

# Functions and Reliability of International Financial Reporting Systems of Rural Smes in Kwazulu Natal: Knowledge and Understanding of Financial Management

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**Abstract** *A review of the understanding of the functions and reliability of International Financial Reporting Systems applied by rural SMEs in KwaZulu Natal (KZN) will determine the level of knowledge and understanding in the use of financial management by rural entrepreneurs in KZN, in order to evaluate the functions reliability of financial reporting systems of rural SME in KZN. Mixed approaches of both qualitative and quantitative techniques were used to collect primary data from five rural villages in KwaZulu Natal. The results of the survey revealed that the majority of respondents do not follow proper international financial reporting international standards. They do, however, use traditional methods in recording their cash collections by using exercise books to keep daily records. Further research should aim to establish financial management training needs of rural SMEs in KZN. Financial management and financial reporting systems knowledge and understanding by rural entrepreneurs will be improved. The paper provides practical guidance on how to perform financial management activities and financial reports as applied in remote rural areas.*

**Key words** Functions; reliability; International Financial Reporting Systems, Rural, SMEs

DOI: 10.6007/IJARAFMS/v3-i3/79

URL: <http://dx.doi.org/10.6007/IJARAFMS/v3-i3/79>

## 1. Introduction

The term financial reporting framework is defined as a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements (Accounting and Financial Reporting, 2012). It has been noticed that in some cases all financial statements are prepared in accordance with a financial reporting framework (Accounting and Financial Reporting, 2012). However, literature indicates that just like every other system; International Financial Reporting Systems (IFRS is a systematic approach that promotes understandability, reliability, relevance and comparability (Kunle; Omoruyi and Haned, 2011). In the case of Small business, the Financial Reporting Framework for Small and Medium-sized Entities (FRF for SMEs) is a self-contained special purpose framework intended for use by privately held small-to-medium-sized entities (SMEs) in preparing their financial statements. The FRF for SMEs draws upon a blend of traditional methods of accounting with some accrual income tax methods (Accounting and Financial Reporting, 2012). The literature review suggested that an absence of accounting and financial management and accounting skills contributes to the poor performance of the sector in South Africa and that the possession of some basic skills in these fields may enhance the growth and profitability of the sector (O'Neill and Rajaram, 2008; Yström, 2010; Danie and Pieter, 2011; Accounting and Financial Reporting, 2012).

### 1.1. Problem statement

Research indicates that those small businesses have limited international structures and activities (Aboagye-Otchere and Agbeibor, 2012). This problem causes inconsistent SMEs financial statements and large discrepancies arise in the ways firms report their financial positions. For example, many firms in developing countries may have two or three sets of books for different audiences. Auditing such statements can be labor and time intensive, which raises the cost of loan processing for SMEs. In addition, even audited financial

statements can be unreliable (Ganbold, 2008. In South Africa, there is a low level of accounting and financial management in the SME sector particularly in KZN (O'Neill and Rajaram, 2008).

### **1.2. Aim and Objectives**

The overall aim of this study was to determine and evaluate functions and reliability of financial reporting systems of rural SMEs in KZN. To achieve the overall aim of the study, the following sub-objectives were fulfilled, by means of a questionnaire/survey, through which data was collected and analyzed:

- (i) To determine how existing the financial reporting systems are used by rural SMEs in KZN;
- (ii) To identify factors influencing the use of financial reporting systems by rural SMEs in KZN;
- (iii) To identify knowledge of financial reporting systems, and to what extent financial reporting system are used by rural SMEs in KZN; and
- (iv) To evaluate whether there is a need to improve the financial reporting systems of rural SMEs.

