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Features, Costs and Benefits of Financial Accounting and Reporting: A Study in Small and Medium-Sized Enterprises in Malaysia

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Abstract

Financial accounting which is a crucial element in any business entity including small and medium enterprises has always been a concern and a profound topic of interest. However, the lack of empirical evidence has prompted the researcher to analyse the financial accounting and reporting practices of small and medium-sized enterprises (SMEs) in Malaysia. This research examines the key features of SMEs' financial reporting and assesses its costs and benefits to the stakeholders. This study adopts a positivist paradigm using a questionnaire. The research design involved a survey of 150 owner-managers of SMEs in the East Coast Region of Malaysia. The data were analysed statistically using both univariate and multivariate analyses. The findings revealed that financial information in the SMEs' financial statements was incapable to satisfy the main users' requirements. Besides, it was also indicated that the main weaknesses of SMEs' financial statement are in terms of its preparation with outdated information, tax motivation and limited disclosures. The outcomes of this research are expected to be valuable to the existing literature on SMEs' financial reporting practices, particularly in terms of the information required by financial statement users, as well as the costs and benefits of financial reporting. As the findings of this research are of particular concern to SME, their accountants, stakeholders and other jurisdictions; thus, it can be concluded that in the future, this research could assist policymakers in formulating an appropriate policy on the financial reporting of SME in the future.

Keywords: Financial Reporting, Malaysia, Multivariate Analysis, Small and Medium-sized Enterprises (SMEs).

Introduction

The small and medium-sized enterprises (SMEs) play a pivotal role in ensuring growth and employment opportunities in both developed and developing nations, besides contributing to the global economy (Mat Nawi, 2015). According to the Malaysian Department of Statistics (2017), a major portion of business entities in Malaysia (approximately 98.5%) is SME; comprising of 76.5% of

microenterprises, 21.2% and 2.3% of small and medium-sized enterprises, respectively. Here, SMEs not only account for 36.6% of Gross Domestic Product (GDP) but also contributes to 65.3% of total employment in the year 2016. It is expected that, by the year 2020, SMEs' contribution to the GDP will increase up to RM120 billion (Bank Negara Malaysia, 2013).

Despite their vast growth and substantial contributions, SMEs are still facing tough challenges in terms of obtaining external loans and having limited or absence of technology adoption. Besides they also face fierce competition from large firms while encountering the effects from globalisation (UNDP, 2007). According to Mat Nawi (2015), one of the reasons which hinder SMEs from securing external financial sources is the lack of transparency in their financial reporting.

As financial reporting poses legal liabilities, thus, they are strictly regulated by authorities under various jurisdictions. In the local perspective, the convergence of Malaysia Financial Reporting Standards (MFRS) with the International Financial Reporting Standards (IFRS) has led to the question of costs relative to benefits in financial reporting, for example in the process of preparing and publishing financial statements. As the characteristics of SMEs are unlike larger companies, the IFRS conceptual framework for financial reporting is found to be inapt for SMEs (Evans et al., 2005). However, this issue had been dealt with effectively through the introduction of the Malaysian Private Entities Reporting Standards (MPERS) Framework in February 2014 which took effect from 1 January 2016.

Another major issue which has been identified in the SMEs' financial reporting is the requirements of the financial statements' users. The users of SMEs' financial statements differ from the users of larger firms (Ploybut, 2012). As such, a distinct SMEs' financial reporting system has been adopted and applied in various nations in order to ease the burden on SMEs (Sian and Robert, 2009).

To date, empirical research on financial reporting by the SMEs is limited, especially in developing economies (Ploybut, 2012). Thus, this research intends to analyse the financial reporting practice by Malaysian SMEs, with relevant insights into the process of preparation and publication of financial statements, besides determining the costs and benefits of financial reporting.

Literature Review

Definitions of SMEs

Although there is no specific definition of the term SME according to international standards, it is generally described as a company with employees or sales turnover below certain limits. In the local setting, however, the SME Corporation of Malaysia (2017) defines SMEs according to either total annual sales turnover or a total number of full-time employees. On the other hand, the Central Bank of Malaysia (2013) defines SMEs based on the threshold of annual sales turnover (STO) or number of full-time employees. Based on this definition, for a business entity to be classified as an SME, its STO and the number of full-time employees should not exceed RM50 million or 200 persons, for the manufacturing sector. Meanwhile, for the service industry and other sectors, the STO and number of full-time employees should not exceed RM20 million or 75, respectively.

