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SMALL COMPANY FINANCIAL REPORTING (SCFR): AN UPDATE BASED ON RECENT DEVELOPMENTS AND SELECTED GROUP PERCEPTIONS

(VOLUME I)

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TABLE OF CONTENTS

TABLE OF CONTENTS (Continued)

TABLE OF CONTENTS (Continued)

TABLE OF CONTENTS (Continued)

TABLE OF CONTENTS (Continued)

LIST OF TABLES

LIST OF TABLES

LIST OF TABLES

LIST OF TABLES

Tables for supplement to Chapter 8

SURVEY OF DIRECTORS

SURVEY OF DIRECTORS

Tables for supplement to Chapter 8 (continued)

SURVEY OF DIRECTORS

Tables for supplement to Chapter 9

SURVEY OF AUDITORS

Tables for supplement to Chapter 9 (continued)

SURVEY OF AUDITORS

Tables for supplement to Chapter 9 (continued)

SURVEY OF AUDITORS

Tables for supplement to Chapter 10

CONTINGENCY TABLES FOR TESTING DIRECTORS' HYPOTHESES

Tables for supplement to Chapter 10 (continued)

CONTINGENCY TABLES FOR TESTING DIRECTORS' HYPOTHESES

CONTINGENCY TABLES FOR TESTING AUDITORS' HYPOTHESES

Tables for supplement to Chapter 10 (continued)

CONTINGENCY TABLES FOR TESTING AUDITORS' HYPOTHESES

CONTINGENCY TABLES FOR TESTING AUDITORS' HYPOTHESES

Tables for supplement to Chapter 10 (continued)

CONTINGENCY TABLES FOR TESTING DIRECTORS' AND AUDITORS' HYPOTHESES

Tables for supplement to Chapter 10 (continued)

CONTINGENCY TABLES FOR TESTING DIRECTORS' AND AUDITORS' HYPOTHESES

Tables for supplement to Chapter 10 (continued)

CONTINGENCY TABLES FOR TESTING DIRECTORS' AND AUDITORS' HYPOTHESES

ADDITIONAL CONTINGENCY TABLES FOR TESTING DIRECTORS' HYPOTHESES

LIST OF ILLUSTRATIONS

LIST OF CASES CITED

CASE NAME

DEDICATION

I dedicate my thesis to

my parents and

my family.

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DECLARATION

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ABSTRACT

The main objective of this empirical research was to investigate whether there is a need for change in the accounting and audit requirements of small private companies in the UK, where there has been little empirical research or application of a theoretical framework for the analysis of the SC audit problems.

In order to achieve the research objective, a comprehensive literature review of small company financial reporting (SCFR) was carried out to ascertain whether there was a generally acceptable auditing framework to offer possible solutions to the SC audit problems. It also sought to identify the role played by the main parties in SCFR, and to examine the main SCFR issues and arguments in the SCFR debate. Furthermore, a survey of SC accounts was undertaken to check whether the disclosures seemed to be consistent with the various financial reporting requirements. In addition, postal questionnaires were used to ascertain the views of selected directors and auditors of SCs about SCFR issues.

The main findings of this empirical research broadly indicate, within a SCFR context, that:

There is a generally acceptable framework for company audit but due to the characteristics of SCs, there are a number of weaknesses in its application to SCs. The literature review identifies possible solutions to overcome some of these problems.

The survey of accounts indicates that there is an apparent improvement in filing of accounts within the statutory time limit and that there is a fall in the number of qualified audit reports. The survey shows that the majority of SCs do not take advantage of filing abbreviated accounts, and the extent of non-compliance with various financial reporting requirements appears not to be wide-spread.

With respect to the surveys of the directors and auditors, the study identifies a number of similar views concerning the ownership and control of SCs by their directors and their families, the limitation of liability as the main advantage of incorporation and the need for an audit as the main disadvantage. Other similarities were the need for replacing full and abbreviated accounts of SCs with one set of accounts including a shortened profit and loss account with possible disclosures of turnover and profit before tax figures. Differences of view emerged over directors' and auditors' perceptions of the value of an audit, with a higher proportion of directors claiming them to be valuable. Cross analysis of results provided some assurances about the consistency of the above results.

Comparing the results of these surveys with those of Page (1981), they appear to suggest that there are changes in directors' and auditors' attitudes over the last decade regarding the need for an audit and the main uses of SC accounts.

In conclusion, this empirical research calls for simplification of the form and content of SC accounts and the relaxation of audit requirement for certain categories of SCs.

LIST OF ABBREVIATIONS

AAPA	Association of Authorised Public Accountants
ACCA	Chartered Association of Certified Accountants
AICPA	American Institute of Certified Public Accountants
APB(C)	Auditing Practices Board (Committee)
ASB(C)	Accounting Standards Board (Committee)
CA	Companies Act
CCAB	Consultative Committee of Accountancy Bodies
CICA	Canadian Institute of Chartered Accountants
CIMA	Chartered Institute of Management Accountants
CIPFA	Chartered Institute of Public Finance and Accountancy
CPA(s)	Certified Public Accountant(s) (USA) (members of AICPA)
CUBS	City University Business School
DoT	Department of Trade
DTI	Department of Trade and Industry
FASB	Financial Accounting Standards Board (USA)
FRS	Financial Reporting Standard
GAAP	Generally Accepted Accounting Principles (USA)
IAPC	International Auditing Practices Committee
ICAEW	Institute of Chartered Accountants in England and Wales
ICAI	Institute of Chartered Accountants in Ireland
ICAS	Institute of Chartered Accountants of Scotland
JMU	Joint Monitoring Unit

LIST OF ABBREVIATIONS

(Continued)

LSCA	London Society of Chartered Accountants
SC(s)	Small Company (ies)
SCFR	Small Company Financial Reporting
SEC	Securities and Exchange Commission (USA)
SSAP	Statement of Standard Accounting Practice
TR	Technical Release
UEC	Union Europeenne des Experts

LIST OF DEFINITIONS

Small Company Financial Reporting (SCFR)

The term SCFR refers to a Small Company's accounts and statutory audit.

Small Company (SC)

For the purpose of this research, a "small company" refers to a non-dormant private company which satisfies at least two of the following thresholds in a financial year (i.e. a definition based on the Companies Act 1985 for filing abbreviated accounts, S 247 CA 1985):

	At time of survey	current limits
- turnover not exceeding	£2.000m	£2.8m
- balance sheet total not exceeding	£0.975m	£1.4m
- average number of employees not exceeding	50	50

(For other definitions of a SC see section 4.3).

Very Small Company (Very SC)

The term "Very Small Company" refers to a private company with annual turnover below the threshold for VAT registration and balance sheet total not exceeding £1.4m (see section 5.8.1 for more details).

Proprietary Company

The term "Proprietary Company" refers to a private owner-managed company with annual turnover in excess of VAT registration threshold but less than 25% of the turnover limit of a SC as defined by the CA 1985.

Audit

"An 'audit' is the independent examination of, and expression of opinion on, the financial statements of an enterprise" (para. 2 to the Explanatory Foreword, Auditing Standards and Guidelines, ICAEW, 1993b). For other definitions of audit see section 2.2. Alternatives to SC audit (for example, review and a compilation report) are compared in section 5.7.

Review

"A review could be described as a procedure whereby an accountant, relying upon the assumption that his client has made a full and fair disclosure of all the relevant information, satisfies himself (after completing work in accordance with an approved review standard) that on the basis of information and explanations so provided the financial statements give a true and fair view" (APC, 1979: para. 43). For other definitions of a review and its comparisons with other alternatives to SC audit see section 5.7.

Compilation Report

Compilation report is a statement by a competent person that accounts have been properly prepared from information supplied by management and conformed as regards content and layout with the specification of the Companies Act (DTI, 1988). For other definitions of a compilation report and its comparisons with other alternatives to SC audit see section 5.7.

VAT thresholds

	At time of survey	current limits
	£	£
i) For VAT registration	36,600	45,000
ii) For VAT cash accounting	300,000	350,000

<u>Note</u>
This thesis makes frequent reference to auditing and the auditor which are to external auditing and the external auditor respectively.

Additionally, references to the auditor are made in the masculine only, but equally applies to the feminine form.

LIST OF ACCOUNTING STANDARDS

SSAPs, FRSs AND FASB Statements

(REFERRED TO IN THIS RESEARCH)

Statements of Standard Accounting Practice (SSAPs)

SSAP 2	Disclosure of accounting policies
SSAP 3	Earnings per share (amended by FRS 3)
SSAP 4	Accounting for Government grants
SSAP 6	Extraordinary items and prior year adjustments (replaced by FRS 3)
SSAP 9	Stocks and long term contracts
SSAP 10	Statements of source and application of funds (replaced by FRS 1)
SSAP 12	Accounting for depreciation
SSAP 13	Accounting for research and development
SSAP 14	Group accounts (replaced by FRS 2)
SSAP 15	Accounting for deferred tax
SSAP 17	Accounting for post balance sheet events
SSAP 18	Accounting for contingencies
SSAP 19	Accounting for investment properties
SSAP 21	Accounting for leases and hire purchase contracts
SSAP 23	Accounting for acquisitions and mergers
SSAP 25	Segmental reporting

Financial Reporting Standards (FRSs)

FRS 1	Cash flow statements
FRS 2	Accounting for subsidiary undertakings
FRS 3	Reporting financial performance

LIST OF ACCOUNTING STANDARDS

SSAPs, FRSs AND FASB Statements

(REFERRED TO IN THIS RESEARCH)

(Continued)

Financial Accounting Standards Board (FASB) Statements

FASB Statement No. 21	Suspension of the reporting of earnings per share and segment information by nonpublic enterprises
FASB Statement No. 33	Financial reporting and changing prices
FASB Statement No. 36	Disclosure of pension information
FASB Statement No. 69	Disclosures about oil and gas producing activities

CHAPTER 1

INTRODUCTION

1.1 Statement of problem

All companies incorporated under the Companies Acts are required to have their accounts audited with the exception of:

- dormant companies (which do not trade and have no accounting transactions during their financial periods); and

- those small companies (with annual turnover up to the VAT cash accounting threshold) which were exempt by the November 1993 Budget (for more details see section 5.8).

However, the laws of almost all other EC countries do not require small private companies (SCs) to have their accounts audited. Similarly, SCs in the United States, Australia, New Zealand and Canada do not require an audit.

The administrative and legislative burdens imposed on small businesses have been a controversial issue for many years. In particular, issues such as the retention of the SC audit and the application of accounting standards to SCs have been the subject of extensive debate in the UK (e.g. APC, 1979 and Carsberg et al, 1985).

SCs as defined by the Companies Act (CA) 1985 may file abbreviated (modified) accounts with the Registrar of Companies but they must prepare and circulate full accounts to their members. The form and content of these full and abbreviated accounts are also subject to debate (e.g. LSCA, 1992; DTI, 1995).

The following section provides an outline of SCFR issues and debate. Full details of these issues and debate are provided in subsequent Chapters.

1.2 Outline of SCFR issues and debate

Over the last twenty years, there have been much public debate and research about SCFR issues (e.g. DoT, 1979; APC, 1979; Page, 1981; Abdel-khalik, 1983; Robertson, 1986a; Keasey and Watson, 1987; Freedman and Godwin, 1993) and in particular on the application of accounting standards to SCs (Carsberg et al, 1985), form and content of SC accounts (DTI, 1985b; DTI, 1995), whether SCs should be audited or not, and alternatives to SC audit (APC, 1979; DTI, 1985b; DTI, 1988; LSCA, 1992; ICAEW, 1992b).

Despite the economic importance of small businesses, for example in creating employment (Storey, 1994) and being innovative (Cross, 1983), there is no single, uniformly acceptable definition of a SC and most definitions of a SC overlap greatly (Storey, 1994) and generally speaking, they comprise the vast majority of all companies in the UK (see Freedman and Godwin, 1993). SCs are claimed to have specific characteristics, such as owner/manager dominance and internal control deficiencies resulting from limited segregation of duties (Raiborn, 1982) which may make it rather difficult for the auditor of a SC to rely on its internal control (UEC, 1983), resulting in the audit of a SC to be different from that of a large company (Humphrey and Turley, 1986).

With regard to <u>ownership and control</u> of SCs, a number of leading studies (e.g. Page, 1981 and Humphrey et al, 1986) indicate that SCs are generally owned and controlled by their directors, possibly bringing into question the appropriateness of the current reporting requirement (based on the stewardship principle) by directors to themselves as shareholders.

As to the <u>application of accounting standards</u> to SCs, Carsberg et al (1985) argues that compliance costs are relatively higher for SCs and their benefits are relatively lower. In this regard, the ASC (1988a) accepted that there was a case, in specific circumstances, for exempting small entities from certain provisions of accounting standards. It is worthy of note that the CCAB working party on "Big GAAP/Little GAAP" recently proposed radical exemptions relieving SCs from the requirements of the majority of accounting standards (for more details see section 4.11).

In terms of the <u>burden of financial reporting</u>, the DTI (1985a) suggested that SCs should be subject to less rigorous disclosure requirements in their annual accounts. Carsberg et al (1985) also investigated the burden of financial reporting on SCs by examining the costs and benefits of accounting disclosure and statutory audit. They found that their sample directors considered the production of the annual accounts one of administrative difficulty rather than one of the main problems facing SCs (see section 4.12).

According to Moizer (1991), <u>auditor independence</u> may be threatened, principally because of the nature of the economic relationship between auditor and client. However, Humphrey et al (1986) found that the reliance placed on the auditor by a SC client increased with multiple services (e.g. accounting, taxation, management advice) and this in fact might increase the auditors' power in dealing with SC clients without conflicting with the interests of management.

With reference to the <u>form and content of SC accounts</u>, LSCA (1992) argues that the distinction between full and abbreviated accounts of SCs, and even the occasion when the latter may be used, is not well understood by SCs. On the other hand, Robertson (1986a) provides some evidence in support of the option for SCs to file abbreviated accounts.

The debate in this area, which has been going on for the past decade or so (see DTI, 1985b and DTI, 1995) is yet to be settled. This warrants a thorough investigation.

As to whether SCs should <u>be audited</u> or not, the APC (1979) in its discussion paper sets out the arguments for and against SC statutory audit requirement. It stresses that the case for retaining SC audit rests on the value of the audit to those who have an interest in SC affairs (shareholders, banks, creditors, etc.). For example, with reference to shareholders, on the one hand, it argues that an audit provides some assurance as to whether the accounts give a "true and fair" view and, in particular, it may protect the interests of minority shareholders. On the other hand, the discussion paper (APC, 1979) argues that the independent audit is of little value to shareholders, who are all directors and actively involved in the management of the company.

The paper also considers the effect of other issues, such as "limited liability". It argues that limited liability is an important benefit provided to shareholders of a limited company and statutory audit is a valid price for this perceived benefit. However, it argues that in many SCs, the benefits of limited liability have been eroded because directors have to give personal guarantees for their companies' borrowings (for full discussion of these arguments see section 5.6).

Furthermore, it has been argued that problems invariably arise in the application of normal auditing principles and procedures to many SCs because of their characteristics (e.g. owner/manager dominance and internal control deficiencies) which may bring into question "whether such a company can and should be subjected to a normal audit" (Woolf, 1994:319). In addition to the above, it has been claimed that statutory audit imposes real costs on SCs (DTI, 1993 and Freedman and Godwin, 1993), in particular, the opportunity cost of diverting management time to deal with the audit matters and the extra cost of the new audit regulation introduced by the CA 1989 (see for example, Fearnley and Page, 1992 and 1993 and section 5.4). In this regard, Fearnley and Page (1993:59) report that opinion against retaining the SC audit has been hardened.

In anticipation of change, the DTI (1988)'s consultative note considered alternatives to an SC audit, in particular, a compilation report and a review (for full discussion see section 5.7). In response, the ICAEW (1988) expressed some concern at how the various alternative forms of report would be interpreted by the reader of the accounts. In this regard, a study by Johnson et al (1983) found that the decision to grant a loan or determine the interest-rate premium was not "significantly" affected by involvement of the auditor. In another study carried out by Arnold and Diamond (1981), who investigated the reactions of CPAs and bankers to the introduction of new services (in July 1979) to nonpublic companies in the USA - namely compilation, review and audit - found that their respondents claimed that the introduction of review and compilation services was a positive development by the accounting profession.

In addition, there are a number of recent discussion papers on this issue, for example, LSCA, 1992; ICAEW, 1992b and DTI, 1993 highlighting the importance of the SC audit debate and the controversy surrounding it which warrants an empirical investigation.

It is worth mentioning that published literature covers issues around the SCFR debate in a piecemeal fashion only and there is little research of an empirical nature on this topic (Robertson, 1986a and 1986b). In fact, according to Robertson (1986a:21):

> "...there has been a failure to obtain general consensus in the small company financial reporting and auditing debate. It was suggested that one factor which may have contributed towards this lack of achievement is that the various organisations and bodies involved in the debate and concerned with making submissions to the Department of Trade have not all been in possession of the same information - that is, in the form of published empirical research".

This research seeks to contribute to this field by obtaining general consensus in the SCFR and auditing debate.

1.3 Lack of application of a theoretical framework to SCs

The literature review identifies broadly two main types of approach adopted to establish a rationale for auditing within a coherent theoretical framework. The first approach (i.e. audit postulates), which was developed by Mautz and Sharaf (1961) and adopted by other audit theorists such as Sherer and Kent (1983) and Flint (1988), includes assumptions which are claimed to be "the fundamental theoretical truths of corporate auditing" (Lee, 1993:74) and are thought to provide the basis for the development of general auditing concepts. However, there are conflicting viewpoints about the usefulness of this approach. For example, Hamilton (see Gwilliam, 1987:42) has argued that Mautz and Sharaf (1961)'s conceptual model has failed to provide any empirical testable results.

By contrast, the second approach explains the demand for and supply of audit services within the context of various theories of an economic framework for auditing. In particular, the agency theory, which generally speaking is concerned with the principal-agent problem in the separation of ownership and control of the firm (Jensen and Meckling, 1976), argues that shareholders (the principals) may be able to maximise their wealth by using incentive compensation contracts together with independent monitoring of the financial reporting, and that the need for monitoring may also come from the agent (Evans, 1980). Indeed, according to Ng and Stoeckenius (1979) the above situation encourages more accurate reporting and demand for external auditing. Other theories within the economic approach provide some explanation for the need for audit; for example, the information theory indicates that an audit can help investors to improve their decision making (Wallace, 1985) or, according to the insurance theory, an audit may be needed to provide protection against financial failure of companies

(Antle, 1982).

The signalling theory predicts that an external audit may be required by some clients in order to set themselves apart from others in the market (Morris, 1987), whereas according to the behavioural theory, an audit may, generally speaking, influence the behaviour of staff in a company (Churchill et al, 1982).

The two other main theories in this approach, namely the contracting theory and the political process theory, have the potential to explain auditing practice. Watts and Zimmerman (1986) argue that these explanations are generally intuitive and their predictions are not formally tested. However, one study (Chow, 1982) used contracting variables to predict which firms hired professional auditors in 1926 when such an audit was not required by law. With reference to the political process theory, there are a number of empirical studies which indicate that regulation has an effect on auditing (DeAngelo, 1982; Watts and Zimmerman, 1981b; Simunic, 1980).

From the above published literature and research on a theoretical framework for company auditing, there appear to be gaps in understanding their application to the SC audit debate. Indeed, the need for their application has been put forward by Robertson (1986b), who argues that one of the factors which may have contributed to lack of progress in the SC audit debate is that "there has been no application of a theoretical framework for the analysis of the small company audit problem". He goes on to add that "without reference to an underlying theory, it is difficult to put the various arguments in perspective. There is, therefore, no rational or consistent means of evaluating alternative solutions" (pp. 50-51). This piece of work is a contribution in this direction.

1.4 Research objective and significance

The main objective of this research was to investigate whether there is a need for change in the accounting and audit requirements of small private companies, based on recent developments and the perceptions of selected groups affected by the debate, i.e. directors and auditors of SCs. To achieve this objective, a comprehensive literature review of the SCFR issues was undertaken together with a review of some SC accounts. Furthermore, postal surveys of SC directors and auditors were carried out.

This study is significant insofar as it comprises empirical research which develops issues raised in various discussion papers, for example, the DTI, 1993; ICAEW, 1992b and LSCA, 1992 and it responds to Robertson's (1986a and 1986b) identified need for research in this field. This research also responds to the need of the APC (1991) which considered the scope of SC audit. It was because of the significance of this study and the topicality of the SCFR debate that CUBS sponsored and LSCA supported this research.

Preliminary reports on the research findings were presented to the DTI, ICAEW, LSCA and other interested parties in July 1993 which demonstrated substantial support for SCFR reform. It is hoped that the research findings might provide a basis for APB and ASB pronouncements affecting the SCFR with a view to reducing the accounting and audit burdens on SCs.

Finally, it is hoped that the research findings might help to provide a basis for a way forward in the apparent division between the accountancy profession and the DTI, and also among accountancy bodies on the SCFR issues.

1.5 Outline of the study and summary of the major findings

The rest of this work is structured as follows:

In Chapter 2, a comprehensive literature review on the theoretical framework for company auditing is provided. This helps to establish a rationale for auditing and to examine its application to the SCFR debate. The review identifies apparent weaknesses in the assumptions which form the foundation of the framework as far as SCs are concerned. In the search for a possible solution, two broad options are identified, namely: change the "practice" or change the "aims and objectives" to make them compatible. However, in order to decide which option might be preferred, there is a need to obtain general consensus in the SCFR and auditing debate (see surveys in Chapters 7, 8 and 9).

Chapter 3 examines the role played by the major parties (e.g. the regulatory bodies and professional institutions) in the SCFR debate, what they represent and how their decisions are influenced. For example, with regard to the professional institutions' role in the SCFR debate, the literature review indicates that "self-interest" has led to the lack of consensus among them.

Chapter 4 reviews the published literature to identify some of the important issues in a SC environment which affect SCFR. In particular, the review examines the economic importance of small businesses; definitions of a SC; their characteristics, ownership and control; the form and content of SC accounts; and their main users. The review concludes that some of these issues need to be investigated further in order to establish a fair balance between the different needs of the diverse interests involved.

Chapter 5 considers the SCFR debate by reviewing the history of the company audit; provisions of the main CAs; and the background to the SCFR debate since 1979. The effects of audit regulation on the SC audit debate, the main arguments in favour and against SC audit requirement, alternatives to an SC audit and their consequences are discussed in detail in this Chapter. The review concludes that the statutory audit requirement may impose a real cost on SCs and the government's drive to free SCs from unnecessary burdens appears to be in the right direction.

Chapter 6 considers the methods of data collection and analysis.

The main findings of the survey of accounts are presented in Chapter 7, which broadly indicate that there is an apparent improvement in the filing of accounts within the statutory time limit and also a fall in the number of qualified audit reports on SC accounts. The review also indicates that the accounts of SCs generally comply with the requirements of the CA and the "basic" SSAPs requirements.

Chapters 8 and 9 report respectively on the main findings of postal surveys of a sample of SC directors and auditors. The surveys were carried out in order to obtain a general consensus in the SCFR and auditing debate. With regard to the form and content of SC accounts in particular, the surveys provide some interesting empirical evidence in support of replacing both full and abbreviated accounts of SCs with only "one set of accounts", and also point to their possible benefits and contents. With reference to a possible change of audit requirement of SCs, the findings provide empirical evidence in support of SC audit relaxation and also examine its consequences.

Chapter 10 is devoted to testing the research hypotheses and provides some assurances regarding the consistency of the primary results reported in Chapters 8 and 9 it also identifies some diversity of opinion among respondents in respect of SCFR issues.

Finally, Chapter 11 sets out the research summary, main findings and recommendations, and areas for further research.

CHAPTER 2

AUDIT: THEORETICAL FRAMEWORK

2.1 Introduction

In this Chapter, an attempt will be made to provide some definitions of an audit and an outline of the modern view of the audit function. It will also discuss the main types of approach that a number of researchers have adopted to establish a rationale for auditing within a coherent theoretical framework. The first approach considers some fundamental postulates which are assumed to provide the foundations for the development of a logical and integrated theory of auditing. In this respect, the company audit framework as put forward by Mautz and Sharaf (1961) and Lee (1982) will be considered. The second approach looks at the economic considerations of the need for auditing (i.e. the demand for and supply of audit services). Within the economic framework, the application of agency theory, information theory, insurance theory, signalling theory and behavioural theory will be discussed.

Furthermore, within the economic framework, the application of positive accounting theory to auditing will be explained. The application of a theoretical framework to the SC audit debate and possible solutions are presented in this Chapter.

2.2 Audit

This section briefly provides some of the definitions of an audit and an outline of the modern view of the audit function. Other special audit functions are considered in the remaining part of this Chapter.

Unaudited statements and data are claimed to have an information value (Flint, 1988) and the purpose of audit is:

> "...to add to that information value by expressing an opinion on the credibility, meaning, significance, reliability, legitimacy, legality or regularity of the statement or the data. The audit lends some authority, or alternatively explicitly denies authority, to the message which the originator of the statement or the data intended to convey...". (Flint, 1988:38).

According to Flint (1988), most definitions of audit are "oriented to a specific situation" as the following definitions by the two major international bodies bear out:

The first International Auditing Practices Committee of the International Federation of Accountants Guideline (IFAC, 1980:9) states that:

> "The objective of an audit of financial statements prepared within a framework of recognised accounting policies, is to enable an auditor to express an opinion on such financial statements. The auditor's opinion helps establish the credibility of the financial statements".

Furthermore, the AICPA (1973:1) states that:

> "The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles".

The main theme common to these definitions appears to be the process of an independent examination of financial statements and the expression of an opinion to certain users. Indeed, in the UK, the explanatory foreword to

Auditing Standards and Guidelines (see ICAEW, 1993b) states that:

> "An 'audit' is the independent examination of, and expression of an opinion on, the financial statements of an enterprise".

This definition was adopted for the purpose of this research.

With reference to the above definition, the Green Paper "The Future Development of Auditing" (ABP, 1993:89) argues that "the present role of company audit is narrowly drawn" as the CA requires an "auditor to report to shareholders on a financial account of past activity" and it is "based on legislation formulated nearly fifty years ago" (the CA 1947). The APB (1993:89) goes on to argue that this definition is not concerned with the future and it does not recognise a public interest beyond the needs of shareholders.

The Green Paper offered for public debate a number of proposals for change in the current state of auditing and suggested that in the face of substantial change both in the commercial environment and in the expectations of users of financial statements, the <u>auditing profession needs to accept change</u>.

In particular, the Green Paper proposed the need to redefine the role and scope of audit and the acceptance by auditors of wider responsibilities. These could extend beyond those currently required by statute or case law, such as warning shareholders or other stakeholders of substantial future risks, to encompass the detection of fraud or other illegal acts.

The outcome of the debate on the Green Paper (APB, 1993) and other APB's initiatives were considered in the paper

"The Audit Agenda" (APB, 1995). The key proposals of this paper (APB, 1995) relate to the future role of auditors and the scope of audit which mainly apply to listed companies, and they are considered below. The paper proposes that the scope of audit for listed companies and major economic entities must be differentiated from that of unlisted, owner-managed businesses and in this regard it suggests that the APB will develop guidance on the application of auditing standards to the audit of owner-managed businesses.

In the foreword to this paper, Professor Percy refers to the function of an audit; he states that it is about governance, and about upholding the integrity of financial reporting and business conduct. He stresses that audit is about "constructively adding value to confidence in those entities".

In explaining why a need for audit exists, the APB (1995:para. 2.4) states that:

> "...legal or market requirements for audit arise from the existence of one or more groups with a valid interest in the entity which do not have direct access to information concerning its performance, whose members will often seek an account, from those who run the entity, of the matters with which they have concerns and will look to auditors to add value to that account".

Furthermore, commenting on the nature of the interests which give rise to the need for audit, APB (1995) states that there is a public interest in ensuring proper accountability by those who manage entities.

With reference to the purpose of audit, the APB (1993 and 1995) argues that there are perceived gaps in the scope of audit, particularly regarding directors' stewardship, future prospects and detection of risk and fraud. To deal with these concerns, the APB (1993 and 1995: para.

4.3) proposes that the purpose of audit should be defined as being:

"to provide an independent opinion to those with an interest in a company that they have received from those responsible for its direction and management an adequate account of:

* <u>the proper conduct of the company's affairs</u> - a role which is now widely expected of auditors but is not part of the conventional definition of an audit;

* <u>the company's financial performance and position</u> - the traditional role of reporting on financial stewardship;

* <u>future risks attaching to the company</u> - a newly defined role, recognising that it is not the purpose of financial statements to predict the future".

As regards the precise scope of the auditors' role, the APB (1995) suggests that it should encompass the above three elements of the definition of audit but it is concerned that those might be construed too widely, extending the expected role into areas in which auditors would be ill-placed to deliver any assurance. Taking these concerns into account, the APB (1995: para. 4.7) proposes the following general statement of the role of auditors:

a) "to provide objective assurance on an entity's published financial reports, principally for the benefit of primary stakeholders to whom the auditors owe a duty of care, but also for the information of other stakeholders".

b) "to provide advisory reports to directors or officers (including the audit committee) on governance matters, including risks and sensitivities relating to going concern and the appropriateness and adequacy of its systems of controls; in particular, arrangements for stewardship of assets, minimisation of risk of fraud and compliance with laws and regulations".

c) "to provide to appointing agencies in the public sector or to regulators the information or assurance that they require through statute or by agreement".

It is worth mentioning that the existing statutory requirements cover some, but not all, elements of the role of auditors as defined above.

The APB (1995) recognises that auditors will be reluctant to expand their statutory role until changes take place to the legal environment in which they operate, in particular in respect of Section 310 of the CA 1985 which prohibits persons appointed as auditors of a company from obtaining exemption from any liability attached to them in respect of breach of duty towards the company. However, in order to encourage auditors to expand their statutory role, the APB (1995) stresses that these proposals should allow for the scope of audit to be determined on a "market-led basis", to be agreed by contract, rather than the imposition of new legal requirements.

It is worth pointing out that the various definitions and the scope of audit cited above relate to what is generally referred to as "corporate or company audit". This is different from an operational audit, a management audit and a social audit, which are briefly alluded to below.

According to Flint (1988:174-175) an operational audit is intended "to provide a measure of the achievement of an organisation towards its goals and objectives...", whereas, a management audit is concerned with:

> "A comprehensive examination, analysis and evaluation by an independent external auditor of the performance of management in regard to the objectives, plans, procedures and strategies of the business enterprise...".

With regard to social audit, Flint (1988:75) states that:

> "Social audit has to do with social responsibility and

monitoring the way in which an organisation conducts itself in its various relationships with society - as employer, manufacturer, supplier, member of the community, etc.".

It should be borne in mind that there are alternatives to company audit such as a review or a compilation report, which are considered in detail in section 5.7.

Finally, it is worth pointing out that an audit can commence after the necessary accounting work has been completed. However, in practice, especially in the case of SCs, the distinction between audit and accountancy work, as Woolf (1994) has observed, is not clearly appreciated. This lack of appreciation apparently is due to the limited book-keeping and accounting experiences of those involved in managing SCs.

The preparation of the accounts is not part of the audit but it may provide the SC auditor, who has prepared the accounts, with extra assurance, thus allowing for reduced testing in other audit areas.

2.3 Postulates framework for auditing

2.3.1 Mautz and Sharaf's company audit framework

Mautz and Sharaf (1961) provide a skeleton framework within which auditing thought could be developed. They focus on the nature of the audit process for determining those criteria necessary for the adequate performance of the audit function.

Mautz and Sharaf (1961:42) offer the following "tentative" postulates which provide the foundations for developing a logical, integrated theory of auditing:

- "financial statements and financial data are verifiable;

- there is no necessary conflict of interest between the auditor and the management of the enterprise under audit;

- the financial statements and other information submitted for verification are free from collusive and other unusual irregularities;

- the existence of a satisfactory system of internal control eliminates the probability of irregularities;

- consistent application of generally accepted principles of accounting results in the fair presentation of financial position and the results of operations;

- in the absence of clear evidence to the contrary, what has held true in the past for the enterprise under examination will hold true in the future;

- when examining financial data for the purpose of expressing an independent opinion thereon, the auditor acts exclusively in the capacity of an auditor; and

- the professional status of the independent auditor imposes commensurate professional obligations".

According to Mautz and Sharaf, postulates are:

> "...assumptions that do not lend themselves to direct verification. The propositions deduced from the postulates of a given system, however, can be directly verified and such verification bears evidence of the truth of the postulates themselves" (Mautz and Sharaf, 1961:37).

They emphasize (1961:39) that "...the postulates, once accepted as useful and valid, may at a later date be challenged and even demonstrated to be invalid". Therefore, these postulates must be reviewed continually to see if they have become invalid because of new circumstances and if so, they should be discarded.

Mautz and Sharaf (1961:42) provide explanations for each postulate as justification for their selection. References to some of these explanations are made here. With reference to the postulate that "financial statements and financial data are verfiable", they argue that "Unless financial data are verifiable, auditing has no reason for existence. If we release this assumption, we do away with the very subject of auditing" (p.42). In this regard, they refer to various definitions of "verification" and in particular, they state that (p.43):

> "Verification is the vehicle that carries one to a position of confidence about any given proposition. Such confidence may be positive or negative; that is, there may be assurance supplied by the verification procedure that the proposition is right or wrong, but the confidence cannot be blind. There must be evidence to support it, sufficient reason, sufficient " competent evidential matter". Otherwise the fancied assurance is nothing more than folly".

Furthermore, it is worth pointing out that Mautz and Sharaf (1961:43) have cited Hospers noting that:

> "In order to know what a statement means, we must know how to verify it; we must know what operations we would have to go through in order to determine its truth or falsity".

With regard to the proposition that financial statements are free from collusive and other unusual irregularities, Mautz and Sharaf (1961:46) argue that:

> "If we assume that the data under examination do include irregularities resulting from extensive collusion and of the most unusual nature, we must design an audit program far beyond anything now considered necessary. In fact, there is some question whether any type of examination could be designed that would give even a reasonable assurance that all such irregularities would be discovered".

