

# Financial Performance of SMEs—Evidence on the Influence of Environmental Uncertainty: A Conceptual Framework

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The purpose of this study is to understand the association between environmental uncertainty and financial performance of small and medium enterprises (SMEs). Current study describes the influence of environmental uncertainty on the financial performance of SMEs in Iraq. The objective of this study was to assess the influence of environmental uncertainty on financial performance of SMEs. SMEs play an important economic role in many countries. In Iraq for example, the available data from the Central Organization for Statistics (COS) indicate that private sector in Iraq consists primarily of SMEs where those companies represent 99% of all companies in Iraq and this sector contributed over 50% of new jobs created. Despite their significance, facing competitive business environment, SMEs are required to develop innovation strategy in order to sustain competitive advantage. SMEs also are faced with the threat of failure with past statistics indicating that three out five fail within the first few months. This study sought to understand how SMEs manage the challenges they face. These challenges seem to change (evolve) according to different environmental uncertainty conditions. In this study, authors will develop an empirical model that can be applied in other sectors to improve financial performance of SMEs in Iraq.

*Keywords:* small and medium enterprises (SMEs), financial performance, environmental uncertainty

## Introduction

Small and medium enterprises (SMEs) are critical for the jobs and generating income for low income people and contribute to the development of a dynamic private sector. SMEs play an important role in the economic growth of a country (Harash, Alsaad, & Ahmed, 2013; Harash, Al-Tamimi, & Al-Timimi, 2014b; Harash, Al-Timimi, & Alsaadi, 2014c, 2014d). The relationship between environmental uncertainty and financial performance of SMEs has been the subject of an important debate in the business finance literature. This study investigates the effect that environmental uncertainty has on performance in a sample of Iraq SMEs. It is one of few researches that shed lights on how environmental uncertainty affects financial performance of SMEs. SMEs are very important. The only way to reduce poverty in a sustainable way is to promote economic growth through wealth and employment creation in the developing countries. SMEs are the major source of

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income, a breeding ground for entrepreneurs, and a provider of employment in many countries (Kraja & Osmani, 2013). SMEs particularly have a vital role to play in the development of Iraq, for example, the available data from the COS indicate that private sector in Iraq consists primarily of SMEs where those companies represent 99% of all companies in Iraq (Harash et al., 2013). But despite their significance, SMEs are faced with the threat of failure with past statistics indicating that three out five fail within the first few months (Harash et al., 2013, 2014c, 2014d; Mokamba, Gakure, & Keraro, 2013). However, at the present time, centre for Entrepreneurship, SMEs and local development in Organisation for Economic CO-Operation and Development (OECD) stated that SMEs have been especially hard hit by the global crisis. These firms are more vulnerable now for many reasons: It does not only have the traditional challenges of accessing finance continued to apply, but also the new particularly supply-side difficulties are currently apparent. It is important to stress that SMEs are generally more vulnerable in times of crisis for many reasons among which are:

- It is more difficult for them to downsize as they are already small;
- They are individually less diversified in their economic activities;
- They have a weaker financial structure (i.e. lower capitalization);
- They have a lower or no credit rating;
- They are heavily dependent on credit and they have fewer financing options.

SMEs in global value chains are even more vulnerable as they often bear the brunt of the difficulties of the large firms. In the previous literature, the environmental uncertainty can play a dominant role in assisting SMEs to make financial performance better and stronger; while, many researchers are of the opinion that the role of environmental uncertainty is important to enable SMEs to develop financial performance (Al-Temimi Suhail, Azlan, & Sofri, 2012; Harash et al., 2013, 2014b, 2014c, 2014d). To achieve this goal, SMEs need to be responsive to the changes in the environments, in particular to the information technology revolution. Nowadays, information technology is a must in many SMEs. It is difficult to gain competitive advantage and survive without some adoption or implementation of this advancement in technological products (Al-Temimi Suhail et al., 2012; Harash et al., 2013). In summary, the problem statement of the research can be stated as follows: Despite the effort made by the Iraq government to support the growth of SMEs sector by creating enabling environment through appropriate legal and regulatory procedures, studies have shown that 60% more (65%) of SMEs fail within few months of their operation (Harash et al., 2013, 2014b, 2014c, 2014d). Furthermore, research has also confirmed the opinion that the role of environmental uncertainty is important to enable SMEs to develop financial performance (Al-Temimi Suhail et al., 2012; Harash et al., 2014b, 2014c, 2014d). This study investigates the effect that environmental uncertainty has on performance in a sample of Iraq SMEs. It is one of few researches that shed lights on how environmental uncertainty affects financial performance of SMEs.