## **2. Literature review**

### **2.1. Financial reporting in the SMEs context**

Previous research conducted focuses on financial reporting in the SME context more specifically the entrepreneurial entities within the SME group indicate that it is appropriated to sort out the extent to which accounting standard setters have taken into account the results of academic studies when developing accounting solutions for SME (Yström, 2010). This means that suggested solutions made by academic studies to improve financial reporting of SMEs needs to be implemented. The Financial Reporting Framework for Small- and Medium-sized Entities (FRF for SMEs) is intended to assist small –to-medium-sized entities (SMEs) in preparing their financial (Accounting and Financial Reporting, 2012). The IFRS adoption includes transparency, accounting quality and reduced cost of capital (Outa, 2011). However, IFRS are facing many challenges including the development of a legal and regulatory framework, awareness campaign, and training of personnel (Madawaki, 2012). Therefore, based on these assumptions, it is important to look if applied accounting quality measures can improve rural SMMEs financial performance more specially in KZN. There is an indication that financial information quality is affected by financial reporting standards (Jara, Ebrero and Zapata, 2011). According to Francis (2009), in many cases, access to capital for SMEs must be accompanied by capacity building through management training, business and strategic planning, marketing, accounting and technology upgrading. This means that SMEs owners/managers that intend to access financing must have an effective knowledge of the types of financial of the types of financial institutions, the various products and services available and credit policies and procedures.

### **2.2. SMEs awareness and use of IFRS**

It is very important for the SMEs owners/managers to know their financial positions ((Myagkova, 2011. SMEs owners/managers need to produce financial statements to the financial lenders and interested investors when they look for financial support for their business expansion. Research indicates that financial information quality is affected by financial reporting standards (Jara Ebrero and Zapata, 2011). Danie and Pieter (2011) indicate that in South Africa, the introduction of International Financial Reporting Standards (IFRS) made it even more difficult for SMEs to adhere to accounting requirements. There are also many limiting characteristics of SMEs, such as a lack of 'formality' in terms of accounting procedures. According to Laing (2012), the cost of meeting the financial reporting requirements is a burden that SME's are ill prepared to bear and such costs are not justified by any claim to being useful for the owners/ managers or other possible stakeholders. With regard to SMEs, the most significant users are likely to be owners/managers, government and creditors, who may have the power to obtain information additional to that contained in the financial statements. Management is also interested in the information contained in the financial statements, even though it has access to additional management and financial information (SME-FRF & SME-FRS, 2011). All the counties using IFRS (International Financial Reporting Standard) can easily make comparisons of their financial statements across the industries and countries (Jacob and Madu, 2009).

### 3. Research Methodology

The total sample of the study consisted of 150 SMEs owners/managers in rural KZN. The literature was used as the source of information to formulate the questionnaire for this survey. Closed –end and open-end questionnaire was used. Self – administered questionnaires were designed and distributed to 150 SMEs owners/managers in the selected rural areas of KZN. The questionnaire was designed in a manner that made it easy to read and understand. Non – probability sampling method in the form of quota sampling was used in order to obtain the desired sample. The research design was exploratory and cross-sectional in nature. A mix approach of quantitative and qualitative methods was used to collect primary data. In order to standardize the conditions under which the questionnaires were completed; research assistants at local villages in the selected areas were recruited and trained as fieldworkers. Interviews with respondents were conducted during the 1 December 2012 to 25 February 2013, on weekdays and over weekends, the respondents' ability to answer the questionnaire was increase by the provision of a number of instructions throughout the questionnaire, and the questionnaire was personally administered.

### 4. Results and Discussion

#### 4.1. Results

This research was conducted among entrepreneurs in rural KZN. The total sample size of the study was made up of 150 registered entrepreneurs. The analysis of data reveals the following results:

Respondents number of people with accounting and financial management skills working in their business