Further discussion on the above has been provided in section 2.5, where the application of a theoretical framework to the SC audit debate has been considered (see "Major fraud and error").

Finally, with reference to the postulate that internal control eliminates the probability of irregularities, it is worth noting that the term "probability" rather than "possibility" has been used. This is because, as Mautz and Sharaf (1961:47) argue, "It is doubtful that the possibility of irregularities can ever be eliminated, although of course it can be reduced". Furthermore, in this regard they emphasize that (p.47):

> "...it is the probability of irregularities that is *eliminated, not irregularities themselves.* Irregularities are still possible under good internal control, but they are no longer probable. On the other hand, if the internal control is not satisfactory, then errors and irregularities must be considered something more than merely possible".

In their work, Mautz and Sharaf (1961:245) offer a comprehensive view of auditing in a five level structure which shows the relationship between <u>audit theory</u> and <u>audit practice</u>. A <u>simplified version</u> of their original pie-shaped chart (Mautz and Sharaf, 1961:247) showing the structure of auditing as a field of knowledge is presented below:

<u>Illustration 2.1: Structure of auditing as a field of knowledge</u>

Central core of abstract thought
(Mathematics, Logic and Metaphysics)

|

Level 1: Philosophical Foundation (rests on fundamental disciplines)

|

Level 2: Postulates (provide a groundwork for concept development)

|

Level 3: Concepts

|

Level 4: Precepts (provide directives for guidance of the practitioner)

|

Level 5: Practical Applications (practice)

In the above illustration each level is derived from the level immediately above it (e.g. concepts are derived from postulates and so on).

This illustration will be used later in conjunction with Lee (1982)'s and Robertson (1986b)'s illustrations to consider their application to the SC audit debate.

2.3.2 Lee's company audit framework

Lee (1982) develops three groups of auditing postulates from ideas contained in Mautz and Sharaf's monograph "The Philosophy of Auditing" (1961). The first group of postulates (justifying postulates) is concerned with justifying assumptions relating to the existence of the company audit. The second group (behavioural postulates) is concerned with the behavioural aspects of company auditing and the third group (functional postulates) relates to actual work performed by the auditor.

These postulates are briefly considered below.

a) Justifying postulates

There are five main postulates relating to the existence of the company audit (Lee 1982:84), reproduced below with explanations where necessary.

i) "Unaudited annual accounting information lacks sufficient credibility".

The CA 1985 requires all companies (with the exception of those companies noted in Chapter 1) to have their accounts audited. The ultimate aim of verified information (audited accounts) is that it is credible and that it should have the capacity to give its users belief in the overall quality of its accounting message content (see Lee, 1993:48).

The company directors are legally responsible for the preparation of the accounts. In this way, they make themselves accountable to the shareholders for their stewardship of the company's resources. It could be argued that due to economic incentives, management may not act impartially when producing the company's annual accounts. Therefore, there is sufficient doubt about the credibility of annual accounts to justify an audit. The need for audit becomes more evident in the large public companies where shareholders and other users of the accounts are firmly divorced from management. (For further discussion see "agency theory" in section 2.4.1).

The above postulate, Lee (1993:75) argued, is the most fundamental of all in corporate audit theory. If it is not acceptable, then no other is reasonable.

ii) "Attestation of annual accounting information credibility is the most pressing audit need".

iii) "Attestation of annual accounting information credibility is best achieved by a legally required audit".

iv) "The credibility of annual accounting information can be verified and attested".

The CA 1985 requires the auditor to give an opinion on the "truth and fairness" of annual accounts and in this regard Lee (1982:76) argues that "it has to be assumed that the information can be satisfactorily verified and attested...", because to believe otherwise, Lee argues, "would be asking the auditor to attempt an impossible task".

However, Lee (1982:76) acknowledges that there are "certain circumstances which are a potential threat to the absolute validity of this notion..." as there may exist "certain items of information which are difficult, if not impossible, satisfactorily to verify and evidence" (Lee, 1982:77). For example, in smaller companies, the auditor may find it difficult to verify all accounting information and records. Nevertheless, Lee (1982:77) argues that "on the whole, it appears to be reasonable to assume that accounting information in general can be adequately audited".

v) "Shareholders and other report users cannot normally attest annual accounting information credibility personally".

b) Behavioural postulates

The quality of an audit depends on the behavioural standards of the auditor. For this reason, the UK professional accountancy bodies set their own guidance statements on professional conduct and ethics and they expect their members to observe them in their audit assignments in order to lend further credibility to the accounting information they audit.

There are five main behavioural postulates for auditing, reproduced from Lee (1982:85) with relevant explanations.

i) "There is no unnecessary conflict of interest between the auditor and management".

The above postulate is based on the assumption that the company management will cooperate with the auditor to enable him to proceed with his audit in order to meet audit objectives.

The CA 1985 (S237(3)) gives adequate right to the auditor to access all such evidence necessary to report on the accounts.

ii) "There is no unreasonable legal restriction on the auditor".

The CA 1985 allows the auditor freedom of action to conduct his audit. These can be found in the following sections of the Act:

* S388(3) and S387(2) CA 1985 - giving the auditor the right to make personal representations to shareholders and to attend and be heard at the relevant meeting.

* S237(3) CA 1985 - giving the auditor the right of access at all times to the books, records, information and explanations necessary for his audit.

* S387(1) CA 1985 - giving the auditor the right to attend and be heard at any general meeting of the company.

iii) "The auditor is suitably independent".

As accounts lack sufficient credibility without audit, it is therefore essential that the auditor be free from any pressure and potential bias which might impair his judgement.

In order to give credibility to the audited accounts, the auditor not only should be independent but also be <u>seen</u> to be independent, as this visible evidence is vital for users of the accounts to determine the degree of the auditor's independence.

iv) "The auditor is suitably skilled".

The CA 1985 (S389(1)) requires the auditor of every company to be a suitably qualified accountant in order to carry out an audit and give an opinion on the audited accounts.

Furthermore, the professional accountancy bodies require their members to have adequate training and skills for carrying out audit assignments.

v) "The auditor can be held accountable for the nature and quality of his work".

The auditor is accountable to the shareholders (and possibly to some specific users) for the quality of his work as is evident from auditing case law.

The professional accountancy bodies have issued a series of Auditing Standards and Guidelines which are intended to provide the auditor with a framework of practice below which the quality of audit work must not fall and these are used by the court to judge the adequacy of the auditor's quality of performance.

c) Functional postulates

Functional postulates relate to the actual work performed by the auditor. Lee (1982:85) provides three functional postulates which are reproduced below with explanations where necessary.

i) "There is sufficient competent audit evidence available to the auditor".

ii) "The annual accounting information is free of major fraud and error".

It is the company management's responsibility to detect or prevent fraud and errors by establishing a reliable system of accounting and internal controls.

It is not the main objective of audit to detect or prevent fraud and errors. However, the auditor should plan his audit to reveal material fraud and errors.

iii) "There are generally acceptable accounting concepts and bases to measure and disclose annual accounting information".

In the UK, the CA 1985 provides the auditor with an accounting framework of standards to use as a basis for arriving at his audit opinion on the accounts.

The above postulate (iii) in its original form has been deleted from the list of functional postulates provided by Lee (1993). However, Lee (1993) gives the following additional functional postulates:

iv) "The over-riding quality of reported financial statements for corporate audit purposes is interpreted mainly in terms of their relevance and reliability, and there are standards by which the corporate auditor can determine the existence of such a quality". (Lee 1993:83).

v) "The relevance and reliability of reported financial statements to shareholders and other report users can be reported meaningfully to them by the corporate auditor". (Lee 1993:87).

From the above postulates, Lee (1982) developed four concepts which are listed below (see Table 2.1) together with the equivalent comparative concepts suggested by Mautz and Sharaf (1961).

Table 2.1: Auditing concepts

Lee (1982)	Mautz and Sharaf (1961)
Independence	Independence
	Ethical conduct
Responsibility	Due Audit Care
Evidence	Evidence
Truth and Fairness	Fair Presentation

It is worth mentioning that Flint (1988) also provides similar concepts.

The importance of the concept of independence is considered in detail within the contracting theory explanations for auditing practice, because of the central role it plays in understanding the auditor's role (see 2.4.6(a)).

2.3.3 Conflicting viewpoints

The major feature of Lee (1982 and 1993)'s company audit framework is the existence of certain assumptions which are developed from or supported or used by the work of other audit theorists such as Mautz and Sharaf (1961); Schandl (1978), Sherer and Kent (1983) and Flint (1988). These assumptions (postulates) are "the fundamental theoretical truths of corporate auditing" (Lee, 1993:74) and provide the basis for the development of general auditing concepts.

According to Robertson (1986b:52):

> "A generally accepted framework for company auditing does, therefore, exist - a framework most familiar through Lee's text on company auditing, but one which has strong support from earlier auditing thought".

Furthermore, Sherer and Kent (1983:19), who used these postulates in their theory of company auditing argue that the categorisation of postulates "forms a rational and comprehensible basis upon which to base an examination of auditing theory".

In contrast, Gwilliam (1987) does not support the above approach and prefers any development of audit theory to be within the context of agency theory (see 2.4.1 for a detailed discussion of agency theory). Gwilliam (1987) is against the uncritical acceptance of the postulates specified by Mautz and Sharaf, because he appears to be concerned that these postulates "seek not so much to uncover a rationale for the audit process as a whole as to identify those circumstances in which an audit may be successfully carried out". (Gwilliam 1987:42).

These criticisms were strongly opposed by Lee (1993:74).

It is also worth mentioning that Gwilliam (1987:48) noted that Hamilton, Mautz and Robertson have given different viewpoints in respect of the audit postulates originally advanced by Mautz and Sharaf (1961).

Hamilton, for example, has argued that the conceptual model put forward by Mautz and Sharaf has failed to provide any empirically testable results. He is of the opinion that any theory of auditing should be in a position to explain the demand for and supply of audit services and that such a theory should be developed within the context of the agency theory.

However, Mautz sees the agency theory as described by Hamilton as stating the obvious and suggests that, like other economic theories, it exists at a level remote from the problems of the day (see Gwilliam 1987:48).

Robertson is of the view that although the framework put forward by Mautz and Sharaf is imperfect, it can, in fact, serve practitioners and researchers in their work.

A number of reasons could account for this contention. Chief among them is the fact that auditing is a control mechanism which has its roots in behavioural and economic theory and as suggested by some commentators (e.g. Bird, 1970 and Flint, 1971) the audit role has changed and may need to change further to adapt to a changing society (see also APB, 1993 and APB, 1995). Therefore, it does not fit neatly into a fixed framework as suggested by Mautz and Sharaf (1961).

This leads to a discussion of auditing in an economic framework which is considered below.

2.4 Economic framework for auditing

External audit serves many functions; for example, it can monitor the performance of management on behalf of shareholders - this function is referred to as "stewardship" - or as a demonstration by management to existing and potential shareholders of their effort and performance (<u>"agency theory"</u>).

It can also help investors to improve their decision making by means of adding credibility to the accounts of companies (<u>"information theory"</u>). It may be viewed by investors as a protection against financial failures of companies (<u>"insurance theory"</u>). It may also be required by some companies in order to differentiate themselves from others in the market ("signalling theory"). Furthermore, an audit may influence the behaviour and actions of staff at all levels in a company ("behavioural theory").

An attempt will also be made to explain auditing practice using "contracting theory" and "political process theory" within "positive accounting theory". All these theories are discussed in turn.

2.4.1 Agency theory

In the nineteenth century, the role of the auditor was seen as directly linked to the stewardship function of company management (i.e. management integrity and honesty). As such, a monitoring role on behalf of shareholders who had entrusted their assets to the care of the company management was carried out by the auditor. (See for example Flint, 1971).

However, following recent developments in the application of agency theory to auditing, the above monitoring role has been extended to include not only management integrity, but also managerial effort and performance. (See for example Ng, 1978; Evans, 1980; Antle, 1982).

The shareholders, as principals, have limited means besides management reports of observing the success and actions of agents (i.e. management). Therefore, management may have economic incentives to bias management reporting to shareholders with little fear of detection if management remuneration is related to reported performance. Ng (1978) appears to support this line of argument.

Even where management has no economic incentive to bias the reporting (for example, having a fixed remuneration), the reporting may be accurate, but the level of management effort may be low which will be to the disadvantage of the shareholders.

A possible solution to the above problem is considered by the agency theory which, generally speaking, is concerned with the principal-agent problem in the separation of ownership and control of the firm (Jensen and Meckling, 1976). Firms are described by Jensen and Meckling (1976) as sets of contracts among the factors of production and that different sets of contractual arrangements provide different incentives for opportunistic behaviour by the contracting parties, which reduce the value of the firm. They argued that in markets characterised by rational expectations, the cost of the opportunistic behaviour is borne by the offending party, who has an incentive to write contracts which restrict his opportunistic behaviour. For this reason, according to Jensen and Meckling (1976), corporate managers write contracts to restrict their own opportunistic behaviour. The enforcement of the contracts requires monitoring of management's activities. Jensen and Meckling (1976) hypothesised that an <u>audit</u> is one type of monitoring activity that increases the value of the firm. An audit by someone independent of the manager reduces the incentive problems that arise when the firm's manager does not own all the residual claims on the firm.

> "An audit will be successful in changing expectations and hence reducing the opportunistic behavior costs (agency costs) borne by the manager only if it is expected that the auditor will report some discovered breaches of contract..." (See Watts and Zimmerman, 1983:615).

According to the agency theory, the shareholders may be able to maximise their wealth by using incentive compensation contracts together with independent monitoring of the financial reporting. This argument seems to support the "justifying postulates" (i.e. the reasons for company audit).

Interestingly, Ng and Stoeckenius (1979) have demonstrated that in a similar situation, auditing will encourage more accurate reporting and that depending upon the price of audit services, there will be a demand for external auditing.

Furthermore, according to the agency theory, the need for a monitoring service does not necessarily come from the shareholders.

> "It is argued that as the shareholders recognise the scope and incentives for adverse management action and reporting they will protect themselves by reducing managerial compensation. 'Good' management will then have an incentive to demonstrate its greater effort and efficiency by hiring auditors to verify the truthful nature of their reporting". (Gwilliam, 1987:50).

In developing this point, Evans (1980) in his study demonstrated that the need for the audit will come from the agent.

It is worth mentioning that the majority of research studies of the agency theory have generally been theoretical in nature, based on simplified models using mathematical arguments. Indeed, Jensen (1983) refers to two separate bodies of literature addressing the same set of problems in the agency theory. The first (the "principal-agent") is generally mathematical and non-empirically oriented, and Jensen (1983) argues that it may suffer from the inability to generate mathematical solutions without simplifying assumptions.

The second (the "Positive theory of agency") is generally non-mathematical and empirically oriented. The concept of the positive theory was introduced into accounting literature relatively recently (1960). This will be discussed in detail in section 2.4.6 (see positive accounting theory).

In conclusion, Gwilliam has asserted that (1987:52):

> "Apart from the insight that management may voluntarily seek to be audited so as to demonstrate the greater credibility of its reporting, there appears to be little else in the models developed so far that adds fresh understanding of audit processes or of the market in which they are offered".

Perhaps it is worth noting that there are problems inherent in attempting to measure (monitor) management performance "in an uncertain world of imperfect markets" and so like Mautz and Sharaf's postulates, one comes up against the inadequacy of GAAP (Gwilliam, 1987:52).

2.4.2 Information theory

Information theory may also help to explain why there is a demand for external auditing. It explores the economics of the provision of data to financial markets and how this enables efficient allocation of capital flows.

Audits add credibility to the financial information and improve their quality, which may help investors to improve their decision making.

According to Wallace (1985:26), the information theory:

> "...predicts a demand for audited information as a means of reducing the risk of investments, improving internal and external decision making, enhancing gains from trade, and improving the portfolio investment position of individuals."

This may explain the case for enforcing the external audit as a statutory requirement if the cost of the external audit is lower than the benefits derived from more efficient capital market operations and if the market fails to provide the right amount of auditing. (See Gwilliam, 1987:54).

In examining the market for auditing services, Gwilliam (1987) argues that there is a considerable degree of overlap between the agency theory and the information theory. However, the information theory pays greater attention to the needs of investors generally and the information requirements of prospective investors who are unlikely to have a contractual relationship with management. Therefore, the information theory tends to support the need for the compulsory requirement for audit and disclosure of financial information. However, it is worth noting that the extent to which investors do rely upon audited financial accounts in decision making is not clear. Lee (1977) appears to suggest that non-audited data (for example, interim results or forecasts in the chairman's report) are perhaps of more importance to investors for their decision making. Furthermore,

> "...while people say the audit report is important, when it comes to making decisions a relatively minor role for the audit report is found in terms of both user perceptions and of market reactions to the presence of audit qualification". (Gwilliam, 1987:55).

As Gwilliam (1987:55) has noted, it is rather difficult:

> "...to reach any firm conclusions as to the force or otherwise of the information theory arguments concerning the value of audit or the significance of the audit report itself".

2.4.3 Insurance theory

Insurance theory is concerned with the auditor's role as an insurer.

In Antle (1982)'s model, the audit fee is regarded as compensation for risk sharing with the owner (i.e. apart from ensuring truthful reporting, the auditor acts as insurance for risk averse shareholders against the possibility of correctly reported adverse results). In such circumstances the value of the actual audit work is to determine efficiently the likely risks in various types of clients.

Wallace (1985) identifies a number of different perspectives: for example, reporting managers look to the auditor as a form of insurance policy should something go wrong with the use of the information concerned; or the auditor assists in improving the quality of information disclosure for management; or the auditor represents a form of protection for an otherwise uninsured business risk.

2.4.4 Signalling theory

External audit may be required by some audit clients in order to differentiate themselves from others in the market. This is addressed by the signalling theory, which deals with the problems of information asymmetry in the market. The theory illustrates how this asymmetry can be reduced by the party with more information signalling it to others.

According to Morris (1987:48), the following steps occur in most signalling models:

> "Initially, sellers in a market are assumed to possess more information about their product than buyers. If buyers have no information about specific products but do have some general perceptions ..., then buyers will value all products at the same price which is a weighted average of their general perceptions".

Morris (1987:48) goes on to say that:

> "Sellers of above average quality products incur an opportunity loss because their products could sell at a higher price if buyers knew about the superior quality, while sellers of below average products make an opportunity gain. Sellers of high quality products have an incentive to leave the market... unless they can communicate their product's superior quality to buyers and thus increase its price".

This communication is done by a signal in the form of a costly act taken by the seller of high quality goods to indicate the superiority of his product (for example, by providing a product warranty, which acts as a prediction of superior quality). This process continues as long as the increase in price obtained exceeds the signalling costs.

The prediction of the signalling theory for the audit market is that:

> "...auditors will be appointed voluntarily by higher quality firms in order to discriminate themselves from other firms in the market... this incentive should be greatest in firms with large and widespread numbers of shareholders". (Morris, 1987:53).

The market for audit services in terms of incentive-signalling theory was examined by Bar-Yosef and Livnat (1984). They demonstrated that management with high expectations of future cash flows will in fact select a larger, more highly priced, auditing firm.

Morris (1987:53), in comparing the signalling theory with the agency theory concluded that both theories are consistent and that there is considerable overlap between them, for example:

"Rational behaviour is common to both theories; information asymmetry is implied by positive monitoring costs in agency theory; quality can be defined in terms of agency theory variables; and signalling costs are implicit in some bonding devices of agency theory".

2.4.5 Behavioural theory

External audit may influence the motivation, integrity and conformity with organisational rules of the employees of a firm at all levels. A study by Churchill, Cooper and Govindarajan (1982) suggested that an audit could exert behavioural effects in a number of ways through the audit report and the occurrence of the audit itself and even through anticipation of the audit.

Churchill et al (1982) tested the behavioural effects of an audit not in the context of an external financial audit but in that of a medical audit, and found that the audit occurrence and anticipation "significantly" reduced the average length of stay at hospital and its variance. It is worth noting that they also found that the actual audit occurrence had a greater effect than the audit anticipation.

2.4.6 Positive accounting theory

Positive accounting researchers have developed theories of accounting practice by applying economic theories that assume nonzero contracting and information costs. The two main theories: <u>contracting theory</u> and <u>political process theory</u> have the potential to explain auditing practice. In discussing both theories, an attempt will be made to delve into the work of Watts and Zimmerman (1986).

a) Contracting theory explanations for auditing practice

Accounting researchers have applied the contracting theory to auditing and have developed intuitive explanations for auditing practice. For example, explanations have been developed for the emphasis on auditor's competence, independence and reputation; the existence of professional societies; the audit firm's organisational form, size and industry specialisation. Furthermore, the contracting theory had been used to predict which firms hired professional auditors when such an audit was not required by law (see Chow, 1982).

Auditor's competence and independence

The concepts of an auditor's competence and independence are central to the explanations for auditing practice. The demand for accounting arises from its use in contracts that reduce the firm's agency costs. However, those contracts are of little use in reducing agency costs unless their provisions are monitored and enforced. Auditing is one of the ways in which the contracts are monitored. The auditor's monitoring is not valuable to other parties to the firm unless those parties consider the probability that the auditor will report a contract breach, should one occur, is nonzero. The very existence of a demand for the auditor's services, and the amount a firm will pay for those services, depends on the assessment of a nonzero probability of reporting a breach. The probability that an auditor will report a breach, if it occurs, depends on:

i) "The probability that the auditor <u>discovers</u> a given breach".

ii) "The probability that the auditor <u>reports</u> the discovered breach". (See Watts and Zimmerman, 1986: 314).

These probabilities depend on the auditor's <u>competence</u> and <u>independence</u> from the client respectively. Therefore, in order to create a demand for audit services, auditors have to convince the market that they have some competence and independence from the client.

However, managers may impose costs on auditors if auditors refuse to give in to their pressures not to report a discovered breach. It is suggested that one way in which managers impose costs is by changing auditors, which denies the existing auditor a stream of quasi-rents arising through the practice of low-balling (DeAngelo 1981a and 1981b). However, as suggested by Moizer (1985:36) both listed companies and their auditors have a strong economic interest to be independent because:

> "Auditors who are perceived to be more independent and hence more likely to report a breach by management, will be valued more highly by the capital market. The greater the reputation enjoyed by auditors, then the greater will be the increase in market value of the companies audited by them and hence the greater will be the fees that they can command for audit services".

Furthermore, there are some institutions and contractual arrangements (such as the auditor's reputation, professional societies, the audit firm's organisational form, and large-scale audit firms) which provide the auditor with incentives to be independent and to resist the manager's pressures. These are considered below:

Auditor's reputation

Watts and Zimmerman (1986:315) in citing Benston pointed out that reputation gives auditors incentives to be independent. Watts and Zimmerman argued that once this reputation is established, it increases the demand for the auditor's services. This view on auditors' independence is consistent with that of Moizer (1985).

The auditor's reputation is a valuable asset which serves as a collateral bond for independence.

Watts and Zimmerman (1983) took this view when they provided a historically based explanation for the practice of auditing and when they offered an explanation for the prevalence and continuance of auditing even before it was required by statute (see 5.2).

Professional societies

By accrediting auditors, professional societies can help their members to establish a reputation for independence and competence. Professional societies such as the ICAS (formed in 1854) and the ICAEW (formed in 1870) appeared at the time of the replacement of the shareholders' audit committees by professional audit firms (Watts and Zimmerman, 1983: 631). The professional societies established brand names and gave their members designations, thereby providing information on their minimum level of audit competence and independence. By setting and monitoring standards of conduct, examinations for admission and a period of training with a member, the professional societies maintain their brand name.

Like the auditor's reputation, membership of the professional society serves as a collateral bond. Loss of membership leads to loss of audit fees.

Audit firm's organisational form

According to Watts and Zimmerman (1986:316) the organisational form of audit firms evolved as unlimited partnerships which contributes in at least two ways to the auditor's incentives to be competent and independent:

i) unlimited partnerships (as compared with limited liability corporations) provide a greater amount of assets available as a bond on the auditors' independence; and

ii) unlimited partnerships provide mutual monitoring by the partners (as each partner is liable for the other partners' actions), thereby, increasing competence and making it more difficult for the manager to bribe the auditor. It has been noted that a similar form existed before the development of the professional audit firms, when the audit was conducted by a committee of shareholders (Watts and Zimmerman, 1983).

Furthermore, the above circumstances, according to Fama and Jensen (1983), will increase the market's assessment of the auditor's competence and independence.

However, it is worth pointing out that KPMG Peat Marwick had recently incorporated part of their audit practice in order to limit their partners' exposure to liability and to enjoy the perceived "greater freedom" incorporation would bring. (See, for example, "KPMG consults clients" - Accountancy, November 1994:13).

Audit firm size and industry specialisation

A large audit firm can provide a much larger bond for its services than can a single auditor. The bond consists of the assets of the partnership as well as the individual partners' assets, together with all the partners' human capital (Fama and Jensen, 1983).

"The value of that human capital", Watts and Zimmerman (1986:317) point out, "is sensitive to the auditor's reputation, and the auditor's reputation is tied to the partnership reputation".

Therefore, because of the availability of larger bond, a large firm is more likely than a single accredited auditor to resist pressure from a client's manager not to report breaches.

Furthermore, as a large firm has many clients, the value of quasi-rents lost if a manager of a client changes auditors is more likely to be less on the firm's brand name and its audit fees than the effect of the failure to report a breach.

It is worthy of note that Watts and Zimmerman (1986:318) have cited Dopuch and Simunic in observing that the initial audit start-up costs and economies of scale in information can help to explain the audit firm specialisation by industry.

The above explanations indicate that contracting theory can provide a wide set of explanations for auditing. Nevertheless, these explanations are intuitive and their predications are not formally tested (Watts and Zimmerman, 1986: 318).

However, one study which attempted to provide empirical evidence to support contracting theory was that of Chow (1982). Chow (1982) used contracting variables to predict and explain the firm's choice in 1926 between being audited and not being audited at the time such audits were not required by USA law.

In that study, 1926 was chosen as the base year, a year in which a large majority of the New York Stock Exchange firms voluntarily engaged external auditors but a substantial minority (18%) did not (see Gwilliam, 1987).

Chow (1982) hypothesises that external auditing is associated with firm size, capital structure and the number of debt covenants written in terms of accounting numbers.

He argues that as managers of larger firms typically own a smaller fraction of the firm's shares then they have a greater incentive to transfer wealth from shareholders. Therefore, larger firms are expected to have greater demand for audits. Furthermore, he argues that because of economies of scale in auditing, larger firms are more likely to be audited than smaller ones.

Chow (1982) also argues that firms with higher debt/equity ratios are more likely to be audited. This is because, without an audit, shareholders (equity-holders) have a greater incentive to transfer wealth from bondholders (for example by paying excessive dividends). Therefore, bondholders anticipate the likelihood of such actions and protect themselves by increasing the cost of their funds. To prevent this increase in the cost of debt, firms with substantial amounts of debt in their capital structure would voluntarily have their accounts audited.

In addition, Chow (1982) argues that firms are also more likely to have audits if the audited results have a direct effect on the fulfilment of debt covenants.

Chow (1982)'s study ignores the availability and cost of monitoring methods other than auditing. However, his results are generally consistent with the hypotheses. Indeed Watts and Zimmerman (1986:321) observed that: "These results are generally consistent with contracting theory. They suggest that contracting theory has the potential to predict auditing practice".

It is worth noting that the absence of sufficient data relating to the level of managerial shareholdings prevented Chow (1982) from testing a hypothesis that a firm was more likely to engage in voluntary auditing if management were divorced from shareholders (see Gwilliam, 1987:53).

b) The effect of political process on auditing

Political process affects auditing through regulation and threatened regulation - for example, the Companies Acts requirements in the UK or the securities acts in the US; the role of the DTI (through appointed supervisory bodies) in the UK or the Congressional committees in the US - in monitoring auditing standards.

Regulation and threatened regulation affect the nature of audit by providing auditors with the opportunity to offer new services to their clients and giving auditors chance to transfer wealth to themselves. These are considered below.

Effect on audit

The auditor's role and duties under statute are broader than the contract monitoring role. The auditor is required to determine if contracts have been breached under the contract monitoring role, within the scope and definitions written in the contract.

However, under statute, the auditor's role depends on the investor's decision-making process. Numbers and definitions other than those used in contracts may be considered relevant. Therefore, the political process expands the scope of the audit and changes its emphasis.

For example, the accounting standards may reduce the effectiveness of accounting-based contracts in controlling agency costs and consequently may reduce the demand for auditing as a contract monitoring device.

> "Hence, while regulation is broadening the nature of the audit and increasing the demand for auditing to meet legal requirements, it decreases the contracting demand for auditing". (Watts & Zimmerman, 1986:323).

It is worth mentioning that the introduction of <u>audit regulation</u> in October 1991 in the UK has brought with it major changes to auditing firms. These changes warrant specific attention which will be dealt with in section 5.4.

Additional services

Regulations provide auditors with the opportunity to offer additional services to their clients. As new regulations can impose costs on clients, they may value lobbying and regulation information services provided by their auditors. Indeed, these services are considered by potential clients when they choose an auditor and audit fees reflect these services, thereby increasing both the auditor's and the client's wealth.

It is worth mentioning that lobbying is rather more common in the US than the UK. In this regard, in the UK, a Committee chaired by Lord Nolan has produced a report tightening lobbying practices, particularly by MPs, after a number of "sleaze" allegations which resulted in the resignation of Neil Hamilton, the then corporate affairs minister (see "Government rules out Nolan probe into party funds", Financial Times, 15th May 1995:1).

Wealth transfers

Auditors have incentives to lobby for more complicated accounting standards which could increase demand for their services. However, if the consequent drop in demand for the auditor's monitoring services (resulting from more complex accounting systems) exceeds the increase in demand because of the greater complexity, then auditors would oppose the more complex system.

Furthermore, state licensing of auditors has the potential to restrict entry into the audit profession and increase existing auditors' wealth.

Empirical studies

Three types of empirical studies that test the hypotheses about the effect of regulation on auditing are reviewed below.

1) A study of auditor turnover by DeAngelo (1982)

   Using data for the period 1973-80 relating to the US Federal Securities and Exchange Commission (SEC) firms, DeAngelo (1982) found that oil firms, adversely affected by the proposed elimination of full cost accounting, increased the rate at which they changed their auditors during the period of controversy. This supported her hypothesis that firms most negatively affected by an accounting standard are more likely to change auditors than less severely affected firms. However, although clients appeared to change firms with whom they disagreed, the data did not support an overall shift to firms with whom they agreed as hypothesised by Watts and Zimmerman (1981b).

2) A study of auditor lobbying by Watts and Zimmerman (1981b)

   Watts and Zimmerman (1986:327) made reference to their work (1981b) in which they hypothesised that the auditors' position on a proposed accounting standard was positively related to their clients' managers' positions. This is because their audit fees depend on their clients' market value, which provides them with an incentive to argue for accounting standards that increase their clients' market value. However, the auditors' position and interests differ from those of their clients, where for example, the auditor has an incentive to support accounting standards which create more work for them. Taking these diversities into account, Watts and Zimmerman (1981b) investigated the combined implication of contracting theory and the political process theory for auditors' lobbying on proposed accounting standards, by deriving and testing a complex relation between an audit firm's position on an accounting standard and its clients' managers' positions. Their evidence is generally consistent with that relation.

3) A study of auditor competition by Simunic (1980)

Simunic (1980) investigated the charge that the Big Eight audit firms have an effective cartel or monopoly on audits of listed companies and that they are able to charge higher fees than their small rivals.

Simunic (1980)'s results suggest that there is competition in the auditing market, that auditors (at least Price Waterhouse) specialise in audits of different quality (as suggested by DeAngelo, 1981b), and that the complexity in client accounts increases audit fees.

2.5 Application of a theoretical framework to SC audit debate

Having discussed the postulates and economic framework for company auditing, this section considers whether the

SC audit debate can be placed within the context of such a framework. In fact, the need for this consideration has been put forward by Robertson (1986b:50-51), who has argued that two factors may have contributed to the lack of progress in the SC audit debate:

i) "there has been no application of a theoretical framework for the analysis of the small company audit problem. Without reference to an underlying theory, it is difficult to put the various arguments in perspective. There is, therefore, no rational or consistent means of evaluating alternative solutions".

ii) "little research has been published on the small company problem...".

It is considered necessary first and foremost to look at a number of SC audit issues that appear to give rise to some <u>weaknesses</u> in the assumptions on which a theoretical framework is built as far as SCs are concerned.

Shareholders in owner-managed private companies

It has been observed that the independent audit is of little value to shareholders who are all directors and actively involved in the management of the company or to shareholders who, although not involved in the management of the company, have complete confidence in the integrity of the directors (APC, 1979). This appears to weaken to some extent the application of justifying postulates in relation to SC audit. As Lee (1993:76) has pointed out:

> "...in such cases, the absence of significant external interests may cause the postulate to be unreasonable. Indeed, there is a persistent implied concern about its legitimacy in the context of small companies [Page, 1991]".

Internal control

It has been noted that in SCs, internal controls are generally weak or absent because of owner/manager dominance (Raiborn, 1982). As a result the quality of reported financial statements to shareholders and others may not be satisfactorily attested by the verifications process of an external audit, which makes the application of justifying postulates to SC audit rather weak. Lee (1993:78) argues that "in certain smaller companies, inevitable weaknesses in control systems may be such that the postulate cannot be expressed in a strong form [Page, 1991:217]".

Independence

The infringement of the auditor's independence has always been viewed with serious concern. For example, Mautz and Sharaf (1961:49) assert that "Independence is of the essence in auditing".

Lee (1993:81) in his own contribution to this issue points out that:

> "...it is vital to the credibility of the corporate audit opinion, and to the perceived quality of the reported accounting information, that the corporate auditor is assumed to be mentally independent and physically seen to be so independent".

