THE ROLE OF ACCOUNTING INFORMATION IN THE SUCCESS OF SMALL & MEDIUM ENTERPRISES (SMEs) IN NORTH CAROLINA

by

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Abstract

This study examines what accounting knowledge is lacking in the average SME business owner, and how those gaps may inhibit business success. This research found that business owners were able to complete algebraic problems relating to breakeven analysis and inventory control but struggled in correctly identifying accounts, performing journal entries, and understanding the importance of internal controls. These findings highlight a lack of basic accounting knowledge such as bookkeeping and financial statement comprehension. Additionally, this research uncovered that most business owners are not directly involved in the accounting of their business, instead utilizing the professional services of a certified public accountant. While the sample size was limited, the results emphasize the potential benefit of further research in this area, to eventually provide SME owners with the knowledge and financial literacy necessary to gain competitive advantage and grow sustainably.

1. Introduction

The personal touch of an entrepreneur on the accounting practices of their small to medium-sized enterprise (SME) can be the deciding force between success and failure (Ahmad, 2017). A lack of knowledge makes it difficult to be personally involved in the accounting activities of their business and a lack of free time reduces the likely hood of learning this knowledge. This can be explained by looking at where most business professionals received their accounting education. High school education seems to lack adequately conveying this knowledge, considering only 2% of accountants stopped their educational journey after attaining a high school diploma (Zippia, n.d.). According to the United States Census Bureau, about a quarter of business owners in America have not attended college, leaving a large minority of entrepreneurs with an inadequate understanding of accounting (Bureau, 2023). If one does decide to attend college, majoring in a subject other than accounting seems to inhibit the retention of accounting information. According to Knight (2015), only 40% of non-accounting business students can achieve an A or B in an accounting course compared to 75% of accounting students achieving an A or B (Knight, 2015). Non-accounting students also experience “little interaction with professional accountants and relatively little interaction with accounting,”(Knight et al., 2021, p. 6). From this, we can reasonably expect a large disconnect between non-accounting focused business owners and applicable accounting knowledge. As SMEs have increased sensitivity to changes in the business environment when compared to large enterprises, entrepreneurs must understand and implement accounting practices to gain a competitive advantage (Srbinoska et al. 2020).

Small to medium enterprises are the backbone of most economies around the world. They make up the majority of all businesses no matter what stage in the economic lifecycle a country may be in (Ahmad, 2017). SMEs have a very positive impact on a nation’s economy as economically developed countries can attribute over half of their GDP to SMEs (Arnold, 2019). This is evidenced by the fact that in the United States, “around 98% of export activities are triggered by SMEs”. (Ahmad, 2017, p. 2). They also provide many job opportunities, consisting of almost half of private sector employment in the U.S. (Beasley, 2023). SMEs can provide very specific jobs as well as provoke industry specialization (Ahmad, 2017). Without small businesses, the economy would lose a great amount of innovation and job creation. To start a small business, however, and manage it successfully is a challenging endeavor, as about half of small businesses fail within the first five years of operation (Beasley, 2023). This can be attributed to amateurish record keeping as Schiff & Szendi (2014) note that most users of QuickBooks, an accounting software tailored to self-employed individuals, do not have the understanding to effectively record transactions (Schiff & Szendi, 2014). This leads to low-quality financial statements that "may create a significant obstacle for an evaluation of creditworthiness” (Waniak-Michalak, 2017, para. 26). These difficulties of entrepreneurship are known to influence the mental health of business owners. High levels of stress are common among the self-employed due to the substantial number of responsibilities burdening entrepreneurs according to Cardon & Patel (2013). This stress can lead to health problems and dysfunctional coping (Cardon & Patel, 2013). To limit this stress and increase competitive advantage, entrepreneurs can focus on specific accounting practices that will help them record the present and plan for the future with reliable and applicable data. By executing a study to learn the knowledge gaps concerning bookkeeping, budgeting, product costing, tax preparation, and other managerial accounting practices, we will be able to provide SMEs with the knowledge that will give them a greater probability of success.

