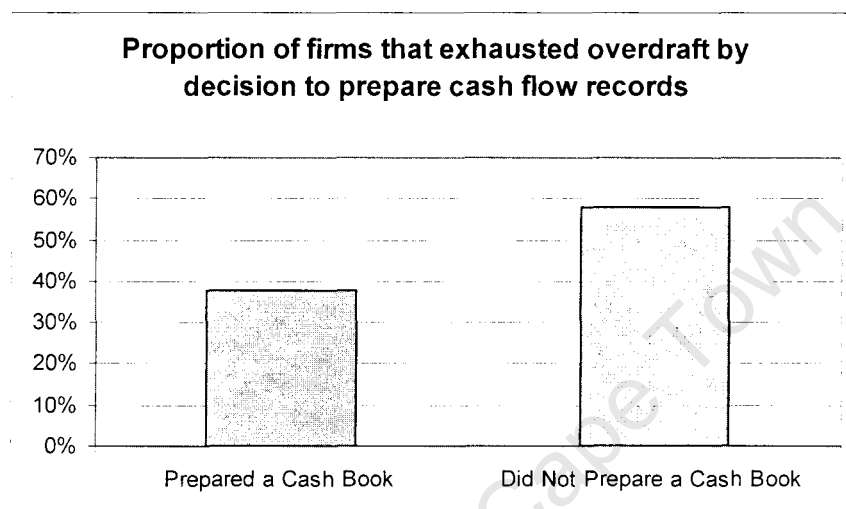
It is interesting that the rate of running too short on cash to cover costs over the previous 6 months would not be different among the two groupings. Cash flow records provide an up-to-date depiction of a company's cash situation, and external service providers should possess the skills necessary to provide a relatively robust depiction of the cash flow activities of a firm. Even without more advanced forecasting, these records should enable businesses to better prepare for periods of restricted cash flow.

The lesson here appears to be that the act of keeping a cash book is far more important to the business than the individual conducting the procedure. Where external service providers are engaged to compile cash flow records, it seems appropriate to suggest that they do so in the form of a cash book in order to provide the most value to their clients. Those who chose to prepare cash flow records, either internally or through external services, reported an overdraft exhaustion rate of

<sup>34</sup> The proportions depicted were based on the following data: 3 out of 8 firms that sought external service provision had exhausted their overdraft, and 64 out of 141 of those that performed the procedure internally had exhausted their overdraft.

approximately 38%. Those who chose not to prepare a cash book, by contrast, reported an overdraft exhaustion rate of 58%. This stark comparison is portrayed in Figure 3.3-7.

*Figure 3.3-7: Proportion of firms that exhausted overdraft in the last 6 months by decision to prepare a cash book*<sup>35</sup>



Again, these findings (along with many others regarding the importance of performing basic financial procedures) have been well documented by the GEM study on effective financial procedures (Fisher and Wood, 2003). The intention of the research herein is to branch beyond those findings in order to identify the marginal impact of external service providers. In this case, that impact appears to be negligible.

It appears, however, that in the case of keeping a cash book, the findings of past research are worth reiterating. Effective cash management can be maintained through a simple procedure of daily record keeping. This has enormous implications for financial stability. Although external financial service providers can be helpful with this procedure, the individual conducting the exercise is not as important as ensuring that the exercise itself is being performed.

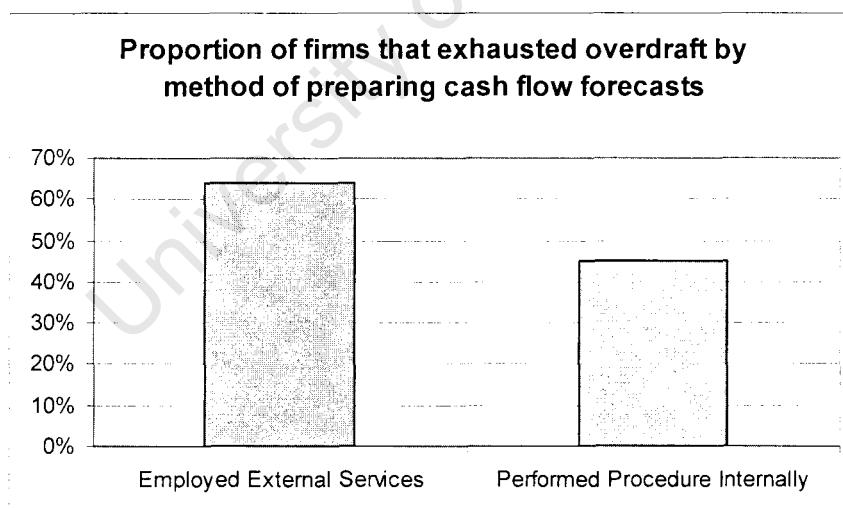
<sup>35</sup> These differences were found to be statistically significant using a Mann Whitney non parametric test (Fisher and Wood, 2003).

### Cash Flow Forecasting

Cash flow forecasting is used to project the future cash transactions of a business. It allows a business owner to be cognizant of future cash needs, and to plan accordingly for items such as supplier payments, employee wages and mortgage expenses. Although the procedure is not complicated and could be taught to a business owner in a short period of time, cash flow forecasting requires a degree of financial knowledge that surpasses most basic financial procedures. Therefore, it is an area in which external financial expertise could be particularly helpful.

A little over half the sample practiced some form of cash flow forecasting. Of this group, 19% employed an external accountant to do so. Overall, external support with cash flow forecasting failed to help alleviate financial distress in three out of four financial distress variables. Sixty-four percent of this group had exhausted their overdraft in the last 6 months compared to 45% among those that performed the procedure internally. These findings are displayed in Figure 3.3-8.

*Figure 3.3-8: Proportion of firms that exhausted overdraft in the last 6 months by method of preparing cash flow forecasts*<sup>36</sup>



<sup>36</sup> These differences were *not* found to be statistically significant using a Mann Whitney non parametric test. The proportions depicted were based on the following data: 9 out of 14 firms that sought external service provision had exhausted their overdraft, and 22 out of 49 of those that performed the procedure internally had exhausted their overdraft.

Among those who employed external services, 36% did not have enough cash on hand to cover costs at some time over the past 6 months, and 18% reported an inability to pay wages at some point over the last 12 months. These statistics were comparable to those who performed cash flow forecasts in-house, which reported results of 32% and 17%, respectively. Once again, profitability was the only variable which was affected positively by the external provision of cash flow forecasting. Only 9% of those who sought external financial support with cash flow forecasting reported no profits over the past 3 months.

These conclusions continue to be worrying. As mentioned, cash flow forecasting requires a degree of increased financial knowledge. When evaluated with regards to propensity for overdraft exhaustion, the discrepancy between those who performed the procedure in house and those who sought external service provision is substantial. Furthermore, given the fundamentals of cash flow forecasting, the high rate of firms experiencing an inability to cover costs among both groups is surprising. Cash flow forecasting should add foresight to the owner's actions, even beyond that of keeping cash records. The process is aimed specifically at allowing the entrepreneur to identify and avoid upcoming cash shortages (i.e. enabling them to avoid situations in which the business does not have enough cash to cover costs). The results suggest that this is not the case.

#### Overall Expenditure on Accountants and Bookkeepers

The GEM survey asked previously disadvantaged business owners to report their annual expenditure on bookkeepers or accountants. When interpreted as a percentage of annual turnover, this figure ranged from 0% to 24%.

Upon further analysis, there appears to be no significant correlation between increased expenditure on these services and a decreased propensity for financial distress. In total, 37% of respondents (83 businesses) spent 1% or more of annual turnover on bookkeepers or accountants. Of those that spent more than 1% and had access to an overdraft facility, 45% had exhausted this facility in the last 6 months. This figure is the same as the proportion reported by the total sample. Therefore, it seems that increased expenditure on accountants and bookkeepers is not associated with a decreased likelihood of overdraft exhaustion.

It is important to note that this section's findings do not relate specifically to external services. The data does not specify whether the money was spent on internal bookkeepers and accountants or on outsourced help. Nevertheless, it is an interesting and pertinent finding. One would expect that businesses which chose to allocate increased resources to financial administration would have a decreased propensity to encounter financial distress. Judging by the analysis above, this does not appear to be the case.

#### The Effect of External Service Provision on Access to Finance

When evaluating loan applications, formal loan institutions generally seek an overall understanding of a company's financial situation. Based on this understanding, they can assess the probability of a venture's continued success and the probability of loan repayment. Therefore, it is logical to expect that a history of financial stability is likely to result in a more favorable assessment, and an increased probability of qualifying for finance. If the adoption of sound financial management procedures allows for increased financial health, then it is also logical to assume that this, in turn, will lead to a higher rate of success in applying for loan finance.

Previous research has found this to be true. In 2003, Fisher and Wood concluded that sound financial practices had a significant impact on an SME's ability to procure finance -- "Banks evidently prefer to channel finance, via term loans, to entrepreneurs that adopt good financial practices. More than 70% of entrepreneurs that have implemented the 'four essential financial management practices' have been successful in applications for loan finance" (Fisher and Wood, 2003: 50).

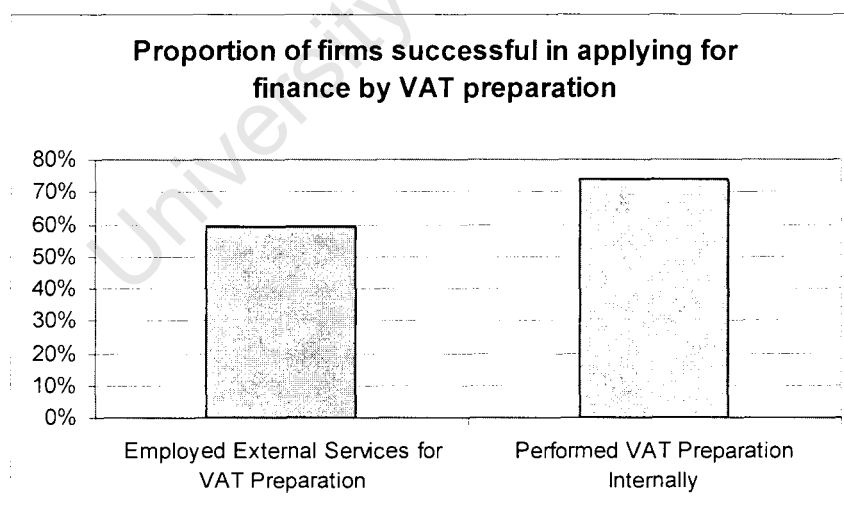
Moving forward, the same assumption could be made of external financial services. If the provision of such services is beneficial to an SME's financial situation, then it is also likely for these services to have a positive impact on a company's loan eligibility. However, because external financial service provision has not been found to relate consistently to an increased rate of financial health, it is logical to assume that it is unlikely to have a positive effect on an SME's ability to procure financing.

The GEM survey measured access to loan finance in several forms, including: terms loans, financial leases, operating leases, mortgage bonds, bridging finance, equipment bonds and factoring. Within

the group that had been successful in applying for finance, term loans accounted for the vast majority of financing. Almost three-fourths of those who had successfully qualified for finance at some point in the past had used term loans, rather than alternative financing products. Overall, 63% of respondents in the study were found to have been successful in applying for finance.

Of those that had employed external financial help, only the categories of VAT preparation and sales documentation were found to have sufficiently large sample sizes for analysis – 37 and 11, respectively.<sup>37</sup> Those who sought external help for VAT preparation were less successful in loan applications than those who performed the procedure internally: the proportions of firms that had been successful in applying for finance were 59% (external preparation) and 74% (internal preparation). Given the negligible, and sometimes adverse impact, which external VAT preparation had on a company's financials, it is not surprising to discover that this procedure also has little impact on a company's ability to procure financing. Firms that performed this procedure internally were much less likely to suffer from financial distress, which in turn, makes them more attractive candidates for financing. Figure 3.3-9 depicts these findings.

Figure 3.3-9: Proportion of firms successful in applying for finance by method of VAT preparation<sup>38</sup>

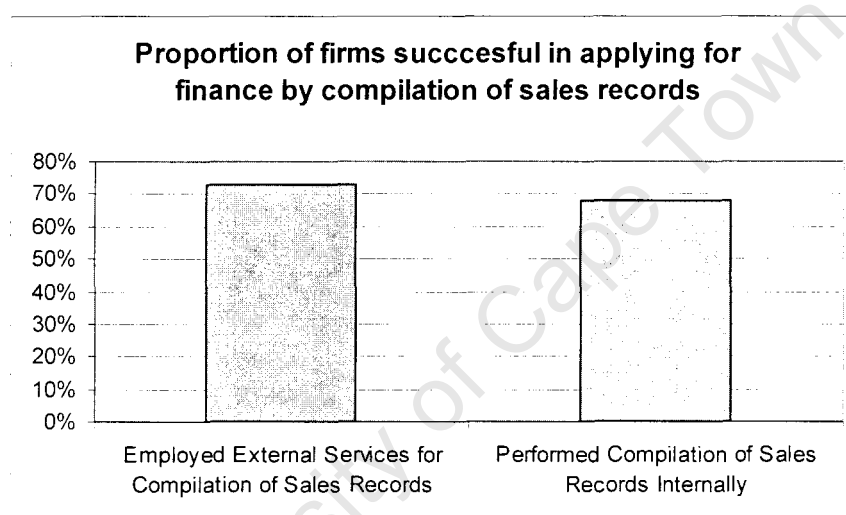


<sup>37</sup> The combined tabulation of both those who sought external accountants to perform these procedures, as well as those who had applied for loan finance reduced the sample sizes considerably.