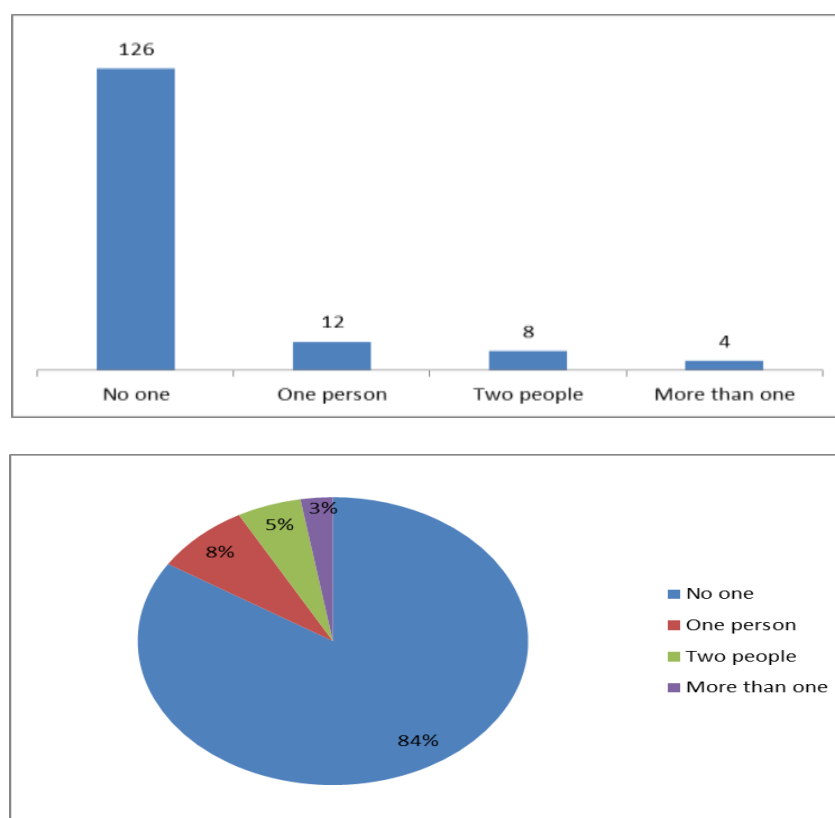


Figure 1. Percentage of respondents of people with accounting and financial management skills working in their business

A total of 84 percent of the respondents indicated that no one with accounting and financial management skills working in their businesses. This finding shows that people working in rural SMMEs in KZN including business owners/managers do not have accounting and financial management skills. Respondents indicated that they do not have money to pay qualified people and most of the time people who have accounting and financial skills do not like to working in rural areas. 8 percent of the respondents said that they

have one person with accounting and financial management skills working in their businesses. 5 percent indicated that they have two people working in their businesses. 3 percent indicated that they have more than one person working in their businesses.

