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FINANCIAL REPORTING QUALITY AT SMEs – A THEORETICAL APPROACH

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***ABSTRACT**: Financial statements are an organized set of data, which are required to be disclosed for each financial year in accordance with internationally accepted standards (IFRS) and / or the country-specific generally accepted accounting principles (GAAP). This published dataset, accessible to all, will be re-used and may form the basis for additional obligations such as taxation, decisions, analyses, statistics, etc. In view of this, quality expectations have been formulated in the regulation and on the part of users in connection with the financial statements. Research topics related to quality expectations can be found continuously in accounting journals. Particular emphasis has been and is being placed on these researches in connection with the scandals affecting various accounting fields periodically. Research on the financial reporting quality focuses mainly on listed companies.*
Such studies of financial reporting qualities in small-, and medium size enterprises (SMEs) are rare, despite the fact that in terms of their number, these companies make up a larger proportion of operating enterprises in almost all countries.
In the framework of the present research, we review and systemize the different approaches to the financial reporting quality based on the studies published from 2010 to the present. We examine the relevance of these identified quality aspects in the case of SMEs. We also examine, whether these methods used to examine the financial reporting quality of listed companies in particular are suitable and applicable for SMEs.
Our explore extends the research on the financial reporting quality to SMEs. By analysing the relevance of quality aspects and the adaptability of testing methods, it makes a significant contribution to the knowledge base of this limited researched topic.

JEL Codes: M41

1. Introduction

Investors and creditors consider several factors in their decision making process when investing in or providing debt finance to other companies. From this perspective, it is important to investigate, to what extent the financial statements published by the companies can be considered as qualitative. In recent years, after accounting scandals, quality of financial statements were investigated from several aspects, mainly from creative accounting and earnings management point of view. Reviewing the literature of and exploring these areas, we identified that most of the studies mention the quality of financial statements. We also gained the experience that researchers interpret and investigate the quality of financial statements from

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different perspective. However, research should not be carried out on a particular element from a given perspective, but the whole research framework should be investigated, even if this is complex to perform. This diversity aroused our curiosity about this research area and topic.

Researches in area of financial reporting quality is not so wide, therefore our aim is to contribute to this topic, by investigating it from Small and Medium Enterprises (SMEs) perspective.

As quality is key to our research, first we discuss what quality means.

2. Quality

According to the Merriam-Webster dictionary, quality has the following three meanings:

- How good or bad is something
- A characteristic or a feature that someone or something has: something that can be noticed as a part of a person or thing
- A high level of value or excellence

This variety of definitions also confirm the wide range of approaches on quality. Theory of Quality has not created an uniform concept of quality. The quality theory has not provided an unified, common accepted definition, thus we highlight some well-known approaches of quality.

According to Juran (1974) „quality is fitness for use." Quality means that a product meets customer needs leading to customer satisfaction, and quality also means all of the activities in which a business engages in, to ensure that the product meets customer needs.

Taguchi (1986) created the negative approach of quality, as he thought, that „quality is the loss a product causes to society after being shipped, other than losses caused by its intrinsic functions", meaning that quality is optimal where this loss is minimized.

According to Crosby (1979) defined quality based on 4 questions:

- What is quality?
- What systems are required to provide quality?
- What kind of quality standards should be used?
- What quality assessment methods are needed?

Quality is neither the conformance to requirements nor the goodness, but it is based on prevention, not on detection. Errors and mistakes are caused by lack of knowledge and attention,. He created the so called DRIFT theory, which means „do it right first time". He suggested to measure cost/price of non-conformance instead of cost of conformance.

Garvin (1987) proposes 5 approaches of quality, which were:

1. transcendent
2. product-based;
3. production based;
4. user based;
5. value based.

He also proposes eight critical dimensions of quality that can serve as a framework for strategic analysis. These are performance, features, reliability, conformance, durability, serviceability, aesthetics and perceived quality.

Literature on quality highlights some aspects can affect quality, like markets, money, management and leadership, people, suppliers, machines, IT systems, quality standards and requirements.

Interpretation of quality is one of the most complex area of quality theory. It is explained by that its subject cannot be only product, but it can be also a process, an activity, a system, a person, an organisation and the combination of these as well.

These are meeting demands, which can be distinguished by pre-defined and expected or required demands. However, pre-defined demands are identifiable e.g. from laws and regulations, expected demands are not easy to identify. These demands are defined as compliance.