2. Background

No matter what business is in question, an understanding of cash flow is extremely important when making current and future decisions. Cashflow activities should be classified as either operating, investing, or financing activities (Christie & Brozovsky, 2010). By correctly classifying and tracking these activities, managers and owners get a better understanding of their financial position in terms of cash. Entrepreneurs need to focus on this area of their business considering “sixty-one percent of small businesses worldwide struggle with cash flow” (Goldman, 2021, para. 1). This struggle can inhibit external financing according to Beasley (2023) as they found over a quarter of small business owners reported the inability to find sufficient capital for operations (Beasley, 2023). The insufficient cash on hand only adds to the problems faced by entrepreneurs, increasing stress and the likelihood of failure. When over one-third of small businesses are at risk of not being able to afford payroll, much less outside vendors, a change to cash flow management must be implemented (Beasley, 2023). One of the easiest ways to control cash flow is to accurately keep the financial records of the business.

Financial statements are extremely useful tools for business managers. SMEs have the option of creating more simplified statements than larger firms, though they still harbor relevant financial information (Waniak-Michalak, 2017). This is because the reporting standards that are required for public companies are often overly complex and costly to adhere to (James, 2012). A correctly prepared financial statement can "provide useful information about the financial position, performance, and cash flows of an entity" (Christie & Brozovsky, 2010, p. 4). They also positively contribute when attempting to obtain external financing by providing quality information to creditors decreasing credit risk (Waniak-Michalak, 2017). According to Schiff & Szendi (2014), to begin keeping good financial records, it is essential to create a ledger of accounts and understand how these accounts interact with one another. This can be difficult as "most entrepreneurs, particularly those who are just getting started, lack the expertise to fine-tune these accounts for their specific business" (Schiff & Szendi, 2014, para. 8). The next goal of financial reporting is correctly logging journal entries. This is a big problem for non-accountant entrepreneurs as over half the time spent by accounting professionals is attributed to correcting mistakes made by the client (Schiff & Szendi, 2014). Correction of this will not only reduce professional and legal expenses but will also increase an entrepreneur's personal understanding of the numbers behind the business.

Entrepreneurs and business owners have the tendency to look to the future optimistically. An assessment of the creditworthiness of a business is much higher when done as a self-assessment by an entrepreneur than when done by a potential creditor (Waniak-Michalak, 2017).

Optimism is a good trait to have but when decisions are made based on pure optimism rather than relevant and correct data, a small business can be negatively affected.

3. Purpose of the Study and Research Question

Small to medium-sized enterprises are at a greater risk of failure than well-established businesses (Beasley, 2023). Because of this, any research that can be done to boost the probability of success will greatly help the owners of SMEs. A survey of SMEs in Eastern North Carolina can provide insight into the level of accounting knowledge of SME owners and potentially identify gaps in this knowledge that lead to inadequate business practices. Ahmad (2017) identified a significant relationship between costing and budgeting systems and financial performance. This research only looked at managerial accounting practices but failed to examine the effect of basic accounting knowledge such as record keeping, and more advanced concepts such as tax accounting practices and depreciation methods. It is imperative to understand the level of basic accounting knowledge, as most small to medium-sized business owners cannot effectively record the operations of their business through personal accounting (Schiff & Szendi, 2014). It is also necessary to identify the advanced accounting practices that can help business owners as Bruce and Gurley-Calvez (2014), found that a large amount of deprecation benefits are forgone annually by businesses who don't know about the benefits (Bruce & Gurley-Calvez, 2014). By educating business owners on the topics of accounting necessary to manage an SME, those business owners will have the ability to succeed, improving the economy and creating more jobs. This study seeks to generate interest in the accounting knowledge of SME owners and can lead to further research on the topic of SME accounting standards and best practices. This motivates the research question: What are the specific areas in accounting that are incomplete in the knowledge of small business owners that may lead to competitive advantage and increased probability of success if they were known?

