

# THEORETICAL AND PRACTICAL ASPECTS OF PERFORMANCE OF SMALL AND MEDIUM-SIZED ENTERPRISES

**Inta KOTANE**

Mg.oec., lecturer, researcher, Rezekne Academy of Technologies, Rezekne, Latvia,  
e-mail: Inta.Kotane@rta.lv, phone: + 371 29415644

**Abstract.** *The number of small and medium-sized enterprises (SMEs) comprises a significant share in total number of enterprises in national economies, the SMEs are considered to be the backbone of economic growth, and most often their significance is valued by the gross value added and a number of new jobs created. Notwithstanding the established role of SMEs in national economies and the research studies conducted by Latvian scientists, the author considers that the theoretical and practical aspects of the SME's performance have not been sufficiently studied and published in Latvia. The purpose of the current study is to explore the theoretical and practical aspects of the SME's performance. The theoretical study is based on the analysis of the research publications, and the practical aspects are analysed using statistical information. General scientific research methods – information analysis and synthesis, the logical construction, monographic, data grouping and graphical representation methods – are used in the research. In the result, the theoretical aspects of the SMEs' performance are explored and the main indicators measuring the SMEs' performance are assessed.*

**Keywords:** *small and medium enterprises, measuring indicators.*

**JEL code:** M10, M20

## Introduction

SMEs have received great attention in recent years due to the important role they play in most national economies, in both developed and developing countries (Ahman, Alaskari, 2014) and they are important drivers of the economy (Bernaert, Poels, 2011; Forsman, 2008).

In Latvia, SMEs have a significant share in the total number of enterprises; they have an essential role in contributing to the gross domestic product and increasing the employment rate. In 2015, the average number of SMEs as a % of the total number of enterprises in the European Union (EU) and in Latvia was 99.8%. SMEs employed on average 66.8% of all private sector employees in the EU and 79.0% in Latvia in 2015. On average, SMEs produced 57.4% of the value added in the EU and 72.1% in Latvia (SBA Fact Sheet. Latvia, 2016). It is evident that the share of the people employed in SMEs in Latvia was 12.2 percentage points above and the share of output by SMEs 14.7 percentage points above the EU average. Overall, the SMEs have an important role in the economy of the EU and Latvia.

Notwithstanding the established role of the SMEs in national economies and research studies conducted by Latvian scientists (Ciemleja, 2010; Kantāne, 2013; Liše, 2013), the author considers that the theoretical and practical aspects of the SME's performance have not been sufficiently studied and published in Latvia.

The purpose of the research is to explore the theoretical and practical aspects of the SME's performance.

The tasks of the research:

- 1) to explore the theoretical aspects of the SMEs' performance;
- 2) to assess the main indicators measuring the SMEs' performance;
- 3) to draw conclusions.

General scientific research methods – information analysis and synthesis, the logical construction, monographic, data grouping and graphical representation methods – are used in the research.

In the current research, the theoretical study of the SMEs' performance is based on the analysis of research publications, and the SMEs' practical aspects are assessed using statistical information.

### **Theoretical aspects of SMEs**

SMEs are considered as a backbone of economic growth in all countries. They contribute to providing job opportunities, act as suppliers of goods and services to large organizations (Rahman, 2001; Anuar, Yusuff, (2011; Eggers et al., 2013). SMEs are defined by a number of factors and criteria, such as location, size, age, structure, organization, number of employees, sales volume, worth of assets, ownership through innovation and technology (Rahman, 2001). The SMEs can be described as catalysts of the future economy; hence, it is necessary to accelerate the growth of the SMEs and to improve their competitiveness (Forsman, 2008).

The Bolton Committee established in the UK (1971) has formulated definitions of "economy" and "statistics" of a small enterprise (Tonge, 2001). According to the definition of an economy, an enterprise may be considered small if it meets three criteria: 1) it has a relatively small market share; 2) it is personally run by the owner or co-owner without the mediation of a formal management structure; and 3) it is independent and is not a part of a larger company. The "statistics" definition stipulated that the size of a company was determined by the market share and the intensity of competition in the sector.