Quality and compliance are the characteristics of the same object like product or manufacturing process, from different aspects.

Table 1

Comparison of comparison and compliance

Subjects Comparison aspects	QUALITY	COMPLIANCE
Nature of the concept	subjective	objective
Dimension	value	naturel
Dominant properties	functional	descriptive
Measurability	difficult to measure	easy, accurate measurement
Importance	primarily theoretical	primarily practical

Source: own editing by Turcsányi (2014)

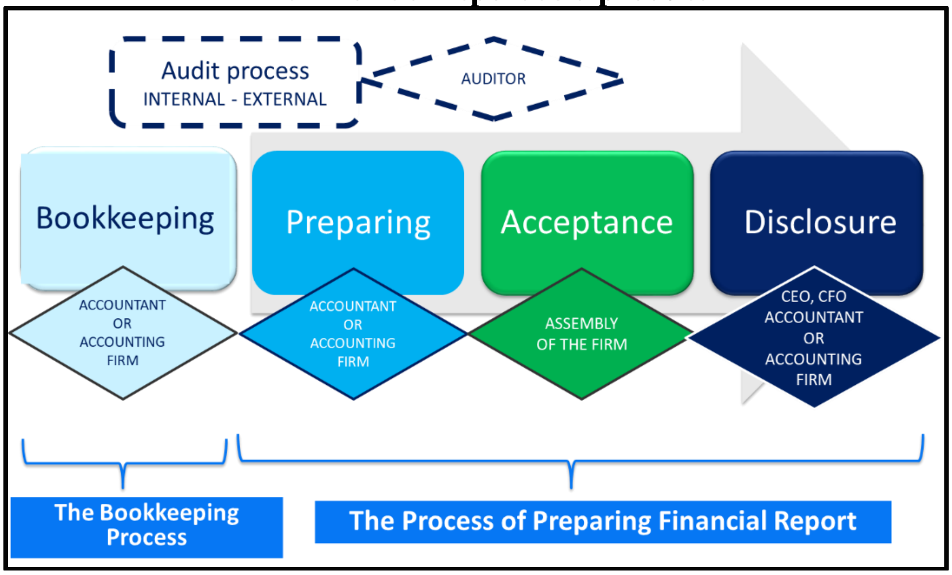
In Table 1 we have a comparison of quality to compliance from several perspectives. Taking the nature of the concept into account we can say that quality is subjective, but compliance is objective. From dimension point of view, quality can be defined in value, whereas compliance is natural. In case of quality, its dominant properties are functional, but these are descriptive in regard to compliance. From measurability perspective, quality is difficult to measure, whereas compliance can be measured easily and accurately. Both quality and compliance are important, but quality has theoretical importance primarily, compared to compliance, which is important primarily in practice.

After the general approach of quality, we investigate the financial statement as a product, which needs to be prepared in compliance with general presumptions of quality.

2. The Financial Reporting

Financial report or statement is the common result of more processes. The first process is the bookkeeping process, which supports the process of financial report preparation. This process is performed subsequent to the current year, paralel with the bookkeeping of next year. Beside these two processes, there is also an auditing process comprised by external and internal audit.

