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## **Financial Management in SMEs**

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***Abstract:***

*The principal goal of this paper is to review recent studies on small and medium sized companies in order to concentrate on the main critical issues of SMEs financial management. There are three core elements of financial management: (1) the question of liquidity management and cash flow management. Cash is company's most precious nonhuman asset. (2) The question of long term asset acquisition – which directs the long term course of business. (3) Questions of funding, capital structure and cost of funding. The most imminent question is the liquidity management. A business will never see the long term if it cannot plan an appropriate policy to effectively manage its working capital. Generally, the poor financial management of owner-managers is the main cause underlying the problems of SMEs.*

***Key Words:*** *SMEs, Financial Management, Liquidity Management, Capital Structure, Financial Failure*

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***JEL Classification:*** *O16, M14, G31, P34*

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## **1. Introduction**

Many people who start to run a business do not engage themselves in financial matters. The reason may be because they do not have enough knowledge or interest in recording transactions, preparation and analysis of financial statements and secondary they are extremely involved in other aspects of business like managing people, sales purchasing and production. These entrepreneurs rely on their accountants to run the financial side of their business.

While financial management is a critical element of the management of a business as a whole, within this function the management of its assets is perhaps the most important. In the long term, the purchase of assets directs the course that the business will take during the life of these assets, but the business will never see the long term if it cannot plan an appropriate policy to effectively manage its working capital. In effect the poor financial management of owner-managers or lack of financial management altogether is the main cause underlying the problems in SME financial management.

A great many small businesses fail not because the owner does a poor job or provides an inferior service, but because their firm is not run like a business. Most small business people only know one-half of what it takes to succeed. The part they are missing is how to manage and grow their business. Small business owners that succeed in this part learn these issues while working or they already have the knowledge.

## **2. Previous literature on finance in small business**

Literature on small firms' financial management is quite voluminous and it concentrates on different aspects of firm's management. For this research paper we have selected just a few studies from the recent period concentrating predominantly on various issues of financial management and small firms' strategy. The following table summarizes studies across the globe and points out the main point of interest.

**Table 1. Literature on small firms' financial management**

Author(s) (year)	Country	Research question
McNamara (1988)	Australia	Small enterprise failure
Hall and Young (1991)	UK	Voluntary liquidation
Peel and Wilson (1996)	UK	Capital budgeting
McMahon (1998, 2000 and 2001)	Australia	Determining characteristics of enterprise growth. Stage model
Michaelas and Chittenden, (1999)	UK	Financial structure
Robson and Bennett (2000)	UK	Influence of external advice and business collaborations
Klapper, Sarria-Allende and Sulla (2002)	Eastern Europe	Financing patterns of SMEs in Eastern Europe More innovative firms, small SME sector in every country
Rutherford, Muse and Oswald (2006)	US	Development model of family business
García-Teruel and Martínez-Solano (2007).	Spain	Working capital and profitability
Escribá-Esteve, Sánchez-Peinado, L. and Sánchez-Peinado, E. (2008)	Spain	Strategic orientation and performance
Juan García-Teruel and Martínez-Solano (2010)	Europe	Trade credit granted and received, alternative sources of financing
Struhařová (2010)	Czech Republic	Effect of the shift from Financial Reporting under the CZ GAAP to the IFRS and impact on management practices
Czarnitzki and Hottenrott (2011)	Germany	Working capital management R&D funding
Newman, Gunessee and Hilton (2012)	China	Theories of capital structure and cultural context in China
Bhunia (2012)	Europe	Relationship between default behaviours of SMEs and the credit facets of their owners

### **2.1. Studies on causes of financial failure**

#### ***Prediction of Financial Failure***

Some researchers tried to predict small enterprise failure to mitigate the collapse of small businesses. McNamara et al. (1988) developed a model to predict small enterprise failures giving the following four reasons: a) to enable management to respond quickly to changing conditions, b) to train lenders in recognising the

important factors involved in determining an enterprise's likelihood of failing, c) to assist lending organisations in their marketing by identifying their customer's financial needs more effectively, d) to act as a filter in the credit evaluation process. The authors argued that small enterprises are very different from large ones in the area of borrowing by small enterprises, lack of long-term debt finance and different taxation provisions.

