NON-COMPLIANCE WITH STANDARD ACCOUNTING PRACTICES BY SMALL AND MEDIUM SCALE ENTERPRISES IN SRI LANKA

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ABSTRACT

This study is done in relation to the factors leading to non-compliance with Standard accounting practices by the small and medium scale enterprises (SMEs), specifically in relation to a developing country like Sri Lanka. The main objectives of the study focused on identifying the nature of the accounting practices and the factors leading to non-compliance with standard accounting practices by the SMEs. Efforts are made to examine the possible causes for non-compliance with the Standard accounting practices by the SMEs in Sri Lanka and the researcher expects that this study would fill the knowledge gap. The researcher used structured interviews to collect data and has selected 30 SMEs in the manufacturing sector and 10 auditors for the study. Two interview guides are prepared by the researcher for the SME owners, and for the Auditors. In the conceptual model the non-compliance is considered as the dependent variable and the independent variables are the cost of adherence to accounting standards, knowledge and competence of the owners, lack of qualified employees, relevance of standard guidelines and parties interested in the financial reports. The key finding is that, higher cost of adherence to accounting standards, lack of knowledge and competence of the owners, lack of qualified employees, and unavailability of parties interested in the financial reports other than owner is leading to non-compliance and the relevance of standard guidelines does not have a relationship with non-compliance. The non-compliance with Standard accounting practices is not only due to SMEs 'can't comply' with them, but also due to they 'won't comply' with them even when the are able to comply. The researcher finally makes recommendations to the policy makers, government and professional accounting bodies to design the policies and frameworks to ensure SMEs' compliance with standard accounting practices.

Key Words: SME Accounting, Standard Accounting Practices, SME, Auditors, SLASSE

1. INTRODUCTION

Small and Medium Enterprises (SMEs) play an important role in both developed countries and developing countries. It contributes to the growth of the economy through employment generation, new venture development and by opening up new avenues for the growth in the economy. However, the failure rate of SMEs is also high. The Central Bank of Sri Lanka (1998) had stated that inadequate capital, inadequate institutional credit facilities, use of outdated technology, improper accounting techniques, inadequate sales promotion competencies and inattentiveness of small businesses are the main problems faced by the small businesses in Sri Lanka. Huck and McEwen (1991) argue that 12 competency areas such as starting a business, planning and budgeting, management, marketing/selling, advertising and sales promotion, merchandising, finance and accounting, personal relations, purchasing, production, facilities and equipments and controlling risk is needed for small business success. Similarly several studies highlight poor accounting practices as a factor contributing to the failure of SMEs, in addition to other factors identified in various studies. According to the preliminary study done by the researcher it was evident that most of the failing SMEs are not getting actively involved in maintaining standard level of accounting records.

2. RESEARCH ISSUE OF THE STUDY

The numerous advantages that the SMEs can gain by adhering to Standard accounting practices are missed due to non-compliance. Specifically, the growth have slow down, proper investment and re-investment decisions are not made, the ability of obtaining external funds to the SMEs are limited and many other problems are visible in this sector. There are studies that are focused on the factors that lead to failures of SMEs and most of them have identified “lack of accounting records” as a factor leading to failure in SMEs. But the prior literature addressing issues surrounding the preparation of financial information by smaller entities is somewhat limited and has a country-specific focus (IFAC, 2006). Due to the fact that there are no studies done on this topic area, the researcher expected that this study would fill the knowledge gap.

In Sri Lanka there is one Accounting Standard introduced for the small scale enterprises in Sri Lanka, by the Institute of Chartered Accountants of Sri Lanka (ICASL) called, Sri Lanka Accounting Standard for Small Enterprises (SLASSE). But it is not being adopted by many of the small entities in keeping accounting records. Meanwhile, the auditors look for the compliance with the Sri Lanka Accounting Standards (SLASs) even for the SMEs instead of the SLASSE, mostly due to convenience and the ease to proceed with the audit with SLASs. Presently there are 44 SLASs introduced by the ICASL that are applicable to all general purpose financial statements prepared and presented in accordance with Sri Lanka Accounting Standards. According to the SLAS 3, a complete set of financial statements comprises of a balance sheet; an income statement; a statement of changes in equity showing either all changes in equity, or changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders; a cash flow statement; and notes, comprising a summary of significant accounting policies and other explanatory notes. These should be prepared in accordance with the applicable SLASs to the companies, either public quoted or private.

