

1. Introduction

In the developed countries such as the U.S., Canada, the United Kingdom (UK) and Australia, it has long been recognized that profitability is very important in determining the success or failure of a business. At the establishment stage, a business may not be profitable because of investment and expenses for establishment. When the business becomes mature, profits have to be produced.

Due to the importance of profitability, Edmister (1970) among previous researchers suggested that small firms need to concentrate on profitability. Jen (1963) found profitability to be a significant determinant of a small firm's credit risk. Thomas and Evanson (1987) stressed the aim of a business is not only the generation of sales, but also generation of profits. Profit is especially important because it is necessary for the survival of a business. Low profitability contributes to under-capitalization problems because it leads to fewer dollars as retained earnings and therefore to a reliance on external capital (Davidson and Dutia, 1991).

management (Ebashi, Sakai, and Takada, 1997). Objectives of this survey are to determine whether these difficulties affect SME profitability and to provide an overview of profitability of SMEs in Vietnam.

2. Measuring SME profitability

One of the most difficult attributes of a firm to conceptualize and measure is profitability (Ross, Westerfield and Jaffe, 1999). In a general sense, accounting profits are the difference between revenues and costs. However, the problem with accounting-based measures of profitability is that they ignore risk. In the economic sense, a firm is only considered as profitable if its profit is greater than what investors can earn independently in the capital market. In their text, Ross et al. (1999) suggest some methods to measure profitability including profit margin or return on sales, return on assets, and return on equity.

Burns (1985) measured profitability using three indicated variables: return on total assets, return on net assets and return on equity. Hutchinson, Meric and Meric (1988) used two indicated variables: return on sales and

SURVEY OF PROFITABILITY OF SMEs IN VIETNAM

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In Vietnam, an emerging country, profitability is extremely important because SMEs have to face with uncertainty of business environment and difficulty in seeking for external sources of finance (Ebashi, Sakai and Takada, 1997; Vuong, 1998).

It is apparent that since the government introduced the series of economic reforms, the private sector has rapidly grown in terms of the number of businesses, capital and employees. From the base of zero in 1991, the number of private businesses and limited companies had quickly risen to 28,811 in 1998 (Tran, 1998, p. 54) and almost all are small and medium enterprises (SMEs). SMEs have contributed considerably to growing GDP and creating jobs for working population. Vu (1998, p. 18) summarized SME contributions as follows:

- providing a large number of diversified products, occupying 26 % of GDP and 30 % of industrial outputs,
- creating jobs for 4.5 million people,
- mobilizing temporarily unused resources such as land, capital, labour and management skills to develop production, and
- increasing export volume and lessening trade deficits.

Besides achievements and contributions as mentioned above, SMEs in Vietnam are facing many serious difficulties such as shortage of capital for expanding and renovating equipment and technology, low productivity and competitiveness, lack of experience in terms of marketing, production management, and financial

return on equity to measure profitability, while Cohen (1989) suggested four variables: asset earning power, return on equity, net profit on sales and return on investment. Generally, depending upon their own purpose, researchers used different indicated variables to measure profitability. However, three variables: return on sales (ROS), return on assets (ROA) and return on equity (ROE) were most widely used by the researchers and authors such as Ross, Westerfield, and Jaffe (1999), Meric et al. (1997), and Burns (1985) to measure profitability.

Previous researchers have used several different ratios to measure profitability of SMEs depending on their research purposes. Table 1 summarizes the ratios used by previous researchers to measure profitability of SMEs. Of these ratios, return on sales, return on assets and return on equity are the most popular.

