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Liquidity management in small firms: a learning perspective

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Abstract

Purpose – This paper aims to focus on liquidity management in small firms and how this may be best met. It seeks to present results from eight case study firms to demonstrate different types of learning in small firms.

Design/methodology/approach – The paper uses a qualitative methodology that involves in-depth, semi-structured interviews and direct observation, conducted longitudinally in eight case study companies.

Findings – The findings suggest that liquidity management is either based on owner-manager past experiences, experiences of others or is strongly influenced by industry norms, which are shared rules within the industry, and not based on the calculation of costs and benefits of particular causes of action.

Research limitations/implications – The study is limited to the extent to which it can be generalised to a wider population of small firms. The main implication is that policy makers should facilitate networking opportunities where owner-managers can interact with external advisors.

Originality/value – The originality and value of the paper is that it conceptualises liquidity management in small firms as a learning process utilising closed and open loop learning.

Keywords Liquidity, Learning organizations, Decision making, Finance, Qualitative methods, Small enterprises

Paper type Research paper

Introduction

The paper is concerned with liquidity management in small firms and how this may be best handled. Liquidity management in small firms can be defined as the planning and controlling of cash flow by owner-managers in order to meet their day-to-day commitments (Collis and Jarvis, 2000). The case study firms were selected from the printing and clothing industries, because previous research (e.g. North et al., 1997; Ekanem, 2002, 2005) had emphasised their different technology bases and different levels of investment expenditure. This has potential implications for financial management issues faced by owner-managers of these industries.

Small firms are not a miniature of large firms or scaled-down versions of large firms (Jarvis et al., 1996), but differ from large firms in a number of respects, two of which are particularly important from the point of view of this paper. The first is the combination of ownership and management in an individual business owner. The second is the limited resources (such as finance and management skills) compared to large firms. Consequently, management needs of small businesses are different from those of large businesses and simply watering down or simplifying management tools used by large firms is not always effective in the small firm context.

Ever since the Bolton Committee (1971) drew attention to the poor financial management skills in small firms, there have been various studies in this area that
have found that the situation has only improved slightly (Drever, 2005). Although there have also been several “how to do it” studies on the subject, dealing with advice to small firms with respect to financial management (e.g. Barrow, 1993), recent studies have found that poor credit management is a major concern for small businesses as they feel powerless to do anything about their debtors’ late payments (Peel et al., 2000; Drever, 2005).

The limited impact of previous studies is the result of weaknesses in the methodologies used and the over-reliance on the financial practices of large firms as well as the standards and practices used by accountants, banks, and other professionals, without paying much attention to the practices actually used by small business owners themselves. The core argument in this paper is that to improve practices in dealing with liquidity problems in small firms, advice given and methods recommended should be those grounded in the actual behaviour of small business owners (Ekanem, 2005). This means understanding the motivations of small business owners and their experiences and not just making assumptions about it.

By focusing on the behaviour of owner-managers with respect to liquidity management, the paper is aimed at how small business owners and managers actually manage their cash in- and out-flows, rather than how they ought to behave. Following a brief review of the literature context and the research methodology employed in the study, empirical evidence from the eight case studies is presented and analysed under a learning framework. The final section draws conclusions from the analysis and highlights the limitation of the study and the implications for further research.

The literature context

The uniqueness of liquidity management in small firms

Efficient and effective liquidity management is crucial if the survival and prosperity of small firms is to be ensured (Deakins et al., 2000; Sardakis et al., 2007). Sadly, the assessment of liquidity management practices in small firms, and how these should be improved, has tended to be based solely on the standards and practices used by large companies or those adopted by professionals such as accountants, consultants, banks, etc., with relatively little attention being paid to the practices actually used by owner-managers themselves. Nayak and Greenfield (1994) argue that owner-managers in their survey of 200 small firms in the West Midlands did not use financial management techniques very effectively. Yet, these techniques are those designed for large companies and consequently the process of financial management and associated decision-making in small firms remains something of “a black box” (Deakins et al., 2000).