### ***Involuntary liquidation***

Hall and Young (1991) performed UK a study of 3 samples of 100 small enterprises that were subject to involuntary liquidation in 1973, 1978 and 1983. The authors have found that the reasons given for failure were of financial nature in 49.8%. In the study of perceptions of official receivers interviewed for the same small enterprises, 86.6% of the 247 reasons given were of a financial nature. The positive correlation between poor or non-existent financial management (including basic accounting) and business failure has well been documented in western countries according to Peacock (1985, 2004).

### ***Default behaviours of SMEs and the credit characteristics of their owners***

Bhunja (2012) examined relationship between default behaviours of SMEs and the credit facets of their owners. Identifying and measuring credit risk of SMEs should be different from that of large firms, for SMEs appear to be influenced by their owners more directly and significantly, so that a more appropriate and effective way of credit management of SMEs could be applied in practice. This study implement an empirical study of logistic regression analysis with repeat sampling data after segregating the owners' characteristics data into variables of basic aspects, credit capacity aspects and credit will aspects. The results reveal that variables reflected credit capacity aspects share more significant relationship with the SMEs' credit default behaviour. This indicates that "credit will" variables and "personal credit" history have the closest relationship with enterprises' default probability and the proportion of overdue loans. These are the extreme significant variables which are valuable indicators in default risk estimate model.

## ***2.2 Growth and development of SMEs***

### ***Studies of small enterprise growth and development***

McMahon (1998, 2000 and 2001) worked for establishment of a theoretically sound and empirically validated explanation of small and medium-sized enterprise growth to serve as broad conceptual framework for research and policy-making regarding the business growth phenomenon. After a critical appraisal of recent research in the field, the paper argues that reconsideration should be given to a conceptual framework that represents SME growth as a series of stages of development through which the business may pass in an enterprise life-cycle.

In the follow up study from 2000 the author substantially extended his previously undertaken pilot study as part of an on-going research effort to derive, characterise and employ empirically based development taxonomy for SMEs in the manufacturing sector using panel data recently made available from Australia's Business Longitudinal Survey. Cluster analysis was used with key variables: enterprise age, size and growth variables to discover whether there appear to be any stable development pathways evident in the data. Each of four annual data collections was examined separately, and then comparisons were made of the resulting cluster analysis outcomes over time. Descriptive statistics for various enterprise characteristics facilitate interpretation of the cluster analysis solutions. Using the clusters as markers or signposts, three relatively stable SME development pathways are discernible in the longitudinal panel results. The first is a low growth pathway apparently leading to the traditional or life-style SME configuration (around 70 per cent of the panel). The second is a moderate growth pathway possibly leading to the capped growth SME configuration (around 25 per cent of the panel). And the third is a high growth pathway seemingly leading to the entrepreneurial SME configuration (around 5 per cent of the panel).

Statistical analysis revealed that differences between the identified SME development pathways in terms of enterprise age, size and growth variables were highly significant. This author has returned to the topic again in 2001 in his working paper entitled "Stage Models of SME Growth Reconsidered".

In the paper from 2001 McMahon presents a study of financial management characteristics on business growth and performance among small and medium-sized enterprises (SMEs) engaged in manufacturing. The author finds that enterprise characteristics seem to dominate in their impact upon SME achievement, with financial management characteristics, other than use of external financing being relatively unimportant. Development orientation and the existence of internal and external constraints appear to be the most influential enterprise characteristics.

### ***Development model of family business***

Rutherford et al. (2006) concentrated on the family business and contributes to the literature stream by providing the first empirical test of the developmental model for family business (DMFB) first developed by Gersick, Davis, Hampton, and Lansberg (1997). The tests of the DMFB model allowed the authors to identify key groups of variables that can help explain family business development. Specifically, they identify owner, firm, and family characteristics to augment the DMFB, and used hierarchical regression analysis of 934 firms. The authors suggest that the original model provides a solid foundation for classifying family firms, but the augmented model explained significantly more variance in family firm development.

### ***2.3 Studies on Capital Structure Studies of level of debt in SMEs***

Michaelas and Chittenden (1999) researched the financial structure of SMEs using quantitative methods on panel data of UK SMEs. The article utilised financial panel data, and investigated the capital structure of small and medium sized enterprises (SMEs) in the U.K. Different capital structure theories were reviewed in order to formulate testable propositions concerning the levels of debt in small businesses, and a number of regression models were developed to test the hypotheses.

