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Accounting Profit As A Measurement of Performance A Case Study of Small Retail Enterprises

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Abstract

In this paper the issue of performance measurement for very small enterprises is examined. A case study was undertaken to examine seven small retailers in the Northern NSW City of Lismore. The retailers' beliefs and attitudes about profit and performance measurement are shown to be at a variance with normative expectations. Participants demonstrated a poor understanding of profit measurement, and were inclined towards other measures of performance.

measurement by small retail enterprises. The interviews were structured using a questionnaire so as to limit bias and ensure consistency. Interview time ranged from 40-60 minutes. During interviews, not only were questionnaires completed but detailed field notes of discussions were also taken to gain an insight into small enterprise management practices.

Enterprise Profile

The small retail enterprises studied are located in the city of Lismore (situated in rural setting), Australia. These enterprises mainly retail products such as toys, household appliance, fine china, men's and women's clothing, and hosiery, but also handle other goods, including food, gifts and sports related products. The younger owner / managers aged in their mid 30s work without the assistance of sales staff. By contrast, older owner / managers ranging in age from 40 to 60 years old employ sales staff and also attributed their success to well trained, competent, and reliable staff. The owner/managers interviewed possess a wealth of business experience and personal intuition, and appeared to adhere to a high level of business ethics in terms of dedication and attitude toward customer satisfaction and quality of the products sold. They all employed the services of professional accountants when they needed financial guidance and advice. Nevertheless, the owner / managers who participated in this study placed heavy reliance on their "personal intuition" / "gut feeling"

in decision making and conducting business activities.

The enterprises examined in this case study were relatively very small, ranging from sole owner / managers to family businesses with several employees.

Information regarding time spent as owner / manager, reasons for going into business, major source of finance and owner's equity is presented in Table 1.

Business Activity	Time Spent As Owner/Manager	Reasons For Going Into Business	Major Source Of Finance	Owner's Equity
Sports and Toys	10 years	Earn extra income	Banks	30-50%
Household	1 - 3 years	Own boss and independence	Banks	30-50%
Men's Clothing	> 10 years	Independence	Banks	100%
Women's Clothing	< 1 year	Independence	Personal and Business	100%
General Store	5 - 10 years	Independence	Banks	50%

Table 1

For many of these owner / managers, their business provides the environment to work independently and secure an income. Of the seven enterprises five stated independence as the reason for going into business. Independence is a theme common to newly formed businesses under one year old as well as older businesses. Most of the participants in this case study had worked for large organizations prior to starting their own business and bought into and existing retail enterprise and thus appeared to be

knowledgeable in regards to operating and determining the performance of their retail business. These retail enterprises seem to be enjoying prosperous business growth and all owner / managers appeared to be satisfied with business results. Several participants attributed their success to previous business experience.

Banks were considered to be the major source of funding. Substantial personal assets were used as security where banks were the major funding bodies. There would seem to be a strong argument in favour of a need for appropriate measurement of performance and preparation of additional accounting information in order to control risk and survive. This is in contrast however to the general attitude shown by these owner/managers towards preparation of additional accounting information and performance measurements.

In general, owner/managers declared that they prepare or acquire a profit and loss statement annually and rarely use accounting information to evaluate their performance. This finding conforms with Alizadeh (1992), Holmes (1988), Peacock (1984), Dunlop & Sheehan (1983), and Back (1978) in that most small enterprise owner/managers engage the services of practising accountants only to satisfy legislative requirements and facilitate the lodgement of tax return. However, all participants suggested that they have a sound knowledge of calculating and measuring profit and loss figures. When asked to explain how they calculate

interim or annual profit and loss, there were some interesting responses. For example, one owner/manager considered profit to be "debtors less creditors plus the balance as at each month is the profit" (sports and toys) whereas another owner/manager defined profit as "sales less what is owed in that week or owed to the banks" (fine china and gifts). Yet another definition of profit was "each month's invoices plus stock less sales at cost" (household appliances). Finally the women's clothing proprietor believed "my profit is what I can allocate to myself as income".

The above mentioned perceptions of profit described by owner/managers in this study highlight the fact that one important component of P & L statement, namely sales, is taken into account but expenses are ignored or at least not given due recognition. Owner/managers of the retail enterprises also stated that neither wholesalers / suppliers nor other external parties such as bankers required any performance reports.

Performance Measures

A number of questions were asked in order to examine the methods used by the owner/managers in evaluating the performance of their enterprise. The owner/managers firmly believed the price of their goods to be an essential component of the profit and that achieving the best possible gross profit was a business issue of great concern. Thus the pricing policy developed and practised by small retail enterprise owner/managers becomes

critically relevant to their perceptions of business performance. Typically, these retail enterprises had developed two pricing strategies for retailing their products:

1- own pricing policy which incorporates cost plus percentage mark-up; and

2- recommended retail price by wholesalers/suppliers.