<sup>38</sup> These differences were *not* found to be statistically significant using a Mann Whitney non parametric test. The proportions depicted were based on the following data: 22 out of 37 firms that employed external services for VAT preparation had been successful in applying for financing, whereas 26 out of 35 of those that performed VAT preparation internally had been successful in applying for financing.

In the case of SMEs that sought help with sales documentation, the findings are somewhat different, although much more subtle. Seventy-three percent of firms that used external services for sales compilation documents were successful in applying for finance whereas those that performed sales documentation internally reported a 68% success rate. These findings are depicted listed in Figure 3.3-10.

Figure 3.3-10: Proportion of firms successful in applications for finance by method of compiling sales records<sup>39</sup>



Given the earlier findings indicating that the external preparation of sales documentation had little effect on alleviating financial distress, this latter finding is interesting. One possibility is that external accountants help to bolster the appearance and polish of a company's sales documentation and future sales projections, which may lend credibility to their applications for finance. If this is the case, it is a misleading and incongruous tendency. As indicated above, the external preparation of sales documentation was not associated with an increased rate of financial health, indicating that it should not be associated with higher probabilities of gaining finance. However, these findings must be interpreted with care. This was the smallest sample size of the study, rendering it highly

<sup>39</sup> These differences were *not* found to be statistically significant using a Mann Whitney non parametric test. The proportions depicted were based on the following data: 8 out of 11 firms that employed external services for the compilation of sales records had been successful in applying for financing, whereas 51 out of 75 that that performed the procedure internally had been successful in applying for financing.

susceptible to variations in sampling. In addition, the difference between the two groups is only 5 percentage points. As a result, and in context of the previous conclusions, it would be unwise to place a high degree of importance on this finding alone.

### **3.4 Quantitative Analysis Conclusions**

Ultimately, the results of the first component of this study suggest that further research is needed. While some findings are in line with earlier assumptions and existing research, others present surprising implications.

Based on an analysis of contemporary World Bank data on loan success rates, it appears that the previously disadvantaged SME sector continues to struggle to receive financing more than other sectors within the business community. This is in keeping with other contemporary research (Schoombee, 2004; Bonti-Ankomah, 2000; World Bank, 2006). These findings were found to hold true when exposed to both subjective and objective measurements. Previously disadvantaged SMEs are more likely to rate access to finance as a major or severe obstacle than their white owned counterparts; they are less likely to have applied for a loan; and they are more likely to have been rejected for loans they did apply for.

Furthermore, it appears that a significant minority of previously disadvantaged SMEs are in some form of financial distress. This finding is salient when considered in light of the potential that exists for more efficient capital investment on the part of SMEs. Financial distress is not limited to young or new businesses within the previously disadvantaged community. If many of the older businesses in the sample have been able to survive for years without effective financial administration practices, it implies that sound underlying operating methodologies and sufficient sales revenue have allowed them to do so. This indicates that a reformulation of financial practices could pose tremendous benefits – more effective financial management leads to a more optimal use of funds, which has positive implications for growth and employment generation.

Moving forward, it appears that the provision of external financial services is less helpful than expected. With the exception of the external preparation of purchase documentation and the compilation of cash flow records, external financial support was found to have little effect on alleviating financial distress amongst previously disadvantaged SMEs, across a range of financial

procedures. In fact, in a number of circumstances, SMEs who sought external service provision had a *higher* propensity for overdraft. In the case of VAT preparation, the additional expertise and insight of accountants was found to be of little benefit. Businesses that employed the services of external accountants in this area were worse off across all four indicators of financial distress. Those who chose to utilize external preparation of sales documentation proved to be little better off. The tendency for overdraft within this group was almost 20% above those that chose to perform the task in-house. It is also worrying that SMEs who sought help with cash flow forecasting and the compilation of cash flows did not report a significantly higher rate of financial health. These tools are critically important to financial management, but require a somewhat more sophisticated knowledge of financial procedures. Although it was assumed that this area could be one in which external accountants offered significant value addition, the findings of this study suggest that it is not the case. External accounting was found to be somewhat helpful for the compilation of cash flow records, but no greater than keeping a cash book internally. And those that sought external support for cash flow forecasting reported the highest rate of overdraft exhaustion among any of the measures for external service provision. Of the financial procedures measured, only the external preparation of purchase documentation proved to have a significantly positive association with increased financial health.

With regards to access to financing, the provision of external financial services proved to be of mixed impact. While the external preparation of VAT documentation was associated with a decreased rate of success in applying for loans, those who sought help with sales documentation reported a higher rate of success than those that performed the procedure in house. The latter finding, however, should be interpreted with caution. Sales documentation was not associated with an increased rate of financial health. In fact, those who chose to employ external help with this procedure reported a higher rate of overdraft than those that performed the procedure internally. Therefore, it is likely that a third factor may be influencing the banks' decision making process; or, that the banks' decisions are not based on sound financial analyses. Further research on the logic and motivations behind a bank's decision to provide financing would help to clarify this issue.

In conclusion, it is worth stating again that many of these findings run somewhat contradictory to the original hypotheses, and are therefore noteworthy. Overall, the provision of external financial support has not proven to be largely beneficial to the previously disadvantaged SMEs that seek it. If it is assumed that sound financial practices are important to financial health, as Fisher and Wood (2003) concluded, then the findings of this study point toward a few exploratory conclusions.

First: the quality of external service provision is low. If the procedures are not being performed with a high degree of proficiency and attention to detail, they may result in incorrect or incomplete information that leads business owners to poor operating decisions. Second: the services are not accompanied by sufficient managerial advice. Value addition lies in the correct interpretation of financial records, and a business owner's ability to make operating decisions based on these interpretations. If accountants are not providing sufficient managerial advice to explain their findings and guide business owners toward appropriate financial decisions, this value addition may fail to materialize. Third: the services are overpriced, mitigating any value addition and rendering the exchange harmful to SMEs. Even if the quality of services provided is exceptional, overpricing would mitigate any significant impact the services may ultimately have on the company's financial position. This is difficult to measure without a widespread pricing analysis – and somewhat unlikely given the relative abundance of accountants – but it poses another possibility. Forth: SME owners choose to ignore the information or advice given to them. This too, is difficult to measure, but a very real possibility. Entrepreneurs often see accountants as a way to free up capacity, rather than as a source of valuable advice. If the businesses owners choose to ignore the information provided by accountants, and in doing so, ignore important financial data, it is easy to understand why many end up in financial distress. Fifth: the SME owner does not possess the knowledge needed to interpret and implement the advice effectively. Although accountants can act as valuable informational sources, much of the dialogue depends on the business owner possessing a basic degree of financial understanding to begin with. Without this understanding, it will be difficult for the business owner to interpret the information provided, rendering it impossible for them to make future business decisions based on this information.

It is likely that a combination of these possibilities is contributing to the overall trends depicted in the quantitative conclusions above, rather than one prevailing factor. However, mention of these possibilities serves to highlight the complexity of the issue. Uncovering further answers requires a more intricate understanding of the relationships between external financial service providers and previously disadvantaged SMEs.

#### 4. Qualitative Analysis

In order to more accurately interpret the findings from the quantitative research, and to better understand the relationship between SMEs and financial service providers, a qualitative analysis was conducted. As previously indicated, the qualitative component of the study was designed to be complementary in nature; to offer an alternative perspective to the preceding research (that of the accountants, rather than the SME owners); and to gain a deeper insight into the nature of the relationships between entrepreneurs and independent financial management service providers. While the findings of the first piece of research are noteworthy on their own – especially because they run contradictory to the initial hypotheses – such an analysis would be incomplete without further investigation. The broad implication that SME owners cannot alleviate their financial problems by using an accountant is somewhat one dimensional and limited. Ultimately, such an analysis would contribute another “problem” to the academic discourse on this subject matter, rather than an “answer.” The qualitative research component is important not only because it buttresses earlier findings and creates a more comprehensive study, but also because it brings us one step closer to answers which are helpful to previously disadvantaged business owners.

The qualitative component of the study is based upon 8 semi-structured interviews with accountants who cater to the previously disadvantaged SME community. The questionnaire for the interviews flowed from the findings of the quantitative analysis, and was designed to elicit insights to answer the following research question: “What barriers exist which may be impeding the effective provision of financial management services?”<sup>40</sup> The barriers reported have been divided into three groupings: 1) barriers on the side of previously disadvantaged business owners; 2) barriers on the side of accountants; and 3), co-dependent barriers which are an inherent component of the relationship between accountants and previously disadvantaged SMEs.

Once again, in an effort to find answers that are useful to previously disadvantaged business owners, and in hopes of uncovering obstacles in a way that allows for possible “remedies,” the following analysis should be interpreted in context of a larger question. The larger question being: “Given the widespread nature of financial distress in the previously disadvantaged community and the need for further financial administration skills, why aren’t accountants having a more positive impact on the financial performance of SMEs in this sector?” In light of the proven relationship

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<sup>40</sup> This questionnaire is provided in Appendix C.

between sound financial management, increased financial health and an SME owner's eligibility for finance (Fisher and Wood, 2003), this question has significant implications for business sustainability and creditworthiness in the previously disadvantaged sector.

#### 4.1 Methodology

As previously indicated, the methodology of the qualitative study entailed primary data collection in the form of semi-structured interviews with 8 service providers who cater to previously disadvantaged SMEs. Because the study is qualitative, the sampling methodology was purposive rather than random. Respondents were chosen based on the following criteria:

- Registration as a CA, and ability to perform the roles of an accountant;
- Offices located within the Western Cape Province;<sup>41</sup> and
- A history of at least 2 years servicing previously disadvantaged SMEs.

Although there may be instances of financial service support through public sector programs on the Western Cape, those services fall outside the realm of this study. Meaningful conclusions are more likely to derive from a study of private service providers, which supply the bulk of financial service support and are likely to continue to do so in the future. Further, the study sample included accountants rather than bookkeepers. It is widely acknowledged that where bookkeepers are capable of compiling daily and monthly records, accountants have the ability to interpret these records and provide managerial advice. The latter capacity allows for a more substantive value addition and is critical to effective financial service.

In 2001, Warren noted that "The purpose of most qualitative interviewing is to derive interpretations, not facts or laws, from respondent talk" (83). The interviews carried out in this research were designed to elicit interpretations, with particular emphasis on understanding the perceived responsibilities of financial service providers and their difficulties in providing effective

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<sup>41</sup> It should be noted that this sample group does not correspond directly with that of the sample group from the GEM survey, due to geographical differences. It is unlikely, however, given the SARS nationwide regulations for VAT and other accounting procedures, that relationships between accountants and previously disadvantaged SME owners should differ significantly across geographic locations. Nonetheless, it is once again important to understand that this analysis paints an indicative picture, rather than an authoritative one.

financial services. Where appropriate, they also aimed to uncover perceptions of overall trends amongst previously disadvantaged SMEs.

Given the small number of respondents to be interviewed, and the intention to augment the quantitative data analysis with qualitative understanding, semi-structured interviewing was deemed to be the most appropriate methodology. The interviews lasted between 45 minutes and 90 minutes. Dreyer (1995) provides a helpful description of the semi structured interview process:

“... the interviewer sets up a general structure by deciding in advance the ground to be covered and the main questions to be asked. The detailed structure is left to be worked out during the interview, and the person being interviewed has a fair degree of freedom in what to talk about, how much to say, and how to express it. Semi-structured interviewing is a very flexible technique for small-scale research. It is not suitable for studies involving large numbers of people, but is most helpful in mini-studies and case studies.”<sup>42</sup>

Although the interviews were designed to be flexible in nature, all respondents were asked a minimum number of questions, included in the questionnaire.<sup>43</sup> The questionnaire contains two sets of questions. The first set inquires into the nature of the relationships between service providers and SMEs. It seeks to understand what difficulties accountants face when working with previously disadvantaged SMEs, and also to understand what accountants feel is their main area of value addition for clients. The second set of questions is related to the findings of the quantitative component of the study. Respondents were asked these questions only after they had been given ample opportunity to speak about their experiences with previously disadvantaged SMEs, and their perceptions of their own value addition. This sequencing allows for an “untainted” analysis of the service provider’s difficulties in dealing with clients, but also reveals something about the accuracy of the service provider’s own perceptions. For example, if an accountant felt that financial distress was relatively rare in the previously disadvantaged community, or that accountants offered value addition in all areas without fail, the data concludes that these interpretations are misguided; indicating that either this accountant works with a client group that is not representative of the larger population, or that his own understanding is not in line with the realities portrayed in the quantitative data.

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<sup>42</sup> The “general structure” referred to here was largely based on the findings of the first analysis.

<sup>43</sup> The questionnaire for the interviews can be found in Appendix C.

Each respondent was briefed on the design of the study and its intentions before questioning began. All conversations were tape recorded and transcribed, and assurances of anonymity and consent forms were provided in advance.<sup>44</sup>

## 4.2 Sample

The respondents in the sample worked in a range of settings with varied backgrounds. Some were previously disadvantaged individuals themselves, operating small accounting practices and relying heavily on sales connections from the Cape Chamber of Commerce or the RED Door Programs; while others worked under the umbrella of much larger accounting firms with international offices and well known brand recognition.<sup>45</sup> Specializations tended to focus on one of two areas: tax preparation, and business registration advice. Some respondents also provided a wider array of business consulting skills, but the interviews dealt primarily with their roles as accountants.