Respondents' numbers regarding to the people who prepare their financial reports

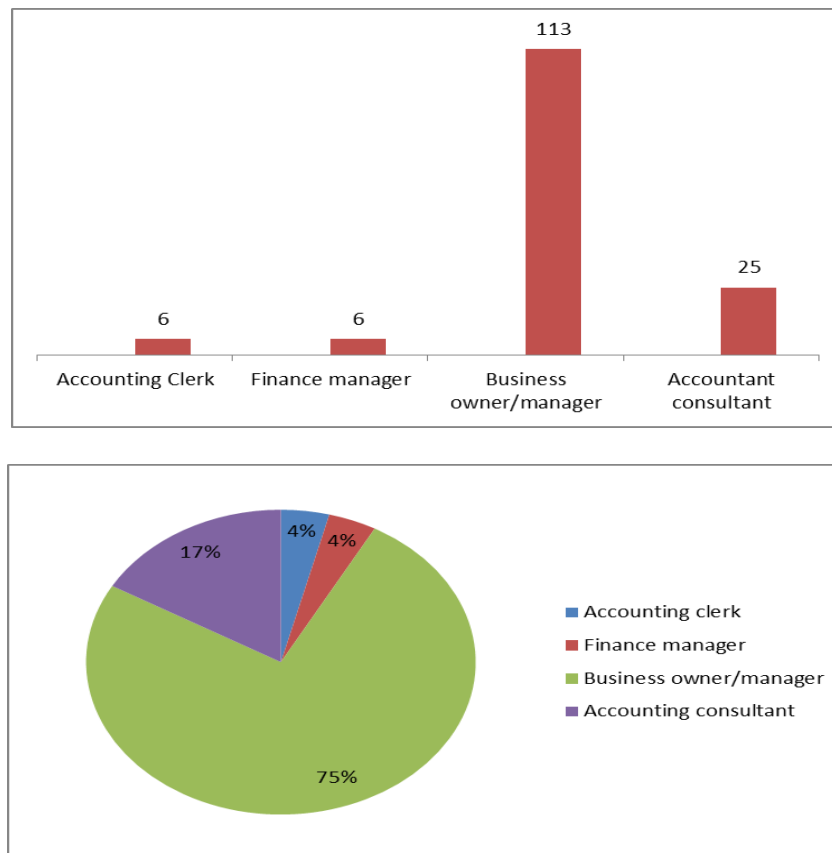
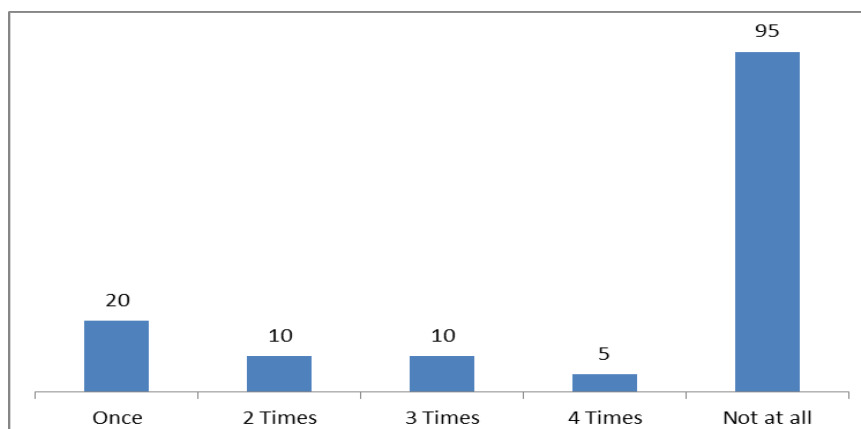


Figure 2. Percentage of respondents regarding to the people who prepare their financial reports

75 percent of the respondents indicated that business owners/managers are the ones who prepare financial reports. 17 percent of the respondents indicated that accounting consultant prepare their financial reports. 4 percent of respondents indicated that accounting clerk prepare their financial reports. 4 percent of the respondents indicated that finance manager prepare their financial reports. This finding shows that majority of rural SMMs owners/managers in KZN areas prepare their own financial reports even if they do not have accounting and financial management skills.

Respondents number of many times in a year do they report on their financial positions?



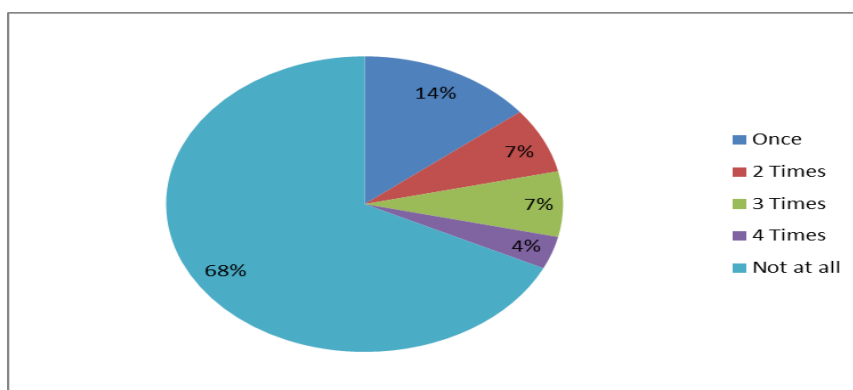


Figure 3. Percentage of respondents of many times in a year do they report on their financial positions?