Nevertheless, the most of owner/managers employed their own pricing using cost plus percentage mark-up method. The owner / manager of the general store indicated one difficulty with the recommended retail pricing strategy was that his business was not achieving optimal profitability. According to this owner / manager, recommended pricing policy fails to take into account the cost structure of the business.

When asked to specify the methods of performance measurement used, a range of responses were received. These responses are summarised in Table 2.

The focus of attention on cash balance as a performance indicator is evident from Table 2. Performance measures such as ratio analysis, break-even analysis, and / or industry averages were not mentioned by any of the case study participants. Cash balance, sales, annual profit and past performance were common performance measures used by the owner / managers. Notably cash balance seemed to be the most important measure of their business performance. This evidence supports the conclusion made by McMahon and Holmes (1991) that simple solutions such

Business Activity	Methods of Measuring Performance
Sports and Toys Store	Cash balance, budgets, previous month's sales.
Household	Cash balance, weekly income, annual profit, past performance, profit margin.
Men's Clothing	Cash balance, sales, annual profit, past performance, profit margin.
Women's Clothing	Cash balance, sales, net profit.
Women's Accessories	Sales, budgets, profit over sales ratio.
Gift Ware	Cash balance, sales volume, past performance, net profit, intuition.
General Store	Cash balance, sales, annual profit, past performance, profit over sales ratio.

Table 2

as "... cash - based accounting systems may be perfectly adequate and provide for an acceptable level of financial control in smaller enterprises". P. 27.

Because of the sensitive nature of the phenomenon in focus, and due to the current recessionary business climate, participants were asked to evaluate the overall performance of their business in terms of overall profit and net profit after tax rather than declare actual income levels. Surprisingly, in this evaluation, the owner / managers used sales and clients volume as performance indicators and stated that high sales and regular clients are an indication of satisfactory results. Their responses with respect to the last five years are reported in Table 3.

In another attempt to cross examine the owner / managers' perception of business performance, they were asked to identify

Business Activity	Enterprise Performance Evaluation	Net Profit Evaluation
Sports and Toys	Excellent	Average
Household	Good	Good
Men's Clothing	Good	Average
Women's Clothing	Excellent	Good
Women's Accessories	Good	Good
Gift Ware	Good	Good
General Store	Good	Good

Table 3

what information they would supply to a prospective buyer. As indicated in Table 4 many of the responses were related to financial as well as non - financial information such as business location, reputation, suppliers reports / recommendations, customer's list, quality of services, and customer's reports.

Furthermore, it was found that there was little consistency between responses to this question and those on performance measures mentioned by the owner / managers previously (see Table 2). Only one owner / manager admitted they would supply information suggested and prepared by their accountant. It is interesting to note that this participant is the only one whose predominant reason for going into business was stated as major source of income. All participants who stated independence as their reason for going into business emphasised measures other than accounting profit.

Finally, the owner / managers were asked to comment on

Business Activity	Information Supplied to a Potential Buyer
Sports and Toys	Net profit, information required by law.
Household	Cash book, stock book, sales book.
Men's Clothing	Verbal information, well established, customers list, reputation, personalised service, customers reports.
Women's Clothing	Sales book, reputation, quality of service and goods, suppliers reports, business location.
Women's Accessories	Trade references, stock turnover, order book, cash book.
Gift Ware	Annual financial statements prepared by accountant, daily figures, suppliers reports/recommendations.
General Store	Annual turnover and profit, past performance, business location, traffic flow, stability of staff, regular customers, product variety.

TABLE 4

business issues of great concern. Notably, "achieving profitability" and "taxation" presented the most serious concern to managing a small retail enterprise and dealing with Australia's business downturn. These comments are also consistent with the results of the Coopers and Lybrand (1988) survey in which the majority of small enterprise owner / managers were very concerned with achieving profitability and coping with taxation. Achieving higher profitability and minimising tax are two separate issues. Perhaps one set of financial statement may be quite inadequate for reporting profit for the purpose of minimising tax as well as objectively measuring performance.

V- Conclusions

For any small retail enterprise some financial information is

arguably vital for success. If accounting information is recorded correctly and interpreted properly, it will help in detecting potential problem areas and allowing corrective actions to avoid failure. While for many small enterprise owner / managers "independence" is of paramount importance, they must operate profitability in order to survive. Of the various financial statements available to small enterprise owner / managers to evaluate the performance of their business, a profit / loss statement is generally believed to be essential. Although small business researchers and advisers recommend the preparation of profit and loss statement as often as possible to monitor business performance, it is often prepared and / or acquired annually to satisfy legislative requirements. The owner / managers of the retail enterprises in this study considered profit more appropriate as a measure of survival and independence (an underlying business objective) than a measure of financial performance.