The results suggested that most of the determinants of capital structure presented by the theory of finance appeared to be relevant for the UK small business sector. Size, age, profitability, growth and future growth opportunities, operating risk, asset structure, stock turnover and net debtors all seem to have an effect on the level of both the short and long term debt in small firms. Furthermore, the paper provides evidence which suggested that the capital structure of small firms is time and industry dependent. The results indicated that time and industry specific effects influenced the maturity structure of debt raised by SMEs.

Important finding was that in general terms, average short term debt ratios in SMEs appear to be increasing during periods of economic recession and decrease as the economic conditions in the marketplace improve. On the other hand, average long term debt ratios exhibit a positive relationship with changes in economic growth (Michaelas and Chittenden, 1999, 114).

### ***Capital structure in Chinese SMEs***

Newman et al. (2012) studied applicability of financial theories of capital structure to the Chinese cultural context using a new dataset of 1,539 Chinese small and medium-sized enterprises. The article investigated the firm-level determinants of capital structure and tested them against the predictions of financial theory. Firm size and profitability were both found to be related to leverage as proposed by pecking-order theory. In contrast a little support was found for the predicted relationship between asset structure and leverage. These findings were discussed in relationship to their Chinese cultural context.

### ***2.4 Studies on working capital management***

#### ***Studies of investment appraisal and working capital practices***

Peel and Wilson (1996) researched the capital budgeting and working capital practices of small firms. Their paper presented the results of a preliminary study on the working capital and financial management practices of a sample of small firms located in the north of England. In general, the results of the survey indicated that a relatively high proportion of small firms in the sample claimed to use quantitative capital budgeting and working capital techniques and to review various aspects of their companies' working capital. In addition, the firms which

claimed to use the more sophisticated discounted cash flow capital budgeting techniques, or which had been active in terms of reducing stock levels or the debtors' credit period, on average tended to be more active in respect of working capital management practices.

#### ***Effects of working capital management on SME profitability***

The importance of working capital management has been discussed by García-Teruel and Martínez-Solano (2007), and Thalassinou and Curtis (2005). The object of the research presented was to provide empirical evidence on the effects of working capital management on the profitability of a sample of small and medium-sized Spanish firms. The authors have collected a panel of 8,872 small to medium-sized enterprises covering the period 1996–2002 to test the effects of working capital management on SME profitability. Their findings demonstrate that managers can create value by reducing their inventories and the number of days for which their accounts are outstanding. Moreover, shortening the cash conversion cycle also improves the firm's profitability.

Their work contributes to the literature with usage of robust test that have been conducted for the possible presence of endogeneity problems. The aim was to ensure that the relationships found in the analysis were due to the effects of the cash conversion cycle on corporate profitability and not vice versa.

#### ***Issues of working capital management on trade credit***

García-Teruel and Martínez-Solano (2010) analysed the determinants of the trade credit granted and received on a panel of 47,197 SMEs in Europe over the period 1996–2002. Their results show a strong homogeneity in the factors determining trade credit in European countries. On the one hand, firms with greater capacity to obtain resources from the capital markets, and more cheaply, grant more trade credit to their customers. Moreover, the results appear to support the price discrimination theory. They also found that firms react by increasing the credit they grant in an attempt to stem falling sales. On the other hand, larger firms, with greater growth opportunities and greater investment in current assets, receive more finance from their suppliers. Where firms have alternative sources of finance they are less likely to resort to vendor financing (substitution effect).

#### ***Working capital management and profitability***

Czarnitzki and Hottenrott (2011) analyzed the relation between working capital management and profitability of small and medium-sized enterprises in Germany by controlling for unobservable heterogeneity and possible endogeneity. The authors examined a non-linear relation between these two variables and have shown that there is a non-monotonic (concave) relationship between working capital level and firm profitability, which indicates that SMEs have an optimal working capital level that maximizes their profitability. In addition, a robustness check of our

results confirmed that firms' profitability decreases as they move away from their optimal level.

### ***2.5 Studies on Eastern Europe***

#### ***Financial Management of SMEs in Eastern Europe***

A specific paper was written on Europe by Klapper et al. (2002) is devoted to understanding firms' access to finance, particularly in the financing of small- and medium-size enterprises. The financing patterns of SMEs across countries are not well understood. For example, little is known about the relative importance of equity, debt, and inter-firm financing for SMEs across countries.

