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Impact of Poor Accounting Practices on the Growth and Sustainability of SMEs

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Abstract:

SMEs act as backbone of the business and commerce creating many entrepreneurs, involving different stakeholder, creating job opportunities for skilled and half skilled workforce, playing role like lubricant for the local economy. Due to the lack of public accountability, regulations, audit requirement and some other reasons many SMEs do not have systematic accounting practices which incorporate a huge negative impact on the growth and sustainability of SMEs. Due to the lack of quality accounting information many owners/ managers of SMEs are found to take inaccurate and clumsy decisions regarding investment, credit, operations etc. Such inaccurate and faulty business and strategic decisions results excess costs of capital, investments in the low return even in the loss project, inefficient business operations etc. The main purpose of this study is to focus how poor accounting practices hamper the growth and sustainability of SMEs, how different stakeholders are affected due to the lack of quality accounting information. Effective and systematic accounting practice is necessary to increase the operational efficiency, profitability and growth of SMEs.

Keywords: *Small and Medium Enterprise (SME), Accounting Information, Growth & Sustainability*

1. Introduction

Small and Medium Enterprises (SMEs) play very vital role in the economy of any country particularly for developing countries and economically emerging nations. It is generally believed that above 80% of the total business enterprises is represented by the SME sector. There is no unique definition of SME. Tudor & Mutiu (2008) argue that SMEs' world is not a homogeneous and unified one. In IFRS for SMEs (2009), the International Accounting Standard Board (IASB) defines SME as business entities that do not have public accountability and publish general purpose financial statements. The ownership structure of SMEs is based on individual or family members. That's why there is lack of effective and systematic accounting practice. Even in recent times, many SMEs are found to recruit a bunch of smart sales personnel rather appointing accounting or finance practitioner. The main reasons behind having such poor accounting environment are the lack of public accountability, lack of regulations, lack of mandatory audit requirement, lack of resources, . There is a significant negative impact of poor accounting practices on the growth and sustainability of SMEs. Quality accounting information is very necessary in order to take efficient business and strategic decision .According to the European Federation of Accountants, business decisions need to be supported by good quality financial information which need to be relevant, user friendly and in timely manner. But many owners or managers operate their business activities without any accounting or financial judgment, take many important investment and credit decision without any accounting and financial analysis which. Due to the lack of proper accounting system, different stakeholders involved with the SMEs face a lot of difficulties. Sometimes owners or managers of the SMEs fail to understand about the actual financial status of their own business. According to Ntim, A, L.(2014), accounting system provide a source of information to owners and managers of SMEs operating in any industry for use in the measurement of financial performance. They often have very poor liquidity management, credit management, internal recording system, asset management as they do not prepare financial statements and do not have any analysis. In many cases they are found to rely on single entry, manual and unsystematic accounting practices. All these things make the many SMEs unable to sustain in the competitive and sophisticated business arena and face a threat to ensure growth and sustainability.

2. Literature Review

Due to the immense impact of SMEs over the economy, this sector demands more literature. Studies indicate that in both advanced economies and developing countries SMEs contribute on average 60% of the total formal employment in the manufacturing sector, Ayygari, et al.(2007).Mkasiwa, T. A (2014) SMEs' financial reporting has been scantily reviewed. As the many business entities under this sector is either based on individual owners or family members, they often have lack of knowledge and awareness about the

accounting and financial issues. Holmes, S. and Nicholls, D. (1989), concludes that the development of sound Accounting information System (AIS) in SMEs depends on the owner's level of accounting knowledge. Kinney (2001) posits that accounting is one of the important types of information for decision making both within and outside the organizations. The businesses that are small in size today are expected to grow day by day and turn into medium even one day large corporate house. Padachi, K.(2012) in developing countries, SMEs serve as a useful bridge between the informal economy of family enterprises and the formalized corporate sector. Kofi, M.E, et al (2014) mentioned that two-thirds of new businesses survive for at least two years and only 44% survive for at least four years because of poor management in the areas such as finance, to be precise lack of proper financial accounting practice. Mia and Chenhall (2003) argued that failure to adopt and implement AISs is the reason why most companies fail to make sound decisions as their information keeping tend to be haphazard as the firm grows. According to European Federation of Accountants, poor accounting and reporting and decisions based upon inaccurate or incorrect financial information can actually cause problems which may threaten the solvency of the business. Managing the capital is considered one of the obstacles on the way of growth and expansion of SMEs. Germain (2010) poor or lack of record keeping in business specially the small business enterprises lead to their collapsing. One of the major sources of finance in SMEs is the banks and other financial institutions. But these banks and other financial institutions are often found to face difficulties to assess the loan proposal of those SMEs that do not have proper accounting and financial records. Kwok (2002) previous research shows that financial information is one of the primary measures used to assess the capacity of a business to effect payment of credit. William (2008) studies show that it is hard for the SMEs to access finances from the financial institutions since they lack proper financial records as requirements. It is very much necessary to have a practice of proper accounting in SMEs to create a smooth and easily accessible financial sector for them. Olufunso, F.O.(2010) it is recommended that SMEs keep detailed accounting records and audit their financial statements on an annual basis. This will enable the banks to make a proper evaluation of SMEs which should improve their accessibility to credit. Tagoe, et al. (2008) quality of SME records keeping attracts investors to invest and for financial institutions to provide finance. Zhao, Z. et.al (2015) suppliers and franchisers (buyers) involved in the long term transactions with a firm will also consider its accounting performances when evaluating the possibility that the firm might experience financial distress and no longer perform their implicit contracts. In many cases, owners or managers of SMEs are found to take their business and strategic decisions based on their own perception or guess as they usually do not have quality accounting information. Hall and Young (2005) established that lack of AISs use was the major reason why most small businesses make unsound decision.

