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The Development of Financial Reporting Framework for SMEs in Sri Lanka Special Reference to Vavuniya District

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Abstract

This study develops a financial reporting framework for SMEs in Vavuniya District. It identifies the main users of SME financial information, examines their needs, and considers the relevance of international standards. The research uses qualitative methods, including surveys of SME owners and accountants, as well as interviews with bank officers, tax officials, and policymakers. Results show that owner-managers focus on cash flow and business survival, banks want reliable, comparable information, and tax authorities drive reporting through compliance requirements. For smaller businesses, international comparability is not essential. The analysis finds that Sri Lanka adopted IFRS for SMEs mainly under global pressure, not local needs. To address this, the study suggests a four-level reporting system: full IFRS for public companies, a simpler SLFRS for large SMEs, basic accrual reporting for medium SMEs, and cash-based templates for micro and small businesses. This user-focused approach aims to help SMEs get credit, improve accountability, and support sustainable growth in Vavuniya and similar areas.

Keywords: SMEs, financial reporting, IFRS for SMEs, Sri Lanka, institutional theory, Vavuniya District

Introduction

Small and Medium Enterprises (SMEs) are vital to Sri Lanka's economy, accounting for over 75% of businesses and about 45% of jobs (Thathsarani, Naranpanawa, & Bandara, 2023). They contribute roughly 30% to the country's GDP and are central to industrial growth and reducing poverty (Wijekoon, 2018). In the Northern Province, especially in Vavuniya District, SMEs help rebuild communities after conflict by creating jobs, supporting trade, and strengthening local supply chains. For people recovering from years of civil war, SMEs are important for resilience, social inclusion, and regional growth. Despite their importance, SMEs in Sri Lanka face structural and institutional challenges, including limited access to credit, inadequate financial management, and high vulnerability to economic shocks (Abeygunasekera & Fonseka, 2012; Thathsarani et al., 2023). Poor financial reporting is widely cited as a key reason for SME underperformance and financial exclusion. Owner-managers often prepare accounts mainly for tax purposes rather than decision-making or credit evaluation, resulting in information asymmetry that limits access to finance (Wijekoon, 2018; Devi & Samujh, 2014).

These problems are especially clear in the Vavuniya District. Most SMEs here operate in small-scale farming, trading, and services, with limited contact with international markets and access to professional accountants. They often cannot meet complex accounting rules. Still, banks, tax authorities, and government agencies expect reliable and comparable financial statements. This gap underscores the need for a reporting system that aligns with the local context and balances user needs with what SMEs can afford.

Problem statement and research questions

Sri Lanka adopted the IFRS for SMEs in 2012, in line with international convergence trends. While the standard was intended to simplify reporting for non-publicly accountable entities, it retains many concepts irrelevant to SMEs in developing contexts, such as fair value measurement, hedge accounting, and foreign currency translation (Evans et al., 2005; Wijekoon, 2018). Empirical research shows that Sri Lankan SMEs rarely require internationally comparable information, given their limited cross-border operations (Wijekoon, 2018; Nguyen et al., 2023). Instead, they prioritize practical, cost-effective financial information for survival and credit access.

Research Questions

RQ1: Who are the users of SME financial information in the Vavuniya District, and what are their information needs?

Information needs?

RQ2: To what extent do SMEs in Vavuniya require internationally comparable reporting standards such as IFRS for SMEs?

RQ3: Which financial reporting framework best balances user needs, comparability, and compliance costs for SMEs in this region?
How are the compliance costs influencing SMEs in this region?

Objectives of the Study

- To identify SME financial information users in Vavuniya and assess their needs.
- To evaluate the suitability of IFRS for local SMEs.
- To propose a user-focused, tiered financial reporting framework for Sri Lankan SMEs and identify the compliance costs affecting SMEs in the Vavuniya District.

This research adds value in theory and practice. It uses institutional theory to explain why global accounting standards do not always fit local needs. For policymakers and professionals, it suggests a framework to improve credit access, lower compliance costs, and help SMEs grow sustainably.

