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## **STRATEGIC MANAGEMENT PRACTICES AND FINANCIAL PERFORMANCE: AN EXPLORATORY STUDY OF SMALL BUSINESSES IN TERENGGANU.**

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### **ABSTRACT**

*This study is based upon a pilot test conducted on small entrepreneurs during a Financial Management course conducted at Yayasan Pembangunan Usahawan, Kuala Terengganu on May 2000. The purpose of this research is to study the relationship between strategic management practices of small businesses and the impact on their financial performance. The interrelationship between entrepreneur characteristics, entrepreneur objectives, business environment, strategic management practices adopted and financial performance were analysed. Samples were analysed using reliability analysis, cross tabs, correlation and regression. The result shows that generally there is no significant relationship between financial performance and strategic management performance adopted by small businesses. However, entrepreneur characteristics were found to have a significant relationship with business strategies in comparison to entrepreneur objectives. Among the small businesses, government contractors were found to utilise low supplier bargaining power to obtain cheaper source of finance. Other interesting findings include strong emphasis on planning strategies by high financial performers. While average financial performers tend to focus on aggressive marketing strategies and Porter's generic strategies.*

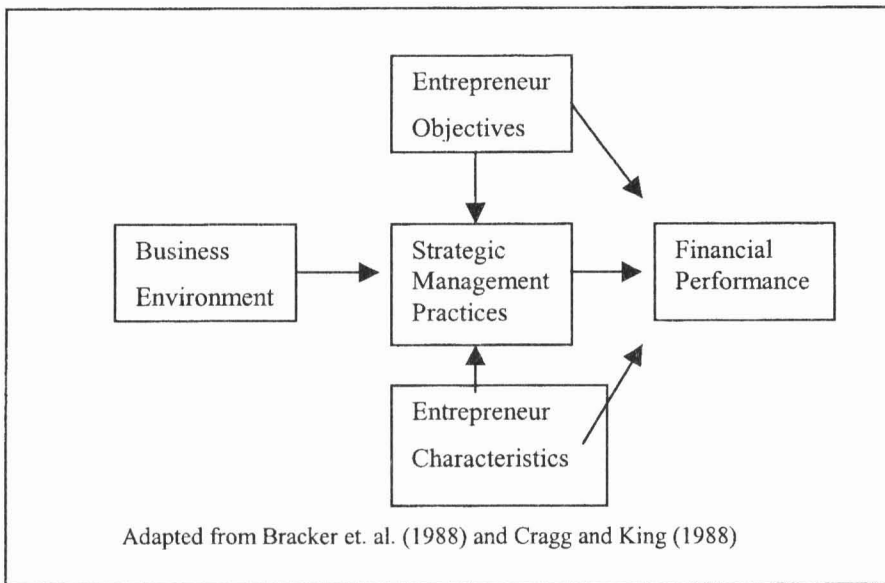
Keywords: *Strategic management practices, small business, business strategy, financial performance.*

### **INTRODUCTION**

Small and medium-sized enterprises (SMEs) play an important role in the national economy especially in business unit development, job creation opportunities and contribution to economic output (Hashim, 2000). Extensive research has been undertaken on this subject in developed countries. On the contrary, a limited attempt has been made to study SMEs from the strategic management point of view in developing countries.

This paper attempts to study the relationship between strategic management practices of small businesses and the impact on their financial performance. The theoretical framework was based upon the conceptual models developed by Keats and Bracker (1988) and Cragg and King (1988). Both models attempted to provide a comprehensive framework of various success factors that determine small business performance. Within the context of local businesses, the models have been simplified to address the relationship between entrepreneur characteristics and objectives, business environment, strategic management practices and financial performance (Figure 1).

Figure 1. Factors that influence the financial performance of small businesses



This model demonstrates that the possible main constructs directly affecting financial performance are entrepreneur objectives, entrepreneur characteristics and strategic management practices. Strategic management practices in turn are influenced by entrepreneur objectives, entrepreneur characteristics and business environment.

As this is an exploratory study, there are obviously many limitations. The main one is probably the small sample size (i.e. 20) is not representative of the actual population. Nevertheless, it is hoped that this study will shed some light to the factors that may have contributed to the success of small businesses.

