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# The Effects of International Financial Reporting Standards Adoption on Smes Performance: A Case Study Mombasa – Central Business District (CBD)

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**Abstract**

**Introduction**

The world over, SMEs contribute 90% of the sector production and they are prime source of new jobs in developing countries and play a crucial role in income generation especially for the poor. For their progress, SMEs are required to keep books of accounts and several companies irrespective of their size are bound by statutory rules of a particular country in which they operate to prepare financial reports that conform to specialized set of accounting principles. In July 2009, the IASB published the IFRS for SMEs. The IFRS for SMEs is intended to be applied to the general purpose financial statements that do not have public accountability. The essence of this study is to identify the effects of IFRS adoption by SMEs on their performance. The sampling procedure used was stratified sampling technique. Primary data was collected by use of self-administered questionnaire and it was purely quantitative. Data collected was analyzed with the aid of Statistical Package for Social Scientist (SPSS) and Regression analysis.

Finally the findings of the study are presented in bar graphs, diagrams and figures. Tables are used to summarize responses for further analysis and facilitate comparison hence see if the objectives are achieved from conducting the study. The research study sought to evaluate the effects of international financial reporting standard on SMEs performance in Mombasa CBD, Specifically the study explored the objectives provided in chapter one. The study employed descriptive data analysis. The sample under study comprises 39 respondents. The study used primary and secondary data that was collected using questionnaires that was served on the respondents and findings presented using tables. The first part of the objective was to investigate the effect of accessibility of capital on SMEs performance. Majority of the respondents agreed that accessibility of capital had a high effect on performance since in improved on service delivery and production. The second part of analysis was to evaluate the effect of comparability of financial statements on SMEs performance in Mombasa CBD. Majority of the respondents agreed that it has great effect that they were able to their SWOT analysis with accuracy. The third part of the analysis was to investigate the effect of governance on performance. There was high level of acceptance that it reduced levels of fraud and management of resources. The last part of the analysis was to examine the effect of information asymmetry on SME performance. Majority of the respondents agreed that it helped stakeholders in making informed decisions. In investigating the effect of accessibility of capital on SMEs performance, it can be concluded that it had great effect in improving SMEs service delivery and production of goods. The issue of governance has helped in proper utilization of resources and to a great extends reduced levels of fraud. Comparability of financial statements has helped the SMEs in having easy access to financial institutions and being to do accurate SWOT analysis thus giving them a competitive edge. Information asymmetry improved the levels of investment and enabling stakeholder's make informed economic decisions. In conclusion is apparent that international financial reporting standards are an important component in the performance of SMEs.

**Statement of the Problem**

The term Small and Medium sized Entities (SMEs) has different meaning in different jurisdictions. The term in the context of the International Financial Reporting Standards (IFRS) for SMEs is entities that do not have public accountability and publish general purposes financial statements or follow generally accepted accounting principles (GAAP**)**. SMEs in most countries including Kenya are subject to the same financial reporting standards as larger enterprises and corporations. Datuk Johan Rasian a proponent of this single financial reporting regime, argues that there is the need to produce a single set of high quality global Financial

