The Crucial Role of Financial Reporting for SMEs in Nigeria

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Abstract

Financial reporting is critical for accountability and transparency in business organizations, including Small and Medium Enterprises (SMEs). Financial reporting plays a vital role in enhancing the sustainability, financial performance, and credibility of SMEs in Nigeria. Uniform financial reporting standards such as GAAP and IFRS have a significant impact on global business practices. SMEs contribute to economic growth and employment across different regions, particularly in Nigeria, playing a pivotal role in the economy. Despite the benefits, Nigerian SMEs face significant challenges in adopting effective financial reporting practices due to limited resources, lack of awareness, and insufficient accounting expertise. The research recommends strategies to improve financial reporting among SMEs, including education, policy support, and the adoption of digital tools, to enhance their access to finance and strategic decision-making capabilities.

Keywords: Financial reporting, Small and Medium Enterprises, Economic Growth, Business Sustainability, and International Financial Reporting Standards.

Introduction

Financial reporting is essential to accountability and transparency in a business organization. SMEs are not exempted. Financial reporting describes the procedure for generating and informing external stakeholders about a company's financial performance and status (Joshi and India, 2021). Having an in-depth comprehension of these financial reporting standards is essential for business executives to guarantee the accuracy and trustworthiness of financial reporting. Business professionals must, therefore, effectively assess the profitability, liquidity, and financial standing of their potential business entities and rivals to prosper and expand in a global market (Sogomi et al., 2024). As such, global accounting standards have been developed, which are diverse, with every nation employing a unique set of generally accepted accounting principles (GAAP) (Schroeder and Cathey, 2022). These standards enable businesses to present their financial statements in compliance with the relevant GAAP.

Small and Medium Enterprises (SMEs) play a vital role in the global economy, accounting for a significant portion of employment and contributing to economic growth (Maow, 2021). In the USA, SMEs are essential, comprising around 50% of the workforce. Their contributions to innovation, job creation, and economic growth cannot be overstated. Similarly, in the European Union, where there are about 23 million SMEs, they generate a vast number of jobs, accounting for 95% of all enterprises (Okafor and Daferighe, 2019). This shows how integral they are to the economic landscape of the EU. Moving to Nigeria, the significance of MSMEs is even more pronounced. In Nigeria, they contribute about 85% to the GDP, which is a substantial portion. This shows how pivotal SMEs are for these countries' economic development and employment. According to Albaz et al. (2020), small and medium-sized enterprises (SMEs) make up a large percentage of the economy's private sector manufacturing process (over 90%), and are the main employers in the developing world, and are essential for creating revenue, particularly for the underprivileged. Considering that SMEs are fundamental to the economy, they frequently encounter various difficulties, especially when it comes to managing operations and obtaining funding for their expansion, which is reflected in their accounting processes and financial procedures.

Businesses classified as small or medium-sized produce general-purpose financial statements for public use and are not accountable to the public (Mohammed et al., 2020). The fact that SMEs are not publicly accountable gives room for inconsistencies in financial statements This absence of consistency impacts adjustments to the acquisition of operations, the assessment of the creditworthiness of businesses, and the investment in prospects. SME businesses may lose out on these opportunities to grow and expand as a result (Sogomi et al., 2024).

Financial reporting standards are primarily intended to guarantee the uniform sharing of data across publicly traded corporations around the globe (Joshi and India, 2021). This consistency makes it easier to compare different businesses, which helps stakeholders like creditors, analysts, investors, and regulators make educated choices. However, in many developing countries including Nigeria, financial reporting has not been given its due focus when considering SMEs as they don't usually prioritize their accounting records for financial reporting (Abraham and Adeiza, 2021). Many SMEs are micro and would consider proper accounting as needless due to the requirements of professionals as well as the cost of carrying out such endeavors (Najera Ruiz, 2021).

The purpose of this research is to examine the critical role that efficient financial reporting plays in improving the sustainability, financial performance, and credibility of SMEs in Nigeria. The research will consider the importance of financial reporting in SMEs as well as the challenges.

SMEs in Nigeria - Concept

No one definition of SMEs can adequately represent the variety of small and medium-sized businesses or account for the variations among industries, nations, and companies at various stages of development (Varga, 2021). Most definitions of SMEs that are based on size make use of metrics like annual revenues, net asset value, or the number of employees (ACCA Global, 2024). Broken down, small-sized enterprises are defined as companies having between 10 – 49 employees and boasting a revenue of between N5,000,000.00 and N49,000,000.00, excluding properties and structures (SMEDAN). SMEDAN also defines medium-sized companies as those with 50 - 99 employees and having an annual revenue of between N50,000,000.00 and N490,000,000.00.

