

Decision usefulness of SME financial statements in Sri Lanka

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Abstract

This paper examines the users of Sri Lankan small and medium-sized entities' (SMEs) financial statements, and their information needs. Semi-structured interviews found the main recipients of SME financial information are banks, the Inland Revenue Department and other government institutions. However, the users' concerns, such as manipulation of financial results, tax orientation, insufficient detail, and out-of-date information, hinder the decision usefulness of SME financial statements. Given this context, the widespread problems of unreliability and non-compliance with accounting principles and standards present a substantial hurdle in evaluating the decision usefulness of SMEs' financial statements in Sri Lanka. The Chartered Accountants of Sri Lanka, regulatory bodies and government authorities need to pay greater attention to SMEs' financial reporting and take steps to make it credible and relevant to users' needs.

KEYWORDS

decision usefulness, IFRS for SMEs, qualitative research, Sri Lanka, standard setters

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1 | INTRODUCTION AND BACKGROUND

Financial reporting by small and medium-sized entities (SMEs)¹ has attracted much attention, particularly after the issue in 2009 of the *International financial reporting standard for small and*

¹In Sri Lanka, there is no universal definition for SMEs. Various government agencies and other organisations use different criteria to identify SMEs based on their assistance programs. For the data collection purpose of this study, SMEs are defined as firms with 5–99 employees. This determination is consistent with the definition given by the World Bank's enterprise survey for Sri Lanka (World Bank, 2016). World Bank (2016) defines SMEs as firms with 5–99 employees for their enterprise survey data for Sri Lanka.

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medium-sized entities (IFRS for SMEs) (see: Aboagye-Otchere & Agbeibor, 2012; Albu, 2013; Albu et al., 2010, 2013; Chand et al., 2015; Devi & Samujh, 2014, 2015; Eierle & Haller, 2009; Kaya & Koch, 2015; Litjens et al., 2012; Ram & Newberry, 2013). Even though the *IFRS for SMEs* is simpler than the full *IFRS*, its framework focuses strongly on outside equity investors as the main users of financial statements (Devi & Samujh, 2014; Di Pietra et al., 2008; Evans et al., 2005; Marina, 2020).

Di Pietra et al. (2008), Evans et al. (2005), Rathnasiri (2014) and Sian and Roberts (2009) identify significant gaps in the research literature on SMEs, concluding that there is a lack of clarity about the users and their uses of SME financial statements. Ram (2012) argues that the existing literature does not adequately address the users of SMEs' financial statements and their information needs, which is a problem for regulators. Evidence is lacking on the extent to which SME financial statements are used by bank lending officers and income tax officers in their decision making. Consequently, fundamental questions about the identity of the users, and how they use SME financial statements, remain unexplored. There have been calls by Chand et al. (2015), Goncalves et al. (2022), Devi and Samujh (2015) Handley et al. (2018) and Perera et al. (2022) for additional research in developing country contexts that examines users' financial information needs when determining SME financial reporting requirements. The needs of users of financial statements of SMEs in developing (or emerging) economies may be very different from the needs of users in developed economies. Hussain et al. (2012), p. 116) argue that developing and developed countries are not a homogeneous group. Differences exist in, for example, legal systems, taxation, sources of finance, inflation, political ties, colonial history, and culture and diversity in accounting practices (Doupnik & Salter, 1995; Evans, 2004; Jaggi & Low, 2000; Nobes, 1998; Richardson, 2007). These contextual factors are deeply embedded in the accounting environment of a country. As such, they may not be easily changed. They could therefore act as an impediment to the decision usefulness of financial statements prepared in compliance with the international financial reporting requirements (Poudel et al., 2014). Hence, this study contributes to the existing body of accounting literature by examining the decision usefulness of SME financial information addressing two research questions: (i) Who are the users of Sri Lankan SME financial statements?; and (ii) What uses do they make of the SME financial statements?

SMEs account for more than 90% of the total number of industrial establishments in Sri Lanka (Fonseka et al., 2022; Perera et al., 2022) and contribute 52% of the country's gross domestic product (Sri Lanka Export Development Board, 2021). Given that SMEs are important in the economy of developing countries, it is important that the financial information produced by these entities helps their users to make informed decisions. These decisions include operational and planning decisions by SME managers, lending decisions by financial institutions, and assessment of income tax liability by the income tax department.

In this study, the perceptions of accountants and owners, bank lending officers, income tax officers, suppliers, representatives of government agencies, and the accounting standards setting authority of Sri Lanka are obtained to provide an understanding of how SME financial statements are being used in decision making. In Sri Lanka, the regulatory bodies responsible for accounting standards include The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) and the Sri Lanka Accounting and Auditing Standards Monitoring Board.² Table 1 summarises different government bodies' expectations from SME financial statements. The

²CA Sri Lanka plays a significant role in setting accounting standards and guidelines for accounting professionals in the country. It adopts and adapts international accounting standards as necessary for local regulations. The Sri Lanka Accounting and Auditing Standards Monitoring Board, on the other hand, oversees the adoption and implementation of accounting and auditing standards in Sri Lanka. It ensures that these standards are in line with international best practices and that they are consistently applied. These bodies work together to ensure the integrity and reliability of financial reporting in Sri Lanka, promoting transparency and accountability in business practices.

TABLE 1 Government institutions and their purposes in using SME financial statements.

Government institution	Purpose of using SME financial statements
Department of Inland Revenue	To assess income tax liability
Department of Finance unit of the Ministry of Finance	To administer and approve SME funding schemes obtained from international donor agencies such as the Asian Development Bank and the World Bank
Board of Investment of Sri Lanka	To renew registration of SMEs
Sri Lanka Customs	To renew registration of SMEs
Defence Ministry, and provincial councils	To obtain business permits and government grants
Other government organisations	When SMEs want to get supplies from or sell goods to government organisations, they need to provide financial statements to provide assurance that they will be able to undertake the task or pay for the goods obtained

rationale for the identification of users and uses of financial statements is based on decision usefulness theory (Son et al., 2006), which designates accounting as a process of providing the relevant information to the relevant decision makers (Gray et al., 1996; Perera et al., 2022). Given the dearth of empirical literature about the users of SME financial statements and the statements' use for decision making in emerging economies, the results of our study are of special relevance to Chartered Accountants of Sri Lanka (CASL), regulatory bodies, and government authorities responsible for formulating, overseeing and assessing the financial reporting practices of SMEs.

The remainder of this paper is organised as follows. Section 2 discusses the financial reporting environment in Sri Lanka. Section 3 explains the decision usefulness of SME financial information. Section 4 reviews the literature on users and uses of SME financial statements. Section 5 presents the method for the research and the demographics of the participants. Section 6 provides the findings relating to the identification of users. Section 7 reveals the uses and usefulness of financial statements. Section 8 discusses the findings and concludes the paper.

2 | FINANCIAL REPORTING ENVIRONMENT IN SRI LANKA

Financial reporting in Sri Lanka can be traced back to the ninth and tenth centuries (Liyanarachchi, 2009). Archival evidence shows that Buddhist monasteries were required to maintain accounting records and to read these records publicly, every year (Liyanarachchi, 2009). Buddhist monasteries had wealth to maintain in the form of land and money received from the king, officials, and private individuals. However, the Buddhist–Sinhalese civilisation and institutions in Sri Lanka came under attack during the colonial eras of the Portuguese, the Dutch, and the British.

The British colonial period is seen to be the most significant in influencing Sri Lankan accounting practices (Narayan et al., 2002). Until 1970, Sri Lankan financial reporting requirements were largely based upon British legislation and professional promulgations (Narayan et al., 2002). Thereafter, the accounting laws and regulations related to financial reporting of business entities in Sri Lanka were developed in response to changes in the business and economic environments of the country, and included the Companies Act No 7 of 2007.

Sri Lanka's Companies Act No. 7 of 2007, replacing the 25-year-old Act of 1982, came into effect on 3 May 2007. Under the Companies Act No. 7 of 2007, public company financial statements are open for public inspection, but private company financial statements are not.

