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# The Alternative to Assuming “Rational” Use of Financial Information within Small Firms

Brian Gibson

Since emerging as a separate domain, research concerned with financial management in small firms has proceeded on a foundation of assumptions, primarily influenced by economics, which do not appear to be in accord with reality. Two fundamental assumptions are reviewed in this paper and the validity of each is questioned. These are that the small firm owner/manager is a rational economic decision maker and must have access to financial information to properly engage in decision making activities. Alternative interpretations, associated with the purposive action assumptions of the Austrian school of economic thought, are proposed as a more appropriate foundation for the development of theories of small firm financial management.

## INTRODUCTION

Research in the small firm financial management domain is influenced by developments in a range of other disciplines. The dominant influence, however, appears to be economics. Observed behaviour of small firm owner/managers often appears to be atypical when using behaviour patterns derived from mainstream economic assumptions as a benchmark. This would not be the case if behaviour expectations were derived from a less structured environment such as the interpretive framework of the Austrian school of economics. Adopting a new framework would enable a better understanding of the diversity of observed practices and also engender a more liberal research environment in which to study small firm owner/managers, the firms they manage, the financial information they use, and the decisions they make.

This paper commences with a review of the environment in which extant small firm financial management research is conducted. Influences from other established sciences and related research areas are examined with a special emphasis on the dominant influence from economics. Two fundamental assumptions underpinning the economics influence are then examined. These are the assumption that the small firm owner/manager is

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a rational economic decision maker and the associated assumption that the small firm owner/manager must have access to financial information to properly engage in decision making activities. Evidence which suggests a departure in small firms from behaviour in accordance with these assumptions (such as the variety of objectives guiding decisions, the poorly structured evaluation of alternatives, and the limited use of financial information) is then examined. Finally an alternative economic treatment of observed behaviour, based on the Austrian school of economic thought, is developed. Concentration is on the acquisition of knowledge to guide action through experience rather than organized search and the potential limit this places on the pervasive role of financial information in decision making. Concluding comments highlight the potential of an interpretive economic framework to generate a more liberal environment for small firm financial management research.

### **THE EXTANT RESEARCH ENVIRONMENT**

Research in the small firm domain (including both small enterprise and entrepreneur based concentrations) is primarily influenced, as is most business orientated research, by developments in economics with secondary influences from other established sciences such as mathematics, psychology, and sociology. Evidence of these influences is reflected in most reviews of small business and entrepreneurship research. Financial management in small firms (a crucial element of the broader domain of small business research) is further influenced by developments in the associated areas of accounting and finance.

The influence of other sciences on small business research is illustrated by Bygrave [2] and is reflected in Table 1. In this hierarchy of sciences, fundamental assumptions of the higher placed "basic" sciences tend to be passed on to those further down the hierarchy. In turn, these assumptions are mirrored in associated "applied" sciences. Hence, the assumptions underlying economics are aligned with those dominant in sociology and psychology and reflect influences back to the "Queen" of sciences, mathematics. Applied sciences such as business and entrepreneurship (either or both of which include small business considerations) are therefore influenced by economics as well as the basic sciences which shape the assumptions of that discipline. The existence of multidisciplinary influences on areas such as entrepreneurship is also argued by Low and MacMillan ([15] p. 141) who suggest the field can be productively investigated from disciplines as varied as economics, sociology, finance, history, psychology, and anthropology.

**Table 1**  
**Hierarchy of Sciences**

<i>“BASIC”</i>	<i>“APPLIED”</i>
MATHEMATICS	
PHYSICS	
CHEMISTRY	ENGINEERING
BIOLOGY	
PSYCHOLOGY	MEDICINE
SOCIOLOGY	ECONOMICS
	BUSINESS
	ENTREPRENEURSHIP

Source: Bygrave [2] p. 10.

Subsumed in the science of “business” in Table 1 are other applied disciplines such as management, finance, and accounting. Developments in each of these areas also tend to be cross disciplinary. However, most separate disciplines within this group of applied “commercial” sciences have also developed from, and adopted the assumptions of, the dominant science of economics. This is not surprising as all are principally concerned with varied aspects of economic activity. As Perryman ([8] p. 377) suggests separate analytical treatment of economic activity in small businesses seems to have developed in most of the commercial sciences in response to the pragmatic difficulties they present.

Attempts to understand how economic activity is conducted within small firms must therefore be conducted with full knowledge of the extensive range of influences from a variety of sciences which shape fundamental understanding of that activity. A specific commercial activity such as financial management has to be understood in the light of influences from disciplines such as finance, management, and accounting. That each of these has been principally influenced by economics suggests that the most important applied science shaping the research environment for financial management in small firms is economics.

