

# A Study on Accounting Practice and Financial Reporting in SMEs (In Case of Arba Minch Town, Snnpr, Ethiopia)

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## Abstract

The research was conducted on 'Accounting practices and Financial reporting in Small and Medium Sized Enterprises (SMEs)' in Arba Minch Town, SNNPR, with the motive of to sort out areas of accounting practice and financial reporting information that are likely to be of significance to managers/owners of SMEs in their provision of information to users. To fulfill the objective of the study, descriptive research approach was used. Stratified sampling technique applied for the research study; in this regard out of 178 SMEs operating in Arba Minch Town 64 firms was selected. The required data were collected from primary source of data by using self-administered questionnaire and secondary source document which are available for the study including financial statement of the small enterprise. The collected data was analyzed by using different methods like tabulation and percentage code used for numerical and organizing large volume of data into homogenous group. The major finding of the study disclosed that the bookkeeping practices in SMEs are not organized to produce required information to both external and internal users for decision making purposes. Further the result shows that SMEs operating in construction sector maintained all receipts and invoices of their transaction in a systematic manner than the other sectors, while none of urban agricultural SMEs kept these activities well. However, the study show that the majority of SMEs encounters challenges in complying with accounting requirements and that most SMEs outsource the preparation of their financial statements to specialist service. One of the areas of financial reporting information that have been sorted out in this study as likely to be of significance to managers of SMEs in their provision of information to users is cash flow.

**Keywords:** Accounting Practice, Financial Reporting, SMEs, Managers.

## 1. Introduction

These days organizations are operating and competing in an information age. Information has become a major resource of most organizations, economies, and also societies (Xu, 2003). Currently information systems are widely used by many organizations to automate existing operation and to improve performance activities efficiency (Saira, K., et al. (2010). Accounting information system (AIS) is one of an important component of modern information system (IS). Developments in the areas of accounting, information technology (IT) and IS over the last decades of twentieth century have widened the range and roles of AIS (Mitchell, Reid & Smith, 2000).

Small and medium enterprise have been defined in various ways according to the capital of the enterprise size, number of people employed by the enterprise, the ownership and management of the enterprise and sale volume, all the definition agree on the common view that small or medium business employ few people and characterized by a relatively as all amount of capital. Accounting system is responsible for analyzing and monitoring the financial condition of the firm, preparation of documents necessarily for tax purpose, providing information to support the money other organizational function such as production, marketing, human resource management and strategy planning. Without such a system, it was very difficult for small medium enterprise to determine performance, identify customer and supplier account balance and forecast future performance of the organization. The primary purpose of an accounting information system is the collection and recording of data and information regarding events that have an economic impact upon organization and the maintenance processing and communication of such information to internal and external stockholders (Stefanou, 2006).

A core function of Accounting system is to avail accurate information to owners and managers of small and medium enterprise (SME) operating in any industry for use in the measurement of financial performance companies, preparation of documents necessary for tax purpose, providing information support to many other organization function (Amidu et al, 2011). In context of small and medium enterprise, accounting information is important as it can help the firm manage their short-term problem in critical area like costing, expenditure, and cash flows by providing information to support monitoring and control (Mitchel et al 2000 and Son et al 2006). Most of small and medium enterprise are owned and managed by family unit. However, the work force is drawn from non-family member. Therefore, small and medium operate under a different style and the culture that the

family inherited from generation to generation (Peter and Buhalis 2004).

Fitzgerald et. al (2006) argue that business enterprise must improve production if they are effectively competing in this era of rapid economic and technological changes. Small business enterprise has become perceived as key asset for industrialization it is recognized that this sector provides not only employment opportunity to an increasing number of people in the country and it is an effective means of fighting poverty and income inequality. Research conducted in this area shows, (Tafa, 2011), shortage of financial resource to adopt effective accounting system and relevant application in business. Lack of update accounting system even when it is update its installation use are not perfect, poor technologies use to the system lack of personnel and techniques qualified to use and operate the system. Most of small business enterprise handle their business traditionally they do not have any knowledge of accounting system. However, small business has to establish effective and efficient accounting system to produce financial statement so as to give precise information for personal or group in business and satisfy the external parties.