The Registrar may, by notice in writing, require a private company to deliver to the Registrar the financial statements of the company together with copies of any auditors' reports on those statements (Companies Act, 2007). The Inland Revenue Act No. 10 of 2006 requires all listed companies and companies, partnerships, and sole proprietorships having a turnover of not less than 250 million rupees or a net profit of not less than 100 million rupees for the year, to submit their annual tax return to the Department of Inland Revenue together with audited financial statements. All other entities including private companies, partnerships, or any sole proprietorships are also required to submit detailed balance sheet and revenue accounts. However, a cash flow statement is not a compulsory requirement for these entities.

Since 2003, Sri Lanka has recognised that SMEs need a reporting framework (Confederation of Asian and Pacific Accountants, 2003). Many countries recognise the inappropriateness of general-purpose financial reporting requirements for SMEs and have introduced differential financial reporting frameworks (Confederation of Asian and Pacific Accountants, 2003). Differential reporting for SMEs has been practised since 1992 in Australia, followed by New Zealand in 1994. Other developed countries followed (for example, US in 1996, UK in 1997, and Canada in 2002), as did some developing countries (for example, South Africa and Malaysia in 2000, and Sri Lanka in 2003) (Confederation of Asian and Pacific Accountants, 2003). In 2003, the Chartered Accountants of Sri Lanka (CASL), the governing body responsible for regulating the accounting and auditing profession within the country, issued Sri Lanka accounting standards for smaller enterprises (SLASSE) (Institute of Chartered Accountants of Sri Lanka, 2003). CASL used listing status and size measures to classify companies into three tiers. Figure 1 presents the evolution of the financial reporting framework of Sri Lanka.

This three-tier framework remained in place until Sri Lanka decided to converge with IFRS. Following its evaluation of Sri Lanka's accounting and auditing standards, the World Bank made recommendations through its Report on the observance of standards and codes (World Bank, 2004). Consequently, Sri Lanka adopted into its financial reporting system the IFRS issued by the International Accounting Standard Board (IASB) (World Bank, 2004). The CASL decided to converge fully with all standards issued by the IASB in 2012. The CASL introduced the Sri Lanka accounting standard for small and medium-sized entities (SLFRS for SMEs) as a word-for-word Sri Lankan language translation of the International Accounting Standard Board (IASB's) *IFRS for SMEs*, effective for financial periods beginning on or after 1 January 2012. However, the CASL later introduced a third tier for “smaller entities” to take

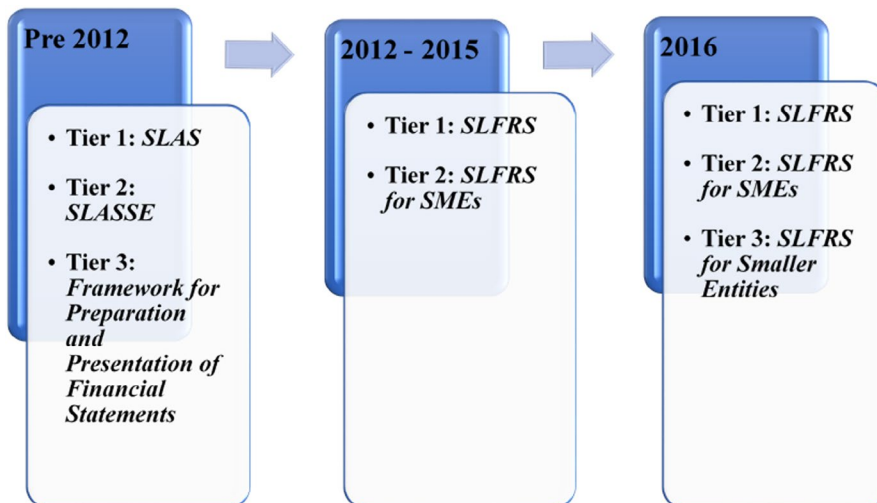


FIGURE 1 Evolution of the financial reporting framework of Sri Lanka.

effect on 1 January 2016. When the CASL adopted the *IFRS for SMEs* as the SLFRS for SMEs in 2012, it specified that its application was for non-publicly accountable entities (Institute of Chartered Accountants of Sri Lanka, 2012). No size criteria are contained in the specification used to classify an entity as belonging to Tier 2. For the 4 years (2012–2015) following adoption of the IASB standards, only two tiers existed, and SMEs had no option but to follow the SLFRS for SMEs.

The CASL reintroduced a third tier of accounting standards, known as Sri Lanka accounting standards for smaller entities (SLFRS for smaller entities), which came into effect from 1 January 2016. The Tier 3 accounting standards could be applied by a smaller entity based on size and fiduciary relationships. Although the CASL introduced the third tier in 2016 to simplify the financial reporting requirements of smaller SMEs, it still retains some irrelevant accounting topics for smaller SMEs such as government grants, and foreign exchange rates (Institute of Chartered Accountants of Sri Lanka, 2015). This financial reporting framework does not follow the “user needs” approach as used in New Zealand and Australia (Australian Accounting Research Foundation, 2001; External Reporting Board, 2012).

The adoption of *IFRS for SMEs* is not likely to result in increasing transparency and accountability due to the underdeveloped legal and institutional framework in Sri Lanka (Freedom House, 2013). Sri Lanka was ranked 101 out of 180 countries on the corruption perception index in 2022 (Transparency International, 2023). According to Transparency International, corruption is a serious problem threatening democratic and economic development in Sri Lanka. High tolerance of corruption, non-sanctioning of corrupt behaviour, and a culture that tends not to question authority, provide an environment in which corruption can flourish (Transparency International Sri Lanka, 2011). Corruption in Sri Lanka is closely linked to inadequate legal and institutional frameworks (Freedom House, 2013).

Recruitment of skilled personnel can also be problematic and very expensive for Sri Lankan SMEs as there is a shortage of qualified accountants (*Sunday Observer*, 2012). Lack of widespread technical expertise in Sri Lanka may have implications for the effective implementation of international accounting standards. In 2012, the World Bank extended a grant of US\$500,000 to CASL. One of the aims of this grant was to strengthen the financial reporting of SMEs by improving the awareness of and skills in *IFRS for SMEs* among SME accountants (*Sunday Observer*, 2012). The IASB and the CASL play an active role in promoting the adoption of the *IFRS for SMEs* and provide training and seminars to the CASL members. These institutions also educate CASL members by providing interpretations and guidance on the standard (Wijekoon et al., 2022).

Wijekoon et al. (2022) found that small and mid-tier audit firms who provide accounting and auditing services to Sri Lankan SME encourage the adoption of the *IFRS for SMEs* in Sri Lanka. Audits of SME financial statements can be undertaken by either registered auditors or small and mid-tier audit firms in Sri Lanka. There is a low level of compliance with auditing standards by small and mid-tier audit firms due to their limited technical capacity (Wickramasinghe, 2015; Yapa et al., 2017). Small and mid-tier audit firms find it difficult to bear the cost of implementing auditing standards due to competitive pricing from registered auditors (Wickramasinghe, 2015). Similarly, staffing, knowledge management, keeping up to date through professional development, and stress are known challenges faced by small and mid-tier audit firms in general (Alam & Nandan, 2010; Ciccotosto et al., 2008). The registered auditors who operate in Sri Lanka include officers of the Department of Inland Revenue; holders of the higher national diploma in Accountancy; members of the Ceylon Audit Service who are not below the rank of Superintendent of Audit; members of the Ceylon Government Accountancy Service who are not below Class III; and members of any other institute or society of accountants or secretaries approved by the Board of Registrar of Companies as per the Ceylon Government Gazette, 4 September 1964 (Wickramasinghe, 2015). Since registered auditors are not necessarily members of the CASL, they are not mandated to adhere to the

Code of Ethics or Continuing Professional Development requirements. Consequently, the public perception of the value of an audit of an SME is weak (Wickramasinghe, 2015).