The authors used the Amadeus database, which includes financial information on over 97,000 private and publicly traded firms in 15 Eastern and Central European countries. The Amadeus database allows the authors the opportunity to provide a new analysis of the general financing patterns of private firms across a large sample of Eastern European countries. The summary statistics show that the size of the SME sector (as measured by the percentage of total employment) in Eastern European countries is smaller than in most developed economies. However, SMEs seem to constitute the most dynamic sector of the Eastern European economies, relative to large firms. In general, the SME sector comprises relatively younger, more highly leveraged, and more profitable and faster growing firms. This suggests that a new type of firm is emerging in transitional economies that is more market and profit-oriented. However, these firms appear to have financial constraints that impede their access to long-term financing and ability to grow at the same time. Although the authors find in almost every country in the sample a large number of SMEs as a percentage of total firms, the SMEs in Eastern Europe are generally small and hire few employees. This paper – a product of Finance, Development Research Group – is part of a larger effort in the group to better understand small- and medium-size enterprise financing.

#### ***Changes in accounting of SMEs***

Struhařová (2010) evaluated the effect of the shift from Financial Reporting under the Czech legislature (CZ GAAP) to the International Financial Reporting Standard for financial management in Small and Medium-sized Enterprises (IFRS for SMEs) and Its Effect on Financial Management. The paper analysed the changes relevant to the shift. The author defined the changes in accounting department of SMEs and also the changes that affect a company as a whole. Furthermore, information from Financial Reporting used in Financial Management is described. The paper also analysed the changes in Financial Reporting related to modifications affecting Financial Management of SMEs. Fekete, et al., (2010) and Asuman Atik, (2010) have evaluated similar effects for Romania and Turkey respectively.

## ***2.6 Influence on performance and profitability***

### ***Influence of external advice***

Robson and Bennett (2000) presented the multivariate analysis of the relationship of SME growth with the acquisition of external business advice, whilst controlling for the influence of SME characteristics of age, manufacturing/services, high technology and innovation, level of skill of the workforce, exporter and number of competitors. The relationship of external business advice with SME performance is statistically significant for only a small number of sources and fields. Obtaining external advice in fields such as business strategy and staff recruitment is associated with positive firm performance. The main positive relationships of advice and performance are dominated by private sector sources such as lawyers, suppliers, customers and business friends/relatives. Collaborative arrangements with suppliers nationally/internationally have a strong positive relationship with employment and turnover growth; collaboration with local suppliers has a strong positive relationship with growth in profitability. There is little evidence of statistically significant relationships between government-backed providers of business advice such as Business Link and firm performance.

### ***Strategic orientation and performance***

Escribá-Esteve et al. (2008) focused on the factors that moderate the relationship between firm's strategic orientation and performance in small and medium-sized firms. Most of the prior research has focused simply on identifying environmental conditions conducive to the effectiveness of the strategic orientation approach. However, recent research has called for studies focused on investigating internal moderators of the strategic orientation-performance relationship. The authors propose a contingency framework, considering how corporate and competitive strategies, top management characteristics, and environmental conditions may moderate this relationship. Based on a survey of 295 Spanish small and medium-sized enterprises from seven manufacturing sectors, the study shows that the positive influence of the firm's strategic orientation may be moderated by the environment conditions, the previous experience of top management team, and the corporate and competitive strategies developed by the firm.

## ***2.7 Summary of literature review***

The literature on small firms' financial management is very broad and it draws upon different aspects of firm's life. The initial interest of research in SMEs bankruptcies and default risk has widened to studies investigating capital budgeting, development and growth models of small business and relationship between default behaviours of SMEs and the credit facets of their owners. Another interesting point of investigation were the financing patterns and capital structure and working capital management

In this paper we will concentrate on two major aspects – working capital management and issues of financing long term assets and risk the firms undergo in fixing substantial portion of their funds in such assets.

### **3. Working Capital and Liquidity Management – Practical Approach**

A successful business tries to have optimum working capital – not minimum or maximum but optimum (Liapis, 2010). Working capital is the difference between current assets and current liabilities. If a business has too much working capital, then you incur costs of funding unemployed assets that resemble interest which can and should be avoided. Very little working capital can also have a disastrous effect on your business. For example very little or no stock of raw material could result in a break in production, which in turn could result in huge losses.

The major components of working capital are:

- Inventories (raw material, work – in – progress, finished goods)
- Receivables
- Cash

Each of these components needs to be looked into.

