

CHAPTER 1

INTRODUCTION TO THE STUDY

1.1 Introduction

In Malaysia, Small and Medium Enterprises (SMEs) have a particularly important part in the country's economic development. The effect of SMEs on the global or international economy plays a critical role in the development of a poverty-free society. It is obvious that businesses not only provide sufficient job opportunities to people from all backgrounds of life, but it also ensures that money flows effortlessly between them (IQualify UK, 2020). SMEs are crucial because they now employ over 7.3 million people from 15.1 million total of Malaysia's employment. Data from the economics census 2016 stated that, SMEs in Malaysia accounted for 98.5 percent of all business establishments cut across all sizes and sectors. Based on the Department of Statistics Malaysia in 2020, the sector of SMEs resulted 38.2 percent of the gross domestic product (GDP) country's, 13.5 percent of total exports, and SMEs employment comprised 48 percent of Malaysia's employment (SMEs Annual Report, 2019/2020).

Since the transition to MPERS for SMEs was announced in 2013, private entities have had two years to get ready for the new requirements. The Public Practice Committee (PPC) members did observe that private entities generally lacked urgency and awareness regarding the MPERS transition. PPC members noted that there would be some difficulties in the new standard's adoption, which will take the place of the outdated PERS. According to a study by Krishna et al. (2020), SMEs may regard MPERS as being too complex for business use and that its unfavourable characteristics, such as cost that outweighs its benefits, make it less likely for business to adopt it. These

changes have raised a mixed response between the market players such as business owners, government, and the accounting bodies.

In accordance with Malaysian Accounting Standard Board (MASB), from 2016, the financial statements of private entities including SMEs will be comparable in at least 73 countries, involving Hong Kong, United Kingdom, Singapore, Australia, and 14 countries are considering adopting the IFRS for SMEs which is International Financial Reporting Standard for Small and Medium Enterprises. The key differentiation between IFRS for SMEs, MPERS, and MFRS is MPERS applicable for private entities, while IFRS for SMEs are only applicable for SMEs without public accountability, and MFRS is only being applied by non-private entities except for transitioning entities. MPERS is in accordance with IFRS for SMEs, but with some adjustments and customisations for the Malaysian business environment, it is seen as an opportunity for companies because it can ensure the convergence and comparability of local and foreign businesses as an international accounting standard and MPERS.

1.2 Background of the Study

From 1978 until 1996, the Malaysian Institute of Accountants (MIA) and the Malaysian Institute of Certified Public Accountants (MICPA) produced accounting standards that were enforceable under their ethics codes. The Malaysian Accounting Standards Board (MASB) was established in 1997 as an independent institution to create, issue, and introduce accounting and financial reporting standards in Malaysia under the Financial Reporting Act (FRA).

The primary responsibilities of the MASB are to create and implement an accounting and financial reporting framework that will be used for general purposes when applying financial statements of private firms. Prior to now, SMEs used Private Entity Reporting Standards (PERS), which were considered to be out of date because no modifications had been made since the last IAS, which was implemented in 2003. (Team, 2016). Private firms can use PERS instead of complicated international reporting requirements to submit annual financial statements. PERS removes a number of disclosure rules that are burdensome for private firms to comply with and less useful for decision-making. Only when a private company qualifies to be administered as a private entity for the entirety of the annual period. Furthermore, organisations that are accountable to public such as charitable organisation, social services and other public accountable activities, are not permitted to use PERS and must rather use the Financial Reporting Standard (FRS).

The Malaysian Private Entity Reporting Standards (MPERS), which were published by the MASB in February 2014, established new financial reporting guidelines for private enterprises in Malaysia. The MPERS framework was examined in May 2015 using the IASB standard, which is IFRS for SMEs. For annual periods beginning on or after January

1, 2016, all private entities, including SMEs, must implement MPERS to produce their financial reporting (MASB, 2016). Various market participants, including accounting bodies, business owners, and governments, have reacted to its acceptance in different ways.

Only private entities are covered by MPERS. A private entity, which is defined as a private company, operating under the laws of Malaysia and incorporated under the Companies Act 2016 (previously known as the Companies Act 1965), is not required to make or prepare financial statements in accordance with the requirements of the Securities Commission or Bank Negara Malaysia. In addition, a private firm is not a subsidiary, associate, or joint venture of a business that is required to produce financial statements by the Securities Commission or Bank Negara Malaysia. Business may use the Malaysian Financial Reporting Standards (MFRS) in its place if it does not even intend to adopt MPERS. All private entities using the MFRS or MPERS framework should make sure the standard is adhered to strictly (PWC, 2015). SMEs must make a decision in advance regarding whether they should convert to MFRS or migrate to MPERS because of the complexity of the first-time MPERS adoption criterion.

