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Financial Accounting and Reporting: Empirical Evidence on Small and Medium-Sized Enterprises in Malaysia

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Abstract

The research investigates the financial accounting and reporting of small and medium-sized enterprises (SMEs) in Malaysia. The aims are to discover features of SMEs' financial reporting and to assess its costs and benefits to the stakeholders. This study adopts a positivist paradigm. The research design was drawn from a survey of 150 owner-managers of SMEs in the Northern Corridor Economic Region of Malaysia. The data is analysed using both univariate and multivariate analyses. Results reveal that financial information in the SMEs' financial statement is incapable to satisfy the main users' requirements. Results indicate that the main weaknesses of SMEs' financial statements are in terms of financial statements' preparation with outdated information, tax motivation and limited disclosures. This study makes several important contributions to the existing studies of SMEs' reporting, particularly in the literature related to information requirements of financial statement's users and the financial reporting's costs and benefits. The results of this research are of particular concern to SMEs, their accountants and stakeholders in Malaysia and other jurisdictions. Research findings should assist policymakers in formulating an appropriate policy on SMEs' financial reporting.

Keywords: *Financial Reporting, Small and Medium-sized Enterprises (SMEs), Malaysia, Multivariate Analysis, Northern Corridor Economic Region (NCER).*

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 playing a vital role in the global economy (Mat Nawi, 2015). According to the Malaysian Department of Statistics (2017), a major part of business entities in Malaysia (approximately 98.5%) is SMEs; comprising of 76.5% of microenterprises, 21.2% and 2.3% of small and medium-sized firms, respectively. SMEs account for 36.6% of GDP and 65.3% of total employment in the year 2016. It is expected that, by year 2020, the SMEs' contribution to the GDP will increase up to RM120 billion (Bank Negara Malaysia, 2013).

However, SMEs are still facing hard challenges in accessing external loans, low-quality or absence of technology adoption, fierce competition from large firms and the effects from globalisation (UNDP, 2007). According to Mat Nawi (2015), one of the reasons which hinders SMEs from accessing external financial sources is lack of transparency in financial reporting.

In addition, the convergence of Malaysia Financial Reporting Standards (MFRS) with the International Financial Reporting Standards (IFRS) has led to the issue of costs relative to benefits in financial reporting (i.e. the process of preparing and publishing financial statements). Since the characteristics of SMEs are different from large companies, the IFRS conceptual framework for financial reporting is found unsuitable for SMEs (Evans et al., 2005). The problem had been dealt with effectively after the introduction of Malaysian Private Entities Reporting Standards (MPERS) Framework in February 2014 (with effect from 1 January 2016).

Another issue in the SMEs' financial reporting is the requirements of SMEs financial statements' users. The users of SMEs' financial statement are different from the users of large firms (Ploybut, 2012). According to Sian and Robert (2009), a distinct SMEs' financial reporting system has been applied in various nations in order to ease the burden on SMEs.

So far, empirical research on financial reporting by the SMEs is limited, especially in developing economies (Ploybut, 2012). Thus, the current research intends to investigate financial reporting practice by the Malaysian SMEs, with relevant insights into the process of preparation and publication of financial statements, besides ascertaining the costs and benefits of financial reporting, as well as the users and uses of financial information.

Literature Review

Definitions of SMEs

There is no specific definition of the term SMEs according to international standards. However, SME Corporation of Malaysia (2017) defines SMEs according to either total annual sales turnover or a total number of full-time employees. The following table presents the definitions of SMEs.

Table 1: Definitions of SMEs

	Micro	**Small**	**Medium**
Manufacturing			
Sales turnover (in RM)	< 300,000	300,000< 15 million	15 million≤ 50 million
Number of Employees	< 5	5 to < 75	75 to ≤ 200
Services & Other Sectors			
Sales turnover (in RM)	< 300,000	300,000< 3 million	3 million≤ 20 million
Number of Employees	< 5	5 to < 30	30 to ≤ 75

Source: SME Corp Malaysia

Financial Reporting: Regulation and Conceptual Framework

Business entities should be aware of accounting laws, regulations and standards in the process of preparation and publication of financial statements. Standards of accounting have become part and parcel of the financial reporting frameworks for business entities. Some countries make it compulsory for both listed and non-listed entities to follow the accounting standards, while others make it mandatory to public listed companies only. In Malaysia, according to Section 167 of Companies Act (1965), it is legally required for all business entities to keep their accounting and other relevant records for at least 7 years for proper auditing. The entities can prepare their own accounts or hire the external accountants to prepare them. .