68 percent of the respondents indicated that they do not report on their financial positions at all.

14 percent of the respondents indicated that they do report on their financial positions once a year. 7 percent of the respondents indicated that they do report on their financial positions 2 times in a year. 7 percent of the respondents indicated that they do report their financial positions 3 times in a year. 4 percent of the respondents indicated that they do report on their financial positions 4 times in a year.

Respondents number regarding finance managers' knowledge of IFRS

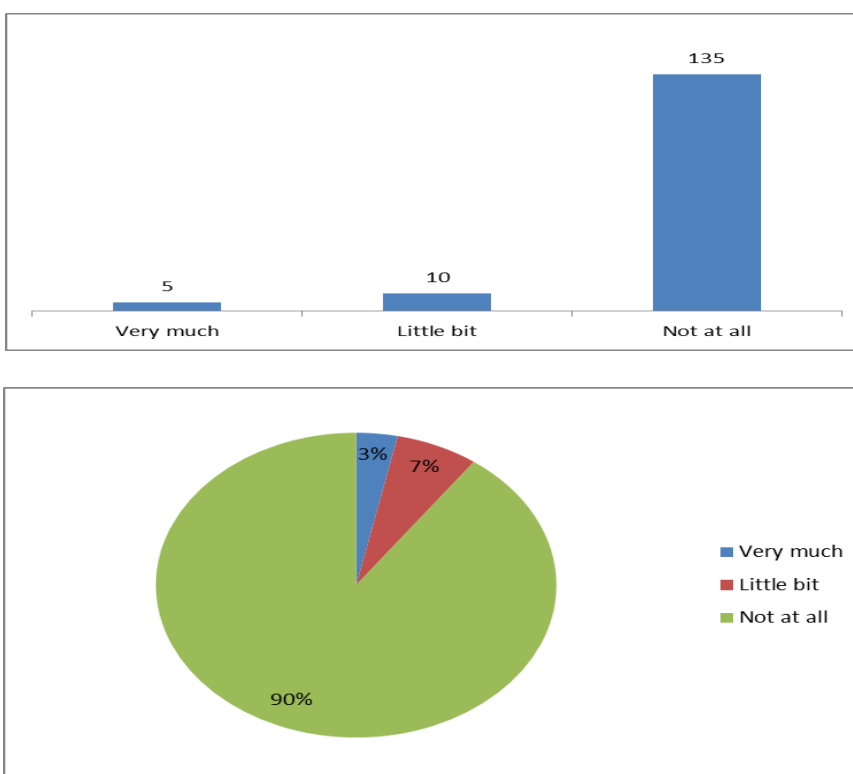


Figure 4. Percentage of respondents regarding finance managers' knowledge of IFRS

90 percent of the respondents indicated that they do not have accounting and financial management at all. 3 percent of the respondents indicated that they do have little bit of accounting and financial management. Only 3 percent of the respondents indicated that they do have very much knowledge of accounting and financial management.

Respondents number on following international standards when reporting their financial positions