The Sri Lanka Accounting Standard for Smaller Enterprises (SLASSE) – prescribes the basis, for those entities within its scope that have chosen to adopt it, for preparing and presenting their financial statements. The definitions and accounting treatments are consistent with the requirements of Companies legislation and, for the generality of smaller enterprises, are the same as those required by other accounting standards or a simplified version of those requirements. Reporting entities that apply the SLASSE are exempt from complying with other Sri Lanka Accounting Standards unless when preparing consolidated financial statements and accounting for defined benefit plans (excluding gratuity), in which case certain other accounting standards apply. Financial statements will generally be prepared using accepted practice and, accordingly, for transactions or events not dealt with in the SLASSE, – smaller enterprises should have regard to other Sri Lanka Accounting Standards, not as mandatory documents, but as a means of establishing current practice (ICASL, SLASSE: 2).

The researcher conducted a preliminary study to understand the level of compliance with these Standard accounting practices (i.e. maintaining the financial statements complying with SLASs or SLASSE) and the reasons behind non-compliance by the SMEs in Sri Lanka. The preliminary survey revealed that there is not much usage of Standard accounting practices in most of the SMEs. Due to the fact that it is not mandatory for the SMEs to comply with SLASs or SLASSE, it was difficult to identify the compliance or non-compliance with the standards. Thereby for the purpose of this study the researcher discussed with a sample of auditors and identified that, for a SME to be in line with Standard accounting practices they should at least maintain the minimum records either on SLASs or SLASSE such as: the Trial Balance, General Ledger, Cash Book, Balance Sheet, Profit and Loss Account, Receipt and Payment Book, and having a basic Accounting System.

Through this research the researcher examined whether there is a relationship between the factors identified as causal factors (identified through the preliminary survey done by the researcher and through perusing literature) and non-compliance with Standard accounting practices by the SMEs in Sri Lanka. The research problem of the study was "Why are Small and Medium Scale Enterprises in Sri Lanka Not Complying with the Standard Accounting Practices?"

3. OBJECTIVES OF THE STUDY

The objectives of the study were to describe the accounting practices adopted by the SMEs in Sri Lanka while establishing the factors leading to non-compliance with standard accounting practices by the SMEs. In addition, the study makes recommendations as to how policy makers and professional accounting bodies can design policy frameworks to ensure SMEs' compliance with standard accounting practices.

4. LITERATURE REVIEW

Identification of a specific uniformly acceptable, definition of a SME firm is not possible (Storey, 1994). Firms differ in their levels of capitalization, sales and employment. Hence, definitions that employ measures of size (number of employees, turnover, profitability, net worth, etc.) when applied to one sector could lead to all firms being classified as small, while the same size definition when applied to a different sector could lead to a different result.

The first attempt to overcome this definition problem was by the Bolton Committee in 1971, when they formulated an "economic" and a "statistical" definition (Storey, 1994). According to Meulenberg (2004) SME is defined s as "a firm that is run and controlled under the direct supervision of the owner." SMEs have also been defined based on the number of employees, such as: Tiny establishments – firms with 5-9 workers; Small establishments – firms with 10-49 workers; and Medium establishments – firms with 50-99 workers. In addition SMEs have been defined as firms having less than 100 employees by Nooteboom, 1994 and Fong, 1971 (Bhutta and Asad 2007:412-413).

