

**THE CORRELATION BETWEEN MANAGEMENT COMPETENCIES
AND THE RETURN ON EQUITY OF SMALL BUSINESSES**

by

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Abstract

Background

Small and Medium Enterprises (SMEs) have over the years played a crucial role as productive drivers of inclusive economic growth and development in the macroeconomic aspect in which its existence helped in job creation and sustainability of the economy, thereby making it imperative to keeping them in existence.

Research problem

Is there a relationship between return on equity and management competencies?

Motivation

Having noted that the two variables, return on equity and management competencies, have a domino effect, it became imminent that further research be conducted. Reason behind this is to then understand reasons behind high failure rates of small businesses.

Proposed research approach and methodology

The purpose of this study is to identify the influence that management competence has on the financial interpretation of return on equity within the business environment of Small to Medium Enterprises (SMEs).

Main findings expected

There's an expectation that this research will outline the correlation between return on equity and management competencies within the context of small businesses.

Managerial implications

The results of the study will provide reasons as to why most small enterprises fail to succeed in the competitive business environment as management competencies are of utmost importance in determining financial performance of the business.

Anticipated contribution

The results of this study will help the business environment pave way to solutions as to how management could better use the resources to their disposal in enhancing business performance towards improving the return on equity of the business.

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THE CORRELATION BETWEEN MANAGEMENT COMPETENCIES AND THE RETURN ON EQUITY OF SMALL BUSINESSES

1. INTRODUCTION

The main objective for a business is to make profit and have a return on capital invested by owners of the business. However, this is dependent on factors such as management competencies, which describe the 'quality' of decisions made by managers in bid to succeed in business ventures.

In a study conducted by Carter (2021), it was outlined that 20% of small businesses in the world fail within the first year of being in operation. The reasoning behind this was supported by the fact that management's decisions had a direct impact towards the companies' financial statements. Management competencies have a direct impact towards the success of a business as was noted by Bosma et al. (2004). The authors noted that every decision made by management determines the future success of the business. Bosman et al.'s theorem was given support by Black et al.'s (2001) theory which gave emphasis on how shareholder value creation comes into implementation when the equity returns of the business exceed the cost of that equity initially when the business started.

With the different point of views of the authors at this study's disposal regarding the return on equity and management competencies, this brings forward the question that is there a direct interdependence between the decisions made by management and the financial statements of the business? According to Fatoki (2014), different researchers found that financial ratios give an insight of an overview of how a company is performing. However, he emphasised on how it is imperative to also note that managerial skill factors are often neglected when analysing business performance. The reasons for omission are that it is difficult to observe them as they can't be quantified into value. If these unquantifiable factors are continuously neglected this means that results obtained through financial statements would be inaccurate as these factors could have a strong influence towards the business' return on equity.

In order to discover the correlation between management competencies and return on equity, it is imperative that one considers how a particular variable has a direct impact towards another. For example, if management has poor bookkeeping knowledge, this may bear a negative result on the actual performance of the business through its financial statements, or, how good leadership skills leads to great performances of employees which then leads to high return on equity. According to Fatoki (2014), it was found that in Malaysia a few companies were under financial distress despite the companies having competent management in terms of qualifications. He went on to note that the reason behind the low return on equity was attributed by the fact that management was using inadequate leadership style on employees they were managing which resulted in high employee turnover rate and inefficiency.

Therefore, in the preceding paragraphs, extensive research will be compiled in which a comprehensive discussion shall analyse the interdependence between return on equity and management competencies. Furthermore, an investigation shall be carried out in which the effect of management competencies towards the return on equity of small businesses shall be discussed. This would add a new insight to the relationship between management skills and

return on equity from the perspective of small businesses. The preceding chapter will consist of relevant literature of different perspectives of other authors.

2. LITERATURE REVIEW

For the success of SMEs that have just entered the market, it is imperative managers ensure that their main priority is to ensure that the financial statements of the business are closely paid attention constantly.

This requires management to take into consideration different factors that sum up the relationship that strategic decisions made by management have towards the business' financial statements. According to Chou, Chi- Chun et al (2018), it was emphasised that businesses should ensure that they make use of quantitative factors, such as financial ratios which amount to hard information. The authors argued that hard information gives more accuracy to analysis of what transpired for the business during the financial year. Additionally, the authors also noted that the use of qualitative factors helps in contextualising information which describe factors which influenced the success of the business but cannot be quantified, for example, the motivation of workforce.

In the preceding paragraphs, a comprehensive discussion of the correlation between Return on equity and management competencies will be carried out in which different authors outlined different perceptions of the two variables.