Figure 1
The Financial report as a product

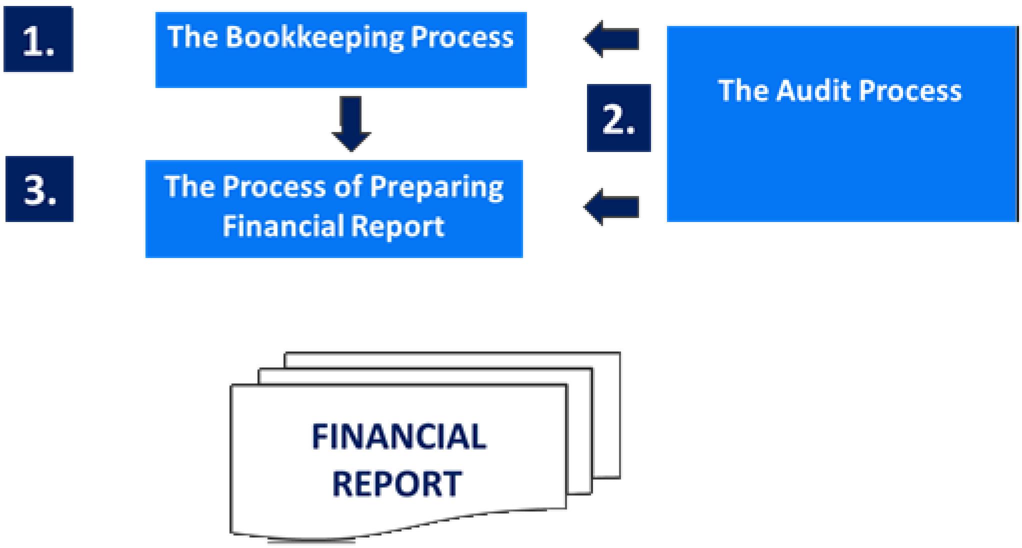


Source: own editing

Figure 1 shows well that the whole process, consisting of bookkeeping, report preparing and auditing processes, is a multi-actor one and these actors use several hardwares and softwares, to which they also contribute by their professional knowledge.

It is identifiable, that financial statement can be considered as the product of the whole process comprised by the three subprocesses in Figure 2. Furthermore this dataset is disclosed publicly.

Figure 2
The process of financial reporting



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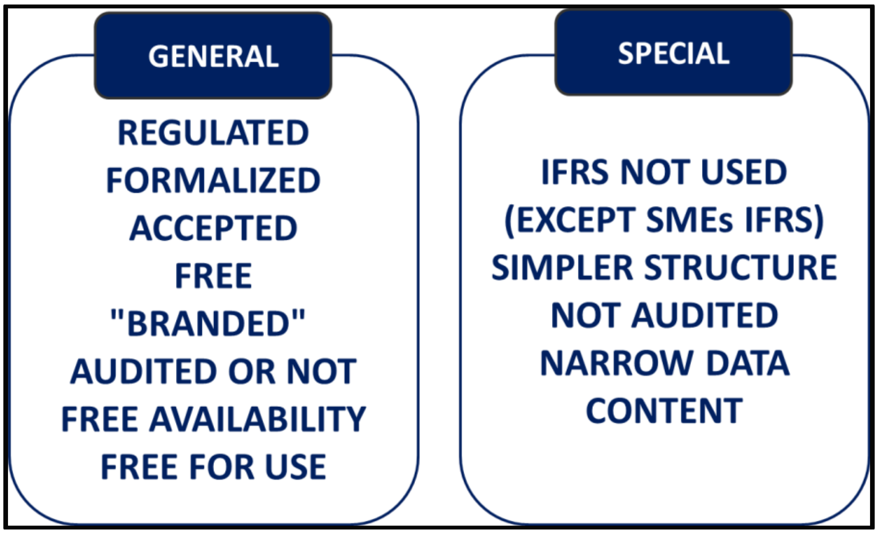
Considering the differences between the previously described process for regular large or bigger companies and for SMEs, the main deviation is that the audit process is missing from the majority of SMEs, there is neither internal nor external audit. Another difference is, that for SMEs, bookkeeping and also financial report preparation is mostly outsourced to an external bookkeeping service provider. An additional point to be mentioned is that the management of most of the SMEs are comprised by one or two persons, who are the Chief Executive Officers of the company and they are also the owner(s) of it. Furthermore, we cannot say that segregation of duties is exist, as in most cases, Chief Financial Officer function is not separated and relating tasks are also performed by the CEO(s) at an SME.

Taking a look at the situation of financial reports, it is still true that financial statement is a product, but for SMEs, it is only the result of bookkeeping and financial report preparing processes, as there is no audit process.

After the differences described, general characteristics of financial statements are compiled in Figure 3. They are regulated, by generally accepted accounting principles, or standards. They are also formalized as created by softwares. Financial statement can be called branded because the name of the company is included in every page of the report and in case of external bookkeeping service provider, their name is also mentioned. In most of the countries, it can be accessed and used free without any fees, but for databases created from more reports, we need to pay.

The general characteristics are still the same for SME reports, but there are additional special characteristics. For example, a huge difference is that SMEs do not use the regular IFRS standards, but they are allowed to use a limited IFRS called IFRS for SMEs. Other difference is that SME reports have an easier structure, mostly they are not audited and consists of a narrow dataset.

Figure 3
General and special characteristics of financial reports



Source: own editing

In the following, we examine the quality of the financial statements disclosed.