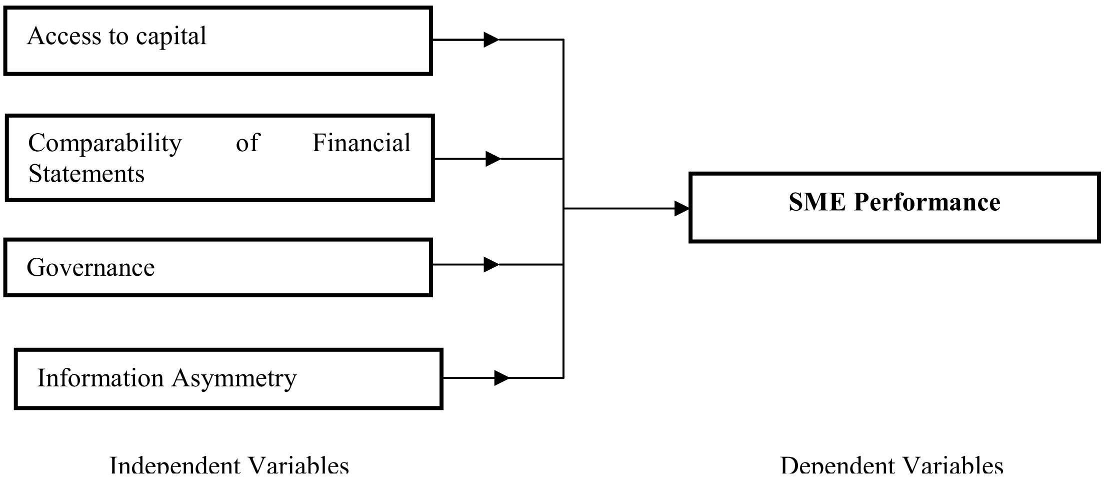
Reporting standards aimed at eliminating the incomparability factor while increasing the transparency of financial statements and heightening disclosure. IFRS and GAAP are tailored to the sophisticated needs of large public companies and not to the special needs of SMEs. SMEs face several obstacles including small size, limited access to business opportunities and information, inability to get credit, financing and insurance, inappropriate government regulations, and lack of managerial staff, skills and technical knowledge.
In the recent past, however, several SMEs in Kenya have adopted IFRS that they use together with the GAAP to suit their individual needs. This study seeks to establish the effects of IFRS on SMEs performance. It has been argued that these obstacles make it onerous for them to comply with the same reporting standards as large enterprises (Devi, 2003). Taking into consideration the above, would a new financial reporting standard specifically tailored to the special needs of SME be more appropriate in the Kenyan context? Several countries have already responded to the need for differential reporting. In the United States, SMEs are exempted from complying with certain portions of GAAP. In the United Kingdom, SMEs are required to comply with the special locally tailored SME standard, namely the FRSSE. The IASB has also responded to calls for differential reporting and issued a draft of the proposed IFRSSE. In the case of Kenya also responding to calls for differential reporting, which type of these differential reporting regimes should be adopted?

## 2.0 Literature Review

**Conceptual Framework**

According to Kotler (2000), a conceptual framework is a basic structure that consists of certain abstract blocks which represent the observational, the experiential and the analytical/ synthetically aspects of a process or system being conceived. The interconnection of these blocks completes the framework for certain expected outcomes. For the purposes of this research, the independent variable will be the indicator affecting performance of SME's which is the adoption of international financial reporting standard while the dependent variable will be access to capital, comparability of financial statements, improved governance of SME's and information asymmetry on stakeholders.

**Conceptual Framework**




## 2.1 Access to Capital

In Kenya, strong SMEs tend to be located in urban and peri-urban centres and are usually registered. However, they face a number of constraints, which include the difficulty in employing competent people with techniques in financial management because of the salaries such people would demand, financial problems arising from late payments by debtors, and inability to raise own finance and access financial services from formal sources. This category of SMEs usually looks to the banking sector and other financial Intermediaries for instruments to finance working capital and to provide credit for short-term liquidity; Economic Survey 2009; The Micro Finance Act 2008 management. They, however, often fail to access the financial resources in the required amounts because banks evaluate them on the basis of a checklist, including: Audited financial statements for the last three years including management accounts;
Project proposal highlighting the strengths, weaknesses, opportunities and threats; Financial projections; Monitoring costs; Credit or default risk because of the problem of information asymmetry; Enforcement costs. Additionally many SMEs employ less than 5 people, mostly family members who are usually not legally registered, apply simple and relatively rudimentary technology in production and, therefore, the quality of their products is likely to be poor. They may suffer from limited market access and fierce competition from many rival producers. This category of SMEs usually does not have proper physical structures such as premises from which to operate business, accessible roads and other essential utilities, which are major catalysts to accessing

formal sector credit. In addition, there is a general lack of professionalism within this category of 7SMEs in terms of strategic planning procedures, decision-making processes and business planning, and management in general.