2.1 Return on equity (ROE) as a measure of small business success

According to Ahsan (2012), return on equity (ROE) was described as a tool (ratio) which is used by financial analysts to measure financial performance of a business. The ratio calculation is achieved through dividing net income by shareholders' equity. The net income is the profit achieved after all deductions in a financial period. Shareholders equity is capital invested into the organisation by investors. Ahsan (2012) elaborated the importance of return on equity ratio as it helps management determine how efficient they have been in turning shareholders' invested capital into profit.

Tarwirei (2015) also defined return on equity as being a measure of profit in which it calculates how much of monetary units of profit that an organisation generates from each spent sum of money invested by shareholders. The ratio is usually used by management to make an analysis in comparison with how they are performing against competitors and the overall market. As was discussed earlier, return on equity would be classified as a quantitative technique used by management to measure the business' success over a financial year. In the context of a small business' success, Lekovic and Maric (2015) identified that it is of importance that small businesses use quantitative factors by using accounting ratios such as

the use of return on equity as these ratios provide an objective overview on how effective the business has been in using the resources to maximising shareholder return. Furthermore, this helps management in establishing a trend analysis of the business' financial status. For example, ROE can be used by management to determine how much dividend can be issued out by analysing the financial feasibility. Tarwirei (2015) further discussed that it is of utmost importance for managers of SMEs to make use of ROE ratio as it is a measure of efficiency within a specific financial period.

The ROE ratio is used by investors to determine if a business is utilizing the shareholders capital to create more net income. Du Toit (2007) emphasised that the result of ROE calculation should reflect a high positive percentage as this reflects that management is utilizing the company's assets to create profits. Furthermore, this would also result in the SME having an increased efficiency of making good use of shareholders' funds at their disposal effectively.

2.2 Management competencies

According to Bhardwaj (2015), management competency entails a combination of knowledge, skills, attributes, and attitudes that contribute to the effectiveness of task completions. These set of skills enable management in making sound strategic decisions which determine the business' performance either favourably or adversely. Tarwirei (2015) also makes a distinction that management competencies demonstrate a significant distinction between effective and ineffective performances portrayed by managers through financial statements. This means that although management competencies can't be clearly identified in financial statements, their non-quantifiable impact can be seen on aspects such as sales which have an impact on ROE.

2.2.1. Knowledge

With the market environment becoming competitive globally, this is prompting businesses to acquire the best employees in the market as they aim to seek efficiency. Thereby a team of employees which is knowledgeable attracts the attention of investors. According to Zajda (2021), knowledge entails the awareness or familiarity gained by experience either through practice or fact. Knowledge of management can be experiences gained through seminar courses.

2.2.2. Attributes

When describing attributes, this may refer to inherent characteristics in which one possesses. Shirazi and Mortazavi (2009) were of the idea that for a manager to be competent and effective, characteristics like responsiveness, proactiveness, effective communication, team building, negotiation, and decisiveness are indeed mandatory attributes that management should possess in their arsenal for the success of SMEs.

2.2.3. Skills

According to Rambe and Makhramele (2015), it is imperative for management to possess the

adequate skills for a guaranteed success of a business. Failure to do so contributes to one of the reasons why small businesses fail within the first three years of existence. Skills includes abilities which encourage management efficiency such as servant leadership, resilience, negotiating skills, charisma etc.

2.2.4. Values

According to Fatoki (2014), many SMEs fail to strike success as managers expose their inabilities to manage the organisation as management us the wrong approach when leading SMEs. This entails that management needs to have certain criteria of values they adhere to which give employees direction towards the business. These values were described by Jaakson (2010) as being certain protocols that are followed by the company which are regarded as being of utmost importance in achieving organizational success. The phenomenon of value for an SME may refer to management preferring a certain leadership style towards its employees, for example, the use of an autocratic leadership style. Under an organisation's value criteria, it is imperative for management to follow protocols which adhere to Corporate Social Responsibility which promote growth of communities they are operating in. This ensures sustainability which in return guarantees success for the business in the long run.

2.3 The correlation between management competencies and the ROE of small businesses

According to Stipic and Ruzik (2021), strategic planning which is done for small and medium enterprises to some extent is related to the return on equity. Stipic and Ruzik argue that when managers make well and informed strategic decisions the business regarding how they make use of the resources at their disposal, it would influence the financial status of the business. For example, if managers are proactive in terms of planning their expenses well ahead of time rather than being reactive, this would result in less expenses, more profits and a higher return on equity ratio. These can only be managed well if the manager has

managerial competency in terms of the experience they possess, and other factors which impact at that time. According to Kamange et al, (2014), the authors explained that there is a relationship between managers' ability to interpret financial statements and SME performance if they possess the ability to conjoint their managerial competency together with assessing performance.