2.1. Research Objective

The objective of this research paper is to contribute in the accounting philosophy regarding how poor accounting and financial reporting practice affects the growth and sustainability of SMEs in Bangladesh. This research will analyze the possible consequences of poor accounting and financial reporting practice by SMEs; how such practice hampers the growth and sustainability of this sector.

2.2. Research Methodologies and Hypothesis

The study is attempted to focus on the impact of poor accounting practices on the growth and sustainability of SMEs. The study also tries to find out the reasons why SME sector is seen to have poor accounting environment and find out the possible ways to ensure a systematic and effective accounting system to make all stakeholder beneficial.

The primary source of the data used in the research work is the survey of different well known organizations of Bangladesh including SMEs and other financial institutions located in Cox's Bazar. The questionnaire has been provided to the 10 banks and 15 SME firms and responses have been collected from the employees who are working at the managerial and decision making level.

- Hypothesis 1: There is a significant negative relationship between poor accounting practices and the growth and sustainability of SMEs.
- Hypothesis 2: There is a significant positive relationship between the quality accounting information and strategic business decision.

3. Data Analysis

3.1. Scenario Analysis of SMEs' accounting practices

From the survey of 15 different small and medium enterprises, a scenario of their accounting practices has been represented in the following table.

Survey issues Response	Computerized record keeping	Single entry accounting system	Full time accountants	Maintaining daily books of accounts	Formulation of annual budget	Financial analysis for decision making	Consultancy from professional accountants
Yes	6	11	5	9	2	4	4
%	40 %	73 %	33 %	60 %	13 %	20 %	27 %
No	9	4	10	6	13	11	11
%	60 %	27 %	67 %	40 %	87 %	73 %	73 %

Table 1: Scenario of Accounting Practices by SMEs.

Among the 15 SME firms only 6 firms record their daily transactions and other records through computer. It is rare to find the use of accounting software in the SMEs. Most of the SME firms are found to keep their records manually. Another noticeable fact is that although the size and volume of the business increases but the owners or managers of the SMEs are reluctant to shift from single entry system to double entry system. Among the total sample of survey, 73 % of the SMEs still use single entry system. There are some suggested books of accounts particularly for the small sizes org. Survey indicates that 60 % of the SMEs have separate books of accounts but they do not maintain those books systematically. There is lack of internal and external audit and inspection of those books. Many SMEs’ owners think that the appointment of full time accountants is just like wastage. They go for traditional and manual record keeping done by the regular employees to save the organizational expense. In the sample size, very few of the SMEs have been found to have a practice of formulating annual budget. In many cases they do not know what future courses of action they have to accomplish. They just look towards the current sales and profit volume. Among the 15 SMEs only 4 go to the professional accountants/ expert for consultancy services. That’s why most of the SMEs take decision based on guess and personal experience without accounting and financial analysis. All these aspect show that many SMEs have very poor accounting practices which lead them inefficient business operation and work as a hindrance to the growth and sustainability.

Such type of poor accounting practices make many owners of the small and medium business enterprises unsuccessful. Their traditional approach to the business blocks the way of growth and expansion. If we see the growth rate of small and medium size business firms in Bangladesh, it can be understood that most of the SMEs fail to lead their business in right direction due to the poor operation and inefficient business decision.