The subsequent research studies (Storey, 1994; Atkinson & Meagher, 1994) had pointed out the contradictions of the definitions of economy and statistics regarding the owner's ability to manage the company with more than 100 employees on his own, without management structures, as well as

regarding the possibilities to influence the level of market price and to get higher profits with a relatively small market share.

It should be noted that similar SME criteria do not exist in the world. For instance, in the US, it is officially defined that SMEs are enterprises employing between 1 to 500 people. A company corresponds to the small business category if it employs up to 100 workers; it corresponds to the micro-business category if it employs up to 20 workers (Fadahunsi, 2012).

In Latvia, the definition of a SME, or business category, is determined by the Regulations of the Cabinet of Ministers of December 16, 2014 (Kārtība, kādā komercsabiedrības deklarē..., 2014) in accordance with Article 2 of Appendix 1 of the EU Regulation No.651/2014 of June 17, 2014 (Commission Regulation (EU) No. 651/2014).

The criteria for SMEs were defined by the EC in 1996 and 2003 (96/280/EC; 2003/361/EC). The criteria to define the category of an enterprise is the number of employees and annual turnover, or the total value of balance. In 2003, when compared with 1996, the criterion *number of employees* was the same, though the criteria *annual turnover* and *total value of balance* had increased.

In accordance with the size and possibilities, SMEs have some specific features that could be characterised both as advantages and disadvantages. These characteristics fall in two main categories: *external environment and internal environment* (Cocca, Alberti, 2010).

Regarding the *external environment* (Garengo et al., 2005), SMEs operate in the conditions of high competition, in the insecure and rapidly changing market environment. The main aim of the SME is to survive in the market of competition (Levy et al., 1999). SMEs usually do not have control or influence over the market, therefore they have to adapt to the changes of the market (Hudson, 2001). SMEs can address particular market niches, as it is easier to focus on an exact known number of clients and to satisfy their needs with custom products and personalised services (Taticchi et al., 2008); the SMEs rely upon a limited range of clients and are closer to their customers thus developing more personalised and individual relations (Hong, Jeong, 2006; Maldifassi, Caorsi, 2014)

The lack of resources can be emphasised as one of the main problems and a typical characteristic of SMEs' internal environment, taking into account that the concept "resources" is reviewed not only from the point of view of staff, including the management, but also from the perspective of financial stability and security. Not only employees have limited skills (Singh et al., 2008), owners – managers do often lack management experience and organizational capacity, and that includes poor strategic planning and human resource management (Pansiri, Temtime, 2008).

SMEs have insufficient financial resources and there are difficulties ensuring financial stability (Levy et al., 1999; Watts, Baard, 2005). There is a strong relationship between entrepreneurs' knowledge (education level, work experience; knowledge of the functional requirements, self-esteem) and SMEs' performance (Omerzel, Antoncic, 2008).

The SME's size determines its organizational structure, which is not characterized by bureaucracy, as well as has a positive impact regarding flexibility, adaptability, and speed at which the organization can adapt to a changing environment (Garengo et al., 2005). SMEs often have great potential for innovation and possibility to meet the customers' requirements. An organizational structure with a few management levels promotes mutual relations, simplifies communication and provides the manager with a clear understanding of the processes, as well as with an opportunity to influence employees directly (Singh et al., 2008). Managers are often the owners of the company as well, and the control over the SME is mainly in the hands of one or a few people with a high level of autonomy (Pansiri, Temtime, 2008); the SMEs generally have a lower level of bureaucracy, which enables faster problem solving and better decision-making capacity (Vinten, 1999).

Success or failure of the SME's management can much be affected by organizational skills of the owner – manager, because decisions are largely based on the manager's personal skills and intuition rather than on analysis of the information. The owner – manager usually applies a personalized management style, following the “react and adapt” philosophy and “fire-fighting” strategies, focusing on the short-term goals, and do not engage in the strategic planning (Hudson et al., 2001b; Ropega 2011). SMEs often lack a long-term strategy or, if they do, it is unclear (Kueng, et al., 2000).