Financial Reporting: Regulation and Conceptual Framework

With regards to financial reporting, all business entities should be aware of the existing accounting laws, its regulations and the required standards in the process of preparation and publication of financial statements. Standards of accounting practice have become an essential

component of the financial reporting frameworks for all business entities. While some countries make it compulsory for both listed and non-listed entities to adhere to the accounting standards, others make it obligatory to public listed companies only. In Malaysia, in accordance with Section 167 of Companies Act (1965), it is a legal requirement for all business entities to maintain their accounting and other relevant records for at least 7 years mainly intended for auditing purpose. It is therefore up to the entities whether to prepare their statements of accounts or hire the external accountants to prepare them.

Historically, the inception of the Financial Accounting Standards Board (FASB) came into reality in the 1970s based on the U.S. framework. According to Alfredson et al. (2009), the framework was important not only to develop the standards of financial reporting but also to deal with matters concerning accounting that are not usually discussed in the accounting standards. Furthermore, the International Accounting Standards Board (IASB), which came into existence on April 1, 2001, regards a framework as “the concepts that underlie the preparation and presentation of financial statements for external users” (IASB, 2009, p. 4). Essentially, the IASB recognised the need for a simpler, more appropriate set of accounting standards for SMEs as a result of the purported intricacy of IFRS and also from the legal requirements demands for SMEs to comply with the complete IFRS requirements in various governments (Epstein and Jermakowicz, 2007). Thus, in recent times, a different set of accounting standards for SMEs or firms outside capital markets were applied in several nations, irrespective of whether or not complete IFRS was implemented (Pacter, 2011).

As aforementioned, the Malaysian Accounting Standards Board (MASB) issued the Malaysian Private Entities Reporting Standards (MPERS) in February 2014. The MPERS emulates the IASB’s *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs) issued in July 2009 by introducing MASB’s *Amendments to MPERS* in October 2015 which are equivalent to the IASB’s *Amendments to IFRS for SMEs published* in May 2015. The amended standards had slightly altered the standards of MPERS to guide SMEs on the requirements and alignments of other relevant standards to those of the MFRSs. With effect from January 1, 2016, it was directive that every SME should engage in financial accounting and reporting in accordance with the requirements of MPERS. This regulation is seen as more apt especially for SMEs that opt not to go for *initial public offering* (IPO) in the foreseeable future. Besides, the regulation is also seen as conducive for those SMEs that give priority on cost savings.

SMEs’ Financial Statements: Users and Uses

Efforts to determine the financial statements’ users and its uses are crucial to develop or simplify the SMEs’ financial standards. The users and uses of financial statements are discussed in detailed hereafter.

To date, empirical evidence from studies on SMEs financial statements users depicted a wide array of user groups. For instance, Collis and Jarvis (2000) stated that the main users of the small company’s statutory accounts are banks and other finance providers, followed by tax authorities and directors who are not shareholders. On the contrary, Dang-Duc, Marriott, and Marriott (2006) found that tax authorities and governmental agencies were the primary users of small firm’s financial statements. In addition, a study by Srijunpetch in 2009 found that most of the respondents perceived tax authorities as the main user of SMEs’ financial statements, followed by shareholders and the

management. Moreover, the IASB predicts that the financial statement users are banks, suppliers or trade creditors, credit rating agencies, customers and non-manager shareholders (ACCA, 2008).

In terms of the uses of financial statements of SMEs, a study by Collis and Jarvis (2000) stated that the statutory accounts of small firms were considered as most beneficial in “deciding director’s pay and bonuses, comparing performance with previous periods and in connection with loans or finance” (p. 57). On the contrary, these statutory accounts were also considered to be less beneficial for the purposes of management, unlike management information. Findings from several studies also revealed that various SMEs resorted to the use of computerisation to a great extent in their accounting system in order to produce their financial records besides providing the required management information (Marriott and Marriott, 2000; Sian and Roberts, 2009). It is noted that management information is crucial and could be easily generated for management’s uses in this way. However, it is also anticipated that the purported utility of financial information in the annual accounts for management use will be declining.