Generally, the smaller the enterprise, the less likelihood its management will understand the need for financial management and the poorer the understanding of financial management. Likewise, the size and the distance from major cities/urban centres are negatively related to the level of awareness of financial instruments. That is, the smaller the size of the enterprise and the farther away from the city/urban centre the enterprise is, the less aware the firm is of the financial instruments available. This makes them vulnerable to shocks to revenue or costs and, therefore, and makes them unlikely to expand beyond a certain limit. This explains why the turnover of majority of SMEs in Kenya is estimated at only the Kshs.5 million (app US$63,000) a year threshold. Thus, poor returns, lack of good financial records, and lack of collateral make them not creditworthy.

### 2.2 Comparability of Financial Statements

The International Financial Reporting Standard for Small and Medium Sized Entities (IFRS for SMEs) should considerably ease the financial reporting burden for clients who do not have public accountability. Published by the International Accounting Standards Board, the IFRS for SMEs (the "Standard") is intended for use by businesses that publish general purpose financial statements, but do not have public accountability. We are actively encouraging the adoption of the Standard for eligible private businesses and family offices, since it is considerably less complex than full IFRSs. Critically, there are no size limits, however the following do not meet the criteria, and will continue to report under full IFRSs:

Those with debt or equity instruments traded in a public market;

Those in the process of issuing such instruments; or

Banks, brokers, mutual funds and others holding assets in a fiduciary capacity as part of their primary business.

Legislative and regulatory authorities and standard-setters in individual jurisdictions across the world will ultimately decide which clients are required or permitted to adopt the Standard for the purposes of statutory financial reporting. It has not yet been adopted as a statutory reporting framework in the member states of the European Union or the United States; however it is already widely applied elsewhere. Many of our international business corporation clients and family offices have already adopted the Standard, and we expect most to do so in due course. The Standard can be adopted immediately, and there are special rules for those making the transition from full IFRSs, or another set of generally accepted accounting principles. For example, the first-time adopter may elect not to apply the sections on business combinations and share-based payments for transactions effected or granted before the date of transition. Similarly, a first-time adopter may elect to measure an item of property, plant or equipment, an investment property, or an intangible ass

### 2.3 Information Asymmetry

Financial reporting plays a crucial role in contractual setting. It is direct consequence of economic realty which is characterized by uncertain expectation about future developments and ensuring information asymmetric between contract partners. The financial reporting disclosure process reduces information asymmetric between corporate insiders (management) and its external contract partners such as owners, capital markets, creditors and fiscal authorities. All parties contracting with the firm demand information about the firm's ability to satisfy the contractual terms and the firm's compliance with its contractual obligation (Bushman and Smith 2003).

### 2.4 Governance

The collapse of some multinational organizations has made the issue of quality control assume greater importance in global disclosure particularly as a strategy for rebuilding the confidence of the public in accountancy profession. International Financial Reporting Standard promotes transparency and accountability. The debate on quality control are the issue of compliance to standards, adherence to professional; ethics independence of the auditor and continuous training.

### 2.5 Research Gap

The definition given by ISAB is more suitable for a research into financial reporting standards of SMEs. This is because unlike the country definitions which employ quantitative size criteria without regard to whether an enterprise publishes general purpose financial statements for external users, the IASB defines SMEs from a financial reporting viewpoint.

## 3.0 Methodology

### 3.1 Research Design

Research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure (Kothari, 2004). According to Kothari (2004) research design is important as it facilitates smooth sailing of various research operations benchmarking research efficient as possible yielding maximum information with minimal expenditure of effort, time and money. A descriptive research was used to obtain information concerning the current status of the phenomena and to describe what exists with respect to variables. According to Cooper and Schindler (2003), a descriptive study is concerned with finding out what, where and how of a phenomenon.

### 3.2 Population

A population refers to the total collection of all cases in which the researcher was interested and is thus the entity that the researcher wished to understand. The population for this study refers to individuals and institutions who are interested in the financial reporting of SMEs in Kenya. The population was divided into two; internal and external parties with respect to financial reporting of SMEs. Internal parties included those individuals responsible for the management of SMEs and external parties include institutions which had a stake in the financial reporting of SMEs.