The most problematic aspect of small firm financial management is liquidity management, which is more critical than that indicated in the financial management literature (Jarvis et al., 1996). Liquidity refers to the level of cash and near-cash assets held, as well as cash inflows and outflows of these assets. McMahon and Stanger (1995, p. 24) emphasise the importance of liquidity in a small enterprise as being “a matter of life or death for the small business” since a small business can “survive for a long time without a profit, but fails the day it can’t meet a critical payment”. But this important issue has for some time been overlooked in some countries, with limited research in others (Chittenden and Bragg, 1997; Drever and Hartcher, 2003).
Deloof (2003) posits that the efficient management of working capital (inventory, debtors and creditors) is crucial in respect of the prosperity and survival of SMEs, and Drever (2005) sees the soundness of liquidity management as the most critical influence on survival and financial well-being in small enterprises. Liquidity management takes the form of cash management and credit management. Whilst the most important aspect of cash flow management is avoiding extended cash shortages, credit management involves not only the giving and receiving of credit to customers and suppliers, but also involves the assessment of individual customers, the credit periods allowed and the steps taken to ensure that payments are made in time (Poutziouris et al., 1999).

The Bank of England (2003) indicates that small firms are particularly vulnerable to bad debts because they tend to have a smaller customer base than large enterprises. Small firms with fewer than 50 employees also seem to be net providers of trade credit (Bank of England, 2003). The Bank of England (1999) argues that the amount of finance tied up in credit transactions that could potentially be used for cash flow purposes should not be underestimated. On average 91 per cent of daily business transactions in small firms are on credit terms (Chittenden et al., 1998), whilst over 90 per cent of small businesses have not noticed any improvement in late payment since the introduction of the Late Payment Act in 1998 (Bank of England, 2001).

In examining liquidity and small firm financial management, Ang (1992) points out that working capital management takes a major proportion of a small firm owner-manager’s time, and that part of this is devoted to management of excess liquid funds. McMahon and Stanger (1995) argue that the difference in liquidity between large and small firms supports the belief that working capital shortages are a common problem for small firms, and that this difference could be the result of the small firm’s limited access to capital markets and/or the basic nature of the enterprise. They conclude by stating that liquidity should be a matter of concern for the small enterprise because cash is such a critically scarce resource as a result of supply constraints, which do not exist to nearly the same extent for a large firm. This cause of concern is reinforced by the fact that small firm owner-managers are inclined towards risk-taking in an inherently risky and uncertain environment (Curran et al., 1997). In this respect, organisational learning becomes a crucial factor in the survival of the firm because survival in a risky and competitive environment requires innovation and innovation requires new knowledge or a new way of combining current knowledge (Michna, 2007).

Organisational learning in small firms
Although there is a growing recognition of the role of organisational learning, there are limited empirical studies to demonstrate the link between learning and organisational effectiveness. This suggests that not enough attention has been paid so far to the specific character of the learning processes in small firms and the impact of the processes on their performance (Michna, 2007).

The ability of the owner-manager to learn from previous decisions, experience, mistakes and from others within their network is crucial to the ability of small firms to survive and/or gain competitive advantage (Harrison and Leitch, 2005; Gibb, 1997). This learning entails not only reacting or adapting to the environment in order to cope with it and survive but it also entails ‘generative’ learning, which embodies the capacity to create and ‘bring forward’ experience, rather than wait for (and learn from)
Organisational learning in small firms can take the form of tacit knowledge or formal knowledge. Polanyi (1967) distinguishes between tacit knowledge, which is implicit and not codified, and formal knowledge, which is explicit and codified. Although Polanyi discusses tacit knowledge in the context of an individual, organisational learning leads to the mobilisation of tacit knowledge held by individuals within an organisation, which can provide a forum for knowledge creation and greater effectiveness (Lumpkin and Lichtenstein, 2005). In this context, the learning process may include bringing forward the learning of customers and others such as accountants, agents, marketing channels, as well as acquaintances, friends and family as nodes in a complex network of economic relationships, dependencies and mutual obligations (Spender, 1996).