Furthermore, as already pointed out, there are some economic reasons for companies and their auditors to be independent (Moizer, 1985).

However, in SCs where the auditor, generally speaking, prepares the accounts and audits them, and where he may also act as financial adviser, it is questionable whether the auditor is fully independent. In fact, as Keasey and Watson (1991:46) have noted:

> "...many important features of the small firm sector, such as lack of separation of ownership from control, the much less stringent financial reporting and other regulatory requirements and the very wide variety of audit firms that are able to audit their accounts,

reduce the applicability of this line of reasoning".

Consequently, the behavioural postulate that "The auditor is suitably independent" may not be applicable in the SCs context vis-a-vis larger companies.

Audit evidence

In considering the audit evidence, the APC in its discussion paper (1979, para 35) argues that:

> "In some small companies because of the personal involvement of the proprietor, the level of independent audit evidence which the auditor of a larger organisation would reasonably expect cannot be provided. In other small companies this level of audit evidence may be available, but the cost of collecting and evaluating it may well be disproportionate to the benefit arising either to the company or to user of its financial statements".

It is therefore rather questionable whether the first functional postulate, that "There is sufficient competent audit evidence available to the auditor", is reasonable in the context of SCs.

Major fraud and error

Gwilliam (1987:47) argues that the second functional postulate, that "The annual accounting information is free of major fraud and error", appears:

> "...to contradict the justifying postulate relating to the need for audit to enhance the credibility of the accounts. If 'due to the existence of internal controls' the accounts are 'free from major fraud and error' then they are in themselves credible and do not require audit. What purpose is there in adding credibility to numbers that are already credible?".

However, Lee (1993:86) points out that to assume otherwise "would result in a fraud investigation of a type wholly incompatible with the corporate audit task specified by present regulation". Indeed, as Mautz and Sharaf (1961:47) have observed, such a situation would require:

> "...either complete disclaimer for the discovery of irregularities or an extremely detailed and tedious examination, and even with the latter some disclaimer of responsibility would still be required".

In considering this assumption, Robertson (1986b:52) argues that:

> "...attention to the matter of fraud often distracts attention from the equally serious matter of error. And it is about the presence of error that the auditor must perhaps be most concerned in the small company situation. Where internal control is weak, there comes a point where the auditor approaches his task with the <u>expectation</u> that his subject-matter contains major error. Some might argue that this is an unsatisfactory starting point for a conventional audit investigation".

Auditing standards

One of the vital points about having GAAP is "To judge the fairness of financial statement presentations" (Mautz and Sharaf, 1961:47). In other words, Standards are needed for the accounts to give a true and fair view and also to promote comparability. However, Carsberg et al (1985) argue that compliance costs are relatively higher for SCs and their benefits are relatively lower. Perhaps, it is worth bearing in mind that as Carsberg et al (1985) have argued, there is no need for accounts of SCs to be comparable with those of large companies because their users are different kinds of people and they have different needs.

As a result, following Carsberg et al (1985)'s recommendations, the ASC (1988b) has accepted that there is a case, in specific circumstances, for exempting SCs from certain provisions of accounting standards relating to disclosure requirements, rather than to recognition or measurement rules. (For detailed discussion see section 4.11).

It is worthy of note that similar conclusions were made by the Committee on GAAP for Smaller and/or Closely Held Businesses in the US (see section 4.17).

Consequently, there is doubt as to whether GAAP should be applied equally to both small and large companies and this may well explain why the third functional postulate has been deleted from Lee (1993)'s current list of postulates.

So far, in the above discussion, emphasis has been placed on the problems which may exist in the application of the various postulates to SC audit debate. It is worth mentioning that it is possible to observe similar problems in the economic framework, particularly when applying the agency theory to the SC audit debate. As already noted, the main focus of the agency theory has been concerned with the conflict between managers and shareholders. However, as asserted by Keasey and Watson (1991:47) "this particular type of conflict will not normally be important for the majority of small firms because of their close company status".

Generally speaking, a close company is a company under the control of five or fewer persons and their associates (see for example Burns and Dewhirst, 1983). Since directors/managers are usually the major shareholders in SCs, the agency problems between shareholders and management are generally considered to be of less importance. However, in respect of other contracting entities such as external lending institutions, the agency theory suggests that debtholders are concerned with the possibility of wealth transfers to shareholders (see for example, Chow, 1982). For this reason, there is the possibility of conflict of interest arising between owner/managers and other contracting entities.

Furthermore, the agency theory recognises the conflict between owner/managers and debtholders in the appointment of auditors when there is a high level of existing debt or when a new debt is required. For instance, as noted by Keasey and Watson (1991:48), in the case of existing debt "the owner/managers may have both strong incentives and the ability to change to more 'accommodating' auditors" because this will allow value to be switched from debtholders to shareholders. However, when new debt is required, Keasey and Watson (1991:48) argue that:

> "...the debtholders are likely to demand less 'accommodating' auditors. Thus owner/managers will attempt to engage auditors that satisfy external lenders' requirements while being accommodating to their own needs".

The above analysis indicates that there are a number of weaknesses in the assumptions on which company auditing theory is built as far as SCs are concerned. In attempting to provide possible solutions to the inherent weaknesses in the theoretical framework, Robertson (1986b) has suggested possible solutions which are considered below.

2.6 Possible solutions

Robertson (1986b:52) summarises Lee's company audit framework by adding a "practice" element which was not explicit in Lee (1982:84-85)'s original illustration. (See Illustration 2.2 below).

Illustration 2.2: Lee's summarised company audit framework

```
 ------------------------
| Company Law            |................Observable
 ------------------------
            |
 ------------------------
|  Aims & Objectives     |................Implicit
 ------------------------
            |
 --------------------------
| Assumptions [&] Concepts |..............Derived
 --------------------------
            |
 ------------------------
|  Practice              |................Observable
 ------------------------
```

In this regard, Robertson (1986b:52) notes that:

> "By observing company law and audit practice, the aims and objectives of the existing audit function become apparent and are agreed. The assumptions (be they justifying, behavioural or functional in nature) are made in order to reconcile the apparent aims and objectives of the audit function with observed practice. Once practice has been observed, the aims and objectives clarified and the underlying assumptions derived, then general ideas about the audit (concepts) can be developed".

However, in order to show how "practice" may follow "concepts", the idea of "precepts" as defined by Mautz and Sharaf (1961) needs to be incorporated in the above summarised framework. As Mautz and Sharaf (1961:246) state:

> "...out of these concepts and deriving their strength from them appear certain more or less obvious directives for the guidance of the practitioner; we feel these may properly be described as precepts".

Mautz and Sharaf (1961:246) further argue that if practice follows the precepts and if the precepts are properly developed from the basic philosophy, postulates and conceptual structure, then practice can rest on a strong foundation of theory.

The revised framework is shown below:

<u>Illustration 2.3: Lee's adjusted company audit framework</u>

```
 -----------------------
|   Company Law         |
 -----------------------
           |
 -----------------------
|  Aims & Objectives    |
 -----------------------
           |
 -----------------------
| Assumptions & Concepts |
 -----------------------
           |
 -----------------------
|  Precepts             |
 -----------------------
           |
 -----------------------
|  Practice             |
 -----------------------
```

As discussed earlier, many of the arguments raised in the SC debate show apparent weaknesses in the assumptions which form the foundation of the framework.

Robertson (1986b:53) argues that if these assumptions appear to be absurd in a SC context, then <u>existing practice is in some way incompatible with existing aims</u>

and objectives. Robertson (1986b:53) suggests two options for reconciling practice with aims and objectives in a SC context:

i) **Change practice in order to become consistent with the existing aims and objectives**

In order to maintain the existing aims and objectives of the audit function within a SC context (i.e. to keep the existing SC audit requirement), it has been suggested that a clear distinction be made between SC audit and large company audit, which may require separate audit guidance for auditors of SCs and those of large companies. This option is shown in the following illustration.

Illustration 2.4: change practice

```
                  ----------------------
                 |   Company law        |
                  ----------------------
                            |
                  ----------------------
                 |   Aims & objectives  |
                  ----------------------
                            |
                  ------------------------
                 | Assumptions & concepts |
                  ------------------------
                       |           |
 -----------------------     ----------------------
|  Small company precepts|   |Large company precepts|
 -----------------------     ----------------------
                       |           |
 -----------------------     ----------------------
| Small company practice |   |Large company practice|
 -----------------------     ----------------------
```

It is not surprising to note that already a number of specific guidelines for audit of SCs have been introduced. For example, "The total vouching audit system" (Kestrian, 1992a), "The really small company audit system" (Kestrian, 1992b) and "Small company audit system"(ICAEW, 1991).

However, it would appear that the existing guidelines are inadequate. As Humphrey and Turley (1986) found, the most important influences on the procedures adopted in the audit of SCs are:

* the lack of sufficient available reliable evidence;

* the extent of the auditor's involvement in the preparation of accounts;

* the absence of an internal control system; and

* the degree of personal control exercised by the directors.

They noted that all of these influences relate to areas in which the differences between large companies and SCs are likely to be great. Humphrey and Turley (1986) observed that the effect of the influences mentioned above is reflected in the extent to which auditors used particular types of audit procedures or techniques in SC audit.

In their studies, Humphrey and Turley (1986:31) observed that the majority of their responding auditors of SCs used substantive procedures and overall reviews, such as obtaining a bank certificate, analytical review, post balance sheet review and review of accounting policies.

Nevertheless, they found that relatively little use was made of debtors circularisations and attendance at stocktaking despite the fact that they are recommended in professional statements as means of overcoming the inability to place reliance on internal controls in SCs. Therefore, it appears that there is a need for additional guidance on these important audit procedures for use in SC audit.

It is worth bearing in mind that, the introduction and application of these additional guidelines and procedures may create additional responsibility for SC auditors and additional audit costs which auditors might find unable to pass to SC clients. Furthermore, it seems unlikely that the SC auditor can reach the same high degree of assurance in the audit of a SC as he can in the audit of a large company.

This option does not appear to have strong support. Nevertheless, if it were to be considered as a solution to the SC audit debate, it is important to identify the relative importance of the various SC accounts users and their accounting information needs, and whether their needs justify the existence of an audit. Once the need for an audit is justified, then appropriate guidance should be provided to SC auditors to carry out their audit assignments most efficiently and effectively.

ii) **Change the existing aims and objectives to achieve what is feasible and agreeable in practice in a SC environment**

This option can be shown by the following illustration:

Illustration 2.5: change the existing aims and objectives

```
              ----------------------
             |     Company law      |
              ----------------------
                   |          |
 ----------------------   ----------------------
| Small company aims   | |Large company aims    |
| and objectives       | |and objectives        |
 ----------------------   ----------------------
                   |          |
 ----------------------   ----------------------
| Small company        | |Large company         |
| assumptions & concepts| |assumptions & concepts|
 ----------------------   ----------------------
                   |          |
 ----------------------   ----------------------
| Small company precepts| |Large company precepts|
 ----------------------   ----------------------
                   |          |
 ----------------------   ----------------------
| Small company practice| |Large company practice|
 ----------------------   ----------------------
```

Under this option, it is suggested that there should be a clear and different set of aims and objectives for both SCs and large companies. As far as SCs are concerned, this option implies that different sub-categories of SCs might have different levels of attestation, such as review, compilation, audit or total exemption.

At present, this option has very strong support from the Government (DTI, 1993), accountancy bodies (e.g. ICAEW, 1992b), accountancy firms and SCs (ICAEW, 1993a) and other interested bodies (e.g.

LSCA, 1992) for SCs with annual turnover up to the VAT cash accounting threshold. A detailed discussion of this option is provided in sections 5.7 and 5.8.

It is important to consider <u>what is feasible and agreeable in practice in a SC environment</u> before setting new aims and objectives. This may require an examination of the following issues:

* the ownership and control in SCs;

* the advantages and disadvantages of incorporation for SCs;

* the relative importance of the various SC accounts users and their accounting information needs;

* the usefulness of SC accounts for decision making

* the form and content of SC accounts:

  - full accounts
  - abbreviated accounts
  - one set of accounts for both shareholders of SCs and public filing;

* the accountant's role in SCs;

* the difficulties in auditing SCs;

* the audit benefits

* the arguments for and against and the assessment of cost and benefits of SC audit and its alternatives (e.g. review or compilation report);

* the various SC accounts users' attitudes to change of SC audit requirement;

* the effect of SC audit abolition; and

* the effect of replacement of an audit with a statutory review (for SCs with annual turnover above the VAT cash accounting threshold).

This research investigated the above by ascertaining the views of SCs' directors/shareholders and auditors/accountants by postal questionnaires (see Chapter 6). The questionnaires were designed with the research objective and the hypotheses (see Chapter 10) in mind.

2.7 Summary and conclusion

A number of broad conclusions can be drawn from the various discussions in this Chapter.

It is convenient to say that the various theoretical approaches discussed above have different purposes. The economic approach attempts to explain the existence of the audit through economic means, whereas the postulates approach is generally concerned with operationalising the audit process given its existence.

The basis of the postulates approach is to help to construct a set of basic assumptions implicit in auditing about financial information. It is about relationships between management, the auditor and outside parties, and the possible contribution of the audit. The contribution of this approach to audit is to deduce a set of concepts relevant to audit practice.

In contrast to the postulates approach, the economic framework has attempted to develop a theoretical understanding of auditing in terms of economic transactions between various parties connected with the firm.

In particular, the agency theory is concerned with the problem of the separation of ownership and control of the firm by shareholders and managers, each with different vested interests. As a result of that, the agency theory argues that shareholders may be able to maximise their wealth by using incentive compensation contracts together with independent monitoring of the financial reporting. As noted, there is a considerable degree of overlap between the agency theory and the information theory. It is worth noting that the information theory however, is principally concerned with the needs of investors and the information requirements of prospective investors who are unlikely to have a contractual relationship with management. The above theories differ from the insurance theory, which is concerned with the auditor's role as an insurer.

The signalling theory predicts that auditors "will be appointed voluntarily by higher quality firms in order to discriminate themselves from other firms in the market". Like the information theory, the signalling theory also has some considerable amount of overlap with the agency theory; for example, rational behaviour is common to both theories.

In the discussion of behavioural theory it was observed that external audit may have some influence on the motivation, integrity and conformity with organisational rules of the staff of a firm at all levels.

In the contracting theory, auditing and accounting are related, and the use of accounting in contracts requires monitoring. The role of the political process too has been found useful in developing a theory of auditing.

One important conclusion from the studies discussed is that contracting has been used to explain why the auditor is concerned with his independence and reputation; to explain the development of professional societies, large firms and the organisational form adopted by audit firms.

Furthermore, some of the studies have attempted to show that contracting variables were used to predict which firms were likely to hire a professional audit firm when external professional audits were not a legal requirement.

Some evidence shows that regulation has a bearing on the nature of the audit. On the one hand, the auditor is legally responsible for information beyond that used in contracts, a situation that affects auditing's contracting role, particularly its efficiency as a monitoring device. On the other hand, regulation provides the auditor with the opportunity to lobby on accounting standards on behalf of clients and to lobby for increasing accounting complexity because of its audit fee effect. This in turn determine the auditor's relationship with the clients.

Despite all the findings, it is worth mentioning that further studies are needed to explain in detail the subject matter of auditing.

The application of the above theories to the SC audit debate identified a number of weaknesses in the assumptions which form the foundation of the framework, indicating that the existing practice is in some way incompatible with the existing aims and objectives in a SC context. In an attempt to reconcile practice with aims and objectives, a number of broad possible options were considered: either to change the practice or change the aims and objectives so that they become compatible. To achieve this, there is a need for a detailed consideration of the SC issues and the SC audit debate which are addressed in Chapters 4 and 5 respectively.

Furthermore, in order to obtain a general consensus in the SCFR, surveys of SC accounts, directors, and auditors were carried out. Their primary findings are reported in Chapters 7, 8 and 9 respectively. The cross analysis of the results and testing of the research hypotheses are presented in Chapter 10.

Before considering the SC issues and debate, it may be useful to provide an overview of the role of the major parties in the SCFR debate, which is presented in the next Chapter.

CHAPTER 3

AN OVERVIEW OF THE MAIN PARTIES IN THE SCFR DEBATE

3.1 Introduction

The major active parties in the SCFR debate are:

a) regulatory bodies

- Department of Trade and Industry (DTI); and
- Accounting Standards Board and Auditing Practices Board.

b) professional institutions;

c) accountancy firms;

d) banks and other institutional creditors;

e) tax authorities; and

f) small companies (SCs) and organisations representing the interests of small firms.

The role played by each of the above parties in the SCFR debate is considered below. It should be pointed out that this Chapter does not consider the SC issues and debate. These are considered in detail in Chapters 4 and 5 respectively. However, suffice to state that brief references have been made where necessary.

3.2 Regulatory bodies

3.2.1 Department of Trade & Industry (DTI)

The DTI has always been concerned about the administrative burdens on SCs resulting from the requirements of company law. In March 1985, the DTI (1985a)'s "Burden on Business" report proposed the removal of audit for shareholder-managed companies and the simplification of SC accounts.

Furthermore, in June 1985, the DTI (1985b) considered the arguments for and against audit for all SCs and in March 1988, considered all possible alternatives to audit for SCs (DTI, 1988).

However, the response to the DTI's proposals has always been mixed due to the fact that they came from parties (e.g. ICAEW, ACCA, small firms, large firms) with conflicting interests (see sections 3.3 and 3.4).

The Government had been under pressure from the professional bodies and SCs to offer SCs some measure of relief from the statutory requirements. In April 1993, the DTI (1993) proposed the abolition of the audit for Very SCs or its replacement with a compilation report.

In the November 1993 Budget, the Chancellor of the Exchequer confirmed the abolition of the audit for Very SCs with turnover up to £90,000 per annum and also replacement of audit by a simple compilation report certified by an independent accountant for SCs with turnover up to £350,000 per annum. These measures came into effect in August 1994 which "reduced burdens on some 500,000 smaller companies...". (DTI, 1995:9). For further detail see sections 5.8.1 and 5.8.2.

It is worthy of note that in November 1994, the DTI (1994) published a consultative document to review the company law applicable to private companies. In this regard, the DTI states that "Our concern is that the law should meet the needs of small firms and impose minimum burdens, while maintaining protection for creditors and shareholders". (DTI, 1994:para.2).

As part of the deregulation initiative, in May 1995, the DTI (1995) also published a consultative document to examine statutory accounting requirements. According to that document, the Government's aim was expressed as:

> "...to minimise the burdens imposed on companies, while at the same time ensuring that the information provided meets the reasonable needs of users of accounts, such as shareholder, banks, the Inland Revenue, creditors and others dealing with the company" (DTI, 1995:3).

The document contains an invitation to contribute views on the level of accounting disclosure required of SCs (DTI, 1995, Section 4: 9-18). In particular, whether form and content of SCs should be further simplified and whether there should be a "standard format" in which to give accounting information to Companies House and the Inland Revenue.

3.2.2 Accounting Standards Board and Auditing Practices Board

The Accounting Standards Board (ASB) which replaced the Accounting Standards Committee (ASC) in 1991 as the Standard-setting body in the UK and Ireland develops and adopts Statements of Standard Accounting Practice (SSAPs) and Financial Reporting Standards (FRSs) to narrow the areas of differences in the accounting treatments of the matters which they deal. Adoption by the ASB gives the SSAPs/FRSs the status of "accounting standards" within Part VII of the CA 1985.

In 1985, the ASC investigated whether or not accounting standards should apply equally to large and small companies (see Carsberg et al, 1985). However, it took more than 3 years for the ASC (1988a and 1988b) to define a "small company" (see section 4.3) which should be exempt from certain provisions of accounting standards. Even this exemption did not help SCs from the burden of compliance with accounting standards requirements.

The other regulatory body, the Auditing Practices Board (APB) which replaced the Auditing Practices Committee (APC) in 1991 develops auditing standards and auditing guidelines which are approved by the Councils of the Accountancy Bodies (consisting of ICAEW, ACCA, ICAS, ICAI, CIMA, and CIPFA).

The APC (1979)'s discussion paper contributed significantly to the SCFR debate by setting out the arguments for and against SC audit and invited the public for views and comments (for further details see section 5.6).

In March 1991, the APC (1991) also issued a draft guideline considering the main issues in respect of the audit of small businesses. It concluded that "to the owner-manager... the cost of an audit is invariably considered to outweigh its benefits".

In November 1992, the APB (1993) published a "green paper" on "The Future Development of Auditing", prepared on its behalf by a group chaired by John McFarlane, in order to review the role of auditing and the way auditors and other interested parties considered that it should develop so as to meet future needs. The quantity and quality of the responses and research flowing from the above initiative have been impressive (see "The Audit Agenda", APB, 1995). Indeed as noted by the APB

(1995:116):

> "...much has been achieved since by the APB in developing and issuing standards and bulletins on going concern, governance reporting flowing from the Cadbury initiative, fraud, laws and regulations and the revisions project due to be finalised in 1995".

However, as indicated by the APB (1995:126) most of these reforms relate to large and listed companies and this may explain why the APB's role in the SCFR has been criticised for being unduly influenced and populated by major firms (see, for example, "Small firms must unite to beat big six APB bias", Accountancy Age, 14 October 1993):

> "The debate over whether the Auditing Practices Board represents the concerns of the big firms at the expense of others is just one indicator of unease among smaller practitioners and their small company clients. Generally there is a growing feeling that the agenda for reform in financial reporting and corporate governance is being set by large organisations, whether listed blue-chip companies or their big six auditors".

Furthermore, quite recently, the APB has been criticised by Mitchell (1985) for being run by vested interests and also lacking accountability.

3.3 Professional institutions

The role played by each of the major professional institutions in the SCFR debate is determined to a large extent by the membership they serve.

Auditors

The CA 1989 contains provisions designed to ensure that only persons who are properly supervised and appropriately qualified are appointed as company auditors, and that their duties are carried out properly, with integrity and with a proper degree of independence.

Only members of the ICAEW, ACCA, ICAS, ICAI and AAPA can practice as auditors in the UK.

a) **ICAEW** (The Institute of Chartered Accountants in England & Wales) has the highest number of members in public practice (accountancy/audit), and it is the most important institution contributing to SCFR debate. This is evident from the SCFR literature review (ICAEW 1985, 1988, 1989, 1992a, 1992b).

ICAEW had previously been criticised for being "pro-audit" in the SC debate because it has the highest number of members in audit practice.

In their response to the DTI's discussion paper "Accounting and audit requirements for small firms", the ICAEW (1985) argued that audits are valuable because:

> "They ensure proper accounting in many small companies and represent an important form of investor protection. They also assist directors to comply with the accounting provisions of the Companies Act and have developed over time to become a vehicle for advice on accounting, control and financial matters to a company's management. We therefore believe that, as a general rule, the accounts of small companies should continue to be audited". (Para. 4).

However, ICAEW (1985) argued that in SCs:

> "...the investor may be closely involved in the management of the company and may not need to delegate the review function to an auditor. Therefore, where all shareholders who are entitled to vote agree, we believe that such a company should have a choice as to whether it is to be audited or not. There should, however, always be adequate safeguards for minority investors and the wider public". (Para. 4).

Furthermore, in their latest report, the ICAEW (1992b) recommended the abolition of audit for Very SCs and the replacement of audit with a compilation report for companies with turnover up to VAT cash accounting threshold subject to unanimous annual resolution to dispense with the statutory audit (for more details see section 5.8).

In September 1992, the London Society of Chartered Accountants (LSCA) published a report on the audit requirement for SCs. The LSCA (1992) suggested that Very SCs audit should be abolished and certain proprietary companies should have the option of dispensing with the audit if all shareholders agreed.

b) **ACCA** (The Chartered Association of Certified Accountants) is the second largest institution with members in public practice. ACCA has been historically "pro-audit" in the SC audit debate, as its members in public practice are mainly small firms providing services to SCs (ACCA, 1993).

c) **ICAS** (The Institute of Chartered Accountants of Scotland) is the third largest institution with members in public practice.

In 1985, the ICAS proposed the replacement of statutory audit for small owner-managed companies with a report from an independent accountant.

However, in their response to the DTI (1988)'s discussion paper the ICAS (1988) in general supported the replacement of SC's statutory audit with a compilation report, together with an additional assurance that the SC has kept proper accounting records.

d) **ICAI** (The Institute of Chartered Accountants in Ireland) supported the retention of SC audit in 1985.

e) **AAPA** (The Association of Authorised Public Accountants), whose members are unqualified persons, previously authorised by the Secretary of State for Trade and Industry to act as company auditors under the provisions of the CA 1967 were able to apply for continued recognition but allowed to audit unquoted companies only. If application for audit registration had not been made by 30 September 1992, such persons lost their entitlement to audit. Most of the AAPA's members are sole practitioners.

Other bodies

f) **CIMA** (The Chartered Institute of Management Accountants). Its members are not allowed by the CA to practice as auditors. In its paper "Small Company Audit: The Way Forward", CIMA (1985) proposed that the compulsory SC audit requirement to be rationalised and made optional. CIMA has long advocated a procedure under which SC accounts are <u>certified</u> rather than audited.

Under the certification procedure the person primarily responsible for preparing the accounts, should be a professionally qualified accountant and would have to sign a certificate stating that the accounts have been properly prepared in accordance with the relevant UK generally accepted accounting principles. CIMA believes that certification would mean that annual accounts would be produced more speedily and more cost effectively. Furthermore, certification would add value to SCs and is more relevant to their needs (CIMA, 1985:2).

g) **CIPFA** (The Chartered Institute of Public Finance and Accountancy), whose members are not allowed to practice as auditors, has not participated in the SC audit debate.

In summary, the role played by the professional institutions in the SC audit debate can be seen to have been influenced to some extent by their members' interests and pressures and for this reason, it would appear that the professional institutions have not been united on this debate.

3.4 Accountancy firms

Small accountancy practices benefit from growth in the small firms sector. Given that both are from the same sector, small practices with lower overheads are able to provide a more personal service to SCs at significantly lower charge rates.

However, the maturity of the market for audits of major quoted companies has pushed larger accountancy practices into the small firms market. This has significantly increased the competitive pressure faced by smaller accountancy practices, and has influenced the nature and cost of services offered to SCs.

Furthermore, medium sized accountancy practices, which hoped to benefit from the growth in small firms sector, have found themselves squeezed between the low overheads and more personal service provided by small local practices, and the expertise and extensive marketing of the larger accountancy practices.

It appears that in general small accountancy practices have retained the advantage in their competition with medium sized and larger firms in acquiring and retaining

SC clients, but have tended to lose some of their clients with higher growth rates to the larger accountancy firms.

In general, accountancy practices (small, medium sized or large) are interested in the small firms sector and for this reason they participate strongly in the SCFR debate. It is not surprising to note that 67% of responses to the APC (1979)'s discussion paper and 72% of responses to the ICAEW (1992b)'s discussion paper came from accountancy firms and sole practitioners.

A detailed analysis of the responses to these discussion papers is presented in the table below. In total, 181 comments were received in response to the APC (1979)'s discussion paper "Small Companies -the need for audit?" and 188 comments in response to the ICAEW (1992b)'s consultation paper "The statutory audit of small companies: the case for reform". They have been divided into the following categories:

Table 3.1: Analysis of responses to discussion papers

	Response to APC (1979)		Response to ICAEW (1992b)	
	No.	%	No.	%
a) Accounting firms and sole practitioners	121	67	135	72
b) District societies and other groups of accountants	51	28	24	13
c) Representative bodies, companies and individuals	9	5	29	15
	181	100	188	100

At the end of the APC (1979) discussion paper (Para. 64), readers were asked to consider four questions, which were identified as fundamental. The number of respondents replying to each question was as follows:

For the first question, a total of 178 responses were received, of which 89 (50%) respondents agreed that audit in its present form should continue to be mandatory for all SCs.

In response to the second question, 46 (69%) respondents out of a total of 67 considered that it was acceptable that a significant number of companies were likely to receive qualified audit reports.

In considering the responses to the third question, a total of 90 responses were received, of which 55 (61%) respondents who had already answered "no" to the first or the second question considered that a SC which chooses not to have an audit, should be required by law to have its accounts <u>reviewed</u>.

In response to the last question, 23 (34%) respondents out of a total of 68 agreed that the right to choose a review should apply to all companies coming within the description "bottom tier" set out in the Green Paper (see Appendix 1 to APC, 1979).

It should be noted that, the majority of responses to the above four questions came from members in practice which were respectively: 120 (out of 178 responses to the first question), 43 (out of 67 responses to the second question), 62 (out of 90 responses to the third question) and 42 (out of 68 responses to the fourth question).

Referring to responses to ICAEW (1992b)'s consultation paper, it was reported that:

> "Of the 188 respondents, 132 were in favour of relaxing the statutory audit requirement in some way. With 135 responses from firms and practitioners, the majority of these responses have by definition been from small firms. Five of the Big Six responded, all favouring relaxation. Of the next tier of larger firms (roughly, the next 20), 10 out of 15 favoured relaxation. Thus, 79 out of 115 small and very small firms favoured relaxation (69%)" (ICAEW, 1993a:4).

It is noteworthy that the majority of the responses (101 out of 135) came from small accountancy firms with not more than five partners, highlighting the importance of the SCFR debate for their economic survival.

3.5 Banks and other institutional creditors

According to Eddie George, Governor of the Bank of England "the big banks are committed to the small business sector and necessarily so because it is an area where they have a competitive advantage" (Certified Accountant, February 1994:19).

This is because unlike larger companies, SCs cannot borrow directly in the money and capital markets. Therefore, as the big banks are the main sources of finance for SCs, they are in a position to ask for audited accounts as part of their lending requirements.

However, Abdel-khalik (1983:81) in his study of financial reporting by private companies, found that "bankers are not always as successful in obtaining information on request from private companies as outsiders are led to believe". Furthermore, in the follow-up to that study, the following comments were made by the ten Ohio bankers (Abdel-khalik, 1983:100) in response to the question "why do not you insist on obtaining the information you requested?":

Table 3.2: Comments made by ten Ohio bankers

Comments	Number of responses
I always receive it	5
Usually receive it, but exception is made based on judgement	3
Competition may intervene	2
	--
	10
	==

The above findings are also supported by Berry, Faulkner, Hughes and Jarvis (1993: 136-137) who reported that:

> "A further problem that bankers face is that information is frequently out of date (Egginton, 1975; Berry et al, 1987). While, in theory, they have the power to demand more up-to-date information, there was a reluctance to exercise this power and run the risk of alienating an established customer. Therefore, except in the case of an existing customer wishing to expand or diversify, or a new customer with an existing business where up-to-date information is likely to be required, the banker may well be working with out-of-date as well as unreliable information. This may provide an explanation for their use of surrogate information...".

Banks use accounts for initial lending decisions as well as the subsequent monitoring of the ongoing security in respect of advances already made.

In response to the APC (1979)'s discussion paper on SC audit, the Committee of London Clearing Banks, the Committee of Scottish Clearing Banks and the Finance Houses Association argued that without an audit the assessment of the credit worthiness of potential borrowers would be more difficult and could result in a reduction of credit/loan granted (APC, 1980).

However, the ICAEW's working party in their recent discussion paper on SC audit (ICAEW, 1992b:2) concluded that "Banks and other financiers are generally in a position to make specific conditions for providing finance, and therefore have little need of a statutory audit".

Furthermore, in response to the ICAEW (1992b)'s discussion paper, the British Bankers Association argued that the statutory audit is only one of the factors which a lending banker will take into account when assessing a SC's financial standing in order to determine the extent to which facilities should be made available. Other important considerations are:

* the company's track record with the bank;
* the quality of the company's management team; and
* the timeliness and accuracy of management information and forecasts.

The British Bankers Association concluded that none of these factors are necessarily affected by the existence or absence of a statutory audit requirement for SCs.

3.6 Tax authorities

The Inland Revenue is among the largest users of accounts, which uses the accounts as a basis for agreeing the computation of taxable profit.

The Customs and Excise also uses the audited accounts for verifying the accuracy of turnover and expenses reported in VAT returns.

In response to the APC (1979)'s discussion paper on SC audit, the Board of the Inland Revenue confirmed that it did not insist on a mandatory audit, and that a review report would be sufficient (APC, 1980).

According to ICAEW (1992b:2):

> "The Inland Revenue's reliance on audited accounts is largely illusory, in that it does not appear more likely to accept them [the audited accounts] without further enquiry than unaudited accounts of similar unincorporated businesses".

In a recent letter sent to all Inspectors of Taxes, the Inland Revenue said that:

> "...the lack of an audit report will not of itself be a reason for an investigation. However, the effect of the relaxation [of audit] is being monitored, and could lead to a change of view in the future, if in the opinion of the Inland Revenue it leads to 'deterioration in voluntary compliance'". (See "Taxation and the AUDIT EXEMPTION", Certified Accountant, May 1995:28-29).

3.7 Small Companies (SCs) and organisations representing the interests of small firms

The analysis of responses to the APC (1979)'s discussion paper and recently to the ICAEW (1992b)'s discussion paper indicates that the least important and interested party in the SCFR debate are SCs themselves. Only one out of 6 responses to the recent ICAEW's discussion paper came from bodies representing SCs (ICAEW, 1993a). One possible explanation for this low response by SCs could be attributed to the perceived benefit of annual audit.

In this respect, Keasey, Watson and Wynarczyk (1988:324) have pointed out that:

> "The major distinguishing internal control and ownership characteristic of small companies is that

the major shareholders are generally also working directors personally involved in the day-to-day control of the business. The traditional 'stewardship' function of the audit would thus seem to be limited relevance for many small company shareholders. Benefits accruing to the director/shareholders from an audit are, therefore, likely to be minimal since they will normally already have free access to this information."

Furthermore, Rutteman (1985:12) argues that:

"A statutory audit is of little value to shareholders of such companies [shareholder-managed]. They may well wish to employ outside accountants to advise them and prepare the accounts (and usually do) but the audit requirement is superfluous as far as its main purpose - shareholder protection - is concerned, because the shareholders are already in a position to know the true financial situation of their company".