## 4.0 Data Presentation, Analysis and Interpretation

### 4.1 Response Rate

The categories of respondents included in the research are presented in the Table 1 below

**Table: 4.1 Response Rate**

| Questionnaires Administered | Questionnaires Received | Percentage (%) |
|---|---|---|
| 50 | 39 | 78 |

**Source: Research Study**

From the table above, 39 questionnaires were received out of the total of 50 administered. This therefore forms a 78% response rate.

### 4.2 Effect of accessibility of capital

Under this section, the researcher sought to find out from the respondents the effect of accessibility of capital on SMEs performance

**Table: 4.2 Effects of accessibility of capital**

| Effects of capital accessibility | Frequency | % |
|---|---|---|
| Increases production of goods & services | 25 | 45.45 |
| Improves customer satisfaction | 10 | 18.18 |
| Improves credit worthiness | 12 | 21.81 |
| Gives competitive edge in service delivery | 8 | 14.54 |

From the above findings 45.45 agree accessibility of capital increases production of goods & services, 18.18% believe it improves customer satisfaction, 21.81% improves credit worthiness and 14.54 gives a firm competitive advantage.

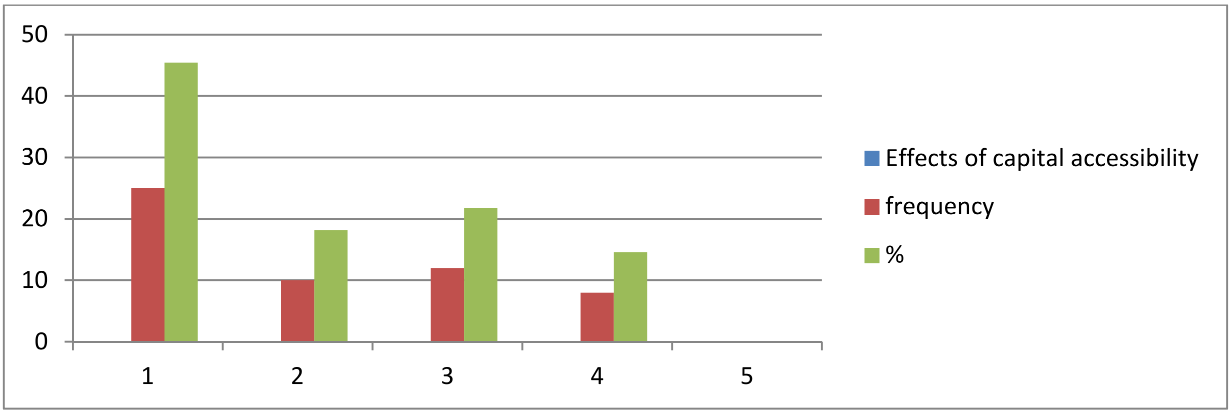



**Figure: 4.1 Effects of accessibility of capital**

**Source Research**

From the above table and graph it is clear that 45.45% of respondents believe accessibility of capital has an effect on SMEs performance because it increases production of goods and services. In conclusion it can be said that accessibility of capital has an effect on SMEs performance.

#### 4.2.1 Extend to which accessibility of capital affect SMEs performance

The objective of this section was to find out the extent to which accessibility of capital affect SMEs performance

**Table: 4.3 Extend to which accessibility affect SMEs performance**

| Extend to which accessibility of capital affect SME performance | Frequency | % |
|---|---|---|
| **Very high** | **18** | **38.46%** |
| **High** | **10** | **25.64%** |
| **Low** | **12** | **30.76** |
| **Very low** | **2** | **5.13** |

From the table above it is clear that 38.46% have very high believe that accessibility of capital have an effect on performance,25.64% think it is high,30.76% it is low and 5.13% it is very low.

