

## An Assessment of Basic Accounting Practices and Business Entity Concept on the Performance of Small and Medium Enterprises in Kenya

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### **Abstract**

*Small and Medium Enterprises (SMEs) in many economies play significant roles in the economic growth of both developed and developing countries including employment generation and poverty reduction among others. These facts notwithstanding, majority of SMEs have failed to embrace Accounting Business Entity Concept. Instead they have treated business assets as private assets. This has resulted into a number of SMEs operating below standards and in worst cases even collapsing. The main objective of the study was an assessment of the relationship between basic accounting practices and Business Entity Concept on the performance of SMEs in Kenya. A cross-sectional descriptive research design was adopted to establish the performance of SMEs that practiced the accounting basics and applied the concept of Business Entity. Data was obtained through personalised interviews to 50 small and medium enterprises business owners. The study revealed that first; there is a direct relationship between accounting basics practices and SMEs performance and second, that there is a moderating effect of Business Entity Concept on the relationship between accounting basics practices and SMEs performance. The study recommended that SMEs should embrace the application of Business Entity Concept if they are to perform well. The study concentrated on basic accounting practices on the performance of SMEs moderated by Business Entity Concept against prior studies that hitherto concentrated only on accounting record keeping.*

**Key words:** *Small and Medium Enterprises; Business Entity Concept; Basic Accounting Practices; performance of Small and Medium Enterprises*

### **Introduction**

Small and Medium Enterprises (SMEs) have contributed greatly to the economies of all countries, in spite of their level of development (Nketsiah, 2018). They account for a large share of new jobs (Tambunan, 2004), stimulate growth, create social cohesion, generate income (Nketsiah, 2018) and thus sphere head the Gross Domestic Product (GDP) growth in most countries. SMEs are the main source of employment in first and third world countries. Small and Medium Enterprises comprise over 90% of African business operations and contributing to over 50% of African employment and GDP (Okafor, 2012). According to the economic survey in Kenya (2006), the SMEs sector contributed over 50% of new jobs in the year 2005. This has culminated into; a reduction of unemployment problem, raising the standards of living of the populaces and hence contributing to economic growth of the country.

For SMEs across the world to record high performances, it is mandatory that they embrace Business Entity Concept that treats business as a separate entity from its owners. In addition, this should be applied in conjunction with Accounting Basics in their day to day operations (Sangster, Gordon, & Wood, 2018). Accounting basics entail the following steps; opening up of a business bank account, tracking of expenses, developing a bookkeeping system which involves use of double entry system, setting up of a payroll system, investigating import tax, determining the payment methodology, establishing sales tax procedures, determining tax obligations, calculating gross margin, applying for funding, finding high quality accounting partners and periodically re-evaluating the methods (Aladejebi & Oladimeji, 2019). It was expected that the Small and Medium Enterprises which applied the accounting basics would perform well. These facts, notwithstanding, research have shown that the SMEs have not been able to apply accounting basics (Nketsiah, 2018); (Muteti, Namusonge, & Nzomo, 2018). This has been partly attributed to low level of education and lack of business advisory services (Muchira & Jagongo, 2018)

Applications of accounting basics are significant for the SMEs growth and performance in any economy. For instance, opening of bank accounts will enable proper record keeping whereby the business entity concept will apply. This concept separates personal incomes from business (Gupta & Radhaswamy, 2014). Furthermore, loans and taxes are also based on earnings (Sangster, Gordon, & Wood, 2018). Most of the SMEs lack funds and therefore requires short term loans from financial institutions especially Cooperatives and Savings Societies to finance their business given their low interest rates. However, this is usually not possible as financial institutions would like to track their cash flows for a given period of time to assess their credit worthiness (Sangster, Gordon, & Wood, 2018). This can only be achieved if SMEs maintain a separate business bank account. More importantly, accounting basics also involve proper record keeping through the art of double entry system (Musa, 2020). Proper record keeping would thus enable businesses to keep track of all transactions and thus easy allocation and corrections of errors which is geared towards improved performance of SMEs (Senzu & Nebugri, 2018). This would enable financial institutions determine the

amount of loans given to SMEs based on credit worthiness. Maintaining of business bank account would also ensure that SMEs keep a record of cash book in their organizations to keep track of cash flows which enable the monthly preparation of bank reconciliation statements. Based on the Business Entity Concept, SMEs should also keep an account of its assets and should treat them solely as business properties.