Literature Review

SMEs and their Economic Significance

SMEs are widely seen as necessary for the economy. In the European Union, they make up more than 99% of all businesses (Kaya & Koch, 2015). In developing countries, SMEs help drive growth, create jobs, and support regional development (Islam, Rahman, & Ali, 2011). In Sri Lanka, they are the backbone of the economy, leading innovation and helping reduce poverty (Wijekoon, 2018). This is especially true in Vavuniya District, where there are few large industries and SMEs lead post-conflict recovery.

Recent research underscores that SMEs contribute to financial inclusion and community resilience. Thathsarani et al. (2023) developed a financial inclusion index for Sri Lankan SMEs, highlighting demand-side, supply-side, and institutional determinants. Their findings reveal that SMEs' ability to access finance is directly linked to the quality and credibility of their financial reporting. This reinforces the need for reporting frameworks that align with SME realities.

Financial Reporting Challenges for SMEs in Developing Contexts

The problems SMEs face with financial reporting are well known. Many lack the money or skills to prepare good financial statements (Huck & McEwen, 1991). In Sri Lanka, tax authorities have significant influence, so reporting focuses on meeting tax rules rather than supporting business decision-making (Wijekoon, 2018). This makes financial statements less useful for banks and owners, who need up-to-date, accurate information for decision-making and loan approval (Abeygunasekera & Fonseka, 2012).

Globally, poor reporting practices have been identified as a barrier to the survival and growth of SMEs. Devi and Samujh (2014) argue that, in many developing countries, IFRS for SMEs imposes unnecessary complexity and fails to address the information needs of local users. Recent evidence from Nguyen et al. (2023) supports this, showing that institutional, educational, and contextual factors significantly affect the adoption of IFRS in emerging markets. Similarly, Javed (2024) finds that sustainable IFRS practices are linked to economic growth but require adaptation to local contexts to avoid compliance overload.

IFRS for SMEs: Rationale, Critiques, and Sri Lankan Experience

The International Accounting Standards Board (IASB) introduced IFRS for SMEs in 2009 to reduce the reporting burden on non-publicly accountable entities. The standard eliminates specific complex requirements of full IFRS while maintaining comparability across borders. However, critics argue that it remains too complex for micro and small entities, especially in developing countries (Evans et al., 2005; Schiebel, 2008).

In Sri Lanka, IFRS for SMEs was adopted in 2012 and rebranded as SLFRS for SMEs. Wijekoon's (2018) doctoral thesis provides comprehensive empirical evidence that many SMEs find the framework costly and irrelevant, as their transactions are simple and domestically oriented. Owner-managers rarely see value in international comparability, while banks and tax officials demand information that IFRS for SMEs does not necessarily emphasise. More recent debates in Sri Lanka have considered whether "smaller entity standards" should be introduced, echoing calls for proportionate frameworks (Wijekoon, 2025).

Internationally, alternatives have emerged. For instance, New Zealand's External Reporting Board (XRB) has adopted a multi-tier framework that allows micro and small entities to report using simplified cash-based templates (XRB, 2025). In Australia, reforms have phased out special-purpose financial reports in favour of proportionate general-purpose reports (BDO, 2020). These experiences suggest that tiered approaches can strike a balance between comparability, relevance, and cost-effectiveness.

Institutional Theory and Standard-Setting in Developing Countries

Institutional theory, particularly New Institutional Sociology (NIS), offers a valuable lens for understanding the adoption of accounting standards. DiMaggio and Powell (1983) describe three forms of isomorphism: coercive (external pressures from regulators and donors), mimetic (imitation of perceived best practices), and normative (professionalization). In the Sri Lankan context, the adoption of IFRS for SMEs was mainly driven by coercive pressures from international organisations such as the World Bank and the IMF, alongside mimetic pressures to align with global trends (Wijekoon, 2018).