Nevertheless, it is worth mentioning that a number of organisations representing the interests of small firms have contributed to the SC audit debate. For example, in their responses to the APC (1979)'s discussion paper, the Engineering Industries Association supported the retention of audit, particularly in the interests of shareholders, management and trade credit organisations, while the Association of Independent Businesses supported a limited review in place of statutory audit provided all shareholders agreed.

The above responses indicate that these organisations appear not to have a clear and unique policy on this issue.

In addition in 1985, such organisations contributed to a study by the DTI on how to reduce the administrative burden on companies arising from certain company law requirements (e.g. the burden of the statutory audit requirement on owner-managed SCs). (See Appendix 4 to "Burden on Business" report, DTI, 1985a).

Furthermore, in their response to ICAEW (1992b)'s discussion paper, the Federation of Small Businesses urged for a stronger representation to the government for the abolition of the SC audit requirement because they believed that the compliance costs imposed upon both small businesses and their professional advisers appeared to have been set out of all proportion to the perceived benefits of limited liability.

3.8 Summary and conclusion

Having recognised the administrative burdens on SCs resulting from the requirements of company law, the regulatory bodies appeared to have attempted to relieve SCs of the burdens of some of these statutory requirements (e.g. exempting Very SCs from the statutory audit requirement). Furthermore, they are considering to simplify the form and content of SC accounts.

While, the professional institutions' role in the debate appeared to have been influenced to some extent by their members' interests, it would seem that this "self-interest" has led to the lack of consensus among the professional institutions involved in the debate.

From responses to the SC audit discussion papers, it is evident that accountancy firms in general and small accountancy firms in particular, are interested in the SC audit debate.

With reference to banks, it has been claimed that audit is one of the factors that bankers would take into account for lending decisions. However, they may also take into account the company's track record with the bank as well as the quality of its management. Furthermore, the research indicates that bankers have not always been successful in obtaining the required information partly due to competition.

With respect to tax authorities, it was observed that they are among the largest users of accounts but their reliance on audited accounts has been described as "largely illusory".

Finally, as far as SCs and other organisations representing their interests are concerned, audit seemed to have a limited relevance to their shareholders.

A number of major issues raised in this Chapter together with other issues affecting SCFR are considered in detail in the next Chapter.

CHAPTER 4

SCFR ISSUES

4.1 Introduction

This Chapter considers some of the important issues in a SC environment which affect SCFR. It begins by considering the economic importance of small businesses and reviewing the various definitions of a SC, their characteristics and numbers. An attempt is also made to provide a comparative analysis of the financial structure and profitability of large and SCs.

Ownership and controls of SCs, their corporate status and the client-auditor relationship in a SC environment are also examined. Furthermore, the form and content of SC accounts as required by the CA 1989, application of accounting standards to SCs together with the burden of financial reporting on SCs are provided. The main users of SC accounts and their accounting information needs are also reviewed in this Chapter. This is followed by a discussion of audit problems and audit report with references to SCs and the possible conduct of an efficient and effective audit in a SC audit environment.

Finally, an overview of the USA literature with respect to financial reporting for private companies and audit requirement in a number of overseas countries are provided.

4.2 The economic importance of small businesses

> "The small business sector in the UK started to attract political attention during the 1970s, but it was not until the middle of the 1980s that the ideology of the Conservative party, with its sympathy towards competition

> and the market mechanism, focused attention on the role that small firms were expected to play in the economy" ("Accounting for growth", Accountancy, March 1987:160).

The importance of the role played by small businesses in the economy cannot be disputed. Small businesses increase consumer choice, challenge larger businesses to keep prices low and act as a defence against monopoly and state control.

Small businesses provide vital supplies and services to large businesses and often grow into the medium and large businesses of the future. It is the growing small businesses which could offer the opportunity for employment (see Table 4.4 in section 4.5) and the improvement in economic growth. They play a great role by creating and sustaining employment in situations where their medium-sized and large firms counterparts would fail to do so, in particular, in inner-city and rural areas (Cross, 1983). Furthermore, they have also played an important role in the introduction of innovations in the UK over the 1945-80 period. According to Cross (1983:104):

> "Over the 1945-80 period small firms have provided between 11 and 17 per cent of all innovations across a variety of industrial sectors (30 in all) and it would appear that through time the small firm sector has managed to maintain its level of contribution whilst the very large firms (10,000 or more employees) have substantially increased their contribution".

In social terms, it would appear that small firms play an important role in a number of ways. The setting-up of a small firm offers an outlet for those individuals who for whatever reasons, for example, class, ethnic, religious or political backgrounds have been unable to find work in or forced to withdraw from labour market (see for example Stanworth and Curran, 1973). Furthermore, small firms are the natural routes for the talents of all artists to find their expression and give status and recognition to their hard work.

For the remaining part of this section, the birth, death and growth of firms, particularly, small firms are considered.

The birth and death of firms occurs on a high scale. According to Storey (1994:49) "In the United Kingdom each year nearly 14 per cent of all businesses have registered for VAT during the previous twelve months". In 1990, these new firms (births) constituted a gross addition to the stock of UK businesses of approximately 235,000. However, Storey (1994:76) argues that:

> "Given that only two-thirds of businesses are registered for VAT, and that those which are unregistered are likely to be younger than those which are registered, it suggests that the 14 per cent figure is likely to be, if anything, a significant under-estimate of the importance of very young firms in the stock of businesses".

It is interesting to note that the formation rates of new firms vary for different sectors, different time periods and regions. According to Daly (1991), registration rates for VAT for new firms varied from 3.5% in agriculture to 12.9% for motor trades and it was as high as 20.2% for the miscellaneous service sector. Formation rates of new companies in the UK were very high during the 1980s and comparatively low during the late 1960s and early 1970s (Storey, 1994:76).

With reference to business failures, Storey (1994:92) identifies eleven factors which influence the probability of failure of a business (for example, size, age, sector, etc.). He notes that business failure rates, almost however they are defined, are inversely related to firm <u>size</u>.

In fact, Storey (1994) argues that the main characteristic which distinguishes small from large firms is their higher probability of ceasing trade. For example, firms with an annual turnover of less than £13,000 in 1980, according to Ganguly (1985), were six times more likely to deregister for VAT than firms with a turnover in excess of £2m.

According to Daly (1987), deregistration for VAT relates to business age. His data shows that deregistration rates are at their peak in the second and third years of the life of a business, when the annual deregistration rate is about 20% compared to 7% once a business is ten years old.

In considering the growth of firms, for some business owners, as Curran (1986) points out, growth of their business is not an objective. Hakim (1989) found that the typical no-growth firms were unincorporated businesses that were home-based, employing only one or two people (including the owner-manager) whereas limited companies were found more likely to be among the faster-growth firms. However, for small businesses to grow to maturity stage, Scott and Bruce (1987) argue that they should go through survival, growth and expansion stages which change the role their top management play, the management style and the organisation of structure. Furthermore, Storey (1994) argues that there are three main factors which influence the growth of firms - the background/resources of the entrepreneurs (for example motivation and education), the nature of the firm itself (for example smaller and younger firms grow quicker, as do limited companies) and the strategic decisions taken by the owner-manager in the firm (for example a willingness to share ownership, the ability to identify market niches and the introduction of new products).

Various definitions of SCs, their characteristics, numbers and financial structure and profitability are considered in the following sections respectively.

4.3 Definition of a small company (SC)

As a number of authors (e.g. Raiborn, 1982; Storey, 1994 and Freedman and Godwin, 1993) have pointed out there are various definitions of a SC for various purposes. These definitions may be grouped under two broad headings based on:

i) quantitative limits (e.g. turnover, assets, number of employees, balance sheet total, profit or market share) and/or

ii) qualitative characteristics (e.g. owner/manager dominance).

The following review in this section will shed light on some of the definitions of a SC, based on quantitative limits, while, in the next section the definitions of a SC, based on qualitative characteristics will be considered. The definitions provided in these sections are not intended to be exhaustive.

The Committee of Inquiry on Small Firms (1971) (the Bolton Committee) gave a very wide definition of a small business which recognised that a small business has a relatively small market share, cannot affect the market and is managed in a personalised way by its owner(s).

The Bolton Committee recommended different definitions for a small business in different industries. For example, for manufacturing, construction, mining and quarrying industries, the criterion was employment. In retailing, miscellaneous services, motor trades and wholesale trades, the criterion was sales turnover. However, in catering and road transport industries the criteria were based on ownership and the number of vehicles respectively. This made comparison and analysis between different industries difficult, if not impossible.

Indeed, Storey (1994:13) draws attention to the EC definition of "small and medium enterprise" (SME) which is disaggregated into three components:

* micro-enterprises: those with between 0 and 9 employees;
* small enterprises: those with 10 to 99 employees;
* medium enterprises: those with 100 to 499 employees.

Storey (1994) argues that the above definitions are more appropriate than those of the Bolton Committee because they are based upon employment rather than a multiplicity of criteria and also they recognise that the SME group is not homogeneous (i.e. distinctions are made between micro, small and medium-sized enterprises).

However, it should be pointed out that the definitions provided by the Bolton Committee had no direct significance for SCFR.

The next definition of a SC is provided by the CA 1985 (S247), which defines a company as "small" for a financial year for the purposes of <u>filing abbreviated accounts</u> with the Registrar of Companies, based on its turnover, total balance sheet assets and average number of employees (see List of definitions). In this regard, according to Freedman and Godwin (1993:108):

"It seems that at least 90 per cent. of all companies

> would fall within the Companies Act "small companies" definition".

Furthermore, they argue that:

> "If this is the case then this classification, although valuable for many purposes, is unlikely to be sufficiently targeted to be helpful in discussing the audit issue".

This is because as they have noted:

> "Companies falling within this category will range from the one person entity operated from a back bedroom to a substantial organisation with minority shareholders, sizeable borrowing and a number of employees. Different considerations clearly apply to these very different entities".

It is worthy of note that a similar definition was used by the APC (1979) in their discussion paper "Small Companies: the need for audit?".

Another definition of a SC, which is provided by the ASC (1988b), refers to specific circumstances for <u>exempting SCs from certain provisions of accounting standards</u>. SCs, for this purpose, are defined as those excluding:

i) Public Limited Companies (PLC);

ii) Companies that have a PLC as a subsidiary; and

iii) Companies which exceed ten times the qualifying conditions for a company to be treated as a medium-sized company under Section 248 of the Companies Act 1985.

The effect of this definition for the purpose of accounting standards is that a company is able to avail itself of relaxation specified in respect of all or part of accounting standards if it is not a PLC and does not have a PLC subsidiary and it meets two or more of the following conditions:

* turnover does not exceed £112m (since 16 November 1992);

* balance sheet assets do not exceed £56m (since 16 November 1992); and

* average number of persons employed in the year under review does not exceed 2500.

Clearly, the effect of the above exemptions apply to companies other than very large ones. Therefore, it appears that the ASC has introduced an unnecessary definition by including the size criteria in the exemption. Perhaps, it would have been more beneficial if the ASC had distinguished between <u>public</u> and <u>private</u> companies for this exemption.

Other definitions of a SC worth noting are those used for tax purposes, application of SSAP10 and FRS1 and also for sampling purposes.

For <u>tax purposes</u>, a company is deemed to be "small" if its taxable profit is less than £250,000 for the year ended 31 March 1994.

For the <u>application of SSAP10</u>, a company with annual turnover of £25,000 or less was considered to be "small". However, SSAP10 was replaced with <u>Cash Flow Statement (FRS1)</u>, which exempts small companies (as defined by S247 CA 1985) from the requirement to prepare a cash flow statement.

For sampling purposes, for example, in their research study, Carsberg et al (1985) defined a SC as one with less than 150 employees, being exactly half of the limit (300 employees) used by Robertson (1986a) in an empirical survey of 100 small Scottish manufacturing companies. Furthermore, the DTI (1985a)'s "Burden on Business" report effectively defined SCs as those in the manufacturing sector with employment of 50 or less and in the service sector with a turnover of £150,000 or less.

It is worth mentioning that the current definitions of Very SCs and SCs used by ICAEW (1992b), LSCA (1992) and DTI (1993) are based on VAT registration and VAT cash accounting thresholds (see sections 5.8.1 and 5.8.2). These thresholds are considered to have significant implications for the way a company conducts its business as they are reviewed and upgraded annually.

Referring to the definition of a SC in other countries, it would appear that any international comparison would prove difficult. For example, in Canada, various provinces have different definitions for companies to be exempt from SC audit requirement (LSCA, 1992). Furthermore, the definitions used in different countries, such as in Australia, Canada and South Africa for exempting their SCs from audit requirement are different and therefore they are not comparable (LSCA, 1992).

From the above consideration, it would appear that there are many definitions of a SC for different purposes and that most of the definitions cited in these studies overlap as they are generally based on one or a combination of the following factors: number of employees, turnover, balance sheet total, profit or market share. Furthermore, most of the definitions cover majority of companies in the UK.

It would appear, in the words of Storey (1994:8) that:

> "There is no single, uniformly acceptable, definition of a small firm. This is because a 'small' firm in, say, the petrochemical industry is likely to have much higher levels of capitalisation, sales and possibly employment, than a 'small' firm in the car repair trades".

Storey goes on to say that:

> "Definitions, therefore, which relate to 'objective' measures of size such as number of employees, sales turnover, profitability, net worth, etc., when examined at a sectoral level, mean that in some sectors all firms may be regarded as small, while in other sectors there are possibly no firms which are small".

In search of a possible definition of a SC, Page (1981:21) has pointed out that:

> "...there are plain administrative advantages to choosing a relatively simple and uniform definition rather than a complex definition such as that used by the Bolton Committee".

Furthermore, Cross (1983:88) is also of the opinion that it is important to have "...an agreed definition which can be commonly and readily applied".

Freedman et al (1993:108) observed that "The problem of defining "small company" plagues the small company audit debate ..." and that, "No one definition will be suitable for all purposes".

In other studies SCs are defined based on their characteristics which are considered below.

4.4 Characteristics of a SC and their consequences

The following studies have either identified the main characteristics of a SC or defined a SC based on its characteristics.

In a research project in the United States (Raiborn, 1982), reference was made to the AICPA's definition of a small business as one possessing some or all of the following characteristics:

i) owner/manager dominance, allowing management to override internal accounting controls which are informally designed;

ii) management personnel or employees have limited accounting knowledge and easy access to physical assets;

iii) internal control deficiencies resulting from limited segregation of functions; and

iv) the firm has an inactive or ineffective policy-making body such as a board of directors.

It is worth pointing out that the UEC (1983) Auditing Statement Number 14 (para. 2) lists almost similar characteristics of a SC as the above. In addition, it states that a SC relies heavily on the services of outside advisors (e.g. accountants/auditors).

A study by the Canadian Institute of Chartered Accountants (CICA 1988) divides the main characteristics of SCs into two groups in order to identify the main characteristics of a SC, namely:

Primary characteristics:

* concentration of ownership
* operations are not complex
* systems and authorisation procedures often lack formal documentation
* segregation of incompatible functions is limited

Secondary characteristics:

* potential for management to override internal controls
* management personnel have limited accounting knowledge
* an inactive or ineffective policy-making body

In general, similar SC characteristics as the above have been reported by the International Auditing Practices Committee (IAPC, 1988), Accountants Digest 245 (ICAEW, 1990) and the APC's draft auditing guideline (1991).

The characteristics of SCs do not have an effect on the standard of the audit or on the duties and responsibilities of the auditor.

However, in SCs, the approach to the audit needs to be responsive to SC characteristics (Anderson et al, 1982; Humphrey and Turley, 1986; and UEC, 1983). This is generally due to internal control deficiencies in SCs resulting from some of their characteristics such as limited segregation of functions and the potential for management to override internal controls. This would make it difficult for the auditor of a SC to test and rely on internal controls (UEC, 1983). The UEC (1983: Para. 4.3) has argued that:

"...in approaching the audit of financial statements of a small enterprise the auditor will normally place less emphasis on the study and evaluation of internal controls of the enterprise and more on the verification of transactions and balances through detailed audit tests and analytical review procedures".

Furthermore, as shown earlier (see 2.6(i)), Humphrey and Turley (1986), who investigated the factors influencing the choice of audit procedures adopted in the audit of SCs (e.g. absence of an internal control system), concluded that:

"...the audit of a small company will be different from that of a large company not only in matters of detailed procedures but also in fundamental approach...". (Humphrey et al, 1986:31).

4.5 Number of small firms

Given the problems identified above in defining a small firm, Storey (1994:6) argues that:

"...it is perhaps not surprising that, in the United Kingdom, there is no single definitive statement about the total number of firms in the economy, or the proportion of those which, however defined, could be regarded as small".

This is partly due to lack of consensus about what constitutes "small" and also the absence of any single comprehensive data covering all firms in the UK economy. However, it is worth mentioning that data bases on the UK firms do exist. For example, statistics are available on the number of companies filing SCs' abbreviated accounts in Great Britain (DTI, 1994):

Table 4.1: Companies filing SCs' abbreviated accounts in Great Britain

	Number of Cos. ('000)	% of total companies filing accounts
1990/91	252	32.2
1991/92	268	32.5
1992/93	300	34.0
1993/94	308	40.5

(Extracted from Appendix C, Table 1, DTI, 1994
Source: Companies House, limited to "active" companies and compiled in December of each year).

With reference to the effective number of companies in Great Britain on the register of Companies House, these were nearly 979,800 companies at the end of 1991/92 period (see DTI, 1991-92: Table A2) with the following legal structures:

Table 4.2: Legal structures of companies in Great Britain, 1991/92

	Number ('000)	%
Public companies	11.6	1.2
Private companies	968.2	98.8
	-----	-----
	979.8	100.0
	=====	=====

With regards to other legal structures in 1991/92, the DTI (1994, Appendix C: Table 2) provides the following data:

	Number ('000)
Partnerships	629
Sole traders	2,840

According to the DTI (1994:7) "There are no government statistics on the number of entirely owner managed companies". It is worth mentioning that according to the DTI (1995:7)'s estimates the numbers of small private companies (as defined by the CA 1985) were 870,000 out of 957,000 companies on the register in 1993/94.

With regards to turnover statistics, the DTI (1994) provides the following data which are only available in VAT statistics in 1991:

Table 4.3: Size by turnover according to VAT - 1991

Turnover (£'000)	% of companies	% of Partnerships	% of sole traders
22 - 50	18	25	46
51 - 100	13	27	27
101 - 250	21	31	19
251 - 500	15	11	5
501 - 1000	13	4	2
1001 - 2000	8		
2001 - 5000	6	2	1
5001 - 10000	3		
10000+	3		
	100	100	100

(Adapted from Appendix C: Tables 4,5 and 6, DTI, 1994).

Note: the above table does not include 69,577 companies and 140,596 sole traders with a turnover below £23,600 and 45,000 partnerships with a turnover below £23,000 (see DTI, 1994).

From the above table, it is interesting to note that 88% of companies registered for VAT had a turnover up to £2m, satisfying turnover criteria of the CA 1985 definition of a "small company".

Furthermore, the following table presents a comparative data on number of businesses and their share of employment according to employment size.

Table 4.4: Numbers of businesses and employment share by size band in the United Kingdom

Employment size band	Numbers ('000) 1979*	1986*	1991+	Share of total (%) Employment 79*	86*	91+
1-2	1,099	1,595	1,735	7	11	11
3-5	319	535	565	6	10	10
6-10	179	178	196	7	7	7
11-19	109	84	97	8	6	6
20-49	46	56	65	7	8	9
50-99	16	16	20	5	6	7
100-199	15	9	10	10	7	8
200-499	5	5	6	8	10	9
500-999	2	2	2	8	7	6
1,000+	2	1	1	35	29	27
Total	1,791	2,481	2,697	100	100	100

(Extracted from Storey (1994:21).
Sources: *McCann (1993), +Daly and McCann (1992)).

The key point of the above table is the fact that almost two-thirds of UK firms from 1979 to 1991 had two employees or less. In 1979, there were about 1.1 million firms having two employees or less, out of a total of 1.791 million firms, representing nearly 61% of all firms trading at that time. The numbers of firms having two employees or less were increased during the 1980s, so that, there were about 1.595 million and 1.735 million of such firms by 1986 and 1991 respectively, representing 64% of all UK businesses for those years.

The above data emphasises the <u>key numerical importance</u> of tiny businesses in the UK. For example, taking the EC definition of the micro-enterprises (with ten, rather than nine employees or less), it can be seen that in 1991, 92% of all UK businesses were micro enterprises.

However, the contribution of the "small" businesses to employment, is very much less than their contribution to the number of businesses. For example, although businesses with two employees or less accounted towards two-thirds of UK firms throughout the 1980s, but their contribution to UK employment was not more than 11% for the period.

Similarly, the micro-enterprises (with 10 employees or less) accounted towards about 90% of UK firms throughout the 1980s, but their contribution to UK employment was approximately 20% and 28% of employment in 1979 and 1991 respectively. Storey (1994:21) concludes that:

> "Even so, it is likely that there was an increase in the total number of firms in the UK economy in the 1980s, with the bulk of these being micro-enterprises with less than ten workers. Such enterprises dominate the UK stock of businesses, although they only provide just over a quarter of employment".

International comparisons

The UK and Europe

The following table provides a comparative analysis of the number of enterprises in 1988 and their contribution to employment between UK and the rest of the European Community (EC) countries.

Table 4.5: EC enterprise by member states, 1988

Country	No. of enterprises (x1,000)	No. of enterprises per '000 inhabit.	Ave. firm size	Employment share 0-9 %	Employment share 0-499 %
Belgium	530	53	5	28	69
Denmark	180	35	9	22	76
France	2,040	36	7	28	67
Germany*	2,160	35	9	17	62
Greece	670	67	3	59	91
Ireland	130	36	6	34	83
Italy	3,170	55	4	48	81
Luxembourg	20	43	9	23	74
Netherlands	420	28	10	28	72
Portugal	640	62	4	36	80
Spain	2,020	52	4	36	83
UK	2,630	46	8	26	65
Total EC	14,600	45	6	30	70

(Extracted from Storey (1994:22)
Source: ENSR (1993))
(Note: *Former FRG only)

As can be seen from the table, Italy and Luxembourg with 3.17 million and 20,000 businesses had the largest and the smallest number of enterprises in the EC respectively. However, by taking number of inhabitants in such countries into account, the average number of enterprises in the EC was 45 per 1000 inhabitants in 1988, which was almost the same as that for the UK. Countries such as Greece, Spain and Portugal had a higher number of enterprises per 1000 inhabitants than the UK. Whilst, countries such as France, Netherlands and Denmark had a lower number of enterprises per 1000 inhabitants than the UK.

The analysis of the third column (i.e. average firm size) in the table provides interesting results. According to Storey (1994:22) who cited ENSR (1993) data and results (including the above table statistics), the average firm size is broadly inversely related to the number of enterprises per 1000 inhabitants. For example, Netherlands and Greece with the lowest (28) and highest (67) number of enterprises per 1000 inhabitants had respectively the highest (10) and lowest (3) average firms size in the EC.

However, the UK average firm size (8) was higher than the EC average size (6) in 1988 but it was lower than those in Denmark, Germany (before unification), Luxembourg and Netherlands. According to Storey (1994:22):

> "It is also the case that it is the less developed countries of Spain, Greece and Portugal which have the largest number of enterprises per 1000 inhabitants, so that number of small firms looks to be inversely related to level of economic development".

For example, in more wealthy countries such as Netherlands and Denmark the average number of employees per firm was more than twice that of less wealthy countries such as Greece and Portugal in 1988.

With reference to the employment share, the above table shows the percentage distribution of employment by size class for each Community country in 1988. This emphasises the importance of micro-enterprises in the economies of countries such as Greece, Italy, Spain and Portugal.

From the above table, it is interesting to note that the size structure of enterprises having up to 500 employees in the UK was similar to that of Germany (before unification) and France in 1988 than any other EC countries. However, the only notable difference appears to be that, the UK had a higher proportion of its employment (26%) than Germany (17%) in enterprises with less than ten employees in 1988, which is in line with the earlier finding that during the 1980s, there was an increase in the total number of micro-companies in the UK.

Europe and the United States

A comparison between the UK and both the EC and the United States (US) of the size structure of enterprises in 1988 is presented in the following table.

Table 4.6: Employment by enterprise classes, 1988

	<100 %	100-499 %	500+ %	Total %
All sectors				
USA	37	14	49	100.0
UK	47	18	35	100.0
EC-12	55	16	29	100.0
Manufacturing				
USA	20	15	65	100.0
UK	24	15	61	100.0
EC-12	42	20	38	100.0

(Extracted from Storey, (1994:24)
Sources: EC data taken from ENSR (1993)
US data from: The State of Small Business (1991))

As can be seen, the distribution of manufacturing employment according to enterprise size in the UK was closer to that of the US than to the EC.

However, for all-sector employment a much higher proportion of employment in the US was in large enterprises than was the case for the UK or for the EC. For example, nearly half of all employment in the US was in enterprises having more than 500 employees, compared with 35% in the UK and 29% in the EC. As it can be seen from the table, the difference between the EC and the US did not lie in the relative importance of middle-sized firms, but rather in small firms with less than 100 employees, which employed 55% of the EC workforce in 1988 as compared with 37% in the US. Similarly, for manufacturing employment a much higher proportion of employment in the EC (42%) was in small enterprises with less than 100 employees than in the case of the US (20%). Given that small business was viewed as the bed-rock of the US economy, the above finding could have been regarded by some as a surprising result.

4.6 The comparative financial structure and profitability of large and small companies

Financial structure

This section draws heavily on the work by Cosh and Hughes (1994). In that work, they provided a summary analysis of the balance sheet structure, gearing and profitability of large and small UK non-financial companies in the period 1987-9 based on their published accounts (Cosh and Hughes, 1994:35). In that context, "large" companies were those ranked in the top 2,000 in terms of capital employed in the UK non-financial corporate sector, whereas "small" companies were a one in 300 sample of the remainder of the sector, stratified by size of capital employed.

Their work demonstrates that the financial structure and profitability of large and SCs differ significantly, even where account is taken of the distinction between manufacturing and non-manufacturing. A number of interesting conclusions may be drawn from their work which are listed in the following subsections:

Asset structure

SCs have a lower ratio of fixed to total assets as compared to large companies. However, SCs have a relatively high proportion of trade debt in their asset structure than large companies.

Current liability

Trade and other creditors are a higher proportion of total liabilities for small than for large companies. For example, in manufacturing, trade and other creditors were 35.3% of total liabilities compared to 23.6% for large companies. The small manufacturing companies were net receivers of credit.

One particular important result is that SCs are more reliant on short-term bank loans and overdrafts than large companies. In non-manufacturing, for instance, bank overdrafts and loans were 11% of total liabilities for SCs compared to 4.4% for large companies.

Long-term liabilities

SCs are less reliant on shareholders interests to finance their assets. In non-manufacturing, gearing (as measured by ratio of total loans to shareholders interest) is higher for SCs (78.7%) than for larger companies (44.5%). However, in manufacturing, SCs are slightly less highly geared than larger companies.

In manufacturing, long term loans are only 20.5% of all loans for SCs compared to 61.7% of all loans for larger companies. Similarly, in non-manufacturing, long term loans are 29.4% of all loans for SCs compared to 72.9% of all loans for larger companies.

Cosh and Hughes (1994:37) conclude that:

> "The high reliance on short term finance provided by banks, and the relatively low proportions of assets financed by shareholders interests are clearly long run persistent features of small business finance. The same is true of the relative importance of trade debt, and trade credit and the relative unimportance of fixed assets in their balance sheet structure. Thus our results match the results of previous investigations for the 1960s and 1970s for the UK and for other countries...".

Examples of the UK investigations in this area are those of Jones (1979) and Page (1984). In his survey of SCs' annual returns, Page (1984:274) confirms some of Jones (1979)'s findings for the financial structure of SCs that:

> "... as compared with large companies:
>
> (1) shorter term assets and liabilities are more prominent;
>
> (2) small companies are net receivers of trade credits;
>
> (3) small companies are more dependent on bank overdrafts and loans;
>
> (4) small companies are more dependent on equity (including directors' loans)."

Profitability

Table 4.7: The relative profitability performance of large and small UK companies in the manufacturing and non-manufacturing industries (excluding oil) in the period 1987-1989 (average %)

	Manufacturing companies		Non-manufacturing companies	
	Small %	Large %	Small %	Large %
RONA	15.9	19.6	19.1	14.4
ROTA	12.4	14.3	13.0	17.6
ROE	10.4	19.1	18.8	13.3

Where:
RONA = Pre-tax return on net assets
ROTA = Pre-tax return on total assets
ROE = Pre-tax return on equity

(Extracted from Cosh and Hughes (1994:35)
Source: Business Monitor MA3 Company Finance, Various Issues)

The above table shows that the average profitability of small manufacturing companies is below that of large manufacturing companies on each of the three measures used (RONA, ROTA and ROE) for the period 1987-9.

However, for non-manufacturing companies, for two of the measures (RONA and ROE) SCs seem to be more profitable than large companies.

Cosh and Hughes (1994:42) show that the above results contrast with those obtained earlier, by both the Bolton Committee (1971) and the Wilson Committee (1979) which showed apparently that small firm profitability was between 8% and 30% higher than larger firm profitability, depending on the measure and time period [1968 to 1975]. Jones (1979) also found that SCs were on average more profitable than large companies.

However, it is apparent, according to Cosh and Hughes (1994:42) that "over the years shown the gap was narrowing, and that, as we have seen, it was reversed by the late 1980s".

Storey (1994:217) points to the limitations of the above official figures and argues that the concept of profitability in small firms is likely to differ sharply from that in a large firm. For example, as shown by Keasey and Watson (1993) the measures of profitability are after directors' remuneration which constitutes 65% of gross profit margins. Storey (1994:217-218) concludes that:

> "The lack of strict comparability occurs because in small firms profitability is more 'discretionary', and includes a larger element of 'return' on owners' equity than is the case for large firms. In short, there is likely to be greater variety in the accounting procedures employed by small firms than by large".

4.7 Ownership and control of SCs

Page (1984:274)'s review of SCs' annual returns indicates that SCs are generally owned and controlled by their directors:

> "In 95.9% of cases 50% voting control is in the hands of the two shareholders owning most shares and in 77.5% of the cases these two shareholders have the almost complete control given by possession of 75% or more of the share capital. Similarly directors owned 50% or more of the shares in all but 8.8% of cases and in 64.6% of cases had total control."

A similar finding is also reported by Humphrey and Turley (1986). Page (1984) concludes that if the above pattern of ownership by directors continues, then in almost two-thirds of cases, directors report to themselves as shareholders.

Humphrey and Turley (1986) report that the ownership of a large number of SCs include non-management interests, but the information needs of these interests were not regarded as significant by owner-managers.

4.8 A new form of incorporation for SCs

The limited liability company was devised based on the fundamental concept that management and shareholders are separate persons. For this reason, a relationship of accountability developed between owners and managers. Therefore, company law is concerned with the regulation of the relationship between management and shareholders which is not relevant to those SCs where there is a complete identity of management and ownership.

The DTI (1981) proposed that there was a need for a new small business vehicle distinct from private limited company because of the burden of legal and operating formalities.

In response to the above proposal, the Councils of the CCAB (ICAEW, 1981) considered that:

> "...there is a strong case for exempting those small firms where there is a complete identity of management and ownership from all those provisions of company law which presume a separation of management and ownership. We propose the creation of a new class of limited liability company: the "proprietary company" in which the proprietors are also the managers... it may be desirable to remove proprietary companies from the ambit of company law and to enact separate legislation" (para. 4).

According to Swinson (1985:12):

> "It is now time to recognise that the traditional approach to the development of company law is mistaken and that the proprietary company is not simply a smaller, simpler version of the public company but a different form of business organisation".

Furthermore, according to Page (1982:92):

> "There has long been unease about the suitability of the limited company as a vehicle for small business, probably since the famous case of Salomon v Salomon 1897. The increasing complexity of companies legislation certainly makes it desirable that the law relating to small companies be simplified and clarified".

Page (1982:92) concludes that there is also a need:

> "...to reduce all government form filling by the small businessman, and amendment to our tax system - in the widest possible sense - to recognise the difference between a multinational and the incorporated family business".

In 1992, the LSCA (1992:5), having considered the advantages and disadvantages of a form of corporate status with other form of business entity such as partnership, concluded that:

> "...a form of corporate status was preferable, mainly due to the advantages that incorporation infers. The principal ones being:
>
> * limited liability of members;
> * continuity of the entity;
> * ease of raising external finance; and
> * legal status of the entity.
>
> Consequently, we recommend the retention of corporate status for small business enterprises".

The APC (1979) confirms that limited liability is a substantial benefit conferred on the shareholders of a limited company but it argues that in many SCs, the benefits of limited liability have been eroded as directors of SCs have to give personal guarantees to lending institutions, particularly banks.

In a recent consultative document issued by the DTI (1994:41) to consider a reform of the law applicable to private companies, the Law Commission expressed "...doubts as to whether a new incorporated limited liability structure would be of significant assistance to small businesses". Furthermore, they consider that:

> "...a reform of partnership law which addresses its main deficiencies, provides a statutory draft partnership agreement and possibly gives partnerships independent

legal personality may well be of benefit to small businesses". (DTI, 1994:42).

4.9 Client - auditor relationship in a SC environment

The SC auditor often provides advice and assistance on a wide range of financial matters (e.g. accounting, taxation, management and business advice) in addition to providing an audit opinion on the client's accounts. The auditor's knowledge of a client's business is extended whenever additional services are provided.

A research by the Study Group of the Canadian Institute of Chartered Accountants (CICA, 1988:5) considers that:

> "...an auditor who has developed a close working relationship with the client can obtain, relatively easily, the knowledge of the client's business necessary for the audit. Specifically, the auditor is in a better position to assess the:
>
> * reliability of the recordkeeping;
> * preparation of financial statements;
> * control environment of the business;
> * results of analytical review procedures; and
> * integrity of management".