Historically, the inception of Financial Accounting Standards Board (FASB) came into reality in the 1970s based on the U.S. framework. According to Alfredson et al. (2010), the framework is important to develop the standards of financial reporting as well as to deal with matters concerning accounting not usually discussed in the accounting standards. Alternatively, the International Accounting Standards Board (IASB), which came into existence on April 1, 2001, regarded a framework as "the concepts that underlie the preparation and presentation of financial statements for external users" (IASB, 2009, p. 4).

The IASB recognised the need for a simpler set of accounting standards for SMEs as a result of the purported intricacy of full IFRS and from legal requirements demanding SMEs' compliance with full IFRS in various governments (Devi, 2003; Epstein and Jermakowicz, 2007). Recently, a different set of accounting standards for SMEs or firms outside capital markets was applied in various nations, irrespective of whether or not complete IFRS was implemented (Pacter, 2011).

The Malaysian Accounting Standards Board (MASB) issued the Malaysian Private Entities Reporting Standards (MPERS) in February 2014. MPERS emulates the IASB's *International Financial Reporting Standard for Small and Medium-sized Entities* (IFRS for SMEs) issued in July 2009. Subsequently, the MASB's *Amendments to MPERS* in October 2015 are equivalent to the IASB's *Amendments to IFRS for SMEs* made in May 2015. Those *Amendments* had slightly changed the Standards of MPERS in order to provide guidance on the requirements and alignments of some standards to those of the MFRSs. With effect from 1st January 2016, every SME should prepare its financial accounting and reporting in accordance with the requirements of MPERS. This regulation is seen as more suitable for the SMEs that opt not to go for *initial public offering* (IPO) in the foreseeable future. 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 uses are crucial to develop or simplify the SMEs' financial standards.

a. Main users of SMEs' financial statements

Empirical evidence from studies on SMEs financial statement's users depicted a wide array of user groups. For instance, Collis and Jarvis (2000) stated that the main users of small company's statutory accounts are banks and other finance providers, followed by tax authorities and directors who are not shareholders. Further, Dang-Duc, Marriott, and Marriott (2006) found that tax authorities and governmental agencies were apparently considered as the primary consumers of small firm's financial statements. Srijunpetch (2009) found that most of the respondents perceived tax authorities as the main consumer 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).

b. Uses of SMEs' financial statements

i. Management

Findings by Collis and Jarvis (2000) stated that the statutory accounts of small firms were apparently considered as the most beneficial in "deciding director's pay and bonuses, comparing performance with previous periods and in connection with loans or finance" (p. 57). Nevertheless, the statutory accounts were apparently considered to be less beneficial for the purposes of management, unlike management information. Additionally, results from a number of studies have revealed that various SMEs resorted to the use of heavy computerisation in the accounting system in order to initiate their own records besides providing management information (see Marriott and Marriott, 2000; Sian and Roberts, 2009). Management information is crucial and could be easily generated for management's uses. It is anticipated that the purported utility of financial information in the annual accounts for uses of management will be dwindling.

ii. Shareholders

Legally speaking, firms are normally obliged to prepare and submit the annual accounts to their shareholders (French, Mayson and Ryan, 2008) before the general meeting. However, the above 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 can be understood that the shareholders or owners could monitor the conduct or actions of a hired manager every day, thus made it less difficult 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 so as to control and monitor their businesses, thus made the stewardship role of financial reporting to owners or shareholders “overlapping” (p. 31).

iii. Tax authorities

Generally, tax authorities used financial statement to examine expenses 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 possess powers to obtain extra information from the firms. Moreover, tax reporting and financial reporting have different objective. The former serves as a basis in determining taxable income; conversely, the latter provides information for users (Ploybut, 2012).