This case study indicates that the manner in which business performance is measured reflects owner / managers' reasons for going into business. As a means of measuring business performance, these owner / managers have developed many intuitive methods which do not conform to what theory and literature dictates as desirable. Sales and cash balance were considered adequate performance measures without much recognition being given to the accounting profit and loss figures. Given the misconceptions of profit found in this case study, it is

concluded that profit is a potentially illusive performance measure, that it can create false or deceiving impressions. Further the implications of the numbers that make up "profit" are somewhat elusive, that is for many owners the importance of these numbers escape clear perception or complete grasp.

The owner / managers possessed a wealth of experience and expertise in retail business management and had intimate knowledge of their business but did not seem to be very well acquainted with conventional financial accounting reports. Participants demonstrated a lack of appreciation of the concepts underlying profit and loss calculation. In the absence of financial management knowledge and additional financial information, perhaps these owner / managers all but act on intuition and personal instinct in measuring business performance.

For many of these owner / managers, their business was a primary source of income and personal assets were the collateral to secure bank finance. Normative expectations, therefore, are that feedback in terms of financial performance should have a high priority (August 1992). Presently, the accounting information prepared and / or acquired by these owner / managers is heavily oriented toward tax minimisation. The profit figure from the annual profit and loss statement prepared for taxation purposes can portray a misleading picture and would not be an effective measure of business performance if used in isolation of non - financial information. Given the lack of understanding of financial

I- Introduction

Small business owners are generally encouraged to make better use of financial information as an aid to the management of their enterprises. Prescriptions are often based on the use of accounting information, which for most small enterprise means an historical profit and loss statement. In this paper the question of the appropriateness of profit as a measure of performance for a very small enterprise is addressed.

In section II small business usage of accounting information is reviewed. Section III focuses on profit as a construct. The research questions which arise are addressed in a case study of 7 small retailers, the method and results of which are outlined in section IV. Section V concludes the paper.

II- Small Business Usage Of Accounting Information

Considerable research effort in Australia has been devoted to the subject of small business and the use and preparation of accounting information. While many questions have been answered, and behaviour patterns with respect to small business owner / managers' application of financial information have become clearer, many questions remain unanswered.

Research has revealed that many small enterprise owners rarely utilise accounting information other than for annual taxation purposes (Holmes 1988). Many owners only acquire information required for statutory purposes from their external

accounting constructs, it is not surprising that non - financial indicators and cash balances gain priority as business performance measures.

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accountant. However, research findings also indicate that practising accountants are considered to be the major source of financial information (Holmes 1988, Peacock 1984). The implications of these findings are that many small enterprise owners get by on very little and in some instances no financial management advice. Studies have shown there is a clear link between success of a small enterprise and the use of accounting information (Pryor 1983, Peacock 1984, Homes & Nichols 1989, Williams 1991). Peacock highlighted the importance of the small business finance function (Peacock 1985), while texts for small enterprise and university education continue to stress the need for better use of financial information (Meredith 1988, English 1990, McMahon 1986).

As microcomputers have become relatively very much cheaper in the last five years, and will probably continue to be more affordable, perhaps there has never been a better environment for small firms to acquire, collect, and analyse information of all types, particularly numerical and financial information. One concern is that the pattern of financial information utilisation by small firms may not be altered by this new opportunity. Evidence suggests that the pattern of financial information usage has changed very little over the preceding decade or more despite many education programmes and publications (McMahon and Holmes 1990). If the nature of the information available to small enterprises is not consistent with the owners' business rationale

and objectives, then relative ease and affordability of computers may do little to improve the situation.

If policy makers and educators are to be successful in persuading small business owners to acquire and utilise more financial information in their decision making processes and to aid the management of their enterprises, then small business owners' rationale should be better understood. One question that arises out of these findings of prior research is: What measures do small firms utilise to appraise their own performance? If the accounting information acquired is limited to statutory accounts, then for many small enterprises the only objective and structured financial information will be historical Profit and Loss, and Balance Sheet prepared for the purpose of filing an annual tax return. This raises the question of whether accounting profit is an appropriate measure of performance. Such a question can be addressed from the perspective of the small enterprise owners, or from a normative perspective. A normative view might not be very helpful. Rather, researchers might benefit from an empathetic perspective in gaining understanding of current financial practice, and its real value to owner / managers (McMahon and Holmes, 1990, P. 32). Gniewosz (1984) points out that the form and content of accounting reports will influence the way the information is processed, and thus impact on the usefulness of that information. Griewosz argues that debate on the use of information for improved decision - making should not

be undertaken without being aware of the constraints in the decision - making process itself. In the current context, one very important constraint is the level of understanding that small enterprise owners have of the constructs that go to make up the traditional accounting reports on which they rely. The following questions arise:

- * how cognisant are small enterprise owners of the meaning of the numbers which make up a profit and loss and balance sheet?