SMEs will have opportunities, but they will also face significant challenges as a result of globalisation. It is noteworthy and significant that Malaysian SMEs created an international financing reporting language, which is now used by 73 nations globally (MASB, 2015). Malaysia's SMEs have done remarkably well, with overall GDP rising by 5.8% in 2019 compared to 6.2 percent in 2018. The performance was still higher than Malaysia's GDP, which grew by 4.3 percent. The contribution of SMEs to GDP rose to 38.9 percent, up from 38.3 percent in the previous year (SME Annual Report 2018/2019). However, due to Coronavirus disease (COVID-19) outbreak in 2019, for the first time in

17 years, SMEs' GDP growth in 2020 was negative in 7.3 percent, lesser than Malaysia's GDP for the first time since 2003. In 2020, SMEs projected 38.2 percent of GDP, with a value added of RM512.8 billion, dropping from 38.9 percent and RM553.5 billion of the previous year (SME Annual Report 2019/2020).

The general health of the economy depends on highlighting the role that SMEs play in economic development, long-term sustainability, and growth. Malaysia's government has implemented a variety of policies and programmes to support economic development, innovation, and global competitiveness. To assist businesses and households affected by the COVID-19 outbreak in 2020, Bank Negara Malaysia (BNM) is investing RM3.3 billion in financing facilities under its Fund for SMEs. These funds will be used to support business operations, increase employment, and encourage domestic investment (Bank Negara Malaysia., 2020). In addition, the most important thing for SMEs, according to the MASB, is to support and execute higher quality accounting and financial reporting standards that are compatible with global quality standards for the benefit of Malaysian users, preparers, auditors, and the general public. One of the advanced factors for MPERS adoption is stakeholder desire for quality information and greater transparency. The quality of the financial statements is explained in qualitative characteristics. The qualitative characteristics of financial statements, according to Syahputra and Saraswati (2020), are normative steps that must be incorporated into accounting information in order to achieve their objectives. The necessary regulatory specifications for financial statements that will fulfil the required standard, are relevant, reliable, comparable, and understandable.

The quality financial reporting will measure the value of financial reporting and relies on it. The requirement to measure the value of financial reporting has gone out all over the

world to have a clear and accurate description of the quality of the financial statement. The requirement of faithfulness and the financial information quality in a business financial report are due to the basic principle of determining the consistency of financial reporting quality, in accordance with IASB. These qualitative characteristics enable an assess of financial reports usefulness, which can lead to the higher standard of quality.

Improved accounting quality and the growth of more value-added accounting data relevant to MPERS are frequently linked to MPERS implementations. The introduction of MPERS is intended to improve the quality of financial reporting. However, how this characteristic might be operationalized and measured has been the main focus of previous study. Financial reports must be relevant, timely, understandable, comparative, and reliable in order to be of the highest quality possible. As a result, emphasis is placed on giving users accurate financial reporting rather than false information, as well as on the significance of predictability and consistency as signs of greater financial reporting quality (Gajevszky, 2015).

This thesis attempts to study the MPERS adoption and financial reporting quality by SMEs through evidences obtained in Malaysia. Accordingly, this study also intends to shed light on the qualitative characteristics, (relevance, timeliness, comparability, understandability, and reliability) of financial reporting quality, and this will reflect the relationship of the MPERS framework and quality financial reporting. Through this research, it will be establishing a relationship between MPERS adoption with financial reporting quality and will discuss how MPERS adoption affects the quality financial reporting. Aside from contributing to the existing literature, the study not only explores the MPERS framework, but also provides insights view into SMEs in Malaysia. Meanwhile, this thesis also provides empirical evidence on the relationship between

MPERS and quality financial reporting, which subsequently provides recent evidence to Malaysia SMEs and contributes to the current literature.

1.3 Statement of the Problem

Malaysia is currently facing more fierce competition from other countries across the world in the era of globalisation and the higher demand for transparency. One of the actions taken by the MASB in its attempt to develop an effective and higher financial reporting quality that will supplement the financial system required to support Malaysia's SME's economic development is to introduce a latest financial reporting standard for private entities, known as the MPERS framework.