3 | DECISION USEFULNESS OF SME FINANCIAL INFORMATION

In this paper, decision usefulness theory is used to analyse the usefulness of SME financial information to users; especially SME owners, bank loan officers, income tax officers and creditors. Decision usefulness theory focuses on the needs of users and how they use the information provided (Florou & Kosi, 2015). The theory has been used in prior accounting research to understand how a specific accounting standard, practice and system is useful to the users of financial information. For instance, Gassen and Schwedler (2010) use decision usefulness theory to assess the decision usefulness of financial accounting measurement concepts to professional investors and their advisors. Perera et al. (2022) adopt decision usefulness theory to provide empirical evidence about the decision usefulness of SME financial statements prepared in compliance with *IFRS for SMEs* on bank lending decisions. Staubus (2000) contends that the key to the theory is the decision-usefulness objective. The rationale for the identification of users and uses of financial information is therefore based on the decision usefulness objective (Son et al., 2006). The objective designates accounting as a process of providing the relevant information to the relevant decision makers (Gray et al., 1996). Accordingly, useful information should be included in financial statements while subjective information is discouraged unless it provides users with crucial information (Ijiri, 1975).

The decision usefulness objective was first promoted by the Trueblood Report in the USA (Son et al., 2006). The American Institute of Certified Public Accountants (AICPA) asserts that the objective of financial statements is to provide information useful to investors and creditors for making economic decisions (American Institute of Certified Public Accountants, 1973). Although primary attention was devoted to investors and creditors, the AICPA explicitly acknowledged the existence of a variety of users, including employees, by declaring that “while users differ, economic decisions are similar” (American Institute of Certified Public Accountants, 1973, p. 18). The Trueblood Report states that the societal goals of an enterprise are as equally important as the economic goals (American Institute of Certified Public Accountants, 1973). Therefore, enterprises should provide decision useful information to all stakeholders, not just investors or creditors (American Institute of Certified Public Accountants, 1973).

In the United Kingdom, the Corporate Report (Institute of Chartered Accountants in England and Wales, 1975) was an early attempt to discuss the decision usefulness perspective of financial statements (Son et al., 2006). The Institute of Chartered Accountants in England and Wales (1975, p. 28) states the basic objective of corporate reports is to “provide information useful to those having reasonable rights to such information”. The IASB's aim in introducing new financial reporting standards for SMEs is based on the concept of “user oriented financial information” (International Accounting Standards Board, 2009b, p. 1). The IASB points out that the differences between full IFRS and *IFRS for SMEs* should be established based on the accounting information needs of the users and cost–benefit considerations (International Accounting Standards Board, 2009a). Financial statement users identified by the IASB in the *IFRS for SMEs* include banks, vendors, credit rating agencies, customers, and shareholders who are not managers of SMEs (International Accounting Standards Board, 2009b). Users such as owner-managers and tax authorities are specifically excluded because they have access to non-public information (International Accounting Standards Board, 2009b). However, prominent scholars have raised concerns about inadequate user involvement and users' financial information needs in the due process of developing the *IFRS for SMEs* (Di Pietra

et al., 2008; Potter, 2013; Ram & Newberry, 2013; Schiebel, 2008). The International Financial Reporting Standards (IFRS) Foundation (2015) also acknowledges that the IASB received no written comments from users of SME financial statements on the Exposure Draft for proposed amendments to *IFRS for SMEs* during its initial comprehensive review process. As other participants do not adequately represent the interests of users (Perera et al., 2022), inadequate user involvement in the accounting standard setting process may impair the decision usefulness of accounting information for users (Durocher et al., 2007; Harding & McKinnon, 1997).

According to the decision usefulness objective, a financial reporting framework needs to be derived through the financial information needs of users at large. Jonas and Young (1998) and Young (2006) argue that a user perspective is emphasised frequently in financial accounting standards but in the absence of empirical knowledge about information needs and users of financial statements. Therefore, determining the SME users and their financial information needs provides useful insights to the standard setters, particularly to the IASB and SME Implementation Group as they are presently considering ways to increase user involvement for the next review of *IFRS for SMEs* (Perera et al., 2022).

4 | SME FINANCIAL REPORTING LITERATURE

Research undertaken in developed countries (such as Ireland, the United Kingdom, Canada and Germany) has shown that the most important users of SME financial statements are entity directors, followed by tax authorities and banks or lenders (see for example: Barker & Noonan, 1996; Carsberg et al., 1985; Collis & Jarvis, 2000; Haller & Eierle, 2007; Maingot & Zeghal, 2006; Page, 1984; Rennie & Senkow, 2009; Sian & Roberts, 2009). Non-manager owners were not identified as important users of financial statements (Collis & Jarvis, 2000; Di Pietra et al., 2008; Evans et al., 2005; Son et al., 2006).

By studying four emerging economies (the Czech Republic, Hungary, Romania, and Turkey), Albu et al. (2013) find that taxation authorities and banks are the main users of SMEs' financial statements. However, they surveyed only five to seven stakeholders from each country and do not investigate the information needs of these users. Through 19 qualitative interviews in Vietnam, Son et al. (2006) find that the main users of SME financial statements are tax authorities and government agencies. By contrast, studies conducted in developed countries did not identify government institutions as a main user of SME financial statements. Only four interviewees out of 19 identified banks as an important user of SME financial statements in Vietnam (Son et al., 2006). Thus, results are not consistent throughout the world.

Owner-managers use SMEs financial information for their business decisions (Barker & Noonan, 1996; Carsberg et al., 1985; Collis & Jarvis, 2000; Maingot & Zeghal, 2006; Page, 1984). However their general-purpose financial statements use complicated accounting rules and unfamiliar accounting concepts that limit the usefulness of financial statements for their decision making (Argilés & Slof, 2003; Bunea et al., 2012; Halabi et al., 2010; Marina, 2020; Sian & Roberts, 2009). Nandan (2010) and Sassi and Damak-Ayadi (2022) highlight the importance of management accounting information for the owner-managers of SMEs. Several reasons are provided for why owners hold a negative attitude towards financial statements. For example, Argilés and Slof (2003), Bunea et al. (2012), Halabi et al. (2010), and Sian and Roberts (2009) indicate that owner-managers are unfamiliar with the accounting concepts, and the complicated accounting rules add to their negative perceptions. Further, SME owners have problems in understanding the accounting terms and jargon used by accountants (Nandan, 2010). Handley et al. (2018) find that SME users prefer less complex reports that provide information regarding an entity's liquidity, profitability and solvency. In contrast, Ehalaiye et al. (2020) identify that SME users place relatively more importance on the financial statements than their public

sector counterparts. They place high importance on narratives explaining the entity's performance and financial position.

Hansey et al. (2021) summarise the feedback from the user survey and user interviews on the second comprehensive review of the *IFRS for SMEs* standard. Fifty-four user surveys were completed, of which 14 were from users and 40 from non-users. Most users of the financial statements of SMEs are particularly interested in information about short-term cash flows, obligations, commitments or contingencies, liquidity, and solvency.

The IASB's view that SME financial statements are helpful for lending decisions (International Accounting Standards Board, 2009a) is supported by other researchers who claim financial statements play an important role in bank lending decisions in developed countries (Berry & Robertson, 2006; Collis & Jarvis, 2000; Deakins & Hussain, 1994; Duréndez Gómez-Guillamón, 2003; Maingot & Zeghal, 2006) and emerging economies such as Jordan, Malaysia and Sri Lanka (Abu-Nassar & Rutherford, 1996; Jamil et al., 2020; Perera et al., 2022). A quantitative study by Palazuelos et al. (2018) of bank officers' decisions in Spain finds that they are more willing to provide credit if they perceive high accounting information quality, and if the accounts are audited.

Perera et al. (2022) identify bank lending officers as the main users of SME financial statements. Their findings show that most of the disclosure requirements of SME financial statements are useful for lending decisions; however, bank lending officers do not consider all disclosure requirements presented to them as equally important for their lending decisions. By contrast, Dang-Duc et al. (2008) find that small entities' financial statements are not very useful in loan decision making. Rather, site visits and direct communication with clients are used as alternative sources of information by bank lending officers (Dang-Duc et al., 2008). Similarly, Erdogan's (2018) study of the requirements of SME bankers finds that financial reports are not kept well by SMEs and the lack of such reliable financial data limits the ability of banks to make loan provision decisions.