4. Thesis

A lack of managerial accounting and tax accounting knowledge by SME owners leads to inadequate record-keeping and irrational assumptions on the business increasing risk of failure.

5. Methodology

This research gathers data from SMEs across Eastern North Carolina. In this research, an SME will be considered as an enterprise with less than 100 employees and less than ten million dollars in assets on its balance sheet. These specifications were chosen as the IRS defines a small business as having 10 million dollars or less in assets, and similar countries such as Canada have defined their small businesses as having less than 100 employees (Liberto, 2023). The United States does not have a set number of employees in the definition of an SME, stating that the type of work a firm is involved in determines how many employees are needed in small vs. large businesses (Liberto, 2023). This research employes qualitative and quantitative approaches, specifically using an online survey and utilizing semi-structured interviews. The survey was developed using prior surveys of similar participants that relate to small business and accounting. The interviews were conducted after the survey was taken by the participant, at the will of the participant, to obtain more detailed information than the survey could provide.

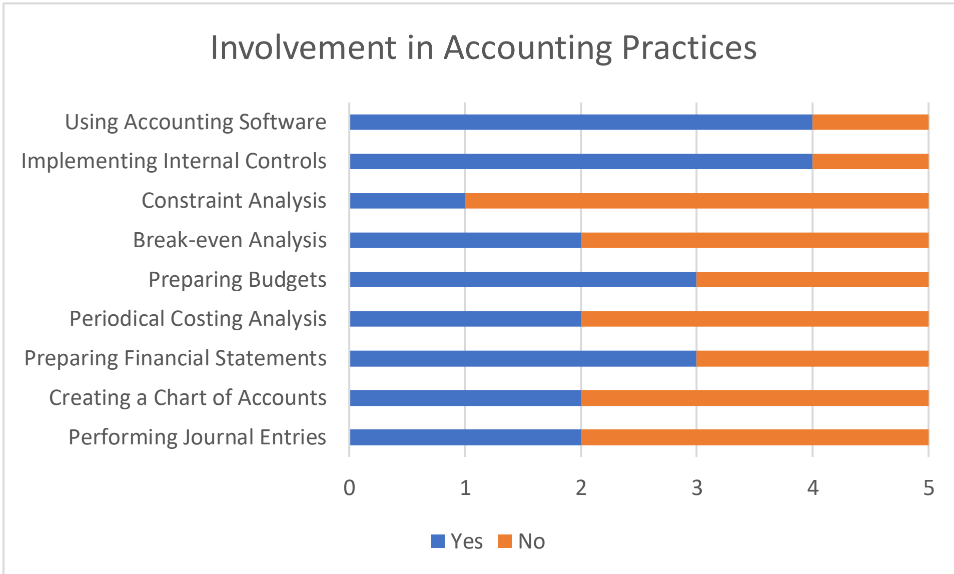
6. Data

It is important to acknowledge that the sample size of participants was fairly limited. Despite efforts to achieve a large sample size of small to medium sized business owners, there is great difficulty in achieving survey participation. The limited free time of SME owners proved to be a critical challenge in increasing response rate. For this reason, the results of this study may not be applicable to the entire population of SME owners.

The distributed survey collected responses from five SME owners in North Carolina. From the participants sampled, two were male, two were female, and one chose not to identify their gender. One of the respondents was of African American decent, and four of the respondents were ethnically white. Every respondent was a college graduate, with two respondents having master's degrees and the other three having bachelor's degrees. Four of these degrees were in a field besides accounting, while one respondent does have an accounting degree. Of the five business owners, four are in the industry of professional services, while the other one is in the industrial sector. The age ranges of the business owners and their businesses had a large variance. For the ages of the participants, one is aged 20-29, one in between 40-49, two from 50-59, and one that is older than 70. As for the ages of the businesses, one is less than a year old, one is from 5-9 years old, two are aged between 10-20 years, and one has been in operation for more than 20 years.