In providing advice and assistance to SC clients, the auditor must ensure that <u>audit objectivity</u> is retained. An objectivity problem arises when auditor is not independent by reason of fact or appearance. There are situations which may cause a lack of objectivity (CICA, 1988:7):

* "provision of business advisory services to audit clients; and

* business or personal relationship with the client other than with respect to audit itself".

In practice, auditor independence may be threatened in a number of ways, principally because of the nature of the economic relationship between the auditor and the client (Moizer, 1991).

The main threats to audit objectivity (or independence) may arise where the size of the client is such as to constitute a major source of income for the audit firm. However, Lee (1986) demonstrates that there are potential threats to independence in <u>all</u> types of auditor and client relationships.

To avoid a lack of audit objectivity in SC environment, the auditor should ensure that accounts comply with approved auditing standards, and that SC management accept responsibility for their preparation (although the auditor may have prepared them). Furthermore, in providing business advice, care must be taken to ensure that the auditor is not making decisions for the client.

The CICA (1988) concludes that there are advantages to both parties in a close client-auditor relationship. The broadening of the auditor's knowledge of the business activities may be of significant assistance in the conduct of an efficient and effective audit.

Humphrey and Turley (1986) find that the audit is not independent of other services provided by the auditor in SCs, nor is it perceived as a separate activity by SC owner-managers. They find that the reliance placed on the auditor by SC client increased by multiple services (as suggested by Goldman and Barlev, 1974) and this may increase the auditor's power in dealing with SC clients without conflict of interest with management.

4.10 Form and content of SC accounts

The detailed requirements on the form and content of accounts are included in Part VII and Schedules 4 and 8 of the CA 1985. The CA 1985 requires that all companies prepare full statutory accounts for their members. SCs (as defined by sections 246 and 247 of the CA 1985) may file abbreviated accounts at the Registrar of Companies for the use by the public. The SC abbreviated accounts consist principally of an abbreviated balance sheet and related notes (without a profit and loss account or directors' report).

In order to reduce regulatory burdens on small (and medium-sized) companies, the DTI introduced new regulations contained in SI 1992 No. 2452 (amending Schedule 8 to the CA 1985) ("Accounts of small and medium-sized enterprises and publication of accounts in ECUs") Regulation 1992. These regulations reduced the detailed disclosure requirements in accounts for members of SCs for accounting periods ended on or after 16 November 1992. Due to their importance, the effects of SI 1992 No. 2452 are worth considering below, before returning to the debate on the form and content of SC accounts.

SI 1992 No. 2452 determines the minimum disclosure required in a SC's annual accounts. A SC, however, does not have to take advantage of all the exemptions and modifications (see below) permitted if it does not wish to do so. Schedule 8 to the CA 1985, which sets out the exemptions for small and medium-sized companies, has been amended by SI 1992 No. 2452.

Schedule 8 to the CA 1985 allows modifications to Schedule 4 formats essentially by combining and re-numbering certain items in the formats (to which an arabic number is assigned) in order to make a less detailed balance sheet. For example, there is no need for analysis of stocks (i.e. raw materials and consumables, work-in-progress, finished goods and goods for resale), other debtors and other creditors.

Notes to the balance sheet formats apply to items in the amended format of balance sheet which have been re-numbered or combined into other items.

Furthermore, a SC need not set out in the notes any of the information specified in Schedule 8 (CA 1985, Sch. 8, Paras. 6-12). For example, according to CA 1985, Schedule 8, Paragraph 6 a SC need not set out in the notes to its accounts any information required by the following paragraphs of Schedule 4, inter alia:

40	Contingent right to allotment of shares
47	Provision for taxation
48(2)	Particular of debts
48(4)(b)	Nature of security given for debts
51(2)	Loans provided by way of financial assistance for purchase of own shares
51(3)	Dividend
54	Particular of tax
56	Particular of staff

In addition, the CA 1985, Schedule 8, Paragraph 15 states that the directors' report of a SC need not give any of the following information, inter alia:

* Fair review of business
* Amount to be paid as dividend
* Amount to be carried to reserves
* Asset values

* Insurance effected for officers or auditors
* Health, safety and welfare at work of company's employees
* Employees involvement

After the above exemptions, the directors' report of SCs, taking the exemptions provided by SI 1992 No. 2452, is only required to provide the following information:

* names of directors
* principal activities
* directors' share interests
* directors' share options
* political and charitable gifts (exceeding £200).

It should be pointed out that a SC company which takes advantage of the exemption with respect to the preparation of annual accounts for shareholders and directors' report must include the following directors' statements in its accounts:

i) a statement that advantage has been taken, in the preparation of the report, of special exemptions applicable to SCs (in both directors' report and balance sheet); and

ii) a statement of the grounds on which, in the directors' opinion, the company is entitled to those exemptions (in directors' report or balance sheet).

The accounts of a SC which have taken any of the above exemptions continue to be deemed to give a "true and fair" view as required by the Act (Sch 8., Para. 14(2)) and the auditors in their report are only required to state whether in their opinion the annual accounts have been properly prepared in accordance with the provisions of the Act applicable to SCs (Sch. 8, Para. 14(3)).

There is no longer a requirement to state explicitly that the accounts present a "true and fair" view. However, it is considered best practice that the auditors' report should continue to state whether the accounts give a "true and fair" view.

Having considered the effects of SI 1992 No. 2452, it is worth considering the form and content of SC accounts, which have been a subject of a public debate. In 1985, the DTI (1985b) considered the arguments for and against the form and content of accounts for SCs. It argued that preparation of full accounts for shareholders in "shareholder-managed" SCs was expensive and unnecessary and also in order to protect their competitive position, SCs had to prepare two sets of accounts which were expensive.

However, the DTI (1985b) argued that any further relaxation of the current form and content of accounts for SCs should be viewed with caution because if accounts were only available in abbreviated form, shareholders' interests would be adversely affected and that separate accounts might still need to be prepared for tax purposes or to meet the need of major creditors such as banks. Nevertheless, the DTI (1985b) proposed that only abbreviated accounts should be prepared by all "owner-managed" SCs and/or by other categories of SCs.

The ICAEW (1985) supported the DTI (1985b)'s proposal that only abbreviated accounts should be prepared for all SCs but asked for the additional requirement of a summarised profit and loss account.

It has also been argued that the distinction between full and abbreviated accounts and the occasions when the latter may be used are not particularly well understood by SCs (LSCA, 1992). For this reason, the LSCA (1992:8) believe that these requirements should be simplified and proposed that an "annual accounting return" should be developed for both filing at the Registrar of Companies and use by SCs' members.

However, Robertson (1986a) finds that there is a fairly high degree of interest in the option to file abbreviated accounts despite extra preparation costs to SCs. Robertson (1986a:21) also finds that:

> "...it appeared that the smaller the company and the smaller its firm of auditors the more likely it was that its financial statements contained evidence of unfamiliarity with the required contents of modified [abbreviated] financial statements; poor compliance with legislative requirements and formats; and lack of adherence to SSAP requirements".

Finally, it is worth pointing out that very recently the DTI (1995)'s consultative document ("Accounting Simplifications") has proposed a further simplification of form and content of SC accounts. These are considered in section 8.7 together with the results of this Survey in respect of form and content of SC accounts.

4.11 Application of accounting standards to SCs

Generally Accepted Accounting Principles

Generally Accepted Accounting Principles (GAAP) should be complied with by all companies preparing statutory accounts in order to give a "true and fair" view. GAAP include the principles laid down in the CA 1985 and SSAPs/FRSs approved by the ASB.

The burden of complying with accounting standards is greater for SCs. Although the principles of accounting should apply equally to all companies, it has been recognised that the application of certain accounting standards is not cost effective and appropriate for SCs. For this reason, where appropriate, exemption has been granted to SCs in the application of some accounting standards. In particular, SCs are exempt from the requirement to prepare a cash flow statement under FRS1.

Main arguments for and against universal application of standards

In a research study carried out in the UK by Carsberg et al (1985:1-2) on SCFR, the following arguments were considered:

a) arguments <u>for</u>

- standards are needed for the accounts of small and large companies to give a true and fair view;

- standards promote comparability and are needed if large companies' accounts are to be comparable with the accounts of SCs; and

- a distinction among companies according to their size is an arbitrary cut-off and difficult to defend.

b) arguments <u>against</u>

- compliance costs are relatively higher for SCs and the benefits are relatively lower;

- the users of SC accounts are different kinds of people with different kinds of needs from the users of large company accounts, therefore, there is no need for their accounts to be comparable; and

- some standards will be ignored by SCs which will undermine the whole standard-setting process.

With respect to the second argument above (i.e. different users of accounts), Chazen and Benson (1978) found that owner-managers and creditors are the main users of private companies' accounts, whereas public stockholders and financial analysts are the main users of public companies' accounts with different information needs. Furthermore, with reference to the first and second arguments above, Abdel-khalik (1983:23) provided similar arguments against universal application of GAAP.

Compliance with standards

According to Carsberg et al (1985) SC directors (managers) have little awareness of what is involved in complying with standards because they leave this aspect of their accounting to their auditors.

Carsberg et al (1985) found that some standards were well accepted by SC auditors as applicable to SCs (e.g. SSAP2, SSAP6, SSAP9 and SSAP12) and auditors were less concerned with compliance with accounting standards than the CA requirements.

Furthermore, Carsberg et al (1985) found general opposition towards SSAP10, however, Robertson (1986a) found not only a low level of non-compliance but also instances of exempt companies producing the fund statement when not required to do so.

Robertson (1986a:20) states that "In general, those companies most likely to disregard SSAP requirements appear to be those with small firm auditors and which are themselves relatively small in size".

Carsberg et al (1985)'s study recommended that:

* no case existed for exemption from all accounting standards;

* the standards most suitable for universal application were those dealing with fundamental topics; and

* the ASC should be prepared to give exemption to SCs if their compliance costs would exceed their benefits.

The ASC views

The application of accounting standards to SCs and the definition of "small company" for the purpose of applying accounting standards were considered by the ASC in 1988 and their conclusions were issued in Technical Release numbers 690 (ASC, 1988a) and 706 (ASC, 1988b) respectively.

The ASC (1988a) envisages that:

> "...there may be situations in the future where the strict application of the universality concept may prevent it from making progress in the regulation of publicly accountable enterprises. This may be because future standards would be inappropriate for small companies on purely conceptual grounds or, more likely, on grounds of practicability..." (para. 17).

Accordingly, the ASC (1988b:para. 5.1) accepted that:

> "...there is a case, in specific circumstances, for exempting small entities from certain provisions of accounting standards. Such exemptions are likely to relate more often to disclosure requirements, rather than to recognition or measurement rules. Exemptions will not be proposed where they are considered to impair a true and fair view or to entities perceived to have a special responsibility of public accountability".

For the definition of a SC qualifying for exemption from certain provisions of accounting standards, see section 4.3.

Furthermore, it is worth pointing out that recently, the CCAB working party on "Big GAAP/Little GAAP" has proposed that "...all entities that meet the Companies Act definition of a small company should be exempted from all but a handful of accounting standards...". (See "A GAAP in understanding", Accountancy, February, 1995:93).

Companies Act exemption

Section 246 of the CA 1985 exempts small (and medium-sized) private companies from the statutory requirement to <u>disclose</u> in their accounts whether the accounts have been prepared in accordance with applicable accounting standards and to give particulars of and reasons for any material departure from those standards.

Application

Table 4.8: Application of particular FRSs and SSAPs to SCs

Statement	Accounting standard	Application
FRS1	Cash flow statements	Not applicable to SCs
SSAP3	Earnings per share	Only applicable to listed companies
SSAP13	Accounting for research and development	Applicable but with disclosure exemptions
SSAP25	Segmental reporting	Not generally applicable

The other FRSs and SSAPs are generally applicable where appropriate. It is worth bearing in mind that under S249(3) CA 1989 small and medium-sized groups are exempt from the requirement to prepare consolidated accounts under SSAP23/FRS2.

4.12 Burden of financial reporting

There has been much debate about the burden of financial reporting for SCs. The DTI (1985a)'s "Burden on Business" report suggested that SCs should be subject to less rigorous disclosure requirements in terms of their annual accounts.

Carsberg et al (1985) investigated the burden of financial reporting for SCs by focusing on the costs and benefits of accounting disclosure and statutory audit.

Carsberg et al (1985:5-6) interviewed a sample of SC managers (directors) to ascertain their views about the burden of financial reporting on SCs. They found that:

* production of the annual accounts was considered to be one of the administration difficulty rather than one of the main problems facing SCs;

* general accounting was considered less onerous than complying with VAT regulations and roughly level with PAYE and DHSS regulations;

* preparation of the annual accounts was normally left to the auditors, and so the principal burden of preparing the annual accounts was within the fees paid to the auditors;

* directors objected to the disclosure of personal information (e.g. directors' emoluments);

* disclosure of commercial information (e.g. turnover and stock) was not seen as a burden.

In a parallel survey, Carsberg et al (1985:7-8) interviewed SC auditors to ascertain their views about the burden of financial reporting on SCs. Their findings are summarised below:

* apart from accountants' fees, bookkeeping was seen as the main component of the financial reporting burden;

* reductions in disclosure requirements and in the scope of the audit together with improved client bookkeeping were considered to be the ways of reducing the burden of reporting on SCs;

* 25% of respondents said that there were no feasible ways of reducing the burden of reporting or accountants' fees;

* 56% of the auditors thought that the burden on small business of complying with SSAPs was too great;

* 68% of the auditors thought that the burden of complying with company legislation was too great.

Carsberg et el (1985) found that firms either ranked the burden of accounts relatively high or relatively low; a similar finding was also noted by Keasey and Short (1990). However, they extended the existing literature on the accounting burdens facing small firms by examining whether the perceived relative burden of accounts is general or contingent on a number of firm specific factors (Keasey & Short, 1990:310):

* ownership title
* perceived benefits from preparation of annual accounts
* size of accountancy firm
* provision of all accounting needs by accountant
* preparer of annual accounts
* regularity of preparation of management
* number of employees
* growth in volume of turnover
* use of computer for preparation of annual accounts
* age of business
* previous business experience
* receipt of start-up advice

Keasey and Short (1990) found that in general, the perceived relative burden of annual accounts is not influenced by the above specific factors investigated.

Comparing the Holmes and Nicholls (1989) study of the factors determining the information requirements of Australian small businesses with the above, it would appear that although the preparation or acquisition of additional accounting information (of non-statutory nature) is dependent on firm specific factors (such as business size, the number of years the business has been operating under existing management, industrial sector or the education of a business' owner/manager), the burden imposed by general accounting requirement is not dependent on firm specific factors (see above).

In their conclusion, Keasey and Short (1990:311):

> "...cautiously suggest that if the burdens associated with the production of annual accounts are to be reduced in the small firm sector, attention will have to be given, by both researchers and practising accountants, to the general costs and benefits of the accounting requirements imposed on small firms".

Similarly, Carsberg et al (1985:41) asserted that:

> "Any consideration of the "burden" involved in preparing financial reports must be set within the context of the uses and benefits derived from the reports. If accounts are little used, even a low level of cost may be hard to justify".

In this regard, it is appropriate to consider the main users of SC's annual accounts and their needs, which are considered below.

4.13 Main users of SC accounts and their needs

The Corporate Report (ASSC, 1975) identifies the general user groups of accounts (equity investor, loan creditor, employee, analyst-adviser, business contact, government and public) and the APC (1979) considers the main users of SC accounts.

One of the main studies into the uses of SC accounts has been carried out by Page (1981). Page (1981) ascertained by postal questionnaires the views of SC directors and auditors about the main users of SC accounts. He found that both groups independently ranked the main users of SC accounts in the following order:

i) management (use accounts for management decisions);

ii) Inland Revenue (use accounts to agree tax computations); and

iii) bank and loan creditors (use accounts for lending decisions).

With reference to management as the main user of SC accounts, Page (1981:90) said that "This is an unexpected finding". It is worth pointing out that generally, infrequency and delay in the production of annual accounts limit their usefulness for decision and control by management. Furthermore, Page (1981) reported that low priority had been given to the use of the accounts made by shareholders because in SCs they are usually part of management.

Similar ranking of the main users of SC accounts were found by Carsberg et al (1985) when they interviewed SC auditors. However, in a parallel survey of directors, they found that SC directors ranked Inland Revenue and banks in reverse order to the above. According to Carsberg et al (1985) management uses the accounts for decisions on dividend, directors' pay and capital expenditure. The accounts have little perceived influence on pricing decisions.

With reference to banks which are among the main users of accounts, according to Berry, Crum and Waring (1991:29):

> "Overall there is strong evidence that bank lending officers wish to look at:
>
> a) audited financial statements;
>
> b) pro forma financial statements;
>
> c) cash forecasts;
>
> d) management accounts;
>
> e) age analysis of debtors and creditors."

They further argue that:

> "Although there is fair agreement on the data collected there is conflicting evidence about the importance assigned to the various elements in the data set and the use actually made of them". (Berry et al, 1991:29).

With reference to use of the financial information, a report by the CIMA, prepared by Bob Berry of University of East Anglia and others, entitled "Corporate Performance Evaluation in Bank Lending Decisions" found that "Bankers are not making the best use of the financial information found in company accounts when making lending decisions". (Gleeson, 1993:9).

With reference to differences in information requirements by banks dealing with large and SCs, Berry, Citron and Jarvis (1987:7) found that "the information, which is at present disclosed in the full Statutory Accounts, is used by bankers irrespective of the size of the company they are dealing with". However, they found "differences in the emphasis placed on certain specific items of information due to the complexity of the business, and the availability of up-to-date information". They also found "Other differences arise due to the relative uncertainty of small businesses which result in a shorter term view being taken". (Berry et al, 1987:7).

In particular, Berry et al (1987:12) referred to the perceived importance of the management accounts and noted that:

> "Management Accounts, are perceived as 'very important' by the majority of bankers irrespective of the size of company they are dealing with. However,..., the frequency of use does not accord with the importance ratings. The reason for this is that bankers experience problems in obtaining this information".

According to Berry et al (1987:12)'s results:

> "...in general bankers dealing with Large Companies attribute less importance to management accounts than those dealing with Small Companies. One of the main reasons for this is that bankers take the view that Large Companies are more financially secure which reduces the importance of this source of information in the decision making process. On the other hand, banks dealing with Small Companies attribute greater importance than the norm to management accounts. This may well be due to the relative volatility of small businesses, together with the fact that the greater delays in publishing the Audited Accounts of Small Companies mean that the information is out of date and Management Accounts are needed as a surrogate".

They also found that for SCs, banks can and do exert pressure to obtain the management accounts and it would appear from the comments of some respondents that the situation is improving as a result of this pressure. However, Large Companies, generally due to confidentiality, they are reluctant to provide this information and "indeed 30% of the respondents dealing with Large Companies indicated that this source of information was never available to them". This may be due to "the existence of a highly competitive large corporate lending sector as evidenced by the impact of foreign banks in recent years..." (Berry et al, 1987:12). (See also section 3.5).

Finally with regard to preference for audited accounts, Berry et al (1987:20) found that "...there is evidence to support the view that bankers prefer audited accounts because they are perceived to be more reliable than the unaudited version".

4.14 Significant SC audit problems

The practical limitations encountered in auditing SCs can be summarised as follows (APC, 1979):

* the need to rely on management assurances;
* the frequent qualification of SC audit report;
* the lack of sufficient reliable audit evidence; and
* the difficulty of applying auditing standards and guidelines in SC audits.

The above practical limitations have been put forward by the opponents of SC audit to argue that these may make a SC unauditable. However, as it will be shown in the next section, in many situations it may be possible to reach a conclusion that will support an <u>unqualified</u> opinion on the accounts.

Raiborn (1982:46-47) identified the following significant SC audit problems:

* compliance testing of accounting controls when a preliminary evaluation determined that reliance cannot be placed on the system;

* assignment of more experienced personnel to the SC audit;

* difficulty and uncertainty encountered in relying on internal accounting control;

* insufficient documentation of owner/manager controls;

* reliance on owner/manager controls to restrict the extent of substantive auditing procedures;

* acceptance of management representations as audit evidence when completeness of recorded transactions cannot otherwise be verified;

* difficulty in applying analytical review procedures; and

* difficulty in communicating the contents of the representation letter.

Furthermore, Raiborn (1982) established that there are "statistically significant" <u>relationships</u> between some SC characteristics and SC auditing problems.

4.15 The conduct of an efficient and effective audit in a SC environment

The conduct of an efficient and effective audit in SC environment has been considered by various national and international auditing bodies (e.g. Raiborn et al, 1983; UEC, 1983; CICA, 1988; IAPC, 1988; ICAEW, 1990 and APC, 1991).

In SCs, the lack of segregation of duties and the possible override of internal controls by management make it difficult for the auditor to test and rely on internal controls (Bryan and Rouse, 1984).

Therefore, the auditor will normally place less emphasis on the study and evaluation of internal controls of SCs and more emphasis on the verification of transactions and balances through detailed audit tests and analytical review procedures (UEC, 1983; Schaps et al, 1984).

In all audits of companies (whether small or large), the auditor needs to obtain reasonable assurance as to the completeness and accuracy of the accounting records to support his audit opinion.

IAPC (1988, para. 16) states that:

> "In many situations, however, it may be possible to reach a conclusion that will support an unqualified opinion on the financial statements by obtaining evidence from extensive substantive testing of transactions such as a careful review of costs and margins. However, in some businesses, such as those where most transactions are for cash and there is no regular pattern of costs and margins, the available evidence may be inadequate to support an unqualified opinion on the financial statements".

This leads to the consideration of "SC qualification" audit report, which is undertaken in the next section.

4.16 "SC qualification" audit report

Where a SC auditor is unable to design or carry out procedures to obtain sufficient appropriate audit evidence as to the completeness of a SC's accounting records, he should either qualify or disclaim his opinion.

In situations where the auditor is of the view that incompleteness may be material but not fundamental to an understanding of the financial statements and he has not found any significant inaccuracies in the records, he should qualify his opinion accordingly. In these circumstances, the auditor generally used the old "Example 6" form of audit report.

The content of the old "Example 6" form of audit report "subject to: acceptance of management assurances" was as follows:

> "We have audited the financial statements on pages ... to ... Our audit was conducted in accordance with approved Auditing Standards having regard to the matters referred to in the following paragraph.
>
> In common with many businesses of similar size and organisation the company's system of control is dependent upon the close involvement of the directors/managing director, (who are shareholders). Where independent confirmation of the completeness of the accounting records was therefore not available we have accepted assurances from the directors/managing director that all the company's transactions have been reflected in the records. Subject to the foregoing, in our opinion ..." (Auditing and Reporting, 1985/6, ICAEW).

However, the "Example 6" audit report was withdrawn in September 1989, because it was suggested that the general wording of the old "Example 6" led it to be regarded as a "standard" or "model" form of audit report for SCs. Indeed, it has been argued that a number of auditors used this form of report routinely as a suitable form of standard audit report for SCs (Accountancy Magazine, May 1989:166).

Furthermore, there was some internal inconsistency with the old report because although the auditor had "accepted assurances from the directors", he nevertheless qualified his audit report.

In situations, where the auditor considers that incompleteness of accounting records is so <u>fundamental</u> to an understanding of the accounts, he is, however, required to disclaim his opinion.

A leading investigation into SC qualification by Keasey, Watson and Wynarczyk (1988) found that the likelihood of receiving a SC qualified audit report was "significantly" greater if the company had:

i) been audited by a large firm of accountants,
ii) few directors,
iii) few non-director shareholders,
iv) a secured loan,
v) a long lag between the accounting year end and the signing of the audited accounts.

Their results also indicated that once a SC audit qualification had been received, a further qualification was more likely the following year. Keasey, Watson and Wynarczyk (1988:332) concluded:

> "Overall, the results would seem to indicate that, unless they were aware of the influence of the above variables

> upon the issuing of the audit qualification, small company account users would have great difficulty in interpreting its meaning".

It is worthy of note that in order to reduce the number of qualified audit reports in SCs, the APC (1991)'s draft auditing guideline "The Audit of Small Businesses" requires that the audit report should not be qualified because of uncertainty as to the completeness of any population, unless:

* there are no controls on which reliance could be placed; and

* sufficient substantive evidence (including analytical review) could not be obtained.

The APC (1991) concludes that since sufficient assurance should usually be obtained in a SC environment, therefore, the need for audit qualification would not arise in most cases.

In the next section, an attempt will be made to provide an overview of the financial reporting for private companies in the USA.

4.17 An overview of the USA literature concerning financial reporting for private companies

In the USA, the compulsory audit requirement normally applies only to those companies registered with the Securities and Exchange Commission (SEC), the number of which is estimated to be about ten thousand companies (Gwilliam, 1987). The audit requirement was introduced by the Securities Acts of 1933 and 1934, however, there is evidence that the majority of firms listed on the New York Stock Exchange voluntarily employed the services of external auditors even before the introduction of a compulsory audit requirement (Gwilliam, 1987: 41).

The potential for creating differences in financial reporting requirements on the basis of either size (small versus large) or legal ownership (public versus private) was considered by the AICPA's three special committees:

i) the Committee on GAAP for Smaller and/or Closely Held Businesses (formed in 1974);

ii) the Special Committee on Small and Medium Sized Firms (formed in 1978); and

iii) the Special Committee on Accounting Standards Overload (formed in 1981).

The 1976 report of the Committee on GAAP for Smaller and/or Closely Held Businesses concluded that the same measurement principles should be applied in the general-purpose financial statements of all entities, but, the nature of information disclosed and the extent of detail necessary for any particular disclosure may well vary depending on the needs of users.

The Committee recommended that the Financial Accounting Standards Board (FASB) should develop criteria to distinguish disclosures that should be required by GAAP (see 4.17.1) from additional or analytical disclosures in the financial statements of all entities. Furthermore, one of their main recommendations was that the AICPA auditing standards division should reconsider pronouncement concerning unaudited financial statements (see 4.17.2). The reaction of the FASB and the AICPA in respect of the above recommendations, relevant to this study, are considered below.

4.17.1 Big GAAP - Little GAAP

In response to the above recommendation, the FASB reacted positively and paid particular attention to the problems of applying GAAP in reporting by small and closely held companies by issuing (see List of Standards for the full names of FASB statements):

i) FASB Statement No. 21 (1978) - Suspending the earnings per share and segment disclosures by private companies.

ii) FASB Statement No. 33 (1979) - exempting private companies from the requirement of the statement on "Financial Reporting and Changing Prices".

iii) FASB Statement No. 36 (1980) - providing flexibility for private companies in that disclosures about pension benefits and assets are required only when the information is readily available.

iv) FASB Statement No. 69 (1982) - exempting certain private companies from some disclosure requirements relating to oil and gas producing activities.

In 1980, in response to the pressure for more relief, a recommendation was made by the AICPA Special Committee on Small and Medium Sized Firms that a special committee be appointed to study ways of providing additional relief from accounting standards that were not considered cost effective for small businesses and to study the development of another comprehensive basis of accounting (see Abdel-khalik, 1983).

As a result, in 1982, a committee of the AICPA recommended changing or eliminating eleven accounting and disclosure requirements for private companies (see Abdel-khalik, 1983: 22).

The AICPA Special Committee on Accounting Standards Overload considered those recommendations and in its own report asserted that a standards overload existed and recommended that the FASB should promptly reconsider and act on certain accounting standards that were widely perceived to be unnecessarily burdensome and costly, particularly for small nonpublic entities, by simplifying the standards and if this was not feasible, by considering:

> "...the information needs of the users of the financial statements of small nonpublic entities and the costs and benefits of developing the information with the objective of providing, within the framework of a unified set of generally accepted accounting principles, differential disclosure alternatives... as well as differential measurement alternatives for such entities". (See Abdel-khalik, 1983:23).

The FASB commissioned a research by Abdel-khalik (1983) for comparative analysis of practices and views of managers, bankers and accountants involved with the private companies to provide insights about the small business environment and also to assess existing financial reporting and the need for change.

The research focused on the information needs of the intended users and on the costs and benefits of using GAAP for financial reporting by private companies.

Abdel-khalik (1983: 1-2) found that:

> "GAAP financial statements for private companies are perceived to benefit both managers and bankers. Managers find GAAP financial statements to be useful in making decisions and in facilitating borrowing. Bankers find that GAAP financial statements provide reliable and understandable data that are helpful in making lending decisions".

The research found that departures from GAAP occur "moderately" frequently for certain accounting standards, particularly for SCs. The cost of compliance and perceived lack of relevance to owners were found to be rated as the primary reasons for those departures from GAAP.

Furthermore, Abdel-khalik (1983) found that bankers, managers and accountants perceive cost-benefit considerations differently. The research concluded that the problem of cost-benefit considerations has elements of both practice (relating to the AICPA) and Standards Setting (relating to the FASB). Therefore, Abdel-khalik (1983:2) observed that:

> "Both organizations, the AICPA and the FASB, share the responsibility of maintaining the credibility of financial statements, including providing a satisfactory resolution to the problem at hand".

4.17.2 Unaudited financial statements

As stated earlier, in its 1976 report, the AICPA Committee on GAAP for Smaller and/or Closely Held Businesses recommended that the AICPA auditing standards division should reconsider pronouncement concerning unaudited financial statements.

In addition to the above, there was also a call by the

Commission on Auditors' Responsibilities (Cohen Commission) for change in private company reporting:

> "The view that users will misunderstand different levels of assurance underestimates users' capabilities. According to this view, any time the auditor is associated with information, users will assume it has been audited. This conclusion is predetermined by present reporting requirements. If the only form of assurance given is an opinion on financial statements, then users have no opportunity to understand other types of assurance... The only way users will become informed is for auditors to change the traditional approach to reporting". (Arnold and Diamond, 1981:4).

In response to the above pressure, in December 1978, the Accounting and Review Services Committee of the AICPA issued Statement on Standards for Accounting and Review Services (SSARS) 1 - "Compilation and Review of Financial Statements".

SSARS 1 came into effect in July 1979 and paved the way for <u>compilation</u> and <u>review</u>, two new levels of nonaudit reports for nonpublic companies and thus replaced the unaudited disclaimer. Until July 1979, CPAs were allowed either to audit a nonpublic company's financial statements and express an appropriate audit opinion or to disclaim an opinion if the accounts were not audited. Therefore, from July 1979, the services available to nonpublic companies have been: <u>compilation</u>, <u>review</u> and <u>audit</u>.

In 1981, Arnold and Diamond (1981) investigated the experiences, reactions and attitudes of CPAs and bankers concerning the services available for nonpublic companies (i.e. compilation, review and audit). The main findings of the research were as follows:

i) According to the CPAs the shifts from audits to reviews/compilations were approximately 2.5% while according to the bankers the shifts were approximately 20% for their customers. The difference was explained by the experience of a minority of bankers, who had encountered substantial movement away from audit. However, the shifts from previous unaudited services to reviews/audits were 40% and 8% for customers of CPAs and bankers respectively.

ii) The dominant factors influencing CPAs in their recommendations for a given level of service were the perceived needs of outside users, the client's systems of internal control and prior experience with the client. However, traditional lending factors, including loan size and the customer's capital structures had the greatest influence on the bankers' decision to require a given level of service. Relative costs of the services were least important.

iii) CPAs and bankers tended to feel that the introduction of compilation and review services were a positive development by the accounting profession.

iv) According to CPAs, for a new client, a compilation required 20% to 25% of the hours needed for an audit, whereas a review required 49%. However, for a continuing client, a review required 44% of the hours needed for an audit.

v) A compilation with disclosures or a review, according to CPAs, was the minimum level of service appropriate for business clients. However, bankers felt that the required level of service increased with the size and complexity of the loan.

vi) CPAs and bankers felt that a compilation was acceptable for personal accounts.

Having considered the audit requirement of companies in the USA, it would be beneficial to look briefly at the audit requirement in a number of overseas countries in the next section.

4.18 Overseas audit requirement for SCs

As part of the move towards harmonisation, the EC Fourth Directive on Company Law allowed the member states to exempt all SCs from statutory audit. The UK Government did not take this option, which was adopted by many members states.

Many European countries control the creation of limited liability companies more closely than in the UK by imposing a minimum capital requirement which would eliminate many owner-managed companies which are too small to have the accounting systems and records required by the CA 1985. "In view of this, it is all the more surprising that in Europe, the UK is very much the exception in insisting that all limited companies should be subject to a statutory audit" (Technical Advisory Committee of the ICAEW - response to the ICAEW (1992b)'s consultation paper).

In other countries, such as Australia, Canada and New Zealand, they all have different audit requirements for different categories of companies. In Australia, for example, "exempt 'proprietary'" companies do not require an audit, if all members agree.

In Canada, private or "closely held" companies do not require an audit and in New Zealand, private companies do not require an audit if shareholders agree.

It is interesting to note that Australia and New Zealand have dropped the SC audit requirements, despite the fact that their company law and business systems are similar to those in the UK.

The definition of SCs in the above countries are not comparable. For example in Australia, an "exempt 'proprietary'" company is a company whose shares are not held by a public company, a foreign company or another proprietary company, whereas, in Canada, the size requirements by the Canada Business Corporation Act (CBCA) which have not been changed for many years are turnover of $10m or assets of $5m. However, various provinces within Canada have legislation differing from that included within the CBCA (LSCA, 1992).

4.19 Summary and conclusion

The review of SC issues broadly indicates that:

* there is no single, uniformly acceptable definition of a SC and that most definitions of a SC overlap greatly. Furthermore, the various definitions of a SC comprise the vast majority of all companies in the UK;

* the majority of SCs are owned by their directors;

* SCs have specific characteristics, for example, owner/manager dominance and internal control deficiencies resulting from limited segregation of functions;

* the approach to SC audit needs to be responsive to SC

characteristics;

* there are "statistically significant" relationships between some SC characteristics and SC auditing problems;

* it appears that, in many situations, an efficient and effective audit of SCs can be carried out;

* the burden of complying with accounting standards is greater for SCs;

* management, Inland Revenue and banks are among the main users of SC accounts;

* SCs' auditors often provide a wide range of financial services in addition to SC audit; and

* the form and content of SC accounts need to be simplified.