The main regulatory body for accounting in Sri Lanka is the Institute of Chartered Accountants of Sri Lanka (ICASL). There are several accounting standards that are being introduced to the entities operating in Sri Lanka by the ICASL. In addition to them in year 2003, the Sri Lanka Accounting Standard for Smaller Enterprises (SLASSE) was introduced and it prescribes the basis for those entities within its scope that have chosen to adopt it, for preparing and presenting their financial statements. The definitions and accounting treatments are consistent with the requirements of companies' legislation and, for the generality of smaller enterprises, are the same as those required by other accounting standards or a simplified version of those requirements. The disclosure requirements exclude a number of those stipulated in other accounting standards (ICASL, SLASSE).

The SLASSE defines the small scale enterprises as follows:

Smaller Enterprises (SE) are companies, not listed in a stock exchange licensed under the Securities and Exchange Commission Act No. 36 of 1987 which fall below all the upper thresholds and stand above any one of the lower thresholds described below:

Upper Thresholds:

Which have an annual turnover below Rs. 750 Mn.; at the end of the previous financial year, had shareholders' equity below Rs. 150 Mn.; at the end of the previous financial year, had gross assets below Rs. 450 Mn.; at the end of the previous financial year, had liabilities to Banks and other financial institutions below Rs. 150 Mn. and have a staff below 1000 persons.

Lower Thresholds:

Which have an annual turnover in excess of Rs. 50 Mn. or at the end of the previous financial year, had shareholders' equity in excess of Rs. 10 Mn. or at the end of the previous financial year, had gross assets in excess of Rs. 30 Mn. or at the end of the previous financial year, had liabilities to Banks and other financial institutions in excess of Rs. 10 Mn. or have a staff in excess of 100 persons (ICASL, SLASSE).

These companies should apply other Sri Lanka Accounting Standards when preparing financial statements. The financial statements of enterprises falling below all the lower thresholds may be prepared in accordance with the accounting concepts as described in the Framework for the Preparation and Presentation of Financial Statements, issued by the Institute of Chartered Accountants of Sri Lanka (ICASL, SLASSE).

Almost all these definitions adopted their main criteria as number of employees, capital employed/total assets and turnover. However, over time these SMEs definition criteria should be changed to fit with changing economic, technology and productivity scenarios (Dasanayaka, 2009).

4.1. Cost Involved in Complying with Standard Accounting Practices

The Business Development Services (BDS) are provided to the SMEs by several private sector organizations as well as government sector organizations. It had been identified that in Sri Lanka, only 40.8% of the SMEs are willing to pay the BDS providers for accounting related services (Fernando, Symposium on Making SME Finance Profitable, Session 8).

It is also found that the IFRSs are difficult to apply to SMEs in developed countries and developing countries especially in countries with economies in transition. Many SMEs in these countries are not profitable enough to be able to afford for professional help that is available due to the cost that they should incur (UNCTAD 2002).

The main argument for separate SME accounting standards are the undue cost burden of reporting, which is proportionately heavier for smaller firms. (http://www.accaglobal.com/members/publications/accounting_business/CPD/ifrs+sme). The adverse impact of regulation is particularly harmful to SMEs because the cost of administration entailed in compliance has a disproportionate effect on SMEs. The flexibility of SMEs may be affected by regulation.

4.2. Knowledge Level and Competence of the Owners of SMEs

The IFRSs are difficult to apply to SMEs in developed countries and even more difficult to do so in significantly different economic environments where the professional infrastructure is limited and the general level of business education does not extend to accounting. This is the case in many developing countries and countries with economies in transition (UNCTAD 2002).

Sian and Roberts, Collis and Jarvis, and Deakins et al., as cited in the IFAC (2006), within the smallest entities financial information tends to be prepared either internally by owner-managers themselves or bookkeepers or externally by a hired accountant. Research focusing on internal preparation seems to suggest that financial awareness amongst owner-managers of the smallest entities is quite low and that there is inadequate record keeping. Other studies have found important differences in the financial awareness and skills in small businesses. John and Healeas as cited in the IFAC (2006), states that the level of understanding is not high among the owners, in relation to the financial reports. Indeed, there are indications that generally few owner-managers are able to understand the contents of statutory accounts and that they tend to rely upon their accountant to explain the details to them.