Organisational learning has been found to enhance financial and knowledge performance (Marsick and Watkins, 2003). Van Gelderen et al. (2005) studied the relationship between organisational learning and small business performance and found a correlation between the ability to learn and the achievement of goals set by the entrepreneurs, while Michna (2007) concluded that proactive processes based on double-loop learning will be crucial as they result in organisational changes.

Organisational learning in small firms depends upon the owner-manager’s ability and willingness to learn from reflection and analysis of critical events that have taken place (Cope, 2003). Key stakeholders with whom the owner-manager interfaces may also trigger the learning process, whereby the owner-manager’s perspective of a given situation is challenged by the stakeholder, offering the benefit of their experiences. Wyer et al. (2000) argue that if the individual is able to reflect and adjust in the light of the new insight then a change takes place. Thus, the potential for adopting an organisational learning perspective to enhance the understanding of how small businesses survive and develop appears high. Although critical learning events represent an entrepreneurial learning process, there is still a lack of understanding within the entrepreneurship discipline regarding the specific forms and levels of learning associated with these events (Cope, 2005).

**Research methodology**

It has been acknowledged in the literature that there is a need for grounded data collection in the study of entrepreneurship (Stockport and Kakabadse, 1992), although the use of qualitative methods is a relatively recent phenomenon. Therefore, a qualitative methodology was used in this study in order to capture owner-managers’ motives for actions (Ekanem, 2007).

The use of this approach provided a basis for understanding the behaviour of small firms and the motivation of owner-managers, which helped to answer basic questions relating to process. A crucial feature of this approach is its capacity to elicit descriptions, explanations, and evaluations of every aspect of owner-managers’ actions. Thus, qualitative methodology generates owner-manager’s knowledge which can be tapped and treated as the basis of an alternative conception of appropriate techniques for smaller businesses.
The research was conducted longitudinally during which owner-managers were interviewed three times at different stages over a period of one year from 1998 to 1999 and case material built up on each company. Deakins et al. (2000) indicate that little longitudinal research has been carried out in small firms.

The case study firms consist of eight limited companies from two contrasting sectors, half in the printing and half in the clothing sectors (as shown in Table I). The two sectors with different technological bases provide contrasting example of issues in liquidity management and how these issues were resolved by the owner-managers. The oldest firm (a printing firm) was established in 1924 and the youngest (a clothing firm) in 1993. The smallest firm had six employees and a turnover of £0.5 million; the largest company had 50 employees and a turnover of £10 million.

Given that the research was inductive, involving longitudinal data collection over a 12-month period, a sample size of eight firms was decided upon for the qualitative case study. The choice of eight firms was influenced by Eisenhardt (1989, p. 545), who argues that “while there is no ideal number of cases to include in the sample, a number between 4 and 10 usually works well. With fewer than 4 cases it is often difficult to generate theory [...] with more than 10 cases it quickly becomes difficult to cope with the complexity and volume of the data”. The firms consisted of those with less than 50 employees, who were mainly based in London and were purposefully selected. To be included in the study the firms had to have been in existence for at least a year, independently owned and of different ages.

The first interview was exploratory in nature, which helped to establish the initial boundaries for the research as well as providing details of the owner-managers' background and personal biographies such as age, education and training, and experience. The second and third interviews were in-depth and focused on the cash flow/liquidity management of the firms. Although owner-managers were the prime focus of attention as the key decision-makers, other informants such as key employees, especially credit controllers, were also interviewed. This helped in checking and stabilising conflicting evidence. The interviews were semi-structured and followed a detailed interview plan, which was designed to flexibility in the order that the topics are to be covered, and the opportunity to follow-up issues raised during the course of the interviews.

The interviews adopted a style of conversation with questions designed to elicit free-flowing narratives (Jarvis et al., 1996). Respondents were encouraged to speak freely and to elaborate on their comments by probing gently. Thus, a conversation was facilitated, giving the interviewee a good deal of leeway to talk in their own terms (Spence and Rutherford, 2001). The initial interviews lasted for about an hour, but the second and third interviews lasted considerably longer than this as matters were dealt with in detail. With the agreement of the owner-manager all the interviews were tape recorded, on the understanding that the material provided would be treated as confidential.