All five of the SME owners were profitable in the years 2021, 2022, and 2023. Each business had between 0-4 employees for all three years. For the years of 2021 and 2022, one business owner had revenue in the range of $0-$999, two were in the range of $1,000-$49,999 and two were between $50,000-$199,999. In 2023, three of the participants had revenues between $1,000-$49,999 while two still had revenues between $50,000-$199,999. The total assets owned by each business followed a similar trajectory. In 2021 and 2022, two businesses had $0-$999, two had $1,000-$49,999, and one had between $50,000-$199,999 in total assets. This changed in 2023 as one participant moved from having $0-$999 to $1,000-$49,999 in assets.

7. Results and Analysis



The first goal of this survey was to determine how involved SME owners are in the accounting processes of their business. As can be seen in the chart of respondents, based on the questions asked in the survey, SME owners are 51.11% likely to be involved in an accounting practice and 48.89% likely to not be involved. When analyzing the specific accounting practices, survey respondents are less likely to be involved in bookkeeping responsibilities such as performing journal entries and creating a chart of accounts. Three out of the five respondents are not involved in these practices, giving reason to Schiff & Szendi's claim that most hours billed by a CPA are used to clean up the client's files (2014). They are also less likely to be involved in managerial accounting practices such as constraint analysis, costing analysis, and break-even analysis. A lack of involvement in these practices limits the SME owner's ability to accurately plan and budget cashflows to achieve their goals. As already mentioned, budgeting and costing analysis have a significant relationship with financial performance (Ahmad, 2017). For this reason, it is disturbing to notice that of the five respondents, not one business owner thinks budgets should be revised monthly to track spending, which happens to be the suggestion of Heaslip at United States Chamber of Commerce (Heaslip, 2024). Even though three of the five respondents are involved in budgeting, they are not performing the practice on a consistent schedule. Using basic accounting software and implementing internal controls are practices that four out of the five survey respondents are involved in. Even though business owners may not be directly involved in journal entries and bookkeeping, they still use accounting software at times in their day-to-day operations. It is not unexpected that a majority of the SME owners are involved in the implementation of internal control, considering each business has less than five employees, reducing the risk associated with keeping a large workforce. Of the five respondents surveyed, four clearly define roles and responsibilities of employees and two perform bank reconciliations. It should be noted that the survey provided internal control answer options of separation of duties, internal audits, and sign-off approvals, which all had a zero-response rate. This shows a lack of understanding of the necessary controls to mitigate financial and fraud risk.

The second goal of this survey was to get an idea of how accurately SME owners can solve basic accounting questions. The first question asked participants to determine the correct journal entry for the following situation: “A firm receives $10,000 in cash for services to be performed at a later date.” This question was asked to determine how accurately SME owners can perform a basic bookkeeping entry that they may come across in their operations. Only two of the five respondents answered with the correct journal entry of “Debit Cash for $10,000 and Credit Unearned Service Revenue.” This lack of bookkeeping knowledge directly contributes to larger professional accounting costs. Considering half the time spent by professional accountants is spent correcting client mistakes, a better understanding of journal entries will help reduce these large expenses. The next question asked participants to identify the financial statement that harbors certain accounts. The accounts were as follows: Assets, Liabilities, Expenses, Shareholder’s Equity, and Income. Every survey respondent correctly identified income as belonging to the income statement. Four of the five respondents correctly stated that shareholder’s equity is found on the balance sheet. Three of the five respondents correctly identified assets and liabilities as belonging to the balance sheet and expenses as belonging to the income statement. It is noticed that the 66.67% correct response rate for assets, liabilities and expenses give evidence to the claim that SME owners just starting out may find difficultly classifying certain accounts and tailoring them to their specific business (Schiff & Szendi, 2014). This also shows a lack of truly understanding financial statements which may lead to inaccurate statements, disrupting the ability for these SME owners to find available credit, which is so necessary when just starting out (Waniak-Michalak, 2017).