In addition to the management, the shareholders are also inevitably the main users of financial statements. Legally, firms are obliged to prepare and submit their annual accounts to the shareholders before the annual general meeting (French, Mayson and Ryan, 2008). However, this requirement is not applicable to SMEs. Previous studies proved that majority of the managers and the owners of SMEs are similar individuals (Collis, 2008; Collis and Jarvis, 2000). Therefore, it is unstated that the shareholders or owners could directly monitor the conduct or actions of a hired manager on a daily basis, making it easier in observing costs (McMahon and Stanger, 1995). Collis and Jarvis (2000) also emphasised that most of the owners or shareholders had access to financial information to control and monitor their businesses, thus made the stewardship role of financial reporting to owners or shareholders overlapping.

It is inevitable that tax authorities use financial statements to examine expenditure and fees of the directors (Barker and Noonan, 1996). Since every country has its specific taxation regulations, it is impracticable to generalise accounting standards to all jurisdictions (Sian and Roberts, 2009). In fact, tax authorities also possess powers to obtain extra information from the firms. In the field of accounting, both tax reporting and financial reporting have different objectives. Generally, the former serves as a basis in determining taxable income while the latter provides information for users (Ploybut, 2012).

Further, the financial institution is frequently associated as users of financial statements from business entities. This is because loans from a bank are one of the most common sources of external funds for SMEs (Berger and Udell, 1998; Mat Nawi, 2015). A study by Mat Nawi (2015) further suggested that SMEs’ owner-managers favour to obtain debt finance instead of equity funding in to retain better control over their businesses. Upon applications to obtain financing, usually, loan officers from banks would transform the potential borrower’s financial statement information into a standard template for loan evaluation (Berry, Crum, and Waring, 1993). Most banks will opt to use these statements to assess their clients as financial statements are noted to be the primary source of information in the bank’s process of internal rating (Zuelch and Burghardt, 2010).

In the current era of capitalization, it is not surprising that venture capitalists have also become one of the prospective users of small firm’s financial statements as they too provide a source of finance to SMEs (Sian and Roberts, 2009). Generally, venture capitalists are equity investors who have shares in the firm’s capital gain, with major priorities over the firm’s progress and profit and a

deep interest in matters related to finance, market and management. (Mason and Stark, 2004). Their investment decision involves a multistage process, comprising of early screening, project assessment and post-investment activities. In the assessment of an investment proposal, venture capitalists give priority to financial information, particularly in growth and income projections (Manigart et al., 2000). On the contrary, they faced difficulties in obtaining information on non-public companies, their management and future prospects as these companies were subjected to many legal requirements (De Prijcker et al., 2017).

Previous researches have also indicated that only a few SMEs furnished their accounts to suppliers or creditors, business partners and clients. According to John and Healeas (2000), practically, trade creditors were independent of statutory accounts for credit decisions, and they inclined to "pursue their own independent sources before extending credit" (p. 33).

SMEs' financial reporting: Costs and benefits

As discussed earlier, balancing between costs and benefits have been a challenge to SMEs. It is almost certain that the requirements of financial reporting for all businesses involve numerous costs. This includes direct costs such as staff remunerations and the costs of preparing and disseminating statutory reports like audit fees and. In addition, indirect costs such as competitive disadvantages and breach of privacy due to publication and disclosure of the company's accounts also exist (Arrunada, 2011). It is invariably contended that the need to prepare and disseminate the accounts cause heavy financial burden to smaller firms. Though the regulatory compliance costs are mostly fixed, small firms suffer from time shortage and lack of expertise to implement the necessary legal requirements (Kitching, 2006; Kitching, 2015). Small firms are also incapable to extend their costs across a large scale of operation; thus, they are usually burdened by proportionally greater costs as compared to larger entities. However, Arrunada (2011) argued that proprietary costs for small firms were expected to be lower. Privacy costs, on the other hand, was noted to be difficult to measure.

No doubt, it is a common practice in business to create ways to reduce costs and maximize benefits. This is not, however, the case for micro firms as the expected cost reduction may be minimal or non-existent since they are still required to prepare financial reports for various purposes such as tax filing, bank financing and prospective business contacts. Conversely, the exemption would relatively result in an insecure business atmosphere because the financial reporting regulations which are necessary to provide sufficient information to those who perform transactions with the firms have been discontinued. Additionally, in the absence of filing requirement, direct communication to convey financial information between the firms and contractual parties may be used. This might lead to heavy costs, as compared to making it accessible to the public (Ploybut, 2012). Besides that, without financial reporting regulation, a firm's financial discipline will also be diminished, thus potentially intensifying financial crimes and misconducts.

