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A FRAMEWORK ON IMPORTANT OF ACCOUNTING AND FINANCIAL REPORTING FOR CREDIT RISK MANAGEMENT

Nur Masitah Binti Muhamad

Post-Graduate Student
Faculty of Economics and Muamalat
Universiti Sains Islam Malaysia
Bandar Baru Nilai
71800 Nilai
Negeri Sembilan, Malaysia
masitahmuhamad@gmail.com

Mohamad Yazis Bin Ali Basah
Corresponding Author
Senior Lecturer
Faculty of Economics and Muamalat
Universiti Sains Islam Malaysia
Bandar Baru Nilai
71800 Nilai
Negeri Sembilan, Malaysia
yazis@usim.edu.my

ABSTRACT

Financial reporting provides important information for a business especially in evaluating credit risk. The aim of this study is to propose the framework on application of credit risk management through financial reporting in a business. The framework of the study showed that in order to investigate an application of credit risk management, some elements should be investigated such as determinants of credit management, elements that can influence credit management and elements in financial reporting practices.

Keywords: Framework, Accounting, Reporting, Credit, Risk, Management

1. Introduction

Financial reporting provides important information for a business especially in evaluating credit risk. It will guide a business and show a better decision for future action and prevent a business from make a wrong decision. A part from that, a framework on application of credit risk management through financial reporting is also important because it can guide a business to apply an appropriate accounting and financial reporting practices for good credit risk management.

2. Overview on Accounting and Financial Reporting

The function of accounting is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions (Natrah et al., 2005). Information in accounting is very useful for stakeholders. In general, stakeholders are all the parties that are interested in the financial health of a company. Stakeholder users of accounting information can be broadly categorized into two categories – internal users and external users. Internal users are those who make decisions that directly affect the internal operations of the business, while external users are those who make decisions concerning their relationship to the business.

Financial accounting focuses on the development and communication of the financial information for external users. In order for a business to grow and expand, it often finds outsource funding to generate more capital. In this situation, accounting information is useful for the external user to obtain assurance about the performance of the business and that they will receive their return on their investment.

According to Natrah et al. (2005), most of the accounting systems are designed to generate information for both internal and external reporting. Three major types of financial reporting are discussed – statement of cash flow, income statement and balance sheet. The statement of cash flow is the most objective of the financial statement because it is somewhat insulated from the accounting estimates and judgment needed to prepare an income statement or balance sheet. Usually, the amount of cash generated and consumed by a company is through the following three types of activity: operating, investing and financing.

The income statement for a certain interval is for recording the net assets generated through the business operation (revenue), the net assets consumed (expenses), and the difference is typically known as the net income. In addition, the balance sheet reports the resources of the business (assets), the company's obligations (liabilities) and the net difference between the assets and liabilities, which indicates the equity of the owner (Natrah et al., 2005).

The financial report is used to record business transactions as well as to evaluate business performance. The primary objective of financial reporting is to provide high-quality financial reporting information concerning economic entities, which is primarily use for economic decision-making. In addition, according to Stergious and Michalis (2012), financial reporting is a two party transaction whereby the issuer of financial report provides it for the user who uses it to enhance their financial decisions. The quality of financial reporting could give an advantage to the user –shareholder or investor (Natrah et al., 2005).

3. The Concept of Credit Risk

Loan is a contractual agreement between borrower and creditor that outlines with the obligation on the payment from the borrower towards the creditor. Loans may be secured with either payment guarantees or collateral to ensure a reliable source of secondary repayment. In a simple loan, credit risk arise because there is possibility that borrower are unable to meets it repayment obligation across the stipulated time. Credit may be offers to the individual or business entity. Credit facilities offers to individual namely as consumer loans, while offer to business entity called as commercial loans.

Credit involves the activities of lending. It has a meaning to finance either directly or indirectly the expenditures of others against future repayment. Direct credit is a credit provided by financial institutions to a customer. While, indirect credit is a credit facilities granted by a trader to a customer. In business, credit risk may happen in two circumstances. First, risk as a borrower and second, risk as a lender.

According to Douglas et al. (2007), credit risk is the risk that a debt instruments will decline in values as a result the borrower's inability to satisfy the contractual terms of its borrowing arrangement. In financial institutions, credit risk occurs resulting from inability to collect anticipated interest earning as well as the loss of principle resulting from loan default.

4. Issues of Financial Reporting and Credit Risk Management

The issue of credit risk management and financial reporting may affect business performance. Numerous countries, such as the United States of America, Australia and the United Kingdom, as well as Malaysia have studied the reasons for business failure. However, the real cause of failure in every country might be different from each other depending on the environment, type of business and the year of the business failure (Ihab, 2014; Mintah et al., 2014 and Humam and Ismail et al., 1992).