The next two questions in the survey focused on basic quantitative skills. The first quantitative questions asked respondents to determine the cost of goods purchased during a period while providing values for the beginning inventory ($100,000), ending inventory ($200,000), and cost of goods sold ($500,000). Four of the five participants correctly answered $600,000 for this question. Next the quantitative question asked participants to determine the break-even point in units for a product, based on the price of the product ($25), the variable cost of the product ($10), and the fixed cost of the business ($90,000). Four of the five SME owners correctly answered this question with the answer of 6,000 units. The high rate of correct answers for these two problems implies that when given basic algebraic math equations, SME owners have the intuition and critical thinking skills necessary to correctly solve problems, even when provided in a word problem format.

Lastly, two questions were asked pertaining to internal control. The first question asked whether it was true or false that "The person who records journal entries should have unrestricted access to the business' cash." All five of the SME owners answered correctly, stating the claim was false. Critics may claim it is somewhat obvious that these duties should be separated, but it should be remembered that not one survey respondent stated they utilize separation of duties in their own business. The next question asked survey respondents how often bank reconciliation should be performed. Two of the five participants correctly answered monthly to this question, while one respondent claimed weekly and two claimed daily. It should be noted that no respondent picked the option of yearly, which would be the most concerning option. Most business professionals, including the Office of the Washington State Auditors, claim that bank reconciliations should be performed monthly or even more frequently, if possible (Office, 2020). The survey responses to this question show good understanding on behalf of the participants of the importance of the frequency of this control. It should be remembered that even though the respondents understand the importance of this control, only two of the five claim to regularly perform this control practice in their business.

In addition to online surveys, an interview was conducted with a recent college graduate of East Carolina University (ECU), who started a dump removal limited liability company in 2023. This interview was conducted to determine how much accounting knowledge this new business owner retained one year after graduating college and how that accounting knowledge has been applied to starting and operating an SME. Three major findings came because of this interview. Firstly, the required undergraduate accounting courses attended by every college of business student at ECU do not give any information on how to plan and pay for taxes. It came as a surprise to this SME owner during his first year of operation that taxes are paid in April, rather than at the end of the year. Secondly, one of the first things he did as a new LLC owner and operator was to hire an outside accountant. Since then, his accountant has been solely responsible for bookkeeping and tax planning. This provides evidence for the claim made by Bruce & Gurley-Calvez, that SME owners do not know the potential depreciation and tax benefits they may be entitled to. Considering CPAs have multiple clients, it is possible that they overlook these benefits, emphasizing the importance that the SME owners review tax documents for the benefits they are entitled to. The last and possibly most important finding from the interview is that the SME owner did not greatly care about the financial details of the business, rather they focused their efforts on continuing operations and gaining new business. Financial and accounting professionals would claim that the two go hand-in-hand, but for this non-accounting business owner, this is not the case. This shows that when starting a business, entrepreneurs have so much to focus on, that they may not commit the necessary time and attention to their financials to facilitate long term success.

8. Closure

With an increased risk of failure, the important knowledge of managerial and financial accounting must be understood by SME owners to decrease this risk. It is important to acknowledge the limitations of this study with the small sample size of survey respondents. To make meaningful claims about the average SME owner, further research with a larger participant pool is needed. Given this, the finding from this survey partially underscores the importance of accounting knowledge considering every SME surveyed has been profitable for the past three years, even though there was not a proficient understanding of accounting knowledge. The finding of this survey did highlight SME owner’s struggle with cashflow management, bookkeeping, and internal control. These struggles must be further investigated as when SMEs struggle with cashflow management there is an extreme risk of defaulting on debts (Goldman, 2021). The inadequate records kept by SME owners increase this risk as inadequate records lead to incorrect assumptions on the trajectory of the business (Schiff & Szendi, 2014). These risks may bring serious negative impacts to the SME and to the country considering the high value that SMEs have on a nation's economy (Ahmad, 2017). This study highlights a lack of specific accounting knowledge and accounting practices when it comes to bookkeeping, budgeting, and internal control. By addressing these gaps in knowledge and by promoting good and effective accounting practices, SME owners will have the ability to gain competitive advantage and grow their business.

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