In practice, however, it is very common that the potentials associated with an intelligent optimization of capital tie-up in inventories, in receivables, in liabilities and in liquid assets are often neglected or are not addressed systematically.

If company holds too much inventories or has very high receivables the WORKING CAPITAL WILL BE POSITIVE, BUT EXPENSIVE!!!!

In the company different people could be responsible for each component, and the manager must give them separate attainable targets so that they work towards an optimum holding of their component of working capital. We have defined a firm's net working capital as its current assets minus its current liabilities. Net working capital is the capital required in the short term to run the business. Thus, working capital management involves short-term asset accounts such as cash, inventory, and accounts receivable, as well as short-term liability accounts such as accounts payable. The level of investment in each of these accounts differs from firm to firm and from industry to industry. It also depends on factors such as the type of business and industry standards. Some firms, for example, require heavy inventory investments because of the nature of their business.

### Operating Cycle and Cash Cycle

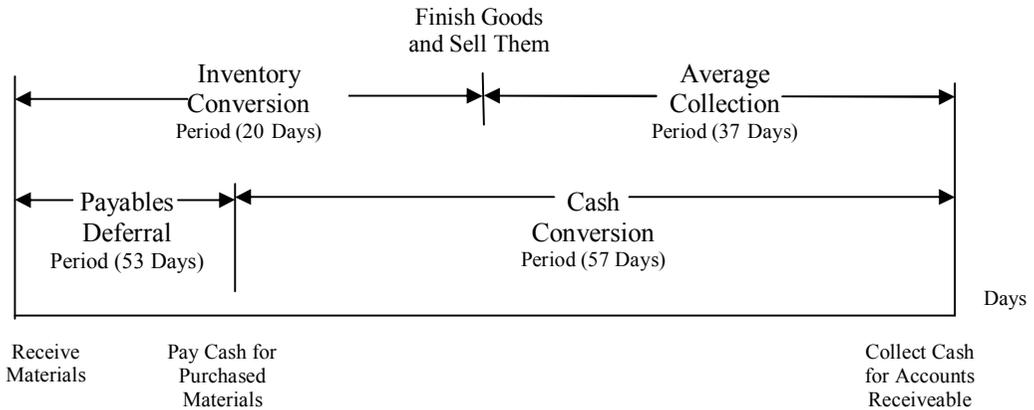
The level of working capital reflects the length of time between when cash goes out of a firm at the beginning of the production process and when it comes back in.

Take Intel, for example.

1. First, Intel buys \$1000 of raw materials and inventory from its suppliers, purchasing them on credit, which means that the firm does not have to pay cash immediately at the time of purchase.
2. About 53 days later, Intel pays for the materials and inventory, so almost two months have passed between when Intel purchased the materials and when the cash outflow occurred.
3. After another 20 days, Intel sells the materials (now in the form of finished microprocessors) to a computer manufacturer, but the sale is on credit, meaning that the computer manufacturer does not pay cash immediately. A total of 73 days have passed between when Intel purchased the materials and when it sold them as part of the finished product.
4. About 37 days later, the computer manufacturer pays for the microprocessors, producing a cash inflow for Intel.
5. A total of days have passed from when Intel originally bought the raw materials until it received the cash from selling the finished product. Thus, Intel's operating cycle is 110 days: a firm's operating cycle is the average length of time between  $53 + 20 + 37 = 110$  days.
6. A firm's cash cycle is the length of time between when the firm pays cash to purchase its initial inventory and when it receives cash from the sale of the output produced from that inventory. For Intel, the cash cycle is 57 days: the 20 days it holds the material after paying for it plus the 37 days it waits to receive cash after selling the finished product.

**Source:** Berk *et al.* (2012, p. 566–567)

Company executives must understand the operating cycle and cash cycle of the firm and appreciate why is of working capital management so critically important. Management could use trade credit to the firm's advantage and make decisions on extending credit and adjusting credit terms. It could also manage accounts payable and ascertain the costs and benefits of holding additional inventory.