All respondents had a minimum of two years accounting experience with previously disadvantaged SMEs, and served clients in the Western Cape Province. With one exception, all respondents were still working with previously disadvantaged SMEs.<sup>46</sup> However, it should be noted that none of the respondents dealt exclusively with previously disadvantaged clients. This is not surprising. An accountant, like any small business owner, tends to seek business where it is available – many respondents emphasized that their services could be helpful to either white or black-owned businesses, giving them little reason to refuse customers based on ethnicity or background. At times, the respondents' ability to draw comparisons between their previously disadvantaged customers and their white clientele offered helpful insight.

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<sup>44</sup> The research consent form can be found in Appendix D.

<sup>45</sup> The RED Door programs were originally designed to provide a wide range of direct support for local businesses. Entrepreneurs could seek advice and help with tax filing, legal documentation, overall business counseling, and some degree of financial administration training (RED Door, 2004). Following a series of scathing critiques regarding the quality of services delivered, however, these centers have since evolved into small outsourcing centers, linking entrepreneurs to a host of private sector business development providers.

<sup>46</sup> One of these accountants no longer worked with a significant number of previously disadvantaged individuals. However, given his prior track record working with previously disadvantaged individuals, and his extensive experience in the field of accounting, his insights have been included.

### **4.3 Analytical Limitations**

The analysis that follows is based on interviews with accountants alone. Naturally therefore, the interviews depict an evaluation of the relationship between accountants and SMEs from a one-sided perspective. Despite its seemingly one dimensional nature, this method of inquiry provides balance to the study in two important ways. First, the interviews enable the voice of the accountants to be heard. The quantitative assessment was focused exclusively on responses from previously disadvantaged SMEs, shaping a clear picture of their difficulties, but giving little explanation of the operating conditions for the external service providers who cater to them. Second, these interviews enable the accountants to provide some form of an explanation. Given the findings of the quantitative study, which indicate that external financial services are less beneficial to previously disadvantaged business owners than expected, it is tempting to intuit that accountants are of limited value; or worse, that business owners have nothing to gain from seeking their services. This is not the case. In fact, in many respects, the following analysis suggests the opposite. The reality of the situation is far more nuanced than the quantitative data depicts, and the interviews with accountants brought these details to light.

Furthermore, it is worth reiterating that the conclusions that follow cannot be interpreted as categorical. The intention of qualitative research is to provide insights and interpretations rather than facts or overarching summaries. Therefore, with the exception of a brief analysis on costing, intended for indicative purposes only, this section avoids the heavy quantitative assessments that made up the bulk of earlier sections. Instead, increased focus has been given to analyzing the insights elicited in the interviews. As often as possible, the words of the accountants themselves have been included.

## **4.4 Findings**

### **4.4.1 Barriers on the Side of Previously Disadvantaged SMEs**

Overall, respondents reported that tax preparation and business registration services were the most commonly sought procedures by previously disadvantaged clients. This is line with the findings of the quantitative analysis. Of the financial procedures included in the GEM survey, VAT preparation was by far the most commonly outsourced. Some respondents reported that clients intermittently

approached them for additional help beyond these procedures – with business plan writing, for example, or the preparation of financial statements for a loan application – but these were usually secondary requests.

One of the first interview questions posed to respondents was, “What do you perceive to be the largest barrier to providing effective accounting services to previously disadvantaged SMEs?”<sup>47</sup> Subsequent questions were intended to continue with the theme of “barriers,” in order to understand what elements on the side of both clients and accountants were impeding the flow of quality services. Respondents felt that previously disadvantaged entrepreneurs suffered from three trends which made it more difficult for the accountants to add value: 1) a very low level of understanding of basic financial knowledge; 2) poor record keeping; and 3), detrimental attitudes or behavioral patterns. These trends were identified as a result of the high proportion of respondents who independently raised them, as well as the high level of importance which respondents attributed to them. Among the first two trends, 8 out of 8 respondents raised the issue independently, and 6 out of 8 raised the issue of detrimental attitudes or behavioral patterns.

#### Financial Knowledge

The low level of financial knowledge amongst previously disadvantaged clients was found to be a universally common complaint amongst the accountants interviewed. A basic level of financial administration knowledge is a prerequisite for sound business operations. However, many accountants found such a fundamental understanding of the basics to be scarce. In some instances, the accountants felt that their attempts to discuss with clients the results of the financial documents they had created was a tiresome and lengthy procedure; and one which often resulted in little real knowledge transfer. The following response captures this sentiment well:

“... most clients are not very well educated, for them it doesn't really make sense. They just want to see that they make money, their business can continue, and their tax affairs are good. So having a discussion with them with regards to gross profit percentage or return on investment; for most of them, that's just gibberish. I'm talking of about 80% of them. For them it doesn't make sense”<sup>48</sup>

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<sup>47</sup> The full questionnaire is featured in Appendix C.

<sup>48</sup> Interview 7: 15 December 2006

Clients were reported to struggle with a number of concepts, including general profit and loss, return on investments, and tax calculations. Understanding the fundamentals of VAT was seen to be particularly rare among previously disadvantaged clients, and poses very real problems for budgeting tendencies:

“Their skills aside from accounting – their costing skills for example, they often don’t understand what to include in a costing analysis. I don’t think they have the educational background they need for many basic business activities. Just from my experience... We say, ‘Ok, we need your VAT returns or your invoices, bring us your invoices.’ And months would go by and they wouldn’t bring us anything, and in the meantime, they are using the VAT money, they are using it for expenses. And SARS sends them a letter, and then we have a whole big story about penalties. That’s a classic example of what happens all the time. So what makes it hard for us is basic understanding – education, education.”<sup>49</sup>

This testimonial provides an important insight into the findings of the quantitative study. Six out of eight respondents reported that their clients struggled to understand basic VAT concepts. Many clients simply use the money as working capital, rather than saving it for future tax payments. Surely, this is both a function of insufficient knowledge as well as irresponsible behavior (which is covered in a section to come). But these explanations offer important insight nonetheless. The quantitative findings indicated that VAT was the most commonly outsourced behavior, but that it was negatively associated with financial health – i.e. those who sought external service provision in this area were actually more likely to report financial distress than the overall average. While this seems like a surprising discovery at first glance, the respondents’ assessment sheds more light on why this trend may be the case. If business owners fail to use the information given to them appropriately because they do not understand the fundamental concepts which the information is predicated upon, it is unlikely that the information will help them to make sound business decisions; and, in doing so, avoid financial distress.

Many clients make the dangerous assumption that after the accountant has compiled the paperwork, their VAT responsibilities have concluded. In reality, the VAT paperwork is a means to an end. An accountant may be capable of providing the documentation, but the assumption is that the client is

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<sup>49</sup> Interview 1: 11 December 2006

armed with a sufficient level of basic knowledge to act on this information. Often, however, this appears to be misguided.

There were other instances in which the interviews revealed that the lack of basic understanding on the part of clients can quickly lead to very poor business behavior. One respondent relayed the following story about a former client:

“I had a client from Germany who came down to SA and started a business. When he got here, he set it up, and I saw to the tax pieces of things. This client invested 2 million into his business. The business didn’t do very well. It’s on the brink of closing. But two million rand later, I asked him, ‘Do you have a problem with your sales stream? Did you look at the business plan?’ And he says, ‘Yeah, it’s fine, the business plan says that the business is profitable so the business is profitable.’ And at that stage it’s very difficult to help... the client’s attitude is, ‘you do the accounting function and leave the rest to me.’”<sup>50</sup>

Again, it is worth noting that the client in mention may well suffer from insufficient financial understanding as well as poor behavioral patterns. It is possible that the client knows of the need to compare the business projections with actual budgets, but has not been diligent about the process. However, a number of accountants emphasized that with many clients, it was unwise to assume even the most basic fundamentals. In some instances, for example, businesses were found to have been operating at a loss for a significant time because they had performed costing exercises incorrectly; the cost of goods sold was higher than the final sale price of the business’s products, causing the business to operate at a loss, even before variable expenses had been accounted for.<sup>51</sup>

More importantly, accountants felt that the lack of basic financial knowledge among their clients significantly limited their capacity to add value. Because they were forced to spend a considerable amount of time teaching basic accounting fundamentals, their capacity for higher-level analysis was eroded:

“What the clients really need is a lecture and an educational service, rather than accounting services. They need someone to explain the process to them, and not get

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<sup>50</sup> Interview 7: 15 December 2006

<sup>51</sup> Interview 8: 15 December 2006

charged accounting fees in the process. At the moment, they are looking for a lecture and some services, but getting charged for both. This has huge implications for the amount of time that an accountant has to spend with someone, and that has implications for affordability.”<sup>52</sup>

The respondent’s use of the word “lecture” in the above quotation is revealing. It seems that clients with little fundamental knowledge often need an educational service, rather than a private sector accounting service. If the accountant is forced to play a largely educational role, their ability to perform more substantive analyses is limited. The difference between an SME owner who has a sound understanding of basic finances and can engage in a higher level conversation concerning how best to depreciate his assets and save taxes, versus that of an individual who struggled with concepts such as profit and loss and needs help to decipher an income statement, is clear. For virtually the same price, if not less, the first individual is able to access a degree of relatively sophisticated advice from the accountant and more optimally manage available resources; the second individual is forced to pay for what often amounts to an important, but very basic tutorial in the fundamentals of finance.

The low knowledge base of the client creates a damaging cycle – the SME owner is forced to spend more time with the accountant in order to learn the basics, but this additional time can be costly; rendering the overall experience too expensive for the client, despite any knowledge which may have been transferred. This has enormous implications for the potential effectiveness of external accounting provision, and will be investigated further in the section which deals with the inherent problems between accountants and SME owners. But for the moment, it is important to recognize that the low accounting knowledge of some clients renders them unable to perform some basic business operations, and to act on the suggestions or findings of the accountant; which, in turn, significantly limits the ability of the accountant to offer value.

### Record Keeping

Frustrations regarding the poor recordkeeping of many previously disadvantaged businesses were also universal (again, 8 out of 8 respondents raised this issue of their own volition). Inconsistent or incorrect record keeping creates a blurry picture of a business’s financials, and not only makes it

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<sup>52</sup> Interview 3: 13 December 2006

difficult for the accountant to compile reports, but also impairs a business owner's ability to evaluate the financial stability of the business.

In response to a question regarding the largest perceived barriers to providing accounting services, an accountant from one of South Africa's "Big Four" accounting firms promptly answered, "The lack of formal bookkeeping and understanding. The lack of records. They seem to operate often on a cash basis, and don't seem to keep enough records. They need to get into a discipline of recording transactions. It's going right back to the basics."<sup>53</sup>

Poor financial records not only mitigate an accountant's ability to add value, but lead to poor internal operating decisions. Seven out of eight respondents indicated that their clients had trouble keeping track of debtors; and that after having put together a list of accounts payable, clients were often alarmed by the amount of outstanding sales that had yet to be collected. If a client fails to pay sufficient attention to outstanding debtors, it will quickly lead to cash flow troubles. This was reported to be the case, with clients often failing to pay VAT because they had insufficient cash on hand due to outstanding debtors.

Just as respondents suggested that the educational levels of a client limited an accountant's ability to add value, so too did they lament their inability to provide help if a business's records were in disarray. One respondent described this phenomenon as follows:

"the first [problem] is compliance issues. An accountant should make sure that these businesses are being compliant, and that they are keeping up to date with industry standards and regulation. Then, after that, you can focus on more complex value addition. But the compliance piece alone can be a huge task; can be a big, time consuming piece of the puzzle. All you're doing is trying to close the compliance gaps all the time. So the energy you expend on value addition is limited all the time."<sup>54</sup>

A second respondent echoed this concern, indicating that the time absorbed in menial tasks detracted from time that accountants could be working on more substantive procedures:

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<sup>53</sup> Interview 8: 15 December 2006

<sup>54</sup> Interview 1: 11 December 2006

“If [the client’s] records are fine, it is easier to make an impact. But if that in itself is a big mess, then you’re ability to add value is limited. Because you have to spend more time just getting things right. But the point is, if you don’t have things right, then there are all sorts of consequences. The moment that the basics are sorted out, then your ability to add value is wonderful – you can do lots of things. But the moment you concentrate on and get sucked into sorting out small little issues, then you are limited in trying to give other types of advice.”<sup>55</sup>

Overall, it should be expected that accountants perform the preparation of financial statements and other financial procedures with an equal or greater degree of proficiency than the business owners themselves. However, it is also fair to expect that the basic level of information which is provided to the accountants is sound and coherent. An analysis can offer helpful outputs only if the correct inputs were available to begin with.

#### Attitude and Behavior

Complaints regarding client attitudes and behavior were also a common component of most interviews (6 out of 8 respondents commented on this issue). Many respondents explained that clients regularly failed to heed the advice of the accountants, and that working with such clients who didn’t “cooperate” could prove tiresome; it lead to cyclical discussions, very little progress in between visits, and increased levels of frustration for the accountant as well as the entrepreneur.

However, these assessments should be interpreted with a degree of caution. Entrepreneurs are expected to make fluid business decisions drawing from a wide spectrum of information. Of the information available to a business owner, an accountant has access to only a limited portion. Therefore, a client’s decision not to take the advice of an accountant is not necessarily emblematic of an abrasive attitude on the part of the client, as many accountants might assert. It could be based on information which the accountant does not have access to; personal or family information, for example; or merely a different set of business instincts. All of these elements factor into a individual’s tolerance for risk taking, and help to shape the decision making process.

