IJCRT.ORG ISSN : 2320-2882

INTERNATIONAL JOURNAL OF CREATIVE RESEARCH THOUGHTS (IJCRT)

An International Open Access, Peer-reviewed, Refereed Journal

FINANCIAL ACCOUNTING PRACTICES AND FINANCIAL REPORTING IN SMALL AND MEDIUM-SIZED ENTERPRISES IN INDIA: ISSUES, CHALLENGES AND IMPROVEMENT STRATEGIES

Author Name: Dr. Giriraj Ganapathi (Ph.D in Commerce Gulbarga University Kalaburagi)

Abstract

Financial accounting is a fundamental management and reporting function that records business transactions, measures financial performance and position, supports decision-making, and provides information to owners, lenders, investors, tax authorities and other stakeholders. In small and medium-sized enterprises (SMEs), accounting practices are often shaped by limited resources, owner-manager involvement, availability of accounting expertise, regulatory requirements and the need to balance compliance costs with business benefits. This article examines financial accounting practices and financial reporting in Indian SMEs using a conceptual and secondary-data-based approach. The paper focuses on bookkeeping, financial statements, revenue and expense recognition, inventory, receivables and payables, cash-flow information, taxation, internal controls, digital accounting, accounting standards and financial reporting quality. The literature indicates that small enterprises can face difficulties related to accounting knowledge, record-keeping discipline, cost, time and professional expertise. At the same time, reliable accounting information can improve financial control, access to finance, planning and business credibility. The article proposes a practical framework for strengthening accounting practices through standardized records, monthly closing procedures, digital tools, internal controls and professional review. No questionnaire or fabricated primary survey results are used.

Keywords: Financial Accounting, Financial Reporting, SMEs, Bookkeeping, Accounting Standards, Internal Control, Digital Accounting, India

1. Introduction

Financial accounting provides the basic information system through which business transactions are recorded, classified, summarized and communicated. The balance sheet, statement of profit and loss, cash-flow information and supporting notes provide a structured picture of an enterprise's financial position and performance. For SMEs, accounting is not merely a compliance activity. Accurate financial records support pricing, working-capital management, budgeting, borrowing decisions, tax administration and evaluation of business performance.

The role of accounting becomes particularly important as an enterprise grows. A very small owner-managed business may rely on memory, bank statements and informal records during its early stage. As transaction volume increases, however, informal methods can make it difficult to identify outstanding receivables, inventory losses, supplier obligations, actual profitability and cash requirements. Weak accounting can therefore affect both internal management and external credibility.

In India, accounting and financial reporting operate within a regulatory environment involving the Companies Act, applicable Accounting Standards or Ind AS, tax laws and professional guidance. The Institute of Chartered Accountants of India maintains the Accounting Standards framework, while accounting standards for companies are notified through the statutory process under the Companies Act. ICAI's current compendium also distinguishes the Accounting Standards framework from Ind AS, which contains India-specific modifications to IFRS.

Research on small enterprises has identified recurring challenges involving bookkeeping knowledge, cost computation, time and adherence to formal accounting rules. Chhabra and Pattanayak's study of small enterprises in Dhanbad and Bokaro, for example, found substantial difficulties in financial accounting practices and highlighted gaps in bookkeeping and related skills.

2. Statement of the Problem

Many SMEs maintain accounting records primarily for taxation or statutory purposes rather than as a management information system. When accounting is treated only as compliance, managers may not receive timely information about gross margins, operating expenses, cash conversion, customer balances, inventory turnover or debt obligations. Inadequate records may also make it harder to demonstrate financial strength to banks and other financing institutions.

Another challenge is the complexity of financial reporting requirements. Smaller enterprises may have limited accounting personnel and may depend on external accountants. The cost of professional support, software, training and compliance can be significant relative to the scale of operations. The policy challenge is therefore to encourage reliable and useful accounting without imposing disproportionate administrative burdens on small businesses.

3. Research Questions

- What are the major financial accounting practices relevant to Indian SMEs?
- How does accounting information support managerial and financial decision-making?
- What are the major challenges affecting accounting and financial reporting quality in SMEs?
- How can digital accounting and internal controls improve accounting reliability?
- What practical framework can SMEs adopt to strengthen financial accounting practices?

4. Objectives of the Study

- To examine the major financial accounting practices followed by SMEs.
- To analyze the importance of accurate bookkeeping and financial reporting for SME decision-making.
- To identify major accounting, reporting and compliance challenges faced by SMEs.
- To examine the role of accounting standards, professional expertise and digital accounting systems.
- To propose practical strategies for improving accounting quality and financial information usefulness.