In Sweden, researchers indicate the following criteria defining the SME: personalised management; severe resource limitations in terms of management and manpower, as well as finance; reliance on a small number of customers and operation in limited markets; high innovative potential; a reactive, fire-fighting mentality; informal, dynamic strategies; and a flat and flexible organisation (Löfvin et al., 2014).

An interesting perspective regarding SMEs' operations, particularly regarding their financial performance, is provided by the Australian researchers (Wijewardena, et al., 2008) who have studied the skills (administrative and business skills) of owners/managers in relation to the company's life cycle stages and the company's sales revenue changes over three years. The researchers have concluded that there is a close link between the skills of owners/managers and the company's financial performance, as well their research confirmed the fact that the financial

performance is better in the companies where the owner/manager has entrepreneurial, not administrative skills.

The analysis of the literature performed by the author reveals peculiarities of functioning and characteristics of economic behaviour of SMEs regarding both the internal environment of operations, and their interaction with the elements of the external environment. Indeed, these peculiarities affect the SMEs' operations.

### **Assessment of SMEs' performance**

SMEs' performance indicators can be viewed as indicators of a business environment development in Latvia, as the SMEs are the most sensitive towards the changes in economic and legal environments, and towards political changes implemented by the government authorities. The role of SMEs in the EU in general and in the Latvian economy particularly can be assessed by analysing the number of SMEs, the number of people employed, and the gross value added.

Table 1 Characteristics of SMEs in Latvia and the EU  
*(calculated by the author, based on the SME Performance Review 2016)*

	2008	2009	2010	2011	2012	2013	2014e	2015e	2016e	2017e
<b>Share of SMEs</b>										
In Latvia	99.7	99.8	99.8	99.8	99.8	99.8	99.8	99.8	99.8	99.8
In the EU	99.8	99.8	99.8	99.8	99.8	99.8	99.8	99.8	99.8	99.8
<b>Share of employees</b>										
In Latvia	78.1	78.1	77.5	77.2	78.8	78.3	78.6	79.0	79.2	79.5
In the EU	66.9	67.6	67.4	67.2	67.0	67.0	66.7	66.8	66.8	66.9
<b>Share of value added</b>										
In Latvia	72.1	68.0	68.7	67.8	69.4	70.4	71.6	72.1	72.4	72.7
In the EU	58.5	58.7	57.5	57.8	57.4	57.7	57.5	57.4	57.5	57.6

e – estimates

An analysis of the data characterizing SMEs in Latvia and the EU (Table 1) shows that in the research period, the share of the SMEs in the total number of enterprises was on average 99.8% in the EU as well as in Latvia, and in the following years the share of the SMEs in the total number of enterprises would not decrease. The share of people employed by SMEs (within the total number of the employed population) and the share of value added (within the total gross value added) in Latvia exceeds the EU average,

however, both indicators tend to show a growth trend. SMEs are an important component of the ‘non-financial business economy’. In the research period, SMEs in Latvia, on average, have generated more than 70% of the value added, and the share of the people employed by the Latvian SMEs accounted for almost 80%. Hence, the share of total value added generated by Latvian SMEs and the number of people employed by the Latvian SMEs are more than 10 percentage points higher than the EU average. Most of that difference is explained by the importance of medium-sized firms.

The author considers as noteworthy a study by *Lursoft Ltd*, which analyses annual reports submitted by 30 186 enterprises operating for at least 11 years. Unfortunately, the information on this study is rather scarce in the public space. The study does not cover micro-enterprises, large companies, credit institutions, and insurance companies. According to the study, the net turnover of SMEs as well as the number of employees continuously declined, while the profit and the amount of taxes paid increased (Ķirsons, 2017).

The total net turnover of economic operators (commercial companies) in 2015, compared with 2007, has increased by EUR 7.65 billion or 15.8% (Statistics Database, 2017), however, on the contrary, the net turnover of more than 30 000 SMEs in 2015, compared with 2007, has decreased by EUR 2.11 billion or 13.86% (Figure 1).