However, local institutional realities, such as a tax-dominated reporting culture, limited accounting education among SMEs, and high compliance costs, constrain effective implementation. Studies in emerging markets confirm that adoption without adaptation leads to symbolic compliance rather than substantive practice (Nguyen et al., 2023; Javed, 2024). This supports the argument that SME reporting frameworks should be contextualized to reflect user needs and institutional capacities.

2.5 Emerging Trends: Digitalization and Sustainability

Recent years have seen the growing influence of digitalization and sustainability reporting on SME financial practices. CA Sri Lanka (2024) has outlined a roadmap to align with the International Sustainability Standards Board (ISSB), raising questions about the proportionality of sustainability reporting for SMEs. Meanwhile, digital platforms are enabling simplified bookkeeping and reporting tools that could lower compliance costs for small entities. While these trends are still nascent in Vavuniya, their integration into a tiered framework could future-proof SME reporting.

Methodology

Research Design

The study employed a quantitative survey to identify broad patterns in reporting practices, complemented by qualitative interviews that offered in-depth insights into institutional dynamics.

Sample and Data Collection

The survey included 120 SME owner-managers and accountants from the manufacturing, trade, and services sectors in Vavuniya. Additionally, 20 stakeholders—comprising bank lending officers, Inland Revenue officials, District Secretariat officers, and accountants—participated in interviews. The survey questionnaires addressed users of financial information, the relevance of IFRS for SMEs, and reporting challenges, while interviews explored institutional pressures and user expectations in greater depth. A convergent parallel mixed-methods research design was utilized, with quantitative and qualitative data collected concurrently, analyzed independently, and integrated during the discussion phase.

General Findings and Analysis

Users of SME Financial Information

Table 1. Users of SME Financial Information (n = 120)

User Group	Frequency	Percentage %
Tax Authorities	120	100.0
Owner Managers	114	95%
Banks	94	78.3%
Government Agencies	50	41.7%

Source: Survey Data

The results provided clear evidence that SME financial reporting in the Vavuniya District is overwhelmingly shaped by tax compliance requirements, with all surveyed firms (100%) citing the tax authorities as the primary users of their financial information. This finding reflects the institutional dominance of the Inland Revenue Department, consistent with Wijekoon's (2018) doctoral research, which highlighted that Sri Lankan SMEs perceive financial reporting primarily as a statutory obligation. While owner-managers (95%) and banks (78%) also emerge as important users, their needs are largely unmet because of reporting formats designed to satisfy tax requirements rather than managerial or credit needs.

Table 2. Perceived Relevance of IFRS for SMEs (n = 120)

Response	Frequency	Percentage (%)
Useful and applicable	24	20.0
Too complex for SMEs	78	65.0
No opinion / unfamiliar	18	15.0

Source: Survey Data

Table 2 demonstrates the limited relevance of IFRS for SMEs in this context. Only 20% of respondents reported finding the standard useful, while 65% considered it too complex. This aligns with international critiques that IFRS for SMEs, though intended to simplify, still includes disproportionate technical requirements unsuited for micro and small entities (Devi & Samujh, 2014; Nguyen et al., 2023). Interview data support this view, with SME owners frequently stating that they require simple, cash-based reporting formats rather than international standards.

Table 3. Weaknesses in Current Reporting Practices (n = 120)

Reporting weakness	Frequency	Percentage (%)
Tax-driven reporting	102	85.0
Poor timeliness	72	60
Lack of comparability	68	56.7
Capacity constraints	86	71.7

Source: Survey Data

The weaknesses identified in Table 3 confirm long-standing challenges in SME reporting. A large majority (85%) prepare reports solely for tax purposes, while 60% admit to late financial statement preparation, often after the close of the financial year. Such practices render financial reports less useful for managerial decision-making or credit appraisal. Moreover, the problem of comparability (reported by 57% of respondents) poses a barrier for banks, which struggle to assess SME financial performance when reporting standards differ widely. Capacity constraints remain a significant barrier, with over 70% of SMEs lacking access to qualified accountants. Instead, they rely on informal bookkeepers, a practice also observed in similar post-conflict economies such as Sierra Leone and Rwanda (Kamara & Mansaray, 2019).