## MATERIALS AND METHODS

### Subject

This pilot study was conducted on 45 entrepreneurs. Each participant was given a questionnaire to complete. Out of 45 respondents, 20 were selected. The remaining samples were rejected because they did not fulfil the required criteria such as respondent must be the owner or employee with senior decision making capability, the business has being operating for at least 5 years and the number of employees must be less than 50 (according to small business definition by Ministry of International Trade and Industry). According to Bracker et. al. (1988) and Covin and Slevin (1989), many researchers agree that 5 years is a sufficient period to evaluate the performance of small firms as they have survived the most critical years.

### Instrumentation

The questionnaire is based on a similar study conducted by David Gadenne (1998) on small businesses in Australia. However to obtain valuable insight on the applicability of strategic management factors that influences local small businesses, an interview session was conducted with a local entrepreneur. Furthermore, a discussion on the questionnaire content and design was conducted with an official of the **state entrepreneurial development agency (MARA)** to determine the suitability of the questionnaire within the context of local small businesses. Finally we had also consulted an experienced researcher on small businesses to validate and give valuable comments to improve the questionnaire design. In all cases, some items were modified and some others were omitted as they were unsuitable to local conditions.

The questionnaire was divided into 6 main areas. The first one is company profile and the rest represent constructs from the model. They are entrepreneur characteristics, entrepreneur objectives, business environment, strategic management practices and

company's financial performance. With the exception the company profile all the other areas utilise 5 point likert scale for measurement. A mean of all the items in each area was computed to indicate the strength of each category. A low strength is indicated by a mean of below 3. Similarly, a high strength is indicated by a mean of above 3.

Company profile addresses questions concerning demographic factors about the business such as location, number of employees, type of business and type of customers.

Entrepreneur characteristics consist of 5 items that are entrepreneur ambition, leadership, creativity, risk taking and self-confidence. Entrepreneur objectives are measured by profit making, market dominance, job satisfaction, contribution to society, business stability and survival.

Business environment analysis consist of 23 items which attempt to capture the business scenario by identifying the firm internal and external environment in terms of operating scenario, economic, human resource, competitive, buyer and supplier bargaining power. A mean of above 3 shows that business environment is favourable and vice versa.

Business strategic practices consist of 26 items which were designed to identify the strategic management practices that have been applied by small businesses such as Porter's generic strategy, marketing, human resource, research and development, operation, planning and financial strategies. All the strategic management practices were adopted from Gadenne (1998) with the exception of Porter's generic strategies that were taken from Bowman (1992). A mean above 3 would indicate that proactive strategies have been adopted while a mean below 3 indicates reactive strategies.

Four items were used to measure financial performance within the last three years; annual sales growth, net profit before tax, return on investment and overall financial performance. Other researchers such as Bracker et. al. (1988), Cheston and Mangles (1997) and Rue and Ibrahim (1998) have adopted similar measurements and agreed that three years is an adequate period to measure the financial performance of small businesses. Furthermore, Covin and Slevin (1989) has concluded that many past research have proven that using objective measures as an indicator of financial performance for small businesses is not practical and could be misleading. Hence, in this case a 5 point likert scale was used to measure financial performance.

### Statistical Techniques used

The data were analysed using SPSS Version 10.05. Among the techniques used are data descriptive, reliability analysis, cross-tabulation and correlation

### Questionnaire Design

Since this is an exploratory study, a reliability analysis was conducted to test the validity of the questionnaire design. With the exception of business environment section all the other sections produce alpha values of greater than 0.5 (Table 1).

Table 1. Mean of the main constructs

Constructs	No. of items	Mean	Std. Dev.	Alpha
Entrepreneur characteristics	5	4.00	0.65	.90
Entrepreneur objectives	6	4.31	0.85	.92
Business environment	23	3.12	0.24	.22
Business strategy	26	3.57	0.32	.66
Financial performance	4	3.69	0.57	.88

The business environment section produces an alpha value of a disappointing 0.22. The item to item correlation shows a mixture of positives and negatives. In our view segregating the positive and negative items would not produce any meaningful combination of items or factors. Furthermore, we believe that the unreliable alpha value might be attributed to the similarity of the questions in this section with the business strategy section. Hence, in the final study we have decided to replace the questions in this section with a clearer means of capturing environmental hostility as practised by Tan and Litschert (1994). In their questionnaire, respondents were directly requested to rate environmental hostility factors such as competitors, customers, suppliers, technological, economic and social-culture.