SMEs in Ethiopia often face problems with regard to recording their daily transactions. This is due to the fact that most of the SMEs operators do not know how to maintain such records in a simple and easy manner. As a result, many operators find it very difficult to give information on their income and expenditure and eventually do not know whether they have lost or profited from their business activities. The absence of recording will cause some problems in handling customer needs, particularly in maintenance services and also in cases of sales on credit services. The lack of recording data also makes it very difficult for the tax offices to levy reasonable taxes that are commensurate with the business activities. As a result, business operators complain on the taxes that are levied on them on the basis of estimation which they say are too heavy to bear. SMEs' managers need to develop information systems that enable them to make the best decision and then to effectively run their businesses.

The main purpose of the study is to sort out areas of accounting practice and financial reporting information that are likely to be of significance to managers of SMEs in their provision of information to users. Therefore, in order to fulfill the main purpose of this study, the following research questions are addressed:

- What constitutes significant financial reporting information of SMEs?
- For what purposes, SMEs make use of the financial reporting information?
- What kind of challenges faced by the SMEs in record keeping and financial reporting?

## 2. Literature review

The previous empirical studies disclosed about accounting and financial reporting in SMEs contexts, which makes up the first step of data collection of the study presented in this research work. The analysis of the data collected in the developed economy on Small and Medium Enterprise Financial Reporting suggests that financial statements, both audited and unaudited, play a vital role for SMEs; not only for tax purposes, but also in helping SMEs improve the financial management of their businesses and facilitate their access to bank financing. Research findings also depicted that the majority of SMEs encounters challenges in complying with accounting requirements and that most SMEs outsource the preparation of their financial statements to specialist service providers suggest that SMEs' potential use of financial reporting is very much dependent on: (i) a system that strikes the appropriate balance between promoting improved financial information and reducing the regulatory burden. (ii) the accounting and auditing profession's capacity to provide reasonable assurance regarding the data accuracy of the financial information provided in a SME credit application.

In order to survive small scale owner and manager need up dated, accurate and timely accounting information. Accounting system is responsible for analyzing and monitoring the financial condition of the firm preparation of document necessary for tax purpose. Providing information to support the money and other organizational functions such as production, marketing, human resource management and strategic planning, without such system it would be very difficult for small business enterprise to determine performance, identified customer and supplies account balance and forecast future performance of the organization (Amiduet.all 2011). Small scale enterprise suffers disproportionality from the regulatory burden compared to large companies. Since small enterprise often do not have sufficient financial and human resource to manage their obligation in the most efficient way.

Bookkeeping is the first essential step of accounting which as a system provide a source of information to owners and managers of SMEs operating in any industry for use in the measurement of financial performance. The importance of financial performance measurement to any business entity cannot be over-emphasized. In this sense, the accounting basics, concepts and principles adopted ought to capture and report all the relevant accounting information to ensure reliability in its measurement.

Cooley and Edwards (1983) contend that reported profits reflect changes in wealth of business owners. This can explain why major economic decisions in business are centered on financial performance as measured by profitability. Germain (2010) observes that most business operators especially those in SME perceive record keeping as a chore that must be done to simply get back some much-needed cash at the end of a particular period

of time, for example, after a year. However, actually accurate record-keeping is not as important to many business operators. With this perspective, it is no wonder so many of these businesses fail from the beginning (Wanjohiet.all, 2012).

SMEs Owners have many tasks. One of the most important and vital to the success of their business is keeping good records. As per Howard (2009) many small businesses fail to keep adequate records. This leads to major problems and quite possibly the closing of the business. Evidence shows that keeping good records helps increase the chances of business survival. In essence, the SMEs owners or manager should be personally involved in record keeping (Sian, 2006). Good record keeping will make them more aware of what is going on in their businesses and it will save them money. According to research, there are some basic financial records SMEs managers or owners need to keep for the success of a business. These basic records will normally include the sales day book (sales journal), purchases day book (purchases journal), cash receipt book, cheque payments book, petty cash book, general journal, nominal ledger, debtors' ledger and creditors' ledger. Germain (2010) asserts that small businesses must consider maintaining a positive cash flow as a vital element.