iv. Banks

Loan from bank is one of the most popular external funds for SMEs (Berger and Udell, 1998; Mat Nawi, 2015). Mat Nawi (2015) further suggested that SMEs’ owner-managers favour to obtain debt finance instead of equity funding in order to retain control over their businesses. Normally, loan officers from banks transformed the potential borrower’s financial statement information into a standard type for loan evaluation (Berry, Crum, and Waring, 1993). This is because financial statements were primary sources of information in the bank’s process of internal rating (Zuelch and Burghardt, 2010).

v. Venture capitalists

Venture capitalists become one of the prospective users of small firm’s financial statements because they provide a source of finance to SMEs (Sian and Roberts, 2009). They are equity investors who have shares in the firm’s capital gain, with major priorities over the firm’s likely progress and possible profit, and they have a deep interest in financial matters, market and management skills (Mason and Stark, 2004). Venture capitalists’ investment decision involves a process of various stages, comprising of early screening, project assessment and post-investment activities. In the assessment of an investment proposal, venture capitalists gave priority on financial information, particularly in projections (Manigart et al., 2000). Nevertheless, information collections on non-public companies, their management and future prospects were even harder because those companies were subject to a number of legal information requirements (De Prijcker et al., 2017).

vi. Business partners and other users

Previous research indicated that only few SMEs furnished their accounts to clients and suppliers/creditors. 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

The requirements of financial reporting for all businesses involve the costs of preparing and disseminating statutory reports (like audit fees and staff remunerations), as well as indirect costs (like competitive disadvantages and breach of privacy due to publication and disclosure of the company's accounts) as stated by Arrunada (2011). It is invariably contended that the need to prepare and disseminate the account causes heavy and unbalanced budgets on smaller firms. The regulatory compliance costs are mostly fixed, but small firms suffer from time shortage and lack of expertise to implement those legal requirements (Kitching, 2006; Kitching, 2015). Small firms are incapable to extend the costs across large scale of operation, thus they are usually burdened by proportionally greater costs as compared to larger entities. Nevertheless, Arrunada (2011) argued that proprietary costs for small firms were expected to be low. With regard to privacy costs, it was hard to measure. Corporations which obtain benefit from limited liability should reveal some financial information for potential creditors' advantage.

The expected cost reduction may be minimal or not existent due to the fact that micro firms are still required to prepare financial reports for other purposes such as tax filing, bank finance and prospective business contacts. Conversely, the exemption would relatively cause insecure business atmosphere because the financial reporting regulations necessary to provide enough information to those who perform transactions with the firms have been discontinued. Additionally, in the absence of filing requirement, direct communication of financial information between the contractual parties might lead to heavy costs, as compared to making it accessible to the public (Ploybut, 2012). Besides, a firm's financial discipline will be diminished without financial reporting regulation, 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. A survey questionnaire was conducted among SMEs in the Northern Corridor Economic Region of Malaysia. The survey methodology was used because it is the most efficient means of data collection as the subject of interest is perception (Robson, 2011). Taking into account the shortcomings of the mail questionnaire in the SMEs' research (Ploybut, 2012), this study used telephone and face-to-face structured interview methods in collecting data. The questionnaire was developed by adopting and adapting the questions from previous research, such as Collis (2003) and Ploybut (2012) with consideration on their suitability with the context, population and objectives of the study.

This study used a convenience random sampling as it is convenient, quick and less expensive. The study had received 150 usable responses, giving a response rate of 69 percent. In terms of analysis, a pilot test had been undertaken prior to the main survey to ensure no issues of reliability and to clarify the questionnaire. No data had been excluded from the data screening with regard to the data from the main survey. The study then proceeds with a descriptive analysis and bivariate analysis. The Cross-tabulation was used for the descriptive analysis; specifically to compare responses. Alternatively, the bivariate analysis was used for a cross-analysis of the responses and to compare between sizes of entities. This study performed non-parametric tests 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 results of 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, and the users and uses of financial information.

Demographic information of the sample entities

Table 1 gives descriptive statistics for the sample entities. Approximately 52 percent of the sample entities were small-sized enterprises. Almost two-third of them was in manufacturing sector. In terms of number of years in business, the table shows that 62 percent of them have been in business for more than 10 years.