4.3. Relevance of Standard Guidelines in Accounting for SMEs

Guidance is important for both, preparers and users of SMEs financial statements. At the mean time a simple illustration of the accounting treatment would be vital. Likewise, a clear understanding of the notion of materiality seems essential as it could reduce significantly the burden of SMEs which enters into specific operation that may not be material with respects to their other operations (ECCBSO, 2005). International Accounting Standard Board (IASB) is concerned with the objectives that a set of prospective accounting standards for SME's should have. Under IASB opinion, those objectives are five: high quality and understandable, based on users needs, built on same framework as full standards, reduce financial reporting burden and allow easy transition to full IFRS's (Anacoreta and Silva, 2005).

In Sri Lanka, according to the ICASL, the SLASSE should be applied to all financial statements intended to give a true and fair view of the financial position and profit or loss (or income and expenditure) of all entities that are covered under the definition of smaller enterprises.

4.4. IMPORTANCE OF FINANCIAL INFORMATION OF SMES

There are several obstacles for SMEs, mostly in accessing fund from financial institutions or capital market. These hinders are resulted from inefficient business administration and lack of experiences in some important business functions, especially accounting. Most SMEs usually disregard the accounting system; although this system is crucial for every company in providing financial information to make economic decisions in the entities. The accounting and financial reports, for both internal and external use, could help SMEs to plan and control their operations in order to achieve companies' goals (http://www.library.ait.ac.th/ThesisSearch/summary/Earl%20Kongsuwan.pdf). The availability of detailed concepts that are comparable among companies is a fundamental prerequisite for credit lenders to build a thorough and robust analysis of the creditworthiness of a company (ECCBSO, 2005).

The literature indicates that owners of small entities have mixed views on the cost/benefit balance of regulation and producing such information. Most respondents were also in favor of a simplified set of GAAP for unlisted corporate entities. (AICPA, 2005).

4.5. PARTIES INTERESTED IN THE SMES FINANCIAL STATEMENTS

According to IASB, if an entity is having public accountability, then they are required to prepare its financial statements using IASB Standards for SMEs rather than on the basis of full IFRS. **Public accountability** is the overriding characteristic that distinguishes SMEs from other entities according to IASB. All entities that do not have public accountability are potential adopters of IASB Standards for SMEs. If a subsidiary, joint venture or associate of an entity with public accountability prepares financial information in accordance with full IFRSs to meet the requirements of the parent, venturer or investor, it should comply with full IFRSs in its separate financial statements (Anacoreta and Silva, 2005).

4.6. IMPORTANCE OF SME TO THE ECONOMY

The developmental role of the small and medium scale enterprises (SMEs) sector in developing countries has been highly recognized. They serve as engines through which the growth objectives of developing countries can be achieved. SMEs are necessary engines for achieving national development goals such as economic growth, poverty alleviation, democratization and economic participation, employment creation, strengthening the industrial base and local production structure (Centre on Regulation and Competition, Working Paper Series, Paper No. 10, 2001).

4.7. CONSEQUENCES OF NOT HAVING PROPER PRACTICES

A company that adheres to standard accounting practices derives numerous benefits. They are in a position to analyze the entity's performance accurately and can plan and anticipate the future trends precisely. The actual profitability of the entity can be obtained only when it keeps proper records of its transactions. The comparisons among the competitive entities can be easily made when the entities of the same nature record their transactions in a uniform manner. The accounting standards used by SMEs are minimal or outdated or not aimed at providing information to those who provide capital to SMEs. In those countries, SMEs' access to capital may be impeded, or the cost of capital is raised to reflect the 'information risk' (ACCA and ECSAFA, 2007).