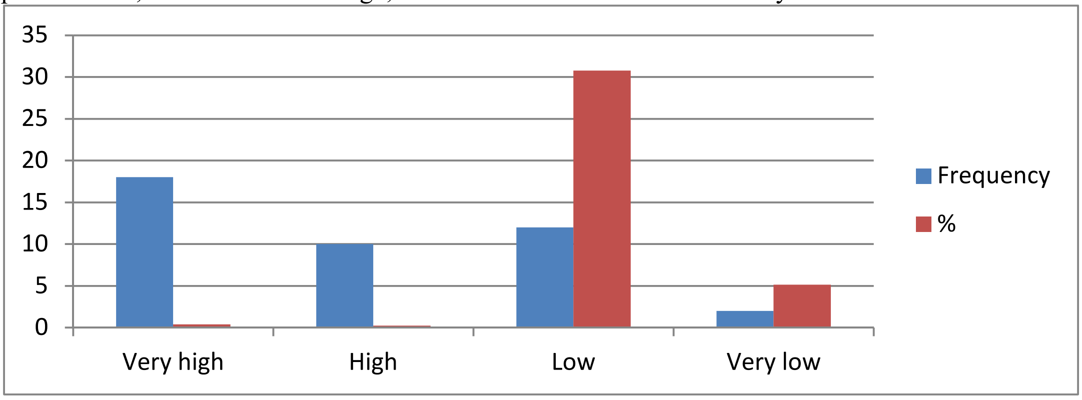



**Figure:4.2 Extent Comparabibility on performnance**
**Source Research**

**4.3 Comparability on SMEs performance**

The researcher in this case wanted to know whether comparability of financial statements has an effect on SMEs performance.

**Table: 4.4 Comparability effect on SMEs performance**

| Comparability of financial statement | Frequency | % |
|---|---|---|
| SMEs can do SWOT analysis | 20 | 44.44 |
| Borrow best practices | 15 | 33.33 |
| Improve on financial management | 10 | 22.22 |

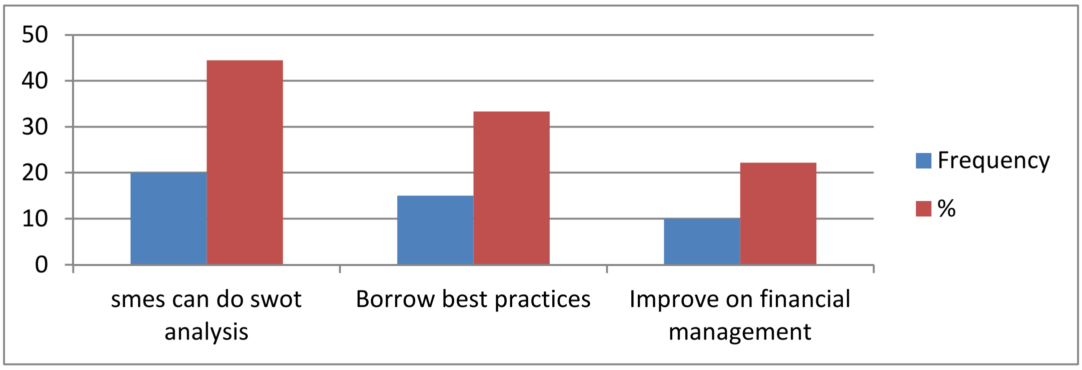



**Figure: 4.3 Comparability effect on SMEs performance**
**Source Research**

The findings from the table and graph indicate 44.4% agree it helps knowing their strengths and weaknesses, 33.3% it enables a firm borrow best practices from firm in same industry and 22.2% believe it improves financial management. Therefore it can be concluded that comparability of financial statements assist in SWOT analysis as it has a bigger percentage of 44.4%.

**4.3.1 Extend to which comparability affects SMEs performance**

The researcher wanted to test the degree at which comparability of financial statement affect SMEs performance.