Lundell (2005) studied a financially successful entrepreneur's (that is the owner and manager of a company that can be characterized as an SME) use of accounting information in perceiving risk. The results of the study show that the entrepreneur uses accounting information in order to perceive risk in managing operations as well as in entrepreneurial processes. In the daily management of operations, the entrepreneur keeps himself updated on sales, variable costs and cash flow, which are seen as fundamental figures in terms of the short-term control of the business. In entrepreneurial processes, accounting information is considered crucial in determining whether an opportunity should be exploited or not. Since the entrepreneur is constantly involved in the update of accounting figures, he can quickly decide whether an entrepreneurial opportunity is economically feasible to exploit or not. In cases where an opportunity turns out to be appealing as well as economically feasible, additional and more exact information – including accounting information – is collected. With respect to financial reporting the entrepreneur studied by Lundell(2005) supplements the balance sheet and income statement with a cash flow statement.

The study by Hansen (2005) revealed that accounting information is vital and is used actively for decision-making, control and organizational learning in both companies Large and SMEs. The reports these companies are mostly interested in are relatively short-termed but the monthly profit and loss accounts as well are considered important. In the SME that operates in a less complicated environment that is easier to survey than the context of the larger company, a more standardized accounting system is in use. The entrepreneur managing the SME relies to a high extent upon formal reports where the focal point is on revenues, variable costs (COGS are considered to be of certain significance) and gross margin. In the larger company, the formal systems are to a greater extent complemented by oral information and discussions, and the most important factors are believed to be non-financial, such as production yield and volume.

Studies conducted on the role of accounting information in informing external actors illustrate how a simple spreadsheet model designed by the entrepreneur himself successively grows into a sophisticated tool for accounting control as well as for informing external financiers (Collier, 2005). The original spreadsheet model, which was intended for internal use and cash-flow dominated, was used not only as a historical record but also as a forecasting device and a tool for ongoing decision-making. In relation to the involvement by entrepreneurs in the year-end procedures of constructing financial statements. The study by Blomkvist's (2008) aimed to describe if and how entrepreneurs engage in the process of constructing financial statements and to explain the reasons for the entrepreneurs' participation. The results of the study show that the studied entrepreneurs are not merely participants in the process of creating annual accounts but highly active in both discussions on how to give accounts in a proper manner, and the very procedure of doing so. Among other things, the entrepreneurs' wish to influence the content of the financial statements in order to assure that the information needs of users are satisfied. In Ethiopia, a little research was conducted in relation to accounting practice and financial reporting.

### **3. Research Methodology**

#### **3.1. Research Design**

This study used a descriptive research design. A descriptive research design attempts to describe or define a subject, often by creating a profile of a group of problems, people, or events, through the collection of data and tabulation of the frequencies on research variables or their interaction, (Cooper & Schindler, 2006). It is concerned with describing the characteristics of a particular individual, or of a group. In this case, the research problem was to investigate effect of financial management practices on growth of small and medium enterprise with focus to service enterprises in Nairobi County, Kenya. A descriptive research defines questions, people surveyed, and the method of analysis prior to beginning data collection. Thus, this approach is appropriate for this study, since the researcher intended to collect detailed information through descriptions and is useful for identifying variables and hypothetical constructs.

### 3.2. Target population

The target population selected to achieve the objective of this study are Small and Medium Sized business enterprise registered with the trade and industry in Aruba Minch town. According the registration record, 178 SMEs are registered and operating in different sectors in Arba Minch area.

### 3.3. Sampling Technique & Sample Size

The sampling technique selected for this study was proportionate stratified sampling technique. Proportionate stratified sampling is a probability sampling technique wherein the researcher divides the entire population into different subgroups or strata, then randomly selects the final subjects proportionally from the different strata (Steven Nickolas, 2017). This technique is employed to use the same sampling fraction for each stratum regardless of the differences in population size of the strata. The stratified sampling used by the researcher divided the target population into five sub-populations that are individually more homogeneous than the total population or into strata and select item from each stratum to constitute sample. The researcher used simple random sampling to select the sample from each stratum. There are several references to determine the sample size even though no one really standard for it. Sevilla et.al (at Tejero, 2006) stated that for descriptive study, the sample size is equal to 10% of the total population. The statement was adopted what Gay (1976) delivered before. Sevilla also expressed Slovin (1960) formula to determine sample size. Accordingly, this study used this formula to determine the sample size as follows.