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<sup>55</sup> Interview 3: 13 December 2006

Moreover, attitude is often a function of knowledge. If a client does not know the importance of a particular procedure or financial metric, it is difficult for them to attribute meaning to it. Respondents reported that many clients regard accountants with suspicion, and do not see the need for their services, beyond tax compilation or business registration advice. Some, it appears, fail to see the need for effective financial management procedures altogether. But this sentiment is not unique to the previously disadvantaged sector. Entrepreneurs and business owners are trained to be wary of unnecessary expenses and time consuming procedures that produce little bottom line value. Given the exorbitant rates charged by many large accounting firms, such suspicion is not unfounded. Many larger South African firms are now being forced to manage their accounting fees more judiciously, prompted by shareholders to re-evaluate whether or not expensive accounting services are producing any value (Temkin, 2003).

However, given the desperate need for further financial management support within the previously disadvantaged sector, one might assume that this trend dissipated with clients who lacked sophisticated financial understanding, and could not rely on large, in-house accounting departments. Instead, the opposite appears to be the case. Burdened by tight cash flows, and an often insufficient understanding of basic financial procedures, respondents explained that previously disadvantaged SME owners often regard accountants with even more suspicion, and use their services very sparingly. When accountants are employed, it is within the realm of very archetypal accounting procedures. The following response from a respondent working with one of South Africa's "Big Four" accounting firms further elaborates on this problem:

"[Previously disadvantaged clients] don't appreciate the possibility of value addition from accountants. There is serious potential there, but I think most of the time people use the services just because they have certain perceptions about it. And that becomes the only thing they want. But they don't think you can do more."<sup>56</sup>

However, even in light of these qualifications, the interviews suggest that accountants are often hamstrung by the reticent or stubborn attitudes of their clients. Frustrations tended to center around two different types of demeanors: those who were unable to understand the information and were not interested to learn; and those who were able to understand the information given to them but unwilling to heed the accountant's advice. Among the first grouping, respondents indicated that in

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<sup>56</sup> Interview 3: 13 December 2006

order to elevate their level of understanding, clients must, at a minimum, be committed to learning. As the following quotation depicts, this is not always the case:

“There are some that we work with on a monthly basis and who are really concerned with understanding. But the huge majority isn’t interested in understanding. They think as if they are employees that we need to get this next job done, but they don’t think of it as business owners – they have to also look at the financial side of things.”<sup>57</sup>

The most common example cited amongst those who were capable of understanding the financial information given to them, but unwilling to heed the advice (or inconsistent in its application), was with respect to cash flows.

“[I try] to explain, that you have a certain plan for your business. And from that information, we try to produce results. And we try to underestimate income and overestimate expenses. Your job as the owner of the businesses is to, as time progresses, compare your budget to your actual and vice versa. And to change or adjust your figures. They don’t do that. They don’t compare the actual to the budget. And if they did that, they would find that it might be distorted, it isn’t an acceptable range. And therefore, they must realize that their other projections after that must be aligned with what has happened thus far. But they don’t do that, and that’s what causes financial distress.”<sup>58</sup>

This tendency reveals a critical insight into the findings of the quantitative study. The data from the first analysis suggests that the external provision of cash flows was not associated with a decreased rate of financial distress. It seems that this could be caused by two trends on the part of the client: insufficient knowledge to understand these cash flows, as depicted in the earlier section on financial knowledge; or a dearth of commitment and action on the part of the client to utilize the cash flows appropriately.

When questioned about why it seemed that the external preparation of cash flows was not associated with alleviating financial distress, the responses were mixed. Some accountants indicated

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<sup>57</sup> Interview 1: 11 December 2006

<sup>58</sup> Interview 2: 12 December 2006

that they had no helpful explanation to offer – as far as they were concerned, businesses that planned proactively should be better able to avoid financial distress. Other respondents, however, were not surprised by the finding, and reported that often they had seen effective cash flow projections utilized incorrectly, or completely abandoned. Several stories surfaced which were similar to that of a business owner who believes that because the business plan reported that the company was profitable, the actual day-to-day operations must also be profitable. As the story recounts, this proved to be a costly mistake. But judging by the testimonials of many of the accountants interviewed, it is not an uncommon one. The following description provides a simple, but critical explanation of the dichotomy that often exists between preparation and follow-through:

“... cash flow forecasting helps a client know if they have a problem. They know that they need to plan ahead and to budget. But cash flow forecasting is only on paper. It needs to be implemented. And, if the attitude of the entrepreneur is of such a nature that he isn't too worried about what's on paper, or in the business plan, then it won't reduce financial distress. If a company has managed cash flow in an acceptable manner, you'll see that those companies don't always need lots of cash flow forecasting because it's an intrinsic part of what they are doing. Often companies just don't follow through. When you start doing that, it must be a mind shift. You need to change from the way you did things previously. If your attitude is not right, then that mind shift is not going to happen.”<sup>59</sup>

This testimonial is an effective reminder that the powers of an accountant are limited. Without a willing diligence on the part of the client to use financial metrics appropriately, and to take financial evaluations seriously, little can be done to ensure that the business stays healthy. Once again, the tendency to treat such procedures lightly probably stems in part from the clients' limited knowledge base. However, given the consistency of the responses which indicated that attitude was a large hurdle in providing effective service, it seems clear that poor behavior goes beyond a general lack of knowledge. In order for accountants to perform valuable work, they must have access to a capable and cooperative client base.

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<sup>59</sup> Interview 7: 15 December 2006

#### 4.4.2 Barriers on the Side of Financial Service Providers

While accountants were quick to point out the flaws in their previously disadvantaged clientele, they were more hesitant to suggest that problems may exist on the side of the financial management providers themselves. This is not surprising; in general, individuals are hesitant to assume blame without first having utilized all nearby channels to disperse it. Moreover, some of the questions pertaining to the findings of the quantitative study challenged the accountants' overall capacity for value addition, evoking responses that were at times defensive or stubborn. This too is understandable. The majority of respondents were entrepreneurs themselves, all of whom depended on their ability to garner sales from additional clients while also satisfying their current clientele. As a result, they will have been well versed in an ability to assure clients of their value addition – their livelihoods depend on it. It is important to note that such behavior should not necessarily be interpreted as disingenuous. Accountants offer services with real intrinsic value. Although the quality and type of these services may differ, accountants often have good reason to believe that the value they offer to clients is real. And many respondents made the market-based inference that if they didn't offer valuable services, their client-base would shrink. As one respondent indicated, most accountants were well aware that they weren't "the only shop in town."<sup>60</sup>

Moreover, respondents' perceptions of the difficulties their clients faced were generally accurate. Seven out of eight respondents indicated that they felt they had a strong understanding of their client's financial difficulties. In conjunction, there was a widespread understanding of the financial distress that exists amongst previously disadvantaged clientele – 5 out of 8 respondents reported that they worked with a large number of very financially unstable clients.

Nonetheless, several limitations surfaced on the part of accountants, some of which came to light through willing admissions, while others were discovered through discrepancies between the respondent answers' and the data depicted in the quantitative analysis. The two largest issues that surfaced from the accountants' side, which may be limiting the value of financial service provision are: 1) a varied perception of the main area of value addition provided by accountants, including the somewhat common perception that an accountant should not carry any responsibility for bettering the financial situation of a business; and 2) the inadequate provision of managerial advice. Once again, these trends were identified as a result of the high proportion of respondents who

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<sup>60</sup> Interview 4: 14 December 2006

independently raised them, as well as the high level of importance which respondents attributed to them. These proportions are featured in the sections below.

### An Accountant's Value Addition

Perceptions regarding an accountant's main area of value addition varied widely. While all respondents agreed on the overall importance of accounting, the basis of their explanations regarding *why* it was important were somewhat sporadic. Some respondents saw it as their role to educate clients and to develop relationships where they could help the business grow; others saw their role as entirely outsourced based – to free up capacity, or to perform a procedure which the business owners felt incapable of doing themselves.

Interestingly, the notion that an accountant should be focused on strengthening the financial stability of a client's business was not a unanimously shared assumption between respondents. Respondents were asked two questions which allowed them to elaborate on what they felt to be the primary responsibilities of an accountant: "Do you see assisting the owners in improving the financial performance of their businesses as part of your role?" And, "What do you perceive to be an accountant's main area of value addition for previously disadvantaged SMEs?"

Three out of eight respondents felt that it was not their role as accountants to help bolster the financial performance of a business. However, this finding seems inconsistent with elements of the rhetoric from other parts of these interviews. A few of the accountants in this group mentioned that they lamented their inability to provide added value addition, and were frustrated when clients refused to heed their advice; but when asked to comment on their own responsibilities as an accountant, stated that their roles had little to do with helping the business become financially better off. An accountant cannot be asked to solve the financial difficulties of a business alone, as is well depicted in the earlier testimonials regarding client behavior. But it would be fair to suggest that an accountant's role should be seen as a contributing factor on a pathway towards sound financial management. For if a service does little to benefit the financial health of a business, either directly or indirectly, one must logically ask, "why is it being undertaken in the first place?"

If accountants do not feel that they should be responsible for bettering the financial situation of a business, this gives some insight into the trends depicted in the first component of the research. The

combination of insufficient financial understanding on the part of the clients, coupled with the notion that some accountants do not feel any larger responsibility to aid in the financial wellbeing of the business, offers one possible explanation for why external financial management has little impact on alleviating financial distress. Essentially, some accountants simply do not feel that alleviating financial distress should be a main aim of accountancy.

Furthermore, only two of eight respondents mentioned the idea of helping business owners utilize funds more effectively in their assessment of an accountant's "main area of value addition for previously disadvantaged SMEs." Once again, this is somewhat incongruous with earlier remarks. Many answered that the primary role of an accountant was educational, or informative – to point out what the financial status of a business was, or to explain the process of VAT returns. As indicated previously, this may well be a function of the accountant's experience in dealing with previously disadvantaged SMEs. Because businesses in this community are plagued by problems at a very basic level, accountants may feel that the primary value they provide is relegated to a more basic set of procedures.

Regardless, it is noteworthy that many accountants did not include the idea of helping a business to use funds more creatively as a central component of their perception of value addition. In some instances, this was found to be the result of anxieties regarding liability:

"I tend not to give advice. You have to be careful with that unless you are a registered financial advisor. It's very difficult. All I try to do is to point out to them what options they have got available, and make sure they understand those options so they can make a choice and a decision that is going to be the right decision. I'm not in a place to say this is what you should do, but I can lay out the options so that it is clear for them, and so that it is often clear what the best option is. But at the end it is their decision, not mine."<sup>61</sup>

Perhaps, if the question had been asked in stages, it may have elicited a different set of responses – i.e., "Assuming that a business has a sound base of financial knowledge and record keeping, what do you perceive to be an accountant's main area of value addition?" Such phrasing would have allowed accountants to think of the higher-level analytical components of accounting, and may have elicited responses which included mention of a more sophisticated use of cash resources. However,

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<sup>61</sup> Interview 4: 14 December 2006

the “assumption” within the question would have eliminated a large component of the previously disadvantaged SME community, rendering it applicable only to a very different set of businesses.

This is not to say that all outsourced financial procedures do not offer some form of tangible benefit to the bottom line. There are instances in which the procedure itself can add substantial bottom line value, without added managerial guidance. Respondents suggested that the external preparation of purchase documentation is a good example. If an accountant is intricately involved in purchase documentation, they are in a good position to enable business owners to claim back taxes, and to ensure that no claims are missed.

“If people have kept good track of purchase documentation, then they can claim VAT. So keeping track of purchase documentation effectively reduces tax, and has huge benefits as far as income or claiming expenses.”<sup>62</sup>

A comparable explanation was offered in a later interview:

“[F]rom a VAT perspective, obviously you’ve got the ability to claim back money from your purchases, rather than from your sales. So you have more to gain there... certainly from a claiming back standpoint, I can see that as being beneficial.”<sup>63</sup>

This reveals a key insight into the findings of the quantitative component, and it illustrates the difference between outsourcing purchase documentation versus outsourcing sales documentation. The external provision of purchase documentation was found to be the one procedure which was associated with a positive rate of financial health. This seems, in part, to be the result of the accountants’ direct involvement with the procedure and the process of VAT returns. Their ability to point out rebates which the business owner might have missed contributes to cost savings, and directly impacts the financial condition of a business.

Sales documentation, while important, is a less direct process. It gives a business owner a clear understanding of historical sales and current outstanding debtor accounts. While the accountant can be helpful in the preparation of this document, he can do little to actively pursue outstanding debtors.

