

IS THE LITERACY OF SMALL BUSINESS OWNERS IMPORTANT FOR CASH FLOW MANAGEMENT?: THE EXPERTS' PERSPECTIVE

MELISSA BELLE ISLE, BRETT FREUDENBERG AND TAPAN SARKER*

ABSTRACT

Small businesses play a crucial role in the Australian economy in terms of income and employment. Reliance on small business however can be concerning, as many small businesses fail to survive for a period of more than five years. This has been associated with the difficulty that small businesses face in maintaining a consistent cash flow. Research suggests that this may be related to financial and taxation literacy of the small business owner (SBO). Although SBOs have been identified as having a higher degree of financial literacy than individuals, it is unclear whether their level of literacy is adequate to support the management of the cash flow of their business. A continuing large research project investigates the required level of literacy that SBOs should possess to operate a successful business, with particular focus on cash flow management. This article reports expert perspectives of the degree of knowledge that is essential for SBOs in terms of professional financial literacy, computer accounting software (CAS) literacy and business taxation literacy in order to implement effective cash flow management practices.

Keywords: Small business; Cash flow; Tax literacy; Financial literacy; CAS literacy.

* Department of Accounting, Finance and Economics, Griffith Business School, Griffith University. Contact: m.belleisle@griffith.edu.au.

I INTRODUCTION

The lifecycle of many small businesses in Australia and throughout the world is less than five years.¹ This has been attributed in part to their struggle to maintain consistent cash levels. Cash flow management appears to be difficult for many SBOs; however, it is unclear why SBOs find it so problematic. It appears that financial literacy of SBOs may have some impact on their ability to make sound financial decisions.²

Another concern for effective management of cash flow by SBOs relates to the obligation to collect and settle tax liabilities. It has been suggested that taxation may negatively impact the ability of SBOs to maintain consistent cash levels. The current research project seeks to gain a greater understanding as to whether cash flow difficulties are a direct result of taxation or whether there are other underlying issues that influence cash flow (and/or the taxation relationship).

Considering that research has identified that the relationship between small business cash flow and tax may be distorted by other business factors including individual characteristics of the SBO, it was deemed important to investigate areas of SBO characteristics not previously studied when analysing cash flow. In particular it was determined that some specific types of SBO literacy may have an effect on the tax and cash flow relationship.³ When identifying the appropriate areas of literacy, it was necessary to determine what influences a SBO's ability to understand cash flow and implement effective cash flow management strategies. These strategies can be linked to literacy of business tax systems as a number of business taxes require SBOs to understand the effects of incurring taxes today and planning for payment of the tax liability in the future.

Recent research suggests that to a large extent SBOs identify that increased literacy could be beneficial to their cash flow management.⁴ However, when investigating the level of literacy held it was found that only 12 per cent of SBOs implemented systematic cash flow management practices in their business, and only those educated in accounting made use of financial statements to help them to determine the liquidity of their business. Also, even though SBOs recognised managerial benefits from use of computer accounting software (CAS) in the form of accurate record keeping it was apparent that CAS was not being used to support cash flow management. More than half (56 per cent) of SBOs had limited knowledge on what financial reports could be produced in their CAS, and 12.5 per cent of SBOs were not aware that they could prepare any financial reports in their CAS. This suggests that SBOs were not realising any managerial benefits in the form of cash flow

¹ Australian Bureau of Statistics, *8165.0 – Counts of Australian Businesses, Including Entries and Exits, Jun 2012 to Jun 2016* (20 February 2017) <<http://www.abs.gov.au/ausstats/abs@.nsf/mf/8165.0>>; Olawale Fatoki, 'The Financial Literacy of Micro Entrepreneurs in South Africa' (2014) 40(2) *Journal of Social Sciences* 151. The survival rate of small business increases as annual turnover increases. Those generating less than AU\$200 000 per annum have a lower chance of survival than those earning over AU\$200 000.

² Fatoki, above n 1, 153.

³ Melissa Belle Isle and Brett Freudenberg, 'Calm Waters: GST and Cash Flow Stability for Small Businesses in Australia' (2015) 13(2) *eJournal of Tax Research* 492.