To further cement on the correlation, Fatoki (2014) outlined that there's similarities between managerial competencies and the resultant figures reflected in the financial statements. He further explained that managerial competencies fuel a crucial role in the post-failure in securing returns by the managers for the SME as decisions made pertaining to the business have consequences. For example, if a manager of an SME has a relatively low level of skills required to complete bookkeeping, this would negatively impact the business as monies would not be accounted for. Consequently, this would prompt errors coming into existence. With a lower ROE, this entails that management is making poor decisions in terms of reinvesting capital in unproductive assets they have.

Escriba-Esteve et al (2009) was of the idea that management of SMEs that have recently commenced business have to possess a high level of education and experience in which this enables them in making the best decisions as they hold the cognitive skills to execute complex strategic decision and thereby influence the results in the form of higher returns to shareholders. For example, a manager who holds at least a BCom degree and a few years of experience in management would likely make better strategic decisions for the SME compared to a person who holds a Matric qualification. This would turn out that way as the experience and knowledge play a huge role in influencing quality decisions.

Management competencies and return on equity enable SMEs to make a sound decision based on the results they have seen provided by the financial statements. According to Bersin (2007), the results that reflect in financial statements of an SME help managers in determining the direction of the business based on the results that would be present at that time. For example, if the results show a lower ROE ratio, this reflects that the business need to secure and make use of assets that would turn shareholder's capital into profits.

On the other hand, Damodaran (2007) outlined that it's not always accurate for businesses to make use of return on equity comparing with management competencies. Damodaran's reasoning is that it's all depended on the type of industry the SME is operating in as some industries don't require intensive capital usage. For example, if the SME is into service industry of providing consultation to clients, return on equity would not be the best measurement of managements' competency as there's relatively low usage of capital. This would be in the instance of law firms who use significantly low levels of capital as compared to manufacturing businesses.

According to Chiliya (2012), she conducted a study in which she concluded that ROE should be the overall indicator of success in relation to SMEs. This is provided management is applying strategies in which management competency is crucial. Such instances would be management using team building activities, delegation and leadership styles that are relevant to the employees. For example, management would need to ensure that they are using the

correct leadership styles (autocratic, democratic or laissez faire) to ensure that employees are highly motivated which then results in effective productiveness from employees which then leads to effectiveness.

Furthermore, according to Rambe and Makhalemele (2015) the authors emphasised that although literature confirms a positive relationship between managerial competencies and performance, it remains unclear as to whether the size of the business, or how the business' nature looks like within the associated industry in which the business is located correlates the relationship between the two. Rambe and Makhalemele further explained their study that there is a link between firm's performance and management competencies as in South Africa the failure of acquiring profitable businesses that bring in a higher ROE to SMEs is greatly contributed by the lack of a lack of education and training.

Having looked at research carried out by other authors, it is evident that there has been contradictory research done in the past regarding the correlation between return on equity and management competencies. Additionally, the research gap lies on the fact that there's little to no research carried out in relation to the two variables. For this reason, it is imperative to conduct additional research regarding the correlation between management competence and return on equity in the preceding paragraphs.

3. RESEARCH PROBLEM

According to Mashavire et al (2019), the duo found that most small businesses in the Southern region of Africa struggled to find success as the management lacked competencies regarding the qualitative aspects of leading a business. These involved aspects such as planning, leading, organising and controlling the resources which provide a direct impact towards the success of organisations which fall within the category of Small to Medium Enterprises. Similarly, Cohen (2019) emphasised the issue surrounding the success of organisations by outlining how businesses, regardless of their size, should ensure that non-quantitative techniques such as motivation of employees are key to the success of an organisation. He further elaborated that failure to implement such a management of having a highly motivated workforce would have a direct impact on the financial statements of the business. For example, if employee motivation is low in the organisation, this could result in the business having a high employee turnover rate. This is costly to an organisation as each employee leaving may be given a lumpsum exit package. Furthermore, costs related to employee training and recruitment further hinder on the organisation's success, which consequently negatively affects the return on equity of a business.