The use of qualitative methodology was necessary because rather than testing concepts, it allows experiential understanding while still allowing comparison (Deakins et al., 2000). A case study approach was also used because the study was asking “how” and “why” questions relating to process (Yin, 2003), which allowed a deeper, individualised understanding of the process of decision-making in companies (Gummesson, 2005).
<table>
<thead>
<tr>
<th>Company</th>
<th>Sector</th>
<th>Year started</th>
<th>Legal status</th>
<th>Number of staff</th>
<th>Turnover</th>
<th>Liquidity management</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Printing</td>
<td>1982</td>
<td>Limited</td>
<td>35</td>
<td>£3m</td>
<td>Use gut-feeling and judgement 30 or 90 days' credit, although industry norm is 60 days Recommendation from customers Advice from staff Advice from accountant/solicitor</td>
</tr>
<tr>
<td>2</td>
<td>Printing</td>
<td>1966</td>
<td>Limited</td>
<td>20</td>
<td>£2m</td>
<td>Use gut-feeling and judgement Industry norm of 60 days Recommendation from customers Advice from staff Advice from accountant</td>
</tr>
<tr>
<td>3</td>
<td>Printing</td>
<td>1924</td>
<td>Limited</td>
<td>17</td>
<td>£0.75m</td>
<td>Use gut-feeling and judgement Industry norm of 60 days Recommendation from customers Advice from staff Advice from accountant</td>
</tr>
<tr>
<td>4</td>
<td>Printing</td>
<td>1991</td>
<td>Limited</td>
<td>6</td>
<td>£0.5m</td>
<td>Use gut-feeling and judgement Industry norm of 60 days Recommendation from customers Advice from staff Advice from accountant</td>
</tr>
<tr>
<td>5</td>
<td>Clothing</td>
<td>1982</td>
<td>Limited</td>
<td>50</td>
<td>£10m</td>
<td>Use gut-feeling and judgement Industry norm of 14 days</td>
</tr>
<tr>
<td>6</td>
<td>Clothing</td>
<td>1993</td>
<td>Limited</td>
<td>35</td>
<td>£0.7m</td>
<td>Use gut-feeling and judgement Industry norm of 14 days</td>
</tr>
<tr>
<td>7</td>
<td>Clothing</td>
<td>1974</td>
<td>Limited</td>
<td>20</td>
<td>£0.5m</td>
<td>Use gut-feeling and judgement Industry norm of 14 days</td>
</tr>
<tr>
<td>8</td>
<td>Clothing</td>
<td>1993</td>
<td>Limited</td>
<td>11</td>
<td>£1m</td>
<td>Use gut-feeling and judgement Industry norm of 14 days Look at historical records to forecast cash flow</td>
</tr>
</tbody>
</table>
The data analysis utilised a set of techniques, such as content analysis, pattern matching, and explanation-building technique (Yin, 2003; Ekanem, 2007). Content analysis involves listing the features associated with the liquidity management by each owner-manager (Silverman, 1993). Examples of such features included debtor control, inventory control and credit control. These involved identifying the number of days of credit granted to customers, how long inventory was held and number of days taken to pay creditors. Pattern-matching technique involved examining whether there were any interesting patterns and how the data related to what was expected on the basis of common-sense knowledge, or previous theory (Hammersley and Atkinson, 1995). When a pattern was established, the transcriptions were read again in order to make comparisons with different case study firms to identify stable features (Shaw, 1999). Explanation-building technique allowed series of linkages to be made and interpreted in the light of the explanations supplied by each respondent (Yin, 2003).

The data analysis was inductive, utilising a data coding approach, which allowed for ongoing modification and adjustment as analysis unfolded and which also allowed for content analysis to be conducted at different levels of aggregation (Fisher, 2004). The coding was used to select quotations made by interviewees to illustrate or emphasise a particular issue within a case study firm.

Case study findings
As illustrated in Table I, the approaches to liquidity management were different in the two industries. Extracts from the interviews with the eight case studies are presented in order to demonstrate the different approaches.