There are some significant key impacts or changes in certain areas arising from MPERS implementation. First is the concept of undue cost or effort exemption. MPERS has introduced the concept of undue cost or effort, which exempts an asset or liability from using the fair value approach if it incurs undue costs or effort throughout the valuation process (MIA, 2018). This necessitates taking into account how the lack of information required to comply with a requirement usually involves cost or effort and could affect the financial decisions made by private entities that are expected to use the financial statements. Secondly, there are also significant changes in the measurement concept of 'fair value less cost to sell' (Tan, 2015). MPERS does not prescribe how fair value must be measured for each form of asset or liability, so it will affect SMEs to measure asset or liability. Then, there is a significant key impact or changes included in section 13 for deciding inventory costs, MPERS last in, first-out (LIFO) method has been disallowed. Due to the potential for distortions in a company's profitability and financial statements, MPERS forbids LIFO. Additionally, it may lead to out-of-date and obsolete inventory valuations, which will affect SMEs' ability to make decisions.

Therefore, these significant key impacts or changes would affect the quality of financial reporting by the implementation of MPERS as it affects decisions making as well as its performance level. So, due to these changes, this study wants to see the extent MPERS has been adopted and to ascertain the relationship between MPERS and financial reporting quality.

Additionally, one study by Pais and Bonito (2018) has explored that, if countries including Malaysia allow or require listed companies to use the IFRS framework and have a similar legal framework, the cost of establishing their own financial reporting framework, as well as familiarity with the IFRS settings may be reduced. MPERS might enable convergence and comparability of local and foreign businesses with a little adaptation and adjustment to the Malaysian industry environment. The MPERS is issued to reduce the cost of financial reporting. Therefore, through MPERS, the business will save and reduce the reporting costs when it comes to national planning and implementation of the standards. The fundamental argument for the SME standard, as mentioned in IFRS for SMEs (2021), is the unnecessary cost reporting burden, which is proportionally larger for small businesses. The cost of applying the entire set of IFRS standards may not be justified due to user's needs as well as high reporting costs. The reporting cost could be reduced by the adoption of MPERS, but whether the results of quality financial reporting will be higher or lower. Thus, this study wants to show whether the cost of compliance with MPERS will compromise the quality of reporting or vice versa.

According to Jamil et al. (2020), there seem to be issues or problems in respect of the MPERS adoption due to the no latest PERS framework issued by MASB. PERS previously prepared private entities with an alternative way of reporting annual financial statements in line with international accounting standards. MASB issued PERS up until

2003 according on accounting standards developed by the Committee for IAS, which are now outdated and should be reviewed as soon as possible. Since then, no new PERS has been released after January 1st, 2006. Between PERS and the latest reporting framework, MPERS, there is an 11-year gap. Despite the fact that the MFRS has faced significant changes, developments, and improvements over the former 11 years, the PERS framework has remained unchanged. The IFRS and MFRS have always been modified as a whole, but not for SMEs specifically. MPERS was published by MASB to introduce the improved standard for SMEs and to assess the quality of the financial reporting after the implementation. SMEs will face the problem if there are no new standards such as the financial reporting cannot provide relevant, reliable, and useful information which could bring to lower quality and less understandable set of accounting framework for SMEs.

As a result, from 1st January 2016, all private entities must adopt MPERS, making management able to analyse the gap and assess the implications to guarantee a smooth transformation into the latest standard. By providing a Malaysian version of the framework called MPERS, it will contribute to convergence and comparability of local and international companies. Subsequently, the financial statements of local SME companies are becoming more comparable and consistent. Could the lack of adoption of MPERS be attributed to the perceived low quality of financial reporting? Considering the problem and issues addressed earlier, it is noteworthy for the study to critically study the relationship between the adoption of MPERS for SMEs and the quality of financial reporting to address the impasse from an informed perspective.

1.4 Purpose of the Study

The main purpose of this research is to study the relationship between Malaysian Private Entity Reporting Standard (MPERS) adoption and the financial reporting quality by Small and Medium Enterprises (SMEs) in Malaysia.

1.5 Research Questions

The research aims to answer the following questions:

- i. How far MPERS has been adopted by SMEs?
- ii. What is the state of financial reporting quality by SMEs?
- iii. What is the relationship between MPERS adoption and financial reporting quality by SMEs?

1.6 Objectives of the Study

There are three primary objectives of this study:

- i. To establish whether SMEs have adopted MPERS.
- ii. To assess the financial reporting quality by SMEs.
- iii. To ascertain the relationship between MPERS adoption and financial reporting quality by SMEs.