Methodology

This study aims to ascertain the uses and users of financial statements. The study also intends to elicit opinions and perceptions of SMEs' owner-managers on financial reporting practices. To achieve these objectives, a survey questionnaire was conducted among 150 SMEs in the East Coast Region of Malaysia. The survey methodology was used because it is the most efficient mean of data collection to assess the perception of subjects (Robson, 2011). Taking into account the shortcomings

of the mailed questionnaire in the SME research (Ploybut, 2012), this study, therefore, used telephone and face-to-face structured interview methods for data collection. The questionnaire was developed by adopting and adapting relevant questions from previous researches, such as Collis (2003) and Ploybut (2012), with consideration on their suitability with the context, population and aims of the study. In terms of the reliability and clarity of the assessment tool which is the survey questionnaire, a pilot test had been undertaken prior to the actual survey. Based on the responses received, the questionnaire was edited to improve clarity and ensure its reliability. The selection of respondents for the study was done by using a convenience random sampling method as it is convenient, quick and cost-effective. The study had received 150 valid and usable responses, resulting in a response rate of 69 percent. No data had been excluded from the data screening with regards to the data from the main survey. Subsequently, the responses obtained were analysed statistically using descriptive analysis and bivariate analysis. The Cross-tabulation was used for the descriptive analysis of the data specifically, to compare the responses. Alternatively, the bivariate analysis was used for a cross-analysis of the responses and to compare between the sizes of the entities. Data analysis also incorporated non-parametric tests using SPSS software such as Chi-Square test, Kruskal-Wallis test and Mann-Whitney U test since the independent variables are categorical in nature.

Results and Discussions

This section presents the findings of the analysis conducted which include descriptive analysis on the characteristics of sample entities, the analysis of perceptions of SMEs' owner-managers on issues concerning the preparation and publication of financial statements, the users and uses of financial information.

Demographic Information of the Respondents' Business Entities

Table 1 illustrates the descriptive statistics analysis for the sample/respondents' entities. The table indicates that more than two-thirds of the samples were in the manufacturing sector. In terms of the number of years in business, the table shows that more than 50% of the samples have been in business for more than 10 years.

Table 1: Demographic information of the sample entities

	<i>Percent (%)</i>		<i>Percent (%)</i>
<i>Type of main business</i>		<i>Manufacturing</i>	<i>Service</i>
		71	29
<i>Annual turnover (in RM)</i>			
<300,000		23.0	22.4
300,000- 1 million		14.3	16.3
1-10 million		4.0	9.2
10-15 million		2.7	2.4
15-20 million		1.3	2.2
More than 20 million		0.7	1.5
<i>Years in business</i>			

Less than 1 year	5.4
1-3 years	9.3
4-6 years	14.3
7-10 years	19.0
More than 10 years	52.0

With regards to the ownership structure, 100 percent of the respondents reported that owner-managers held more than 50 percent of entities' share capital with more than 80 percent of them wholly-owned by owner-managers. The findings also indicate that an agency relationship between owners and managers is unlikely. Moreover, the stewardship role of financial reporting is redundant in this case since managers are also reporting to themselves as shareholders (Jarvis and Collis, 2003).

Further, the assessment on the presence of non-participating owners related to annual turnover depicts that medium-sized firms are in favour of having non-participating owners as compared to small firms. However, there was no major difference detected among different sizes of entities as the P-value obtained was more than 0.05. This finding is consistent with the study by Eierle and Haller (2009) but inconsistent with the study of Thailand's SMEs by Ploybut (2012).

In addition, findings from a series of statistical test analysis show a major difference in the views of non-participating owners on the costs and benefits of account preparation in terms of over-dependence on accountants and competitive advantages. This is based on the significant results from the Mann-Whitney tests whereby P-values of 0.037 and 0.011 were obtained, respectively.