Liquidity management in the printing industry: evidence from case studies
During the first interview the owner-managers of the firms in the printing industry were quite reluctant to discuss the cash flow position of their company. For example, the owner-manager of Company 1 did not “see where the questions were leading”. Realising this attitude, the researcher did not push the point. At this stage of the interview, he only stated that the company did not have any cash flow problems because according to the owner-manager payment was always made on time. However, during the second and third interviews the owner-managers of the study firms were more willing to discuss the matter because the relationship between them and the researcher had developed. When asked how they decided how much credit to give a particular customer the owner-manager of Company 1 revealed that it is mostly by experience and judgement, but that most of his customers are recommended by other customers and are established businesses with “vested interest” in paying:

It is by experience. It is largely by judgement and gut feeling. Often most of our clients come on recommendation from other clients, but you know, we still have to make provision for an estimate of bad debts a year, as it normally does happen, it’s just one of those unfortunate things, really. Nearly all our clients are established businesses. They are normally people with a vested interest in paying rather than not (second interview, 5 October 1998).

Apart from judgement and gut feeling, there was also a significant evidence of learning from the experiences of other people. For example, when asked about stock control, the owner-manager of Company 1 revealed evidence of learning from his employees such as the production manager. The following response gives an insight into the learning process:
From hindsight, it is a bit silly, but I used to stock a lot of materials to avoid running out. I mean we were basically buying stuff in large quantities. I didn’t realise that I was tying down cash by so doing until my production manager suggested that I should reduce my order size when buying. Initially, I ignored him. I didn’t want to lose my discounts [from bulk buying], but when the liquidity problem became critical, I decided to do as he suggested and it worked. Now, I don’t ignore him anymore (second interview, 5 October, 1998).

The quote indicates that the owner-manager was learning from the critical incident of the liquidity problem arising from his previous decision not to take advice from his employee. When the issue of cash discount was mentioned, the researcher became interested in knowing how he deals with his creditors regarding the payment period. His reply was equally surprising:

Again, I used to be attracted by cash discounts for early payments to my creditors. I did not actually think through whether these discounts were really worth it. My accountant had advised me many times to change my system [of payment] and hold on to my credit until the last moment, but I thought I knew better. However, when the problem persisted, I decided to give it a go. At that stage, I was prepared to do anything to avoid disaster. On the whole, he has been very supportive (second interview, 5 October, 1998).

The response above also indicates that the owner-manager was learning from the knowledge, skills and experience of an external and professional adviser such as an accountant. Similarly, the owner-manager of Company 2 learned from the experiences of his sales manager. With regards to inventory management, this company also used to carry excessive inventory. However, the sales manager suggested a strategy of reducing inventories by “only stocking high-demand items with predictable demand” (Second interview, 5 October 1998).

During the third interview six months latter these owner-managers were probed in order to find out the extent to which the advice of their employees and accountant was still valuable. They revealed that they had not only learned from their advice, but that they had “helped tremendously” (Company 2, Third interview, 7 April 1999) in the sense that they have been able to overcome their liquidity problem.

Liquidity management is dependent on accurate cash forecasts to predict periods of cash shortages when it will be necessary to raise additional finance and periods when it is necessary to plan short-term investments. When the use of cash flow forecast for their liquidity management was put to the owner-managers in the study, the owner-manager of Company 4 revealed the role of his accountant in the learning process:

Oh! This was a nightmare for us before I approached my accountant for help. We basically didn’t know what to do in this regard. Initially, the accountant was doing this for us, but over the years Lynda [the credit controller] has acquired a lot of confidence from the support we have received from him. Now, she can do it herself (second interview, 7 October 1998).

The above quote illustrates the usefulness of the advice and support of the accountant and what was learned from him. It provided this company not only with the knowledge and skills, but it has also provided them with the confidence to be able to prepare a cash flow forecast themselves. During the third interview, the issue was explored with the credit controller who reflected on her acquired skills:

The support from the accountant has given me great confidence to do a cash flow forecast. I feel more able now to cope with it (credit controller, third interview, 6 April 1999).
It emerged from the discussion during the second interview that apart from the industry norm the credit period in the printing industry depends on who the customers are. The industry norm in the printing industry is 60 days of credit, but the owner-managers of the firms were able to exercise their judgement. For example, the owner-manager of Company 3 described the process as follows:

The credit period in this company depends on who the customers are, but it depends very much on the industry’s norm, which is the general kind of thing for everyone. I do give 30 days or 90 days. It depends (second interview, 7 October 1998).