From an institutional theory perspective, the SPSS results illustrate coercive isomorphism: SMEs comply with standards because they are compelled by taxation and statutory frameworks rather than because they find intrinsic value in the information generated (DiMaggio & Powell, 1983). The low relevance of IFRS for SMEs shows that coercive adoption, driven by international pressures, has not translated into effective local practice. Normative pressures from professional accountants remain weak in Vavuniya, while mimetic pressures—imitating global practice—exist only symbolically.
Interviews reinforced this hierarchy. A tax officer explained: “SMEs here prepare accounts because of tax deadlines, not because they see it as useful for management.” A banker noted, “Reports often come only when SMEs need a loan, and they lack comparability. We cannot rely on them.”This reflects the dominance of tax authorities in shaping SME reporting, a pattern consistent with prior Sri Lankan studies (Wijekoon, 2018; Abeygunasekera & Fonseka, 2012).

Qualitative Survey Findings

The qualitative analysis of Vavuniya district SMEs reveals varied perceptions and practices regarding financial reporting standards and their usefulness. Small and medium-sized entities frequently depend on external accountants for bookkeeping, financial statement preparation, and tax services, mainly due to internal resource constraints and insufficient accounting expertise among their in-house staff (Professional Oversight Board for Accountancy, 2006; Halbouni, 2005). In contrast, large SMEs tend to employ in-house accountants. However, they may still rely on external expertise to comply with regulatory requirements, particularly when applying international standards such as IFRS for SMEs (Kitching et al., 2011).

The principal users of SME financial statements are owner-managers, banks, and the Department of Inland Revenue, with government institutions also being notable stakeholders for some entities (International Accounting Standards Board, 2009b; Carsberg et al., 1985; Sian & Roberts, 2009). This reflects the owner-managed nature of most Vavuniya district SMEs, where public disclosure requirements are minimal, and the practical uses of accounting information are internally focused. The manager-owners primarily use financial information for planning, estimating tax liabilities, making decisions on employee remuneration, and developing marketing strategies (Collis & Jarvis, 2000; Barker & Noonan, 1996).

The survey highlights that, as perceived by owner-managers, the most useful financial report for managerial decisions is the profit and loss statement—especially for estimating taxes—while cash flow and balance sheets are more highly valued by professional accountants (Collis & Jarvis, 2002; McMahon & Stanger, 1995). Interestingly, the perceived relevance and frequency of engaging in complex accounting transactions, such as foreign currency dealings or investments, increase with entity size but remain limited overall; most SMEs are domestically oriented and see little need for internationally comparable information (Eierle & Haller, 2009).

The adoption of the SLFRS for SMEs is highest among large entities; yet, the majority of SMEs do not implement the standard, primarily due to perceived irrelevance and associated costs (Aboagye-Otchere & Agbeibor, 2012; Chand et al., 2015). The most significant costs cited include obtaining external technical advice, training staff, and updating accounting systems (Marriott & Marriott, 2000). Many SME owner-managers in the Vavuniya district feel these outweigh the benefits, such as improved comparability and access to finance. Furthermore, there is widespread lack of awareness and uncertainty about newer accounting standards tailored for smaller entities, with over half of respondents undecided about adopting them (Professional Oversight Board for Accountancy, 2006).

The findings highlight a significant gap between the objectives of international standard-setting and the practical realities encountered by SMEs in the Vavuniya district. This underscores the necessity for simplified, context-specific financial reporting frameworks and improved guidance for local businesses (Aboagye-Otchere & Agbeibor, 2012).