Table 1: Summary of measurement of SME profitability

Researcher(s) and year	Ratio	Measurement or computation
Burns (1985)	Return on total assets	Measure of firm's efficient use of assets
	Return on net asset	The key measure of performance
	Return on equity	A measure of the profit return to the shareholders
Hutchinson, Meric and Meric (1988)	Return on sales	Net profit after tax/Sales
	Return on assets	Earnings before interest and tax/Total assets
	Return on equity	Net profit after tax/Owners' equity
Jaggi and Considine (1990)	Return on assets	Operating profit/Total assets
Lairinen (1992)	Return on investment	Return on investment ratio
Meric et al. (1997)	Return on sales	Operating profit/Sales
	Return on assets	Net income/Total assets
	Return on equity	Net income/Common equity

SME profitability is an abstract concept. There are many different ways to measure profitability. This research limits the measures of SME profitability to the following ratios: (1) return on sales, (2) return on assets, and (3) return on equity. This limitation is necessary to narrow the scope of the study and is suitable for financial management practices of SMEs in Vietnam. In addition, in this study, the concept of profitability is defined as a comparative concept. A business is said to be "profitable" if it produces annual average returns (average of return on sales, return on assets and return on equity) that are greater than the risk-free rate of interest, which was estimated as 5.4% at the middle of the year 2000 in Vietnam. Conversely, if the annual average profit of a business is not greater than the risk-free rate of interest, the business is said to be "not profitable". The arguments for the definition of SME profitability as mentioned above are based on the following propositions:

- Firstly, the deposit rate of interest offered by state-owned commercial banks is considered free-risk because these commercial banks are secured the Government.

- Secondly, the risk-free rate of interest is considered the opportunity cost of capital, and SMEs have to produce an annual average profit greater than their opportunity cost, otherwise they should cease operating and deposit money with banks for risk-free rate of interest.

3. Research method

This research study used the stratified sampling technique with the fraction of 90 to select the sample with a planned procedure for selecting the sample. Based on a list of businesses provided by the HCMC Department of Investment and Planning, 14,424 SMEs operating in HCMC at that time, consisting of 5,170 manufacturing (accounted for 35.8%) and 9,254 trading (accounted for 64.2%), were selected as the target population. A sample of 400 SMEs was randomly selected from the list for personal interview. Thirty interviewers - including students from the Faculty of Finance and Faculty of Accounting (HCMC University of Economics) were recruited and trained in contacting and interviewing SMEs selected. One hundred and sixty out of 400 contacted SMEs participated in the survey, a response rate of 40%.

After data editing, ten cases were not usable and, thus, eliminated from data analysis. As a result, the sample of 150 SMEs was used for data analysis in this research study. Structure of SMEs by type of industry and form of ownership in the sample is described in Table

2.

Table 2 reports the distribution of the sample of responding firms in terms of type of industry and form of ownership. Sixty-six percent of businesses in the study sample were trading enterprises, and 34 % manufacturing units while other industries are beyond this research study. Figure 1 and 2 provide a visual distribution of sam-

Figure 1: Structure of SME sample by type of industry

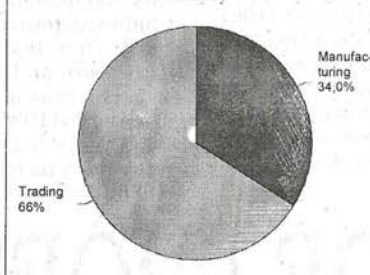
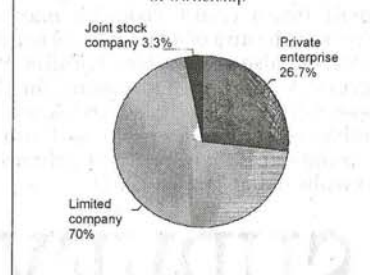


Figure 2: Structure of SME sample by form of ownership



ple in terms of business structure.

Figure 2 represents the business structure of SMEs by form of ownership, by which 70% of businesses in the sample were limited liability companies and 30% of private enterprises (26.7%) and joint stock companies (3.3%). These fractions were not significantly different from the fractions that were planned in the sampling procedure. Therefore, the research remains assured that the sample accurately reflected the population on the basis of the criteria used for stratification.

Table 3 provides the number and percentage of firms by form of ownership within industries. For both manufacturing and trading industries, the percentage of limited companies is highest (65.7% and 78.4% respectively) whereas the percentage of joint stock companies is lowest (3.0 and 3.9% respectively) compared within each industry. These percentages are consistent with the fraction of sampling units as planned by the sample selecting procedure.