Pressed about how he chooses who to grant 30 or 90 days’ credit, the owner-manager indicated that it depends on trust and whether or not they have dealt with the client in the past. The method used in debt collection was explored in this study. When asked what steps were taken to ensure that payments were made on time, the owner-manager of Company 1 replied that his company has a credit controller whose responsibility it was to chase up payment. He described her as a “rottweiller” who “frightens the nation to death” (Second interview, 5 October 1998), whilst the production manager described her as “an angry lady who gets on the cases and gives them some stick if they don’t pay and they end up paying in the end” (Third interview, 1 April 1999).

The production manager also revealed that the steps she takes depend on how much money is involved: “If they owe a lot, then she is on their case big time”. During the third follow-up interview, the credit controller was quite keen to inform the researcher of the steps she takes in the credit control process:

I phone up creditors a few days after the expiration of the credit period. This is followed by several other calls until either payment is made or we seek solicitor’s advice (credit controller, third interview, 1 April 1999).

Liquidity management in the clothing industry: evidence from case studies

The case study firms in this industry were “cut, make and trim” (CMT) firms. As CMT firms they required very little capital and machineries were simple and easy to lease or acquire second hand (Ekanem, 2002). This had implications for liquidity management.

Right from the first interview the owner-manager of Company 8 admitted that the company was experiencing a liquidity problem. He explained that the problem was brought about by their recent huge orders delivered by the company which exerted a great deal of pressure on the company’s resources. The owner-manager also admitted that the firm had cash flow problems from time to time, which affected the firm’s ability to pay its bills and also reduced the ability of the firm to invest in plant and machinery. However for Company 7, the main cause of the cash flow problem was “lack of work caused by cheap competition abroad”, which was a major critical incident affecting the liquidity of the clothing industry enormously.

The use of cash flow budgets was explored in the case study firms in the clothing industry. Unlike their counterparts in the printing industry, firms in this industry did not use this liquidity management tool or seek the help of accountants. When the question was put to the owner-managers during the follow up interview, the owner-manager of Company 8 admitted to a “mental calculation”, whilst the owner-manager of Company 5 simply laughed and replied:
It's not an easy thing to do, you know. It's like looking into a crystal ball. We do examine the last few years book to forecast future cash flows (second interview, 13 October 1998).

Cash flow forecast in this industry was fraught with difficulties due to rapid changes in the environment, which affected the ability of firms to predict the future. Examining the “last few years book to forecast future cash flows” implies learning from past experience which means bringing knowledge and skills together to interact upon the learning process.

The owner-managers of the clothing firms also revealed that the company has a good up-front credit control in that a half of the money must be paid up-front and the balance on delivery. Also, credit references (not bank references) are taken as illustrated by the owner-manager of Company 5 below:

We check them out. It depends on how much is involved. We don't give credit on small amounts. If the money involved is over £1,000, we check them out. If they are known companies or are recommended, we don't. We get money on COD [cash on delivery] (second interview, 13 October 1998).

The owner-manager of Company 7 explained further:

It depends on their track records. Once you get to know somebody, you know what they are doing and why they are doing it, you learn to trust them or not trust them (second interview, 15 October 1998).

The word “trust” suggests learning from past experience. The owner-manager of Company 8 believed that bank references are “no good” since banks are reluctant to give detailed information on customers and “tend to send one of a number of carefully worded standard letters”. He explained that the credit period allowed depends on whether the company is an established company or a new one, but that the average collection period is 14 days, which is what he adhered to.