Discussion of Findings

The findings of this study reveal a persistent misalignment between SMEs' information needs and the reporting requirements imposed by international frameworks, such as IFRS for SMEs. In the Vavuniya District, where the majority of SMEs operate in agriculture, trading, and small-scale services, owner-managers primarily focus on cash flow and short-term survival. For these firms, complex standards that emphasized fair value accounting, foreign currency transactions, or hedge accounting are neither relevant nor cost-effective. Instead, they value simplified reporting mechanisms that allow them to monitor liquidity, measure profitability, and maintain compliance with tax obligations. This confirms earlier studies in developing economies, which argue that international standards have limited practical application for smaller firms whose operations are predominantly local and resource-constrained (Devi & Samujh, 2014; Nguyen et al., 2023).

The dominance of tax authorities in shaping financial reporting practices in Vavuniya is evident. SMEs prepare financial statements primarily to satisfy Inland Revenue requirements, rather than to support managerial or credit decisions. This compliance-driven approach results in reports that fulfill statutory obligations but provide limited value to other stakeholders. Similar patterns have been observed in Bangladesh and Nigeria, where tax considerations largely dictate SME reporting culture (Uddin & Choudhury, 2008; Iyoha & Oyerinde, 2010). As a result, financial statements become symbolic rather than substantive, a phenomenon explained by institutional theory. Sri Lanka’s adoption of IFRS for SMEs exemplifies coercive isomorphism, with external pressures from international financial institutions driving adoption. However, weak normative structures in Vavuniya, characterized by a scarcity of accountants and limited professional training, hinder meaningful application of these standards (Wijekoon, 2018).

The study's results also show that banks occupy a critical position in the SME financing landscape, demanding reports that are reliable, timely, and comparable. However, banks expressed frustration with the inconsistency and poor quality of SME statements, which are often prepared retrospectively and lack basic details. This reflects the broader problem of financial exclusion: SMEs are unable to access credit not only because of collateral requirements but also due to unreliable financial records. Similar challenges have been documented in Kenya and Ghana, where banks cite poor SME reporting as a barrier to lending (Aryeetey, 2001; Ntim et al., 2017). In Vavuniya, this problem is exacerbated by the post-conflict environment, where trust in institutions is still rebuilding, and financial literacy remains low.

Institutional theory provides a valuable lens to interpret these dynamics. Coercive pressures from global standard setters have led Sri Lanka to adopt IFRS for SMEs, but mimetic and normative pressures have not translated into effective practice in rural districts. Unlike Colombo, where professional accountants are more widely available, Vavuniya suffers from an institutional void, where neither professional networks nor accounting associations have sufficient reach. As a result, SMEs often resort to symbolic compliance, issuing statements that exist solely to satisfy tax authorities or lenders when necessary. This analysis supports earlier arguments that international standards must be adapted to local contexts to ensure they are meaningful, rather than unthinkingly transplanted (Javed, 2024).

The findings also highlight emerging opportunities. Although SMEs currently lack the capacity to implement complex frameworks, digitalization offers a potential solution to bridge this gap. Affordable accounting applications, mobile-based bookkeeping tools, and integrated e-filing systems may enable SMEs to generate reliable financial data without extensive technical expertise. Evidence from ASEAN countries, including Vietnam and Indonesia, indicates that digital platform adoption has reduced compliance costs and improved SME-bank relationships (Nguyen et al., 2023). Furthermore, the increasing emphasis on sustainability reporting is beginning to affect Sri Lanka, as reflected in CA Sri Lanka's 2024 roadmap, which signals a gradual transition toward proportionate sustainability disclosures. While most Vavuniya SMEs are not yet prepared for comprehensive sustainability reporting, the phased introduction of fundamental sustainability indicators, such as energy consumption or workforce stability, could help future-proof reporting frameworks in the district.

Conclusion

This research contributes to the ongoing debate on SME financial reporting by providing mixed-methods evidence from the Vavuniya District, a region shaped by post-conflict recovery, limited institutional capacity, and a tax-dominated reporting culture. The study confirms that IFRS for SMEs, while designed to reduce reporting burdens, remains poorly suited to micro and small entities in developing countries. Owner-managers seek survival-oriented, cash-based information, while banks demand reliability and comparability. Yet the dominance of tax authorities ensures that reporting practices remain compliance-driven rather than decision-useful.