3. Quality of financial reports

If we take into account the quality of financial reports, we need to discuss qualitative characteristics first, which are defined by Conceptual Framework for Financial Reporting, published by IFRS Foundation, which separates two fundamental and four enhancing characteristics, those are relevance, faithful representation, verifiability, timeliness, understandability, comparability.

Figure 4
Characteristics of financial reports

Source: own editing by IFRS (2018)

Fundamental qualitative characteristics of accounting information that must be present for information to be useful in making decisions are Relevance and Representational faithfulness.

Relevance refers to how helpful the information is for financial decision-making processes. Therefore, accounting information is relevant if it can provide helpful information about past events and help in predicting future events or in taking action to deal with possible future events.

Representational faithfulness, also known as reliability, is the extent to which information accurately reflects a company's resources, obligatory claims, transactions. In order of accounting information to be reliable, it must be:

1. Complete – Financial statements should not exclude any transaction.
2. Neutral – The degree to which information is free from bias.
3. Free from error – The degree to which information is free from errors.

Fundamental qualitative characteristics are enhanced by secondary qualitative characteristics, which are verifiability, timeliness, understandability and comparability.

Verifiability is the extent to which information is reproducible given the same data and assumptions.

Timeliness is how quickly information is available to users of accounting information. The less timely (thus resulting in older information), the less useful information is for decision-making.

Understandability is the degree to which information is easily understood.

Comparability is the degree to which accounting standards and policies are consistently applied from one period to another. Financial statements that are comparable, with consistent accounting standards and policies applied throughout each accounting period, enable users to draw insightful conclusions about the trends and performance of the company over time. In addition, comparability also refers to the ability to easily compare a company's financial statements with those of other companies.

After the general characteristics of financial statements, we consider the quality of financial statements. Financial Report Quality (FRQ) is a concept that is often referred to in academic literature either directly but more often indirectly through notions of „quality of information". The identification of a single, generally accepted definition has been regarded as difficult (Ball et al., 2003, Cheung et al., 2010, Dechow et al., 2010). This difficulty is evident by the range of approaches used by researchers. Agienhohowa and Ilaboya (2018) comment that the concept of FRQ has been open to complex, confusing, and contradictory dabates on financial reporting and accounting standard-setting globally. Mbobo and Ekpo (2016) note that researchers, practitioners, and regulators either disagree or are even silent as to a clear definition of what constitutes FRQ.

One of the possible reasons for this difficulty of defining FRQ is that different users utilize financial reports with different objectives and different information needs. Beattie et al. (2004), Dechow et al. (2010), McDaniel et al. (2002) and Mai (2013) argued that the quality of information is a subjective construct, and users of that information would judge about its quality for themselves. Therefore, it is not surprising that prior literature has struggled to come up with a generally accepted FRQ definitition and with identifying a set of absolute quality assessment criteria.

Table 2 gives an overview of the variety of quality perceptions and FRQ definitions. Notably, as identified by Achim and Chiş (2014), the definitions vary considerably across individuals, projects, companies, and organizations, depending on the purpose of using financial information.s

Table 2

Definitions and views for FRQ

Author/s	FRQ definition and views
Jonas – Blanchet (2000)	„Full and transparent financial information that is not designed to obfuscate or mislead useres."
Dechow – Dichew (2002)	Accounting quality is linked to the order of magnitude of accrual-based estimation errors.
Cheung et al. (2010)	„Quality depends on „for whom the information is prepared" and „for what purpose"."
FASB (2010)	„Transparency, high quality, internal consistency, true and fair view or fair presentation, and credibility have been suggested as desirable qualitative characteristics of financial information. However, transparency, high quality, internal consistency, true and fair view or fair presentation are different words to describe information that has the qualitative characteristics of relevance and representational faithfulness enhanced by comparability, verifiability, timeliness, and understandability."
Steinheim - Madsen (2017)	Accounting quality is a measure to assess accounting information.
CFA (2019)	"FRQ refers to the characteristics of a firm's financial statements. The primary criterion for judging FRQ is adherence to generally accepted accounting principles (GAAP) in the jurisdiction in which the firm operates. Given that GAAP provides choices of methods and specific treatment of many items, compliance with GAAP by itself does not necessarily result in financial reporting of the highest quality. High-quality financial reporting must be decision-useful. Two characteristics of decision-useful financial reporting are relevance and faithful representation."