- * What beliefs do small business owners themselves have about profit as a performance measure?

These questions are addressed in this case study as an attempt to gain a more empathetic viewpoint for contemplating whether accounting profit is an appropriate measure of performance.

Holmes (1988) found that there was a relationship between size of an enterprise and the propensity to acquire financial information beyond the statutory requirements. McMahon et al (1992) found a similar picture in the UK, where exploratory modelling of growth firms showed that size was a factor in explaining acquisition and usage of budgeted information. Holmes

also showed that industry sector was a factor in explaining extra information acquisition, with retailers being less likely than wholesalers or manufacturers to acquire information beyond statutory requirements (Holmes 1988).

Given the above finding it would seem quite likely that a sample of small retailers would have a very high proportion of owners who did not acquire and use accounting information from their external accountant beyond the annually prepared historical profit and loss and balance sheet for taxation purposes. For this reason, relatively small retailers were selected as participants in case study research to explore the research question outlined above.

In the following section profit as a performance measure is considered from a normative perspective. This is then followed by a report of the retailers case study research.

III- Profit As A Performance Measure

The Profit Construct

For this paper profit is defined as accounting profit not economic profit. In other words opportunity costs are not taken into consideration. Accounting profit, then, is the revenues less the expenses of the enterprise for a period. Potential difficulties for small enterprise owners arise from this profit concept as a measure of performance in several ways. First is the issue of defining and recognising revenues and expenses. It could be

argued that this issue has been well addressed by modern accounting standards, but whether these are appropriate for all small firms is another issue. Of primary concern in their affect on profit or ratios using profit are: asset valuation and / or revaluation, and the defining and recognition of expenses. Profit figures arguably mean more when expressed as a ratio, for example, net profit to owners equity or net profit to total assets (Meredith 1988 P. 318). Asset valuations impact directly on these ratios. Further, the residual nature of profit means that expense definition and recognition is critical to reported results. Expenses, rather than revenues, are seen as being critical for profit measurement in small enterprises. Two items stand out, though there may be others which are worthy of consideration. These are depreciation and salaries.

Depreciation is considered important for discussion because of two reasons. First, the taxation Commissioner may allow different rates than would be deemed appropriate to best allocate business fixed costs. This may not be a worry if a second set of statements is prepared with depreciation adjusted, but the evidence suggests that for most small enterprises the stated profit in a tax return is the only one available for management purposes.

Salaries becomes an issue in any non incorporated enterprises and possibly in many incorporated small businesses. Company profit is a residual after all salaries including owners'. A very different "profit" picture emerges if the same firm was run by a

sole trader where accounting conventions would have profit declared as a residual before distribution to owners. The level of salary recognised is an issue pertaining to opportunity cost considerations, however the payment or non payment of salaries may be an accounting issue and could result in accounting statements painting misleading pictures for small enterprise owners not fully cognisant of the above considerations. It might be argued that these considerations are not an issue, as the accountant simply needs to explain the situation to the enterprise owner. Research results suggest though, that accountants are rarely proactive in offering such advice (Cameron 1992).

Relevance of Profit

The discussion so far has been about potential problems of defining the profit concept itself. Apart from the potentially illusive nature of profit and loss calculations, there is the further question of relevance. Even if profit can be defined consistently and in a way conveying proper meaning to the enterprise owners, its relevance as a measure of the owner's business performance is questionable. Some research has been done in Australia about motivation for small enterprise owners. Peacock (1984) found that financial reward is much less important than independence, and is no more important than job satisfaction.

While it might be argued that some profit is needed for survival and to allow independence, accounting profit per se may not

provide small enterprise owners with a measure of performance directly pertinent to their business objectives.

Much more research is needed in Australia to investigate the variety of underlying objectives of small business owners, and how these relate to performance measurement and the use of accounting information.

IV- The Case Study

Method

Seven small retail enterprises were selected at random from the Universal Business Directory, North Coast Region. These enterprises were mainly involved in the following sub-categories of retail sector:

- 1- Sport and Toys Store.
- 2- Household.
- 3- Men's Clothing.
- 4- Woman's Cloting.
- 5- Women's Accessories / Hosiery.
- 6- Gift Ware.
- 7- General Store.

In the Winter of 1992, data was collected through face - to - face structured interview / questionnaires with principal owners / managers. The multiple site case study approach was adopted in quest of information regarding the perception and methods of calculating the profit figure and its use as a performance