In Nigeria, the informal sector accounts for most of the trade businesses that occur in the country (Dell'Anno and Adu, 2020). SMEs operating in Nigeria function more in the informal sector due to the skepticism of operating in the global market where they can leverage exporting trade opportunities (Omeihe et al., 2021). Understanding the vital role of SMEs in every economy, ranging from positive developments to the creation of employment and their very key impact within the various sectors where they are operational, it therefore becomes crucial to analyze, the benefits and likely challenges of financial reporting for SMEs in Nigeria.

The Significance of Financial Reporting Standards to SMEs

Financial reporting plays a pivotal role in the success and growth of Small and Medium-sized Enterprises (SMEs), going beyond its regulatory mandate to become a strategic asset. They are essential for improving accountability and transparency in business decision-making (Salameh et al., 2022). To make informed financial decisions across different spectrums of the economy and geographical locations, financial reporting must follow a unique set of guidelines to ensure uniformity in reporting and a general understanding of the information being presented (Joshi, 2021). It is for this reason that the GAAP (Generally Accepted Accounting Principles) was instituted. GAAP provides guidelines for reporting financial data while also addressing the classification and identification of transactions as well as the appropriate timing for their disclosure (Schroeder and Cathey, 2022).

International businesses benefit from the use of International Financial Reporting Standards (IFRS) because it enables easier comparison of their financial accounts globally, despite variations in their home countries' accounting regulations. IFRS places a significant emphasis on offering clear guidance regarding asset recognition, depreciation methods, and disclosure prerequisites, particularly for transactions like mergers, acquisitions, or investments. This emphasis ensures consistency and transparency in financial reporting across diverse business landscapes. The International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) was published by the International Accounting Standards Board

(IASB) and is intended for private organizations that are not subject to public scrutiny (Damak-Ayadi et al., 2020).

Transparency and accountability are key benefits of effective financial reporting for SMEs. They are intended to raise the standard of the decision-making process and risk administration among market players, which would boost economic performance and the operation of the global financial markets. In an increasingly competitive business landscape, transparency builds credibility with various stakeholders. Customers, suppliers, regulatory authorities, and potential partners are more likely to trust an SME that provides transparent and easily understandable financial information (Grewal et al., 2024). This commitment to transparency not only fosters trust but also demonstrates ethical business practices. As a result, SMEs can cultivate long-term relationships with stakeholders, which can be instrumental in achieving sustainable growth.

Being transparent and accountable in business dealings as highlighted, contributes to the confidence in partnering or financing SMEs in Nigeria. In a Nigerian context, efficient financial reporting influences SMEs' ability to obtain financing. Financial institutions and potential investors frequently rely on financial reports to assess the creditworthiness and investment potential of SMEs (Varga, 2021). SMEs need financing for sustainability and expansion purposes. Faithful representation of an SMEs financial status illustrates a scenario in which the details and data of an SME are interpreted to reflect what occurred or the financial transaction that took place during a specific time frame (Nwonye et al., 2020). A well-prepared and precise financial statement can greatly enhance the likelihood of SMEs securing loans with favorable conditions. Moreover, it can draw the attention of potential investors by highlighting the company's financial stability and opportunities for growth (Joshi, 2021).

Efficient financial reports provide SMEs with insightful information for strategic planning (Lo and Sugiarto, 2021). These reports offer a thorough understanding of the company's financial situation, considering variables including profitability, cash flow, and possible dangers (Zada et al., 2021). Equipped with this data, small and medium-sized enterprises in Nigeria can make informed decisions about future growth strategies, potential investments, and internal enhancements. Akpa et al. (2021) stated in their research that due to the way strategic planning increases the productivity of organizations, it has become a widely accepted concept and activity across many industries. Planning is now a serious practice for small and medium-sized businesses and it may be an effective tool for monitoring performance swiftly (Abodunde, 2020). Bringing this into context, a thorough examination of the financial data of an SME, for example, may point out places where cost-cutting strategies can be used, or it may identify profitable projects that call for further funding.

Challenges Faced by SMEs in Financial Reporting in Nigeria

Notwithstanding the indisputable advantages, SMEs in Nigeria face several obstacles in their efforts to adopt efficient financial reporting procedures. It is impossible to overestimate the significance of having robust accounting and internal control systems for any size business. The majority of SMEs in Nigeria face common issues related to unexpected failure and a lack of knowledge about potential drivers of business growth and sustainability (Asuquo et al., 2018). Even if they could, many small businesses cannot afford the intricacy of a full accounting system; hence, single entries and, in certain cases, insufficient information are frequently found in their books. Many SMEs operate on tight budgets, making it challenging to invest in accounting software, and training programs, or hire skilled accounting professionals (Joshi, 2021). This limitation often results in errors, delays, or incomplete financial reports.