Source: own editing

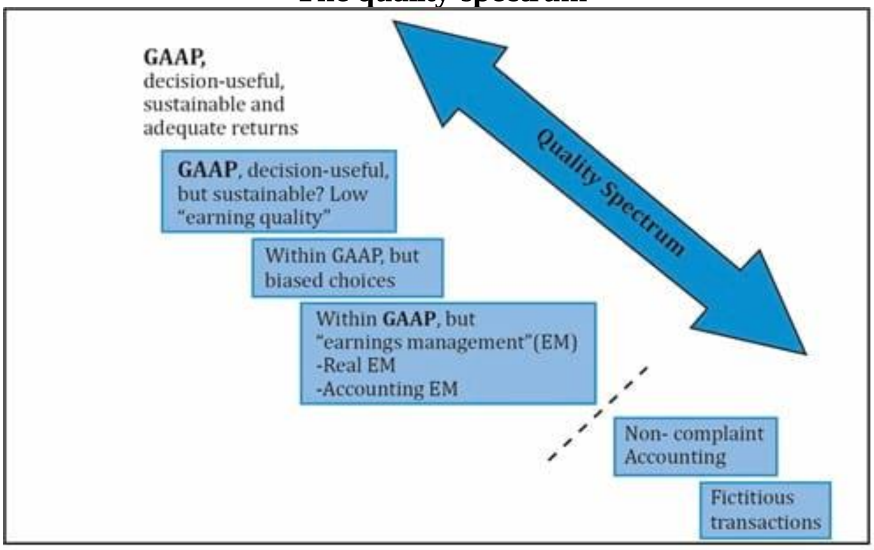
It can also be seen from the above definitions that researchers interpret and examine this quality in different ways.

Figure 5 shows the quality spectrum of financial reports, which is comprised by financial reporting quality and earnings quality. Financial reporting quality means that if financial reports are high quality, they provide information that is useful to analysts in assessing the company's performance and prospects. They contain information which are relevant, complete, neutral and free from error.

High quality reporting helps in making the right decisions and it depicts the true economic reality of the company. Low quaility reporting contains inaccurate, misleading or incomplete information.

In case of earnings quality, sustainability is the key term, because high quality earnings result from activities that the company is likely to sustain in the future and provide a sufficient return on company's investment. When company uses accrual-based earnings management techniques, it suggests a low earnings quality.

Figure 5
The quality spectrum



Source: IFT CFA Program (2020)

These two quality categories together are combined in the quality spectrum, on which we can define six different levels, from the highest to lowest quality levels. In case of situations below the borderline, we can tell that financial reports are not compliant with GAAPs, whereas the four levels above the borderline shows that financial reports are compliant with the actual standards and accounting regulations.

In the next section, we provide a summary of aspects from which financial reporting quality is investigated.

4. Summary findings of our research

During our research we investigated studies published from 2010 to 2021 discussing the topic of financial report quality and came to the conclusion, that financial report quality is equalled to the quality characteristics defined by IASB. Some researchers extended those characteristics by some others. Those studies and researches are mainly based on companies, which are listed on stock exchange, accordingly the sample sizes are on a wide range from 6 to 8 081 companies, mainly using smaller samples. Otherwise, companies investigated are mainly from a specific country exchange, there are few studies examining a cross-border sample. The methodology applied is not unified either, this is mainly the combination of more methods. Results are described as general but ignoring the fact that they only investigated listed companies.

In those researches they tested the compliance to the standards, earnings management and factors affecting the quality.

As Table 3 shows, the investigated studies show a wide variety from the aspect, what the authors examined in comparison to financial report quality.

Table 3

Examination of quality factors

Categorization	Examination	Autors
PEOPLE	Employees quality	Call et al. (2017)
	CEO age	Huang et al. (2012)
	The influence of Auditor	Chyz et al. (2018)
	Gender of CEO	Kim (2017)
UNIT	Audit Committee Characteristics – Audit Inputs	Segal (2013)
	Audit Committees	Kusnadi et al. (2016)
	Company Board	Nouri-Abaoub (2016)
PROCESS	Internal Audit	Johl et al. (2013) Abbot et al. (2015)
	Earnings management	Tariverdi (2012)
	Corporate Governance	Gajevszky-Honu (2014) Katmon-Farooque (2017)
ENVIRONMENTAL FACTOR	The influence of Culture	Hashim (2012)
	Business Ethics	Labelle et al. (2010) Pae (2011) Jinhan (2011)
	Information Technology	Sacer-Oluic (2013)
OTHER	Cost of Capital	Ly (2010)
	Credibility	Shroff (2015)
	Audit fees	Loukil (2016)
	Trust	Garrett et al. (2012)