### **Statement of the Problem**

Small and Medium Enterprises (SMEs) in many economies play significant roles in the economic growth including employment generation and poverty reduction in both developed and developing countries.

Past studies concentrated mainly on the impact SMEs application of double entry system of record keeping and how these influenced their performance or on the extent to which SMEs embraced the advisory services (Otengo, 2016). However, accounting basics such as opening business bank accounts separate from private accounts had been ignored. These studies did not assess the relationship between Accounting Basic practices and performance of SMEs. Further, Business bank account would show the amount of incomes earned and maintained by SMEs. This has been a very serious omission since most of the SMEs lack funds to; train their employees, improve the living standards of their employees and also develop their businesses which would affect performance. It was hence evident that a research gap in literature existed on the application of Business Entity Concept by SMEs. It was against this background that the current study was conducted.

### **Objectives of the study**

The objectives of the study were to:

- 1) To evaluate the relationship between basic accounting practices and SMEs performance.
- 2) To determine the moderating effect of Business Entity Concept on the relationship between basic accounting practices and SMEs performance

### **Literature Review**

For SMEs to achieve high levels of performance leading to the overall economic growth and development, they must ensure that the following areas are addressed: Increase in capital; improved sales; creation of more employment opportunities and engagement in diversification of SMEs products. Increase in capital would mean that SMEs attain high levels of sales as they minimize operating expenses. This is because profits equal sales revenues minus operating costs (Frank Wood & Sangster, 2018). In financial accounting for sole proprietors, where most SMEs fall, capital will definitely increase if it is added to the profits of a business. In most SMEs, this has not been the case as most have failed to adhere to the basic accounting practices (Aladejebi & Oladimeji, 2019).

*Improved Sales Revenues* mean that SMEs should review pricing strategies by cutting down on costs. With an increase in sales revenue and reduction on operating costs, SMEs are likely going to increase their profits and hence economic growth and development.

*More Employment*, SMEs in Kenya have created more jobs to the economy. An economic survey conduct in Kenya (2006) revealed that SMEs played significant roles in economic growth and development due to their provision of economic benefits. They created new jobs, reduced the attrition of human capital. These were made possible by providing substitute employment opportunities for semi- skilled and unemployed workers (Kenyan economic survey, 2011). The economic survey of 2006 indicated that 50% of the new jobs produced in 2005 were a product of SMEs (GoK, 2006). The economic survey of 2003 further indicated that the SMEs sector contributed to 18.4% of the country's gross domestic product, which was an important indicator of a country's economic growth, a gate way to economic development. If the SMEs could faithfully apply the basic accounting practices and embrace the Business Entity Concept, these numbers would grow even higher.

*Product Diversification*; SMEs should undertake the diversification of their products to create exponential growth this is by adding new products and services (Sam Edmunds, 2019). However, it is important to note that SMEs can only venture into diversification if it is financially stable. Thus unless the SMEs embrace Accounting basic practices and Business Entity Concept in their daily operations achievement high performance levels, economic growth and development may never be attained.

### **Double Entry System of Book keeping and SMEs performance**

It is prudent that SMEs should learn to apply double entry system of book keeping, to keep track of business revenues against expenses. This will enable SMEs determine their exact amount of profits which is a strong indicator of high financial performance (Musa, 2020).

Research has shown that most SMEs have not embraced double entry system of record system. This has affected their performances since there is a strong relationship between double entry system and SMEs performance. Double entry system records financial transactions in relation to assets, liabilities, income, owners' equity and expenses related to it through accounting entries (Jain & Narang, 2009; Wood & Sangster, 2015). The procedures of double entry system are important for record keeping purposes (Alvaro, 2012).

A study by Nketsiah (2018), examined record keeping practices of small business operators in the Sekondi-Takoradi Metropolis. Findings revealed that 85% of small business operators kept records relating to customer's indebtedness (Mean score=0.85; SD=0.361); with asset register as the least records kept (Mean Score=0.50; SD=0.502).

A study by Aladejebi and Oladimeji (2019) analysed the extent to which accounting information was used to measure the financial performance of SMEs. Findings revealed that majority of the SMEs owners lacked basic accounting knowledge and criticized the cost involved in preparing financial statement hence they kept the records themselves manually.

SMEs should also apply double entry system in measuring their Working Capital Management (WCM) whose efficiency is inevitable because it is attached to liquidity, survival, solvency and profitability and growth of SMEs. The working capitals of most SMEs have been negative, implying that their current liabilities outweigh their current assets. This has affected their liquidity positions.