$$n = \frac{N}{1 + N \cdot e^2}$$

$$= \frac{178}{1 + 178 \cdot 0.1^2}$$

$$n = 64$$

where n=sample size

N=target population

e=error (1-confidence level)

**Table 1.1: The distribution of SMEs by Sectors**

No	Strata	No of population	Proportionate ratio	Sample size of each strata
1	Manufacturing	52	64(52/178)	19
2	Construction	51	64(51/178)	18
3	Service	58	64(58/178)	21
4	Urban agriculture	3	64(3/178)	1
5	Merchandise	14	64(14/178)	5
Total		178	64(178/178)	64

Source: Primary data

### 3.4. Data Source and Method of Data Collection

The study used both primary and secondary source of data. Primary data were collected using closed and open-ended self-administered questioner distributed to owners or accountants of sampled SMEs. Questioners have ability to generate relevant information as compared to others data collecting instruments which enhances the problem-solving ability of the study (Greener, 2008). The secondary data used/reviewed for this study include source of document, report and other written material available to the study from sampled SMEs. Using secondary data has always been the saving of time and helps in Generating new insights from previous analyses (Ghauri, 2005).

### 3.5. Method of Analysis and Interpretation

After data required for the study are collected, further research procedure like processing and analyzing of collected data were conducted using descriptive statistics techniques. Based on the objective of the study, descriptive statistics are used to describe the basic features of the data in this study to provide simple summaries about the sample and the measures. The translation of primary data into a systematic form that will make them easy to understand and interpret by the researcher and users.

## 4. Survey Result and Analysis

This section present analysis and interpretation of the data collected from both primary and secondary source of data. The researcher distributed and collected 64 self-administered questionnaires representing 100% retrieval (response) rate. The researcher has collected different information related to the accounting and reporting system. Information and data obtained are analyzed, discussed and interpretation are made based on theories and facts.

### Accounting Practices of Small and Medium enterprise

In Ethiopia both SMEs and large companies are required to design their accounting system in accordance with the Generally Accepted Accounting Principles (GAAP) for general purpose reporting. For tax purpose (category A and B), they are subject to the specific rules as provided in the income tax legislation. For tax purpose, SMEs

in Category C taxpayers are expected to make an annual declaration of annual sales, but are not required to keep books of account. If category “C” taxpayer maintains book of accounts acceptable to the Tax Authority, the taxpayer may pay the tax on the basis of book of accounts.

The survey results on bookkeeping practices show that about 30% of SMEs reported that they kept all receipts and invoices of transactions in an organized manner. Result of the study also shows that SMEs operating in construction sector kept all receipts and invoices of their transaction in an organized manner than the other sectors, while none of urban agricultural SMEs kept these activities. The survey results further reveal that, 42 percent maintained full records of revenues and expenses (not necessarily using computer) as per Table 1.2. Similarly, none of SMEs businesses use a computer for purposes of bookkeeping were found to be using specialized accounting or bookkeeping software. This shows that the bookkeeping practice in SMEs is not organized to produce required information to both external and internal users for decision making purposes.

**Table 1.2: Record Keeping practices of SMEs**

Questions	Frequency		Percentage	
	Yes	No	Yes	No
Have you kept all receipts and invoices of transactions in an organized manner?				
Manufacturing Sector	5	14	26.32%	73.68%
Construction Sector	7	11	38.89%	61.11%
Service Sector	5	16	23.81%	76.19%
Merchandise Sector	2	3	40%	60%
Urban agriculture	0	1	0%	100%
<b>Total</b>	<b>19</b>	<b>45</b>	<b>29.69%</b>	<b>70.31%</b>
Questions	Frequency		Percentage	
	Yes	No	Yes	No
Have you maintained full records of revenues and expenses (not necessarily using computer)?				
Manufacturing Sector	7	12	36.84%	63.16%
Construction Sector	9	9	50%	50%
Service Sector	10	11	47.62%	52.38%
Merchandise Sector	4	1	80%	20%
Urban agriculture	0	1	0%	100%
<b>Total</b>	<b>27</b>	<b>37</b>	<b>42.19%</b>	<b>57.81%</b>
Have used a computer for purposes of bookkeeping using specialized accounting or bookkeeping software?				
Manufacturing Sector	0	19	0%	100%
Construction Sector	0	18	0%	100%
Service Sector	0	21	0%	100%
Merchandise Sector	0	5	0%	100%
Urban agriculture	0	1	0%	100%
<b>Total</b>	<b>0</b>	<b>64</b>	<b>0%</b>	<b>100%</b>