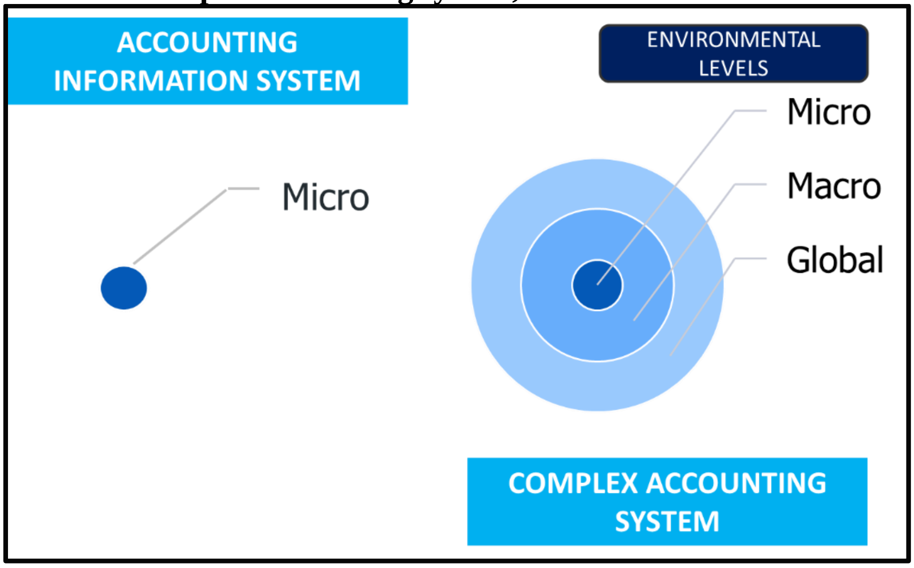
Sours: own editing by literature

After the categorization of each factors, part of those is relating to people, unit, process and environmental factors. This categorization also highlights that researches were performed on an ad-hoc basis rather than in a structured way.

5. Suggestions and room for improvement

Our primary suggestion is to apply a systematic approach in financial report quality researches. This could allow a research framework, which also allows us to distinguish areas which are mainly in focus and those which are out of focus. To this aim, we suggest the complex accounting system model, which we introduce on the next slides.

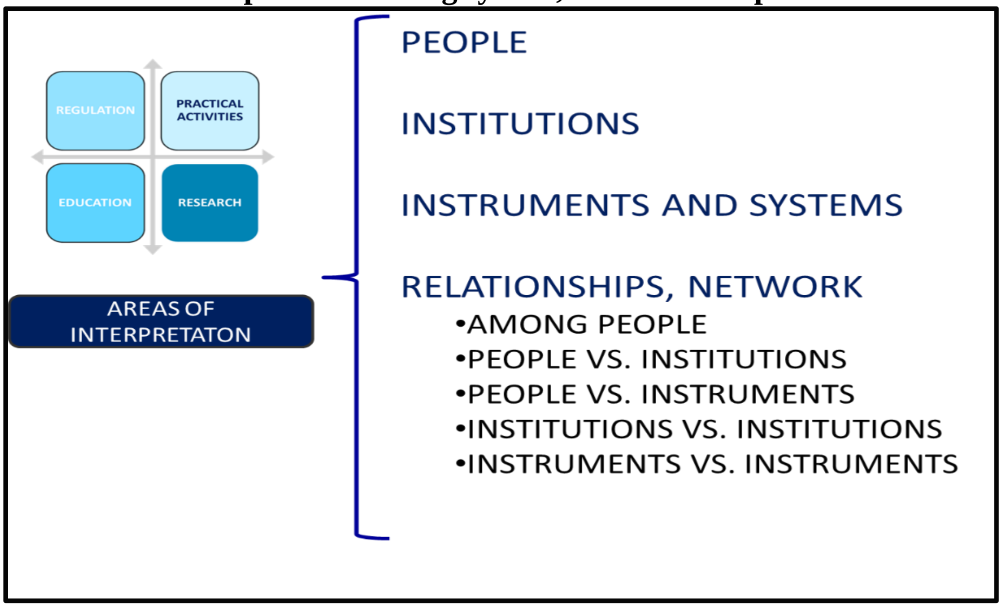
Figure 6
The complex accounting system, environmental factors



Source: Budai (2007)

The model of complex accounting system extends the interpretation of accounting information system by distinguishing three different environmental levels – see in Figure 6. Those are micro, macro and global levels, of which micro level comprises the companies and enterprises, macro level comprises a particular country, and global level comprises the whole world.