⁴ Toni Chardon, Brett Freudenberg and Mark Brimble, 'Tax Literacy in Australia: Not Knowing Your Deduction from Your Offset' (2016) 31(2) *Australian Tax Forum* 321; Brett Freudenberg, Toni Chardon, Mark Brimble and Melissa Belle Isle, 'Tax Literacy of Australian Small Businesses' (2017) 18(2) *Journal of Australian Tax* 21.

management from use of CAS. It appears that literacy levels of SBOs in the research may not be at a level that supports cash flow of their business. Furthermore, from the findings it appears that 25 per cent of SBOs saw little benefit in being tax literate and instead saw taxation literacy to be the role of their accountant or advisor.

As a result of these findings the current research was designed to determine whether there is a required level of literacy that SBOs should possess in order to adequately support the cash flow management requirements of their business. Small business experts from varying professions in the small business landscape were engaged to explore their views on the level of literacy required by SBOs for effective cash flow management. In particular the areas of literacy that were examined when taking cash flow management and taxation into account for small business included two parts (of four) of professional financial literacy,⁵ CAS literacy and business taxation literacy.

This article presents the outcome of the data collected from 23 small business experts using the first stage of a Delphi technique.⁶ The structure of this article is as follows. First, relevant literature relating to cash flow concerns of Australian small businesses is discussed. Second, an overview of prior knowledge relating to SBO literacy in terms of professional financial literacy, CAS literacy and business taxation literacy is presented. Third, the methodology employed for the research is outlined followed by the findings of the research. The article is finalised with a concluding summary and recommendations for future research.

II SMALL BUSINESS CASH FLOW CONCERNS

A critical issue for all businesses is maintaining a consistent cash flow, which can be especially acute for small businesses due to restricted access to finance.⁷ Cash flow is the extent of cash or near cash assets available for use, along with any inflow or outflow of cash related to these assets.⁸ Therefore, cash flow is any business activity that alters the balance of the cash accounts. Previous research in Australia suggests that SBOs have recognised that cash flow is of particular importance to their ongoing survival,⁹ although it can be difficult for them to manage.¹⁰

Cash flow management has been identified as one of the most important problems for businesses in the United Kingdom, the United States of America and Australia.¹¹ Effective

⁵ See Andrew Worthington, 'The Distribution of Financial Literacy in Australia' (School of Economics and Finance Discussion Papers and Working Papers Series 185, School of Economics and Finance, Queensland University of Technology, 2004) 6.

⁶ The Delphi technique is discussed further in the Methodology section of this article.

⁷ Belle Isle and Freudenberg, above n 3, 519.

⁸ Shawn Carraher and Howard van Auken, 'The Use of Financial Statements for Decision Making by Small Firms' (2013) 26(3) *Journal of Small Business & Entrepreneurship* 323; Ignatius Ekanem, 'Liquidity Management in Small Firms: A Learning Perspective' (2010) 17(1) *Journal of Small Business and Enterprise Development* 123.

⁹ Melissa Belle Isle, Brett Freudenberg and Richard Copp, 'Cash Flow Benefit from GST: Is It Realised by Small Businesses in Australia?' (2014) 29(3) *Australian Tax Forum* 417; Ian Wallschutzky and Brian Gibson, 'Small Business Cost of Tax Compliance' (1993) 10(4) *Australian Tax Forum* 511, 527.

¹⁰ Belle Isle and Freudenberg, above n 3; Fatoki, above n 1.

¹¹ Scott Holmes and Des Nicholls, 'An Analysis of the Use of Accounting Information by Australian Small Business' (1998) 26(2) *Journal of Small Business Management* 57, 57; Michael Peel, Nicholas Wilson and

cash management is important to business survival irrespective of the size of the business.¹² When assessing small business liquidity it has been suggested that small businesses are less liquid and exhibit more volatility with cash flow and profit than their larger competitors.¹³ It has been observed that SBOs should try to avoid extended cash shortages, as supply constraints can affect the ongoing operations of the business and thereby make situations worse.¹⁴ In order to reduce cash constraints and achieve better control of cash flow, SBOs need to implement effective liquidity management practices.¹⁵

Effective liquidity management consists of keeping financial accounts, maintaining a business plan and cash budget, keeping records of revenue and expenses, creditor and debtor invoicing and maintaining an inventory schedule.¹⁶ Previous research in Australia and the UK suggests that SBOs are not actively involved in systematic liquidity management practices.¹⁷ While day-to-day recording of activities involving cash inflow and outflow may be undertaken, the process involved in receiving and making payment for those activities or managing cash once received may not be actively conducted.¹⁸