Preparation and Publication of Financial Statements

i. Accounting system

In terms of the system used to keep the records of business transactions, the findings showed that more than half (57%) of the respondents' entities used a computerised accounting system. Meanwhile, the remaining 24% and 19% of them used a manual recording method and both methods, respectively. The findings support previous findings of Ploybut (2012) and Collis and Jarvis (2002). The Chi-square test result performed on the set of data indicated that there was no significant difference between the sizes of entity (defined by turnover) and types of accounting system due to the standardization of computerisation-based accounting practice among all size groups.

ii. Services provided by external accountants

In addition to the system used, the respondents were also required to indicate the types of external services engaged by them for example preparation of statutory accounts, audit service, taxation service, bookkeeping, business and financial advice which are provided by external accountants. Data analysis showed that a majority (67%) of them hired external accountants to prepare their annual financial statements. The findings are in line with previous studies of Ploybut (2012) and Collis (2008). The main reasons for this were due to the regulatory requirements and firm's cost-effectiveness strategy; followed by the complexity in taxation and accounting processes.

Besides that, the hiring of external accountants for regulatory compliance-related tasks was identified in all entity sizes. Majority of smaller entities hired external accountants for annual accounts preparation, bookkeeping, and tax services. Alternatively, medium-sized enterprises preferred to hire in-house accounting staff instead of external accountants. However, the results of

the Chi-square test proved that there was no significant difference between all entity sizes (defined by annual turnover) for all categories of services.

Interestingly, the research found a statistically significant difference between the age of business and services provided by external accountants, specifically the bookkeeping service. This was concluded based on the Mann-Whitney test where $U = 3252.00$, $Z = -2.109$, and a P-value of 0.037 was obtained. This deduces that unlike older businesses, younger businesses relied more on external providers of accounting services.

iii. Perceptions towards changes in financial reporting standards and regulations

In terms of core areas of financial accounting which include financial reporting standards and regulations, the research noted a surprising finding. The findings show that majority of the micro-entities were not aware of the accounting regulations. In contrast, small and medium entities or SMEs reported that they had prior knowledge and were aware of the accounting regulations. However, the proportion of awareness in this group of respondents was notably low at less than 50%.

iv. Purpose of producing annual financial statements

For this, the findings noted that all entities including micro, small and medium were found to prepare the financial statements to comply with regulatory requirements, especially after the implementation of Goods and Services Tax (GST) from April 2015. Most of the respondents reported that the financial statements were prepared by themselves. Findings also indicated that, surprisingly, none of the respondents prepared the financial statements for the purpose of reporting to external parties. In addition, less than two-thirds (54%) of them reported that they prepared it to provide information to the management or report to the owners. The main reason for this was because the owners and the managers are the same individuals which are consistent with a similar finding reported by Marriott and Marriott (2000).

v. Perceptions on costs and benefits of producing annual financial statements

Based on the responses received, this research classified costs and benefits into three major categories. The first and second categories were the cost of producing financial reports exceed the benefits and heavy dependence on accountants to ascertain the form and content of financial reports respectively. The last category was the concern over the issue of competitive disadvantages caused by some disclosure items in the financial reports. The findings revealed that micro and small entities agreed that costs of producing financial report exceed its benefits which fell into the first category. Meanwhile, medium-sized entities tend to be more concerned with competitive advantages (third category). However, the results of the Kruskal-Wallis test proved that there was no significant difference between the sizes of the entities for all three categories.

Use and Users of Financial Information

i. Users of financial statements

The findings further implied that a relatively high proportion (75%) of the respondents indicated that the main users were tax authorities such as the Inland Revenue Board, the management which includes the owner or manager and financial providers namely financial institutions. The remaining users comprised of business contacts, investors, regulatory agency, and partners. The least

percentage of users were noted to be the employees of the firms. Similar findings were found in the previous researches by Sian and Roberts (2009) and Maingot and Zeghal (2006).