Figure 7
The complex accounting system, areas of interpretation

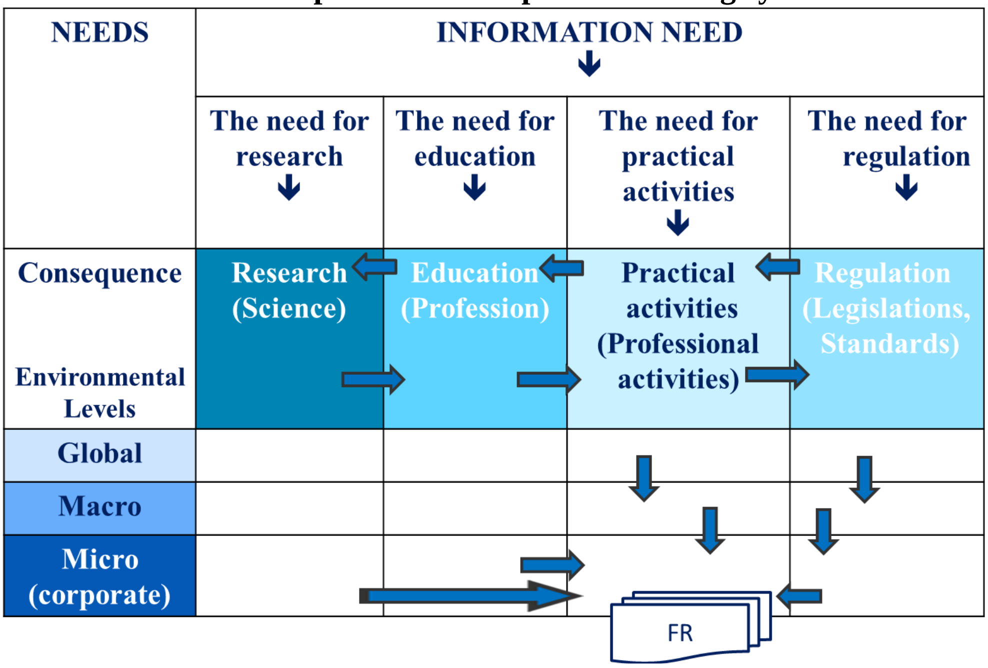


Source: Budai (2007)

The complexity of the model – in Figure 7 – is given by that it defines four interpretation areas on each levels. Those areas are practical activities, regulation, education and research. These four areas are defined and explained by the basic information needs.

All interpretation areas are comprised bythe elements of the system on all levels. Those are people, institutions and organisations, instruments and systems, and relationships and networks.

Figure 8
Financial report in the complex accounting system



Source: own editing based on Budai (2007)

In the complex accounting system, financial report is placed on micro or corporate level, in column of practical activities, due to the fact that financial report is the result and product of the practical activities – see by Figure 8.

This is the particular part of the system which will be also published but it is also used within the system, in the company and in external systems as well. This system allows the analysis and examination of factors affecting the preparation and the quality of financial statement.

Turning back to our suggestions, we also suggest the identification of users of financial reports and their information needs, because current studies assume that those needs are covered by only the six principles published by IASB.

Our suggestions are general and can be used to all researches aiming to investigate the quality of financial statements.

Specifically for investigation of SME financial reports, we suggest country-specific compliance testing, based on a cost-benefit analysis and considering its usefulness. Country-specific approach is explained by the fact that for SMEs, there is no unified system like IFRS for listed companies.

According to literature review and previous researches, for SMEs, we found that M-Score model of Beneish and the modified Jones model (Denich, 2021; Hajdu, 2017) from earnings management detection models could be applied but not ignoring the opportunity that these models could be applied only with some differences.

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