A study by Raji Sadiq (2017) on the impact of working capital management on SMEs performance in Nigeria established that accounts payables period, cash conversion cycles and net trading cycle had positive effect on performance. The study also established a negative relationship between accounts receivables, inventory turnover with performance.

The study, however, ignored the fact that efficient management of working capital starts with adherence to double entry system. For instance, application of double entry will enable SMEs maintain proper records of their accounts receivables, accounts payables, inventories, cash at bank and cash in hand. Thus enabling SMEs in the calculations of current ratios and quick acid test ratios for the determination of their business liquidity position which are important tools in measuring how soon liabilities are converted into assets. Management of proper working capital would lead SMEs on their path to better performance and hence survival and growth.

Other areas where double entry system are applicable include; taxation, auditing. It is clear from the discussions above that when accounting basics are not understood and comprehended, SMEs will record poor performance.

### **Accounting Errors and SMEs Performance**

Poor performance by most SMEs has been attributed to other factors including, lack of business advisory services Otengo (2016); poor record keeping Ghasia; Wamukoya and Otike (2017). However, no attention has been attributable to accounting errors made in SMEs books of accounts which could be the greatest contributor to low sales and thus low profits.

The current study attributes poor performance to accounting error. Errors are made in the books of accounts of SMEs at any given time. They include errors of commission, errors of omission, errors of principles, compensating errors, single entries errors and errors of complete reversal of entries. SMEs are obliged to identify and correct errors. Errors will either understate or overstate profits revealed by SMEs which have negative effects on SMEs performance (Jain & Narang, 2009; Frank & Sangster, 2015). For instance, tax is paid out of profits overstating profit would mean that SMEs would pay an overstated tax. The implication would be underpayment of salaries to SMEs employees and hence low production, low growth and hence poor performance.

### **Accounting Principles and SMEs' Performance**

These are the Generally Accepted Accounting Principles (GAAPs) outlined to be followed in preparing the financial statements of various organizations. Research has shown that most SMEs do not apply the accounting principles in preparing their financial statements. This has a negative effect on SMEs' profits and hence performance. For instance Matching Principle requires that expenses incurred by an organization must be charged to the income statement in the accounting period in which the revenue, to which those expenses relate, is earned. Failure of SMEs to apply these principles appropriately, Incomes for that particular period will be understated and thus not reflect the true net profit for that period. Also, Failure to understand and apply both the matching and revenue recognition principles correctly, would have an effect in the preparation of financial statements and thus performance (Musa, 2020).

A study by Aladejebi and Oladimeji (2019), analysed the extent to which accounting information was used to measure the financial performance of SMEs. Their findings revealed that majority of the SMEs owners lacked basic accounting knowledge and criticized the cost involved in preparing financial statement hence they kept the records themselves manually.

A study by Kayebire (2016) assessed the relationship between the record keeping and performance of small business enterprises in Uganda. The study established that World Vision International should advocate for participative budgeting and that feedback is an important role of budgeting for attaining the expected quality by SMEs.

However, the studies did not assess accounting principles specifically on SMEs performance. For example, the most important aspect of accounting principles is that all financial statements should provide important information that can be used to make informed business decision. Once all the rules and regulations that govern the preparation of accounting books are adhered to, it becomes easier for SMEs to understand other aspects of accounting.

Knowledge of accounting basics would later help SMEs in the computation of correct taxable amount. This will be of great significance because tax is paid based on a firm's net profit. It means that without the knowledge of income statement, SMEs will not be in a position to determine the exact tax return that should be paid accurately.

In Kenya's economy, tax computation is a requirement at the end of every financial year for every citizen (Kenya Revenue Authority, 2018). Knowledge of the preparation of financial statements is important to tax authorities to ensure the accuracy of taxes and additional duties declared and paid by an entity. Preparation of financial statements also applies the relevant principles including; accruals, prudence, matching, revenue recognition as explained above.

In auditing: the purpose of an audit is to provide an objective independent examination of the financial statements which increases the value and credibility of financial statements produced by management. This is with a view to increasing SMEs confidence in the financial statement; reduce investor risk and cost of capital. To record high performance, SMEs should therefore be in a position of producing the most reliable financial statements based on accounting principles.