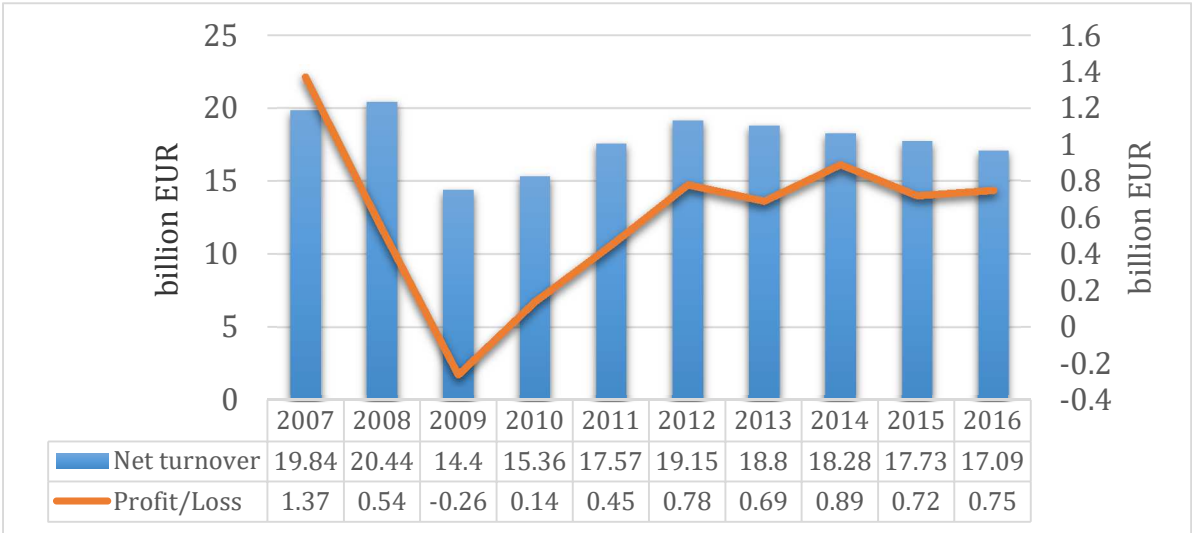


Fig.1 Net turnover and profit/loss of SMEs in Latvia in 2007-2016, billion EUR (calculated by the author, based on Ķirsons, 2017)

In 2016, the net turnover of the SMEs surveyed, compared with 2015, continued to shrink, suggesting that the experienced companies generally operate producing yet lower revenues. According to A. Brūvelis, a researcher of *Lursoft Ltd*, the fall in the net turnover was determined by the introduction

of micro-enterprise tax, as well as by the failures of the insolvency process, as, after the completion of the insolvency, the entrepreneurs were not prevented to re-establish new companies without any obligations (Kirsons, 2017). Profits of the SMEs in 2016, as compared with 2015, has increased, though accounted for only 54.74% of the 2007 profit.

The number of employees in the surveyed SMEs from 2014 to 2016 has decreased, though the amount of tax payments per employee has increased (Figure 2).