From the *regulators'* standpoint, financial reporting and taxation have different objectives. Financial reporting provides information for users while tax reporting provides a basis for determining taxable income (Eberhartinger, 1999). Many SME owners perceive financial reporting as a legal obligation for filing tax returns (Barker & Noonan, 1996). SMEs are required to provide their financial statements to the taxation authorities (Barker & Noonan, 1996; Carsberg et al., 1985; Collis & Jarvis, 2000; Maingot & Zeghal, 2006; Page, 1984; Sian & Roberts, 2009; Son et al., 2006). However, tax reporting does not fall within the scope of general-purpose financial statements proposed by the IASB as each jurisdiction has its own taxation rules (International Accounting Standards Board, 2009a).

Studies reveal that only a small number of SMEs provide their financial statements to creditors, customers and suppliers. John and Healeas (2000) and Sian and Roberts (2009) point out that trade creditors tend to use independent sources before extending credit. Further, Collis and Jarvis (2000), report that only 24% of SME owners read the published financial statements of their major suppliers.

There are a number of limitations in the literature on SME users and their financial statements needs. Many researchers (see for example: Akhtar & Liu, 2018; Barker & Noonan, 1996; Collis & Jarvis, 2000; Haller & Eierle, 2007; Maingot & Zeghal, 2006; Page, 1984; Rennie & Senkow, 2009; Sian & Roberts, 2009) survey the views of a single user group, while ignoring other users of SME financial statements such as lenders, tax authorities, regulators and other government institutions. Only a few studies examine both the users and the uses of SME financial statements, and the context of emerging economies is rare. In our research, the perceptions of six user groups are investigated in one emerging economy – Sri Lanka.

Much of the data used in the literature is now dated and most was collected prior to 2010. The literature portrays that general purpose financial statements use complicated accounting rules and unfamiliar accounting concepts that limit the SMEs' owner-managers decision

making. Erdogan (2018) notes after the release of *IFRS for SMEs* that SMEs are not reporting on the use of general-purpose financial statements but some other format convenient to their owner-managers. Since 2009, SME financial reporting frameworks have undergone substantial reform. For example, the IASB introduced the *IFRS for SMEs* in 2009 and many countries, including Sri Lanka, subsequently adopted that standard. Therefore, up-to-date empirical data on users and their uses of financial statements from our research is useful in evaluating accounting standards for SMEs.

Postal questionnaire surveys of owners of SMEs and auditors of SME financial statements dominate the literature (see for example: Akhtar & Liu, 2018; Barker & Noonan, 1996; Collis & Jarvis, 2000; Haller & Eierle, 2007; Maingot & Zeghal, 2006; Page, 1984; Rennie & Senkow, 2009; Sian & Roberts, 2009). With the exception of research studies conducted by Son et al. (2006), Erdogan (2018) and Perera et al. (2022), research has not evaluated the decision-usefulness of SME financial statements in emerging economies. This evaluation is needed for developing a relevant financial reporting framework for SMEs. Consequently, it is timely and important to evaluate the decision-usefulness of SME financial statements in emerging economy settings.

5 | RESEARCH METHOD

An interview guide was developed based on the research questions of this study and issues identified in the literature. Separate interview questions were generated for preparers, users, and the standard setter. The interview instrument was constructed in English and then translated into Sinhala. Sinhala is the native language of the respondents and most SME owner-managers in Sri Lanka are not fluent in English. After translation, the drafts of interview instruments, in both Sinhala and English, were discussed with academics from the financial and accounting disciplines (especially academics with an interest in financial reporting by SMEs), to assess the face validity of the interview instrument. The interview guides for the three groups (SME owners and accountants, users of SME financial information, and standard setter) are provided in Appendices A–C. Pre-testing of the interview instrument was carried out with an owner-manager and an accountant in Sri Lanka, who were preparers and users of SME financial information. SMEs are defined as firms with 5–99 employees, consistent with the definition given by the World Bank's enterprise survey for Sri Lanka (World Bank, 2016). Forty-six participants were selected from seven user groups of SME financial statements to investigate SME users and their financial information needs in Sri Lanka. Table 2 indicates the number of interviews undertaken with each group and Tables 3 and 4 provide the profiles of respondents.

TABLE 2 Number of interviews with each group.

Group	Subtotal
Owner-managers	23
Accountants	6
Bank lending officers	5
Income tax officers	3
Suppliers	5
Standard setter	2
Government institutions	2
Total	46

TABLE 3 Profile of interviewees.

Interviewee group	Interviewee	Position	Experience (years)
Bank lending officers	01	Head of Credit Division (Public Bank)	12
	02	Head of Micro Finance and SMEs (Public Bank)	11
	03	Credit Officer (Private Bank)	6
	04	Head of Credit Division (Private Bank)	25
	05	Manager – SME Loans (Private Bank)	7
Income tax officers	01	Assistant Commissioner	11
	02	Assistant Commissioner	9
	03	Assistant Commissioner	9
Suppliers	01	Chief Financial Officer	7
	02	Assistant Manager	13
	03	Chief Operating Officer	8
	04	Manager	12
	05	Chief Financial Officer	8
Representatives from government institutions	01	Director, Development Finance	18
	02	Additional Secretary	15
Representatives from the standard setting authority	01	Head of Technical Division	8
	02	Manager, Technical Division	5
SME accountants	01	Chief Accountant	7
	02	Senior Accountant	6
	03	Accountant	8
	04	Accountant	5
	05	Senior Accountant	23
	06	Financial Accountant	11

Purposive and snowball sampling techniques were used to gain access to participants, as in several previous studies of SMEs (see, for example Chambers et al., 2021; Halabi & Carroll, 2015; Holgersson, 2013; Samujh, 2011). Heterogeneity was built into the design to compensate for the non-probability nature of the sample (File & Prince, 1998). For example, SME owners were selected from business entities with different characteristics, as shown in Table 4. The bank lending officers were selected from private and government banks in Sri Lanka. The initial list of private and government banks was prepared and ranked based on loans granted to the SME sector. Suppliers of SMEs were drawn from the researcher's own contacts and the introductions provided by owners of SMEs. Accordingly, nine respondents were approached for interviews but only five agreed to participate. Interview appointments were arranged by telephone and through e-mails. The objectives of the study were explained in detail, in accordance with the ethical approval obtained. This study was guided by the ethical principles on research with human participants set out by the University of Waikato. Accordingly, ethical approval was granted by the University of Waikato. Interviews took place between August 2015 and January 2016, conducted in either Sinhala or English, and varied in length between 30 and 50 min. All interviews were recorded and transcribed verbatim to facilitate qualitative data analysis (the transcriptions in Sinhala were translated into English). Analysis of the interview transcripts was carried out using NVivo version 11. The use of the NVivo software facilitated the process of organising, re-arranging and managing the considerable amount of qualitative data. However, the use of NVivo requires the

TABLE 4 Profile of owner managers.

Owner manager	Number of years in the business	Number of employees	Type of business	Form of business
1	13	28	Manufacturing	Private limited
2	27	22	Manufacturing	Partnership
3	7	15	Service	Sole proprietor
4	8	22	Service	Private limited
5	11	7	Manufacturing	Private limited
6	27	35	Manufacturing	Private limited
7	14	97	Manufacturing	Private limited
8	30	14	Trading	Sole proprietor
9	23	42	Manufacturing	Private limited
10	23	20	Service	Private limited
11	20	16	Manufacturing	Private limited
12	12	10	Manufacturing	Private limited
13	22	45	Manufacturing	Private limited
14	25	95	Service	Private limited
15	23	31	Manufacturing	Private limited
16	28	12	Manufacturing	Private limited
17	38	98	Service	Private limited
18	3	95	Service	Private limited
19	21	52	Manufacturing	Private limited
20	24	98	Service	Private limited
21	26	94	Service	Private limited
22	15	95	Manufacturing	Private limited
23	10	55	Service	Private limited

manual handling of data at various points (Jones & Diment, 2010). The research adopted thematic analysis (Boyatzis, 1998; Braun & Clarke, 2006; Handley et al., 2018) for analysing interview data.