The strengths of an SBO at commencement of their business revolve around the technical skill set of that owner.¹⁹ Research suggests that SBOs are lacking financial management skills at start-up of their business (with the exception of businesses related to finance or accounting).²⁰ Research proposes that liquidity management should be regarded as important at the start and throughout the growth of the business.²¹ Advances or procurement of new liquidity management skills are adopted with time and business development.²² This often occurs as a result of external events or stakeholders that force SBOs to learn new procedures and routines.²³ For instance, if a SBO has never been required to prepare a cash budget or business plan for an external party, they may never be aware of the role that these documents can play in assisting with effective cash flow management practices.²⁴

The level of proficiency of the SBO in relation to cash flow management is not solely reflective of the owner's abilities and capacity.²⁵ Cash flow management practices can be

Carole Howorth, 'Late Payment and Credit Management in the Small Firm Sector: Some Empirical Evidence' (2000) 18(2) *International Small Business Journal* 17, 19.

¹² Arthur R DeThomas and William B Freudenberger, 'Accounting Needs of Very Small Business' (1985) 55(10) *The CPA Journal* 14; Fatoki, above n 1.

¹³ Peel, Wilson and Howorth, above n 11, 19.

¹⁴ Fatoki, above n 1; Ekanem, above n 8, 124–5.

¹⁵ Peel, Wilson and Howorth, above n 11, 19–24.

¹⁶ Alejandro Drexler, Greg Fischer and Antoinette Schoar, 'Keeping It Simple: Financial Literacy and Rules of Thumb' (2014) 6(2) *American Economic Journal: Applied Economics* 1, 13; Ekanem, above n 8, 125.

¹⁷ Belle Isle and Freudenberger, above n 3, 514; Freudenberger et al, above n 4, 34; Peel, Wilson and Howorth, above n 11, 19.

¹⁸ Belle Isle and Freudenberger, above n 3, 514; Peel, Wilson and Howorth, above n 11, 19.

¹⁹ DeThomas and Freudenberger, above n 12; Freudenberger et al, above n 4, 29.

²⁰ Freudenberger et al, above n 4, 30; Peel, Wilson and Howorth, above n 11, 19.

²¹ Peel, Wilson and Howorth, above n 11, 19.

²² David Deakins, Alana Morrison and Laura Galloway, 'Evolution, Financial Management and Learning in the Small Firm' (2002) 9(1) *Journal of Small Business and Enterprise Development* 7, 9.

²³ *Ibid* 15, 16.

²⁴ *Ibid*.

²⁵ Abdel K Halabi, Rowena Barrett and Robyn Dyt, 'Understanding Financial Information Used to Assess Small Firm Performance' (2010) 7(2) *Qualitative Research in Accounting & Management* 163, 169.

influenced by the SBO's attitude or the value they place on having effective procedures within their business.²⁶ Results from previous research advocates that a large number of SBOs undervalue the importance of cash flow management practices in their business decision-making, with more value placed on information gathered from market research.²⁷ Management of cash and credit was rated second last of all management functions, and only a minority of business owners identified any benefit from acquiring any form of cash management training.²⁸ SBOs appear to adopt a minimum standard rather than attempting to achieve a level of best practice when it comes to cash flow management.²⁹ This may be a result of SBOs having low levels of literacy and understanding about the benefits of having an effective cash flow management system in place and how it can be achieved.³⁰

III SMALL BUSINESS OWNER LITERACY

Of interest to the current study of cash flow are the concepts of SBO literacy in terms of professional financial literacy, CAS literacy and business taxation literacy. These areas of literacy are explored further throughout this section and the remaining sections of the article.

A Professional financial literacy

Financial literacy can be described as having the competence to successfully make efficacious decisions and cognitive judgements in financial circumstances that have the ability to influence an individual's financial status or position.³¹ Another term often used in place of financial literacy is 'financial capability'. Financial capability however, takes into consideration an individual's personal financial skills, attitudes and characteristics when attempting to determine their financial decision-making.³² For the purpose of this article financial literacy and financial capability will be viewed as one in the same.