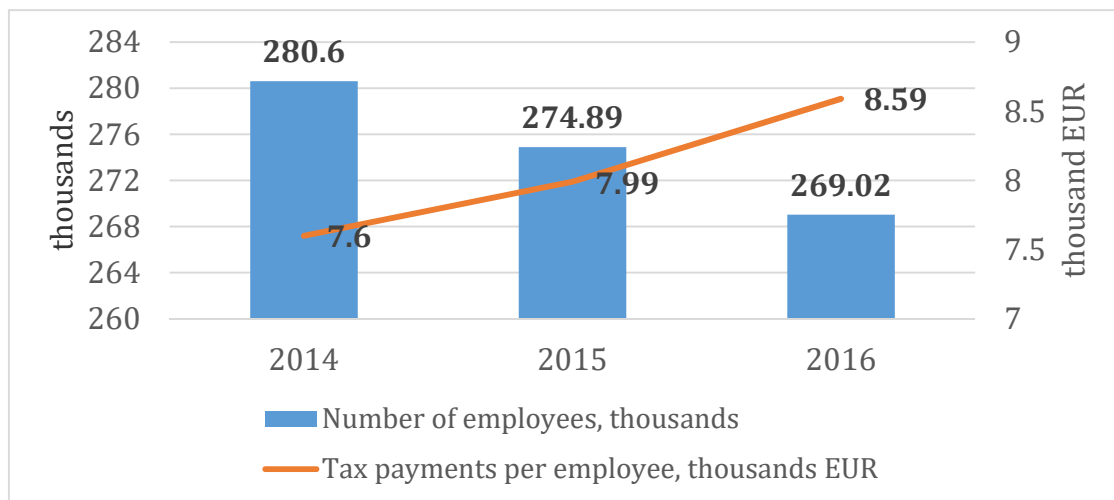


Fig.2 Number of employees and tax payments per employee in Latvian SMEs in 2014-2016  
(calculated by the author, based on Kirsons, 2017)

One of the reasons of the decreasing number of employees could be the increasing use of various technologies in the economic operations of the companies, which determines the decrease in labour demand. As one of the reasons of increasing tax payments per employee, the increase in the average monthly wages of employees (Statistics Database, 2017) could be mentioned. Indeed, the changes in the minimum monthly wage and personal income tax during 2014-2016 could contribute to a reduction in tax payments per employee, as the minimum monthly wage in 2014, 2015, and 2016 was EUR 320, EUR 360 and EUR 370 respectively, while the personal income tax deducted from the wage or salary was 24% in 2014, and 23% in both 2015 and 2016. A. Brūvelis believes that “such a rise in the taxes paid along with the decreasing net turnover and the shrinking number of employees leads to a conclusion about a possible decrease of the share of *under-table wages and salaries*, and the increase of the rate of other taxes payable” (Kirsons, 2017).

An analysis of statistically significant correlations between the net turnover of the SMEs, profits/losses, and the number of employees in 2007-2016 (Table 2) shows that a strong correlation ( $|r| > 0.5$ ) existed between the net turnover and the profit/loss. The causal link suggests that the

increase of net turnover would increase profits/losses. Changes in the number of employees in this case do not show statistically significant correlations with changes in net turnover and profit/loss.

Table 2 Matrix of correlations between SMEs' net turnover, profits/ losses and number of employees in 2008-2016  
(calculated by the author using SPSS, based on Kirsons, 2017)

	N	Net turnover	Profit/ Loss	Number of employees
Net turnover	10	-		
Profit/Loss	10	.783**	-	
Number of employees	10	.601	.066	-

\*\* . Correlation is significant at the 0.01 level (2-tailed).

In general, the results of the SMEs' performance demonstrate the impact of the national economic and fiscal policy, pointing to its favourable or hindering character, the state of the capital market, the level of development of infrastructure and the education system, as well as describe the efficiency of the national support policy and the orderly functioning of the legislation regulating business activities. The author believes that an analysis of the indicators measuring the SMEs' performance and their assessment, the publication and application of the research results would foster the development and implementation of the policies favourable for the development of the SMEs.

## Conclusions

SMEs can be referred to as catalysts of the future economy, they contribute to job opportunities, act as suppliers of commodities and services for large companies. Globally, the criteria defining SMEs differ. Peculiarities of the functioning of SMEs and their economic behaviour are determined by the factors of their internal environment (sufficient labour and financial resources and their rational use, the potential of innovation, the role of managers, etc.) and interaction with factors of the external environment (competition, customer relations, etc.). Indeed, these peculiarities have an impact on the SMEs' performance.

Both in the EU and in Latvia, SMEs account for a significant share of the total number of enterprises, they have an important role in generating GDP and providing employment; therefore, it is crucial to accelerate the growth of the SMEs and to improve their competitiveness. The SMEs' performance can be considered as an indicator of development of the business



environment in Latvia, as the SMEs utmost sensitively react to the changes in economic and regulatory environments, and in the policies implemented by national authorities.