5. Significance of the Study

Reliable accounting benefits several stakeholder groups. Owners require financial information to evaluate profitability and growth. Managers need information for budgeting, pricing, inventory and working-capital decisions. Banks require credible financial information when assessing creditworthiness. Suppliers and customers may also use financial credibility as part of business relationships. Government agencies and tax authorities require records for compliance and verification. Strong financial accounting can therefore contribute simultaneously to internal efficiency and external trust.

6. Review of Literature

Huselid (1995) is widely associated with the broader evidence that organizational management practices can influence business outcomes; in accounting research, the analogous concern is whether reliable information systems improve decision quality and organizational control. Financial reporting research emphasizes the usefulness of information for economic decisions, while SME studies highlight the distinctive constraints created by limited resources and owner-manager dependence.

Das's exploratory work on SME financial reporting argues that reporting in small and medium-sized enterprises may be limited in practice and that owner-manager decisions regarding financial reporting are influenced by multiple economic and organizational factors. The literature therefore cautions against assuming that SMEs simply apply the same accounting practices as large corporations at a smaller scale.

Chhabra and Pattanayak (2014) examined 52 small enterprises and reported problems related to adherence to accounting rules, bookkeeping knowledge, cost computation and time management. Their findings support the importance of accounting skills and disciplined record maintenance in smaller enterprises.

Recent research continues to identify barriers to sophisticated financial reporting among SMEs, including technical complexity, lack of trained personnel, cost burdens, system readiness and difficulty understanding particular measurement requirements. These issues are especially relevant when accounting standards become more technically demanding.

7. Conceptual Framework

The proposed framework treats financial accounting capability as the independent organizational capability influencing financial information quality and management outcomes. Key accounting practices include transaction recording, ledger maintenance, bank reconciliation, receivables and payables management, inventory accounting, fixed-asset records, expense classification, revenue recognition, tax records, financial statement preparation and internal control. These practices influence financial reporting quality, which in turn supports planning, control, financing access and business performance.

The relationship is moderated by enterprise size, industry, accounting knowledge, availability of professional support, digital maturity, transaction complexity and regulatory requirements. A small retail enterprise may require relatively simple inventory and receivables controls, while a manufacturing enterprise may require more detailed inventory valuation, production-cost accounting and fixed-asset records.

8. Proposed Hypotheses for Future Empirical Testing

- H1: Accounting record-keeping quality is positively associated with the quality of financial information available to SME managers.
- H2: Digital accounting adoption is positively associated with accounting process efficiency.
- H3: Strong internal controls are positively associated with financial reporting reliability.
- H4: Accounting knowledge and professional support are positively associated with compliance with applicable accounting requirements.
- H5: Financial reporting quality is positively associated with SME financial decision-making effectiveness.
- H6: Timely financial reporting is positively associated with access to formal business finance.

These hypotheses are proposed for future primary research. This article does not claim empirical testing of these hypotheses.

9. Research Methodology

The article uses a conceptual and secondary-data-based research design. Sources include accounting literature, professional guidance and Indian regulatory material. The approach is analytical rather than survey-based. No questionnaire is used and no primary numerical results are invented. The study identifies accounting practices, synthesizes challenges reported in prior research and develops a practical framework for SMEs.

A future empirical study could survey SME owners, finance managers and accountants across manufacturing, trading and service sectors. Possible measures include bookkeeping quality, digital accounting adoption, internal-control effectiveness, financial reporting timeliness and decision-making usefulness. Statistical techniques such as reliability analysis, correlation, regression and structural equation modeling could then be used, depending on the research design and sample size.

10. Major Financial Accounting Practices in SMEs

10.1 Bookkeeping and Transaction Recording

The foundation of financial accounting is complete and accurate recording of transactions. SMEs should maintain systematic records for sales, purchases, receipts, payments, expenses, loans, assets and liabilities. Transactions should be supported by invoices, receipts, bank records and other appropriate documentation. Timely entry reduces the risk of forgotten transactions and facilitates month-end reconciliation.

10.2 Ledger and Trial Balance

Ledger accounts classify transactions into meaningful categories and provide the basis for preparing financial statements. A regular trial balance can help identify posting and arithmetic errors. SMEs should establish a monthly closing routine rather than postponing accounting until tax or audit deadlines.

10.3 Cash and Bank Accounting

Cash shortages and unrecorded payments can materially affect small businesses. Bank reconciliation should therefore be performed regularly. Differences between the accounting records and bank statements should be investigated promptly. Separating personal and business transactions is another essential practice for owner-managed enterprises.