Source: Primary data

The respondents from the various firms were also asked to specify whether they were using double entry principle of book/keeping or single-entry book keeping in the recording of business transactions. The outcome is as follows:

**Table 1.3. Principle of book-keeping used by SMEs.**

Principle of book-keeping	Frequency	Percentage
Double Entry	24	37.5%
Single Entry	40	62.5%

Source: Primary data

As shown in table 1.3. above, it revealed that 24 firms out of the 64 firms sampled were using double entry principle of book-keeping, which constitute 37.5% of the valid respondents. 40 of them were using single entry principle of book-keeping, representing 62.5 % of the total valid respondents. This shows that the accounting and reporting practice employed by most Ethiopian SMEs, specifically, Arba Minch Town is not in accordance to GAAP.

#### **Financial reporting information of certain importance in a SMEs context**

McChlery, S., Godfrey, A.D. and Meechan, L.(2005), argues that financial reporting practices in SMEs seem to fall short of what is dictated by various external financial reporting imperatives that exist for them, further arguing that, owner-managers appear particularly reluctant to produce financial reports which might become accessible to outside parties either directly or through the offices of regulatory authorities. One of the objectives of this research was identifying areas of financial reporting information that respondents consider to be of specific importance to managers of SMEs in their provision of information to users. Accordingly, respondents



were asked on the commonly prepared financial statements and accompanying disclosures attached by SMEs. The response, from all sampled firms shows that cash flow statement is the only statement prepared by SMEs in Arba Minch town. Further, Disclosure to the financial statement is not used for additional information purpose.

All respondents consider financial reporting information on cash flow to be particularly relevant in the context of SMEs in Ethiopia. The response of the respondent also shows that, the most important statement of the financial reports and tool for control is cash flow statement. By providing investors with the very important information on how the cash flow of an entity has been generated, the cash flow statement makes according to GAAP, the most essential part of the financial reports. Examples of questions revealed by the cash flow statements in this respect is: "Has the cash been generated internally by the sales of the company's products or services?". The cash flow statement is primarily used to borrow money from lenders, particularly from Micro finance institutions operating in their area.

#### **Users and purposes of financial reports in the context of SMEs**

The subsequent analysis of the survey will provide the respondents' views on main users and purposes of financial reports. All respondents put forward the continuous high demand for financial capital as a great challenge to managers of entrepreneurial and growth-oriented SMEs, and that the principal purpose of the use of financial reports in this context is to communicate with external capital providers. The financial reports make up an important informational role not only when new investments require new or additional financial capital but also to ensure the continued capital provision from existing financiers. Among capital providers Microfinance institutions are put forward by all respondents as the most frequent user group of SMEs' financial reports.

In a perfect world, investors, Lenders, and Government bodies would have full confidence in companies' financial statements. They could rely on the numbers to make intelligent estimates of the magnitude, timing, and uncertainty of future cash flows and to judge whether the resulting estimate of value was fairly represented in the current stock price. And they could make wise decisions about whether to invest in or acquire a company, thus promoting the efficient allocation of capital (H. David Sherman and S. David Young, 2016). Unfortunately, that's not what happens in the SMEs in Ethiopia, when asked for their view on which the main users of SMEs' financial reports, respondents mention suppliers are important users' financial information to decide on the reliability. The financial reports of the supplier constitute an important source of information according to this finding. Employees make up another group of users who according to the respondents might have a specific interest in the financial reports of SMEs.

Only 10% of the respondents answered in affirmative to the question of whether financial reporting information is useful to the managers of SMEs in their internal decision-making, which is an issue where the results of previous studies in the SME context diverge (see literature review). Even though the close connection between the information contained in financial reports, on the one hand, and the information provided by internal management accounting systems, the predominant view is that general purpose financial reports (balance sheet, income statement, cash flow statement, and notes) are marginally useful to managers of SMEs in the internal management of their businesses. Most of the respondents (90%) believe that managers find their information for internal decision-making mainly from other sources than financial reports. In the smaller entities within the SME continuum the main users of the financial reports tend to be the owner-managers in general, while other users become more important in larger entities. The above discussion shows that the financial reports tend to be of less use for making decisions within the business and managers tend to orient their use of the financial reports to the communication with external actors.