Table 3: Sample distribution by form of ownership within industry

The form of ownership	Type of industry			
	Trading		Manufacturing	
	No. of firms	Percentage	No. of firms	Percentage
Private enterprise	31	31.3%	9	17.6%
Limited company	65	65.7%	40	78.4%
Joint stock company	3	3.0%	2	3.9%
Total	99	100.0%	51	100.0%

Source: Data analysis for the study

Table 2: Structure of SMEs in the sample by type of industry and form of ownership

Type of industry		No. of firms		Percentage
Type of industry	Trading	99		66.0%
	Manufacturing	51		34.0%
	Total	150		100.0%
The form of ownership	Private enterprise	40		26.7%
	Limited company	105		70.0%
	Joint stock company	5		3.3%
	Total	150		100.0%

Source: Data analysis for the study

Table 4 (next page) provides a general insight into business characteristics of SMEs in the sample. Ninety six percent of SMEs had an operating period of less than 10 years, only 4% had more than 10 operating years. In terms of size, 92% of businesses had not more than 100 employees and 95% had total assets less than VND10 billion. These businesses satisfied the criteria of SME definition in Vietnam. Additionally, 73.3% of SMEs had annual sales less than VND5 billion, 22% have annual sales from VND5 to 30 billion, and not more than 5% have annual sales over VND30 billion.

Table 4: Business characteristics of small and medium enterprises in the sample

		No. of firms	Percentage
Age of business	Less than 2 years	47	31.3%
	2-5 years	55	36.7%
	6-10 years	42	28.0%
	More than 10 years	6	4.0%
	Total	150	100.0%
Annual sales	Less than 5 billion dong	110	73.3%
	5 to 30 billion dong	33	22.0%
	31 to 50 billion dong	2	1.3%
	More than 50 billion dong	5	3.3%
	Total	150	100.0%
Total assets	Less than 5 billion dong	135	90.0%
	5 To 10 billion dong	8	5.3%
	More than 10 billion dong	7	4.7%
	Total	150	100.0%
Labor	1 to 10 employees	66	44.6%
	11 to 30 employees	52	35.1%
	31 to 50 employees	8	5.4%
	51 to 100 employees	10	6.8%
	101 to 250 employees	10	6.8%
	More than 250 employees	2	1.4%
	Total	148	100.0%

Source: Data analysis for the study

4. Research findings**a. Overview of profitability**

As defined, a business is said to be "profitable" if it produces an annual average profit return that is greater than the risk-free rate of interest, which is estimated as 5.4% in the 1990's in Vietnam. Conversely, if the annual average profit of a business is not greater than that rate of interest, the business is said to be "not profitable or unprofitable". The annual average profits are averaged from three profitability ratios: return on sales, return on assets and return on equity. The risk-free rate of interest is here defined as the deposit rate of interest of state-owned commercial banks, which is of 0.45% per month or 5.4% per year in the year 2000.

Based on the definition of profitability as indicated earlier, Table 5 reports that 99 out of 150 SMEs surveyed (66%) were profitable while the remainder (34%) was not

profitable. Table 5 also shows the size of annual profits of SMEs. Only about 10% of SMEs had annual profits of more than VND500 million, while about 50% have annual profit range from VND50 to VND300 million, and 18% annually earn less than VND50 million. Levels of annual profit of SMEs in Vietnam are small compared to other countries because firm size is low in terms of total assets and labor.

What has been discussed above is only an overview of SME profitability. A more specific analysis was carried out to provide a better look at profitability of SMEs in the survey.

b. Profitability and business structure

This subsection analyzes profitability of SMEs in relation to business structure to investigate which types of SMEs are profitable. Table 6 reports relationships between profitability and type of industry in which manufacturing SMEs are found to be more profitable than trading. In terms of business structure, manufacturing industry accounted for 34%

of SMEs in the sample and 36.4% of profitable SMEs while the figures for trading industry were 66% and 63.6% respectively. Conversely, up to 70.6% of unprofitable SMEs are trading ones while this percentage is only 29.4% for manufacturing ones.