**Table:4.5 Extend to which comparability affects SMEs performance**

| Extend to which comparability affect SMEs performance | Frequency | % |
|---|---|---|
| Very high | 20 | 51.2 |
| High | 12 | 30.7 |
| Low | 7 | 17.9 |
| Very low | 0 | 0 |

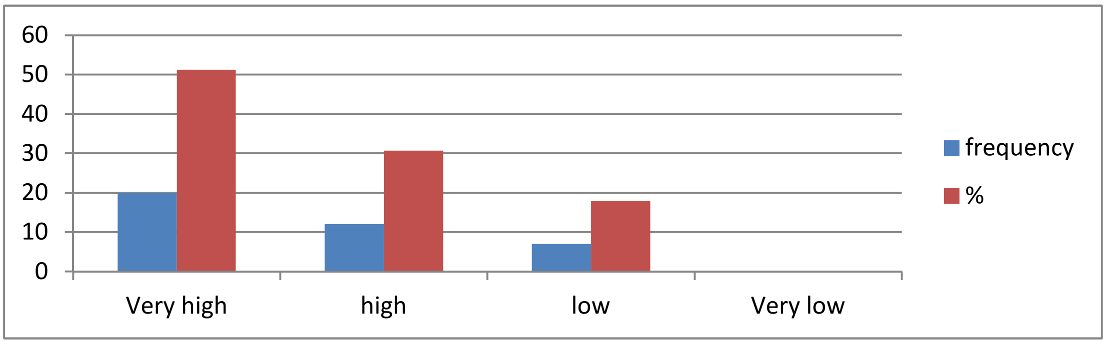



**Figure4.4 Extend to which comparability affect SMEs performance**
**Source Research**

The graph and table above show that 51.2% of the respondents believe that comparability of financial statements have very high effect on SMEs performance while 30.7% think it has high effect and 17.9% believe it has low effect. It can be concluded that comparability of financial statements have very high effect on SMEs performance.

**4.4 Information asymmetry to stakeholders**

The researcher wanted to find out whether information asymmetry has an effect on SMEs performance as a result of IFRS adoption.

**Table: 4.6: Information asymmetry**

| Information Asymmetry | Frequency | % |
|---|---|---|
| Stakeholders make informed decision | 15 | 38.47 |
| Increase investments | 8 | 20.5 |
| Easy access to financial institutions | 6 | 15.38 |
| Leads to tax incentives | 10 | 25.6 |

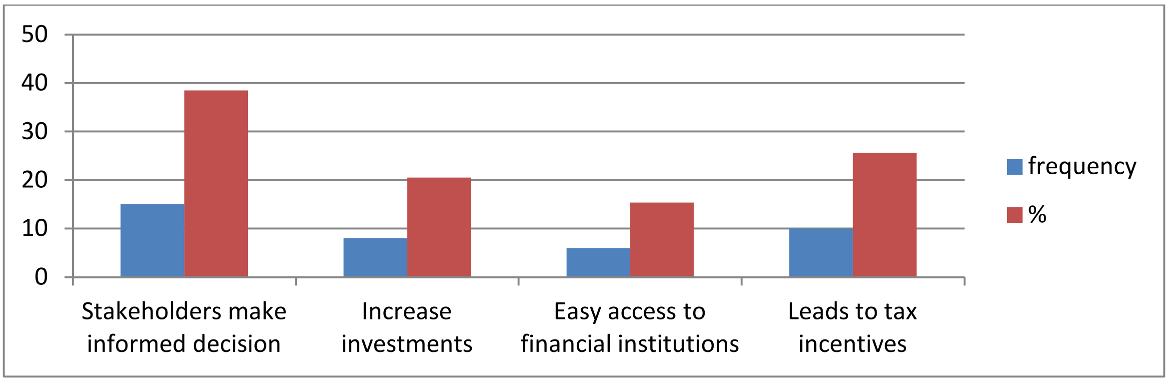



**Figure4.5 Information asymmetry**
**Source Research**

The table above shows 38.47% agree that it leads to investors making informed decisions, while 20.5% think it increases investments to the firm,15.38% believe it makes access to financial institutions easy and 25.6% think it lead to tax incentives by the government.

From the graph 38.46% are of the opinion that it has very high extend effect on performance,12.82% have low expectation and 10.25% have very low believe that it has an effect on performance.

In conclusion, a big percentage of 38.46% are of the opinion information asymmetry has an effect on SMEs performance.