1.7 Significance of the Study

This study contributes in certain ways. First, from the literature point of view, this study is predicted to contribute as empirical evidence on the problems and issues related to the current practices in financial reporting for the new standard, MPERS and the relationship between MPERS and quality of financial reporting by SMEs in Malaysia.

This research is expected to extend the literature on broader and comparative pictures of MPERS adoption in Malaysia and the financial reporting quality by SMEs. This study also will come up with the latest evidence that MPERS play a importance role in SMEs. By considering the outcome of the study and the application of related recommendations on the relationship between MPERS and the quality of the financial reporting by SMEs, businesses will realise the need to adopt standards, policies by which quality financial information can be produced. The preparation of financial statements from set standards will enhance the company's internal controls. Moreover, this will reduce the chances of fraud, manipulating of accounting figures, and deliberate misrepresentation (Rahim et al., 2017). The benefits gained by SMEs using MPERS for SMEs would improve the confidence because the financial statements have been prepared using a higher quality framework introduced by IASB, a well-respected board in the international community because MPERS is accordance of IFRS for SMEs (Salin, 2017). As a result, accurate and reliable financial statements would protect users' interests and increase their trust (Husnin et al., 2016 and Jais et al., 2016).

In addition, this study will contribute to practice by provide evidence to users of financial reports. The fact that formal financial reports are needed by lenders like commercial banks to obtain loans to finance a business. It is necessary because businesses who are unable to repay their loans would put lenders at risk. For suppliers, financial reports are required to assess the liquidity and solvency of the firm. In a business environment, suppliers frequently open trade accounts with a variety of companies. This allows the business to pay for the purchase within a specified period rather than all at once. Financial statements would be required by suppliers to determine if it is safe to extend credit to a business. Financial reports are needed by government authorities, particularly those that assess business taxes, in order to ensure that

corporations pay a fair amount of their tax revenue. It was thought necessary to present evidence from studies proving that MPERS adoption is the key to those who appreciate financial reports that pass quality test. SMEs will be able to understand the need of preparing quality financial reports in line with MPERS as a result of this study.

In terms of policy, this study is anticipated to come out with the framework from quantitative characteristic of quality financial reporting and MPERS by SMEs. For SMEs, the MPERS report will enhance the comparability and consistency of financial statements of local SMEs that have used MPERS for SMEs, and international SMEs financial reporting that have used IFRS for SMEs (Aziz et al., 2019). With certain adjustments to the Malaysian business climate, MPERS can make sure that SME financial reporting and disclosures are consistent and comparable to financial reporting of global SME firms that have accepted the IFRS for SMEs. The findings are also expected to assess the relationships between SMEs' financial reporting quality and MPERS. Higher quality financial reporting is essential to influencing users' decisions to increase market efficiency and make investments. This is one way to put it: the greater the benefits of financial reporting to users and investors, the higher the quality of financial reporting.

Thus, it appears that the need for literature is increasing and growing to complement previous studies. by providing the latest empirical research on MPERS and the quality financial reporting for SMEs in Malaysia. Through this study, SMEs can would aware the need for compiling quality financial reports in line with MPERS.

1.8 Scope of the Study

i. Content scope

This study, which focuses on SMEs, includes all sectors, such services, manufacturing, agriculture, mining and quarrying, and is further classified into three categories: micro, small, and medium. Based on the classification of commercial establishments in Malaysia, these sectors were chosen.

ii. Geographical scope

The study was conducted in Klang Valley to represent Selangor and Kuala Lumpur. This is because, it has the largest concentration of businesses and acts as the main commercial centres in Malaysia with 98.5 percent of all business establishments in Malaysia are SMEs, and Klang Valley (Selangor and Kuala Lumpur) represented for nearly one-third of the total SMEs, which is 34.7 percent based on the Economic Census 2016.

iii. Time scope

The study considered MPERS adoption for SMEs and the financial reporting quality since the implementation of MPERS, that is 1st January 2016. This period choice is long enough to establish a trend, which allows for comparability and thus underpin credible research finding.

1.9 Chapter Summary

The aims of this study are to investigate the relationship between the Malaysian Private Entities Reporting Standard (MPERS) adoption and the quality of financial reporting by SMEs in Malaysia since the standard was released in February 2014. It also aims to provide additional empirical evidence regarding the relationship between the MPERS and quality financial reporting. The background MPERS for SMEs

adoption in Malaysia, problem statement, purpose, research questions, objectives, significance of the study, and scope of the study are all presented in the first chapter. The next chapter presents a review of literature on MPERS adoption and SMEs' financial reporting quality.