Experience in managing business is also one of the factors for business failure. According to Noor and Pi-Shen (2009), SME founder-owner in Australia and Malaysia strongly associated with their experience and difficulties or failure on their own business. Experience in managing business accounting was also influence the performance of a business.

According to Larson and Clute (1979) found that 40 percent of business failures were due to the issue of accounting and finance. In addition, 39 percent of businesses failed due to financial difficulties and the inability to manage inventory, 26 percent of businesses did not have a financial report and 22 percent did not have a complete financial report. Besides that, financial measures problem such as inability measuring profitability, liquidity and operational efficiency among of the internal factor for business failure. Study conducted by Xiangping (2012) revealed that the factors of profitability, liquidity, growth and profit structure are significantly associated with the likelihood of operation failure for business.

On top of that, higher gearing and lower profitability are associated with higher failure risk in SME (Nur Adiana et al., 2014). In this case, financial reporting is very important because business need financial reporting as a medium to record business transaction and use it to analyze business performance. Therefore, financial aspect plays an important role in every business and can gives bigger impact to the performance of a business.

Furthermore, Peacock (1986) study on the factors of bankruptcy among 132 firms in 1986, it was found that the main factor for business failure was the absence of a financial report. Besides that, Ashok (2015) claimed that SMEs was often have lack of knowledge and awareness about the accounting and financial issue. This was proved by William (1987) whereby he was revealed that there is positive relationship between business failure and the preparation of an incomplete financial report. In addition, the frequency for keeping financial reports has a positive relationship with the success of a business.

O'Nell and Jacob Ducker (1986) revealed that debt liability is one of the main reasons for business failure, and that most business failures have a high level of debt. Moreover, a business which is in financial distress can experience cost linked to the situation such as more exclusive financing, opportunity costs of project and less dynamic employee (Ahmad et al., 2014). In addition, the study conducted by Khan and Rocha (1982) revealed that most business failures did not use systematic accounting procedures and most of them only prepared the financial report for the calculation of tax. Khan and Rocha (1982) also found that most businesses faced a problem of working capital management.

A study in Canada indicated that most business failures were due to the absence of a financial report, which led to most of the banks having little confidence in the business. In addition, business failures also faced a higher total bad debt due to the lack of credit risk management. Bruno and Leidecker et al., (1987) found that financial problems was a factor in business failures, such as starting the business with a lack of capital.

According to the European Federation of Accountants (2004), poor accounting and reporting, and decisions based upon inaccurate financial information can actually cause problems, which may threaten the solvency of the business. Furthermore, not being aware of significant problems in accounting will increase the risk for the business. In addition, poor cash flow management and inappropriate sources of finance may also expose the business to risk. For example, unsuitable financing options result in an inconsistency between the liquidity of assets and the source of financing.

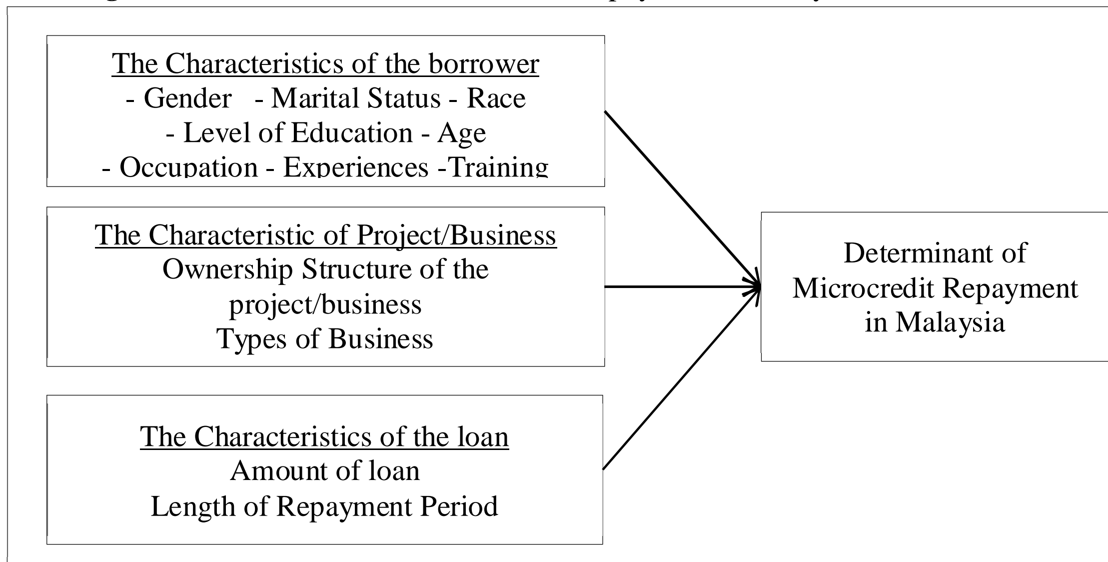
According to Women Entrepreneurship Centre (2011), cash flow problem is one of the reasons of the business failure. Furthermore, ultimate reasons for business failure are poor business planning, poor financial planning, poor marketing and poor management (Micheal, 2008).