**Graph 1. Cash Conversion Cycle**

**Source:** Brigham, Houston (2010, p. 496) with some adjustments.

### **The Cash and Operating Cycle for a Firm**

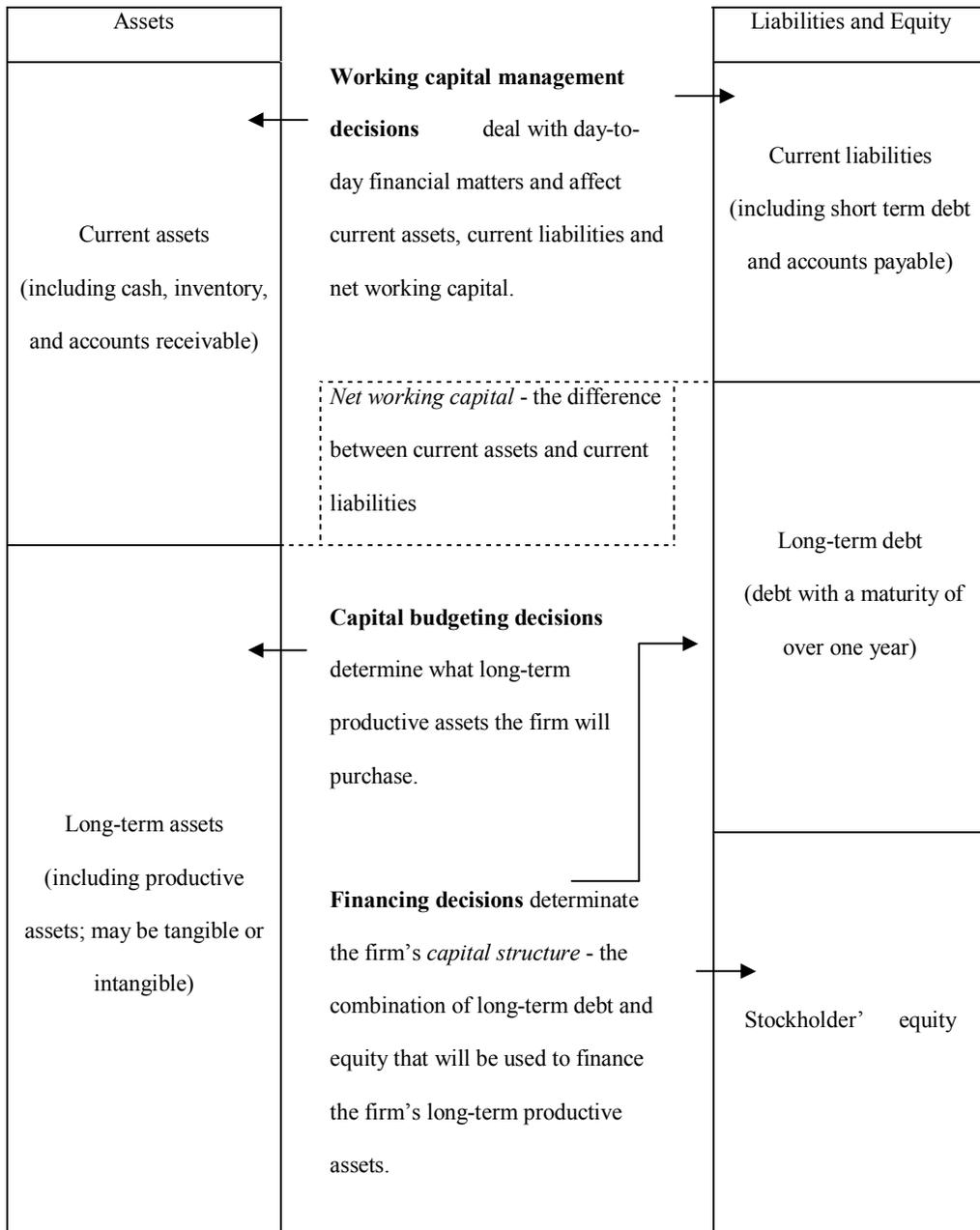
The cash cycle is the average time between when a firm pays for its inventory and when it receives cash from the sale of its product. If the firm pays cash for its inventory, this period is identical to the firm's operating cycle. However, most firms buy their inventory on credit, which reduces the amount of time between the cash investment and the receipt of cash from that investment.

## **4. Investments and investment decision-making**

Many times decisions regarding investment into fixed assets, like Factory Building, Plant and Machinery are taken without doing any scientific analysis. These decisions have long term effects on the business and should be taken only after a detailed analysis of the market scope, competition and by applying discounted cash flow techniques like IRR.