10.4 Receivables and Payables

Credit sales create receivables, while purchases on credit create payables. SMEs need ageing schedules showing how long customer balances and supplier obligations have remained outstanding. Regular follow-up on overdue receivables can improve cash flow, while planned supplier payments can protect business relationships and reduce late-payment problems.

10.5 Inventory Accounting

Inventory records are especially important for trading and manufacturing enterprises. Poor inventory records can conceal theft, damage, obsolete stock and pricing errors. Periodic physical verification should be compared with book records. Appropriate inventory measurement and consistent accounting policies are necessary for reliable profit measurement.

10.6 Fixed Assets and Depreciation

Machinery, vehicles, equipment, computers and other long-term assets should be recorded systematically. An asset register can include acquisition date, cost, location, useful information and disposal status. Depreciation or other applicable accounting treatment should be applied consistently according to the relevant accounting framework.

10.7 Revenue and Expense Recognition

Revenue and expenses should be recorded according to applicable accounting principles rather than solely when cash changes hands. Proper classification of operating expenses, finance costs, asset purchases and owner transactions improves the quality of reported profit. SMEs should avoid mixing personal expenditure with business expenses because it distorts financial performance.

10.8 Financial Statements

The principal financial statements provide structured information about financial position and performance. Depending on the applicable legal and accounting framework, SMEs may prepare a balance sheet, statement of profit and loss, cash-flow information and related notes or disclosures. Monthly internal statements can be simpler than statutory financial statements but are extremely useful for management.

11. Accounting Standards and Financial Reporting

Accounting standards seek to improve consistency, comparability and reliability in financial reporting. ICAI maintains the Accounting Standards compendium, and the Ministry of Corporate Affairs notifies standards applicable to companies through the statutory framework. For companies, the Companies (Accounting Standards) Rules, 2021 apply to relevant accounting periods from 1 April 2021.

The Indian reporting environment distinguishes Accounting Standards from Ind AS. ICAI explains that Ind AS are notified under the Companies Act after the prescribed institutional process and include India-specific carve-outs and carve-ins.

The existence of differentiated requirements for smaller entities reflects a broader concern about proportionality. RBI material has noted that applying the full range of accounting standards to all entities could place a disproportionate cost and effort burden on smaller enterprises, and describes differentiated categories used for applying standards.

For SMEs, the practical objective should therefore be neither minimum compliance nor unnecessary complexity. The objective should be reliable financial information prepared under the accounting framework actually applicable to the enterprise.

12. Digital Financial Accounting

Accounting software and cloud-based systems have changed the way SMEs record and retrieve financial information. Digital systems can automate invoice generation, ledger posting, bank reconciliation, receivables reminders, payroll integration and management reports. However, digitalization does not automatically guarantee accuracy. Incorrect chart-of-account design, poor user controls, duplicate entries or inadequate backups can still produce unreliable reports.

SMEs should therefore adopt digital accounting in stages. The first stage is basic digital bookkeeping and document storage. The second is integration of bank, sales and purchase information. The third is management reporting and dashboard use. Access rights, backups, password controls and audit trails should accompany digital adoption. Staff should also receive practical training.

13. Internal Control and Financial Accounting Quality

Internal controls are procedures designed to protect assets, improve accuracy and reduce errors and fraud. SMEs often have fewer employees, making complete separation of duties difficult. Nevertheless, basic controls are possible. For example, the person making a payment need not be the only person approving it; bank reconciliations can be independently reviewed; inventory counts can be periodically checked; and large transactions can require owner or manager approval.

Financial reporting quality depends on the interaction of people, procedures and technology. Even excellent software cannot compensate for missing source documents or weak review. A monthly management review of profit, cash flow, receivables, payables and inventory can provide a low-cost control mechanism.

14. Major Challenges

- Limited accounting knowledge among owner-managers and employees.
- High dependence on external accountants for technical matters.
- Cost of accounting software, professional services and compliance.
- Time constraints that lead to delayed bookkeeping and reconciliation.
- Mixing of personal and business transactions.
- Inadequate documentation and loss of source records.
- Weak inventory and receivables controls.
- Difficulty interpreting technical accounting requirements.
- Limited use of accounting information for managerial decision-making.
- Cyber security, access-control and backup risks associated with digital accounting.

15. Financial Accounting and Access to Finance

Reliable accounting information can strengthen the credibility of an SME when seeking formal finance. Lenders commonly require information about sales, profitability, assets, liabilities, cash flows and repayment capacity. When records are incomplete or inconsistent, the lender may face greater information uncertainty. Better accounting therefore has the potential to reduce information asymmetry and support more informed credit decisions.