According to a study by *Lursoft Ltd*, the net turnover of the SMEs as well as the number of employees continue to decrease, while the profits and the amount of taxes paid show a growing tendency. The author's research points out that changes in the number of employees do not show statistically significant correlations with changes in the net turnover and profit/loss of the SMEs.

As a general rule, the results of the SMEs' performance would point to the impact of the national economic and tax policies as being favourable or impeding, as well as characterize the efficiency of the national support policy and the orderly functioning of legal regulations. The author believes that an analysis of the indicators measuring the SMEs' performance and their assessment, the publication and application of the research results would foster the development and implementation of the policies favourable for the development of the SMEs.

### References

1. 2003/361/EC. Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (notified under document number C(2003) 1422). Official Journal of the European Union. Downloaded from <http://goo.gl/0YAC1Y>
2. 96/280/EC: Commission Recommendation of 3 April 1996 concerning the definition of small and medium-sized enterprises (Text with EEA relevance). Official Journal L 107, 30/04/1996 P. 0004 – 0009. Downloaded from <http://goo.gl/aNPWaJ>
3. AHMAD, M.M., ALASKARI, O. (2014). Development of assessment methodology for improving performance in SME's, *International Journal of Productivity and Performance Management*, Vol. 63 Iss:4, pp.477-498.
4. ANUAR, A., YUSUFF, R.M. (2011). Manufacturing best practices in Malaysian small and medium enterprises (SMEs). *Benchmarking: An International Journal*, Vol.18, Iss:3, pp.324-341,
5. ATKINSON, J., MEAGER, N. (1994). *Running to stand still: the small business in the labour market*. In *Employment the small firm and the labour market* (Ed.) J. Atkinson and D.J. Storey. London: Routledge.
6. BERNAERT, M., POELS, G. (2011). The Quest for Know-How, Know-Why, Know-What and Know-Who: Using KAOS for Enterprise Modelling. *Advanced Information Systems Engineering Workshops*, pp.29-40.
7. CIEMLEJA, G. (2010). *Mazo un vidējo uzņēmumu darbības rezultativitāte. Problēmas un risinājumi*. Promocijas darba kopsavilkums, RTU. 43 lpp.
8. COCCA, P., ALBERTI, M. (2010). A framework to assess performance measurement systems in SMEs. *International Journal of Productivity and Performance management*, Vol.59, Iss:2, pp.186.-200.
9. Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107