5. RESEARCH DESIGN AND RESEARCH METHODOLOGY

The conceptual framework of the study consisted of five independent variables and one dependent variable, and five hypotheses were derived. The independent variables were: Cost of compliance with standard accounting practices, Knowledge and competence of the owners regarding Standard accounting practices, Availability of qualified (in the field of accounting) employees, Relevance of published standards and guidelines specifically to SMEs and Parties interested in the financial reports in addition to the owners of the SME. The dependent variable was Non-compliance with the Standard accounting practices by the SMEs.

For the purpose of this research, the researcher defined the small and medium scale enterprises as: Small Scale enterprise - Asset Value (excluding land and buildings value) considered between Rs. 1 Mn to Rs. 19 Mn and/or number of employees between 5 and 29. Medium Scale enterprise - Asset Value (excluding land and buildings value) considered between Rs. 20 Mn to Rs. 50 Mn and/ or number of employees between 30 and 149. This definition is attained by the researcher after analyzing the definition given by the Task Force for SMEs Development in Sri Lanka, 2002, which is the white paper done in relation to developing a national strategy for SMEs in Sri Lanka. It was done with the involvement of several governmental bodies and with the consultancy of the Asian Development Bank (ADB). The number of employees is taken into account, in addition to the asset value due to the fact that most of the SMEs are labour intensive and the number of employees is a commonly used characteristic to define SMEs locally and internationally.

As the focus of this study is to examine the causal factors for non-compliance with the Standard accounting practices by the SMEs in Sri Lanka, the researcher selected 30 SMEs in the manufacturing sector where the financial statements of those entities are getting audited, and 10 auditors from three audit firms in the big five audit firms in the world, namely KPMG Ford Rhodes Thornton & Co., Price Waterhouse Coopers, and Ernst & Young. Two Questionnaires are prepared by the researcher for the SME owners, and for the Auditors. The two Questionnaires were weighted with appropriate numbers to transfer the qualitative analysis to quantitative analysis. The statistical technique of correlation analysis (using SPSS 16.0) is used to arrive at the conclusion. The reliability of the data was tested with Cronbach's Alpha measure using the SPSS 16.0 software. The test was performed for all the variables, which can be identified as five independent and one dependent variable. The test result for all six variables can be identified as 0. 0.676 which reflects 67.6% reliability of the data obtained.

The concept of cost is examined through the two variables Cost spent on training and record keeping and the willingness to do so. These were addressed in the questionnaire 1 and to further validate, it was questioned in the questionnaire 2 as well. The concept of knowledge and competence of the owners is addressed in both the questionnaires through the variables such as, Education level of the owners and the Accounting related knowledge of owner. Here, the questions addressed matters such as the level of knowledge and the prior work experience of the owner in relation to accounting and book-keeping, involvement of the owner in record keeping, and the details of the owner's awareness about the SLASs /SLASSE. The concept of the qualification levels of the employees in relation to accounting was addressed through the variables such as, the number of qualified accountants in the business, financial ability of organization to have an accountant and willingness to recruit a qualified accountant in both questionnaires. The concept of relevance of Standards was addressed by the researcher through questions related to types of Standards/guidelines available for SMEs according to the owners' knowledge, in both the questionnaires. The concept of parties interested in the financial information of the SME was addressed in both the questionnaires through the variables parties interested in the financial statements and statutory obligations for financial statements. There were questions in Questionnaire I, to test the compliance with Standard accounting practices. According to the weights given for the items identified based on the experts view, the companies that scores 50 points or more, are considered as companies that are complying with the Standard accounting practices in Sri Lanka. Companies that score 49 points or less are considered as companies that are not complying with the Standard accounting practices in Sri Lanka.

6. KEY FINDINGS/ DISCUSSION AND CONCLUSION(S)

Five hypotheses were derived from the literature survey and the pilot survey, followed by the conceptual model. Pearson correlation analysis was performed using SPSS 16.0 software to test the relationship between the variables. The following table summarizes the results of the five correlation analyses for each independent variable with the dependent variable of 'non compliance with standard accounting practices'.