In addition, the research findings also revealed that the Chi-square test showed that the financial providers' perceptions as primary users differed by the sizes of entity (Chi-Square = 11.072, $df=2$, $p= .002$). Instead, no statistically significant differences were found for the remaining categories of users. A Kruskal-Wallis analysis ($H= 10.015$, $df = 2$, $p= .000$) indicated that medium entities are more likely to report financial providers as significant users based on the statistical findings. On the other hand, the association between business ages and perceptions of financial providers and regulatory agencies which was also investigated in this research using the Mann-Whitney test ($p=.003$) indicated that a significant difference existed between the variables as important users. This elicited that older entities were more likely to have financial providers as their main users and less likely to have regulatory agencies as main users.

ii. Use of financial information by management

a. Use of annual financial statements

Further analysis of the research findings indicated that approximately 55% of the respondents stated that they are not dependent on the financial statements in contract bidding or in obtaining license or credit from creditors. A total of 34% and 19% of them stated that they used the financial statements for loan applications and borrowing agreement purposes, respectively. A very low proportion (3%) of them claimed to use financial statements for comparing their firm's performance with competitors. Further, a Kruskal-Wallis test revealed a significant difference between SMEs' uses of financial statements for loan application ($H= 24.193$, $df = 2$, $p= .000$) and borrowing agreement ($H=8.912$, $df = 2$, $p=.000$). Besides, a significant positive association was also found between business age and the use of financial statements for applying capital financing from banks or investors ($H=6.811$, $df = 2$, $p= .033$).

b. Use of management information

In terms of management information, almost 85% of the respondents were reported to produce and use management information regularly whereby a significant number of them employed budgeting, ratio and variance analysis techniques. It is inevitable that management information was perceived to be more convenient for business management instead of annual financial reports. However, the research findings indicated that most of the SMEs were not dependent on the information from the financial statements; instead, they preferred to use the management information for internal uses.

iii. Source of information in deciding business contacts/partners

Lastly, in deciding on the potential business partners, most SMEs put a high weightage in the payment history and references from banks and other firms. Since most of the entities prepared the financial statements mainly for tax purposes, the respondents were found not to refer primarily on financial statements in the decision making for selecting business partners. This finding is consistent with the study of Arrunada (2011).

Recommendations and Conclusions

This research provides evidence on the SMEs financial statements' users and uses; as well as outlining the costs and benefits of their financial reporting. Findings of the research showed that the primary users of the Malaysian SMEs' financial statements are the owner-managers, tax authorities and creditors. It was also indicated that micro entities are less likely to prepare financial statements for external users. Besides, this research identified substantial dependency on computerisation in the accounting systems to produce financial information for management uses and statutory reporting. The findings of this research also concluded that the majority of SMEs, especially micro and small entities, obtain assistance from external accountants to perform financial reporting. Possibly due to inadequate internal accounting expertise within the firms. Unlike micro and small entities which focus on the disadvantage of the cost of preparation of the financial report over its benefits, medium-sized entities tend to be more concerned with competitive advantages.

Besides, the findings of the research are also expected to have an impact not only on the SMEs, their accountants and stakeholders but also on the national standards boards and regulators. This research offers information on the SMEs' financial reporting requirements, the financial reports' users and the SMEs' latest financial reporting practice which will add on to the pool of knowledge on SMEs financial reporting practices. The results further portrayed that the SMEs' financial statements' information is inadequate to fulfil the users' information needs. In reality, most SMEs' owner-managers viewed that financial reporting is conducted merely to fulfil their reporting obligations. Due to the importance of financial reports, SMEs' owner-managers should be aware of the benefits of first-rate financial statements' preparation and publication for their businesses. Thus, more attention should be put on the preparation of good quality financial statements. Generally, this research makes several important contributions to the existing studies on SMEs' financial reporting, particularly in adding on to the extended literature concerning the costs and benefits of reporting and the information requirements of SMEs financial statements' users.

Despite its valuable contributions, several limitations have also been identified in this research, particularly in terms of representativeness of the sample size of the respondents. Future research may be conducted in the same research area with a higher number of respondents or business entities. Besides, as the current sample population is solely concentrated on only one region, thus it may not be sufficed to generalise the findings to the whole population of SMEs in Malaysia. Moreover, more qualitative and quantitative studies should be carried out on the Malaysian SMEs' financial reporting to gain in-depth information concerning the issue. Further, it is suggested that future research should concentrate on the issues of accounting standards compliance by the SMEs and the implementation of a conceptual framework for SMEs' reporting practices, which were initially intended for large and listed firms. Finally, it is recommended to conduct a more focussed study on the issue of simpler accounting standards for SMEs, specifically the Malaysian Private Entities Reporting Standards (MPERS).

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