The following themes (see Appendix D) were generated from the thematic analysis: the users of SME financial information (e.g. owner managers, tax authority, banks, suppliers, other government institutions and standard setter); the use of SME financial information by owner-managers (e.g. usefulness of financial statements for decision making, usefulness of management information, purpose of using financial information); the use of SME financial information by bank lending officers (e.g. usefulness of SME financial statements for making lending decisions, use of other financial information for lending decisions, usefulness of financial statements for loan monitoring purposes, usefulness of audit reports); and use of financial information by income tax officers (usefulness of SME financial statements for tax assessment, use of other financial information for tax assessment, use of non-financial information for tax assessment). These themes are discussed in the sections below.

6 | FINDINGS PART A: USERS OF SME FINANCIAL STATEMENTS

The participants (owner-managers and accountants of SMEs, bank lending officers, income tax officers, representatives from government institutions, and the standard setter in Sri Lanka),

identified banks, taxation authorities, and government bodies as the main users. Often these users acquired additional information to support their decisions and did not rely heavily on the general-purpose financial statements. Owner-managers were not the main users of the statements; however, they used financial information drawn from their internal reporting systems.

Owner managers of SMEs identified themselves as users of SME financial information, but the general-purpose financial statements were not generally consulted:

We are the decision makers of the entity and we want to check on taxation, and cash flow. I make decisions based on financial information.

(Owner-manager 01)

For decision making I monitor sales and get an update daily. Also, monthly we get a Profit & Loss and the financial ledgers as well.

(Owner-manager 15)

As most of the SMEs had a limited number of owners and were owned and managed by family members, non-manager owners were not identified as users of SME financial statements. All the owner-managers identify the Inland Revenue Department as one of the main users of their financial statements:

Main purpose of their (financial statements) preparation is to submit the tax return to the Inland Revenue Department.

(Owner-manager 06)

Our accounting firm prepares those (financial statements) for regulatory requirements. I mean submit to the income tax department.

(Owner-manager 08)

For most owner-managers, financial statements are prepared by their external accounting firms as a “legal” document to be submitted to fulfil legal requirements, particularly for taxation. Thus, they do not make use of their financial statements for their business decision making.

Income tax officers explained that submitting financial statements is a legal requirement for SMEs, and that every SME is required to submit a statement of accounts prepared by an approved accountant to the Department of Inland Revenue only. Some SMEs are required to submit audited financial statements based on the size of their turnover and/or profits. Income tax officers are among the users of SME financial information:

Most often, they (SMEs) give the financial statements as it is a requirement of the return but providing cash flow statement is not a compulsory requirement for SMEs.

(Income tax officer 01)

All owner-managers in the study identified banks as one of the main users, as they have to submit their financial statements to banks when they want to use loan facilities. Some owner-managers seemed to have developed good relationships with their banks because they had transacted with these banks for a long time. However, they were also required to submit financial statements when obtaining loans:

I applied for a Rs2.5 million loan from my bank to get the main equipment for my business. The bank asked for my financial statements and I submitted financial statements prepared by the external accountant.

(Owner-manager 03)

We have been dealing with this bank for years now from the inception of our business. So, they have a connection with us and our borrowing gets approved within shorter time periods. Whenever we go for a financial facility, they have requested our financial details.

(Owner-manager 06)

Banks confirmed their use of the financial statements as part of their assessment for lending:

When financing an SME, the first thing we consider is the nature of the business they are operating in and second, if the business is registered. The third thing we consider is the business volume and the management tools that they are using. Fourth, the management accounts and financial accounts that they are preparing.

(Bank lending officer 01)

When giving a loan for a working capital requirement, or a renovation or expansion, we use their financial reports to calculate the gearing and other ratios to evaluate their repayment capacity and the effect that a loan will have on them.

(Bank lending officer 03)

The two government institutions interviewed said that they use SMEs' financial statements when they administer and approve SME fund schemes obtained from international donor agencies such as the Asian Development Bank and the World Bank:

We normally get the loans from donor agencies such as ADB and World Bank and we do not have an arm to distribute. So, we give that loan as a sub-loan to selected banks. Before giving the loans to SMEs, they have to get our approval. When we approve the loans, they have to send the documentation, including financial records, to us. We study the SME financial records at that time.

(Government institution 01)

Additionally, some owner-managers, who registered their businesses under the Board of Investment of Sri Lanka, identified the Board and Sri Lanka Customs as users of their financial statements. Owner-managers say it is a regulatory requirement to submit their financial statements as Sri Lanka Customs requests turnover and bank details from SMEs when they renew their customs registration.

To obtain business permits and government contracts, SMEs are required to submit their financial statements to government organisations such as the Defence Ministry, and provincial councils. Moreover, owner-managers stated that they must provide their financial statements to government organisations when they want to get supplies from or sell goods to government organisations. SMEs provide their financial statements to these government organisations to provide assurance that they will be able to undertake the task or pay for the goods obtained:

The Defence Ministry and provincial council check on our income because they provide the permits.

(Owner-manager 12)

When we are getting new business from the government agencies, they need about 3 years of financial statements to check our strength.

(Owner-manager 23)

Non-governmental suppliers and customers are not identified as users of SME financial statements by owner-managers. Even SMEs who undertake international transactions do not receive any requests to provide financial statements to their foreign suppliers or customers:

No, they [suppliers and customers] cannot ask for our financial statements because we are not a public company. The only thing is we might give an overview of the company and things like that for them to know that they are dealing with a reputable company with good standing but we don't give financial statements.

(Owner-manager 20)

I don't think suppliers want our financial statements. In my 16 years, I have sent it to maybe two people.

(Owner-manager 21)

Suppliers of SMEs shared similar thoughts on this and reaffirmed that they do not use SME financial statements for their decision making.

Once we receive an order from a new customer, we usually see the reliability of the customer as we want to make sure that we get money without any delay. For that we can check the business registration. Normally government maintains various databases on SME registrations so that we can see whether this customer is registered with that. That is more reliable because most of the information included there is correct, and we verify them through site visits.

(Supplier 01)

We never ask for their (customers') financial statements. However, we ask for bank statements to see their cash flows and a copy of the business registration. Sometimes we take decisions based on our gut feeling. Industry reputation is also a matter.

(Supplier 03)

It appears that suppliers and customers tend to use alternative methods to ensure the credibility of SMEs and thus, they do not request financial statements.

Accountants did not identify non-manager owners, suppliers, and customers as users of SME financial statements:

We do not prepare these financial statements for public purposes, it is for internal users and for some limited external users. We give them to banks when we get loans and Inland Revenue department as it is a regulatory requirement. Other

than that, it is only the directors who refer to them. Our suppliers and customers do not request for our financial reports.

(Accountant 01)

When we are called for tenders and quotations from government organisations, we have to submit our financial statements, and the recent months' P and L, and cash flow data.

(Accountant 04)

However, the perceptions of owner-managers and accountants on government institutions as users of SME financial statements were not reflected in responses from the standard setter:

according to my understanding and from information we have gathered from different participants, different people basically, the main users of financial statements of SMEs would be the owner itself and mainly the bankers and Inland Revenue authorities. Therefore, whatever the financial statements they are preparing should be targeted to their requirements.

(Standard setter representative 01)

Banks, and the Inland Revenue Department were identified as the main users of SME financial statements. Certain other government institutions were found to be users of SME financial statements. The owner-managers revealed they had to provide their financial statements to government institutions when they sold to or purchased goods and services from government agencies. Moreover, Ministries in Sri Lanka require SMEs to provide their financial statements when they apply for SME loans that are funded by foreign donor agencies such as the World Bank and Asian Development Bank. Ministries administering such loan programs require SMEs to provide their financial statements.

Non-manager owners were not identified as users of SME financial statements. The majority of Sri Lankan SMEs were owner-managed and consequently non-manager owners would be insignificant users of SME financial statements (Wijekoon et al., 2024). Overall, the findings do not agree with the list of financial statement users identified by the IASB in the *IFRS for SMEs*.

7 | FINDINGS PART B: USE OF SME FINANCIAL STATEMENTS

The participants were asked how they used financial statements in their decision making. The following sub-sections share the perceptions of owner-managers, bank lending officers, and income tax officers on the usefulness of SME financial statements.