Year	Growth rate of Small firms	Growth rate of medium - large firms
2004-05	7.93 %	8.30 %
2005-06	9.21 %	11.41 %
2006-07	9.61 %	9.74 %
2007-08	7.1 %	7.26 %
2008-09	6.6 %	6.58 %
2009-10	7.7 %	5.98 %
2010-11	5.8 %	10.94 %
2011-12	7.2 %	10.78 %

Table 2: Growth rate of Small, medium & large firms in Bangladesh

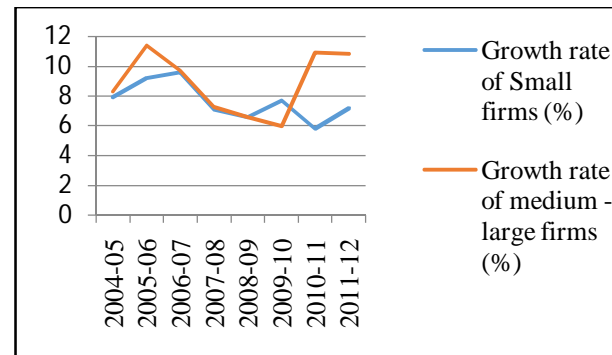


Figure 1: Growth rate of Small, medium & large firms in Bangladesh

3.2. Scenario Analysis of banks as a important stakeholder of SMEs

There are different stakeholders involved with the small and medium enterprises. The success or failure of SMEs has also some impacts on others stakeholders like financial institutions, suppliers, employees etc.

The survey of 10 banks including 7 private commercial banks and 3 state owned banks reveals the following issues.

Survey issues	Separate service line for SMEs	Accounting records & F/S from SMEs	Credit risk	Complexity in Loan recovery	Rate of loan disbursement	Need of regulations
Private Commercial banks	Yes	Below 30 %	Medium	Medium	High	Yes
State Owned/ Nationalized banks	Yes	Below 10 %	High	High	High	Yes

Table 3: Impact on banks as a stakeholder of SMEs.

In the both type of banks there is a separate service line for providing credit facilities to the SMEs called SME banking. Due to the immense contribution of SMEs on the economy the central bank of the country (Bangladesh Bank) has provided special guideline for SME banking service.

In the context of Bangladesh, many SME org. try to take credit facilities from the state owned banks/ nationalized banks due to the more flexibility of loan sanctions. That’s why we can see that only below 10% of the SME clients can provide proper accounting records and financial statements to the banks for evaluating loan proposal as the very few SMEs have proper accounting system. They also think that in order to ensure the effective accounting practices in SMEs there is a need of regulation from authoritative body.

4. Impact Analysis

Accounting is called the language of business. Without the quality accounting information, it is very difficult to take operational and strategic business decisions. The growth and sustainability of a business is hampered if there is operational inefficiency, taking inappropriate decision, investing in the wrong projects etc. A model has been represented below showing how poor accounting practices create threat for the growth and sustainability for the SMEs.

4.1. Inefficient Business Operation

Accounting information plays a vital role in the daily business operation of the org. The working capital management is a big issue for any business org. particularly for SMEs. Due to poor working capital management current liabilities equals or even sometimes exceed current asset which results financial distress for SMEs.

4.2. Inefficient Business Control

Without systematic accounting structure it is very difficult to create sound internal control systems for the business org. In SMEs there are some important control points like stock control, cash control, assets control etc. Accounting record is a key tool to facilitate control process. If there is no proper accounting records fraud, misuse, corruption will increased and will create financial loss for the org.

4.3. Poor Liquidity Management

Poor liquidity management is one of the reasons that blocks the road of growth and sustainability of SMEs. Without systematic accounting practices effective liquidity management is not possible. Lack of effective liquidity management results either excess liquidity or liquidity crisis. If there is excess liquidity the cost of capital will be increased because the idle money will create no return for the business. If there is liquidity crisis operational activities of the org. will be hampered and the org. may face financial difficulties.