### **Financial Performance of SMEs**

Performance is a widely-used concept in many areas. Although, many researches have been conducted on the issues of performance, the definition of performance is still debated. In enterprise management, Moullin (2003) defined an organization's performance as "how well the organization is managed" and "the value the organization delivers for customers and other stakeholders". The performance prism was introduced by Neely Adams, and Crowe (2001) based on three fundamental premises. Firstly, the organizations should think about the wants and needs of all of their important stakeholders and endeavor to deliver value to each of them, if the

organization wants to survive and prosper in the long term. It is no longer acceptable for organizations to focus on one or two of their stakeholders. Secondly, organizations have to align and integrate strategies, processes, and capabilities in order to deliver real value to its stakeholders. Thirdly, the relationship between organizations and their stakeholders is reciprocal—stakeholders have to contribute to organizations as well as to expect something from them. Financial performance is commonly used as an indicator of a business's financial health over a given period of time. Performance and success have been defined in various ways in the literature, and in any business, the related parties always want to see good performance in their business (Harash et al., 2014b, 2014c, 2014d). Many businesses are maximizing their profit, making the development of profits a suitable indicator for financial performance as well. In this regard, it can also be argued that different businesses have differing financial aims and therefore, one financial performance indicator needs not to measure the success rate as perceived by the business itself. Financial performance refers to the act of performing financial activity (Srinivas, 2013). In broader sense, financial performance refers to the degree to which financial objectives are or have been accomplished. It is the process of measuring the results of a firm's policies and operations in monetary terms. It is used to measure firm's overall financial health over a given period of time and can also be used to compare similar firms across the same industry or to compare industries or sectors in aggregation (Gharakhani, Farrokhi, & Farahmandian, 2014; Harash et al., 2014b, 2014c, 2014d). The financial performance of a business can be measured in various different ways. Each of these different measures captures a slightly different aspect of financial performance (Harash et al., 2014b, 2014c, 2014d). Some, such as profitability, gauge return; others, like sales growth and market share growth, gauge the growth of a business. Some measures are indicators of commercial success (growth and market share), while others are indicators of financial success (profitability) (Kaplan & Norton, 1996). The level of success of a company within the SMEs sector is measured through its financial performance based on a selected period of time. In business studies, the concept of success is sometimes used to refer to a company's financial performance (Harash et al., 2014b, 2014c, 2014d; Islam, Khan, Obaidullah, & Alam, 2011). Given that SMEs often play a significant role in improving the economy of a country and lead to economy development globally, this puts performance as one of the key issues for SMEs where management is concerned. Many researchers (Basuony, 2014; Garengo, Biazzo, & Bititc, 2005; Harash et al., 2013; McDermott & Prajogo, 2012) believe that there are three fundamental differences between SMEs and large businesses: environmental uncertainty, innovation in products and service, and sustained evolution. Hence, performance measurement is often used in SMEs to manage uncertainty, innovate products and services, improve their processes, and benchmark against competitors (Garengo et al., 2005; Harash et al., 2013). In this context, most SMEs operate in a fiercely competitive environment; as such, it is important to optimize business practices. It is believed that environmental uncertainty tools can help to identify weaknesses, clarify objectives and strategies, and improve management processes. In addition, study highlights that these tools are difficult to adapt for SMEs. Iraq as one of the less developed countries, witnessed many changes during the last three decades, such as, the chaos of political and economic transformations that followed the invasion by the U.S.. In addition, the recent unprecedented changes have affected the country significantly in all segments of Iraqi society (Harash et al., 2013) and sector of SMEs in particular. These events changed the basic features of sector of SMEs and the instability and constants changes have become a dominant feature of the sector of SMEs in the Iraqi environment as reflected in the environmental uncertainty which affected the financial performance of SMEs in the Iraq. In this context, this study focuses on financial (objective) measures (Dowling & Helm, 2006; Harash

et al., 2013, 2014b, 2014c, 2014d; Thrikawala, 2011; Watson, 2007) based on performance: Financial measures of performance are derived from the accounts of a company or can be found in the company's profit and loss statement or the balance sheet. In addition, financial measures are also referred to as objective measures, because they can be individually measured and verified.