7.1 | Use of financial statements by owner-managers

Owner-managers generally agreed that their financial statements have little decision making value, since they are prepared for the purposes of compliance. The objective of *IFRS for SMEs* is generally to publish financial statements for external users. Examples of external users include owners who are not involved in managing the business. Owner-managers, who are generally not external users, consider the financial statements are too complex, outdated and cannot be understood because of lack of knowledge in accounting:

I do not use the one prepared by the accounting firm for taking business decisions, because I find their format not suitable for my needs and it's very hard for me to understand. It does not give up-to-date financial information about the company.
(Owner-manager 04)

Owner-managers maintain separate sets of records internally and use them for decision making. They are aware that internally prepared documents provide them with a real picture of the business entity, while they consider statements for taxation are prepared to minimise the tax liability. If the income tax authority reveals a discrepancy from a tax audit, the income tax authority issues tax assessment and charge penalties. For owner-mangers, the financial statements are useless for business decisions:

A separate set of accounts is prepared by my accounts executive for the manufacturing division and the selling division, which are located in two different places. These are used by me for decision making.
(Owner-manager 02)

I prefer to use the reports prepared internally. I do not rely on the reports prepared by the accounting firm.
(Owner-manager 14)

Almost all SME owner-managers used internal management information for making business decisions. It appears management information is easy to understand and is relied upon to provide accurate, detailed, and up-to-date information about the entity's business operations:

The management report helps me to make my ground-level decisions to go on with the business day to day.
(Owner-manager 11)

Management accounting information is most useful because we are not accountants. We understand management accounts easier, it's a bit more to our audience, whereas financial accounts are more to an accounting audience. The internally prepared management information is not technical like financial statements, and is up-to date.
(Owner-manager 08)

The owner-managers' view on the usefulness of management information for decision making was confirmed by the accountants, who prepare management information for owner-managers for decision making:

We prepare the management accounts for internal decisions. Only for compulsory compliance purposes, we do the financial statements.
(Accountant 01)

He (owner) mostly prefers to look at the management accounts because he is involved in the business daily.
(Accountant 03)

Many owner-managers place high importance on managing the cash flow position of the business. Owner-managers believe cash flow reports and bank statements are useful documents to monitor the cash flow of the business as they show cash movements and when cheques³ have been presented. SMEs prepare management information daily, weekly, and/or monthly according to their own preferred format. Monitoring the cash flow of the business is a major concern of owner-managers:

We have our own system of recording financial information. I have instructed my management and the workers to prepare a book to record daily sales. They also prepare a separate book for daily expenses. At the end of the day, I check these two books so I can get an idea on daily cash flow position of the business.

(Owner-manager 03)

We do not need the financial statements because I have a track of our daily performance. I check the online bank statements about three times a day so that I have a track of it. I know what is in the bank and about collections, due dates and payments. Apart from that, I check the invoices sent and the pending payments so I can follow up on payments.

(Owner-manager 04)

Owner-managers, who are not external users, place considerable importance on managing their cash flows. Additionally, the larger SMEs (with employees between 40 and 99) use budgets and accounting ratios for their decision making. Those in the manufacturing sector use cost analysis reports, production and productivity plans for their decision making. The owner-managers said they used financial statements mainly to monitor the performance of the business by comparing sales, profits, and costs with previous periods. Some owner-managers use their financial information to make investment decisions such as investing in land and buildings. Other owner-managers use internal financial reports for deciding employees' bonuses and salaries:

I compare our financials against the last 5 or 10 years to understand the progress of the business. So that I can set forecast and set targets. I check our performance last year and see where we went wrong and prepare the track for the next year.

(Owner-manager 01)

I use them mainly to check how to increase the wages I pay my employees. This is because I want this business to be the most productive as a recycling business and also I want my employees to be one of the highest paid employees in the country in this business.

(Owner-manager 13)

Owner-managers believe that financial statements have limited use for making business decisions. Legal compliance was the main driver for preparing financial statements, particularly for taxation. They report that the information in the financial statements is difficult to understand and not suitable for their decision making. They prepare a separate set of accounts

³Cheques are the most extensively used non-cash-based payment instrument and are widely accepted by the business sector in Sri Lanka.

for their internal use. Financial statements prepared for taxation were not reliable for decision making as they were prepared to hide the true results of the SME. The participants have ready access to the internal financial information of the entity and find management information very useful for making their business decisions.

7.2 | Bank lending officers

Bank lending officers believe the *accounting information included in the SME financial statements does not provide them with a true picture of the entity's financial position* as they are prepared for tax purposes. Institutional factors such as lack of knowledge by SME owners on financial reporting was also considered as a main reason for not preparing proper financial statements. Some bank lending officers hold the view that SMEs prepare financial statements only when they need a loan. Consequently, bank lending officers place low reliance on the SME financial statements when they make lending decisions:

We get financial statements to check how they are performing, but just because the numbers are presented, we do not depend on them fully. SMEs are inclined to hide information, and this practice is facilitated by their political connections. This a serious situation in Sri Lanka.

(Bank lending officer 01)

The biggest problem we face in Sri Lanka is that most SMEs do not maintain good accounts because of the lack of knowledge and the rules and regulations. The need for financial reports comes only when they need a loan. They are also scared of taxation. Therefore, they try to manipulate their financial statements. Even if a company brings their own information, we do our own reports because we do not rely on their reports.

(Bank lending officer 02)

Institutional factors such as the accuracy of financial statements presented to the banks were also at play. The bank lending officers' perception of the usefulness of SME financial statements for making lending decisions was consistent with the views given by owner-managers. Both believe financial statements have limited use for obtaining bank facilities. One owner-manager commented on this issue:

I asked for a loan of Rs3 million recently and the only thing they checked was the books I maintain. I normally record my daily transaction in separate books. I handed over these books in the morning and in the evening got the OK on the loan. I asked them if they wanted the reports done by a Chartered Accountant, but they said what I give them is more than enough.

(Owner-manager 13)

Bank lending officers generally agree that audited financial statements enhance the reliability of SME accounting information. However, the other institutional factor at play in Sri Lanka, the credibility of auditors who carry out the audits, is a concern. Bank lending officers prefer financial statements audited by reputable Sri Lankan audit firms:

The audited financial statements are not reliable to evaluate their real income and current state. Most customers try to show a reduced income. Quality of the audit is

a matter. If it is done by a reputable audit firm, then we do consider it. Otherwise, we obtain extra documents to verify the figures.

(Bank lending officer 03)

They do not depend on financial statements to obtain information relating to profitability, cash flows, and gearing due to incorrect figures in the financial statements:

the main problem is 99% of customers prepare financial statements for tax purposes and it does not reveal a true and fair view even though sometimes it includes the audit report. Normally the sales figure has been under-stated, and customers do not include debt that is obtained from other banks. Due to these reasons, we get additional information from SMEs.

(Bank lending officer 05)

Rather than relying on the information contained in the financial statements, bank lending officers verify the accuracy of the financial statements and prepare their own reports. Some bank lending officers report they even examine electricity, water, and telephone bills to estimate production volumes of SMEs. Additionally, the banks' internal database, credit report, borrowers' character, information from SMEs' suppliers and customers, and business registrations are used in making lending decisions.

Although several methods were used to make lending decisions, it appears *collateral is required for all types of loans*. One bank lending officer shared that they normally go for cash flow-based lending for corporate level customers and collateral-based lending for SMEs:

corporate level companies normally do not give any collateral. They usually give their financial statements so when it comes to corporate level, of course, cash flow based lending but when it comes to SMEs, still it will be either against their project assets or maybe movable property.

(Bank lending officer 04)

Further, *bank lending officers do not use SME financial statements for loan monitoring*. However, one bank lending officer asks SMEs to submit their financial statements annually to as a condition when loans are granted. Most bank lending officers make site visits to monitor the progress of a loan:

We do a visit and get a visit report which is included in the file. We also do a review of the facilities to see if there are arrears in other banks and the arrears they have with our bank.