Based on the explanation above, considerable evidence from previous studies showed that financial reporting and working capital management play an essential role in sustaining the successfulness of a business. In addition to appropriate framework could guide a business to manage credit risk by using financial reporting.

5. Discussion on Framework

Framework discussed in this section shows that many elements involved in managing credit risk and financial reporting is one of the important elements. Framework proposed in this study is based on previous research and study. Roslan and Zaini (2009) had study on Determinants of Microcredit Repaymant in Malaysia: The Case of Agrobank. The determinants of microcredit repayment above give the pictures on the characteristics that may influence repayment performance among creditor. It also can be related with the determinant of credit management in micro business. Some of the element will be used as a framework for this study. There are three characteristics have been described by Roslan and Zaini (2009) in their study as presented below:

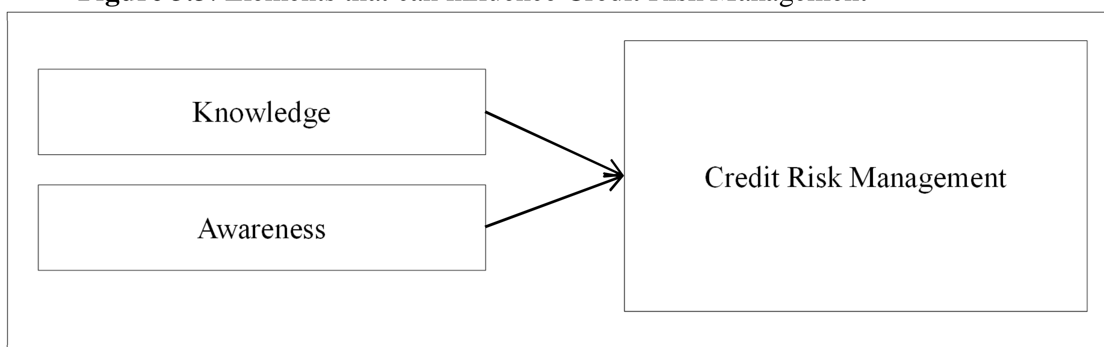
Figure 3.2: Determinants of Microcredit Repayment in Malaysia



Source: Roslan and Zaini, 2009

On top of that, there are two important elements that can influence credit risk management which are knowledge and awareness. According to Eduardo and John (2014), better knowledge management associated with better risk control. In respect of important of knowledge and awareness, Zainuddin (2009) claimed that many implications that illustrate the SMEs' lack of awareness and understanding on the important of various credit function. Thus, he suggested providing training for SME to increase knowledge, awareness as well as skill in managing trade credit. Given that these two elements are essential thus this study taking into account to put these elements in the framework of the study. To extent this further, figure below show the element that can influence credit risk management behavior:

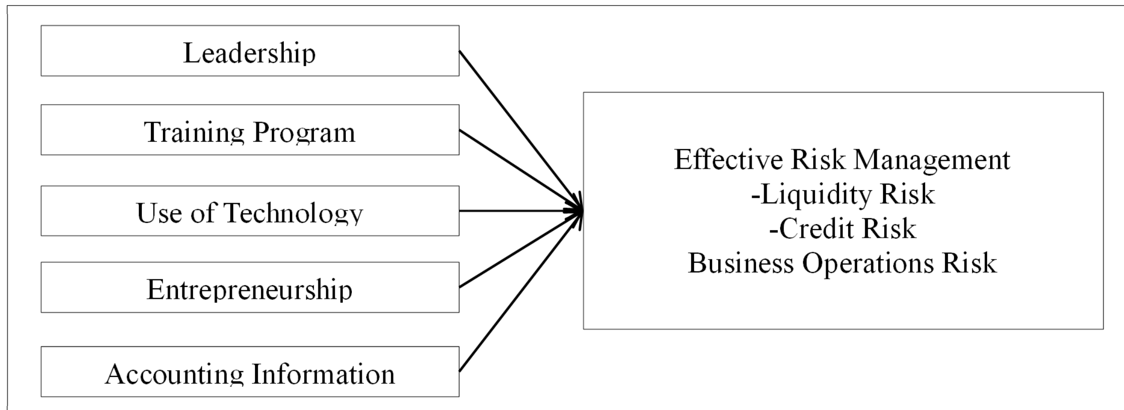
Figure 3.3: Elements that can influence Credit Risk Management



Source: Eduardo and John (2014) and Zainuddin (2009)