### **Environmental Uncertainty**

Contingency theory was one of the best approaches dealing with the problems of organizations that had been faced at that time. In this context, contingency theory is a class of behavioral theory that claims that there is no best way to organize a corporation, lead a company, or make decisions. Instead, the optimal course of action is contingent (dependent) upon the internal and external situation (Al-Temimi Suhail et al., 2012; Harash, Al-Timimi, Alsaad, Al-Badran, & Ahmed, 2014a; Howell, Windahl, & Seidel, 2010). The study uses environmental uncertainty as an independent variable to reflect the influence of contingency variables on the financial performance of SMEs. Milliken (1987) defined the environmental uncertainty as the inability to predict the events or changes of the environment (Al-Temimi Suhail et al., 2012; Harash et al., 2013). The outstanding definition by Galbraith (1973) denotes the relationship between information and uncertainty. He defined uncertainty as the difference between the total amount of information that the organization needs to have in order to accomplish the tasks, and the amount of information in possession of the organization (Al-Temimi Suhail et al., 2012). A few studies have been conducted to investigate the effect of environmental uncertainty variables on the performance, such as that of Al-Temimi Suhail et al. (2012) and Harash et al. (2014a). Some researchers in their studies have explained this by defining the concept of uncertainty which originates from three sources as in: (1) the external environment, (2) organizational interdependence or the internal environment, and (3) task characteristics (Al-Temimi Suhail et al., 2012; Harash et al., 2014a; Sicotte & Bourgault, 2008). That means that uncertainty represents the dimension to measure environment and has multi effects on other factors. According to Al-Temimi Suhail et al. (2012), Donaldson (2001) referred to the following: The contingency theory of organization is a major theoretical lens used to view organizations. He supported the notion of the theoretical and practical use of the contingency theory to explain the behavior of organization and study the designing and measuring the performance of these organizations according to relationship with environment. In this context, contingency theory plays a vital role in studying the organizations and their performance and contains much of importance in the history of organizational science (Al-Temimi Suhail et al., 2012; Harash et al., 2014a). The research in contingency theory is a basis of much that is taught today. In addition, scholars actively pursue contingency research in the contemporary era and it is being projected into the future in a series of exciting theoretical and empirical developments (Al-Temimi Suhail et al., 2012; Harash et al., 2014a).

### **Contingency Framework**

The study uses environmental uncertainty as an independent variable to reflect the influence of environmental uncertainty on the financial performance SMEs in Iraq. Based upon the literature, one can indicate the relationship between the environmental uncertainty variable and financial performance SMEs. The theory of contingency was used to determine the financial performance SMEs. Therefore, in order to let those various variables have a clear structure to indicate their relationship, this paper proposed a model, as shown in Figure 1 to illustrate these relations. The conceptual framework below shows the relationship among the

variables under study. The independent variable is the environmental uncertainty and the dependent variable is the financial performance of SMEs. The model describes the influencing mechanism of environmental uncertainty on financial performance of SMEs. It shows how the environmental uncertainty influences the aspects of financial performance of SMEs.

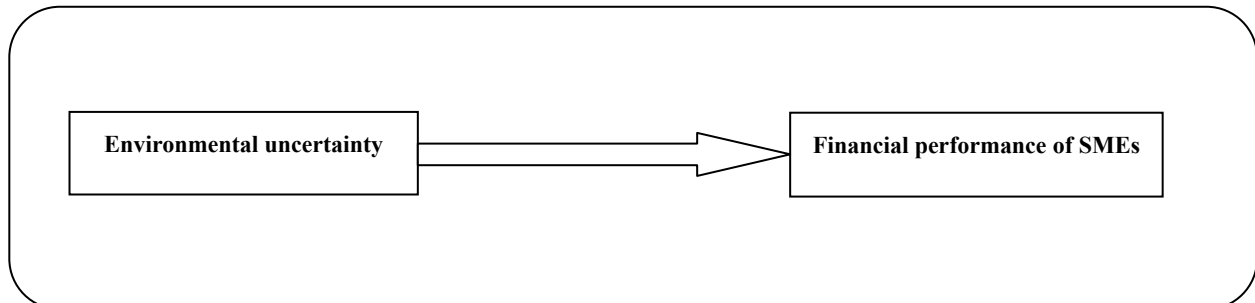


Figure 1. Proposed theoretical framework.

In order to examine the proposed relationships between environmental uncertainty and financial performance of SMEs, there is a proposition developed as a basis for the research. Current study developed the following proposition: The financial performance of SMEs will vary with the choice of environmental uncertainty adopted.

### Conclusions

This study attempts to examine the influence of environmental uncertainty variables on the financial performances of SMEs. More specifically, this study aims to shed some light on what environmental uncertainty actually means and investigate the environmental uncertainty affecting the financial performance of SMEs in the Iraq. This research is based on contingency theory to show the effect of environmental uncertainty on the financial performance of SMEs in Iraq. This study is one of the few studies that tackled this subject. Thus, the lack of studies in this respect is the complex and dynamic nature of the SMEs and the different objectives, especially in Iraq. The current study is a modest contribution to finding some sort of solutions for the problems of the financial performance of SMEs activities in Iraq and the variables that affect it.

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