On the method employed in the collection of debt, the owner-manager of Company 5 explained that his company takes steps to ensure that payments are made on time by running up a credit list every month of what they are expecting, which are on the computer. The customers would then be phoned up and “if they don't pay, we keep phoning them up. After a period of time, there isn't much we can do; we just have to wait, hope and pray” (Third interview, 13 April 1999). The company did not use the services of solicitors for debt collection for reasons of expense and time.

**Discussion**

The efficient management of working capital is important from the point of view of both liquidity and profitability. Poor management of working capital means that funds are unnecessarily tied up in idle assets hence reducing liquidity and also reducing the ability to invest in productive assets. Deloof (2003) argues that whilst providing credit to customers is an inexpensive source of finance for customers, the flip side is that money is locked up in working capital. Deloof (2003) also points out that whilst delaying payment to suppliers can be inexpensive and flexible source of financing for firms, late payment of invoices can be very costly. Therefore, the efficient management of these components is essential.

The efficient management of working capital is particularly important for small firms at a time of economic downturn such as the current “credit crunch”, which
started in 2008. A “credit crunch” is defined as a sudden reduction in the general availability of loans and credit or sudden increase in the cost of obtaining loans from banks (Ding et al., 2008). Consequently, owner-managers find it more difficult to raise finance for working capital due to the higher cost of borrowing, the effect of declining property value on the ability of owner-managers to provide the necessary collateral, and the perception that the banks have become even more risk-averse than they were already.

The analysis of the empirical evidence suggests that a distinction between open and closed loop learning is useful in relation to dealing with liquidity management in small firms.

Open-loop learning

The owner-managers of the four firms in the printing industry adopted the open-loop learning approach. Open-loop learning takes place when the situation is outside the boundaries of what owner-manager’s experience can cope with. It also occurs when the owner-manager asks about the reasons why certain things are done. It implies courage to revise or even question the existing practice, with the possible outcome of changing the strategy that has been used by the organisation (Michna, 2007).

The owner-managers of the printing firms had the courage to depart from the industry-wide norm by granting a credit period of 30 or 90 days despite the industry norm of 60 days. Jarvis et al. (1996) argue that the existence of an industry’s norm does not mean that they were always observed, but only acted as guides to behaviour. The reasons for breaking industry norm in favour of a 30 day-credit period were particularly risk, convenience and administrative costs, whilst the reason in favour of 90 days was based on trust.

Open-loop learning involves the decision maker stepping outside his/her existing terms of reference to assimilate knowledge that is potentially transferable to the situation currently faced, drawing on personal experience judged to be relevant and/or the experience and knowledge of others. Burgoyne and Hodgson (1983) describe this learning process as “gradually eroding one belief and building another with a gradual accumulation of evidence and experience” (p.398). The owner-manager of Company 1 in the printing industry had to change his belief in early payment of creditor by holding on to it till the last moment in order to optimise his cash flow. Drever (2005) indicates that effective accounts payable can have major strengths by optimising cash flow, reducing interest costs and bridging working capital deficiencies.

It is important to note that critical incident played a vital role in the learning process in the case study firms. A deepening liquidity problem constituted a critical incident that became a determining factor for learning from the experience of the external accountant. Deakins et al. (2000) argue that critical events could change behaviour leading to a change in management practices through the accumulation of learned experience. Therefore, significant “events” or “episodes” such as liquidity crises experienced by the case study firms have an influential role to play in stimulating entrepreneurial learning, although such learning can be traumatic and stressful for the entrepreneur to endure (Deakins et al., 2002; Cope, 2005).

Owner-managers in the study were also able to build good relationships with external advisers such as accountants. This type of relationship is necessary in the learning process because they can build up trust and interdependency with these
professionals by turning intermittent business relationships into on-going relationships, thus enhancing understanding and interaction (Gibb, 1997; Morrissey and Pittaway, 2006). In Company 1, the accountant had advised the owner-manager “many times”, which suggests an ongoing relationship. This type of relationship, whether with accountants, bank managers or other professionals and advisors are very important in the learning process (Deakins et al., 2000). Fuller and Lewis (2002) stress the importance of business relationships and the interactive process that takes place between people.