Table 6 also provides the findings of relationships between profitability and business structure in which private enterprises are more profitable than limited and joint stock companies. In terms of structure, private enterprises, limited companies, and joint stock companies accounted for 26.7%; 70.0%; and 3.3% respectively of the number of SMEs surveyed but they accounted for 32.3%; 65.7%; and 2.0% correspondingly of the group of profitable SMEs. As such, although limited companies occupy 70.0% of SMEs in the survey, it account for only 65.7% of the

profitable ones while private enterprises occupy 26.7% of the whole sample, but they represent 32.3% of the profitable and 15.7% of the unprofitable group.

c. Profitability and business size

This subsection analyzes profitability of SMEs in relation to business size to investigate which business size groups (very small, small, or medium) are profitable. Table 7 (next page) reveals smaller businesses in terms of total assets, annual sales, and labor are more profitable than larger SMEs. For SMEs that have total assets less than VND5 billion, percentage of profitable SMEs was higher than that of unprofitable SMEs. These findings support the view that "small" is profitable.

5. Conclusions

Descriptive findings of SME profitability as analyzed above demonstrated that 99 of 150 SMEs surveyed (66%) were profitable and the remainder (34%) were not profitable, that is, they could not produce an annual average profit return that was higher than

Table 5: Overview of SME profitability

		No. of firms	Percentage
Profitability	Not profitable	51	34.0%
	Profitable	99	66.0%
	Total	150	100.0%
Annual profits	Less than 50 million dong	27	18.0%
	50 to 300 million dong	74	49.3%
	301 to 500 million dong	33	22.0%
	More 500 million dong	16	10.7%
	Total	150	100.0%

Source: Data analysis for the study

Table 6: Relationship between profitability and types of business

		Not profitable		Profitable		Total	
		No.	%	No.	%	No.	%
Type of industry	Trading	36	70.6%	63	63.6%	99	66.0%
	Manufacturing	15	29.4%	36	36.4%	51	34.0%
	Total	51	100.0%	99	100.0%	150	100.0%
The form of ownership	Private enterprise	8	15.7%	32	32.3%	40	26.7%
	Limited company	40	78.4%	65	65.7%	105	70.0%
	Joint stock company	3	5.9%	2	2.0%	5	3.3%
	Total	51	100.0%	99	100.0%	150	100.0%

Source: Data analysis for the study

Table 7: Relationship between profitability and business characteristics

		Not profitable		Profitable		Total	
		No.	%	No.	%	No.	%
Total assets (VND)	Less than 5 billion	45	88.2%	90	90.9%	135	90.0%
	5 to 10 billion	3	5.9%	5	5.1%	8	5.3%
	More than 10 billion	3	5.9%	4	4.0%	7	4.7%
	Total	51	100.0%	99	100.0%	150	100.0%
Annual sales (VND)	Less than 5 billion	36	70.6%	74	74.7%	110	73.3%
	5 to 30 billion	13	25.5%	20	20.2%	33	22.0%
	31 to 50 billion	1	2.0%	1	1.0%	2	1.3%
	More than 50 billion	1	2.0%	4	4.0%	5	3.3%
	Total	51	100.0%	99	100.0%	150	100.0%
Workforce	1 to 10 employees	18	35.3%	48	49.5%	66	44.6%
	11 to 30 employees	22	43.1%	30	30.9%	52	35.1%
	31 to 50 employees	2	3.9%	6	6.2%	8	5.4%
	51 to 100 employees	5	9.8%	5	5.2%	10	6.8%
	101 to 250 employees	4	7.8%	6	6.2%	10	6.8%
	More than 250 employees			2	2.1%	2	1.4%
	Total	51	100.0%	97	100.0%	148	100.0%

Source: Data analysis for the study

the risk-free rate of interest (Table 5). The size of annual profits of SMEs was not high. Level of annual profit of SMEs in Vietnam is low compared to SMEs in other countries because of small firm size in terms of total assets and labor. In relation to the types of industry and forms of ownership, the following findings were found:

- The percentage of profitable SMEs in manufacturing industry was higher than that of the trading industry.
- In terms of form of ownership, the percentage of profitable SMEs was found higher for private enterprises than for limited and joint stock companies.
- In terms of business size, the percentage of profitable SMEs was found higher for smaller businesses than for larger SMEs ■

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