### **MAINSTREAM ECONOMIC ASSUMPTIONS INFLUENCING FINANCIAL MANAGEMENT RESEARCH**

The most important of the economic assumptions adopted from a financial management perspective is that the small firm owner/manager is a rational economic decision maker. An associated assumption is that the small firm owner/manager must have access to financial information to properly engage in decision making activities. The implied importance of these

assumptions is reinforced in monographs which prescribe financial management practices for use in small firms, and in research publications which are concerned with the small firm financial management structure.

An important function of economics is the construction of general models which facilitate policy recommendations (Kent [10] p. 252). Assumptions are introduced to simplify and enable analytical investigation of relationships between modelled variables. Concern is with the aggregate behaviour of groups of economic actors. When economists model the resource allocation behaviour of firms in an economy they start with the general proposition that market factors, including complete and free information access, work toward an equilibrium where all resources are allocated efficiently (Mugler [16] p. 4). In such a context, "rational" economic decision makers act as if they are able to identify all alternative courses of action that might lead them to a specified objective (profit or utility maximization). Assisted by complete knowledge of the likelihood of all possible states of nature they are able to make the optimal decision by selecting the action which maximizes the expected value of the specified objective.

The assumption of rational economic decision making embodied in this process has become fundamental to, and the backbone of, most facets of business education (Smith et al. [22] p. 225) including that which concentrates on small business. Most monographs prescribing behavior in small firms are based on a decision making process in which:

- a) an objective (usually of profit maximization) is specified;
- b) alternative actions are identified;
- c) options are evaluated in the light of expected environmental states;  
and
- d) an objective maximizing choice is made.

Because of the emphasis in this prescription on profit maximization or monetary rewards, it follows that when alternative actions are evaluated they need to be evaluated in financial terms. Thus an important assumption, in the context of small firm financial management, is that decision makers will have access to financial information to facilitate the evaluation of available options. To the extent that possible alternatives are likely to be similar in many respects to those followed in the past, financial information from an accounting system which accumulates data about past events is assumed to be essential for rational economic decisions to be made.

## VERACITY OF ECONOMIC ASSUMPTIONS

The fundamental economic assumptions of rational decision making using financial (and other) information continue to dominate despite evidence that the assumptions may not be valid. It is doubtful that small business owner/managers make decisions in a manner which is even close to that suggested. There appears to be a wide variety of objectives which the small firm owner/manager seeks to satisfy. It also appears that very little evaluation of alternatives takes place and that there seems to be only a limited use of financial information in decision making. Either the vast majority of small business owner/managers exhibit deviant decision making behaviour or the fundamental assumptions which shape expectations of behaviour are inappropriate.

There has long been an "awareness that conventional [economic] wisdom sometimes does not hold up under the light of careful scrutiny" (Paulin et al. [17] p. 367), and that in several important areas of economics small firms behave in opposite ways to that predicted by conventional theory (Storey [25] p. 179). The very existence of small firms is an antithesis to many economists as suggested by Kaish and Gilad [9]:

Generally speaking, while entrepreneurship [and small enterprise are] essentially an economic phenomenon, most neoclassical economists have trouble dealing with [them]. The fact that each year a multitude of new firms find a niche where they not only survive, but flourish, challenges one of the basic assumptions of economic theory - full and free flow of information - and one of the fundamental conclusions of the theory - the notion that competitive markets reduce profit opportunities to zero. When both of these conditions are fulfilled, the economy should be in equilibrium and every profit opportunity fully exploited. Entrepreneurship belies equilibrium and equilibrium is the stock and trade of the neoclassical tradition. Hence the difficulty among economists. (p. 46)

The specific assumptions analyzed in this paper are also found wanting when subjected to closer scrutiny. Mugler ([16] pp. 7-9) discusses a range of behavioral motives which seem to replace profit maximization as the primary objective of single owner firms. Similarly Solomon and Winslow [23] suggest wealth accumulation (through profit maximization) is not the major determinant of success in small business. There is also an increasing volume of research findings which suggests small firm owner/managers and entrepreneurs are not inclined to use formal, conventional economic modes of analysing alternatives and opportunities (see for example Specht [24], Smith et al. [22], and Kaish and Gilad [9]). The economic assumption of rational decision making appears to be questionable.

The rational decision making model is robust enough to accommodate other than a profit maximising goal and (by introducing the concept of bounded rationality) to accept less than complete alternative evaluation. Access to internally generated financial information is still however integral to rational decision making. Yet such information appears to be lowly regarded in small business. In an evaluation of new ventures and the extent of support they receive from venture capitalists, Sweeting [26] found access to accounting information was not preeminent. When small business owner/managers are asked about information they need and/or use, financial information is not identified by a majority and often appears below a range of other information types (see, as examples, Holmes and Nichols [6], Hood and Young [7] and Banks and Taylor [1]). There seems to be little evidence to support the derived economic assumption that financial information is important in the decision processes of small firm owner/managers.