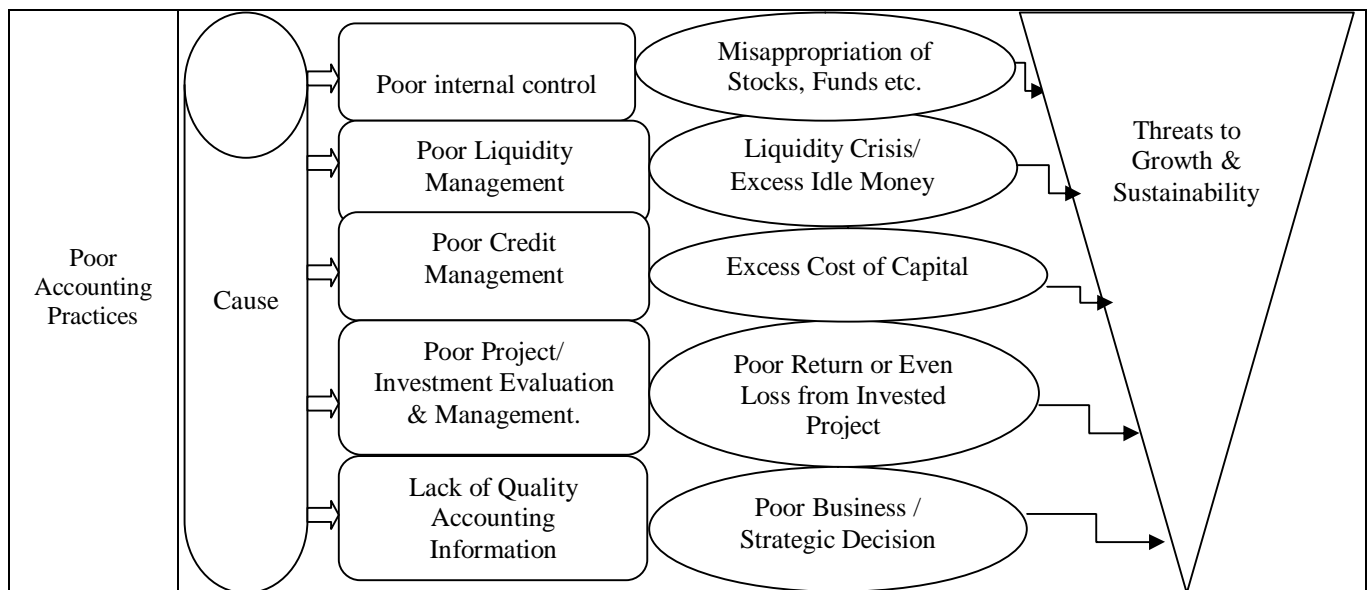


Figure 2: Model: Threats to growth and sustainability caused by poor accounting practices

4.4. Poor Credit Management

Selection of appropriate capital structure is very important for the solvency of the business. Many SMEs are found to run for credit from different financial institutions. Such excess reliance on credit finance increases the cost of capital and creates a pressure on the liquidity of the business with heavy regular payment of installment and interest. Many medium size enterprises cannot go for public equity financing due to the lack of financial statements and proper accounting records.

4.5. Poor Project/ Investment Evaluation & Management

One of the most harmful consequences of not having proper accounting practice is poor investment management and evaluation. It is very common to see many SMEs to invest in the wrong project as they take investment decision based on their own perception, hearing from previous investor of that particular project, advice of family members etc. without having any investment analysis through Net Present Value (NPV), Internal Rate of Return (IRR), Accounting Rate of Return (ARR) etc. By investing in the wrong project they lose their capital and gradually go for collapse.

4.6. Poor Business / Strategic Decision

Information is a key to take decision. In every business org, owners/ managers need to take numerous business decisions. Without accounting information it is not possible to take informed and better decision. Because effective accounting system ensures relevance, reliability, comparability and consistency of the information that are used to take decisions. Quality accounting information not only serves the information needs of SMEs' owners/ managers but also serve the information needs of other stakeholders like creditors, suppliers, employees etc. who are related with the financial ups and downs of SMEs.

5. Findings & conclusions

In conducting the survey and study for this research paper, the following issues have been found regarding the accounting practices of SMEs and the impact of such practices on the growth and sustainability of this sector-

- i. Many SMEs do not have standard and systematic accounting system.
- ii. The reasons behind poor accounting practices by many SMEs are lack of regulations, lack of audit, size of the business, ownership structure, lack of resources, lack of awareness etc.
- iii. Due to the lack of quality accounting information owners/managers of many SMEs often take very clumsy decisions regarding credit, investment etc.
- iv. Poor accounting practices have serious negative impact on the growth and sustainability of SMEs.
- v. Poor accounting practices not only affect the SMEs but also create a lot of difficulties for the other stakeholders who are related with the business structure of the SMEs.
- vi. There is a need of external audit in SMEs to increase the quality of accounting practices.
- vii. The SMEs those who have not enough financial capabilities to recruit full time accountants they can go for outsources of their records & accounts and might take consultancy from accounting professional regarding strategic issues.
- viii. There is a need of regulation from authoritative body to create an environment of systematic and effective accounting practices by SMEs.

The growth and sustainability of SMEs is not only necessary for the SMEs' own individual existence but also for the different stakeholders who are closely related with the financial ups and downs of SMEs. Limited financial capabilities, low risk taking ability, lack of effective management make it difficult for SMEs to operate in the age of complex and sophisticated business and commerce. In such circumstance lack of proper accounting practices block the way of growth and sustainability of this sector. Govt. and other regulatory bodies should come forward with regulations to create a systematic accounting environment.

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