- and 108 of the Treaty Text with EEA relevance. Retrieved August 5, 2017, from <https://goo.gl/xi7F41>
10. EGGERS, F., KRAUS, S., HUGHES, M., LARAWAY, L., SNYCERSKI, S. (2013). Implications of customer and entrepreneurial orientations for SME growth. *Management Decision*, Vol. 51, Iss:3, pp.524-546.
  11. FADAHUNSI, A. (2012). The Growth of Small Businesses: Towards A Research Agenda. *American Journal of Economics and Business Administration*, Vol.4, Iss:1, pp.105-115.
  12. FORSMAN, H. (2008). Business development success in SMEs: a case study approach. *Journal of Small Business and Enterprise Development*, Vol.15, Iss:3, pp.606 – 622.
  13. GARENGO, P., BIAZZO, S. AND BITITCI, U.S. (2005). Performance measurement systems in SMEs: A review for a research agenda. *International Journal of Management Reviews*, Vol.7, Iss:1, pp.25–47.
  14. HONG, P., JEONG, J. (2006). Supply chain management practices of SMEs: from a business growth perspective. *Journal of Enterprise Information Management*, Vol. 19, Iss: 3, pp.292 – 302.
  15. HUDSON, M. (2001). *Introducing integrated performance measurement into small and medium sized enterprises*. PhD thesis, University of Plymouth, Plymouth
  16. HUDSON, M., SMART, A., BOURNE, M. (2001). Theory and practice in SME performance measurement systems. *International Journal of Operations & Production Management*, Vol. 21 Iss: 8, pp.1096 – 1115.
  17. KANTĀNE, I. (2013). *Latvijas mazo uzņēmumu vadīšanas īpatnības*. Promocijas darbs, LU, 270 lpp.
  18. *Kārtība, kādā komercsabiedrības deklarē savu atbildību mazās (sīkās) un vidējās komercsabiedrības statusam*. (2014.g.16.dec.). MK noteikumi Nr.776. Skatīts 05.08.2017., pieejas veids <https://m.likumi.lv/doc.php?id=271191>
  19. KUENG, P., MEIER, A., WETTSTEIN, T. (2000). Computer-based Performance Measurement in SMEs: Is there any option? *1st International Conference on Systems Thinking in Management*, pp.318.-323.
  20. ĶIRSONS, M. (2017). *Pārsteidz finansiālais „brīnums”*. Dienas Bizness,, 23.05.
  21. LEVY, M., POWELL, P., GALLIERS, R. (1999). Assessing information systems strategy development frameworks in SMEs. *Information & Management*, Vol.35, Iss:5, pp.247–261.
  22. LIŠE, S. (2013). *Mazo un vidējo uzņēmumu konkurētspējas analīze koka mēbeļu ražošanā Latvijā*, LLU, 91 lpp.
  23. LÖFVING, M., SÄFSTEN, K., WINROTH, M. (2014). Manufacturing strategy frameworks suitable for SMEs. *Journal of Manufacturing Technology Management*, Vol. 25 Iss:1, pp.7-26.
  24. MALDIFASSI J.O., CAORSI, J.C. (2014). Export success factors of small- and medium-sized firms in Chile. *Journal of Small Business and Enterprise Development*, Vol. 21, Iss:3, pp.450-469.
  25. OMERZEL, D.G., ANTONCIC, B. (2008). Critical entrepreneur knowledge dimensions for the SME performance. *Industrial Management & Data Systems*, Vol. 108, Iss:9, pp.1182 – 1199.
  26. PANSIRI, J., TEMTIME, Z.T. (2008). Assessing managerial skills in SMEs for capacity building. *Journal of Management Development*, Vol. 27, Iss:2, pp.251 – 260.
  27. RAHMAN, S. (2001). A comparative study of TQM practice and organisational performance of SMEs with and without ISO 9000 certification. *International Journal of Quality & Reliability Management*, Vol.18, Iss:1, pp.35-49.

28. ROPEGA, J. (2011). Reasons and symptoms of failure in SME. *International Advances in Economic Research*. Vol.17, Iss:4, pp.476–483.
29. *SBA Fact Sheet. Latvia* (2016). Retrieved August 5, 2017, from <https://goo.gl/QHMKhd>
30. SINGH, R.K., GARG, S.K., DESHMUKH, S.G. (2008). Strategy development by SMEs for competitiveness: a review. *Benchmarking: An International Journal*, Vol.15, Iss:5, pp.525 – 547.
31. SME Performance Review 2016. Retrieved August 5, 2017, from <https://goo.gl/2E5kWm>
32. Statistics Database, 2017. Retrieved August 5, 2017, from <https://goo.gl/k9wSiw>
33. STOREY, D.J. (1994). *Understanding the small business sector*. London: International Thomson Business Press.
34. TATICCHI, P., CAGNAZZO, L., BOTARELLI, M. (2008). Performance Measurement and Management (PMM) for SMEs: a literature review and a reference framework for PMM design. *Annual Conference La Jolla*.
35. TONGE, J. (2001). *A Review of Small Business Literature. Part 1: Defining The Small Business*. WPS025. Manchester Metropolitan University Business School Working Paper Series. Retrieved August 5, 2017, from <https://goo.gl/FHygbK>
36. VINTEN, G. (1999). Corporate communication in small and medium-sized enterprises. *Industrial and Commercial Training*, Vol.31, No.3, pp.112.-119.
37. WATTS, T. & BAARD, V. (2005). The design of a performance measurement model for small firms within the service sector. Small Business Development Conference, pp.1-14,
38. WIJewardena, H., Nanayakkara, G. AND Zoysa, A.D. (2008) The owner/manager's mentality and the financial performance of SMEs. *Journal of Small Business and Enterprise Development*, Vol.15, Iss:1, pp.150–161.