Table 1: Demographic information of the sample entities

	Percent (%)		***Percent (%)***
Type of main business		***Annual turnover (in RM)***	
Manufacturing	68.32	<300,000	23.0
Service	31.68	300,000- 1 million	9.7
Years in business		1-10 million	11.5
Less than 1 year	0.4	10-15 million	30.6
1-3 years	9.3	15-20 million	15.6
4-6 years	14.3	More than 20 million	9.6
7-10 years	14.0	***Number of employees***	
More than 10 years	62.0	<5	23.0
		5 to <30	51.8
		30 to <75	17.3
		75 and above	7.9

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. Results indicate that an agency relationship between owners and managers is unlikely. Moreover, the stewardship role of financial reporting is redundant since managers are 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, no major difference was detected among different size of entities as the P value is more than 0.05. The finding is consistent with the study of Eierle and Haller (2009) and inconsistent with the study of Thailand's SMEs by Ploybut (2012).

Moreover, results of a series of statistical test analysis show a major difference in the views of non-participating owners on the costs and benefits of account's preparation in terms of over-dependence on accountants and competitive advantages; (Mann-Whitney U= 3732.60, Z= -1.928, p= .039) and (Mann-Whitney U= 3161.50, Z= -2.212, p =. 014), respectively.

Preparation and publication of financial statements

i. Accounting system

In terms of the system used to keep the records of business transactions, results showed that more than half (53%) of the sample entities used computerised accounting system, 24% and 23% of them manually recorded it and used both methods, respectively. The results support previous findings of Collis and Jarvis (2002) and Ploybut (2012). The Chi-square test result indicated no significant difference between the sizes of entity (defined by turnover) and types of accounting system due to better application of computerisation among all size groups.

ii. Services provided by external accountants

The respondents were required to indicate the services (e.g. preparation of statutory accounts, audit service, taxation service, bookkeeping, business and financial advice) provided by external accountants. Majority (67%) of them hired external accountants to prepare their annual financial statements. The finding is in line with the previous studies of Collis (2008) and Ploybut (2012). The main reasons were due to the regulatory requirements and firm's cost-effectiveness strategy; followed by the complexity in taxation and accounting rules.

In addition, the hiring of external accountants for regulatory compliance duties were identified in all entity sizes. Majority of smaller entities hired outside accountants to prepare annual accounts, bookkeeping, and tax services. Alternatively, medium-sized enterprises prefer to hire in-house accounting staff instead of external accountants. However, the results of Chi-square proved no significant difference between all entity sizes (defined by annual turnover) for all categories of services.

Interestingly, the study found a statistically significant difference between age of business and services provided by external accountants, specifically the bookkeeping service (Mann-Whitney U= 3132.50, Z= -2.009, p=.039). Unlike older businesses, younger businesses relied more on external providers of accounting services.

iii. Perceptions towards changes in financial reporting standards and regulations

The study found that majority of the micro entities was not aware of the accounting regulations. In contrast, small and medium entities reported that they knew about the accounting regulations. However, the proportion of awareness was still less than 50%.

iv. Purpose of producing annual financial statements

Most of the respondents reported that they prepared the financial statements themselves. All entities (i.e. micro, small and medium) were found to prepare the financial statements for the purpose of complying with regulatory requirements, especially after the application of Goods and Services Tax (GST) starting from April 2015. None of the respondents prepared the financial statements for the purpose of reporting to external parties. Less than two-third of them prepare it to provide information to the management or report to the owners. The main reason was because the owners and the managers are the same individuals. Similar finding was found by Marriott and Marriott (2000).

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

This study classified costs and benefits into three major categories; namely, the cost of producing financial reports exceed the benefits, heavy reliance on accountants to ascertain the form and content of financial reports, and concern over the issue of competitive disadvantages which might be caused by some disclosure items in the financial reports. Results revealed that micro and small entities agreed that costs of producing financial report exceed its benefits. Medium-sized entities tend to be more concerned on competitive advantages. However, the results of Kruskal-Wallis proved that there is no significant difference between the sizes of entity for all categories.