In defense of mainstream economics it must be stressed that the model of rational choice is designed to explain aggregate behaviour in a contrived static equilibrium economy. Most economists would not argue that the models they develop will explain an individual's actions. Rather they believe that in the presence of market equilibrium the combined effect of all actions, even the most idiosyncratic, is the same as if all individuals acted in the assumed manner. Nevertheless it is individuals and not "blank or interchangeable economic units" (Livesay [14] p. 12) which are the object of study in small enterprises. That so few exhibit decision making behaviour which even closely resembles that adopted from the assumptions of economic models must cast doubt on the usefulness of studying and advising individuals on the basis of these models. Researchers and educators in the applied commercial sciences must be wary of prescribing normative status to these assumptions and perhaps should seek a research environment which deals more closely with individuals.

## **REALITY AND THE ASSUMPTIONS OF AUSTRIAN ECONOMICS**

Decision making behavior in small firms would not be regarded as atypical if research expectations were developed from an alternative understanding of economic activity such as that at the core of the Austrian school of economic thought. The fundamental premise of this interpretation of economic activity is that all actions are purposive and directed toward achieving a desired end. In this regard there is a similarity with the "objectives" governing traditional economic rationality. There is, however, no associated assumption that a vigorous or organized evaluation of alternatives will occur. Knowledge which guides action is, in Austrian

economics, gained from experience and not organized search. It follows that financial information may not have a pervasive role in decision making.

Unlike mainstream neoclassical economists who work in a framework of market equilibrium, Austrian economists posit "an environment of ongoing economic *disequilibrium*" (Kaish and Gilad [9] p. 46). Entrepreneurs (including, but not limited to, those who establish new enterprises) take actions to exploit opportunities presented within this disequilibrium. It is emphasis on this entrepreneurial role which differentiates Austrian economics from its mainstream counterpart. As Kirzner [12] suggests; economists are right to draw attention to the powerful forces which point towards equilibrium but "they are wrong to assume that the forces are so powerful and so rapid as to make to make the entrepreneurial process unimportant" ([12] p. 273). Entrepreneurs involved in entrepreneurial activity are the focal point of Austrian economics.

Like the rational decision maker assumed by most economists, the decision making entrepreneur of Austrian economics is concerned with choosing a course of action which will satisfy an *ex ante* objective. Opportunities are exploited by taking actions which are intended to leave the entrepreneur "better off" in some tangible way. Unlike the rational decision maker, however, the chosen actions are not the result of an evaluation of known alternatives but are a consequence of discovering "profitable discrepancies, gaps and mismatches in knowledge and information that others have not yet perceived and exploited" (Cheah [3] p. 343). A comparison of the parameters and outcomes of the traditional deliberate search and the Austrian experiential alertness approaches to knowledge acquisition are contained in Table 2. Experiential alertness is not perceived as an ingredient to be deployed in decision making, but rather as something in which the decision itself is embedded (Kirzner [13] p. 22), hence its zero cost. From an Austrian economics perspective, the majority of knowledge which guides decisions is a consequence of learning experiences and not deliberate search (Kirzner [11] p. 142).

Research results exist which support the proposition that small business owner/managers are more likely to acquire knowledge through experiential alertness than through deliberate search. Johnson and Kuehn [8] found owner/managers of small firms, when compared with counterparts in large firms, were more concerned with their external environment and inclined to "talk to suppliers, distributors, and customers with a view toward uncovering opportunities in the marketplace" (p. 60). In a review of environmental scanning practices, Smeltzer et al. [21] reported a focus on opportunity finding and a perception that the marketplace was the most important environmental unit of analysis. Notwithstanding a note of caution concerning sample size and random selection, Kaish and Gilad [9], in a study



**Table 2**  
**Approaches to the Acquisition of Knowledge**

	<i>Deliberate Search</i>	<i>Experiential Alertness</i>
Cost	Positive	Zero
Acquirer	Managers, corporate strategists, market researchers, research & development workers etc	Entrepreneur as arbitrageur
Parameters	The unknown is definable <i>ex ante</i> and its attainment is determined only by cost and apparent worth-whileness	The unknown is unknown <i>ex ante</i> and <i>ex post</i> - awareness of it depends only on alertness to the existence of a hitherto unexploited opportunity
Returns and Private Objectives	Wages, interest, risk premia on capital employed, plus unexpected surpluses or deficits on computed returns due to unanticipated changes occurring with the passage of time	Profits or losses to the extent that the entrepreneur's alertness was correct or inaccurate
Societal outcome	Facilitates tomorrow a deliberate move towards today's equilibrium	Permits a move towards tomorrow's (perceived) equilibrium

Source: Reekie [19] p. 94.

testing propositions derived from Austrian economic theory, report confirmation of the hypotheses that "entrepreneurs exhibit a different search behavior and [different] search characteristics than others" (p. 59).