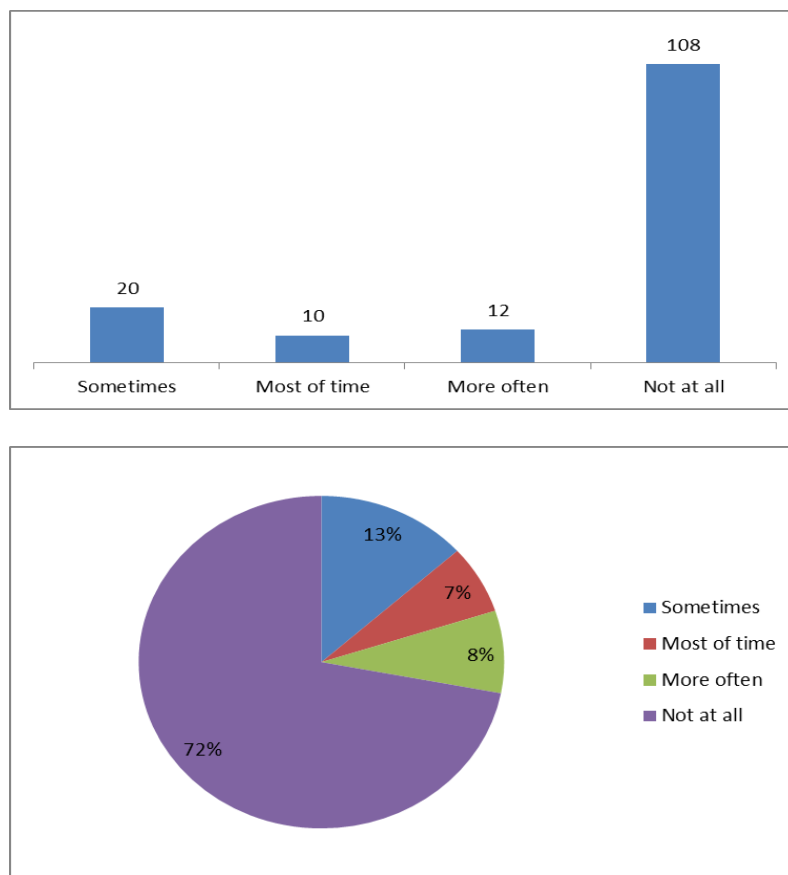
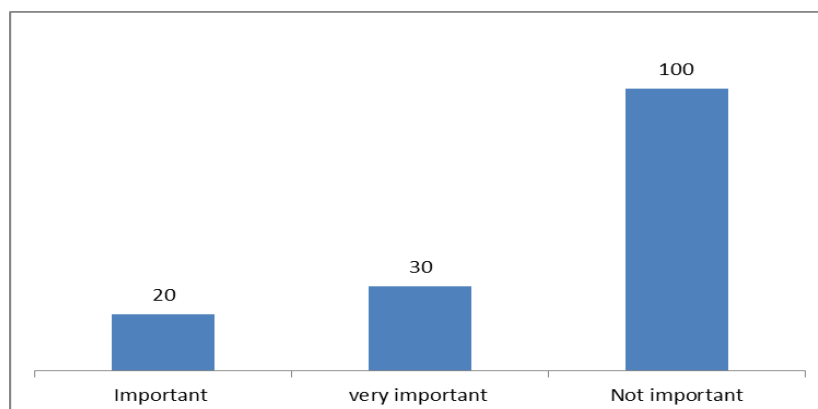


Figure 5. Percentage of respondents on following international standards when reporting their financial positions

72 percent of the respondents indicated that they do not follow international reporting standard at all when reporting their financial positions. 13 percent of the respondents indicated that sometimes they do follow international standards when reporting their financial positions. 7 percent of the respondents indicated that they do follow international reporting standard most of time when reporting their financial positions. 8 percent of the respondents indicated that the do follow international reporting standard when reporting their financial positions.

Respondents number on how they perceive the important of accounting and financial management



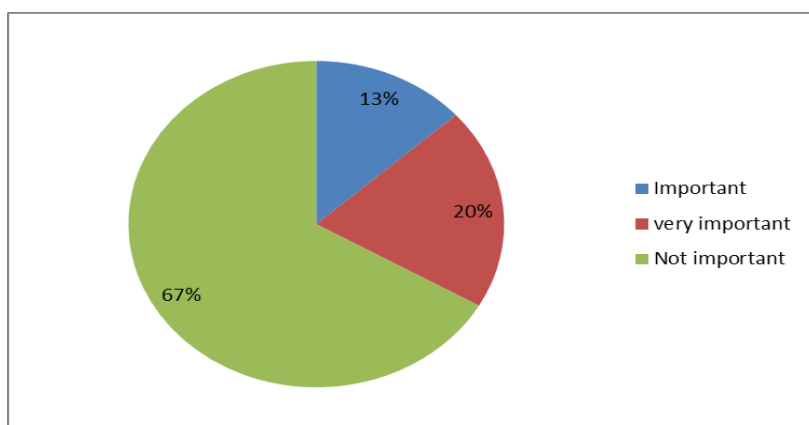


Figure 6. Percentage of the respondents on how they perceive the important of accounting and financial management skills