Table 1: Correlation analysis

Hypothesis	Independent Variable	Dependent Variable	Correlation (r)	Significance	Confirmed / Not Confirmed
H1	Cost of compliance with Standard Accounting Practices	Non compliance with Standard accounting practices	.564	.001	Confirmed
H2	Knowledge and competence of owners		.458	.011	Confirmed
H3	Lack of qualified employees		.594	.001	Confirmed
H4	Relevance of standards and guidelines		-.134	.481	Not Confirmed
H5	Parties interested in the financial reports		.597	.001	Confirmed

Source: Survey Data

The H1, H2, H3 and H5 were further substantiated by the interviews held with the auditors, while H4 is not confirmed nor it was subsatantiated through the further discussions with the auditors.

When the non-compliance with Standard accounting practices is considered, it can be viewed that even the SMEs that were categorized as complying with Standard accounting practices, are not complying at the same level and same manner. They perform accounting related activities in different scales. And most of the SMEs in the complying category are not maintaining their records 100% in accordance with the Sri Lanka Accounting Standards/SLASSE.

Most of the SMEs do have a separate accounting function, but the person involved in that function is not a fully qualified accountant in any of the cases. The companies that are considered as complying with the Standard accounting practices are also not interested in recruiting a fully qualified accountant due to factors such as the unaffordable cost they have to incur, the less complex transactions they have in the entities that can be managed easily, the unwillingness of qualified accountants to join a SME and the lack of felt need by the owners to recruit a qualified accountant. In addition, the owners are not willing to maintain accounting records in accordance with the Standard accounting practices fully, unless it becomes mandatory. When there are pressures from external and internal parties of the entity, they will practice Standard accounting practices. The lack of knowledge and competence of the owner also contributes to non-compliance with Standard accounting practices. According to the study it revealed that the availability of standards and guidelines will not necessarily lead to compliance with Standard accounting practices by the SMEs.

After further analyzing the variables in conceptual model with the data gathered by the researcher, the five independent variables in the conceptual framework can be categorized into two types of factors leading to non-compliance with Standard accounting practices by SMEs as, non-compliance due to “Can’t Do” and non-compliance due to “Won’t Do”. The cost of compliance with Standard Accounting Practices, knowledge and competence of owners and lack of qualified employees can be categorized as the ‘Can’t Do’ factors and relevance of standards and guidelines and parties interested in the financial reports can be categorized as the ‘Won’t Do’ factors. Finally, when the behavior of the five independent variables are considered, it can be further concluded that, the non-compliance with Standard accounting practices is not only due to the fact that the SMEs can’t comply with them, but also due to the fact that they won’t comply with them even when the are able to comply/can do.

In order to make the SMEs comply with the standard accounting practices: a set of simplified standards specific to the SMEs can be introduced, so that the SMEs need not deal with complex SLASs; the SME owners can be educated in relation to the advantages that they can obtain by complying with the Standard accounting practices; conduct workshops in order to make the SME owners aware on the benefits of complying with the Standard accounting practices; the ICASL and other accounting regulatory bodies in Sri Lanka can conduct training programs and introduce new courses related to the SMEs, in order to maintain financial reports according to the SLASs/SLASSE inorder to reduce the cost the SMEs should incur in relation to training and record keeping will be reduced and they will have qualified employees in the SMEs; additional regulations may be imposed on the SMEs and can make it mandatory to comply with the standard accounting practices; the accounting regulatory bodies can conduct competitions for SME financial reports thereby they will be interested in preparing accounting reports complying with the Standard accounting practices; and can ensure through rules and regulations that they do not face additional burdens when they comply with the Standard accounting practices. The results of this study are based only on SMEs in a single sector, i.e. the manufacturing sector. The future research can focus on the other sectors in Sri Lanka. In addition they can also focus on differences in accounting practices among the SMEs in different sectors.

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