On top of that, financial reporting also plays a significant role in managing credit risk. Besides that, it should be able to help a business in revealing the performance and position of business from time to time. With regard to the matters, Nurulhasanah et al. (2015) has proposed the theoretical framework as figure below:

Figure 3.4: Theoretical Framework of Effective Risk Management

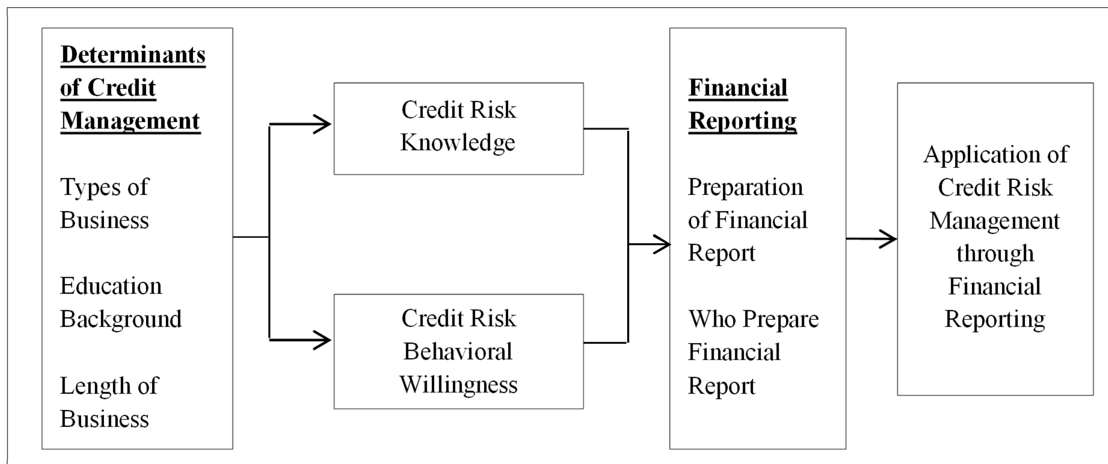


Source: Nurulhasanah et al., 2015

The study is highlighted on accounting information as one of the effective risk management including credit risk. Therefore, financial reporting will be investigated and included in the framework for this study.

Figure below shows the proposed conceptual framework for this study. Based on the previous literature and theory, the study used this framework with some modification for this study.

Figure 3.5: Proposed Conceptual Framework of the Study



Source: Framework proposed by Author

Three determinants of credit management variables were examined to investigate how its influence credit risks knowledge and behavioral willingness among micro-businesses. Types of business are the first variable to be investigated. It was divided into (1) sole-proprietorship, (2) partnership and (3) private limited company. The framework aimed to investigate whether differences in the type of business influenced credit risk management knowledge and behavioral willingness. Educational background was the second variable to be investigated. It was divided into (1) SPM and certificate, (2) Diploma, (3) Degree and (4) Master and PhD. The framework aimed to investigate whether educational background influenced credit risk knowledge and behavioral willingness. Third, the length of business was the variable investigated. It was divided into (1) less than one year, (2) two to four years, and (3) five to nine years. The framework aimed to investigate whether length of business influenced credit risk knowledge and behavioral willingness.

Credit risk knowledge refers to the experience or education concerning credit risk acquired by a person. The aim of this element was to investigate the credit risk knowledge towards variables whether it influenced credit risk knowledge. The variables to be investigated were determinants of credit management including (1) type of business, (2) educational background, and (3) length of business; while financial reporting included (1) financial report preparation and (2) who prepares financial report.

Credit risk behavioral willingness defines as an openness to risk opportunity – what an individual would be willing to do under some circumstances (Gibbons et al., 1998). The aim of the elements is to investigate the credit risk behavioral willingness about the variables and whether it influences credit risk behavioral willingness. The variables to be investigated are determinants of credit management including (1) type of business, (2) educational background, and (3) length of business; financial reporting included (1) financial report preparation, and (2) who prepares the financial report.

Two financial reporting variables were examined to investigate how its influence credit risks knowledge and behavioral willingness among micro-businesses. First, to examines the influence of the preparation of financial report on credit risk knowledge and behavioral willingness. Preparation of the financial report was further divided into (1) yes and (2) no; whereby indicating the preparation of financial reports among the respondents. The framework aimed to investigate whether preparation of financial report influenced credit risk knowledge and behavioral willingness. Second, considered the influence of who prepares the financial report on credit risk knowledge and behavioral willingness. This was further divided into (1) own preparation and (2) audit firm. The framework aimed to investigate whether who prepares the financial report influences credit risk knowledge and behavioral willingness.

6. Conclusion

The framework was indicated that it is important for all businesses to improve themselves with credit risk knowledge and credit risk behavioral willingness as these influence the preparation of financial reporting. Besides that, the aim of proposed framework is to guide a business in managing credit risk through financial reporting practices.

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