(Bank lending officer 01)

Bank lending officers placed low reliance on the financial statements of SMEs when making lending decisions. They gathered the information they needed through site visits and interviews with the owners.

Sri Lankan bank lending officers place little importance on audited financial statements. Banks obtain additional information from SMEs to make lending decisions and do not depend on financial statements provided by the SMEs. Overall, the findings suggest that the decision usefulness of SME financial statements for making lending decisions and monitoring borrowing is limited, largely due to the tax-oriented financial reporting practices among SMEs in Sri Lanka.

7.3 | Income tax officers

Income tax officers expressed major concerns over the credibility of SME financial statements. The institutional factor of faithfulness of financial statements is common in Sri Lanka in relation to tax issues. Income tax officers are aware that financial statements for tax purposes understate profits. Further, they have reservations about the institutional factor of external accountants who prepare SMEs' financial statements, particularly about the qualifications of the external accountant:

there is third-party involvement like an accountant to prepare SME financial statements. Most of the time he is not a Chartered Accountant. When we query them, they are unable to answer our questions. When we use the technical analysis of ratios, we find some abnormal findings in their financial statements. ... the accounts are manipulated, and we find this out when we use the technical analysis of ratios.

(Income tax officer 01)

The summarised data in financial statements are also a major concern for Income tax officers as they carry out the assessment of tax liabilities of SMEs. SMEs are asked to submit detailed information about turnover, expenses, creditors and debtors:

Most of the cases, we cannot get adequate information from SME financial statements because it's a summary for the whole-year transactions. In addition to the financial statements, they are also required to provide detailed financial information; related to both balance sheet and income statement. ... We go through those documents and if we have any suspicion or doubt then we query the taxpayers.

(Income tax officer 02)

Income tax officers compare the financial information supplied with other SMEs in the same industry to reveal any abnormal findings. Further, they are aware of industry trends and mark ups. Additionally, they acquire information from creditors, debtors, and other government agencies (such as the Registrar of Motor Vehicles, and the Land Registration Department), and make site visits to cross-check the data contained in the financial statements.

Income tax officers do not solely depend on SMEs' financial statements for assessing income tax. The institutional factors of the lack of credibility of SME financial statements, the credibility of external accountants, and inadequate detailed information in the financial statements are major reasons for the low reliance on SME financial statements. Income tax officers use their powers to obtain additional information to make their tax assessments. The credibility of accountants who provide accounting and auditing services to SMEs is also a major concern to income tax officers.

8 | DISCUSSION/CONCLUSION

This paper examines the users of Sri Lankan SMEs' financial statements and their information needs. When developing the *IFRS for SMEs*, the IASB identified various user groups including banks, vendors; credit rating agencies; customers; and shareholders who are not managers of SMEs as primary users of SME financial statements (International Accounting Standards Board, 2009b). Our findings indicate that the main recipients of Sri Lankan SME financial statements are banks, the Inland Revenue Department and government bodies. Significantly, shareholders, creditors, employees and the public are not identified as users of the SME

financial statements. This finding concurs with the results of others' research and confirms our claim that stewardship reporting is irrelevant to SMEs in Sri Lanka.

Banks have been identified as one of the main recipients of SME financial statements as they are the leading capital providers to the SME sector in Sri Lanka. However, in Sri Lanka, collateral is required for all types of loans. In contrast to findings from developed countries, bank lending officers place little reliance on the financial statements of SMEs when making lending decisions. However, the finding is consistent with Vietnam (Dang-Duc et al., 2008) – another emerging economy – but not for Jordan (Abu-Nassar & Rutherford, 1996). Hence, the results from emerging economies may be country-specific. The financial information used in lending decisions to Sri Lankan SMEs relates to profitability, cash flow and gearing. Bank lending officers obtain this information from the management reports supplied by the SMEs. This means that banks have to rely on external sources as the financial statements are deemed to be unreliable and the standard of their preparation inadequate.

Bank lending officers generally agree that audited financial statements enhance the reliability of SME accounting statements. However, the credibility of the auditors who carry out the audits is a concern. Therefore, bank lending officers prefer financial statements audited by reputable firms such as the Big Four audit firms in Sri Lanka. The credibility of accountants who provide accounting and auditing services to SMEs was also a major concern of income tax officers. This could be attributed to the fact that there are concerns regarding the quality and credibility of audits conducted by smaller and mid-sized audit firms in Sri Lanka. (Wickramasinghe, 2015; Yapa et al., 2017). The IASB asserts that financial statements prepared in compliance with *IFRS for SMEs* are useful for bank lending decisions (International Accounting Standards Board, 2009b). Nevertheless, the prevalent issue of reliability and non-adherence to the accounting principles and standards in Sri Lanka poses a significant challenge in evaluating the decision usefulness of SME financial statements. Bank lending officers do not use SME financial statements for loan monitoring. The literature on the usefulness of SME financial statements for loan monitoring appears to be silent. This finding is significant as although the literature shows financial statements play an essential role in lending decisions, there is no evidence in the literature that financial statements are used for monitoring borrowing.

Contrary to research conducted in developed countries, owner-managers believe that financial statements have a limited use for making business decisions. Legal compliance was the main driver for preparing financial statements, particularly for taxation. It was further revealed from the discussions with owner-managers that accounting figures provided in the financial statements are altered to minimise their tax liability. Because the figures may not show the real financial situation, using information provided to tax authorities for making business decisions is not recommended. Apart from possible distortion of the financial figures, lack of accounting knowledge, lack of detail and timeliness were also found to be reasons for not depending on the financial statements for decision making.

SME owners or shareholders have access to internal financial information for controlling and monitoring purposes, a situation which makes the stewardship role of financial reporting to owners “redundant”. Owner-managers commented on the usefulness of bank reconciliations, budgets and other management accounts for making their business decisions. They use financial statements to compare sales, profits and costs with previous periods. The owner-managers revealed that internally generated cash flow reports are useful for decision making, but financial statements for stewardship reporting are not relevant.

All the participant owner-managers identified the Inland Revenue Department as one of the main users of their financial statements. The Inland Revenue Department requires SMEs to provide their financial statements together with the annual tax returns for assessment of income taxes. This finding concurs with the literature. However, we found that tax authorities use the financial statements as merely one source of financial information in making the

taxation assessment as they judge the statements provided are unreliable. As income tax officers have the power to obtain additional information for their tax assessments, the findings indicate that income tax officers obtain additional detailed financial information about turnover, expenses, creditors and debtors from SMEs when they submit their annual tax return. Income tax officers compare an entity's financial information with other SMEs in the same industry to reveal any abnormal findings, as they are aware of industry trends and mark-ups.

The findings of this study reveal that SMEs maintain separate records and different documents for different purposes and submit them as “appropriate” for private and governmental purposes. Consequently, financial accounting statements do not reflect true financial performance and position when SMEs are attempting to reduce payments on taxes.

Certain government institutions are users of SME financial statements. Owner-managers must provide financial statements to government institutions when they trade goods and services with government agencies. Moreover, SMEs are required to provide their financial statements to Ministries administering loan programs, where loans are funded by foreign donor agencies such as the World Bank and the Asian Development Bank. These donor agencies put pressure on Sri Lanka to adopt *IFRS for SMEs* (Wijekoon et al., 2022). Sri Lanka's decision to adopt *IFRS for SMEs* was primarily due to coercive pressure from international donor agencies such as the World Bank to make SME financial statements reliable, comparable and transparent (Wijekoon et al., 2022). This finding differs from the research findings in developed countries but is consistent with the results from Vietnam, an emerging economy (Dang-Duc et al., 2008). SMEs are required to provide financial statements to government institutions when they supply and/or sell goods and services to them. Moreover, discussions with the representatives from two government institutions that make policies for the SME sector confirmed that they use financial statements when they administer specific loan schemes that are funded by the World Bank and the Asian Development Bank. Further, they require certain standards of financial accountability from their aid recipients (Mir & Rahaman, 2005; Singh & Newberry, 2008). This point emphasises the need to monitor the standards practised by accountants who prepare financial statements for SMEs.