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<sup>62</sup> Interview 3: 13 December 2006

<sup>63</sup> Interview 8: 15 December 2006

Moving forward, one respondent suggested that it was important to consider the size of the business when evaluating an accountant's primary value addition. In doing so, he was one of the few who emphasized that an accountant should ultimately be aiming to create value for a company in the form of optimal financial management and wealth creation:

“When it grows to 50 people, then it becomes less an issue of affordability, but instead with how to derive value. If, at that stage, the service is still just trying to comply with regulatory standards, it isn't really adding value to the business. Then, at the higher level, people fully understand. But at the service in the middle, the service isn't necessarily appreciated, it's seen as a necessary evil. And I think it's probably because the training that accountants get encourages them to make sure that everything is in order and by the book. But you don't get awards for best corporate citizen in the country, I mean there is no sort of encouragement. It's just a given – but now you need to pay for it? That doesn't sound fair. So on the one hand I'm saying affordability – for the smaller end, but at the middle end, it's about a value proposition. It's about providing value and some form of business advice. If you're just doing basic bookkeeping at that sort of level, then that's a problem.”<sup>64</sup>

This explanation draws attention to the archetypal role which many accountants fall into. Accountants, he suggests, are often trained to adhere to a certain set of procedures. They see their role primarily as a resource to ensure compliance, and to streamline systems of record keeping. However, while these are important components of business operations, they do little to add to the bottom line of a business. The respondent's assertion that “you don't get awards for the best corporate citizen in the country,” is cryptic, but fair. Few financial rewards come with merely ensuring that a business is compliant. If an accountant fails to branch beyond these basics, the value to the business is limited and clients begin to see accounting as a necessary but relatively unhelpful expense. The respondent elaborated on this idea at a later stage in the interview:

“...unless you, as an accountant, step out of that normal perception of a role and comfortable framework, then it just continues to be like that... I'm saying that the accounting profession itself isn't stratified enough to allow people to pick and

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<sup>64</sup> Interview 3: 13 December 2006

choose the type of accounting that they need. From the start, the relationship must be structured correctly – what can you get? What can you give?”<sup>65</sup>

Because many accountants feel that it is not their responsibility to add value to the bottom line of a business, the nature of what many clients “get” is limited. This is clearly a result of the fact that the nature of what many accountants “give” is fairly one dimensional, and utilizes a relatively small aspect of their financial toolkit. These roles are reinforced by the expectations of clients, who see accountants as service providers, capable of creating deliverables, but little else. But it is in the interpretation and analysis of these deliverables where true value for the business lies. Accountants could see themselves as part of a mechanism that enables businesses to utilize cash more effectively, and to become more efficient and more profitable. The reality, though, is that this perception appears to be sporadic, which is one possible explanation for why the provision of external financial management services is so rarely associated with an increased rate of financial distress.

#### Managerial Advice

The provision of managerial advice to accompany financial services was sporadic. Respondents were free to interpret the concept of managerial advice in any manner, but were asked to expand on the nature of the advice if it was provided.<sup>66</sup> Generally, managerial advice entails a discussion in which the financial and regulatory knowledge of the accountant might be used to guide a business owner in future business decisions; the most appropriate manner to depreciate future asset purchases, for example, or how best to structure a new entity so as to shelter the business from risk. Such advice could also pertain to managing cash flows more appropriately, or to purchasing decisions. One respondent relayed a story in which he advised a client to use an excess of cash to begin buying stock in bulk because it would enable the business to negotiate a cheaper rate.<sup>67</sup>

Half of the respondents indicated that they did provide some form of managerial advice to clients. Of this group, only one reported to charge additional consulting fees. The remainder reported that while managerial advice was available, and could be provided at an additional charge, it was rare

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<sup>65</sup> Interview 3: 13 December 2006

<sup>66</sup> Respondents were asked: “To what extent are your services usually accompanied by managerial advice? And what is the nature of this advice?”

<sup>67</sup> Interview 1: 11 December 2006

that customers asked for it. This is a somewhat double-sided issue, and must be interpreted in context of the different motivations between accountants and business owners. It is surely likely that business owners from the previously disadvantaged community could benefit from increased managerial advice. However, if this advice comes with an additional fee – one which is often higher than the norm because it is filed under “consulting session” rates – then business owners would be justified in their hesitation to ask for these services.

The tendency to provide managerial advice often stemmed from the way in which accountants perceived the nature of their value addition. Those who felt that they had a responsibility to help the business succeed financially were more inclined to provide managerial advice as part of their services (i.e. without charging additional rates). Those who saw their role as largely process oriented felt that managerial sessions should be accompanied by additional fees. And, once again, many accountants assumed that because clients were not asking for the advice regularly, it was not needed:

“Managerial advice only really plays a part where planning takes place. Some of my clients, especially those that are financially stable, they normally engage with management accounts and discussions. But most clients are so involved in their business, that they don’t always take time out to look at management accounts and do planning.”<sup>68</sup>

Given the dearth of financial management skills within the previously disadvantaged SME community – revealed in both the quantitative and qualitative components of the study thus far – it is clear that increased managerial advice could play a large role in helping businesses to become more financially stable. Managerial sessions would be particularly helpful for business owners who lacked the financial understanding necessary to interpret the financial statements compiled by the accountants. Conversations following the preparation of VAT documents, for example, were quite rare. Often, in these instances, communication took place only between the clerk and the business owner, with the accountant intervening only if there was a problem of some kind. Surely, even a brief discussion regarding the importance of allocating funds for VAT payments might serve to bolster a client’s knowledge base, and save them from punitive payments to SARS in the future. Managerial sessions enable an accountant to express any problems they see with the business, and to guide a business owner accordingly.

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<sup>68</sup> Interview 7: 15 December 2006

Without these sessions, it is somewhat understandable that many clients do not report an increased tendency towards financial health after seeking help from an accountant. The services provided seem to be largely process oriented. Increased guidance in the form of standard management advice to accompany procedural accounting tasks would surely be of substantial benefit.

#### **4.4.3 Co-Dependent Barriers**

Some barriers which surfaced during the interviews fall into a middle category. They are neither attributable to the business owner, nor the accountant, but are an implicit element of the relationship between the two. Unfortunately, given the abovementioned tendencies exhibited by previously disadvantaged business owners and the accountants who cater to them, these inherent barriers are often exacerbated within the previously disadvantaged business community. Shortcomings on both sides serve to make elements of the relationship more difficult, and decrease the likelihood that the exchange will be valuable. The two primary co-dependant barriers observed were: 1) an overly acute sense of timing and expense; and 2) the historically focused nature of accounting. While a lower proportion of respondents highlighted these issues explicitly (4 and 3, respectively), they are representative of themes that ran across a majority of the interviews. Moreover, they are particularly salient in light of many of the quantitative findings from the first section of this study.

##### Timing and Expense – The “Sand Glass Timer”

All of the accountants interviewed were compensated based upon an hourly fee structure. For the most part, pricing rates were relatively consistent among respondents. With the exception of one outlier, all charges fell between R 250 and R 450 per hour. When describing fee structures, all respondents differentiated between the price of an accountant’s responsibilities versus those of a clerk. Pricing among clerks was even more consolidated than those for accountants, with all but one respondent reporting an hourly rate of between R 120 – R 150. The pricing data from respondents is depicted in Table 4.4-1.

Table 4.4-1: Hourly rates reported by respondents

Respondent	Hourly Rates	
	Accountant	Clerk
1	R 300	R 150
2	R 450	R 150
3	R 2000	R 300
4	R 300	R 120
5	R 300	R 120
6	R 250	R 120
7	R 250	R 150
8	N/A	N/A

In most exchanges between accountants and SME owners, it is likely that both sets of pricing are utilized. The clerk may compile data from sales receipts for VAT documentation, and the accountant may offer advice as to how best to save tax in the future; both rates would be charged in accordance with the hours required to perform these tasks.

While this is a relatively small sample, and is therefore only an indicative representation of what a more general stratification of pricing may look like, the fairly consolidated nature of the pricing suggests that the accounting field for this target market is competitive. It is difficult to comment further on appropriate pricing without a more thorough investigation into market demand. But the close range of pricing among this group of respondents suggests that customers have a consistent perception of how accounting services should be priced, and are not being widely exploited.

More interesting than the hourly rates of the accountants, is the manner in which the hourly fee structure shapes the exchange between accountants and SME owners. Many respondents felt that due to the hourly billing charges, previously disadvantaged clients were acutely aware of how much time they spent in billing sessions. This anxiety tended to result in rushed meetings, in which the deliverables from the accountant were exchanged quickly, but little time was allotted to anything else. One respondent used the analogy of an hourglass to better explain the trend: "A lot of us seem to work in a situation with a sand glass timer. And when a client comes to sit down, they are afraid of that time ticking away."<sup>69</sup>

<sup>69</sup> Interview 6: 14 December 2006

This phenomenon is certainly not unique to the previously disadvantaged community. Business owners worldwide complain about the high hourly rates of accountants. Like lawyers, they often find themselves at the tail end of jokes about “necessary evils.” However, in the previously disadvantaged community, this sense of rushed timing is perhaps even more heightened; and, as a result, more damaging. Suffering from widespread financial distress, and burdened by tight cash flows, previously disadvantaged business owners regard accountants with a heightened degree of suspicion. In some respects, this suspicion is warranted. It derives from a value exchange that is unbalanced within the previously disadvantaged community. The concept is well explained in the following summary:

“Services are based on time, multiplied by whatever rate, etc. So that time component tends to be much more out of proportion in relation to what you are really delivering [in the previously disadvantaged sector]. And if you think, it’s probably also linked to the fact that people in that sector might not have the financial sophistication, and therefore it takes a bit longer to deliver that service. I think it’s a different type of accountant that you need... There is too much emphasis on people who are way to qualified to assist businesses early on – you need another type of help.”<sup>70</sup>

In light of the often precarious nature of their financial situations, and the need for increased financial guidance, this is an unfortunate and counterproductive tendency. As illustrated earlier, business owners within the previously disadvantaged community suffer from a lack of basic skills and record keeping. Many are in dire need of further financial education, and accountants often end up playing the role of educator, which takes time. And time takes money. Other business owners, armed with a sound understanding of financial basics and adequate systems of record keeping, are not forced to pay for the added hours of consulting lessons. But many previously disadvantaged individuals do not have that luxury.

One respondent concluded that in order to learn the basics, business owners should seek alternative resources, without the high prices of accountants: “The truth is that people should go to the receiver

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<sup>70</sup> Interview 3: 13 December 2006

to learn these things.”<sup>71</sup> And while this respondent’s suggestion may be one possible remedy (he is speaking of the South African Revenue Service), his insight was not without qualification:

“The truth is that people should go to the receiver to learn... and get the lecture there. But I understand that if you are worried you haven’t been doing things appropriately, you don’t go straight to the police and ask them what are the rules of the country, and tell them that you’ve been committing transgressions.”<sup>72</sup>

The problem not only derives from an insufficient knowledge base on the part of the clients. Although clients are anxious about rates charged and time expended, accountants often do not allocate sufficient time to each client. In an effort to boost sales revenue and expand client bases, accountants often distill each client into hourly segments, leaving little room for additional out-of-the-office help. One respondent claimed that the insufficient allocation of time was a general problem among accountants, stating, “In fact, a lot of the accountants don’t give [clients] enough time... Time when they can really tell them what the problem is.”<sup>73</sup> Another respondent made a comparable admission, stating, “We don’t spend that much time on any specific client.”<sup>74</sup>

The combination of these forces results in a cycle that can be difficult to break. As indicated earlier, these trends are often exacerbated by existing conditions within the previously disadvantaged community. And both forces push the exchange further away from the value added service delivery which is needed.

### The Historical Focus of Accounting

When given the opportunity to reflect on limitations that were intrinsic to the field of accounting, a common theme emerged among respondents regarding the historically focused nature of accounting processes. Essentially, the majority of accounting procedures require an accountant to spend time tabulating information from the past. Most financial statements and VAT returns are processes which require an accountant to focus solely on a business’s historical performance. Although this is clearly an implicit component of accounting, the observation has important inferences regarding the

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<sup>71</sup> Interview 3: 13 December 2006

<sup>72</sup> Interview 3: 13 December 2006

<sup>73</sup> Interview 6: 14 December 2006

<sup>74</sup> Interview 5: 14 December 2006

potential for accountants to guide clients towards future financial success. These findings were supported by the data set from the first component of the research. Forward looking procedures, including cash flow forecasting and sales forecasting were much rarer than other procedures, regardless of whether they were performed in-house or outsourced.

One respondent differentiated between notions of standard accounting and management accounting, suggesting that procedures which required added foresight fall into the realm of management accounting:

“[W]hat is accounting really? Accounting is the process after everything has happened. And so what you need is more of a management accountant role, instead of a financial accountant role... The management accountant can give much better advice and be more hands on.”<sup>75</sup>

Essentially, the respondent was referring to the limited time which is spent focusing on how better to prepare clients for the future. Accounting, as a purely service driven exercise, offers little to business owners in the way of adding foresight. Managerial advice is critical in this regard. Both the accountant and the business owner get locked into archetypal roles of tabulating the past, rather than evaluating future decisions. This goes hand in hand with the provision of effective managerial advice. Managerial advice, by nature, requires an accountant to help the business owner evaluate current and future business decisions. If made correctly, these decisions can be of enormous benefit to business owners, and can translate into real bottom line value.

Unfortunately, a sound understanding of the past is a necessity when evaluating future business decision. And here-in, a difficult cycle emerges once again. Because many previously disadvantaged businesses struggle with the basics, accountants are unable to spend time on future decisions. Furthermore, many business owners approach accountants when things have already been deteriorating for some time. Several suggested that their clients that struggled the most often approached them only after it was too late (at which point the situations were often unsalvageable without incurring significant costs for the business owner):

“I think that a lot of those businesses start out without proper accounting support.