Use and Users of Financial Information

i. Users of financial statements

A relatively high proportion (three-quarter) of respondents indicated that the main users were tax authorities (i.e. Inland Revenue Board), the management (i.e. owner/manager) and financial providers (i.e.

financial institutions). The remaining users were business contacts, investors, regulatory agency, partners and the least users were employees. The same patterns were found in the previous research (see Sian and Roberts, 2009; Maingot and Zeghal, 2006).

In addition, results revealed that the Chi-square test showed the financial providers' perception as primary users differed by the sizes of entity (Chi-Square = 11.042, df =2, p= .004). Instead, no statistically significant differences were found for the remaining users. A Kruskal-Wallis analysis (H= 12.015, df = 2, p= .002) indicated that medium entities are more likely to report financial providers as significant users based on statistics. On the other hand, this study also tested the association between business ages and perceptions of financial providers and regulatory agencies. Results of Mann-Whitney analysis showed a significant difference existed between the variables as important users. Older entities were more likely and less likely to have financial providers and regulatory agencies, respectively, as main users.

ii. Use of financial information by management

a. Use of annual financial statements

Approximately 57% of the respondents stated that they are totally not reliant on the financial statements in contract bidding or in obtaining license or credit from creditors. 39% and 19% of them stated that they used the financial statements for loan applications and borrowing agreement purposes, respectively. A very low proportion (5.3%) of them used financial statements for comparing their firm's performance with competitors. Further, results of a Kruskal-Wallis test revealed a significant difference between SMEs' uses of financial statements for loan application (Kruskal-Wallis H= 29.998, df = 2, p= .000) and borrowing agreement (Kruskal-Wallis H=7.982, df = 2, p=.000). A significant positive association was also found between business age and the use of financial statements for applying capital from banks or investors (Kruskal-Wallis H=6.811, df = 2, p= .033).

b. Use of management information

Almost 85% of the respondents were reported to produce and use management information regularly. A significant number of them employed budgeting, ratio and variance analysis techniques. Management information is more convenient for business management instead of annual financial reports. Results also indicated that most of the SMEs were not reliant on the financial statements' information; instead they prefer to use the management information for internal uses.

iii. Source of information in deciding business contacts/partners

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

Conclusions and Recommendations

This study provides evidence on the SMEs financial statements' users and uses and the costs and benefits of SMEs' financial reporting. Evidence shows that the primary users of the Malaysian SMEs' financial statements are owner-managers, tax authorities and lenders. Evidence also indicates that micro entities are less likely to prepare financial statements to external users. Besides, this research identified heavy reliance on computerisation in the accounting systems to produce financial information for management uses and statutory reporting. In this research, it seems that the majority of SMEs, especially micro and small entities, obtain assistance from outside accountants to perform reporting duty. This suggests that SMEs do not have adequate internal accounting expertise.

The findings of the research have effects not only for the SMEs, their accountants and stakeholders, but also on the national standards boards and regulators. The research offers information on the SMEs' financial reporting requirements, the financial reports' users and the SMEs' latest financial reporting practice. Results portray that the SMEs' financial statements' information is inadequate to fulfill the users' information needs.

In reality, SMEs' owner-managers viewed that the financial reporting is conducted merely to fulfill their reporting obligations. Thus, more attention should be put on the preparation of good quality financial statements. The priority should be focused on the SMEs' owner-managers who should be educated on the benefits of first-rate financial statements' preparation and publication for their businesses. Generally, this study makes several important contributions to the existing studies on SMEs' financial reporting, particularly in the extended literature concerning the costs and benefits of reporting and the information requirements of SMEs financial statements' users.

Despite its contributions, this study has identified several limitations; particularly in terms of representativeness of the samples. Future research may be conducted in the same research area with a higher total number of samples. Besides, as the current sample is solely concentrated on one region, it may not be sufficient to generalise the findings to the whole population of SMEs in Malaysia.

Moreover, more qualitative studies should be carried out on the Malaysian SMEs' financial reporting so as to gain in-depth information concerning the issue. Further, future research should concentrate on issues of accounting standards compliance by the SMEs and the implementation of a conceptual framework for SMEs' reporting, initially intended for large and listed firms. Future study should also focus on the issue of simpler accounting standards for SMEs, specifically the Malaysian Private Entities Reporting Standards (MPERS).

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