The prevailing cultural factors in Sri Lanka pose significant challenges to the implementation of accounting standards such as the *SLFRS for SMEs*. Corruption is a serious problem threatening democratic and economic development in Sri Lanka. High tolerance of corruption, non-sanctioning of corrupt behaviour, and a culture that tends not to question authority, provide an environment in which corruption can flourish (Transparency International Sri Lanka, 2011). Adoption of the *IFRS* is complicated by lack of regulation and lack of enforcement within a culture of secrecy and fraud (Albu et al., 2011).

In summary, the decision-usefulness objective of financial reporting suggests that financial reporting should provide useful information for users to help them make their decisions. If users do not consider financial statements useful and reliable, then reporting has no value. SME financial reporting in Sri Lanka conflicts with the decision-usefulness objective of financial reporting. It appears from our findings that the incorrect practical application of accounting principles and standards in Sri Lanka is masking whether SME financial statements are decision useful.

This paper makes several contributions both to knowledge, and to practitioners. Because there is a considerable gap in the literature relating to emerging economies and Sri Lanka in particular, this research provides rich data on SME financial reporting, relating to the SME users and their financial information needs, especially in emerging economies. This paper highlights the views of various users regarding the usefulness of SME financial statements, particularly tax officers, creditors, and representatives of government institutions whose views have not been noted previously in the literature. It appears that poor governance and low enforcement and monitoring of rules and regulations in Sri Lanka impact on the quality and credibility of SME financial reporting. For example, SMEs tend to alter their financial

statements for tax purposes. Policy-makers should adopt effective mechanisms to minimise non-compliance with the rules and regulations of the country. Users have major concerns over the reliability of financial statements due to the tax-oriented financial reporting of Sri Lankan SMEs. Therefore, the findings will also be useful for the owners and preparers of SME financial statements in identifying the information needs of users and understanding the extent to which they rely on the accounting information produced by SMEs. This understanding is important to increase SMEs' access to external funds.

Though CASL adopted international accounting standards for SMEs, the findings of the paper reveal that implementation of these accounting standards is impacted by country-specific concerns about how financial reports are generated in Sri Lanka. As CASL has exclusive authority in promulgating accounting and auditing standards while overseeing the accounting profession in Sri Lanka, the research findings have significance and practical value for CASL. For instance, the research sheds light on the concerns of bank lending officers regarding audits conducted by non-reputable audit firms in Sri Lanka, leading them to rely on audits performed by well-established audit firms. In this context, CASL should pay greater attention to SME financial reporting and take steps to make it credible, relevant, and appropriate to users' needs, through education, registration and monitoring of their accountants and auditor members. This paper provides empirical evidence that could be used to inform the worldwide debate on SME financial reporting. The findings of this study have implications for standard setters in Sri Lanka and other emerging economies and in particular the International Accounting Standards Board in understanding the user-needs approach to accounting standard setting.

The outcomes of this research should be interpreted in the light of limitations in the research design. First, the research is limited to a single country. The data were collected from SMEs in Sri Lanka, one emerging economy. Second, the World Bank definition from the Enterprise Survey of Sri Lanka was used to define SMEs as no standard definition of SMEs in Sri Lanka existed at the time of data collection. While interpretation of the findings may be enhanced for making comparisons with other studies using the World Bank definitions, interpretation within Sri Lanka may be hindered by this external definition of SME. It is recommended that future research uses an experimental approach to address the impact on decision making of using or not using the accounting standards adequately. Future research could also be undertaken to compare findings of this research with other emerging economies.

DATA AVAILABILITY STATEMENT

Data available on request from the authors.

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APPENDIX A

INTERVIEW GUIDE – OWNERS AND ACCOUNTANTS OF SMES

I. General information	Could you tell me about your business?
II. Preparation of financial statements	Which types of financial statements do you prepare? How does your entity keep records of business transactions? Who normally prepares your entity's financial information? Do you use the services of external professional accountants?
III. Users and uses of financial information	Who do you view as the main users of your entity's financial information? Apart from financial statements, is there any other financial information you prepare for these users? For what purposes do you use your entity's financial information? Which specific information or parts of financial statements are useful to you, personally, as sources of financial information for business decisions e.g. balance sheet, profit and loss account or notes? In addition to these statements, what additional information do you find useful for business decisions; e.g. management accounts, budgets or bank reconciliation?

APPENDIX B

INTERVIEW GUIDE – BANKS, CREDITORS, TAX AUTHORITY AND GOVERNMENT INSTITUTIONS

I. General information	Could you please describe your main job functions? What is the role of your institution towards providing services to SMEs?
II. Users and uses of financial information	What information sources about SMEs do you normally use for your job? How do you access such information? Do you use SME financial statements in your job? For what purposes do you use SMEs' financial statements? Do you require additional information/any other sources of information not provided by financial statements?

APPENDIX C

INTERVIEW GUIDE – STANDARD SETTER

I. General information	Could you please describe your main job functions?
II. Accounting standards for SMEs	Who do you view as the main users of SME financial statements? What are the financial information needs of these users? Did your institution conduct any empirical studies on users and their information needs on SME financial reporting in Sri Lanka? How did you assess users and their information needs of SME financial reporting?

APPENDIX D

THEMES, CATEGORIES AND SUB-CATEGORIES IDENTIFIED FROM THE QUALITATIVE DATA ANALYSIS

Sub-theme	Categories	Sub-categories
Theme 1: Users of SME financial information		
Purpose of reporting	Financial accounting versus tax reporting	Legal requirement Filing income tax return
Perceived main users of SME financial information	External versus internal users	Banks Owner managers Inland Revenue Department Government institutions, e.g., ministries, BOI, Customs Suppliers
Theme 2: Use of financial information by owner managers		
Usefulness of SME financial statements for making business decisions	Not useful versus useful	Prepared for tax purposes Lack of accounting knowledge Lack of up to date financial information Lack of detailed financial information Check the income tax liability
Usefulness of profit and Loss statement		
Usefulness of management information	Not useful versus useful	Not technical and easy to understand Up-to-date and accurate financial information about the entity Provide detailed information
Types of management reports or information	Management accounts versus other management reports	Budgets Ratio analysis Cost analysis Production and productivity plans Separate set of accounting records for owner managers Bank statements and cash flow reports Income and expenditure reports Creditors and debtors reports Sales and purchases reports
Purpose of using entity's financial information	Types of business decisions	Compare performances with previous periods Compare with targets Deciding on employees' salaries and bonuses Taking investment decisions Taking marketing decisions

(Continues)

APPENDIX D (Continued)

Sub-theme	Categories	Sub-categories
Theme 3: Use of financial information by bank lending officers		
Usefulness of SME financial statements for making lending decisions	Limited use	Not reliable due to tax-oriented financial reporting No proper financial reporting due to lack of knowledge among owner managers Financial statements are prepared for loan purposes
Usefulness of audit report	Limited use	Credibility of auditors and quality of the audit Big auditing firms versus small and medium practitioners (SMPs)
Use of other financial information for lending decisions		Projected financial statements prepared by bank lending officers Ratio analysis Management accounting information and internal documents obtained through site visits and interviews with owners Cash flow position through bank statements Report from Credit Information Bureau of Sri Lanka (CRIB)
Use of other financial information for lending decisions		Collateral Nature of the business Business registration Character of the owner Production volumes through electricity, water, and telephone bills Information from SMEs' suppliers and customers
Usefulness of financial statements for loan monitoring purposes	Useful Not useful	Review annual financial statements Not reliable accounting information
Use of other information for loan monitoring purposes		Monthly/quarterly inspections Check internal records for identifying any arrears with the bank or other banks
Theme 4: Use of financial information by income tax officers		
Usefulness of SME financial statements for tax assessment		Understated figures in the financial statements Lack of detailed information Qualifications of external accountants
Use of other financial information for tax assessment		Detailed financial information including break-downs of turnover, expenses, creditors and debtors Paying site visits to obtain internal records of financial information Compare SME financial information with other SMEs in the same industry VAT returns to reconcile turnover
Use of non-financial information for tax assessment		Internal records and databases Information from customers, suppliers, and distributors Information from government agencies such as the Registrar of Motor Vehicles, and the Land Registration Department