**4.4 Effect of governance in SME performance**

**Table: 4.7 Effects of Governance**

| Effect of Governance | Frequency | % |
|---|---|---|
| Provides accountability | 30 | 44.8 |
| Proper utilization of funds | 15 | 22.3 |
| Mitigates risks | 10 | 14.9 |
| Minimizes fraud | 12 | 17.9 |

The researcher was interested in founding out whether governance had an effect on SME performance as a result of IFRS adoption.

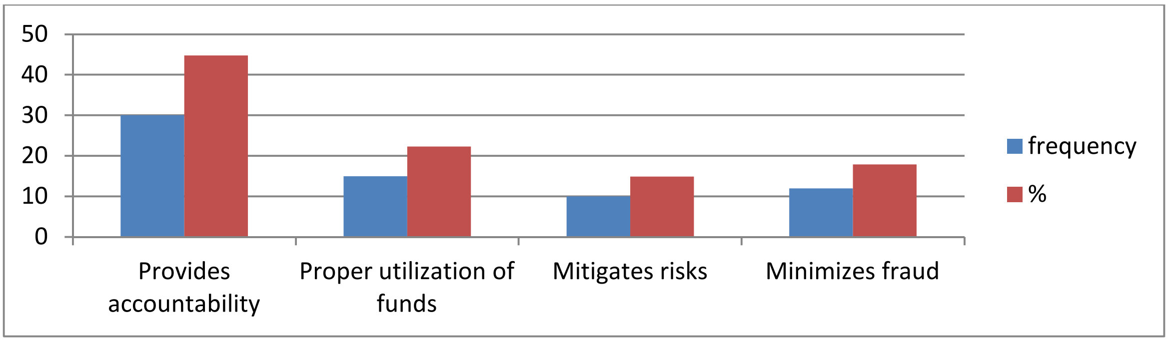



**Figure 4.6 Effects of governance**
**Source Research**
From the findings it emerged that 44.8% agreed it promotes accountability, 22.3% it leads to proper utilization of funds, 14.9% it helps in mitigating risks and 17.9%it minimizes fraud cases. It can therefore be concluded that a majority of the residents do agree that governance has an effect on SMEs performance with a 44.8%.

**4.4.1 Extent of governance on SMEs performance**

**Table 4.7 Extend of Governance**

| Extend of governance effect | Frequency | % |
|---|---|---|
| Very high | 20 | 51.28 |
| High | 10 | 25.64 |
| Low | 5 | 12.82 |
| Very low | 4 | 10.25 |

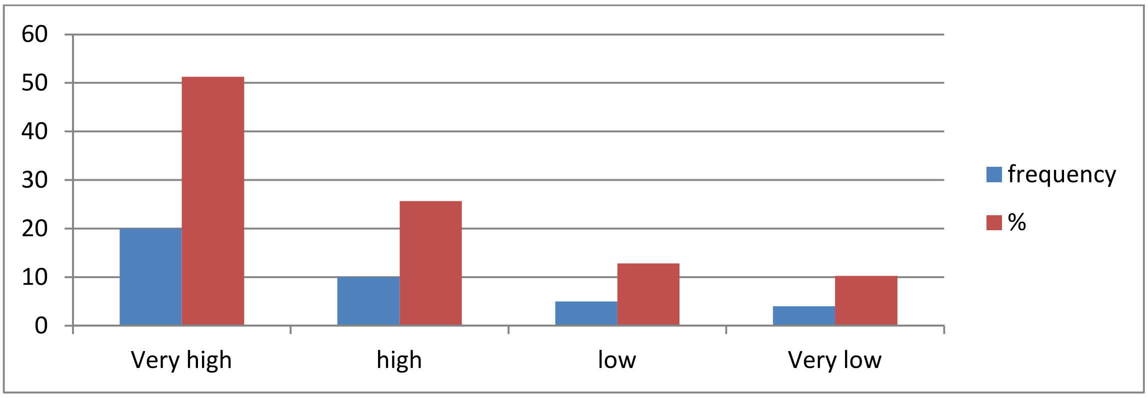



**Figure 4.7 Extend of Governance effect on performance**
**Source Research**
The above findings do indicate at 51.28% agree governance ha an effect on SME performance,25.64% it has high effect on performance,12.82% it has low effect and 5.12% think it has very low effect.Thus,it can be concluded that with 51.28%,govenance has an effect on SMEs performance as a result of IFRS adoption.