But then they need to get financing at some stage, but the banks require things of

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<sup>75</sup> Interview 7: 15 December 2006

them. And then I'd almost say that it's a bit too late. And then at that stage, a lot of things have been neglected, that now all needs to be fixed before you can then go on. And in that process, you get left behind. And I think in the market sector, for the previously disadvantaged individuals, that's most probably a big issue."<sup>76</sup>

Another respondent concurred with this assessment, stating, "a lot of [clients] come to you after they've begun to struggle, and that's often too late."<sup>77</sup> Once again, difficulties on both the side of the client and the accountant serve to impede the effective flow of valuable services. Accountants, by nature, must spend time on the past in order to better evaluate the future. However, many accountants get locked into process oriented roles, focusing almost exclusively on the past. This trend is worsened by the propensity of clients to approach accountants only after things have become very dire. At this stage, the accountant is forced to spend considerable time making up for the mistakes or negligence of the past, leaving less time for an analysis of the future.

#### **4.5 Qualitative Analysis Conclusions**

The findings of the qualitative analysis highlight many complexities in the relationship between accountants and previously disadvantaged SMEs. Successful relationships are predicated upon a number of pre-requisites, some of which are less common within the previously disadvantaged business community.

Respondents reported that three main issues on the part of previously disadvantaged clients impeded the effective transfer of quality services. These issues were as follows: 1) a low level of understanding of basic financial knowledge; 2) poor record keeping; and 3), detrimental attitudes or behavioral patterns. Respondents reported that their clients often lacked even a basic understanding of financial concepts. Although skilled in a particular trade or industry, many had no foundation of financial knowledge. Similarly, respondents reported universally that poor or nonexistent record keeping was a major concern. Accountants were often forced to go "back to basics," to ensure that records were being kept adequately. When combined with the widespread dearth of basic financial knowledge, this significantly limits the accountant's ability to provide sophisticated advice, and to add substantive value. Finally, respondents lamented the poor attitudes and behavior of some

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<sup>76</sup> Interview 3: 13 December 2006

<sup>77</sup> Interview 6: 14 December 2006

clients. This is likely due in part to the widespread lack of financial understanding. If clients do not understand financial procedures, it is difficult for them to attribute a high degree of importance to them. However, among those that do understand basic financials, clearly a level of diligence and openness to advice better enables them to leverage the information provided by accountants.

The two largest issues that surfaced from the accountants' side, which may be limiting the value of financial service provision were: 1) a varied perception of the main area of value addition provided by accountants, including the somewhat common perception that an accountant should not carry any responsibility for bettering the financial situation of a business; and 2) the inadequate provision of managerial advice. Once again, these trends were identified as a result of the proportion of respondents who independently raised them, as well as the high level of importance which respondents attributed to them. Three out of 8 respondents felt that it was not their responsibility to help bolster the financial performance of their clients. This suggests that the nature of the service that many clients receive may be inherently limited. Moreover, given the dearth of financial management skills within the previously disadvantaged SME community – revealed in both the quantitative and qualitative components of the study thus far – it is clear that increased managerial advice could play a role in helping businesses to become more financially stable. Without these sessions, it is somewhat understandable that many clients do not report an increased tendency towards financial health after seeking help from an accountant. It seems that even though accountants are often conscious of the problems which are impeding progress, some take little action to provide a remedy. A lack of focus on helping the bottom line of businesses, coupled with the insufficient provision of managerial advice does little to remedy the educational deficiencies of clients, or to remedy the impression that accountants do not provide value added services.

Finally, two co-dependent barriers emerged from the interviews. These were: 1) an overly acute sense of timing and expense; and 2) the historically focused nature of accounting. Unfortunately, given the abovementioned tendencies exhibited by previously disadvantaged business owners and the accountants who cater to them, these co-dependent barriers are often exacerbated within the previously disadvantaged business community. Shortcomings on both sides serve to make elements of the relationship more difficult, and decrease the likelihood that the exchange will be valuable. Many business owners are in need of further financial education, and accountants often end up playing the role of educator, which adds time and expense to their sessions. As depicted in the quantitative analysis, many previously disadvantaged business owners are hamstrung by tight cash flows, increasing their anxiety over expenditures to begin with. Moreover, accounting is by nature a

“backward looking” profession. Accountants must spend time on the past in order to better evaluate the future. However, many accountants get locked into process oriented roles, focusing almost exclusively on the past. This trend is worsened by the propensity of clients to approach accountants only after things have become very dire. Neither tendency encourages accountants and clients to begin preparing for the future together, further limiting the positive results that come from the exchange.

## 5. Complementary Conclusions

The previously disadvantaged SME community continues to suffer from widespread financial distress, and, in parallel, reports a greater rate of difficulty in accessing loan finance than the white owned business community. Moreover, it seems that the current provision of external financial services does not have a substantial impact on alleviating financial distress. With the exception of the external preparation of purchase documentation, external financial support was not found to be more beneficial to firms than performing the procedures in-house. In many instances, business owners who outsourced financial services were actually found to be worse off than those that performed the procedures in house; a trend which continued during an evaluation of success in applications for finance among previously disadvantaged SMEs.<sup>78</sup>

These findings are not intended to provide (and do not suggest) a blanket indication that the services of accountants are not valuable. Nor do they refute existing research which suggests that business development services (BDS) are best left to the private sector. They do indicate, however, that there are limitations to the private sector in this instance, born of both problems with the clientele as well as with the service providers. A more thorough qualitative analysis supports the quantitative findings regarding widespread financial distress, lending credibility to earlier conclusions. Respondents noted universally that insufficient financial knowledge and poor record keeping were widespread problems among their previously disadvantaged clientele. They also reported that a significant number of their clients were in precarious financial positions.

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<sup>78</sup> The findings concerning success in applying for finance were somewhat less conclusive than those of the section regarding financial distress, given limitations in the data.

The findings of the quantitative study should not be interpreted lightly. On the contrary, clients should be judicious when choosing to employ an external accountant. Some financial procedures contribute more directly to the financial bottom line of businesses, and are less prone to interpretive ambiguities on the part of the business owners. The external provision of purchase documentation was found to be the one procedure which was associated with a positive rate of financial health. This seems, in part, to be the result of the accountants' direct involvement with the procedure and the process of VAT returns. Their ability to point out rebates that the business owner might have missed contributes to cost savings, and directly impacts the financial condition of a business. Moreover, businesses should seek accountants that offer a degree of managerial advice, and maintain focus on how to add value to a business through tangible bottom line results. This also presents an important opportunity for accountants to distinguish themselves from competitors.

The quantitative analysis concluded with a series of exploratory possibilities for why external financial service provision was not found to have a more significant effect on alleviating financial distress. These possibilities included: 1) the quality of external service provision is low; 2) the services are not accompanied by sufficient managerial advice to result in true value addition to clients; 3) the services are overpriced, mitigating any value addition and rendering the exchange harmful to SMEs; 4) the SME owner often chooses to ignore the information and advice; or 5) the SME owner does not possess the knowledge needed to interpret and act on the information effectively. In an effort to provide a degree of complementarity between research components (quantitative and qualitative), the questionnaire for the qualitative analysis was designed to further investigate these possibilities. The qualitative findings should therefore be interpreted in light of a larger research question. The question being: "Given the widespread nature of financial distress in the previously disadvantaged community and the need for further financial administration skills, why aren't accountants having a more positive impact on the financial performance of SMEs in this sector?"

The qualitative analysis indicates that the relationships between external financial service providers and SMEs are complex, and burdened by a number of issues. Successful, value-creating relationships are predicated upon a number of elements which must be in place in order to extract value addition. These relationships are not impossible within the previously disadvantaged business sector, or even rare. But they require a few basic fundamentals.

First, from the business owners' side, insufficient financial knowledge and poor record keeping significantly detract from an accountant's ability to add value. A series of very basic fundamentals would greatly enhance the business owners' financial capabilities, which would likely have positive benefits on financial sustainability, as well as their ability to leverage the more advanced skills of accountants. Once a business has reached a healthy understanding of basic financial principals, an accountant is able to offer significantly more valuable services. The value derived from these services translates more effectively to the business's bottom line because the client is not forced to pay for the time to establish the basics. If clients do not possess a basic foundation of financial knowledge, or a sound system of record keeping, it is difficult to derive significant value from these relationships.

From the accountant's perspective, a greater focus on bettering the financial situation of a company, as well as ensuring that clients understand the information given to them would surely add value. However, a degree of hesitation regarding the provision of advice is somewhat understandable. As depicted in the qualitative analysis, many accountants are conscious of the liability that accompanies the role of a financial advisor. The larger focus from their end, instead, should be to maximize the number of productive working relationships. This entails a conscious intention to help existing clients, but also a wary eye for business owners whom they feel would be difficult to work with. Greater emphasis up front on choosing clients that would fit well into mutually supportive relationships would likely lead to more productive exchanges.

Finally, co-dependent barriers are often exacerbated by existing conditions. Accountants are forced to spend an increased amount of time with previously disadvantaged SMEs who do not possess a sound foundation of financial understanding, increasing the price of billing sessions and furthering the anxiety of the business owners. Moreover, neither party spends enough time analyzing how best to prepare for the future because they are bogged down in problems of the past. If the earlier trends – on both the side of the accountants and the side of the business owners – can be remedied or mitigated, these other co-dependent barriers would also subside, allowing for a more valuable transfer of services.

The combined findings reveal a difficult “catch twenty-two” for previously disadvantaged SME owners with limited financial education. Poor financial administration skills lead to poor financial health and reduced cash flows, limiting the resources available to pay for external expertise. Upon seeking help from external services, these SME owners are often forced to pay more – in the form

of extended sessions – to build a basic knowledge base, despite their constricted financial positions. Yet even with the prolonged billing sessions, they are often unable to leverage the more sophisticated skills of accounting professionals. In order to break this cycle, increased public provision of financial education is needed. In order for this section of the BDS market to function more efficiently, business owners must be endowed with a greater degree of financial expertise to begin with. Responsibility for these expertise cannot and should not fall to accountants alone. Bolstering the provision of financial and entrepreneurial education services would bridge the knowledge gap between SME owners and financial service providers. And rather than rendering financial service providers unneeded, it would better allow them to leverage the sophisticated financial toolbox at their disposal, furthering the benefits to previously disadvantaged clientele.

This research suggests that businesses have a huge amount to gain by building basic skills in-house. These skills allow business owners to use cash more efficiently (increasing the likelihood of long-term financial sustainability); to further enhance their eligibility for loan finance; and to leverage the more sophisticated financial skills of accountants. This combination is powerful and if employed more often, could have significant effects on future growth and employment generation within the previously disadvantaged SME community. These basic financial skills, therefore, should not be seen as supplemental to the skills needed to run a business, but rather as intrinsic components of the tool box necessary to establish sustainable operating conditions.

## Appendix A

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** WORLD BANK DATA ANALYSIS - STATA 9.2

** Note: 603 firms available. Only the manufacturing firms, as depicted in the
World Bank Report, Pg 5.
** Full report to be found at http://www.info.gov.za/otherdocs/2005/dti\_ica.pdf

** ETHNICITY

* Ethnic breakdown of firms sampled
* 1 Denotes African
* 2 Denotes European/Caucasian
* 3 Denotes Asian
* 6 Denotes Colored
* 7 Denotes "Other"

tab q5e

* Those who answered "other":

list q5e_x if q5e == 7

* Note: all respondents listed as "other" are included under the category of
previously disadvantaged businesses.

* New Variable Created:

*generate PrevDisadvBus =.
*replace PrevDisadvBus = 1 if q5e == 1| q5e == 3| q5e == 6| q5e == 7

** SIZE

* To get a list of size of firms included in sample: tab q10a
* Note: only 476 responses are available for the size question.

* New Variables Created:

*generate SMEs =.
*replace SMEs = 1 if (q10a>=10 & q10a <=99)
*generate PrevDisadvSME =.
*replace PrevDisadvSME =1 if SMEs ==1 & (q5e == 1| q5e == 3| q5e == 6| q5e == 7)
*generate NONPrevDisadvBus =.
*replace NONPrevDisadvBus = 1 if q5e == 2
*generate NONPrevDisadvSME =.
*replace NONPrevDiadvSME = 1 if SME ==1 & q5e == 2