**Closed-loop learning**

By contrast, closed-loop learning was much in evidence in the clothing industry. Closed-loop learning arises from a situation, which is similar to what has been dealt with in the past. It is almost a duplication and routine (Cope, 2005). It depicts a process of learning a determined way of doing the work without questioning the rules, goals or plans (Michna, 2007). In the clothing firms, the owner-managers accepted the industry’s average credit period of 14 days without question. By adopting industry-wide practices the confidence of business owners is enhanced, which is embedded in the wide economic and social activities of the community in which they work (Thorpe et al., 2006).

In this context, closed-loop learning can be interpreted in the light of the “procedural rationality” concept (Hargreaves Heap, 1989; Jarvis et al., 1996). Under this type of learning process, liquidity management was strongly influenced by industry-wide norms, which are shared expectations among those operating in the industry. Such norms provide explanations for behaviour, which does not fall within the calculation of costs and benefits of particular courses of action of owner-managers.

In the case studies, closed-loop learning was most evident when firms were deciding whether or not to give credit to their customers. For example, in clothing firms the owner-managers pointed out that the decision to give credit depends on whether the client company/customer is an established company or a new one. The term “established” does not only mean a long-standing company, but one which they have dealt with in the past, thus suggesting a closed-loop learning experience.

Closed-loop learning is akin to “single-loop learning” (Argyris and Schon, 1978), which applied to routine or “lower-level learning” (Chaston et al., 2001). It is like a thermostat that learns when it is too cold or too hot and turns the heat on or off (Argyris and Schon, 1978). The thermostat can perform this task because it can receive information from the temperature of the room and take corrective action.

In this context, liquidity management in the study firms utilised a learning process that was not based on formal rationality of owner-managers’ behaviour (Jarvis et al., 1996). Formal rationality refers to actions that can be understood because they can be interpreted in terms of some calculative model, which is different from the procedural and repressive rationality referred to earlier. Jarvis et al. (1996) argue that, in practice, rather than using formal rationality, people often adopt approaches that are less than optimal.

**Conclusions**

The owner-managers were clearly making use of their knowledge and experience of the industry, as well as the knowledge and experiences of key employees and professionals
in dealing with liquidity problems. This illustrates the importance of interaction and learning from the exchange process in the close-knit network. In view of the competitive nature of both the printing and clothing sectors, a learning approach to liquidity management is the key to their survival.

The analysis in the study has revealed that small firms’ liquidity management is not based on formal rationality concept as advocated in the literature. Rather, it is based on what is conceptualised in this study as open and closed loop learning. The learning perspective provides “satisficing” solutions (Simon, 1960), which, although not explicitly rational, are boundedly rational. In other words, owner-managers were adopting a “good enough” approach which meets some minimum set of acceptable standards rather than attempting to achieve some optimal decision. Thus, the benchmarking threshold offers a variant on conventional notions which assume the objective of simple profit maximisation.

The aim of this paper has been to show how liquidity management in small firms can be understood as a learning process. The argument presented here is not that liquidity management based on formal rationality should be ignored, or that procedural and expressive rationality are more important than formal rationality. Rather, the argument is that human actions cannot be understood solely in terms of formal rationality (Jarvis et al., 1996).

Thus, the study makes a contribution to the growing body of literature on organisational learning in small firms by discussing how owner-managers learned skills and insights from their employees, advisers and peers within the industry. Clearly, relationships are fundamental in learning business practices and skills (Rae and Carswell, 2001).

The implication of this paper for policy makers is that financial management practices of large firms should not be used as a benchmark for small firms. There is strong evidence that successful entrepreneurs utilise networking activities to obtain key information that facilitates the development of trust, rapport, tacit knowledge and learning (Deakins and Freel, 2006). Therefore, it is suggested that policymakers should facilitate networking opportunities where owner-managers can interact with external advisers such as accountants, bank managers, solicitors and other professionals and learn from them.

The implications for further research result partly from the limitations of this study, and partly from new insights, which it has generated. As with most academic studies, the findings of this research are limited to the extent to which they can be generalised to a wider population of small firms because the sample was not random and was derived entirely from one geographic location.

References


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