Evaluators of SMEs prefer financial statements which have passed through vigorous financial audit that provide an opinion whether financial statements are stated in accordance with specified criteria. This is due to the fact that those who make important decisions based on the financial conditions of a business need the most reliable financial information. However, most SMEs are lacking these and their performance has been at stake.

### **Accounting Business Entity Concept and SMEs Performance**

Business Entity Concept reports that financial accounting is based on the premise where transactions and balances of a business entity are to be accounted for separately from its owners. The business entity is therefore considered to be distinct from its owners for the purpose of accounting. Therefore, any personal expenses incurred by owners of a business will not appear in the income statement of the entity. Similarly, if any personal expenses of owners are paid out of assets of the entity, it would be considered to be drawings for the purpose of accounting much in the same way as cash drawings (Gupta, 2014).

Most SMEs businesses have violated this concept as far as business bank accounts, cash accounts and assets of the firms are concerned. It has been observed that most SMEs do not maintain separate business cash accounts but instead mix up business money with their private monies. This makes it difficult for the determination of exact amount of profit. This is because profit is the difference between business revenues and business expenses. The SMEs thus end up collapsing. A typical example is a small kiosk business where the owner uses income from the business for private consumption; very soon this business will close up due to lack of funds. Application of business Entity Concept would save such SMEs from collapsing. SMEs applying Business Entity Concept are expected to keep track of business revenues against expenses. This will result into reporting the correct profits which is a strong indicator of performance (Frank Wood & Sangster, 2018). Prior studies on SMEs performance overlooked this important concept but instead only stressed record keeping, business advisory services and maintenance of financial statements.

Business Entity Concept through the art of record keeping stresses the maintenance of a separate business Bank account. Most SMEs have not opened business bank accounts. However, the few that have opened do not adhere to the Business Entity Concept. In most cases business money is withdrawn anyhow from the bank for personal use until the account is left with bare minimum balance. This has an effect since such SMEs could not qualify even for bank overdraft. Further, most financial institutions borrow SMEs loans based on the bank statements which should show the average amount of money maintained in the accounts. These SMEs fail out on this and are therefore not considered for the loans. The multiplier effect is witnessed when SMEs cannot pay its accounts payables, employee's salaries, suppliers and thus poor performance.



It is evident, if SMEs misses out on the understanding of accounting basics, it becomes very difficult to build a successful Entrepreneurial base. This is based on the fact that all accounting practices are rooted on double entry concept and accounting principles. For example, the most important aspect of accounting theory is that all financial statements should provide important information that can be used to make informed business decision such as the business entity principle. Once all the rules and regulations that govern the preparation of accounting books are adhered to, it becomes easier for accounting SMEs to understand other aspects of accounting.

The application of accounting basics would later help SMEs in the computation of correct taxable amount. This will be of great significance because tax is paid based on a firm's net profit. It means that without the knowledge of income statement, SMEs will not be in a position to determine the exact tax return that should be paid accurately. In Kenya's economy, tax computation is a requirement at the end of every financial year for every citizen (Kenya Revenue Authority, 2018). Knowledge of the preparation of financial statements is important to tax authorities to ensure the accuracy of taxes and additional duties declared and paid by an entity. Preparation of proper financial statements also applies that the relevant principles including; accruals, prudence, matching, revenue recognition are embraced by the SMEs.

In auditing: the purpose of an audit is to provide an objective independent examination of the financial statements which increases the value and credibility of financial statements produced by SMEs management. This is with a view to increasing SMEs user confidence in the financial statement; reduce investor risk and cost of capital. SMEs should therefore be in a position of producing the most reliable financial statements. This is due to the fact that those who make important decisions based on the financial conditions of a business need the most reliable financial information. Evaluators of companies prefer financial statements which have passed through vigorous financial audit that provide an opinion whether financial statements are stated in accordance with specified criteria (Frank Wood and Sangster, 2018).