To conclude, the main SC issues have an important impact on SCFR and accordingly need to be investigated further in order to decide whether there is a need for change in the financial reporting requirements of SCs, and if necessary to establish a fair balance between the different needs of the diverse interests involved.

There has been much debate in the UK about whether SCs should be audited or not which is considered in the next Chapter.

CHAPTER 5

SCFR DEBATE

5.1 Introduction

The accounting and audit requirements of SCs have been subject to debate for a long time.

Currently, all companies, with the exception of those companies identified in Chapter one of this work, are subject to statutory audit and SCs as defined by the CA 1985 may file abbreviated accounts with the Registrar of Companies but they must prepare and circulate full accounts to their shareholders. However, the form and content of these accounts (already discussed in section 4.10) and their needs for a statutory audit are still subject to debate.

This Chapter begins by reviewing the history of the company audit by tracing the origins of auditing in the early corporation and the developments of auditing and the professional audit firms. Furthermore, it reviews the provisions of the main Companies Acts in respect of accounting and audit requirements since the Joint Stock CA 1844.

An attempt is also made to provide some background to SCFR debate since 1979 by reviewing the main events (e.g. studies, research, discussion papers, statutory requirements, etc.) which have contributed to public debate on SCFR. Furthermore, this Chapter examines the application, cost, effects and implication of audit regulation on SC audit debate.

The statutory audit requirement and cost of audit to SCs are further examined in this Chapter. This is followed by a discussion of the main arguments in favour of retaining and against SC audit requirement by considering the needs of the users of audited accounts (e.g. banks, creditors) and other related issues (e.g. limited liability, fraud).

Finally, alternatives to SC audit and sub-categories of SCs to which these alternatives may apply are considered with particular references to the recent audit exemptions to certain SCs and their possible consequences for shareholders, other users of accounts and auditors.

5.2 The history of the company audit

This section reviews the need for auditing in the early corporation, the development of auditing and audit firms and also the main accounting and audit requirements of the CAs.

5.2.1 Auditing in the early corporation

An attempt is made here to trace the origins of auditing in the early corporation and give a brief description of each type of business corporation, starting with English merchant guilds, merchant adventures/regulated companies and joint stock companies. Furthermore, some evidence of auditing for such corporation and incentives for their auditors to be independent from the days of English merchant guilds to the time audits were required by law will be provided. Most of the analysis would be based on the work of Watts and Zimmerman (1983).

English merchant guilds

Watts and Zimmerman (1983:616) citing the work of Gross

(1890) noted that merchant guilds appeared in England shortly after the Norman Conquest in A.D. 1066 and merchant guilds arose to protect the prosperity of the merchants by forming cartels to monopolise trade (see Ekelund and Tollison, 1980).

It would appear that from all historical accounts, the guilds were among the earliest examples of incorporation, which were chartered by the crown and had the monopoly to trade within their own particular towns.

Gross (1890), whose work has been extensively referred to by Watts and Zimmerman (1983) claimed that guilds were expressly incorporated as early as in the reign of Richard II (1367-1400).

One of the interesting evidence given by Watts and Zimmerman (1983:618) is that several craft guilds and companies of merchants were audited annually by committee of members. They also noted that the accounts of the Worshipful Company of Grocers of the City of London and the Worshipful Company of Pewterers of the City of London were audited annually as indicated by their records in 1346 and 1546 respectively.

The evidence suggests that the audits were not "superficial and were not merely counts of cash or assets on hand". As a matter of fact "Expenditures were examined in detail...", and that:

> "The audit of the guild appears designed to monitor the managers' contracts. It came at the end of the managers' tenure and was designed to check for unauthorised expenditure... [and] for other breaches of contracts..." (Watts and Zimmerman, 1983:618).

Another interesting point noted by Watts and Zimmerman (1983) was the use of an audit committee which usually consisted of four guild members and occasionally public officials who encouraged auditor performance and independence by making collusion of the manager and auditor more difficult.

Merchant adventures/regulated companies

All available evidence suggest that before the latter half of the thirteenth century the English export trade was generally carried out by the German Hanse Merchants. However, from that period English export of raw products (mainly wool) was conducted entirely through English and foreign merchants who eventually formed companies of merchants. In such companies, each member provided his own capital (inventories and ships) and traded on personal account (or in partnership).

According to Watts and Zimmerman (1983) most of the regulated companies appeared to have been audited. Further, the similarities of audit arrangements (for example, use of bonding of the officers) and the commonality of membership with the guilds suggest the audit was adopted from the guilds with the same mechanisms to encourage auditors to be independent (for example, use of committees and penalties including loss of reputation).

Joint stock companies

Watts and Zimmerman (1983) have provided some evidence to suggest that in 1553 another form of corporate firm (the joint stock company) appeared in England. The Russia Company and the African Adventurers were the first joint stock companies formed for overseas trade. In the joint stock companies, the officers traded on behalf of shareholders, capital was raised to finance each separate voyage and the proceeds were distributed once the voyage was completed. This method of financing the trade was different from that used in the regulated companies where each member supplied his own capital and traded on his own account or in partnership, using his own ships. The change in method of financing might be due to the magnitudes of the voyages and the greater risk of the voyages undertaken by the joint stock companies.

They also noted that the accounts of the early joint stock companies were audited by a committee of shareholders (members) and/or directors. This practice, they claimed continued into the eighteenth and nineteenth centuries. They went on to assert that (1983:625) "The survival of the committee of auditors for six hundred years strongly suggests it was an efficient monitoring device". However, they point out that some legal historians argued that the method used was inefficient because of the frauds which occurred in the seventeenth to nineteenth centuries and that government regulation was necessary for effective control. Watts and Zimmerman (1983:625) have attributed this to the fact that "They fail to consider the number of firms in which the contracting and monitoring system between managers and shareholders worked..."

5.2.2 Observations on the development of auditing

Watts and Zimmerman (1983:626) have been able to conclude from their findings that the practice of having a committee of auditors was not imposed on the merchant guilds, regulated companies, or joint stock companies by law. Indeed, they asserted that:

> "The auditing was voluntary. Typically there were no references to auditing in the charters of the guilds, regulated companies, and joint-stock companies examined. The auditing was by order of the general court (meeting of members of shareholders) or the court of assistants (directors' meeting). Thus, when the U.K. Companies Act of 1844 required directors to keep accounts and required those accounts to be

audited by persons other than the directors (or their clerks), Parliament was merely incorporating into the law a version of a practice that had existed for six hundred years".

Watts and Zimmerman (1983:626) in their observation on the development of auditing advanced the following hypothesis, namely that, committee of auditors survived because they were an efficient method of monitoring contracts between managers and those supplying capital. However, auditing practice was not constant overtime, it changed as the business corporation changed. Two dimensions in which auditing changed are the composition and relative size of audit committee.

It is worthy of note that the composition of audit committee of the early corporation, consisted of shareholders and some directors (assistants). The inclusion of directors in audit committee was a feature which was investigated by Watts and Zimmerman. The answer, according to Watts and Zimmerman, appeared to be that directors were not exactly equivalent to the directors of a modern corporation. Also, the ratio of directors to shareholders was very large by today's standards (e.g. one to five) which implied that the directors were likely to be representative of the members' interests, and the large number of directors would have made it more difficult to collude against the shareholders. Hence the directors were not audited by shareholders in general (Watts and Zimmerman, 1983). However, the treasurer with direct personal control over resources, was audited by directors.

As use of the joint stock form of organisations grew, the number of directors for each company and the ratio of directors to shareholders dropped substantially, particularly in the early eighteenth century.

"This suggests that it would be less costly for the

> directors to collude against the shareholders. Consequently, there was the increased tendency to use committee of shareholders, not directors, to audit the accounts". (Watts and Zimmerman, 1983:627).

5.2.3 The development of the professional audit firms

The UK Companies Acts from 1844 to 1900 did not require outside independent auditors. However, the change from shareholder auditors to professional auditors occurred in the period when a professional auditor was not required by statute in the United Kingdom and the United States suggesting that the change was the result of market forces (Watts and Zimmerman, 1983:630).

> "There were two major market developments in the period 1844-1900 in the United Kingdom that can explain the shift from shareholder to professional auditors: (1) an increase in the demand for audits and (2) the introduction of a low-cost mechanism for certifying auditor competence and independence". (Watts and Zimmerman, 1983:630).

The demand for audits in the UK in the latter half of the 1800s increased because the complexity of the accounts (e.g. due to government regulation of railroads and utilities), the legal liability of directors and the size and number of corporations all increased.

The increased complexity encouraged specialisation in auditing and the growth of professional firms. The growth in the scale of the capital markets increased the fixed cost of an auditor's establishing a reputation, which led to the development of large professional audit firms.

Furthermore, the professional societies (e.g. ICAS and ICAEW formed in 1854 and 1870 respectively) were formed to provide information on the accountant's reputation, not in auditing, but rather in bankruptcies, which led to the introduction of a low-cost mechanism for certifying auditor's competence and independence because the start-up costs for accrediting accountants were already incurred in certifying accountants for bankruptcy work.

The development of professional audit firms being later in the United States than in the United Kingdom mainly because the absolute increase in the scale of the capital market and in the demand for auditing in the period 1844-1900 was smaller in the United States and also the United States did not experience the same reduction in start-up costs for accrediting professional accountants.

> "The start-up costs of the American societies were borne largely by British accountants who came to America to audit firms raising capital in London and stayed to start their own firms". (Watts and Zimmerman, 1983:632).

5.2.4 Companies Acts requirements

CA 1844 The Joint Stock CA 1844 was the first CA to require all companies to have their accounts audited. The Act required a "full and fair" balance sheet to be presented by the company to its shareholders and filed for public inspection. The Act did not require that the auditor be independent or qualified. The <u>primary objective of audit</u> was <u>detection of fraud and error</u> because of the growing number of dishonest managerial and company employee frauds.

LLA 1855 The Limited Liability Act 1855 allowed registration with limited liability.

CA 1856 The Joint Stock CA 1856 abandoned the audit provisions and gave the Board of Trade the right to audit a company if at least one-fifth of the shareholders (in number and value) asked for it.

During the period 1856 to 1900, due to increased number of frauds and errors by company management and employees, some companies continued to have audit on a voluntary basis. Furthermore, as a result of two famous court cases during this period (re: London and General Bank (No. 2) (1895) 2 Ch. 673 and re: Kingston Cotton Mill Co. (No. 2) (1896) 2 Ch. 279), it was recognised that the auditor should not be responsible to find every fraud or error and management should be responsible in this regard (Lee, 1982).

CA 1900 The CA 1900 required a compulsory audit of every company's accounting records and gave auditors statutory rights of access to company books and records. Auditors were required to report whether in their opinion balance sheets were "true and correct". The Act also required the directors of the companies to supply their auditors with the required information and explanations (Hopkins, 1984).

CA 1907 The CA 1907 distinguished between public and private companies and gave shareholders the right to receive accounts if presented and required the company's balance sheet to be filed by public companies (Page, 1981).

CA 1929 The CA 1929 required a company's profit and loss account and balance sheet to be circulated to members and public disclosure of profit and loss account by public companies (see Page, 1981:12 and Hopkins, 1984:20).

CA 1948 The CA 1948 required that all groups to prepare consolidated accounts. All except the smallest companies (i.e. "exempt private companies") were to be audited by professional auditors (see Hopkins, 1984:21). Exempt private companies could be audited by non-professional auditors (this requirement was abolished by the CA 1967). The Act also introduced many disclosure and accounting requirements including those dealing with reserves and required auditors to report whether in their opinion the accounts gave a "true and fair" view. Furthermore, the Act required the auditors to be either members of one of the recognised UK accountancy bodies or individually authorised by the Board of Trade.

As a result of acceptance by the company management of its responsibility for prevention and detection of fraud and error, the primary objective of the audit was seen that of verification of financial accounting records' accuracy. Detection of fraud and error became the secondary objective of the audit because of their possible effect on the reliability of the accounting information.

In 1961, the Company Law Committee (1961) (the Jenkins Committee) made the following recommendations:

- there should be no distinction in the CA in the treatment of public and private companies; and
- the distinction between the exempt and the non-exempt private company should be ended.

CA 1967 The CA 1967 abolished exempt private company status, therefore, extending the requirement for independent professional audit to all companies. The Act put an end to the granting of individual authorisation to audit firms (Hopkins, 1984). Furthermore, the Act allowed the formation of larger accountancy firms with more than twenty partners.

CA 1976 The CA 1976 contained a number of provisions dealing with the company auditor's appointment, removal, resignation, remuneration and qualification.

In 1971, the Committee of Inquiry on Small Firms (1971) (the Bolton Committee) made the following recommendations:

- the category of exempt private company as defined in the 1948 Act should be restored; and

- the legal concepts of public and private companies should be replaced by new categories to be known as "stewardship" and "proprietary" companies.

The Bolton Committee recommended that the "proprietary" companies by virtue of their small size and lesser importance to the public should be exempted from the more disclosure requirements and should be relieved of some of the burden of the present accounting procedures, such as the statutory audit requirement.

CA 1980 The CA 1980 introduced the provisions governing capital maintenance, directors' transactions and insider dealings. The Act included provisions concerning the status of public and private companies. It also introduced a definition of distributable profit. Among other provisions, the Act placed restrictions upon certain transactions by a company in which either its directors or persons with whom they were connected had interest.

CA 1981 The CA 1981 regulated, for the first time, the structure of accounts and their related accounting practices. The Act exempted small and medium-sized companies from delivering their fully detailed annual accounts to the Registrar of Companies. Instead they can deliver abbreviated accounts.

The provision enabling SCs to file abbreviated accounts and the detailed requirements on the form and content of accounts derived in the main from the EC Fourth Directive on Company Law. The EC Fourth Directive included the options of exempting SCs from audit and allowing SCs to circulate abbreviated accounts to their members, which were not taken in the UK.

The CA 1981 exempted a "dormant company" from compulsory audit. A company qualifies as dormant for this purpose if it is a "small" company as defined by the Act and it is not a holding company and has had no "significant accounting transactions" since the end of the previous financial year. The company has to pass a special resolution that auditors are not to be appointed. However, the company is still required to lodge accounts with the Registrar, but instead of an auditors' report, a statement from the directors that the company was dormant must be filed.

CA 1985 In 1986, the provisions of the CA 1985 came into effect. The detailed requirements on the form and content of accounts were included in Part VII and Schedule 4 and 8 of the Act.

CA 1989 The CA 1989 received Royal Assent on 16 November 1989. The main purpose of the Act was to implement the EEC Seventh and Eighth Company Law Directives. The Act contains provisions designed to ensure that only persons who are "properly supervised and appropriately qualified" are appointed as company auditors. The regulation of auditors is considered in more detail in section 5.4. The CA 1989 also exempted small and medium-sized groups from the requirement to prepare consolidated accounts.

It is worthy of note that the provisions of SI 1992

No. 2452 and those relating to exemptions of SCs from audit (in August 1994) have been subsequently incorporated in the above Companies Acts.

5.3 Background

A summary of the main events, affecting the accounting and audit requirements of SCs, has been presented below in a chronological order since the publication of a green paper by the government in September 1979 to the recent date. It is worth pointing out that the details of some of these events have already been provided in the earlier Chapters.

Sept '79 The Government published a Green Paper (DoT, 1979) on "Company Accounting and Disclosure", inviting comments and views as to whether or not the UK should take advantage of those provisions of the EC Fourth Directive which allowed certain SCs not to have a statutory audit and to prepare and file abbreviated accounts only.

Oct '79 The APC (1979) issued a discussion paper "Small Companies: the need for audit?", setting out the arguments for and against statutory audit for SCs.

Mar '80 The analysis of public comments (APC, 1980) on the APC (1979)'s discussion paper was published which clearly indicated that the accountancy profession was divided on this very important issue.

June '81 The results of research (Page, 1981) sponsored by the ICAEW to investigate the extent to which there was scope for the simplification of the accounting and audit requirements for SCs concluded that savings could arise if, given appropriate safeguards, less information was made available to shareholders and accounts were prepared with the use by management in mind rather than minimal compliance with statutory disclosure requirements.

Dec '81 The introduction of compilation and review services in July 1979 was a dramatic move by the American accounting profession to expand services available to nonpublic companies. In 1981, Arnold and Diamond (1981) investigated the attitudes of CPAs and bankers about the services available for nonpublic companies (i.e. compilation, review and audit).

They found that CPAs and bankers tended to feel that introduction of compilation and review services were a positive development by the accounting profession.

June '82 The provisions of the CA 1981 came into force which required that all SCs should continue to be audited and they must prepare full accounts for their shareholders. However, SCs were allowed to file abbreviated accounts with the Registrar of Companies. These requirements reflected the outcome of consultation and comments received on the Green Paper (DoT, 1979) and the APC (1979)'s discussion paper.

Sept '82 A research project in the United States (Raiborn, 1982) provided evidence that auditors had difficulty in implementing certain auditing standards in SCs audit engagements.

July '83 In Europe, the problems of SC audit were investigated by the UEC (1983) Auditing Statements Board.

Aug '83 A comparative analysis of practices and views of managers, bankers and public accountants about financial reporting by private companies was carried out by Abdel-khalik (1983). He found that GAAP financial statements for private companies were perceived to benefit both managers and bankers. The departures from GAAP occurred "moderately" frequently for certain accounting standards, particularly for SCs where the cost of compliance and perceived lack of relevance to owners were rated as the primary reasons for those departures. Furthermore, bankers, managers and accountants perceived cost-benefit considerations differently.

Mar '85 The DTI (1985a) published the "Burden on Business" report which set out proposals for reducing the administrative burden on companies arising from the requirements of company law. Among the most important of these proposals relating to SCs was the proposal that the Government should eliminate the statutory audit of accounts for "shareholder-managed" companies.

'85 The result of research (Carsberg, Page, Sindall and Waring, 1985) requested by the ASC and commissioned by the Research Board of the ICAEW was published. The research considered the universal application of accounting standards in order to determine among other things, the burden imposed on SCs by accounting standards. Among the recommendations was that SCs should be exempt from certain provisions of accounting standards.

June '85 The DTI (1985b) published its response to the above report in the consultative document "Accounting and Audit Requirements for Small Firms", outlining the arguments for and against statutory audit for SCs, the contents of their accounts, options for change, and invited comments on all the proposals.

Oct '85 The Council of the ICAEW (1985) submitted their response to the DTI's consultative document. They recommended that as a general rule, the accounts of SCs should continue to be audited. However, where all shareholders who were entitled to vote agreed, then such a SC should be able to choose as to whether its accounts should be audited or not, with adequate safeguards for minority investors and the wider public. They also recommended that only one set of accounts should be prepared for both shareholders and public filing in order to reduce the accounting burden on SCs.

Similar views were expressed by the Council of the Institute of Chartered Accountants in Ireland, Scotland and the Chartered Association of Certified Accountants.

Mar '86 The result of a survey by Robertson (1986a) to consider the extent to which SCs were making use of the option to file abbreviated accounts was published. He concluded that there was a high degree of interest in this option, but with poor compliance with statutory accounts formats.

'86 The result of a research carried out by Humphrey and Turley (1986) to examine five propositions relating to the nature of the audit in SCs was published. They found that owner-managers placed a wide variety of interpretations on the role of the audit, many of which did not match its theoretical role.

Winter '86 Given the increasing emphasis on SCs in the UK and the importance of <u>trade credit</u> for their performance, a study by Keasey and Watson (1986b) investigated whether trade-credit specialists and a statistical model could use post 1981 Companies Act financial ratios to predict SC failure with a reasonable degree of success. They found that the ratios selected for their study did not allow the same level of accuracy to be achieved as that obtained in the majority of the large company studies. However, they found that whilst increased information did not on average lead to more accurate or more confident predictions, it led to a greater variability in the accuracy, confidence and consensus of predictions.

'86 The provisions of the Companies Act 1985 came into effect without any change in respect of statutory audit requirement for SCs.

Autumn '87 A study by Keasey and Watson (1987) found that for small UK companies, past reporting lags were important predictors of failure. Furthermore, SC failure prediction models based upon annual accounts generally produce less accurate predictions than similar models for large companies.

'87 Research by Berry, Citron and Jarvis (1987) found that there were differences in information requirements of bankers dealing with large and SCs. They also found that a move towards a reduction in disclosure requirements was unlikely to reduce the burden on SCs unless an alternative approach to lending was taken by bankers.

Feb '88 Internationally, the SCFR also received great attention. The International Auditing Practices Committee (IAPC, 1988) of the International Federation of Accountants considered the main characteristics of SCs and their consequences. They argued that SCs had a combination of characteristics which made it necessary for the auditor to adapt his audit. Furthermore, the result of a study (CICA, 1988) carried out in Canada to provide guidance to practitioners engaged in SCs audit on the conduct of an efficient and effective audit concluded that generally, the accounting records of SCs were auditable.

Mar '88 The DTI (1988) published a consultative note on possible alternatives to audit for SCs. It offered five options for consideration. The ICAEW (1988) favoured the option allowing the SC audit to be replaced by a statement by the directors that the accounts meet the CA requirements. However, the ICAEW (1988) expressed reservations that the alternative forms of report to the audit report might well confuse and mislead readers as to the degree of assurance being given.

The ICAS (1988) favoured a compilation report with an additional assurance that proper accounting records are kept.

July '88 Having considered the findings of "Small Company Financial Reporting" (Carsberg et al, 1985) and realised the extent of the burden imposed on SCs by accounting standards (ASC, 1988a), the ASC (1988b) accepted that there was a case, in specific circumstances, for exempting SCs from certain provisions of accounting standards.

Autumn '88 A research by Keasey, Watson and Wynarczyk (1988) investigated empirically whether organisational, financial, size and auditor variables possess any explanatory power in respect of the receipt of a SC audit qualification. They found that companies audited by large audit practices, companies which had a prior year qualification, a secured loan, declining earnings, large audit lags and few non-director shareholders were more likely to receive an audit qualification than other companies.

Winter '88 A study by Keasey and Watson (1988) provides evidence that Whittred and Zimmer (1984)'s results cannot be applied to the SC sector in the UK where the population of failed and non-failed companies have "significantly" differing propensities to submit accounts. Furthermore, they conclude that given SCs have a high failure rate and a far higher propensity to delay/not submit their accounts, then the adoption of even a simple decision rule seems likely to improve materially the predictive accuracy of a failure prediction model. Therefore, by combining lag and financial information, it should be possible to develop cost-effective monitoring procedures for SCs.

With reference to Whittred and Zimmer (1984)'s study which was concerned with the reporting behaviour of a sample of companies listed on the Sydney Stock Exchange, it is worth pointing out that they found those companies experiencing financial distress take significantly longer than financially healthy companies to publish their annual accounts. They also found that the inclusion of finite reporting lags in a discrimination model does not increase the ability to predict financial distress.

Feb '89 The DTI (1989) published a consultative document in respect of the draft Directive, which was proposed by the European Commission in response to pressure from several Members States (including the UK) in favour of lifting burdens on small (and medium-sized) companies. It included some proposals for mandatory exemption for all SCs from compulsory audit requirement and simplification of their accounts.

Spring '89 Holmes and Nicholls (1989) investigated the factors determining the information requirements of Australian small businesses. They reported that a "significantly" greater proportion of small business owner/managers sought statutory and budgeted information from an external accountant rather than preparing the information within the business, whilst the reverse situation existed for additional information (of a non-statutory nature). Furthermore, small firms were found, in general, to be more likely to prepare to acquire additional information if they were relatively large (in term of number of employees and turnover), if they were less than 10 years old, if they were in the manufacturing, wholesale, business/finance sector and if the owner/manager stayed at high school for 5-6 years and/or attended university or college.

Their results led to the development of a model which could be used as a means of estimating the level of accounting information that a business with specific characteristics is likely to prepare or acquire.

June '89 The Council of ICAEW (1989) responded to the draft Directive by reconfirming its earlier position.

Sept '89 The APC withdrew the old "Example 6" form of audit report for SCs because it had been used routinely as a "standard" form of audit report for SCs.

Nov '89 The CA 1989 received Royal Assent. The Act made some minor changes to the rules allowing SCs to file abbreviated accounts. There was no change in statutory audit requirement for SCs. The Act contains provisions in respect of audit regulation, causing major changes to auditing firms and influencing the SC audit debate (see section 5.4).

Summer '90 Accountant Digest 245 "The audit of small businesses" (ICAEW, 1990) suggested some ways of achieving an effective and efficient audit of SCs.

Autumn '90 Keasey and Short (1990) examined whether the relative burden of annual accounting requirements was general to small firms or specific to certain types of small firms. The main empirical finding was that the relative burden of accounts as perceived by small firms was not contingent on the factors investigated (such as the size of the firm, the use of computers in the preparation of annual accounts, the age of the firm, ownership type, perceived benefits from preparation of annual accounts, size of accountancy firm, provision of all accounting needs by accountant, preparer of annual accounts, etc.).

Mar '91 The APC (1991) issued a draft Auditing Guideline "The Audit of Small Businesses". It considered the various aspects of SC audit issues, and confirmed that to the "owner-manager" the cost of an audit was invariably considered to outweigh its benefits. In particular, there might be no perceived benefits if the audit report was qualified.

'91 A research by Keasey and Watson (1991) used an agency theory perspective to develop an understanding of the determinants of auditor change for small firms in the UK, by extending the existing literature (see for example Williams, 1988) from a consideration of auditor change for large firms in the US to small firms in the UK. Their results indicated that the small UK firms had a greater propensity to change their auditors if they experienced relatively large changes in their use of external loan capital, if they had relatively high levels of loan capital and if none of these loans were secured. Furthermore, their results contrasted with those of Williams (1988) in that the significance of the receipt of a first-time audit qualification variable suggested that some small firms might change auditors partly to secure more accommodating monitors.

Jan '92 The DTI (1992) published a consultative document regarding the amending Directive to the fourth and seventh company law directives in order to reduce the burden on small (and medium-sized) companies imposed by the existing legal requirements.

Mar '92 The Council of the ICAEW (1992a) responded to the above consultative document by suggesting that "what would, we believe, be of greater practical assistance to small companies would be the removal of the requirement to have their accounts audited".

Aug '92 The Council of the ICAEW (1992b) published a consultation paper, recommending the complete abolition of statutory audit for Very SCs, and replacement of the audit with a compilation report for other SCs.

Sept '92 The LSCA (1992) suggested that the audit of Very SCs should be abolished in line with the ICAEW. However, they suggested that the audit of certain "proprietary companies" should be replaced by an independent review carried out by a qualified accountant.

Nov '92 SI 1992 No. 2452 came into force with the effect of reducing the detailed disclosure in accounts for shareholders of SCs (see 4.10).

Jan '93 The results of a survey by Fearnley and Page (1993) in respect of costs and effects of audit regulation indicated that all audit firms had to make significant changes to all aspects of their work and they were bearing a significant amount of audit regulation costs. They further observed that opinions against retaining the SC audit had been hardened.

Mar '93 The response to the ICAEW's consultation paper was published. There was overall support for relaxation of the statutory audit requirement for all SCs (ICAEW, 1993a).

'93 In an article entitled "The Statutory Audit and the Micro Company - An Empirical Investigation", Freedman and Godwin (1993) explored the statutory audit issues relating to "micro" companies (i.e. very small independent companies, with no more than two or three shareholders, complete identity between managers and shareholders, a very low turnover and five or fewer employees)

They concluded that the removal of the statutory audit requirement from "micro" companies would remove a substantial cost and time burden from "these companies without significantly prejudicing creditors". They went on to say that "The onus should be on supporters of the statutory audit to show that the burden is justified". (Freedman and Godwin, 1993:130).

Apr '93 The DTI (1993) which was under pressure from professional bodies and SCs, proposed to relieve Very SCs of the burden of the audit requirement and offered two options for consideration, (1) abolition of the audit requirement and (2) replacement of the audit with a compilation report.

July '93 The result of this research was presented to the DTI which generally supported the relaxation of SCFR requirements.

Nov '93 The Chancellor of the Exchequer in his Budget confirmed the abolition of the audit for Very SCs and replacement of audit by a simple compilation report for certain SCs.

Mar '94	A research by Fearnley and Page (1994) indicated that audit regulation benefits no one except the regulatory bodies and the "free riders" (i.e. banks, creditors and Inland Revenue).
Apr '94	The details of the regulations to be implemented for companies taking advantage of audit exemption were published by the DTI (press notice, 7/4/94).
June '94	The proposed format of the Compilation Report and professional guidance for SC practitioners were published by the APB (1994).
July '94	The regulations to implement audit exemption for SCs were laid before Parliament and came into force on 11 August 1994 (DTI, press notice, 21/7/94).
Nov '94	The DTI (1994)'s consultative document indicated that a reform of Partnership law may benefit small businesses.
Feb '95	The APB (1995) proposed that the scope of audit for listed companies and major economic entities must be differentiated from that for unlisted, owner-managed businesses and in this regard it suggested that the APB should develop guidance on the application of auditing standards to the audit of owner-managed businesses.
May '95	The DTI (1995)'s consultative document "Accounting Simplifications" proposed a further simplification of form and content of SC accounts in addition to fifty proposals to simplify specific CA accounting

disclosure requirements which mainly relate to accounts of large companies but considered to be of interest to SCs as well.

5.4 Audit regulation

Until very recently the continuation of self-regulation in the accountancy profession in the UK never appeared to be in doubt. Of course, there have been some concerns from government departments about the profession's need to "get its house in order" over the seeming disparity, in the public perception, between the profession's performance and the expectations laid upon it. These, in fact, can be traced back to the late 1960s when the Department of Trade inspectors' reports first began to raise serious criticisms of the performance of auditors for corporate fraud, mismanagement, and deception resulting in losses to investors and creditors. The public perception (as expressed by the media, the courts and DTI's inspectors) has often linked these corporate scandals and collapse with audit failures (for example, De Lorean in 1981, Johnson Matthey Bankers in 1987, Polly Peck in 1990, British & Commonwealth in 1990, BCCI Bank in 1991 and Maxwell Communications Corporation also in 1991). Perhaps, mindful of these scandals, the government:

> "...seized the opportunity presented by the EC Eight Directive to enforce a completely new regulatory regime on the profession, and its novel features, such as formal practice inspections, have created understandable anxiety amongst practitioners". (Woolf, 1994: 432).

It has been suggested by Woodley (1991) that two forces compelled the government to intervene in regulating auditors' practice, namely, the need to protect the public and the need to conform with the European Community harmonisation directive.

The CA 1989 contains provisions relating to the qualification, training and conduct of auditors designed to ensure that only persons who are properly supervised and appropriately qualified (with the exception of the members of the AAPA as noted in section 3.3 (e)) are appointed as auditors and that audits are carried out properly and with integrity and also with proper degree of independence. This is achieved by the DTI's recognition of supervisory bodies (competent to establish audit regulations to which registered auditors are subject) and professional qualifications.

Application

Audit regulation started on 1 October 1991. It applies to all registered auditors whether they are sole practitioners or large firms. Every audit practice will be liable to a monitoring visit, which will review all aspects of compliance with audit regulation.

According to Fearnley and Page (1992:21):

> "Audit regulation has brought with it major changes to auditing firms in the form of a heavy rule book requiring new formalised and documented procedures for practice management, independence, professional conduct, training, technical competence and conduct of audits. Monitoring visits to selected firms will check compliance".

There are two monitoring units currently run separately by the three chartered institutes: ICAEW, ICAS and ICAI (which have a joint monitoring unit) and the certified association (ACCA). These units are responsible for monitoring all 10,559 firms registered with the three chartered institutes and 2866 firms registered with the ACCA respectively. These figures are not static, for example, new firms may register or old firms may deregister. (See "Independent oversight?" - Accountancy, March 1994:13).

The scope of monitoring has been designed to relate to public interest (Woodley, 1991). A practice that audits a listed company will be visited at least once every five years by the joint monitoring unit. It is estimated that about less than 200 firms (most of which are registered with the three chartered institutes) audit all listed companies. (See Beattie and Fearnley, 1993:71 and Fearnley and Page, 1992:21). The remaining practices which include a large number of sole practitioners will be monitored by the joint monitoring unit on a sample basis. The sample size has initially been set at 150 firms a year, but this will be kept under review. There will also be special visits where specific problems have been reported or identified.

Costs and effects of regulation

All audit firms had to make significant changes to all aspects of their work. The most extensive changes, according to Fearnley and Page (1993:59)'s survey, were in respect of procedures for recording audit work. They also noted that changes in quality control procedures and audit methods had been necessary and less extensive changes had been in practice management and staff training.

However, their results indicated that "training staff in new documentation and audit procedures" has been the largest single item of cost for a number of respondents to their survey.

The costs of these changes have been significant. Fearnley and Page (1993:59) identified these costs as follows:

i) The average set-up costs per practice (not attributable to individual clients) for firms with three or few partners were estimated at £4,900, comprising expenses of £1,220 and lost chargeable time of £3,680. Furthermore, the subsequent annual recurring fixed costs were estimated at £3,400 (£1,000 expenses and £2,400 lost time).

ii) The estimates of costs of audit regulation attributable to individual clients comprised an uncharged fixed cost per audit of £200 and a variable cost of £100 per £100,000 of company turnover.

Audit firms are bearing a significant amount of these costs themselves. According to Fearnley and Page (1993:59):

> "They had been able to recover only 10% of their set-up costs and 28% of their recurring costs in chargeout rates. Furthermore, they were getting back only 62% (1991 - 52%) of the additional costs of individual jobs."

Furthermore, a research by Fearnley and Page (1994) found that audit regulation benefits no one except the regulatory bodies themselves and the "free riders" - the banks, the creditors and the Inland Revenue - who do not have to pay for it. They also found that the regulation has had no impact on the large firms' approach and that it had raised audit standards and costs for smaller firms. As a result, it has created barriers to entry to the small company market which were not there before, in particular for small chartered accountancy firms.