**4.5 Knowledge of Exposure Draft on IFRS for SMEs (ISFRSSE)**

SMEs were asked to answer "yes or "no" as to whether they were aware of the release of the exposure draft on IFRS for SMEs (IFRSSE)

**Table 4.8 Knowledge of Exposure Draft for SMEs**

| Response | Frequency | % |
|---|---|---|
| Yes | 28 | 71.7% |
| No | 11 | 28.2% |

From the above findings, 71.7% respondents are aware of the IFRS for SMEs while 28.2 % had no idea what it is.

**4.5.1 Factors Considered When Providing Financial Assistance to SME**

The researcher wanted to find out what the providers of SME's finance consider in provision of financial credit to SMEs. The options provided included compliance with financial reporting standards, collateral security, good governance, preparation and presentation of financial statements, management skill, industry type, sound capital and asset base. Respondents were also given the opportunity to suggest other factors they considered important.

**Table 4.9: Factors Considered when providing Financial Assistance to SMEs**

| | Ranks | | | | | |
|---|---|---|---|---|---|---|
| **Factors** | **$1^{st}$** | **$2^{nd}$** | **$3^{rd}$** | **$4^{th}$** | **$5^{th}$** | **6th** |
| Compliance with financial reporting standard | 2 | | 1 | 3 | | 4 |
| Collateral security | 2 | 2 | 3 | 2 | | 1 |
| Good governance | 1 | 3 | | 3 | 1 | |
| Preparation and presentation of financial statement | 2 | | 3 | 1 | 2 | |
| Management skill | 4 | 1 | 2 | | 3 | |
| Industry Type | 1 | 2 | 1 | 2 | 2 | |
| Sound Capital Base | | 2 | | | | |
| Other | 1 | | | | | |

**Source: Research Study**

From the table above, the factor which ranked “$1^{st}$” the most was management skill. Good governance was considered most (3 times) at the “$2^{nd}$” rank. Preparation and presentation of financial statements was also ranked “$3^{rd}$” three times. Compliance with financial reporting standards being the most important variable we were looking out for ranked “$6^{th}$” on four occasions and was considered as the most important factor twice.

The providers of SME finance stated their awareness of the difficulties SMEs face with compliance. They therefore do not look out so much for compliance when assessing their application for credit. Other factors mentioned were account activity and business transactions with other banks.

## 5.0 Conclusions

The broad research questions relating to effects of international financial reporting standard on SMEs performance was studied and the findings analyzed as to draw conclusions. In investigating the effect of accessibility of capital on SMEs performance, it can be concluded that it had great effect in improving SMEs service delivery and production of goods. The issue of governance has helped in proper utilization of resources and to a great extends reduced levels of fraud. Comparability of financial statements has helped the SMEs in having easy access to financial institutions and being to do accurate SWOT analysis thus giving them a competitive edge. Information asymmetry improved the levels of investment and enabling stakeholder’s make informed economic decisions. In conclusion is apparent that international financial reporting standards are an important component in the performance of SMEs.

## 6.0 Recommendation

In this section, we wish to give ideas on how the problems faced by with compliance by SMEs could be solved.

i) **Public Education:** The accounting bodies like ICPAK and Nairobi Securities Exchange must coordinate and educate managers and accountants of SMEs on the importance of financial reporting standards and update their knowledge on current trends in financial reporting relevant to them. They should be made aware of the benefits that will accrue to their business if they prepare standard financial statements. This can be done through seminars, workshops and the media.

ii) **Hiring of competent Accountants:** SMEs should employ competent staff if affordable. The audit firms should also establish a department dedicated to providing accounting services to SMEs at a relatively cheaper cost.

iii) **Adoption of fully international financial reporting standard:** This is because the world is becoming a global village and we cannot isolate ourselves and with the listing of SMEs in the Nairobi Security Exchange.

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