## **RESULTS AND DISCUSSION**

### **Company Profile**

More than 63 percent of the small businesses in the study have permanent and contract employees of less than 5. Therefore, most of the samples in this study are in the micro segment of SMEs. 45 percent were private limited companies and the balance being sole proprietors and partnerships. Moreover most of these firms were either retailers (42%) or government contractors (47.4%).

### **Financial Performance**

The sample distribution of the mean of financial performance showed a skewness of less than 1, with the mean, medium and mode close to each other. This indicates that the distribution is normal. The minimum and maximum performance were 3 and 4.75 respectively. The ratio of distribution between samples with financial performance of 3 to 4 and those with financial performance of 4 to 4.75 is almost equal at 55% to 45%. Therefore, for the purpose of this study we have classified the samples into 2 categories; average performers with a mean of financial performance between 3 and 4, and high performers which have a financial performance mean of greater than 4. Interestingly, there were no low performers or those with a financial performance mean of less than 3. This is expected as being participants of the financial management course, they were presumably more motivated to succeed financially. Clearly, the absence of low performers is one of the limitations of this study.

### **Cross-tabulation**

A cross-tabulation was conducted to identify any significant patterns between type of business and type of customers with the mean of financial performance. Chi-square test shows that there are no significant difference between performance of sole traders, private limited companies and partnerships. Similarly, there are no significant difference between financial performance and type of customers. However, most high performers are from private limited companies (55.5%) and government contractor (55.5%). Therefore, further analysis need to be conducted on these two groups of high performers to identify the factors that could contribute to their success.

### **Correlation**

A correlation was performed on the mean of the 5 constructs in this study; entrepreneur characteristics, entrepreneur objectives, business environment factors, business strategy and financial performance. Due to the small sample size (i.e. 20), spearman's non-parametric correlation was used. Surprisingly, there are no significant relationships between these constructs and financial performance (Table 2). In short, these variables do not have any direct affect on the financial performance of small businesses. These results are in contrast to that of Miller and Cardinal (1994). However, other well-known researchers such as Greenley (1986) and Mintzberg (1990) had argued that planning does not generally benefit performance. Nevertheless, at this stage it is too early to make a conclusion on this area particularly with regards to the small sample size in this study.

Table 2. Correlation among the mean of constructs

Constructs	Entrepreneur Characteristics	Entrepreneur Objectives	Business Environment	Business Strategy	Financial Performance
Ent. Characteristics	1.00	.306	.325	.689**	.030
Ent. Objectives	.306	1.00	.328	.451*	.133
Bus. Environment	.325	.328	1.00	.735**	-.094
Bus. Strategy	.689**	.451*	.735**	1.00	.088
Financial Performance	.030	.133	-.094	.088	1.00

\*\* Correlation is significant at 0.01 level (1-tailed)

\* Correlation is significant at 0.05 level (1-tailed)

Despite that the results exhibited some findings worthy of further analysis. Entrepreneur characteristics and business strategy has demonstrated a significant correlation at 0.01 level. This result is contrary to the findings of Gadenne (1998) but similar with previous research (Perry et. al., 1988 and Burns, 1990). A less significant correlation at 0.05 level was also observed between entrepreneur objective and business strategy. Therefore, there is a strong indication that high entrepreneur characteristic and motivation among small businesses does produce proactive strategies although there is no evidence that their efforts lead to better performance. The results may be consistent with the findings of Bracker et. al. (1988) who suggested that opportunistic entrepreneurs are more likely to adopt sophisticated strategic management practices. Another interesting finding is the significant correlation at 0.01 level between business environment and business strategy. It seems that the environment that a business operate does have some influence on the type of strategies adopted by small businesses.

*Correlation on components of business environment and business strategy.*

To facilitate a more detail analysis, items under business environment and business strategy section were grouped together into smaller components. Hence, business environment is further divided into human resource, competitive, supplier and buyer bargaining power, and economic scenario. Business strategies are broken into Porter’s generic strategy, marketing, human resource, planning, finance and source of supply. Correlation analysis on the mean of these components was performed. Table 3 exhibits significant correlation at 0.05 level between entrepreneur characteristic and strategies of marketing (which includes factors such as improvement of products, customer service, customer needs awareness and aggressive marketing), human resource (assessment of employee performance, reward system, staff training and staff involvement in decision making) and planning (preparation of written plans, budgets and forecasts, comparison of actual results with plans/budgets and corrective action). Similarly, entrepreneur objectives were found to be correlated at 0.05 level with marketing and human resource strategies. As expected, highly entrepreneurial and motivated entrepreneurs were found to adopt proactive marketing, human resource and planning strategies.