According to OECD Library (2020), a conducted study outlined that SMEs in South Africa contribute 36% towards the GDP of the country, and of which a 90% fail within the first 5 years of having conducted business as they become indebted. The Hawthorne effect of the failure rate of SMEs was described by Ncube and Chimucheka (2019) as being present due to lack of management competencies of the strategic leaders within the organisation. These include managers lacking the correct attributes which guarantee organisational success such as using the incorrect leadership style (Autocratic, Democratic or Laissez-Faire) on their employed workforce. Herrington et al (2014) cemented on how there's lack of literature and further research done which outlines correlations between management competencies and financial performances within the business sector of SMEs. This also applies to the correlation between

management competencies and return on equity as the two variables contain a domino effect on one another. This then outlines the importance of management competencies having a direct impact towards return on equity.

3.1 Research goal

The main objective of conducting this study is to devise a mutual link between management competencies and the return on equity on SMEs. Furthermore, it is imperative to note that this study should be able to identify how two variables (management competencies and return on equity) have an impact towards the success of an SME.

3.2 Research questions

The main issue surrounding the study of the two variables is that there's a lack of conjunction used between management competencies and return on equity by small businesses which leads to most of them failing, thereby which brings need as to why a further study should be conducted. Consequently, the following questions need to be addressed:

- What are the challenges encountered when management of SMEs omit to scrutinise the link between management competencies and return on equity?
- What are the possible strategies that can be implemented by management in trying to combat issues arising from neglecting planning, organising leading and controlling, which consequently lead to a direct impact on the return on equity?
- What recommendations can be formulated towards management of SMEs who fail to discover that there's a direct causal effect between management competencies and return on equity?

4. METHODOLOGY

In this paper, the research conducted adopts a quantitative research approach. According to Aspers and Corte (2019), the quantitative research is a research strategy which gives emphasise on quantifying the collection of data, and thereby analyse it. The approach that is being conducted in this paper is of an objective approach and therefore used secondary data when collection of data was done. This collection of data includes peer to peer reviewed articles, together with other sources. With regards to the correlation between management competencies and return on equity, a further discussion will be conducted in which an exploration of data collected which emphasises how SMEs do not pay attention to the variables.

4.1 Research paradigm

According to Singye (2021), research paradigm is a research model or method, which is regarded as a standard by many researchers in this field because it has been verified and practiced for a long time. In the instance of the correlations of the two variables, in this regard it is highly recommended to use positivists paradigm as there is statistical analysis together with data that cannot be quantified. Therefore, it is imperative to also make use of mixed methods for those instances which require analysis of information which cannot be quantified.

4.2 Research approach

According to Thompson (2015), the positivist tradition emphasizes the importance of conducting quantitative research such as large-scale surveys to understand society as a whole and reveal social trends, such as the relationship between educational achievement and social class. Therefore, since a comparison will be made between management competencies and return on equity, it is imperative that statistical analysis of previous trends which indicate that there's a gap within the research be presented.

4.3 Data collection

For the purpose of collecting data, surveys are the main tool of collecting data which will be in use. Having considered making use of surveys, it is imperative to make use of third-party tools in order to get an accurate sample of perceptions that small business owners had based on their previous experiences.

The survey tools at disposal conducting surveys are websites such as Limesurvey, Google Forms or SurveyMonkey. From information provided by Sharkey (n.d.), it is best if Google Forms is used as a source of online survey as internet traffic is generated conveniently for people since they will be redirected from the search engine. Sharkey noted that in 2020 Google forms collected 62% of online surveys in relation to what all competitors had, making competitors collecting the remainder of 38% percent. However, surveys are usually complex usage tool of collecting data as response rate is usually low. Oyson et al. (2020) noted that in most instances 15% of intended survey sample return completed survey forms. The problem that comes about is that this makes the data less accurate.

Nevertheless, a completion of surveys will be done through mailing forms to owners of small businesses enquiring data on their financial statements (statement of financial position), thereby attaching such information to how management conducts business from day to day. This then gives an insight as to how management decisions are impacting the business' performance. In order to make it simple for the sample targets, the survey forms will be sent via electronic platforms such as emails in the form of MsWord and Adobe pdf formats.

Additionally, to encourage people to take surveys, it will be imperative to formulate strategies that encourage participants to carry out surveys. These will be in the form of keeping surveys short and precise, making them easily accessible to all groups of people, and following up with respondents. However, its is imperative to keep ethical considerations in mind by not harassing participants.

4.4 Population and sample size

According to Brynard and Hanekom (2006), the duo outlined that it is imperative to engage with the population at large as they provide a sample of the opinions to what the public has in relation to a certain topic. According to Carter (2021), poll questions in which he conducted to entrepreneurs in which he was asking on why businesses fail within their first years of starting up outlined that 70% of the business owners who had their businesses fail was due to failure to managing resources correctly as the tasks at hand had proved to be too much for them as they are just starting up. From the sample, it was conducted mainly from the US businesses.