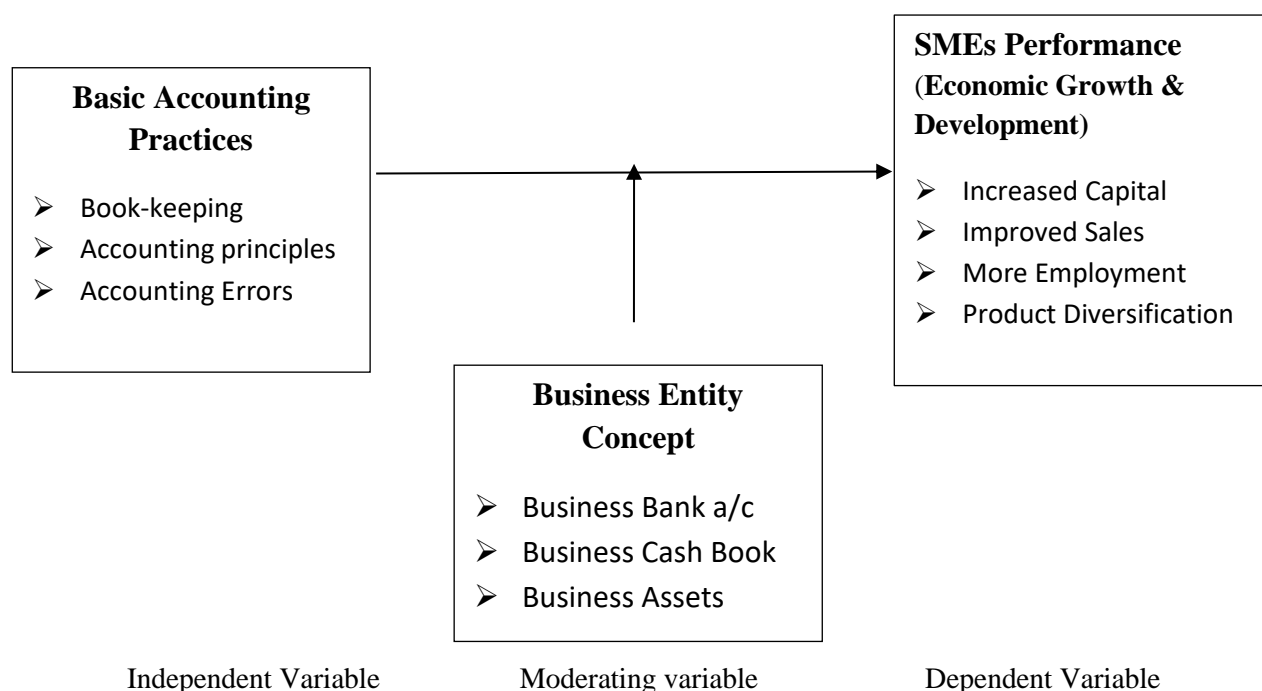
For SMEs across the world to achieve high level of performance based on increased capital, improved sales, more employment and product diversification, it is mandatory that they embrace Business Entity Concept in conjunction with an application of Basic Accounting practices in their day to day operations (Sangster, Gordon, & Wood, 2018).

### **Theoretical Review**

This study applied the Business Entity Theory. The theory states that the transactions associated with a business must be separately recorded from those of its owners or other businesses. Doing so requires the use of separate accounting records for the business that completely exclude the assets and liabilities of any other entity or the owner. Without this concept, the records of multiple entities would be intermingled, making it quite difficult to discern the financial or taxable results of a single business. In accounting, a business or an organization and its owners are treated as two separately identifiable parties. This concept was important to the current study since one of the major problems facing SMEs is lack of funds to finance their businesses, and also to differentiate themselves from their own businesses. The multiplier effects include, lack of funds to train the employees on basic accounting practices, low standards of living, lower salary payments and eventually force the closure of the businesses. The application of Business Entity Concept also implies that SMEs would separate business assets from that of private. Research has shown that most small scale businesses such as those operating kiosks, Motor bike businesses or and Jua kali enterprises have maintained same account for business and their private uses. Such businesses end up collapsing (Kahando, Maina & Maina, 2017).

### **Conceptual Framework**

The conceptual framework shows the direct and moderating relationships that exist between the variables and the independent variable. Basic accounting practices is used as an independent variable, Business Entity Concept has been used as a moderating variable and SMEs performance as a dependent variable.



**Figure 1: Conceptual Framework**  
 Source: Authors Conceptualisation (2020)

### Methodology of the Study

The study employed the use of personalised interviews with a descriptive cross-sectional design to establish the extent to which SMEs practiced the basics of accounting and application of Business Entity Concept. The study relied heavily on primary data since the data collection instrument was a personalised interview with 50 SMEs' business owners. Kothari (2004), argues that descriptive cross-sectional was chosen in view of the fact that, it is a small-scale study of a relatively short duration and it involved a systematic collection and presentation of data to give a clear picture of a particular situation.