#### **Challenges faced by the SMEs in record keeping and Reporting**

The third objective of this study was to find out the challenges the SMEs operators face in keeping records of their business transactions and financial reporting. In line with this the respondents were asked to describe the challenges they face. They gave challenges which are presented in Table 1.4. This table shows that the majority of SMEs (46.88%) attributed the challenges they faced in keeping proper accounting records to lack of accounting knowledge, 9.38% of SMEs indicated cost and time constraints as challenges, 12.5% cited fear of discouragement in case of a loss in their business and lack of skilled man power (31.25%) as contributing to challenges they faced in keeping proper records. The main reason why SMEs did not keep proper accounting records was because of a lack of accounting knowledge. A fairly smaller number of about 9.38% attributed it to costs and time constraints, probably because of various other factors. Mutambanengwe (2012), reveals that the perception of owners/managers of small entities seem to be a major limiting factor in the use of accounting information. Accounting skills are the totality of skills ranging from record keeping, attention directing, financial management and reporting skills that are expected to promote effective decision, performance evaluation and business reporting of any business enterprise. Although studies could not find record keeping skill as positive factor, financial management skill has been found to be contributory to business development.

The reasons given by the respondents as to why they don't practice recordkeeping in their enterprises are not unique to Ethiopia. Lack of accounting knowledge on the part of the managers or the owners of MSEs has been cited in various studies in the world (Everaert et al., 2006). Cost and time constraint is an obvious reason

given by many business owners but researchers and scholars have emphasized the business operators should persevere and keep records of their business transactions for the purpose of efficient management (King and McGrath, 2002)

**Table 1.4. Challenges faced by MSEs Owners/managers in Record keeping**

Challenges	Frequencies	Percentage
Lack of accounting knowledge	30	46.88%
Cost and time constraints	6	9.38%
Fear of discouragement in case of loss	8	12.5%
Lack of Skilled man power	20	31.25%
Total	64	100%

Source: Primary data

## 5. Conclusion and Recommendations

### Conclusion

From this study researchers' are coming to conclusion that the analysis of the data collected from the Arba minch area on Small and Medium Enterprises. Financial Reporting suggests that financial statements, both audited and unaudited, play a valued role for SMEs; not only for tax purposes, but also in helping SMEs to improve the financial management of their businesses and facilitate their access to bank financing. On contrast, the findings of the study show that the majority of SMEs encounters challenges in complying with accounting requirements and that most SMEs outsource the preparation of their financial statements to specialist service.

Despite there has been small enterprise which record every business transaction and prepare basic financial statement (cash flow), the overall result of this study shows that most of the enterprises still follow traditional way, specifically single-entry system. Lack of accounting knowledge and skilled man power in the labor market, fear of discouragement in case of loss and time and cost constraints are the main challenges faced by SMEs to practice record keeping and reporting. Among the items of financial reporting information that have been sorted out in the literature study, only cash flow statement is used for SMEs financial reporting. With reference to cash flow, the majority of the respondents provided that the information in cash flow statement is significant to users, particularly for capital providers. Most of the respondents (90%) believe that managers find their information for internal decision-making mainly from other sources than financial reports. It's good to note that the accounting record and report are necessary for provision of relevant information for decision making process. It means therefore that proper decision mechanism which leads to increased efficiency, reduction of cost and improved performance.

### Recommendations

Based on the finding of the study an adoption of computerized accounting information system is advisable for all firms in abide to insure correctness in reporting and general record management as enterprise that had this system showed an increase in return on investment as opposed to those that had a manual system. Both governmental and non-governmental authorities is also advised to provide short-term training in accounting practice and reporting standards so as to improve the knowledge of accounting system. SMEs owners' are also required to educate their employees by covering the cost of education at least in extension program/training. Since small enterprises are become fundamental to the development of Ethiopia economic growth, private accounting firms are responsible to contribute their share through consulting and training providing to the employees of SMEs. SMEs owners are also advised to establish accounting department that will help to organized the source documents in an organized manner. This will help to fulfil the conversion requirement from GAAP to IFRS to implement soon in Ethiopia.

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