To make the research precise, the population and sample size will be kept within the population of countries which belong in the emerging economies categories. However, it would be a daunting exercise to survey all of these. Therefore, the country in which is going to be targeted for research purpose is South Africa. Johannesburg and Durban will be the prime targets of the research in terms of the population sample size for small businesses. From Johannesburg and Durban, Oecd-ilibrary (n.d.) recorded that by 2020 the two metropolitans (JHB and DBN) had a total of 2.25 million SMEs combined. From the information provided, it is impossible to survey each of the SME. However, a strategy will have to be formulated in which there will be a conducted sample of at least 10 samples in each district. The sample size will be 377 as per recommendation of Raosoft. This means City of Johannesburg and Ethikwini districts will be the prime targets for the sampled SMEs.

4.5 Data analysis

The data that is going to be collected will consist of ordinal data. This will enable data to be collected categorically in which variables (management competence and return on equity) will possess natural and ordered categories. Additionally, the use of multiple regression analysis will be used as it is a statistical modelling which allows statistical processes for estimating relationships between return on equity and management competence. The usage of multiple regression analysis will be done solely in driving a prediction of the dependant variable (management competence) with that of the independent (return on equity). Once data is collected, it will be put on a theoretical analysis chart in which the two variables will be matched together. In this theoretical chart, it will be describing the impact that one has on another, for example, the better strategic decisions implemented by management, the higher the business return on equity ratio.

4.6 Ethical considerations

According to Kruger et al (2014), it is imperative that when collecting data from different sources the researcher should follow certain principles and codes of conduct in order to preserve authenticity of the study. As this study aims to bridge the gap between management competencies and return on equity, it is important to protect the participants of this research by preserving their information and making use of it carefully. Protection of rights for participants in research is supposed to be guaranteed, thereby enhancing the validity of research together by also ensuring scientific integrity is present.

As research will consider adding more participants to conduct surveys, a distinction between science and society should be considered. Science and society considerations were described by Bhandari (2021) as being inclusive of scientific integrity, human dignity and observation dignity when conducting research. This is to ensure that when conducting samples from intended target, the participants should be well informed of what they are being surveyed on, how its going to be conducted, and to whom is the information going to be distributed to.

This gives the participants the freedom to consent towards the research. Any surveys that are conducted must be voluntary. It should also be noting that the participants understood and agreed to participating in the survey. Furthermore, when collecting data from participants it is imperative to be impartial and safe keep data accurate to preserve authenticity of research. Ethical issues that will be addressed which need to be considered are voluntary participation, informed consent, confidentiality, anonymity, and results communication.

It is of utmost importance to safekeep data from participants confidential as part of ethical considerations. This means when receiving participants' data in regards of the small business' financial statements, the information should be kept confidential and free from the public eye. Some small businesses may prefer to being kept anonymous when giving feedback towards the research participation. It is important to hide any identities which may attach the business by giving false names when describing the research results. After results of the survey are available, it is important they are kept as accurate as possible. This includes the results include characteristics of honesty, integrity, reliability and credibility. Reasoning for this is to keep research transparent. Secondary sources that are going to be used in this study must be referenced so that credit is given to authors who conducted previous study by avoiding plagiarism.

5. SUMMARY

The purpose of the study is to investigate the relationship between return on equity and management competencies. Results conducted through quantitative techniques show that there is a direct impact towards return on equity and management skills. Fatoki (2014) came up with the conclusion that managerial skills such as managing costs of the business have an impact towards the company's financial statements. Managerial skills are closely related to return on equity.

The study contributes to the literature as development of an index measure of management skills for small businesses and with the use of upper-echelon theory. However, there's a possibility that the study will have possible limitations. These may rise through usage of data collected. Data which is collected monthly may lack the accuracy that daily data may hold as there's no accurate trend analysis conducted. This means the results will not show the actual relationship between management competency and return on equity. If data is collected daily, it will provide much needed accuracy. This can be achieved through the usage of nonlinear regression analysis.

Although it is of importance that small business owners have the knowledge of financial management, it doesn't warrant that the business would perform since management would have knowledge. A combination of other factors would need to be used when conducting business as different scenarios which may be challenging would require its own strategic approach. For example, instinctiveness of being proactive is one skill which may not be taught but rather a skill that one possesses naturally. The search for the real drivers of management competencies having an impact on return on equity continues.

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