### Data Analysis and Discussion

The study had targeted to interview 50 SME owners, however, only 45 were interviewed contributing a 90 percent response rate.

The first question was whether the business owners adopted basic accounting practices like book-keeping in their day to day business activities. Out of the 45 interviewees, (35) 78 percent acknowledged the use of basic accounting practices.

**Table 1: Adoption of Basic Accounting Practices**

Adoption of Basic Accounting Practices	Frequency	Percentage
YES	35	78%
NO	10	22%
<b>TOTAL</b>	<b>45</b>	<b>100%</b>

The respondents were further asked how basic accounting practices help in their business; they gave a variety of answers; calculating business profits and losses, report writing on the way forward with the business and accountability among others. They attributed their knowledge of basic accounting practices on experience and not training. This is because the longer one operates the business, the better the understanding of the market dynamics, record keeping helps in this. Some SMEs acknowledged interaction with bigger businesses helped them to run their own businesses since business success is key. The 10 SMEs that did not adopt basic accounting practices complained of low results in as far as performance was concerned. However, they indicated keen interest on wanting to know basic accounting practices.

The second question focused on the SMEs that adopted basic accounting practices. The interviewer wanted to establish whether the SMEs regarded the Business Entity Concept. Out of the 35, only (5) adopted the concept.

**Table 2: Application of Business Entity Concept**

Business Entity Concept	Frequency	Percentage
YES	5	14%
NO	30	86%
<b>TOTAL</b>	<b>35</b>	<b>100%</b>

Table 2 above shows (30) 86percent that did not apply the Business Entity Concept, hence did not differentiate themselves from their businesses. The proceeds from the business went directly to their domestic budget. On further questioning, it was established that most SMEs business owners are their families' bread-winners hence whatever they get is what the family feeds on. The 14 percent that applied the Business Entity Concept registered great business performance in as much as profits were concerned. This is because the returns from the business were apportioned appropriately. This made room for expansion of the business to reach a wider market hence increased sales. On further questioning it was revealed that the SMEs that applied the concept were not based as a one-person business but a group of people came together to form a bigger entity.

The study established that basic accounting practices are mandatory for SMEs for accountability reasons. Moreover, Business Entity Concept should be applied, to give room for SMEs to improve their enterprises. This would boost the economy of the country.

### Findings

The first objective of the study was to evaluate the relationship between basic accounting practices and SMEs performance. The study established a direct relationship between basic accounting practices and SMEs performance. The second objective of the study was to determine the mediating effect of Business Entity Concept on the relationship between basic accounting practices and SMEs performance. The study established a positive mediating effect of Business Entity Concept on the relationship between basic accounting practices and SMEs performance. This finding is supported by Aladejebi and Oladimeji (2019), who established that majority of the SMEs owners lacked basic accounting knowledge and criticized the cost involved in preparing financial statement hence they kept the records themselves manually. This was a clear indication that those SMEs performed poorly due to lack of the application of Business Entity Concept. This finding is also supported by Otengo (2016) that employee competences had the greatest influence on the use of business advisory services. The competence could be in form of application of Business Entity Concept where SMEs should be in a position to separate business income from its owners. A study by Kayebire (2016), Produced conflicting results, that World Vision International should advocate for participative budgeting and that feedback is an important role of budgeting for attaining the expected quality by SMEs

### Conclusion

SMEs play vital roles in all economies in employing a large number of the populaces. Adherence to basic accounting practices and use of Business Entity Concept will facilitate their growth and performance. It was clear that transactions associated with a business must be separately recorded from those of its owners or other businesses. Without this concept, the records of multiple entities would be intermingled, making it quite difficult to discern the financial or taxable results of a single business. Hence the growth of SMEs is at stake.

### Recommendations

The study recommended that SMEs should embrace the application of Business Entity Concept if they are to perform well for better business growth and performance. The study concentrated on performance of SMEs with a concentration on basic accounting practices emanating from Business Entity Concept. This was contrary to prior studies that hitherto concentrated on accounting record keeping with a concentration to double entry system and preparation of financial statements, Business advisory services.

### Contribution to the body of Knowledge

The inclusion of Business Entity Concept as a moderating variable by the current study brings out the greatest contribution to the body of knowledge. This is particularly so because most SMEs have 'sank their heads in sand' as a result of treating business bank accounts, business cash and business assets as same entities with owners. Prior studies have hitherto concentrated only on record keeping, financial statements and business advisory services.

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