By applying institutional theory, the study shows that Sri Lanka's adoption of IFRS for SMEs reflects coercive global pressures rather than local demand, resulting in symbolic adoption. To resolve this misalignment, the study proposes a four-tier financial reporting framework that tailors requirements to SME size and capacity. This framework has the potential to enhance decision-usefulness, improve access to credit, and reduce compliance costs, while also preparing SMEs for digital and sustainability transitions.

Theoretically, the study extends the application of institutional theory to the context of SME reporting in post-conflict economies, demonstrating how coercive, mimetic, and normative pressures operate unevenly across regions. Practically, it provides policymakers, regulators, and professional bodies with a roadmap for reform that is both contextually relevant and internationally informed. Future research should expand beyond Vavuniya to include other districts of Sri Lanka, comparing urban and rural dynamics. Further inquiry into the role of digital tools and sustainability disclosures in SME reporting would also provide valuable insights as Sri Lanka modernizes its financial reporting ecosystem.

Recommendations

The evidence generated in this study strongly supports the introduction of a tiered financial reporting framework that aligns reporting obligations with SME size, capacity, and stakeholder needs. A four-tier system, adapted from international models such as New Zealand's External Reporting Board and Australia's proportional reporting reforms, would provide a balanced approach for Sri Lanka. Under such a framework, publicly accountable entities would continue to apply full IFRS, while large SMEs would use a streamlined version of IFRS for SMEs, omitting irrelevant topics. Medium-sized SMEs would rely on simplified accrual-based statements, and micro and small enterprises would be allowed to submit cash-based templates explicitly designed for owner-managers, banks, and tax authorities. This approach would both reduce compliance burdens and increase the usefulness of reports for diverse stakeholders.

Beyond structural reforms, policy-level interventions are necessary to create an enabling environment for effective implementation. CA Sri Lanka should spearhead the development and formal adoption of the tiered framework, ensuring consistency and clarity across different SME categories. The Inland Revenue Department should integrate its tax reporting requirements into the simplified templates to avoid duplication and confusion. The Ministry of Finance could support the reform by offering tax incentives or subsidies to SMEs that adopt simplified reporting practices, thereby encouraging voluntary compliance and strengthening the financial ecosystem.

At the practice level, SMEs in the Vavuniya district themselves need to be empowered to generate decision-useful reports. Training programs should be organized at the district level, enabling SME owners and bookkeepers to become familiar with simplified templates and basic digital accounting tools. Banks should collaborate with regulators to agree on minimum reporting packs required for loan applications, thereby reducing the ambiguity and inconsistency currently faced by SME borrowers in Vavuniya. Accountants and audit firms operating in rural areas must also adapt their services to offer affordable packages aligned with simplified reporting frameworks rather than attempting to enforce complex standards that SMEs neither understand nor value.

Capacity building is central to these reforms. Establishing district-level clinics, under the leadership of CA Sri Lanka, could provide ongoing technical support to SMEs in Vavuniya. These clinics could train SME owners in both financial literacy and record-keeping, ensuring that simplified reporting frameworks are not only introduced but also sustained. Furthermore, digitalisation should be embraced as a long-term solution. The government and private sector could jointly promote low-cost or open-source accounting software that integrates with tax e-filing systems. Mobile-based solutions tailored for micro-SMEs would be particularly relevant in Vavuniya, where access to professional accountants is limited.

Sri Lanka should initiate preparations for SMEs to adapt to the global trend of sustainability reporting. However, the immediate adoption of comprehensive environmental, social, and governance (ESG) disclosures would likely overwhelm most SMEs. A gradual approach would allow Sri Lankan SMEs to align with international reporting standards over time, thereby enhancing their competitiveness and resilience in a business environment that increasingly values sustainability.

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