Most SMEs in Nigeria, due to factors such as resources and lack of awareness of the importance of financial reporting in the growth of their businesses, poorly keep records of their financial transactions creating difficulties in auditing activities of their business. Hendrawan et al. (2023) in their study discovered that Entrepreneurs of SMEs also faced difficulties in accurately calculating business earnings due to the poor use of accounting information for assessing their financial performance. Their research further revealed that the lack of accounting expertise of the owners and managers was blamed for the poor record-keeping. Keeping accounting records requires either a knowledgeable owner or outsourcing such activity to a professional. However, entrepreneurs are not knowledgeable and lack the financial backing to hire professionals to properly manage their books (Roslan, 2022). Skilled accounting professionals and financial experts are in high demand, and SMEs often find it challenging to attract and retain these professionals on a full-time basis (Anderson and McKenzie, 2022).

Moneva and Leukfeldt (2023) in their research of challenges to the adoption of accounting systems in SMEs stated lack of adequate training, willful misconduct, and negligence are among some of the critical issues with SME financial reporting. Supporting the statements of the previous paragraph on lack of knowledge, lack of literacy was identified by their research as a major issue, making it difficult for entrepreneurs to distinguish personal expenses from business expenses. The research further highlighted that enterprises with accounting record challenges struggled to access loans and funding for growth due to reduced creditworthiness. The SME sector's financial stability could be threatened by a lack of accounting knowledge and skills.

Recommendations - Towards Better Financial Reporting for Nigerian SMEs

The impact of effective financial reporting on SMEs in Nigeria cannot be overstated as seen in the preceding discussions. It serves as a powerful tool that, when utilized effectively, can drive growth, attract investments, and enhance the credibility of these enterprises. To sustain the SME sector, there must be widespread awareness among SME owners and managers about the benefits of effective financial reporting. Educating them on how proper reporting practices can improve their access to finance, attract investors, and enhance their business reputation is crucial. SME owners need basic accounting training to acquire the necessary knowledge that can assist in ensuring basic accounting records are kept by their companies. SMEs can also outsource their accounting functions to qualified accounting personnel with good motivational packages to enhance efficiency and morale and maintain a strong internal control system to prevent the misappropriation of funds.

Regulators and policymakers are encouraged to create and implement policies specifically designed to support the growth of Small and Medium Enterprises (SMEs). These policies should target the core constraints that often hinder the development of SMEs, including limited access to finance, bureaucratic red tape, inadequate infrastructure, and challenges in accessing markets (Alam et al., 2024). Training and support programs should be provided to SMEs to enhance their understanding of financial reporting principles. Workshops, seminars, and online resources can help SMEs improve their reporting practices.

Encouraging the adoption of user-friendly accounting software and digital tools can streamline reporting processes for SMEs. These tools can automate routine tasks, reduce errors, and improve the accuracy and efficiency of financial reporting. Many SMEs in Nigeria do not embrace technology to drive their business processes. As such, a lot of businesses struggle with managing their accounting processes which will require physically taking note of transactions (Imene and Imhanzenobe, 2020). There are several types of IT tools for accounting processes and business use, but they all follow a similar pattern. These types of tools include knowledge management systems, transaction registration and processing systems, decision support systems, infrastructure systems, and management information systems. The use of these tools improves the quality of financial information produced by SMEs thereby improving the quality of financial reporting from these firms.

Conclusions

Financial reporting is crucial for the success and growth of Small and Medium-sized Enterprises (SMEs) in Nigeria, as it promotes transparency, accountability, and informed decision-making. It goes beyond regulatory compliance and becomes a strategic asset for SMEs, allowing them to present their financial performance to stakeholders, and building trust and credibility. Efficient financial reporting boosts SMEs' creditworthiness, increases access to finance, and fosters trust in long-term relationships with stakeholders. It also aids in strategic planning, enabling SMEs to make informed decisions on growth strategies, investments, and cost-saving measures.

However, SMEs in Nigeria face challenges in adopting efficient financial reporting practices, such as limited resources, lack of awareness, and a shortage of skilled accounting professionals. To improve financial reporting, widespread awareness campaigns, training programs, and policies from regulators and policymakers should be implemented. Encouraging the use of user-friendly accounting software and digital tools can streamline reporting, automate tasks, and improve accuracy. By implementing these recommendations, SMEs can overcome challenges, improve reporting practices, and thrive in Nigeria's business landscape.

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