** Note -- not all SMEs gave responses to the questions regarding race. This
brings the sample size down.

** PERCEPTIONS REGARDING FINANCING

* Perceptions regarding ACCESS to Finance
* 0 Denotes No Problem
* 1 Denotes Minor Obstacle
* 2 Denotes Moderate Obstacle
* 3 Denotes Major Obstacle
* 4 Denotes Very Severe Obstacle

tab c218k

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\* Perceptions regarding COST of Finance  
\* 0 Denotes No Problem  
\* 1 Denotes Minor Obstacle  
\* 2 Denotes Moderate Obstacle  
\* 3 Denotes Major Obstacle  
\* 4 Denotes Very Severe Obstacle

tab c218l

\* Perceptions regarding ACCESS to Finance among SMEs  
\* 0 Denotes No Problem  
\* 1 Denotes Minor Obstacle  
\* 2 Denotes Moderate Obstacle  
\* 3 Denotes Major Obstacle  
\* 4 Denotes Very Severe Obstacle

tab SMEs c218k

\* Perceptions regarding COST of Finance among SMEs  
\* 0 Denotes No Problem  
\* 1 Denotes Minor Obstacle  
\* 2 Denotes Moderate Obstacle  
\* 3 Denotes Major Obstacle  
\* 4 Denotes Very Severe Obstacle

tab SMEs c218l

\* Perceptions regarding ACCESS to Finance among PrevDisadvBus  
\* 0 Denotes No Problem  
\* 1 Denotes Minor Obstacle  
\* 2 Denotes Moderate Obstacle  
\* 3 Denotes Major Obstacle  
\* 4 Denotes Very Severe Obstacle

tab PrevDisadvBus c218k

\* Perceptions regarding COST of Finance among PrevDisadvBus  
\* 0 Denotes No Problem  
\* 1 Denotes Minor Obstacle  
\* 2 Denotes Moderate Obstacle  
\* 3 Denotes Major Obstacle  
\* 4 Denotes Very Severe Obstacle

tab PrevDisadvBus c218l

\* Perceptions regarding ACCESS to Finance among NONPrevDisadvBus  
\* 0 Denotes No Problem  
\* 1 Denotes Minor Obstacle  
\* 2 Denotes Moderate Obstacle  
\* 3 Denotes Major Obstacle  
\* 4 Denotes Very Severe Obstacle

tab NONPrevDisadvBus c218k

\* Perceptions regarding ACCESS to Finance among NONPrevDisadvBus  
\* 0 Denotes No Problem  
\* 1 Denotes Minor Obstacle  
\* 2 Denotes Moderate Obstacle  
\* 3 Denotes Major Obstacle  
\* 4 Denotes Very Severe Obstacle

tab NONPrevDisadvBus c218l

\* Perceptions regarding ACCESS to Finance among PrevDisadvSME  
 \* 0 Denotes No Problem  
 \* 1 Denotes Minor Obstacle  
 \* 2 Denotes Moderate Obstacle  
 \* 3 Denotes Major Obstacle  
 \* 4 Denotes Very Severe Obstacle

tab PrevDisadvSME c218k

\* Perceptions regarding COST of Finance among PrevDisadvSME  
 \* 0 Denotes No Problem  
 \* 1 Denotes Minor Obstacle  
 \* 2 Denotes Moderate Obstacle  
 \* 3 Denotes Major Obstacle  
 \* 4 Denotes Very Severe Obstacle

tab PrevDisadvSME c218l

\* Perceptions regarding ACCESS to Finance among NONPrevDisadvSME  
 \* 0 Denotes No Problem  
 \* 1 Denotes Minor Obstacle  
 \* 2 Denotes Moderate Obstacle  
 \* 3 Denotes Major Obstacle  
 \* 4 Denotes Very Severe Obstacle

tab NONPrevDisadvSME c218k

\* Perceptions regarding COST of Finance among NONPrevDisadvSME  
 \* 0 Denotes No Problem  
 \* 1 Denotes Minor Obstacle  
 \* 2 Denotes Moderate Obstacle  
 \* 3 Denotes Major Obstacle  
 \* 4 Denotes Very Severe Obstacle

tab NONPrevDisadvSME c218l

\*\* EXPERIENCE REGARDING FINANCING

\*\* 1 Denotes Yes, they have applied for a loan.  
 \*\* 2 Denotes No, they have never applied for a loan.

\* Breakdown of businesses that have or have not applied for a loan.  
 tab q28a

\* Breakdown of SMEs that have or have not applied for loan.  
 tab SMEs q28a

\* Breakdown of PrevDisadvBus that have or have not applied for a loan.  
 tab PrevDisadvBus q28a

\* Breakdown of NONPrevDisadvBus that have or have not applied for a loan.  
 tab NONPrevDisadvBus q28a

\* Breakdown of PrevDisadvSME that have or have not applied for a loan.  
 tab PrevDisadvSME q28a

\* Breakdown of NONPrevDisadvSME that have or have not applied for a loan.  
 tab NONPrevDisadvSME q28a

\* Breakdown of businesses who did not apply for a loan because they didn't think they would get one.

\*\* Note: No responses for the following section.

```

tab q28b5

* Breakdown of SMEs who did not apply for a loan because they didn't think they
would get one.
tab SMEs q28b5

* Breakdown of PrevDisadvBus who did not apply for a loan because they didn't
think they would get one.
tab PrevDisadvBus q28b5

* Breakdown of NONPrevDisadvBus who did not apply for a loan because they didn't
think they would get one.
tab NONPrevDisadvBus q28b5

* Breakdown of PrevDisadvSME who did not apply for a loan because they didn't
think they would get one.
tab PrevDisadvSME q28b5

* Breakdown of NONPrevDisadvSME who did not apply for a loan because they didn't
think they would get one.
tab NONPrevDisadvSME q28b5

* Breakdown of businesses that have or have not been rejected for a loan.
* 1 Denotes Yes, they have been rejected.
* 2 Denotes No, they have NOT been rejected.
tab q30a

* Breakdown of SMEs that have or have not been rejected for a loan.
* 1 Denotes Yes, they have been rejected.
* 2 Denotes No, they have NOT been rejected.

tab SMEs q30a

* Breakdown of PrevDisadvBus that have or have not been rejected for a loan.
* 1 Denotes Yes, they have been rejected.
* 2 Denotes No, they have NOT been rejected.

tab PrevDisadvBus q30a

* Breakdown of NONPrevDisadvBus that have or have not been rejected for a loan.
* 1 Denotes Yes, they have been rejected.
* 2 Denotes No, they have NOT been rejected.

tab NONPrevDisadvBus q30a

* Breakdown of PrevDisadvSME that have or have not been rejected for a loan.
* 1 Denotes Yes, they have been rejected.
* 2 Denotes No, they have NOT been rejected.

tab PrevDisadvSME q30a

* Breakdown of NONPrevDisadvSME that have or have not been rejected for a loan.
* 1 Denotes Yes, they have been rejected.
* 2 Denotes No, they have NOT been rejected.

tab NONPrevDisadvSME q30a

** MANN WHITNEY TESTS FOR STATISTICAL SIGNIFICANCE

*generate EthnicitySME=.
*replace EthnicitySME=1 if PrevDisadvSME ==1
*replace EthnicitySME=0 if NONPrevDisadvSME ==1

```

## Appendix B

```

** GEM DATA ANALYSIS - STATA 9.2

**OVERALL FINANCIAL DISTRESS ANALYSIS

*Those who have an overdraft and a breakdown of those who have exhausted their
overdraft in the last 6 months.
tab exhodraf

*Exhausted credit card facility in last 6 months
tab exhcredc

*Unable to pay wages in the last 12 months
tab unablewa

*Generated profit in the last 3 months
tab profit_i

*Enough cash on hand to cover costs in last 6 months
tab cashcove

**VAT RECORDS AND EXTERNAL SERVICE PROVISION

*Does the business produce VAT records?
tab vatrecor

*Who prepares these VAT records?
*External preparation of VAT records now labeled "ExternalVAT"
tab whoprevt

*Exhausted overdraft by preparation of VAT records
tab whoprevt exhodraf if (exhodraf == 1| exhodraf ==2)

*Exhausted overdraft of those who had external accountants prepare VAT records
*External preparation of VAT records with access to overdraft now labeled
"ExternalVATwithODraft"
tab exhodraf if (whoprevt == 6 & (exhodraf == 1| exhodraf ==2))

*Exhausted overdraft of those who DID NOT have external accountants prepare VAT
records
tab exhodraf if (whoprevt != 6 & (exhodraf == 1| exhodraf ==2))

*Exhausted overdraft of those who performed VAT records INTERNALLY.
tab exhodraf if (whoprevt == 1| whoprevt == 2| whoprevt ==3| whoprevt ==4) &
(exhodraf == 1| exhodraf ==2)

** New variable generated:
*VATPrepIntVersusExt =.
*replace VATPrepIntVersusExt = 1 if whoprevt == 6
*replace VATPrepIntVersusExt = 0 if (whoprevt == 1| whoprevt == 2| whoprevt ==3|
whoprevt ==4)

* -- MANN WHITNEY TEST --

ranksum exhodraf, by (VATPrepIntVersusExt)

*Ability to cover costs by preparation of VAT records
tab whoprevt cashcove

```

```
*Ability to cover costs with cash on hand for those who used external preparation
of VAT records
tab cashcove if whoprevt == 6
```

```
*Ability to cover costs with cash on hand for those who DID NOT have external
accountants prepare VAT records
tab cashcove if whoprevt != 6
```

```
*Ability to cover costs with cash on hand of those who performed VAT records
INTERNALLY.
tab cashcove if (whoprevt == 1| whoprevt == 2| whoprevt ==3| whoprevt ==4)
```

```
*Profitability by preparation of VAT records
tab whoprevt profit_i
```

```
*Profitability over the last 3 months for those who used external preparation of
VAT records
tab profit_i if whoprevt == 6
```

```
*Profitability over the last 3 months for those who DID NOT use external
preparation of VAT records
tab profit_i if whoprevt != 6
```

```
*Profitability over the last 3 months for those who performed VAT records
INTERNALLY.
tab profit_i if (whoprevt == 1| whoprevt == 2| whoprevt ==3| whoprevt ==4)
```

```
*Ability to pay wages by preparation of VAT records
tab whoprevt unablewa
```

```
*Ability to pay wages for those who used external preparation of VAT records
tab unablewa if whoprevt == 6
```

```
*Ability to pay wages for those who DID NOT use external preparation of VAT
records
tab unablewa if whoprevt != 6
```

```
*Ability to pay wages for those who performed VAT records INTERNALLY.
tab unablewa if (whoprevt == 1| whoprevt == 2| whoprevt ==3| whoprevt ==4)
```

```
*Success in applications for financing for those who used external preparation of
VAT records
tab finsucc if whoprevt ==6
```

```
*Success in applications for financing for those who DID NOT use external
preparation of VAT records
tab finsucc if whoprevt !=6
```

```
*Success in applications for financing for those who performed VAT records
INTERNALLY.
tab finsucc if (whoprevt == 1| whoprevt == 2| whoprevt ==3| whoprevt ==4)
```

```
* -- MANN WHITNEY TEST --
```

```
ranksum finsucc, by (VATPrepIntVersusExt)
```

```
**SALES RECORDS AND EXTERNAL SERVICE PROVISION
```

```
*Does the business produce sales records?
tab sales_re
```

```

*Who prepared these sales records?
*Note: Very few used external accounting for this procedure which is not
surprising. Mostly an exercise performed in house.
  tab whoprep1

*Who prepared the sales compilation document? (Note: This document is different
from sales records).
  tab whoprep2

*Exhausted overdraft by preparation of sales compilation document.
*External preparation of sales tracking document now labeled
"ExternalCompSalesRec"
tab whoprep2 exhodraf

*Exhausted overdraft of those who had external accountants prepare sales
compilation document.
*External preparation of sales compilation document with access to overdraft now
labeled "ExternalCompSalesRecwithODraft"
tab exhodraf if whoprep2 == 6 & (exhodraf == 1| exhodraf ==2)

*Exhausted overdraft of those who DID NOT have external accountants prepare sales
compilation document.
tab exhodraf if whoprep2 != 6 & (exhodraf == 1| exhodraf ==2)

*Exhausted overdraft of those who performed the sales compilation document
INTERNALLY.
tab exhodraf if (whoprep2 == 1| whoprep2 == 2| whoprep2 ==3| whoprep2 ==4|
whoprep2 ==7) & (exhodraf == 1| exhodraf ==2)

** New variable generated:
*generate SalesCompIntVersusExt =.
*replace SalesCompIntVersusExt = 1 if whoprep2 == 6
*replace SalesCompIntVersusExt = 0 if (whoprep2 == 1| whoprep2 == 2| whoprep2
==3| whoprep2 ==4| whoprep2 ==7)

* -- MANN WHITNEY TEST --

ranksum exhodraf, by (SalesCompIntVersusExt)

*Note: Findings not found to be statistically significant.

*Ability to cover costs by preparation of sales compilation document.
tab whoprep2 cashcove

*Ability to cover costs with cash on hand for those who used external preparation
of sales compilation document.
tab cashcove if whoprep2 == 6

*Ability to cover costs with cash on hand for those who DID NOT have external
accountants prepare sales compilation document.
tab cashcove if whoprep2 != 6

*Ability to cover costs with cash on hand those who performed the sales
compilation document INTERNALLY.
tab cashcove if (whoprep2 == 1| whoprep2 == 2| whoprep2 ==3| whoprep2 ==4|
whoprep2 ==7)

*Profitability by preparation of sales compilation document.
tab whoprep2 profit_i

*Profitability over the last 3 months for those who used external preparation of
sales compilation document.