They have also suggested that one of the ways the self-regulatory bodies have benefitted from the audit regulation is that:

> "...they now have considerably more power over their members and the quality of their work than previously and are therefore able to defend themselves against criticisms of market failure". (See "A waste of time?", Accountancy, March 1994:15).

Implication for SC audit

The introduction of regulation has affected the SC audit debate because of its considerable and unwelcome burden to the SCs and the small practitioners.

Fearnley and Page (1993:59) report that opinion against retaining the SC audit has been hardened since their previous year's survey (1992:21). They found that 81% of their sample practitioners in 1992 Survey favoured the abolition of SC audit as against 72% in 1991 Survey. Furthermore, in seeking practitioners' views on which SCs should be exempted from audit, they offered the three alternative thresholds taken from the Institute's consultative document and they found that:

> "...only 18% opted for the VAT registration limit (turnover £36,600); 47% were in favour of the VAT cash accounting limit, and 35% opted for the EC small companies definition".

Fearnley and Page (1993:59) found that the most respondents supported abolition of the audit requirement for companies with turnover below the VAT cash accounting limit, subject to safeguards for the protection of minority shareholders.

In August 1994, the DTI, which was concerned about the impact of audit regulation on SCs, exempted certain SCs from statutory audit requirement (see 5.8). This resulted in the exemption of a significant number of companies from audit requirement, thus saving them audit fee costs. However, it is arguable whether this had reduced the overall cost of regulation for small audit firms, because few practices would be able to deregister and eliminate their regulatory overheads. According to a research by the University of Central Lancashire, conducted prior to the November 1993 Budget announcement of the relaxation of the SC audit, found that "One in ten accountancy firms entitled to audit companies could be set to deregister from the regulated audit regime" (see "1,000 audit firms 'may deregister'", Accountancy Age, 13/1/1994:3). However, a survey of small and medium-sized firms by professional publishers Tolleys, which was conducted after the November Budget, found that 16% of small audit firms (i.e. one in six) are undecided about whether they would retain their audit registration ("One in six practices may drop out of registration", Accountancy Age, 3/3/1994:3).

Fearnley and Page (1994:82) argue that:

> "The proposed changes to this [SC audit] requirement will still leave many small companies in the net. If they are to remain there, then ways must be found of cutting the compliance costs for this sector of the market".

The future of audit regulation

The review of the monitoring regime for registered auditors is claimed "to anger the supervisory bodies if proposals, currently in draft form, are included in the finalised version" ("Independent oversight?", Accountancy, March 1994:13). The draft review report which was commissioned by the DTI and carried out by Professor Peter Moizer of Leeds University is understood to suggest that the two monitoring units should be merged and made wholly independent of the supervisory bodies. The report apparently wants all firms currently on the three institutes' audit register to be visited at least once every five years. Furthermore, it is understood to criticise the cost of Joint Monitoring Unit of £2.848m in 1993 as compared to the ACCA's total expenditure of

£418,000.

It is worthy of note that Fearnley and Page (1994:81) refer to debate about who should be doing the regulating and note that:

> "Some have suggested that professional bodies cannot act as regulators and at the same time serve their members' interests - the 'dual role' argument. The barrage from the left claims that the profession should not be allowed to regulate itself because it protects its members rather than the public - the 'self-regulation must go' argument".

However, Fearnley and Page (1994:81) refer to the fact that "all the accounting bodies are operating two forms of regulation, one delegated by the state and the other internally generated..." and observe that "There are obvious economies of scale that should be achievable combining these functions within the same organisation...".

5.5 The statutory audit requirement and cost of audit to SCs

Many businesses start as small family private companies in order to benefit from "limited liability" and other perceived advantages of incorporation. Others start as small family concerns and as they grow they may be converted to corporate entity or a partnership.

The owner-managers, in these SCs, normally participate in the day-to-day activity of the company and have a good knowledge of their company's performance. The financial information contained in accounts tends to substantiate rather than increase their existing knowledge of the company affairs.

However, they have a relatively small group of external business contacts (e.g. suppliers, banks and Inland Revenue) who have some obvious need for formal financial information about the company.

As companies expand, their owners cannot maintain a physical presence to all the activities and may have to employ qualified and experienced individuals to manage the companies. They find themselves becoming less and less involved in the company's operations and they have to rely more and more on the services of professional managers/directors.

The larger the company becomes, the greater will be the tendency for its shareholders to become divorced from its affairs and therefore, the greater will become their needs for financial information about the company's activity, performance and progress (Lee, 1982).

For the financial information to be of any use, it must be <u>reliable</u>. For this reason, in the UK, the Companies Acts require that the financial statements of all companies (with the exception of those companies identified in Chapter one of this work) should be <u>audited</u>.

However, problems invariably arise in the application of normal auditing principles and procedures to many audits of SCs due to SC characteristics such as <u>owner/manager dominance</u> which allows the management to override informally designed accounting controls or <u>internal control deficiencies</u> resulting from limited segregation of functions. Thus, it will be difficult for SC auditor to obtain relevant and reliable audit evidence and to ensure all the transactions have been recorded. This is likely to lead to the need to rely on management assurances that all transactions have been properly recorded and also the frequent qualification of SC audit report.

The above problems even become very frequent for very small proprietary businesses whose accounting records falls within the category known as "incomplete records".

According to Woolf (1994:319):

> "In such a case any reference to an independent audit of the records is farcical. The 'auditor' will in fact attempt to glean enough verbal and documentary information from the proprietor ('managing director') to enable him to prepare a set of accounts, apparently sufficiently respectable to satisfy (1) the registrar of companies, (2) the Inland Revenue, and (3) the bank manager, if overdraft facilities have been granted. In many such cases the information supplied to the accountant will be woefully deficient and often unsupported by documentary evidence. Such situations will invariably demand a qualified audit report, if only on the grounds of failure to maintain proper accounting records".

Woolf (1994:319) concludes that:

> "It is clearly debatable whether such a business should have been granted the privileges of incorporation in the first place... It is equally debatable whether such a company can and should be subjected to a normal audit".

It is worth noting that some of these companies have since been exempted from audit (see 5.8).

In addition to the above, the statutory audit requirement imposes a real cost on SCs. In this regard, a consultative document which was issued by the DTI in April 1993 to offer Very SCs some measure of relief from statutory requirements (for more details see section 5.8.1), referred to three specific surveys about cost of statutory audit which are considered below.

The first survey which was published in November 1991 and carried out by the Manchester Business School estimated that the audit fee may represent 2% - 4.5% of turnover for companies with a turnover in the range of £20,000 to £50,000 (DTI, 1993:para. 4.3). It is worthy of note that these results do not include the effects of audit regulation (see 5.4).

The second survey, a study by the former Business Statistics Office, based on a sample of some 2000 company accounts for 1987, illustrated that "the burden of cost becomes proportionately heavier as turnover decreases" (DTI, 1993:para. 4.3). It is instructive to note that according to Central Statistical Office (CSO) this study is based on the annual Company Finance survey, published as Business Monitor MA3 (See CSO, MA3, twenty-first issue, 1990) and analyses the financial returns of two thousand UK companies. Correspondence (12/9/1995) with the CSO reveals that "the statement in the DTI [1993:para. 4.3] refers to costs in general, rather than audit costs".

Finally, a survey by the Institute of Advanced Legal Studies has suggested that company dissatisfaction with the cost of, and need for, audit increases as company size decreases. (DTI, 1993:para. 4.3).

It is also worthy of note that according to Freedman and Godwin (1993:123), the audit fee for their sample companies was between £500 to £1,500, a sum which was considered to be "sizeable to businesses with profits of £50,000 or below...".

Furthermore, there are two additional costs associated with the audit, which cannot be strictly quantified:

i) the opportunity cost of diverting management time to deal with the audit, which is likely to be proportionately higher for smaller companies than larger companies; and

ii) the extra cost of the new audit regulation, which was introduced in October 1991. It seems likely that many auditors will face additional costs, depending on the complexity of the accounts and their audit, in providing sufficient evidence of compliance with auditing standards. This will lead to rise in audit fees and additional financial burdens on their SC clients. (For more details see 5.4).

Whether the benefits of the compulsory audit of the accounts of SCs justify the above costs has been the subject of public debate for many years.

5.6 SC audit debate - To audit or not?

The APC (1979) argues that the case for retaining SC audit rests on the value of the audit to those who have an interest in SC affairs, namely:

- shareholders
- banks and other institutional creditors
- trade creditors
- tax and other authorities
- employees
- management

The decision of the House of Lords in the case of Caparo Industries plc v Dickman and others (1990) established that the purpose of the annual accounts is to report to <u>shareholders</u> on management's stewardship of the company and auditors are not liable to third parties in respect of statutory accounts. Effectively this decision ignores the other users of the accounts.

However, it has been recognised that in considering whether to relax statutory audit requirement for SCs the needs of <u>all users</u> of audited accounts should be taken into account (ICAEW, 1992b).

Many arguments have been put forward in favour and against SC audit (for example, Mottershead, 1978; APC, 1979; Davison, 1980; Pratt, 1981; Jones, 1985; Accountancy, July 1985: 12-13; Adams, 1988; ICAEW, 1992b; Freedman and Godwin, 1993).

It is the intention of the author to start discussing the SC debate by first of all considering the main arguments put forward by those in favour of retaining SC audit. This would be followed by a discussion of the main arguments against retention of SC audit.

5.6.1 Arguments in favour of retaining SC audit

Those supporting the retention of compulsory audit requirement for SCs have put forward the following arguments by considering the needs of the <u>users</u> of audited accounts and <u>other</u> related issues.

<u>USERS OF ACCOUNTS</u>

Shareholders

An audit provides some assurance to shareholders and in particular to those who are not connected with management of the company as to whether the accounts give a true and fair view of the company's state of affairs and it may protect the interest of minority shareholders. Furthermore, it has been argued that the accounts are often of particular importance to shareholders of SCs because:

> "...they provide virtually the only information available to determine the value of their shares... It is accordingly particularly important that these statements should be fair and an audit provides valuable assurance of this fact". (APC, 1979:para. 14).

Banks and other institutional creditors

Audited accounts are valuable for lending decision by the banks as well as monitoring the continuing security of advances already made.

Qualification of an audit report reduces but does not eliminate its value to the banks and other institutional creditors, indeed, it draws their attention to deficiencies in a company's affairs.

Trade creditors

Trade suppliers assess the creditworthiness of their potential or existing customers by using their accounts or by relying on the reports from their credit agencies for whom the Registrar of Companies files are a valuable source of information. However, the value of this information is reduced if it is not independently audited.

Tax authorities

Accounts are used by the Inland Revenue as the basis for computing corporation tax liability. Accounts are also used by the Customs and Excise for verifying the accuracy of figures (turnover and expenses) contained in VAT returns. The value of the accounts is clearly enhanced by the addition of an independent audit opinion.

Employees

Audited accounts may be used by Trade Unions in conducting collective bargaining and individual employees may also use the audited accounts with a view to assessing the prospective viability of their employer's business.

Management

Supporters of SC audit would also argue that an audit provides an independent check on whether the business is performing as management believes and it provides the management with valuable benefits such as recommendations for improvements to accounting and internal control systems and the detection of fraud and error. Furthermore, they point out that audit provides an independent check on the accuracy and adequacy of accounting procedures performed by the company's own staff.

<u>**OTHERS**</u>

Limited liability

Limited liability is an important benefit provided to the shareholders of a limited company by the Companies Acts. The statutory audit is argued to be a valid price to ask for the benefits of limited liability.

Going concern

Audited accounts provide some assurance as to whether a business continues as a going concern. This is particularly important to suppliers, lenders and other users of accounts.

When forming his opinion, the auditor needs to consider whether there are reasonable grounds for accepting that accounts should have been prepared on a going concern basis. Of course, the auditor does not guarantee that a company will or will not fail.

Accounting records

Audit creates a discipline for the company leading to better accounting records and accounts.

Fraud

An audit may be a major factor in deterring and detecting fraud. The APC (1990)'s auditing guideline on fraud, other irregularities and errors states that:

> "Audit procedures should be designed to give the auditor a reasonable expectation of detecting any material misstatements, whether intentional or unintentional, in an entity's financial statements. He cannot, however, prevent a fraud or other irregularity from occurring; but the recurring annual audit may act as a deterrent" (APC, 1990: para. 7).

5.6.2 Arguments against SC audit

The main arguments against retention of SC audit are provided below.

<u>**USERS OF ACCOUNTS**</u>

Shareholders

The independent audit is of little value to shareholders, who are all directors and actively involved in the management of the company and also shareholders who although not involved in the management of the company, but have complete confidence in the integrity of the directors. Furthermore, it has been argued that statutory audit is of little value to shareholders where the audit report has been heavily qualified (due to the SC's characteristics).

Banks and other institutional creditors

It is doubtful if banks place more reliance on the audited accounts of small limited companies than on the unaudited accounts of unincorporated businesses of similar size which are nearly always prepared by a qualified accountant. Even if a bank considers that it requires audited accounts it would be able to make an audit a condition of granting a loan, therefore, it is difficult to justify the retention of audit requirement for all SCs on this ground.

In practice, banks generally place greater reliance on the manner in which bank accounts have been conducted, cash flow projections and management accounts.

Trade creditors

In SCs, the value of the audited accounts for assessing the creditworthiness is extremely limited, because SCs are exempted from filing their full accounts.

Furthermore, SCs' accounts are generally filed with the Registrar of Companies too late (up to 10 months after the year end) to be of relevance for short terms credit decisions. Trade creditors are more likely to rely on trade references and personal contacts than filed accounts.

In the case of smaller companies, creditworthiness is rarely reviewed on a continuous basis, it is only investigated when an account is first opened, or the level of credit is significantly increased or a trade debtor is considered to be in financial difficulty.

Tax authorities

It is doubtful if the Inland Revenue places greater reliance on audited accounts of SCs than unaudited accounts of unincorporated businesses.

In their response to the APC (1979)'s discussion paper, the Board of Inland Revenue did not insist on a mandatory audit for SCs as long as there was an accountant's report with the accounts. Furthermore, the Chairman of the Board of H M Customs and Excise stated that the abolition of SC audit should not reduce the accountant's involvement with the SCs (APC, 1980).

The Inland Revenue now accepts "three-line" accounts from very small unincorporated businesses with turnover below £15,000 p.a. It would seem unlikely that the Inland Revenue has a particular need for audited accounts in the case of Very SCs, where their accounts provide more than "three-line" information.

Furthermore, it has been observed that tax authorities in most other countries do not require a statutory audit for very SCs. "Comfort should not be provided for the Inland Revenue at the expense of the small company sector". (Freedman and Godwin, 1993:111).

Therefore, it appears that Inspectors of Taxes are more likely to be influenced by the reputation of the accountants who prepare the accounts than with the expression of a particular form of opinion.

Furthermore, the detailed trading account of a company which is of great importance to the Inland Revenue and the Customs and Excise is not explicitly part of an annual audit.

Employees

In SCs, the audited accounts are unlikely to be used as a tool for salary negotiation and employees cannot assess the prospective viability of their employer's business because the accounts are either heavily qualified or the level of profit is heavily influenced by the amount of directors' remuneration and by the extent of low interest loans from the directors (APC, 1979:para. 28).

Management

In SCs, an audit opinion is unlikely to add anything to management's knowledge of the results if the information supplied to the auditor has not been given honestly and accurately by the management. The audited accounts serve only a compliance function and they are unlikely to be used for managing a company's financial resources. Indeed, the removal of audit might enable the accountant to make a much greater contribution to a SC management by concentrating on his management advisory role.

OTHERS

Limited liability

In many SCs, the benefits of limited liability have been eroded because directors have to give personal guarantees for their companies' borrowings and, in any event, it is disclosure of accounting information rather than the statutory audit which is the appropriate price to pay.

It is interesting to observe that unlimited companies are also required by the CA 1985 to undergo an audit, although their accounts are not filed with the Registrar of Companies. This suggests that the audit is not so much the price of "limited liability" as a protection for shareholders in line with <u>Caparo</u> (1990) case judgement.

Going concern

SCs are particularly vulnerable to changes in trading conditions and the actions of their owners which can pose special problems for SC auditors when assessing whether going concern concept applies to their SC audit clients. This will lead to semi-automatic qualifications in many SCs.

Accounting records

The additional burden of an audit does not, specifically in the case of SCs, lead to a better set of accounting records. In fact, the need to have a better set of accounting records derives principally from the need to prepare accounts in accordance with the CA 1985 requirements for filing with the Registrar of Companies and presenting to the tax authorities, which generally, leads in practice to the involvement of a qualified accountant, who would ensure a satisfactory standard of accounting records and accounts.

Fraud

The primary responsibility for the prevention and detection of fraud, and errors rests with management and not the auditor. An audit cannot be relied upon necessarily to detect fraud perpetrated by sole manager or collusive fraud amongst a SC management group.

Audit evidence

Due to the characteristics of SCs (e.g. the personal involvement of the proprietor) independent audit evidence is either not available or, where available, the cost of collecting and evaluating it may well be disproportionate to the benefits arising, leading to a widespread increase in the number of audit qualifications in SCs, which could harm the standing of the audited accounts of the SCs.

Auditing standards

It has been argued that the retention of the audit for SCs will lead to compromises and delays in developing standards of auditing for larger companies which are publicly accountable.

Audit regulation

As explained in detail in section 5.4, audit regulation has caused a considerable burden on SCs and their auditors and the research by Fearnley and Page (1993) indicates that opinion against retaining the SC audit has been hardened (see also Freedman and Godwin, 1993).

5.6.3 Conclusion

The arguments set out above show that the substantive benefit is in the provision of the accounts and the audit provides additional assurance as to the truth and fairness of the information.

However, in most cases, the audit of SCs is an unnecessary burden when viewed on a cost-benefit basis, both to the company and to the wider economy. (ICAEW, 1992b).

This has been recognised by the DTI's "Burden on Business" report in 1985 which made proposals for reducing the administrative burden on companies arising from the requirements of company law.

Furthermore, in March 1993, a report (ICAEW, 1993a) summarising the responses to the ICAEW (1992b)'s consultation paper "The statutory audit of small companies: the case for reform" confirmed that the majority of respondents were in favour of relaxing SC audit requirement in some way.

In relaxing the statutory audit requirement, there is a need for statutory safeguards for minority shareholders or debentureholders not involved in management. The users with legitimate needs (e.g. banks or Inland Revenue) will generally be able to request or require an audit if necessary.

It will be helpful to consider the <u>alternatives to SC audit</u> and the <u>sub-categories of SCs</u> to which these alternatives may apply.

5.7 Alternatives to SC audit

On 4 March 1988, the DTI (1988) published a Consultative Note on possible alternatives to audit for SCs. It offered five options:

i) a statement by the directors that the accounts meet the CA requirements.

ii) an assurance by a competent person that the accounts meet the CA requirements.

iii) a statement by a competent person that the accounts have been properly prepared from information supplied by management and conform as regards content and layout with the requirements of the CA.

iv) as (iii) above, but with an additional assurance that the company has kept proper accounting records.

v) a limited assurance on the validity of the accounts.

The report under option (ii) is essentially an audit report except that the person making it need be neither qualified nor independent. The report under option (iii) is the same as compilation report and the option (iv) is similar to the option (iii). The report under option (v) is the same as Review.

The above options and their consequences are considered below:

Option (i) - a statement by the directors that the accounts meet the CA requirements (DTI, 1988: para. 7).

On 30 March 1988, in their response, the ICAEW (1988) recommended that the accounts of SCs which had decided to dispense with an audit should contain a statement made by all the directors acknowledging their responsibilities for the accounts, stating in particular that they are entitled to the audit exemption and that the accounts are prepared to give a true and fair view and to comply with the CA.

The ICAEW (1988) believed that this option was preferable to the other alternatives because a statement of this type by the directors would focus their minds on their responsibilities.

On 29 March 1988, the ICAS (1988) replied to the DTI's Consultative Note, by confirming that although this option could in theory result in the maximum potential savings to SCs (ICAS, 1988:para. 3) because they would not have to pay an audit fee but it has some very serious disadvantages:

> "It would mean that effectively there were no additional obligations in relation to financial reporting in return for the benefit of limited liability. The quality of accounts produced would inevitably vary widely and the onus would fall to the Registrar of Companies to check compliance with the Companies Act requirements.
>
> Furthermore, sight must not be lost of the fact that the purpose of all accounting activities is to communicate useful and credible information to the readers of the accounts. The lack of an independent view being added to a company's financial statements would undoubtedly be to the detriment of users such as shareholders not involved in the day-to-day running of the company, the Inland Revenue, Customs and Excise and bankers and creditors" (ICAS, 1988:para. 4).

Option (ii) - an assurance by a competent person that the accounts meet the CA requirements (DTI, 1988:para. 8).

Under this option, a report is provided by possibly an unqualified, presumably unregulated and not necessarily independent person as to whether the accounts give a true and fair view. This approach would be contrary to the regulation of auditors contained in the CA 1989.

Both the ICAEW (1988) and the ICAS (1988) did not support this option on the grounds that there is a lack of independent opinion and also the reliance that could be placed on such report would vary and be very difficult for the users of the financial statements to determine.

Option (iii) - a statement by a competent person that the accounts have been properly prepared from information supplied by management and conform as regards content and layout with the requirements of the CA (DTI, 1988:para. 9).

The above option (i.e. "preparation and compliance") is an equivalent to <u>Compilation Report</u>.

compilation approach is similar to that currently carried out by practitioners in relation to the accounts of unincorporated businesses. The ICAEW's guideline on "Reports on accounts of sole traders and partnerships" (ICAEW, Members Handbook, Statement 3.907) states that members should not allow their names to be associated with accounts, even though unaudited, which they believe give a misleading view and they also should ensure that the accounts which they prepare conform to accepted accounting principles.

Under this option, the ICAS (1988) suggested that the reduction in the costs incurred on the present audit could be in the order of 20-25% of the present fee paid to external auditors/accountants. However, there could be two drawbacks for the users of the financial statements:

* uncertainty about the acceptability of this type of report

* a compilation-style report results in the reporting accountants giving no assurance on the financial information and whether proper accounting records is kept by the company or whether the accounts give a true and fair view.

The only comfort to the users of the financial statements is the fact that accounts have been prepared with due professional skill and care.

With reference to other definitions of a compilation, it is worth noting that Abdel-khalik (1983:113) refers to the following:

> "A compilation: is an engagement wherein a CPA presents in the form of financial statements information that is the representation of management (owners) without the

CPA undertaking to express any assurance on the statements."

Furthermore, the APB (1994:Introduction, para. 4) provides the following definition of a "compilation report":

> "The 'compilation report' is a report made pursuant to section 249A(2) Companies Act 1985, stating whether in the opinion of the reporting accountant making it:
>
> a) The accounts of the company for the financial year in question are in agreement with those accounting records kept by the company under section 221, and
>
> b) Having regard only to, and on the basis of, the information contained in those accounting records, those accounts have been drawn up in a manner consistent with the provisions of the Act (i.e. accounting requirements) specified in section 249C(4), so far as they are applicable to the company...".

The APB(1994) and the ICAEW(1993a:24) provide some examples of compilation reports.

Option (iv) - this is the same as the above option, but with an additional assurance that the company has kept proper accounting records. (DTI, 1988:para. 10).

The ICAS (1988) preferred this option to other alternatives to replace SC audit because:

> "It would allow the reporting accountant to establish that the client has employed procedures to provide reasonable accuracy of the underlying accounting records. We confirm that a consistent standard in reporting would be achievable" (ICAS, 1988:para. 13).

Option (v) - a limited assurance on the validity of the accounts (DTI, 1988:para. 11).

The above option (i.e. a "limited assurance") is same as <u>Review</u>. Review is very common in the USA and there is existing guidance from the AICPA and IFAC. The International Auditing Practices Committee of IFAC issued in February 1988, Related Statement No. 1 "Basic Principles Governing Review Engagements".

In practice, according to ICAS (1988), this option would be of little difference from the present SC audit, hence the review fees would be of a very similar level to those presently incurred in an audit.

In their studies, Arnold and Diamond (1981:7) referred to the following description of a review:

> "A review encompasses performance of inquiry and analytical procedures to provide the accountant with a reasonable basis for expressing limited assurance that there are no material changes that should be made to the financial statements for them to be in conformity with generally accepted accounting principles".

Comparing the above with the definition provided by the APC (1979:para. 43 - see List of definitions), it appears that they both provide a limited assurance on the validity of the accounts and they are of little difference from the present audit. A similar definition was also provided by Abdel-khalik (1983:113).

It is worth emphasising that the ICAS (1988:para. 8) has pointed out that:

> "This option [Review] would of course not be to the detriment to users of the financial statements in that there would be very little change from the present audit situation. The important feature of the independent view on the financial statements would still be there".

It should be pointed out that the concept of the review has generated some criticism in the US, where the following question has been raised "Limited assurance is a term that could cause problems of interpretation. When or how does the practitioner determine that this point of comfort has been reached?" (See Arnold and Diamond, 1987:13).

In this regard, in the UK, Flint (1988:174) refers to the debate in respect of the proposal to replace SC audit with a review following the adoption by the Council of The European Communities of the EEC Fourth Directive on Company Law in 1978 and observes that:

> "Some of the problems in the proposal which were highlighted in discussion related to the difficulty of conveying to the user of accounts what a 'review' is and what benefit or assurance it produces for the user".

Furthermore, according to Flint (1988:174):

> "While the presupposition about the understanding of the meaning of audit may not be well founded and it is unclear what a review is, it appears that it was believed that, at least, review could be distinguished as being different from an audit".

In general, the ICAEW (1988) expressed concern at how the various alternative forms of report (under the above options) that might be introduced in place of an audit report would be interpreted by the reader of the accounts.

> "In performing his work, the reporting professional will have to take account of any confusion that may exist in the reader's mind. This may lead him to perform what is in substance an audit, even if his report is nominally in a different form, so eroding whatever cost-savings might have been expected from the alternative form of report" (ICAEW, 1988:3).

Examples of review reports are provided by Woolf (1994:322) and LSCA (1992:22).

Finally, the results of the following studies provide some comparisons between some of the above alternatives and an audit.

In a study by Johnson, Pany and White (1983), the impact of auditor association with accounts on the decisions of bank loan officers was investigated. In particular, they examined differences in reactions to auditor association in the form of compilation, review or a full audit. They found that the decision to grant the loan or the interest-rate premium was not "significantly" affected by the form of auditor association. However, perceptions of confidence were affected and expectation of conformity with GAAP was "significantly" higher with full auditor association.

In another study in 1981, Arnold and Diamond (1981) investigated the reactions and attitudes of CPAs and bankers concerning the services available for nonpublic companies. They found that CPAs and bankers felt that the introduction of compilation and review services were a positive development by the accounting profession (see 4.17.2). Furthermore, Arnold and Diamond (1981:6-7) have cited Dirkes and Deming's study, point out that an audit provides positive assurance as to whether the accounts are presented fairly, whereas, a review provides a limited assurance and no assurance is provided by a compilation because there is no examination or review of accounts.

With reference to review, Hylas and Ashton (1982) found that review procedures were effective and low cost method of detecting material error. Furthermore, according to Woolf (1994:320):

> "There have been a number of advocates of the view that the accountant should limit his work in this context to performing a review as distinguished from audit

procedures, on the grounds that if the financial statements are improper, false or misleading, the accountant is less exposed if he had done no auditing than if he has performed some audit procedures and failed to find the deficiencies".

However, Gwilliam (1987:76) claims that the need for review (rather than full audit) arises from the increasing call for a form of auditor association with interim data, forecast data, etc., that do not necessarily lend themselves easily to traditional audit techniques and also from the recognition that for many SCs, while there is a need for some sort of independent check, the costs of full audit are likely to exceed the benefits.

5.8 Sub-categories of SCs to be exempted from audit

There are a number of ways of defining a SC to be exempted from audit. These could be based on characteristics, legal and other measurement criteria (see also section 4.3).

Defining a SC based on its characteristics is very useful but it is not a suitable basis for statutory rule because SC characteristics are too vague and open to avoidance.

Defining a SC based on legal characteristics (e.g. private or public, limited or unlimited) is useful but requires some additional measurement criteria.

Currently, there are a number of useful and attractive measurement criteria, which already have significant implications for the way a company conducts its business and they are reviewed and upgraded annually. These are:

* the threshold for VAT registration (currently £45,000);

* the threshold for <u>VAT cash accounting</u> (currently £350,000); and

* the threshold for <u>turnover</u> for a SC to file abbreviated accounts (currently £2.8m).

The application of the above thresholds to companies' annual turnover could provide the basis for creation of three categories of companies (within the CA 1985 definition of a SC) to which the alternatives to audit may apply. These are considered below.

5.8.1 Companies with annual turnover up to VAT registration threshold (Very Small Companies)

There are possibly some 250,000 to 300,000 companies, whose turnover is below the VAT registration threshold (DTI, 1993:para. 5.2 and ICAEW, 1992b:para. 64).

They include non-trading companies, such as clubs and flat management companies, whose accounts are only of interest to their shareholders who are mainly also directors of their companies.

In its response to the DTI (1988)'s consultative note, the ICAEW (1988) emphasized that it should be opposed to any statutory distinction between "Small" and "Very Small" companies. However, in its consultation paper in August 1992, the ICAEW (1992b) changed its attitudes towards the above and recommended that Very SCs should be exempted from the statutory audit requirement.

In September 1992, the Technical Committee of the London Society of Chartered Accountants (LSCA, 1992) suggested, in line with the ICAEW, that Very SCs should be exempted from statutory audits.

A significant number of respondents (but not the majority) to the ICAEW's consultation paper supported complete audit exemption for Very SCs (ICAEW, 1993a).

In April 1993, as a result of an initial review by the DTI, the Inland Revenue and the HM Treasury, the Government proposed in a consultative document to relieve Very SCs of the burden of the audit requirement and offered two options for consideration (DTI, 1993):

a) abolition of the audit requirement which would provide maximum deregulatory benefit to the companies themselves;

b) replacement of the audit with a compilation report produced by a suitably qualified independent accountant which would offer eligible companies a more limited measure of relief in order to address the concern of the users of the accounts.

The consultation exercise generated enormous public interest. The overwhelming majority of respondents supported relaxation, but thought that the proposed exemption thresholds were too low to be genuinely helpful to business.

In the November 1993 Budget, the Chancellor of the Exchequer confirmed the abolition of the audit for Very SCs with turnover up to £90,000 per annum (i.e. twice the current limit for VAT registration) and balance sheet total not exceeding £1.4m.

There would however be no change in the statutory duty of directors to prepare annual accounts giving a true and fair view and for accounts to be sent to shareholders and filed at the Registrar of Companies. The directors of companies taking advantage of audit exemption will need to state in the accounts which are filed at the Registrar of Companies that:

- the company is eligible to take advantage of audit exemption; and

- they are aware of their obligation to keep proper records and to prepare accounts which give a true and fair view of the company's position.

An individual shareholder (or shareholders) who holds 10 per cent or more of the issued share capital can demand an audit for the current financial year by depositing a notice in writing at the registered office of the company not later than one month before the end of that financial year.

5.8.2 Companies with annual turnover between VAT registration and VAT cash accounting thresholds

There are possibly some 200,000 companies, whose turnover falls between the above thresholds. This estimate is based on the difference between total number of companies estimated to be exempt from audit (i.e. some 500,000 companies, see DTI, 1995:9) and those with annual turnover below the VAT registration threshold (i.e. some 250,000 to 300,000 companies, see DTI, 1993:Para. 5.2).

In its response to the DTI (1988)'s consultative note, the ICAEW (1988) came out in favour of a statement by the directors of their responsibilities in relation to the accounts but against other alternative forms of report including a compilation report.

However, in its consultation paper (ICAEW, 1992b), the ICAEW proposed that companies with annual turnover between VAT registration and VAT cash accounting thresholds should be allowed to make a unanimous annual resolution to replace the statutory audit with a compilation report prepared by a qualified (not necessarily independent) accountant together with a statement made by all the directors acknowledging their responsibilities for the accounts.

A significant number of respondents to the above consultation paper believed that the VAT cash accounting threshold and the SC limits were equally popular relaxation criteria and the compilation report prepared by an independent qualified accountant was a popular alternative to the auditor's report (ICAEW, 1993a).

Although, this category of SCs was not considered by the DTI (1993)'s consultative document, but it is possible for the following reasons, the Government decided to consider this option:

i) public concern about the rising cost of audit for SCs following the introduction of the new regulatory regime for company auditors;

ii) the majority of respondents to the DTI (1993)'s consultative document thought the proposed exemption thresholds were too low to be helpful to business (DTI, Press notice, 7 April 1994);

iii) since the publication of "Burden on Business" report (DTI, 1985a) and the consultative document "Accounting and Audit Requirements for Small Firms" (DTI, 1985b), the Government policy has been to ease administrative burdens on SCs whenever possible. Relaxing the statutory audit requirement would be consistent with this policy;

iv) in the European Community, the UK is very much the exception in insisting that all limited companies should be subject to a statutory audit.

There are considerations of harmonisation and competitiveness in the EEC which suggest that the UK should take full advantage of the Fourth EC Directive on Company Law, which allows member states to exempt SCs from audit; and

v) there are audit exemptions for SCs in Australia, Canada, New Zealand and USA, where some of these countries (e.g. Australia and New Zealand) have similar company law and business systems to those in the UK.

In the November 1993 Budget, the Chancellor of the Exchequer announced that for companies with a turnover between £90,000 (being twice VAT registration threshold) and £350,000 per annum (being VAT cash accounting threshold) and balance sheet total not exceeding £1.4m, the audit requirement would be replaced by a compilation report produced by a suitably qualified accountant (being a practising member of one of the recognised accountancy bodies).

Companies taking advantage of audit exemption must still keep and maintain adequate accounting records in accordance with the CA 1985 and to prepare annual accounts giving a true and fair view.

There are similar provisions for protecting the interest of minority shareholder(s) and preparing the accounts as those for Very SCs.

In June 1994, the APB (1994) published the "proposed statement of standards for reporting accountants: compilation reports under company legislation" setting out the detailed format of the compilation report and professional guidance for practitioners who are eligible to act as reporting accountants.