Accounting should not be prepared only when a loan application is submitted. Regular financial statements allow management to understand borrowing capacity, debt-service requirements and working-capital needs before financing becomes urgent. This can improve financial planning and reduce dependence on expensive short-term borrowing.

16. Recommendations

- Maintain complete and timely records for all business transactions.
- Separate business and personal bank accounts and expenses.
- Perform monthly bank reconciliation and review outstanding items.
- Prepare monthly internal statements of profit, financial position and cash flow where feasible.
- Maintain receivables and payables ageing schedules.
- Conduct periodic physical verification of inventory and fixed assets.
- Use a standard chart of accounts suited to the business.
- Adopt digital accounting software with appropriate access controls and backups.
- Provide basic accounting training to owners and administrative staff.
- Obtain professional accounting advice for complex transactions and regulatory matters.
- Create a month-end closing checklist and assign responsibility for each task.
- Use accounting reports actively for pricing, budgeting, working capital and investment decisions.

17. Proposed Financial Accounting Improvement Framework

A practical six-stage framework is proposed: Record, Reconcile, Review, Report, Respond and Retain. Record means entering transactions completely and maintaining source documents. Reconcile means matching bank, receivable, payable and inventory information. Review means checking unusual transactions and control exceptions. Report means preparing regular management and statutory financial statements as applicable.

Respond means using accounting information for business decisions. Retain means securely preserving financial records and supporting documents for the required period.

The framework is designed for gradual adoption. A very small enterprise can start with transaction recording, bank reconciliation and monthly profit review. A growing SME can add inventory controls, ageing reports, budgeting, digital dashboards and formal internal review. This approach helps SMEs obtain practical benefits without immediately creating an unnecessarily complex accounting system.

18. Limitations and Future Research

The present article is conceptual and secondary-data based. It does not provide primary survey results or statistical estimates for Indian SMEs. Accounting practices also vary by legal form, sector, size and applicable reporting requirements. Future studies should examine financial accounting practices across districts and sectors, compare digitally enabled and traditional accounting systems, and test whether accounting quality is associated with profitability, financing access, tax compliance and business survival. Qualitative studies could further examine how owner-managers decide which accounting information to prepare and use.

19. Conclusion

Financial accounting is a core capability for SME sustainability because it converts daily business transactions into information for planning, control, compliance and decision-making. Although SMEs may face limitations in finance, skills, time and technology, these constraints do not make systematic accounting impossible. Basic discipline in transaction recording, reconciliation, receivables, payables, inventory, asset records, internal controls and periodic reporting can produce substantial benefits.

The Indian accounting environment provides formal standards and reporting requirements, while the practical challenge for SMEs is to implement the requirements that apply to them accurately and efficiently. Digital accounting can reduce administrative effort, but it must be accompanied by training, review and internal controls. The proposed framework emphasizes simple, regular and decision-oriented accounting practices. Stronger financial accounting can improve transparency, managerial control, financial credibility and the capacity of SMEs to make sustainable growth decisions.

References

1. Chhabra, K. S., & Pattanayak, J. K. (2014). Financial accounting practices among small enterprises: Issues and challenges. The IUP Journal of Accounting Research & Audit Practices, 13(3), 37–55.
2. Das, S. C. (2010). Is small & medium sized enterprises (SME) financial reporting limited in practices: An exploratory study. Invertis Journal of Management, 2(2).
3. Huselid, M. A. (1995). The impact of human resource management practices on turnover, productivity, and corporate financial performance. Academy of Management Journal, 38(3), 635–672.
4. Institute of Chartered Accountants of India. (2026). Compendium of Accounting Standards as on April 1, 2025. ICAI.
5. Institute of Chartered Accountants of India. (2026). Compendium of Indian Accounting Standards and Ind AS guidance material. ICAI.
6. Ministry of Corporate Affairs, Government of India. (2021). Companies (Accounting Standards) Rules, 2021.
7. Reserve Bank of India. (2009). Report on trends and progress of banking in India / accounting standards for small and medium-sized enterprises.
8. Pramahender. (2024). Measuring the barriers in adoption of IFRS for SMEs in developing economies: An ISM-MICMAC approach. Journal of Public Affairs. https://doi.org/10.1002/pa.2958
9. Prasad, C. V., Sivakumar, A., & Menon, M. P. B. (2025). Awareness about proposed update of IFRS for SMEs: A survey on HEIs in Kerala. The IUP Journal of Accounting Research & Audit Practices, 24(1), 291–307.