```

```

tab profit_i if whoprep2 == 6

*Profitability over the last 3 months for those who DID NOT use external
preparation sales compilation document.
tab profit_i if whoprep2 != 6

*Profitability over the last 3 months for those who performed the sales
compilation document INTERNALLY.
tab profit_i if (whoprep2 == 1| whoprep2 == 2| whoprep2 ==3| whoprep2 ==4|
whoprep2 ==7)

*Ability to pay wages by preparation of sales compilation document.
tab whoprep2 unablewa

*Ability to pay wages for those who used external preparation of sales
compilation document.
tab unablewa if whoprep2 == 6

*Ability to pay wages for those who DID NOT use external preparation of sales
compilation document.
tab unablewa if whoprep2 != 6

*Profitability over the last 3 months for those who performed the sales
compilation document INTERNALLY.
tab unablewa if (whoprep2 == 1| whoprep2 == 2| whoprep2 ==3| whoprep2 ==4|
whoprep2 ==7)

*Success in applications for financing for those who used external preparation of
sales compilation document.
tab finsucc if whoprep2 ==6

*Success in applications for financing for those who DID NOT use external
preparation of sales compilation document.
tab finsucc if whoprep2 !=6

*Success in applications for financing for those who performed the sales
compilation document INTERNALLY.
tab finsucc if (whoprep2 == 1| whoprep2 == 2| whoprep2 ==3| whoprep2 ==4|
whoprep2 ==7)

* -- MANN WHITNEY TEST --

ranksum finsucc, by (SalesCompIntVersusExt)

**PURCHASE RECORDS AND EXTERNAL SERVICE PROVISION

*Does the business produce purchase records?
tab purchase

*Who prepared these purchase records?
*Note: Very few used external accounting for this procedure which is not
surprising. Mostly an exercise performed in house.
  tab whoprep3

*Who prepared the purchase compilation document? (Note: This document is
different from purchase records).
tab who_prep

*Exhausted overdraft by preparation of purchase compilation document.
*External preparation of purchase tracking document now labeled
"ExternalCompPurchRec"

```

```

tab who_prep exhodraf

*Exhausted overdraft of those who had external accountants prepare purchase
compilation document.
*External preparation of purchase compilation document with access to overdraft
now labeled "ExternalCompPurchRecwithODraft"
tab exhodraf if who_prep == 6 & (exhodraf == 1| exhodraf ==2)

*Exhausted overdraft of those who DID NOT have external accountants prepare
purchase compilation document.
tab exhodraf if who_prep != 6 & (exhodraf == 1| exhodraf ==2)

*Exhausted overdraft of those who performed the purchase compilation document
INTERNALLY.
tab exhodraf if (who_prep== 1| who_prep == 2| who_prep ==3| who_prep ==4|
who_prep ==7| who_prep ==10| who_prep ==11| who_prep ==12) & (exhodraf == 1|
exhodraf ==2)

** New variable generated:
*generate PurchCompIntVersusExt =.
*replace PurchCompIntVersusExt= 1 if who_prep == 6
*replace PurchCompIntVersusExt= 0 if (who_prep== 1| who_prep == 2| who_prep ==3|
who_prep ==4| who_prep ==7| who_prep ==10| who_prep ==11| who_prep ==12)

* -- MANN WHITNEY TEST --

ranksum exhodraf, by (PurchCompIntVersusExt)

* Note: Findings not found to be statistically significant.

*Ability to cover costs by preparation of purchase compilation document.
tab who_prep cashcove

*Ability to cover costs with cash on hand for those who used external preparation
of purchase compilation document.
tab cashcove if who_prep == 6

*Ability to cover costs with cash on hand for those who DID NOT have external
accountants prepare purchase compilation document. f who_prep != 6
tab cashcove if who_prep != 6

*Ability to cover costs with cash on hand for those who performed the purchase
compilation document INTERNALLY.
tab cashcove if (who_prep== 1| who_prep == 2| who_prep ==3| who_prep ==4|
who_prep ==7| who_prep ==10| who_prep ==11| who_prep ==12)

*Profitability by preparation of purchase compilation document.
tab who_prep profit_i

*Profitability over the last 3 months for those who used external preparation of
purchase compilation document.
tab profit_i if who_prep == 6

*Profitability over the last 3 months for those who DID NOT use external
preparation for purchase compilation document.
tab profit_i if who_prep != 6

*Profitability over the last 3 months for those who performed the purchase
compilation document INTERNALLY.
tab profit_i if (who_prep== 1| who_prep == 2| who_prep ==3| who_prep ==4|
who_prep ==7| who_prep ==10| who_prep ==11| who_prep ==12)

*Ability to pay wages by preparation of purchase compilation document.

```

```

tab who_prep unablewa

*Ability to pay wages for those who used external preparation of purchase
compilation document.
tab unablewa if who_prep == 6

*Ability to pay wages for those who DID NOT use external preparation of purchase
compilation document.
tab unablewa if who_prep != 6

*Ability to pay wages for those who performed the purchase compilation document
INTERNALLY.
tab unablewa if (who_prep== 1| who_prep == 2| who_prep ==3| who_prep ==4|
who_prep ==7| who_prep ==10| who_prep ==11| who_prep ==12)

*Success in applications for financing for those who used external preparation of
purchase compilation document.
tab finsucc if who_prep ==6

*Success in applications for financing for those who DID NOT use external
preparation of purchase compilation document.
tab finsucc if who_prep !=6

*Success in applications for those who performed the purchase compilation
document INTERNALLY.
tab finsucc if (who_prep == 1| who_prep == 2| who_prep ==3| who_prep ==4|
who_prep ==7| who_prep ==10| who_prep ==11| who_prep ==12)

** CASH FLOW RECORDS AND EXTERNAL SERVICE PROVISION

*Does the business produce cash flow records?
tab cashreco

*Who prepared these cash flow records?
tab whoprepc

*Exhausted overdraft by preparation of cash flow records.
*External preparation of cash flow records now labeled "ExternalCashFlowRec"
tab whoprepc exhodraf

*Exhausted overdraft of those who had external accountants prepare cash flow
records.
*External preparation of cash flow records. with access to overdraft now labeled
"ExternalCashFlowRecwithODraft"
tab exhodraf if whoprepc == 6 & (exhodraf == 1| exhodraf ==2)

*Exhausted overdraft of those who DID NOT have external accountants prepare cash
flow records.
tab exhodraf if whoprepc != 6 & (exhodraf == 1| exhodraf ==2)

*Exhausted overdraft of those who performed cash flow records INTERNALLY.
tab exhodraf if (whoprepc == 1| whoprepc == 2| whoprepc ==3| whoprepc ==4|
whoprepc ==9) & (exhodraf == 1| exhodraf ==2)

** New variable generated:
*generate CashFlowRecIntVersusExt =.
*replace CashFlowRecIntVersusExt= 1 if whoprepc == 6
*replace CashFlowRecIntVersusExt= 0 if (whoprepc == 1| whoprepc == 2| whoprepc
==3| whoprepc ==4| whoprepc ==9)

* -- MANN WHITNEY TEST --

```

ranksum exhodraf, by (CashFlowRecIntVersusExt)

\*Note: not found to be statistically significant. (Samples size getting quite small).

\*Ability to cover costs by preparation of cash flow records.  
tab whoprepc cashcove

\*Ability to cover costs with cash on hand for those who used external preparation of cash flow records.  
tab cashcove if whoprepc == 6

\*Ability to cover costs with cash on hand for those who DID NOT have external accountants prepare cash flow records.  
tab cashcove if whoprepc != 6

\*Ability to cover costs with cash on hand for those who performed cash flow records INTERNALLY.  
tab cashcove if (whoprepc == 1| whoprepc == 2| whoprepc ==3| whoprepc ==4| whoprepc ==9)

\*Profitability by preparation of cash flow records.  
tab whoprepc profit\_i

\*Profitability over the last 3 months for those who used external preparation of cash flow records.  
tab profit\_i if whoprepc == 6

\*Profitability over the last 3 months for those who DID NOT use external preparation cash flow records.  
tab profit\_i if whoprepc != 6

\*Profitability over the last 3 months for those who performed cash flow records INTERNALLY.  
tab profit\_i if (whoprepc == 1| whoprepc == 2| whoprepc ==3| whoprepc ==4| whoprepc ==9)

\*Ability to pay wages by preparation of cash flow records.  
tab whoprepc unablewa

\*Ability to pay wages for those who used external preparation of cash flow records.  
tab unablewa if whoprepc == 6

\*Ability to pay wages for those who DID NOT use external preparation of cash flow records.  
tab unablewa if whoprepc != 6

\*Ability to pay wages for those who performed cash flow records INTERNALLY.  
tab unablewa if (whoprepc == 1| whoprepc == 2| whoprepc ==3| whoprepc ==4| whoprepc ==9)

\*Success in applications for financing for those who used external preparation of cash flow records.  
tab finsucc if whoprepc ==6

\*Success in applications for financing for those who DID NOT use external preparation of cash flow records.  
tab finsucc if whoprepc !=6

\*Success in applications for financing for those who performed cash flow records INTERNALLY.

```
tab finsucc if (whoprepc == 1| whoprepc == 2| whoprepc ==3| whoprepc ==4|
whoprepc ==9)
```

```
** CASH FLOW FORECASTING AND EXTERNAL SERVICE PROVISION
```

```
*Who prepares the business's cash flow forecasts?
```

```
*Note: there is no question inquiring whether or not the business produces cash
flow forecasts. It must be derived from answers to this question.
```

```
tab whprepcf
```

```
*Exhausted overdraft by preparation of cash flow forecasts.
```

```
*External preparation of cash flow forecasts now labeled "ExternalCashFlowFor"
```

```
tab whprepcf exhodraf
```

```
*Exhausted overdraft of those who had external accountants prepare cash flow
forecasts.
```

```
*External preparation of cash flow records. with access to overdraft now labeled
"ExternalCashFlowForwithODraft"
```

```
tab exhodraf if whprepcf == 6 & (exhodraf == 1| exhodraf ==2)
```

```
*Exhausted overdraft of those who DID NOT have external accountants prepare cash
flow forecasts.
```

```
tab exhodraf if whprepcf != 6 & (exhodraf == 1| exhodraf ==2)
```

```
*Exhausted overdraft of those who performed cash flow forecasts INTERNALLY.
```

```
tab exhodraf if (whprepcf == 1| whprepcf == 2| whprepcf ==3| whprepcf ==4) &
(exhodraf == 1| exhodraf ==2)
```

```
** New variable generated:
```

```
*generate CashFlowForIntVersusExt =.
```

```
*replace CashFlowForIntVersusExt= 1 if whprepcf == 6
```

```
*replace CashFlowForIntVersusExt= 0 if (whprepcf == 1| whprepcf == 2| whprepcf
==3| whprepcf ==4)
```

```
* -- MANN WHITNEY TEST --
```

```
ranksum exhodraf, by (CashFlowForIntVersusExt)
```

```
** Note: not found to be statistically significant (sample sizes getting quite
small).
```

```
*Ability to cover costs by preparation of cash flow forecasts.
```

```
tab whprepcf cashcove
```

## Appendix C

### Basic Questionnaire for Semi-Structured Interviews with External Service Providers

#### General questions:

- What do you perceive to be the largest barrier to providing effective accounting services to previously disadvantaged SMEs?
- What services do previously disadvantaged SMEs most often approach you for?
- What level of understanding do you have of the financial difficulties of your clients?
- How often do your clients tend to suffer from financial distress?
- To what extent are your services usually accompanied by managerial advice?
- What is your hourly billing rate?
- Do you see it as your role as an accountant to assist owners in improving the financial performance of their business?
- If so, how effective do you feel that you are in that regard?
- What factors, if any, make it harder for you to have a positive impact on the performance of your clients?
- Are there any financial procedures in particular in which you feel that clients have an extra amount to gain in using an external accountant?
- Are there any areas of financial administration or management in which you feel that an accountant can only offer limited value?
- What do you see as an accountant's main area of value addition for previously disadvantaged SMEs?

#### Questions based on quantitative findings:

- Overall, our research has indicated that the provision of external accounting services is not associated with a decreased rate of financial distress among previously disadvantaged SMEs. Is this a surprising conclusion for you? If so, why? If not, do you have any insight on why this trend exists?
- The preparation of VAT documentation was the most commonly outsourced procedure. However, businesses that sought help with this procedure did not mitigate the probability of financial distress. Does this finding make sense to you? What do you feel is the main value addition in outsourcing VAT documentation?
- Businesses who sought external help with purchase documentation were much more likely to avoid financial distress, whereas those who sought help with sales documentation were not. How would you interpret this finding?
- It seems that businesses who seek external help with more complicated financial procedures, including cash flow forecasting, do not reduce their chances of financial distress. Why do you think this might be the case?

## Appendix D

### An Analysis of External Financial Services Among Previously Disadvantaged SMEs

#### Research Consent Form

I volunteer to participate in a research project by Julian Simcock from the University of Cape Town. I understand that the project is designed to gather information and interpretations from accountants who cater to previously disadvantaged SMEs. I will be one of approximately 10 people being interviewed for this research.

1. My participation in this project is voluntary. I understand that I will not be paid for my participation. I may withdraw and discontinue participation at any time without penalty. If I decline to participate or withdraw from the study, there will be no repercussions and no one will be told.
2. If I feel uncomfortable in any way during the interview session, I have the right to decline to answer any question or to end the interview.
3. Participation involves being interviewed by the principal researcher on the project, Julian Simcock. The interview will last approximately 30-45 minutes. Notes will be written during the interview. An audio tape of the interview and subsequent dialogue will be made. If I don't want to be taped, I will not be able to participate in the study.
4. I understand that the researcher will not identify me by name in any reports using information obtained from this interview, and that my confidentiality as a participant in this study will remain secure. Subsequent uses of records and data will be subject to standard data use policies which protect the anonymity of individuals and institutions.
5. I understand that my employer affiliation has no bearing on this interview. The consent of my employer is therefore not necessary, as this information will be not be used in the final tabulation of these interviews.
6. I understand that none of the other interview participants will have access to the information recorded in this conversation. Nor will any of my colleagues or members of the accounting profession. This precaution will prevent my individual comments from having any negative repercussions.
7. I understand that this research study has been reviewed and approved by the UCT Commerce Research Ethics Commerce Committee. For research problems or questions, this group may be contacted through Justine Burns at the UCT Department of Economics.
8. I have read and understand the explanation provided to me. I have had all my questions answered to my satisfaction, and I voluntarily agree to participate in this study.
9. I have been given a copy of this consent form.

\_\_\_\_\_  
My Signature

\_\_\_\_\_  
Date

\_\_\_\_\_  
My Printed Name

\_\_\_\_\_  
Signature of the Investigator

For further information, please contact:  
Julian Simcock  
073 242 3577

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