Table 3. Correlation among business strategy components and entrepreneur characteristics and objectives

strategies	Marketing strategies	Human Resource strategies	Planning
Ent. Characteristics	.415*	.436*	.394*
Ent. Objectives	.479*	.437*	-.070

\*\* Correlation is significant at 0.01 level (1-tailed)

\* Correlation is significant at 0.05 level (1-tailed)

Within private limited companies and high performers, significant correlation at 0.01 level was observed between entrepreneur characteristics and planning strategies (Table 4). Hence, in these two groups, those who exhibit high entrepreneurial characteristics seem to emphasise more on planning strategies such as budget preparation, variance analysis and control. This is reasonable as private limited companies are more

organised than sole proprietors and partnerships since they have to comply with various regulations. However, there is no indication that planning contributes to higher financial performance. This may be attributed to the small sample size in this study.

Table 4. Correlation among business environment components and business strategy components for private limited companies, high performers and average performers

	<u>Private limited co.s</u>	<u>High performers</u>	<u>Average performers</u>	
	Planning	Planning	Marketing	Porter's
	Strategies	strategies	strategies	
	strategies			
Ent. Characteristics	.770**	.788**	.653*	.283
Ent. Objectives	-.057	.585	.542*	-.372
Financial Performance	na	-.0582	-.118	.572*

\*\* Correlation is significant at 0.01 level (1-tailed)

\* Correlation is significant at 0.05 level (1-tailed)

Average performers have demonstrated significant correlation at 0.05 level between entrepreneur characteristic and marketing strategies, entrepreneur objective and marketing strategies and between Porter's generic strategy and financial performance. It follows that highly entrepreneurial and motivated entrepreneurs among average performers were found to emphasise on aggressive marketing strategies. However there is no direct link between marketing strategies and financial performance. Among the various business strategies, only Porter's generic strategy (cost control, competitive pricing, product variety, uniqueness of product and product development) exhibited a significant relationship with financial performance. This is in accordance with the findings of Gadenne (1998) whereby a combination of price cuts, low costs and quality products contributed towards higher performance.

Table 5 shows that among government contractors, significant correlation at 0.01 level was observed between supplier bargaining power (related to not dependant on single supplier and supplier reliability) and financial strategies (secure cheaper source of finance and reinvest profits ). Correlation at 0.05 level was also observed between supplier bargaining power and Porter's generic strategy. This may indicate that government contractors utilised low supplier bargaining power to obtain cheaper source of finance and present more competitive bids for tender. Furthermore, a correlation at 0.05 level between competitive environment and financial performance supports the view that those operating in low competitive environment seem to perform better.

Table 5. Correlation among business environment components and business strategy components for government contractors

Business environment	Porter's strategy	Financial strategies	Financial
performance			
Competitive	-.161	-.121	
.609*			
Supplier bargaining power	.594*	.879**	
-.214			

\*\* Correlation is significant at 0.01 level (1-tailed)

\* Correlation is significant at 0.05 level (1-tailed)

To conclude, the results may indicate that high performers and private limited companies view proactive planning strategies (preparation of written plans, budgets and forecasts, comparison of actual results with plans/budgets and corrective action) as vital to their success. One plausible explanation is that in order to qualify for financial assistance by the government, small businesses are required to attend government approved entrepreneurial courses whereby much emphasis was given on strategic operational planning. On the other hand, average performers rely more on marketing strategies (product improvement, customer service, customer needs awareness and aggressive marketing) to improve performance. It appears that

average performers prefer a more 'straightforward and less hustle' approach by focusing directly on their customers. However, this study does not provide any evidence that the planning and marketing strategies adopted so far were effective tools for their financial success. This may be due to the limitations of this study particularly the small sample size involved. Hence, it is hoped that the final study would produce a clearer picture of this relationship. On the other hand, average performers were found to successfully utilise Porter's generic strategy to improve their financial performance. Alternatively, the result may indicate that average performers may have been adopting a sales growth or market expansion strategy that may require them to sacrifice short term profits for longer run gains. Among government contractors, low supplier bargaining power were probably utilised to obtain cheaper source of finance and present more competitive bids for tender.

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