Having financial literacy skills is an essential basis for both avoiding and solving financial problems.³³ Business owners have been identified as having greater financial literacy than other groups of individuals.³⁴ This includes SBOs, who have a higher level of financial

²⁶ Ibid.

²⁷ Holmes and Nicholls, above n 11, 59; Peel, Wilson and Howorth, above n 11, 24.

²⁸ Peel, Wilson and Howorth, above n 11, 31-2.

²⁹ Deakins, Morrison and Galloway, above n 22, 9; Ekanem, above n 8, 135.

³⁰ Deakins, Morrison and Galloway, above n 22, 11.

³¹ Sandra J Huston, 'Measuring Financial Literacy' (2010) 44(2) *Journal of Consumer Affairs* 296, 303; Freudenberg et al, above n 4, 23; Annamaria Lusardi and Olivia S Mitchell, 'The Economic Importance of Financial Literacy: Theory and Evidence' (2013) 52(1) *SSRN Electronic Journal* 5; Worthington, above n 5, 6.

³² Toni Brackin, *Taxation as a Component of Financial Literacy: How Literate Are Australians in Relation to Taxation* (PhD Thesis, Griffith University, 2014) 22; Freudenberg et al, above n 4, 23.

³³ Freudenberg et al, above n 4, 23; Sonia Marcolin and Anne Abraham, 'Financial Literacy Research: Current Literature and Future Opportunities' in P Basu, G O'Neill and A Travaglione (eds), *Proceedings of the 3rd International Conference on Contemporary Business* (Leura, NSW, Australia, 21-22 September 2006) 3.

³⁴ Reva Berman Brown, Mark N K Saunders and Richard Beresford, 'You Owe It to Yourself: The Financially Literate Manager' (2006) 30(2) *Accounting Forum* 171, 188; Freudenberg et al, above n 4, 25. Other

awareness than other individuals.³⁵ However, the financial literacy required to operate a small business is greater than that required for individual success.³⁶ Previous research suggests that SBOs lack the required level of financial literacy to make important financial decisions for their business.³⁷

The level of financial literacy required can depend upon someone's role. For example, the financial literacy expected of directors has been identified as professional financial literacy and includes having an understanding of financial statements, cash flow management, internal control mechanisms and corporate governance.³⁸ Financial statements that are of particular importance to professional financial literacy include the balance sheet, income statement, cash flow statements and the preparation of a cash budget.³⁹ This is due to their relevance to cash flow management and the influence that these statements can have on determination of business solvency by the SBO.⁴⁰

Solvency of small business is a critical part of small business management and is dependent on the level of professional financial literacy that the business owner possesses.⁴¹ Solvency is achieved through careful cash planning and control, which requires the owner to understand the financial position and activities of the organisation.⁴² SBO professional financial literacy can influence firm growth and productivity, and those with higher levels of financial literacy have been known to be more effective when using financial products and are more engaged in using and offering trade credit.⁴³ It has also been found that those with high levels of literacy are more likely to improve their literacy through using professional advisors whereas those with lower levels of literacy are more likely to rely on financial advice from friends and family, which could have negative effects on their improving their professional financial literacy in the long term.⁴⁴

Adequate financial literacy for SBOs can assist with everyday functions in the business. This can enable the SBO to evaluate financial information in order to make decisions while understanding the consequences of those decisions.⁴⁵ Preparation and use of financial statements can assist business owners to make more informed decisions and can facilitate improved performance. Information from financial statements can illustrate the

individuals with high levels of financial literacy include those with a tertiary education, professional occupation or a member of a couple with no children.

³⁵ Berman Brown, Saunders and Beresford, above n 34, 188.

³⁶ Freudenberg et al, above n 4, 25.

³⁷ Drexler, Fischer and Schoar, above n 16, 1–2; Fatoki, above n 1; Freudenberg et al, above n 4, 25.

³⁸ Worthington, above n 5, 5.

³⁹ Berman Brown, Saunders and Beresford, above n 34, 188.

⁴⁰ Fatoki, above n 1, 153.

⁴¹ Berman Brown, Saunders and Beresford, above n 34, 179–80.

⁴² DeThomas and Fredenberger, above n 12, 21; Fatoki, above n 1.