From a financial management perspective the emphasis on knowledge acquisition by experiential alertness "implies a reduced need for structured calculative information" (Gibson [5] p. 229). In the absence of a deliberate search process involving the evaluation of alternatives, financial information is not of critical significance. The apparently irrational disregard for financial and accounting information discussed in an earlier section of this paper is consistent with such a proposition. Research concentrating on information acquisition processes also provides support. Specht [24] suggests planners in small firms place greater reliance on personal contacts than on written reports (including internal system output). Similar results indicating less conventional economic or formal analysis in small firms are reported by Smith et al. [22] and by Kaish and Gilad [9].

Austrian economics is principally concerned with the entrepreneurial activities of individuals in the market place. There is no structured decision process assumed for each individual. Rather, there is acknowledgement that individuals behave differently and consequently will interpret experiences and information in different ways. The use of financial information in a structured economic analysis may well be an interpretation favored by some business owner/managers. It does not appear to be an interpretation favored

by many. Such a result may be of concern in neoclassical economic theory. To Austrians it is merely confirmation of the diversity of means which exist to achieve the desired end of making a personal gain from perceived opportunities.

### **A MORE LIBERAL RESEARCH ENVIRONMENT**

Adopting an "Austrian" approach to understanding financial management practices in small firms has a number of advantages. Importantly, it enables a better understanding of the diversity of observed practices. Totally embraced it should also provide a research environment which is not as likely to be influenced by "physics envy" and in which there will be no need to justify appropriate research methods as preliminary or exploratory. In time researchers will develop a less structured view of small business owner/managers, the firms they manage, the financial information they use, and the decisions they make. That view will accord more closely with the object of study.

There is no "framework" inherent in Austrian economics which guides the use of financial information in decision making. Diversity is anticipated. Other than an assumption of purposive action (in which purpose is defined by the decision maker) the way in which economic choices are made is not prescribed. Those who seek to exploit market opportunities will, given their different experiences, follow a diverse range of practices in the manner in which they: identify possible opportunities, evaluate alternatives (if perceived), and implement their chosen action. Similarly the relative importance of financial information will vary widely across decision makers. Such diversity is evident in the results of much prior research. Viewed from an Austrian perspective, results of this nature are expected and do not have to be regarded as abnormal or deviant.

The object of study in small business and entrepreneur based research is the individual who, alone or in combination with others, seeks to gain by entrepreneurial activity (exploiting perceived market opportunities). Researchers, if for no other reason than to satisfy wanton curiosity, wish to understand more about such individuals and the actions they take. The research environment appropriate for understanding the diversity of expected practice is not one which is dominated by sophisticated analytical techniques associated with traditional economic analysis. Quantifying statistical deviation enables description of aggregate behavior, but fails to capture the individual diversity associated with entrepreneurial activity. With an underlying appreciation of Austrian economic theory the "classic dissertation" and "physics envy" so dominant in extant research should lose

its attractiveness and make way for more field research and longitudinal studies (Bygrave [2]), which concentrate on the entrepreneurial event (Shapiro and Sokol [20]), and enable a proper concentration on business persons in action in their environment (D'Amboise and Muldowney [4]).

### FINAL COMMENT

Traditional economic frameworks and assumptions appear to fail when the object of study is small firms. This does not imply that traditional economic analysis has no place in understanding small firm behaviour. When concern is with large numbers of businesses with similar characteristics, the analytical models of mainstream economics may usefully describe and possibly predict aggregate behaviour.

When, however, concern is with an individual small firm the assumptions which facilitate aggregate behaviour models are inappropriate. Observed behaviour in small firms is consistent with the Austrian economic notion of diversified but purposive action directing the economic activities of individuals. Reliance on this interpretive understanding of small business and entrepreneurial activity will not facilitate a structured research framework. It will, however, more closely reflect the unstructured nature of the individual economic actors who are the objects of study.

Studying financial management procedures within small firms requires an understanding of the behaviour of individuals. As individual behaviour is the cornerstone of Austrian economics, it appears well placed to provide a research environment which will facilitate a clearer understanding of the use of financial information in small firms. Importantly, by studying small firm financial management within an Austrian economic framework, social and psychological factors can be addressed without the economic nature of the activities under review being subsumed.

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