Optimizing capital investments is one of the most important levers both for improving value-based performance indicators and for securing the availability of sufficient liquidity. In order to carry out measures to increase capital efficiency and install a system whereby it is permanently monitored, you must first have a comprehensive system for managing capital expenditure which also manages your investments, your finance and your working capital.

**Graph 2. How financial management decisions affect the company balance sheet**  
**Balance Sheet**



**Source:** Parrino, Kidwell (2010, 5).

Alongside the primary target of raising capital efficiency, optimizing working capital can also enable companies to increase their ability to reach strategic targets. It is no coincidence that successful companies enjoy above average returns on capital investments rather it is proof of the efficiency of systematic management and control of the working capital cycle.

Financial managers are concerned with three fundamental types of decisions: capital budgeting decisions, financial decisions and working capital management decisions. Each type of decisions has a direct and important effect on the firm's balance sheet and on the firm's profitability.

### **Issues of funding**

Today, the entrepreneur has several options for financing his business. The traditional routes of loans and own funds have now several variants. Certain financial institutions are now offering Factoring services – they finance credit sales – your sales force now needs to concentrate only on sales and not on collections.

One mistake that several entrepreneurs commit is that they use short term loans (like cash credit, overdraft) for purchasing fixed assets. This leads to a severe strain on the funds position.

## **5. Summary**

From what we have learned in both theoretical and practical parts of this study, the following recommendations should be applied to small enterprises.

**Table 2. Recommended Principles for Healthy Financial Management of SMEs**

<ul style="list-style-type: none"> <li>• Have a good in-house Accounts department who are well versed in Accounting principles and are computer savvy.</li> </ul>
<ul style="list-style-type: none"> <li>• Get basic working knowledge about the financial software that your business is using.</li> </ul>
<ul style="list-style-type: none"> <li>• Insist on a monthly reporting system – so that the Profitability Statements and Balance Sheet are on your table by the 5th of every successive month.</li> </ul>
<ul style="list-style-type: none"> <li>• Sit with your managers to prepare an Annual Budget which should be broken down to monthly budgets. Do a monthly joint review of actual achievements with the budgeted/target figures. Take corrective action immediately.</li> </ul>
<ul style="list-style-type: none"> <li>• Keep a constant check on items which affect the liquidity of the business – level of debtors, stock of raw materials and finished goods.</li> </ul>
<ul style="list-style-type: none"> <li>• Interact with your Banker or Financial Institution on a regular basis – not just when you require your cheque to be passed or when you want your credit limit to be raised!! – check out their new financial products.</li> </ul>
<ul style="list-style-type: none"> <li>• Ask your Accounts department to prepare a check list of the various statutory payments and filings. Keep a close check on whether compliance takes place.</li> </ul>

<ul style="list-style-type: none"><li>• Have an interim audit of your accounts done – say for 9 months ended 31st December. This will give you enough time to take corrective action, based on the inputs of the auditors.</li></ul>
<ul style="list-style-type: none"><li>• Never make hasty decisions about purchasing huge fixed assets or getting into new ventures or diversification. Make a detailed study and apply evaluation techniques like IRR.</li></ul>
<ul style="list-style-type: none"><li>• Keep looking for ways to reduce cost – mere cost control procedures may not be long lasting – new innovative methods which will bring down the cost of delivery of your product and services need to be constantly encouraged among all employee of the organisation.</li></ul>

**Adopted from:** Korah Good Financial Management for SMEs available at

<http://www.korahandkorah.com/downloads/FM%20for%20SMEs5March.pdf>

There is a need for more knowledge about basic financial concepts – either through books/ magazines or by attending a workshop on finance. It is to highlight the fact that despite the need to manage every aspect of their small enterprises with very little internal and external support, it is often the case that owner-managers only have experience or training in some functional areas. This is also not always or usually applied because they might be doing everything from telephone calls to ordering products.

There is a school of thought that believes that “a well-run business enterprise should be as conscious of its finances as healthy a fit person is of his or her breathing”. It must be possible to undertake production, marketing, distribution and the like, without repeatedly causing financial pressures and strains. It does not mean, however, that financial management can be ignored by a small enterprise owner-manager; or as is often done, given to an accountant to take care of. Whether it is obvious or not to the casual observer, in prosperous small enterprises the owner-managers themselves have a firm grasp of the principles of financial management and are actively involved in applying them to their own situation.

It is hoped that the issues raised in this research paper will stimulate further theoretical and empirical contributions on this seemingly neglected but important area of small business research.

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