67 percent of the respondents said that accounting and financial management skills are not important. 13 percent said that accounting and financial management skills are important. 20 percent of the respondents said that accounting and management are very important.

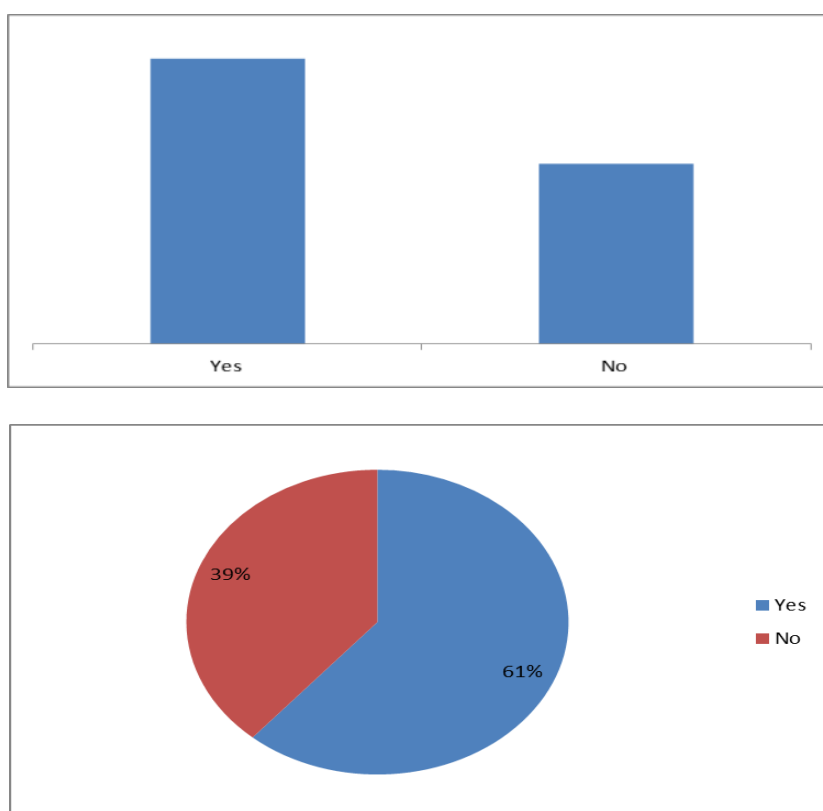


Figure 7. Respondents' number of who believe that accounting and financial management training is essential for their businesses

61 percent of the respondents do not believe that accounting and financial management training is essential for their businesses. Only 39 percent of the respondents believe that accounting and financial management training is essential for their businesses.

## 5. Recommendations

In order to enable SMEs sustainable development and growth in rural KZN, it is recommended that community training in accounting and financial management need to be done. South African government should introduce medium and long-term strategy to support sustainable financial management training over period of in rural KZN. Further recommendations include that the integrated capacity development framework should be developed by policy makers where monitoring and evaluation will be an integral component of framework that will serve to monitor and give support skills to the rural entrepreneurs.

## 6. Conclusions

The understanding of International financial reporting is a major problem among SMEs in rural KZN; it is not properly followed by the business owners/managers, with only a few following international financial reporting system. Lack of understanding and knowledge of accounting and financial management linked to the poor in reporting financial positions by rural entrepreneurs with specific reference to KZN.

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