⁴³ Miriam Bruhn and Bilal Zia, 'Stimulating Managerial Capital in Emerging Markets: The Impact of Business Training for Young Entrepreneurs' (2013) 5(2) *Journal of Development Effectiveness* 232, 234 and 238; Fatoki, above n 1, 152.

⁴⁴ Tabea Bucher-Koenen, Annamaria Lusardi, Rob Alessie and Maarten van Rooji, 'How Financial Literate Are Women? An Overview and New Insights' (NBER Working Paper No 20793, National Bureau of Economic Research, December 2014) 13.

⁴⁵ Berman Brown, Saunders and Beresford, above n 34, 179–80; Fatoki, above n 1, 152.

consequences of the business operations.⁴⁶ Financial statements can also be used to measure profitability, perform ratio analysis, and assist with providing information to external stakeholders including financial institutions and banks.⁴⁷ An important advantage of small businesses using financial statements is that it can provide them with up-to-date cash flow information. Cash flow records can have greater usefulness to small businesses than accrual information when determining solvency, as preparation of reports relevant to cash flow provides a more accurate assessment of the present status of the business, and may assist with implementing strategies to overcome any cash flow problems.⁴⁸

Regardless of the abundance of research that suggests that use of financial statements is valuable to the ongoing success of small businesses, it appears that small businesses in Australia and overseas make limited use of financial statements to assist them in managing their business.⁴⁹ Although a large proportion of SBOs believe that evaluation and use of financial statements is their responsibility, previous research in Australia suggests that only 30 per cent use reports for decision-making, 20 per cent perform any form of ratio analysis, 11 per cent use the information to evaluate business performance and 10 per cent use current financial information for future plans or budgets.⁵⁰ Research both in Australia and overseas suggests that limited use of financial statements could be explained by education levels of the SBO.⁵¹ More educated SBOs are deemed better equipped at analysing and interpreting the figures presented in the statements.⁵²

In addition to literacy, SBOs indicate that the limited use of financial reports was a result of minimal significance placed on the information available in the statement, especially with regard to income statements and balance sheets.⁵³ SBOs believed that the main purpose of record keeping and producing reports was for tax compliance requirements, rather than being a worthwhile source of information and insight for management decisions.⁵⁴ That is, there is a lack of perception of any managerial benefit received from accounting records, other than for tax records/returns.⁵⁵ This confusion about the benefits of record keeping can be demonstrated in compliance cost research, where

⁴⁶ Bruhn and Zia, above n 43, 234 and 248.

⁴⁷ Robyn Dyt and Abdel K Halabi, 'Empirical Evidence Examining the Accounting Information Systems and Accounting Reports of Small and Micro Business in Australia' (2007) 15(2) *Small Enterprise Research* 1, 5; Fatoki, above n 1, 153; Halabi, Barrett and Dyt, above n 25, 167.

⁴⁸ Divesh S Sharma and Errol R Iselin, 'The Decision Usefulness of Reported Cash Flow and Accrual Information in a Behavioural Field Experiment' (2003) 33(2) *Accounting and Business Research* 123.

⁴⁹ Carraher and van Auken, above n 8; DeThomas and Fredenberger, above n 12; Dyt and Halabi, above n 47; Halabi, Barrett and Dyt, above n 25, 163; Peel, Wilson and Howorth, above n 11; Sharma and Iselin, above n 48.

⁵⁰ Dyt and Halabi, above n 47, 5; Halabi, Barrett and Dyt, above n 25, 167. A limitation of the Australian research is that the number of participants was 10.

⁵¹ Carraher and van Auken, above n 8, 333; DeThomas and Fredenberger, above n 12, 20; Halabi, Barrett and Dyt, above n 25, 171-4.

⁵² Carraher and van Auken, above n 8, 333; DeThomas and Fredenberger, above n 12, 20; Halabi, Barrett and Dyt, above n 25, 171-4.

⁵³ Halabi, Barrett and Dyt, above n 25, 171.

⁵⁴ *Ibid* 168.

⁵⁵ Nahida Faridy, Brett Freudenberg, Tapan Sarker and Richard Copp, 'The Hidden Compliance Cost of VAT: An Exploration of Psychological and Corruption Costs of VAT in a Developing Country' (2016) 14(1) *eJournal of Tax Research* 166.