The proposed statement states that:

> "... the reporting accountant is not required, and the procedures will not be sufficient, to give any opinion on whether the accounts have been properly prepared in accordance with the requirements of the Companies Act and whether they give a 'true and fair view'. Apart from those opinions expressed by the reporting accountant, a compilation report cannot and does not provide any assurance that the accounting records and the accounts are free from material misstatements" (APB 1994:preface section).

The proposed statement also states that practising accountants have a professional responsibility not to allow their names to be associated with accounts which they believe may be misleading.

In practice, this may force the reporting accountant to perform such procedures which are needed for audit than necessary for compilation report which will bring to question the extent of savings to be obtained from substituting a compilation report for the statutory audit.

5.8.3 Companies with annual turnover between VAT cash accounting threshold and the CA 1985 threshold for filing SC abbreviated accounts

The companies in this category continue to be subject to statutory audit.

In June 1985, when the DTI (1985b) proposed to exempt all SCs (as defined by the CA 1985 for filing purposes) from the statutory audit, it faced strong opposition from all accountancy bodies. Similarly, in 1989, in response to the draft Directive, which was proposed by the European

Commission in favour of the deregulation measures including mandatory exemption for <u>all</u> SCs from compulsory audit requirement, the Council of the ICAEW (1989) responded by arguing that the deregulation measures were <u>radical</u> and, if adopted, would have the effect of considerably reducing accountability to shareholders of SCs.

The ICAEW (1992b)'s consultation paper recognised that to exempt companies in this category from statutory audit may be regarded as too significant a change to be made immediately.

The Government has also indicated that once the existing proposals in respect of Very SCs and compilation report are implemented, "we will see how the measures work in practice and consider, in due course, whether any further changes might be appropriate" (DTI, Press notice, 7 April 1994).

5.8.4 Other SC category

The concept of owner-management is important, because annual accounts are intended to allow the owners to assess management's stewardship. It seems, therefore, illogical to require an audit of accounts where the directors are also the shareholders in a private company.

The DTI (1985a) and (1985b) proposed to eliminate the statutory audit of accounts for "shareholder-managed" companies.

In March 1991, the APC (1991)'s draft auditing guideline "The Audit of Small Businesses" argued that to an owner-manager, the cost of an audit was invariably considered to outweigh its benefits.

In September 1992, the LSCA (1992) proposed that the statutory audit of accounts of "proprietary" companies (essentially owner-managed companies with some other criteria) should be replaced with an <u>independent review</u> carried out by a qualified accountant.

Despite the above proposals, this category of SCs has not received its own status and exemption from audit (apart from those owner-managed companies which are already covered by other sub-categories, depending on their annual turnover).

Possible consequences of the recent changes

a) For shareholders:

* In Very SCs, the shareholders are mainly the directors who benefit from audit exemption by either saving the audit cost or spending it instead to obtain more needed business and management advice. The opportunity cost of diverting management time to deal with audit matters will be saved.

* The extent of the saving would be less if compilation report is prepared.

* Minority shareholders who are not involved in management may no longer have the comfort of an auditor's opinion that the accounts fairly reflect the directors' stewardship of the company's assets. However, if they hold at least 10% of issued share capital they can ask for an audit.

* Lack of audit and lack of involvement of a suitably qualified accountant in Very SCs may lead to inadequate financial management and discipline which is among the principal factors contributing towards

small business failure.

b) For other users:

* Companies taking advantage of audit exemption must still keep and maintain adequate accounting records in accordance with the CA 1985 and to prepare annual accounts giving a true and fair view and would continue to file their accounts with the Registrar of Companies with a directors' statement of their obligation and eligibility for audit exemption.

  All persons who have dealings with companies benefit from having access to annual accounts.

* Where a compilation report is provided, then additional comfort would be provided to users of accounts because the reporting accountant would not allow his name to be associated with the accounts that he considered to be misleading.

  However, the reporting accountant is not required to give any opinion on whether the accounts give a "true and fair" view.

* The quality of filed accounts are expected to deteriorate especially in case of Very SCs, which do not employ suitably qualified accountants.

* The risk of fraud and error would probably increase.

* It is claimed that banks would continue to demand audited accounts in some cases. In this regard, it is worth noting that a survey by the CharterGroup of 150 bank managers revealed that:

  > "...only 9% of branch managers had any great understanding of the legislation on audit

exemption and that 64% are likely to reduce the amount they are prepared to lend to businesses which dispense with the audit. 41% of the regional managers said they may still insist on audited accounts whilst others stated that they will seek additional security and guarantees where accounts are not audited". (The Small Practitioner, November 1994:2).

Furthermore, according to a research of bank managers by medium-sized firm Hacker Young's Manchester office, 84% of bank managers questioned felt that "audited accounts would remain a requirement for the majority of lending", despite the deregulation of the SC audit. Furthermore, 95% of the respondents also stated that "they would feel far less confident about receiving non-audited financial statements, even if they were from existing clients" (see Accountancy Age, 19 January 1995:3).

However, as argued in section 5.6.2, it is difficult for banks to justify the need for audited accounts from <u>all</u> SCs.

c) For auditors:

* Small accountancy firms are expected to face increased competition from each other and from unqualified accountants for Very SC clients which may cause some firms to consider a merger in order to offer a better range of services.

* Large accountancy firms are also expected to come under pressure from small firms in providing a compilation report, because their clients may employ the cheaper services of the smaller practitioner who has decided to dispense with audit registration.

* As appeared from the surveys which have investigated

the effects of audit regulation on auditors' deregistration (see section 5.4), not many auditors are expected to deregister.

5.9 Summary and conclusion

All available evidence suggest that some early corporation had auditing which was voluntary. In their observation on the development of auditing, Watts and Zimmerman (1983) argued that the committee of auditors survived because they were an efficient method of monitoring contracts between managers and those supplying capital. Furthermore, the shift from shareholder to professional auditor has been attributed mainly to an increase in the demand for audits in the period when audit was not required by statute in the UK and in the USA.

Over the years since 1844, the main objective of audit has changed from detection of fraud and error to attesting to the credibility of financial statements (i.e. verification of financial accounting records' accuracy). This change has resulted from the gradual awareness and acceptance by company management of its responsibility for fraud and error detection and prevention, improvements in company law, financial reporting, accounting and auditing practices, and increasing use being made of reliable accounting information. However, detection of fraud and error remains the secondary objective of company audit because of their possible effect on the reliability of the accounting information.

Generally, the structure of the company, with ownership often divorced from management, appears to justify the audit requirement. However, in SCs where owners and managers are the same and also due to SC characteristics (e.g. internal control deficiencies), it is debateable whether such companies should be subjected to a normal audit. Furthermore, the introduction of audit regulation by the CA 1989 is claimed to have had a considerable burden on SCs and their auditors which has resulted in hardening the opinion against the retention of SC audit requirement.

Having considered the cost of audit and the arguments for and against SC audit requirement and evaluated the alternatives to SC audit and possible cost savings and consequences of the current options, it appears that the government's drive to free SCs from unnecessary burdens is in the right direction. In this direction, the government should also consider exempting all owner-managed private SCs from statutory audit requirement.

It is now up to SCs to show that they are able to satisfy the financial needs of their users and to maintain the quality of their accounts and financial discipline.

CHAPTER 6

THE METHODS OF DATA COLLECTION AND ANALYSIS

6.1 Introduction

This Chapter considers the methods of data collection and analysis used for this research.

6.2 The methods of data collection

The following methods of data collection were used for this research:

i) Literature review

The SCFR issues were identified by reviewing the academic, professional and the Companies Acts literature (for example, text books and academic and professional journals on auditing and accounting with reference to SCs, the Companies Acts, auditing and accounting standards, technical releases, discussion papers and responses to discussion papers).

ii) Personal interviews

Semi-structured interviews with practising accountants/auditors and directors/shareholders of SCs were undertaken to pilot test the questionnaires and to discuss SCFR issues and also to clarify some unclear responses to the questionnaires. Post-review meetings were undertaken with some auditors who had already allowed the author to review a sample of their SC clients' accounts.

Meetings and discussions were undertaken with appropriate officers of the DTI and the ICAEW to obtain materials needed for the research. Meetings and discussions were also held with Mr. Wright, Head of Auditing of the ICAEW, to review the responses to the ICAEW's discussion paper on SC audit, as well as with Mr. Bowen, Secretary of the London Practitioner Board, to seek the LSCA's support for this research.

In addition, extensive correspondence was undertaken with professional bodies in France, Holland, Belgium and Germany to obtain relevant information for international comparison. There were few available published papers on SCFR in those countries.

iii) Survey of SC accounts (review of accounts)

After considering a number of options (see Chapter 7), it was decided to undertake a telephone sample of 40 professional colleagues and their contacts in "small" audit practice in London, of which 21 practitioners agreed to allow the author to carry out a review of their SC clients' accounts. Each practitioner was requested to select randomly a sample of five small non-dormant companies (as defined by the Companies Act 1985 for filing abbreviated accounts) from their SC clients for accounts review.

In total a sample of one hundred and five SC accounts was reviewed to check whether certain disclosures in the companies' accounts were consistent with financial reporting requirements.

The details of sample selection and the main findings of the survey of accounts are provided in Chapter 7. The rest of this Chapter considers postal questionnaire surveys, their sample selection, size and analysis.

iv) Postal questionnaires (surveys of directors and auditors of SCs)

Postal questionnaires were used to ascertain the views of the directors/shareholders and auditors/accountants of SCs about SCFR issues.

The review of the main research in SCFR (Page, 1981; Carsberg et al, 1985 and Humphrey and Turley, 1986) indicates that the surveys of SC directors (as one of the main users of SC accounts) and SC auditors (who also, generally speaking, prepare accounts of SCs) are crucial in understanding SCFR. For this reason, and also the reasons given below, it was decided to ascertain the views of SC directors and auditors.

a) Survey of directors

Directors can play three roles as follows:

- as management of a SC, they need the accounts for business decisions;
- as main shareholders of a SC, they need the accounts for investment decisions; and
- as trade creditors to other companies, they need the accounts for making credit decisions.

Therefore, the survey of directors was very important for the results of this research as the three main uses were covered in this way.

b) Survey of auditors

The survey of auditors (and in particular small firms of auditors) was very important because:

- auditors normally have some small clients and therefore they have a good knowledge of SCs and their needs;

- auditors are providers of services which are needed by SCs; and

- auditors are interested in participating in professional developments and debates which impact not only on their own future and survival but also on their clients'. This has been evidenced in their responses to the discussion papers on SC audit debate (see 3.4) of the APC (1979) and the ICAEW (1992b).

Postal surveys of directors and auditors were used instead of interviews because postal surveys:

- were cheaper;

- covered greater sample sizes spread over a larger geographical area (i.e. it was more representative);

- had relatively easier administration and control; and

- suited simple and closed (i.e. forced choice, pre-coded) questions (for advantages of this type of question see 6.4).

Apart from the vital question of non-response (see 6.6), there are some disadvantages to the mail questionnaire method (Moser & Kalton, 1971: 260-261). For further details see 6.4. These were considered in advance in order to minimise their effects.

Comparison of the above methods of data collection with other major research

Table 6.1: Comparison of the methods of data collection with other major research

Authors/Research	Survey of:	Survey sample size	Methods of data collection
i) Page,1981 (for ICAEW)	Directors	413	Postal survey
	Auditors	413	Postal survey
	Accounts	1000	Review
ii) Carsberg et al, 1985 (for ASC)	Directors	50	Interview
	Auditors	50	Interview
	Accounts	50	Review
iii) Robertson,1986a	Accounts	100	Review
iv) Humphrey & Turley 1986, (for ICAS)	Directors	40	Interview
	Auditors	148	Postal survey

The methods of data collection and the target groups selected for this research (i.e. review of accounts and postal surveys of directors and auditors), are generally consistent with the methods and the target groups selected in the previous major research in this field (see the above table).

6.3 Sample selections and sizes

Surveys of auditors

The surveys were designed to ascertain and compare the views of directors and auditors about SCFR issues. In order to be able to cross-reference their views, it was necessary either to contact auditors via their clients (i.e. directors) or vice-versa.

For the following reasons, it was decided to contact clients (i.e directors) via their auditors:

i) the support of the LSCA could allow selection of auditors to ensure adequate representation of the different size categories of accountancy firms;

ii) with the support of the LSCA, a higher response rate seemed likely, given that clients would receive questionnaires from their auditors, often with a covering letter; and

iii) it was thought to be an efficient way of selecting the right clients, who were considered by their auditors to be of an appropriate size and interested in the SCFR debate.

Three hundred and seventy five auditors were randomly selected from the LSCA's known Practitioner Members List. Based on the analysis of membership by district society and type, as at 30 September 1992, the LSCA had a total of 22,616 Members of which 7,635 were known practitioners (see ICAEW, 1992c:Quarterly Circular, Statistical Circular on Members, Students and Offices as at 30 September, 1992).

It is worth noting that the LSCA is the largest district society of the ICAEW. The ICAEW had 87,567 members in the UK as at 30 September 1992, of which 30,190 were known practitioners (see ICAEW, 1992c:Quarterly Circular). Thus, almost 25% of the UK membership or the UK known practitioners were based in London (LSCA). The auditors' sample size of 375 represents 4.9% of the total number of known practitioners of the LSCA or 1.2% of the total number of known practitioners of the ICAEW.

In arriving at the above sample size, due consideration was paid to the sample sizes of a number of previous major studies in this field (see 6.2). Furthermore, it was necessary to ensure that it would be sufficient to enable unbiased generalisation of the results and to meet the assumptions of the statistical tests that were used (i.e. in the one-degree-of-freedom situation, a minimum expected cell frequency of five is required for the chi-square analysis (Haber & Runyon, 1977:325)). In order to ensure a reasonable distribution across different size and professional staff categories, the following comparative analysis was carried out, looking at "general population" and similar studies to this research.

It is worth noting that, with regard to the <u>regional</u> nature of the data (London based), it is difficult to see why the auditing situation would be any different from London compared with other areas (see for example, Keasey and Watson, 1991).

i) Distribution of auditors in the sample

The majority of auditors (81%) in the sample were from firms with up to 5 partners. A further breakdown of the distribution of auditors in the sample and the "general population" is provided below:

<u>Table 6.2: Comparison of distribution of auditors between sample and "general population"</u>

Size of Audit practice - No. of partners	Respondents No.	Respondents %		general population %
1 (sole practitioner)	70	46	)	71*
2 - 5	53	35	)	
6 - 10	12	8		15
11 - 20	8	5		5
21 - 50	2	1		3
Over 50	8	5		6
	153	100		100

(Source for "general population" data: ICAEW, 1992c: Quarterly Circular, Statistical Circular on Members, Students and Offices as at 30.9.1992).

Although a strict comparison with "general population" data is not possible because the figure of 71%* relates to firms with up to 4 rather than 5 partners, and also the "general population" data assumes that all respondents were partners, nevertheless, a trend is discernible and it appears that the sample has a slightly higher number of "smaller" firms (up to 10 partners).

Furthermore, it is interesting to note that the distribution of auditors in the sample of this research mirrors that of Humphrey and Turley (1986), where a higher proportion of their sample (76.8%) came from firms with up to 5 partners. A similar trend was also observed when the sample was compared with that of Page (1981:73), where again a higher proportion of his sample (62%) came from firms with up to 4 partners. As observed by Page (1981:73) this trend is "...indicative of the fact that accounting work for small companies is usually done by small firms rather than the giants of the profession". This comparative analysis indicates that this research sample may have a slightly higher number of "smaller" firms (up to 5 partners) than that of Humphrey and Turley (1986) and probably that of Page (1981). (It should be pointed out that a strict comparison with Page (1981) is not possible as the figure of 62% relates to firms with up to 4 rather than 5 partners).

ii) Distribution of professional staff

A comparison of the number of professional staff (excluding partners) of the auditors' sample of this research with that of Humphrey and Turley (1986) is provided below:

Table 6.3: Comparison of distribution of professional staff between sample and Humphrey and Turley (1986)'s sample

Number of professional staff	% of respondents This Survey	% of respondents Humphrey and Turley (1986)
	%	%
0 - 10	76	51.7
11 - 25	10	24.5
26 - 50	3	12.2
51 - 100	3	6.5
Over 100	8	5.1
	100	100

The above table indicates that a higher proportion of the respondents to this research compared with that of Humphrey and Turley (1986), came from audit practices with up to ten professional staff. Accordingly, this may support an earlier finding that the auditors' sample of this research has slightly higher number of "smaller" firms than that of Humphrey and Turley (1986).

Other aspects of the sample of auditors are provided in Chapter 9.

Survey of directors

Three hundred and seventy five clients were selected through their auditors. This represents 0.23% and 0.08% of the estimated (see below) number of "active and independent" companies on the register at 31 March 1992, which had registered offices in Greater London and in Great Britain respectively. The estimated number of "active and independent" companies has been calculated on the basis of 40% (see Page, 1981:33) of the number of companies on the register at 31 March 1992 by region of registered office (see Table A3, DTI, 1991/92:28), which was calculated to be 161,320 (40% * 403,300) and 472,080 (40% * 1,180,200) companies with the registered offices in Greater London and Great Britain respectively. It should be pointed out that Freedman and Godwin (1993:108) have included "non-active" companies in their calculations on the grounds that if these are not dormant, they are all subject to a statutory audit requirement. The inclusion of "non-active" companies would have further reduced the above reported percentages of 0.23% and 0.08%.

Considering that this method of selecting clients (i.e. directors) through their auditors might result in a biased sample of unusually compliant clients, a follow-up to the survey was carried out to ascertain how the clients were selected by their auditors. A random sample of 25 auditors was contacted for a follow-up survey. They were among those who had already expressed willingness in the questionnaire to take part in the follow-up survey (i.e. respondents who had supplied their names and telephone numbers in response to questions 7.2 and 7.3 of the questionnaire). A total of 23 auditors eventually agreed to take part in the follow-up survey. The original sample size of 25 was chosen, bearing in mind the cost and time involved.

In the follow-up survey the following questions were put to the auditors:

i) how did you select the client to whom you sent the directors' questionnaire?

ii) did you send a covering letter with the questionnaire?

In response to the first question, it was deduced from 11 auditors that they selected those clients they felt, based on past experience, were "reliable" to complete the questionnaire. Furthermore, 5 auditors claimed they selected clients they thought might be "interested" in the SC audit debate. Finally, 7 auditors claimed they selected SC clients on a random basis.

In response to the second question, 16 auditors disclosed that they sent a covering letter or note in addition to the LSCA's covering letter. 7 auditors said that they did not send a covering letter but handed the questionnaire personally to their clients. Some auditors claimed they had contacted their clients by phone prior to mailing the questionnaire to them.

In addition to the above follow-up survey, in order to ensure a reasonable distribution of the directors sample across different turnover (sales) and employment categories, the following comparative analysis was carried out.

i) Distribution of turnover

Table 6.4: Comparison of distribution of annual turnover between sample and "general population"

Annual turnover	Sample %	"general population" %
£1 - £0.25m	34	55
£0.25m - £0.5m	12	14
£0.5m - £1m	24	12
£1m - £2m	10	8
£2m - £5m	12	6
Over 5m	8	5
	100	100

(Source for "general population" data: "Company size by turnover according to VAT (including building societies)", see Appendix C, Table 4 of DTI, 1994:8).

It is worth noting that the sample appears to have less than the average number of SCs with an annual turnover below £0.5m. According to the table, therefore, the sample of directors appears to come from relatively "larger" SCs (in terms of annual turnover) than average in the "general population".

ii) Distribution of employment

Table 6.5: Comparison of distribution of employment between sample and "general population"

Number of employees in company	Sample %	"general population" %
0 - 9	63	91
10 - 19	25	4
20 - 49	8	2
50 - 99	3	1
Over 99	1	2
	100	100

(Source for "general population" data: Adapted from "Employment" statistics, see Appendix C, Table 7 of DTI, 1994:11).

(Notes: The original ranges of employees in the sample were: 0 - 10, 11 - 20, etc.).

The above published employment statistics in respect of the "general population" do not distinguish companies from other legal structures (DTI, 1994:7), therefore, precise comparison with the sample is difficult. However, the above data may further support the earlier finding that the sample of directors appears to come from relatively "larger" SCs (here in terms of employment) than average in the "general population". For example, up to 63% of the sample companies compared to 91% of the "general population" had up to 9 employees, whereas up to 25% of the sample companies compared to 4% of the "general population" had between 10 and 19 employees. It is worth pointing out that 96% of the sample companies (compared to 97% of the "general population") had up to 50 employees, which is one of the criteria used by the CA 1985 to define a SC.

iii) Ownership and control

Table 6.6: Comparison of distribution of shareholdings by the board between sample and a sample of UK SMEs 1991 (SBRC, 1992)

% of shares held by the board	Sample %	SBRC (1992) All %
0%	1	4.8
1 - 25%	4	2.9
26 - 50%	4	5.8
51 - 75%	4	11.3
76 - 99%	18	15.6
100%	69	59.6
	100	100.0

(Source: Extracted from SBRC (1992), see Cosh and Hughes, 1994:24).

(Notes: percentages of shares held by the board in the sample included those held by their families as well).

The SBRC (1992) data relates to the share ownership characteristics of UK businesses employing fewer than 500 people, who responded to the Cambridge University National Small and Medium Sized Firms Survey in 1991. From the above table, it appears that the percentages of shareholdings by the boards of the sample companies are higher than those of SBRC (1992) survey. For example, 87% of directors of the sample companies as compared to 75% of "All" boards in the SBRC (1992) survey held over 75% of the shareholdings in their companies. This difference might be due to the fact that the shareholdings reported for the sample included those held by the board's families as well.

From the above comparisons, it is possible to conclude, with some caution, that the sample companies appear to be "bigger" than "average" in terms of turnover and employment distribution. In terms of shareholdings (and control), the board of the sample companies appears to have a greater ownership and control than "average".

6.4 Questionnaire design

In order to ascertain the views of SC directors and auditors about SCFR issues, it was decided to use two separate sets of questionnaires.

The starting point in the design of the questionnaire was to refer to the main objective of the research and the hypotheses, and to determine what questions should be included in order to gather relevant information to meet the above aims.

There were four stages in the design of the questionnaires:

Initial preparation

It was decided to divide each questionnaire into the following sections, each section covering one or more specific objectives:

* personal information - to gather personal information about the respondents;

* organisation information - to gather information about the respondents' organisation;

* SC accounts - to ascertain the respondents' views on SC accounts issues;

* SC audit - to ascertain the respondents' views on SC audit issues; and

* others - to ascertain whether the respondents were interested in discussing the issues raised in the questionnaires.

In addition to the above sections, the auditors' questionnaire included the following sections:

* SC clients - to gather information about directors' shareholdings; and

* services to SC clients - to collect information about accountants' services to SCs.

The above sections helped to develop the more detailed aspects of the design in a logical order and were also considered helpful to the respondents in their comprehension of the questionnaire as a whole, thereby influencing the response rate (Moser & Kalton, 1971: 346).

References were made to similar research (see 6.2) and questionnaires to ensure the research objective could be satisfied. In particular, the valuable support of Prof. Page was obtained at this stage to modify and use some of his questions, which he had used in a similar research nearly a decade ago (Page, 1981). This was necessary to compare his findings with those of this research in order to evaluate the extent of changes over the last decade. In total, nearly one-third of the questions in both questionnaires used in this study were based on Page (1981)'s questionnaires. In particular, the author's questionnaires benefited from questions relating to the following key areas:

* the main advantages and disadvantages of incorporation;

* the main users of SC accounts;

* the importance to their users of certain information contained in the published accounts of SCs;

* the principal benefit of audit and the main difficulties in auditing SCs;

* the effects of the abolition of the audit requirement; and

* the importance of services provided by auditors to SCs.

In order to evaluate critically the developments in SCFR since Page (1981)'s surveys, it was considered necessary to raise a number of new questions, particularly those relating to the following areas:

* the extent of audit qualifications in SCs and their reasons;

* the effects of the withdrawal of the old "example 6" audit report;

* the importance and usefulness of abbreviated accounts and the extent of their use;

* the need for "one set of accounts" to replace both full and abbreviated accounts of SCs and their possible effects and contents;

* the most important function of the audit in SCs;

* the statutory audit requirement in respect of three categories of SCs, namely: Very SCs, Owner-managed SCs and Other SCs;

* the effect of replacing the statutory audit by a statutory review;

* auditors'/directors' opinions about the information needs of some users of the accounts (e.g. Inland Revenue);

* views about the CA 1985's thresholds used to define a SC; and

* general views on specific SC issues (e.g. audit regulation, introduction of separate accounting and auditing standards for SCs and possible disincorporation).

Use of closed type of questions

The closed (i.e. forced choice, pre-coded) type of questions was used in the questionnaires because it had the following advantages (Moser & Kalton, 1971 and Oppenheim, 1966):

* answers were standard and could easily be compared between respondents;

* easier to code and analyse the questionnaires;

* respondents were often clearer about the meaning of the questions;

* easier to answer;

* easier to deal with sensitive issues; and

* the number of irrelevant answers was minimised.

However, from the outset, it was recognised that the closed type of questions had the following disadvantages:

* if an appropriate answer was not offered, it might frustrate respondents;

* differences in interpretation might go undetected;

* respondents might simply guess an answer; and

* too many choices might produce errors by respondents or clerical errors in analysis.

In order to overcome the above problems, the respondents were invited to make additional comments if they thought an answer needed expansion.

Adequate definitions and choices were provided and the use of technical terms was minimised as much as possible. At the analysis stage all choices were clearly coded to minimise any clerical error.

Pilot study

It was necessary to conduct a pilot study of the questionnaires in order to identify ambiguities in wording, difficulties in responding to the questions and incompleteness of a question.

At this stage the problem of brevity as against completeness was considered and although it was recognised that a long questionnaire could lead to a lower response rate, it was decided that the advantages outweighed the disadvantages. Nevertheless, as these surveys were sponsored by the CUBS and supported by the

LSCA, high response rates were achieved.

The pilot study was carried out using mailed questionnaire or semi-structured interviews. The pilot study groups, which consisted of the following (Table 6.7) were randomly selected from the author's previous audit practice firm and its clients, with the exception of 3 accountants, who were approached from medium-sized and large firms in order to obtain different points of view.

Table 6.7: Details of pilot study groups

Organisation size by no. of employees	Accountants	Directors
* "small" (up to 10)	7	4
* "medium" (11 - 50)	2	2
* "large" (more than 50)	1	1
	10	7

Each pilot study reviewer was requested to submit a written list of suggestions for improving and revising the questionnaires. The pilot study responses have not been included in the final analysis of the results, because the questionnaires were evolving continuously during this stage and it was difficult to standardise responses.

The results of the pilot study revealed that there was a marked difference in the knowledge of the directors compared to the auditors with regard to SCFR. For example, auditors in general had no problem in distinguishing between different form and content of the accounts (e.g. full and abbreviated accounts) and alternatives to SC audit.

However, a number of directors appeared to lack full understanding of these concepts. For this reason, it was decided not to include some specific questions in the directors' questionnaires, such as the application of SSAPs to SCs or audit requirement of different categories of SCs. It was observed that some of directors in the pilot study could differentiate between full and abbreviated accounts. However, they appeared to lack full understanding of the contents of different sets of accounts. These results should be treated with caution as the pilot group surveyed was rather small.

Revision

Some adjustments were made to the questionnaires as a result of the findings of the pilot study.

Definitions were also added for certain technical terms used within a question.

A final review of the questionnaires was made to ensure their clarity, lack of bias, sensitivity, level of knowledge demanded of the respondents (in particular directors) and their applicability to the research objectives and hypotheses.

6.5 Survey responses

In November 1992, the questionnaires were mailed to a sample of 375 auditors with a covering letter from the LSCA (see Appendix 1) which requested their participation in this survey and also urged their co-operation in forwarding an enclosed questionnaire to their clients' directors. Two questionnaires were sent to each auditor. These were completely different from each other. One for the auditor and one for him to post to one of his clients.

The second requests were made in January 1993. At the cut-off date of 28 February 1993, 106 analysable responses were received from directors of private companies (a response rate of 28.3%) and 153 analysable responses were received from auditors of private companies (a response rate of 40.8%).

The response rates were considered to be satisfactory for this type of survey, taking into account the timing of postal surveys and length of questionnaires; the postal surveys of this research were carried out during the recession of 1992/93 when many SCs were adversely affected and relatively lower response rates were expected from the long questionnaires, which were used.

For comparison, the response rates for similar postal questionnaire surveys were:

- Page (1981): directors (41%) and auditors (69%); and

- Humphrey & Turley (1986): auditors/accountants (nearly 50%).

Sponsorship by the CUBS, support of the LSCA and the topicality of the SCFR debate assisted in achieving the satisfactory response rates.

Details of the respondents (directors and auditors) are given in sections 8.2 and 9.2 respectively.

6.6 Tests of non-response bias

The limitations of postal surveys must also be considered when forming the final conclusions (Moser & Kalton, 1971).

The main problem with a questionnaire survey is non-response (Moser & Kalton, 1971: 262) (i.e. the inference about how representative the answers of respondents are likely to be of the characteristics and opinions of non-respondents).

Moser & Kalton (1971: 267) offer a number of solutions to deal with the non-response problem, one possibility being:

> "to make the assumption that the respondents to a second mailing are a random sample of all the non-respondents to the first mailing and weight them up accordingly; this obviates the need for further mailing but its validity rests on the basic assumption. It is likely that the non-respondents are closer in their characteristics to those who respond to the follow-up effort than to those who do so to the initial mailing, but the assumption that they are the <u>same</u> is dubious".

Therefore, in order to investigate the above, it has been <u>assumed</u> that the answers of the late respondents to the questionnaire were more similar to characteristics of non-respondents than were the answers of respondents who replied promptly.

For both surveys, the cross-tabulation of answers to the following key issues failed to reject the hypothesis of similar responses from prompt and late respondents at a significant level:

* the main users of SC accounts and delay in response to questionnaire;

* the main disadvantage of incorporation and the delay in responding to the questionnaire; and

* the main advantage of incorporation and the delay in responding to the questionnaire

Therefore, there is a little evidence that the responses to the questionnaires are unrepresentative of the opinions and characteristics of directors and auditors of SCs as a whole.

6.7 Analysis of results

The results of the questionnaires were analysed using the Minitab statistical package at the CUBS computer centre.

It was necessary to construct master tables for the results of each questionnaire, which could be sub-divided into a range of different criteria, to facilitate statistical analysis and cross-referencing of the results.

It should be pointed out that where the respondents were requested to rank items in order of importance, their responses were reported in Chapters 8 and 9 on the basis of the number of first ranks accorded by the respondents and not by a weighted score. It has not been possible to carry out rating on a weighted score basis because not all the respondents ranked all the items in order of importance. If rating on a weighted score basis had been carried out, it could have provided a fairer assessment of the relative importance of the items in the questions.

Furthermore, the estimated "average" in this research refers to the weighted average of the mid-points of a five or six - category scale (e.g. 0-20%, 21-40%, 41-60%, 61-80%, 81-100%).

6.8 Statistical tests

Chi-square test of independence

The objective of the statistical tests was to carry out cross-analysis of the results with the aim of confirming consistency of answers and identifying interesting correlations.

As most of the data collected through the questionnaires were in terms of frequencies in discrete categories and their distributions did not exhibit the characteristics of normal distributions, it was necessary to use non-parametric tests which do not rely on the assumption of normal distributions (Haber & Runyon, 1977).

These tests, such as chi-square, are robust and are applicable to a wide range of distributions but they tend to result in a conservative treatment of the data (e.g. it may not be possible to state that a statistically significant difference exists between the clients of small and large practices in relation to some attribute, despite what appear to be large differences between the means of their distributions).

However, it was considered that the chi-square test of independence was the appropriate statistical test because the groups were independent and the data were in terms of frequencies in discrete categories (Siegel, 1956) (i.e. contingency table), where:

Null hypothesis (H 0): There is no relationship between groups of people in their opinion about a given issue.

Alternative hypothesis (H 1): There is a relationship between groups of people in their opinion about a given issue.

Therefore, the significant non-random association between results were identified by chi-square tests giving a significance (chance of random association) of less than 5%.

Limitations in the use of the chi-square test

According to Haber & Runyon (1977), the limitations of chi-square tests are:

- the frequency counts must be independent of one another.

- a rule which has been generally adopted, in the one-degree-of-freedom situation, is that the expected frequency in all cells should be equal to or greater than 5. When the degree of freedom is greater than one, the expected frequency should be equal to or greater than 5 in at least 80% of the cells.

There are several procedures which can be followed with tables having too many small expected frequencies:

* reduce the number of rows and/or columns; or

* remove one or more levels of a classification.

The above procedures result in testing a different null hypothesis.

Correction for continuity

In the one-degree-of-freedom situation, a correction for continuity is required to obtain a closer approximation of the obtained chi-square values to the theoretical distribution, because the empirical distributions of categorical variables are discrete, whereas the theoretical distributions of chi-square are continuous (Haber & Runyon, 1977:323).

This correction is also referred to as <u>F. Yates' adjustment</u> (Fisher, 1970:94), where each observed frequency is reduced by half a unit.

Gamma statistic to measure the degree of association

Where associations between variables were indicated by significant chi-square tests and the variables were either dichotomies or naturally ordered, the degree of association had been measured by the use of the Gamma statistic.

Where both variables are dichotomies, Gamma is known as "Yule's Q" and the following conventions are used for describing the association (Davis, 1971):

Table 6.8: Conventions to describe association (Gamma)

Absolute value of Gamma	Convention
0.00 - 0.09	negligible association
0.10 - 0.29	low association
0.30 - 0.49	moderate association
0.50 - 0.69	substantial association
0.70 or higher (up to 1)	very strong association

"Yule's Q" is one of the best known measures of association in the social sciences. It lies between -1 and +1 with zero implying statistical independence (Reynolds, 1977). It is a very simple measure of association for a 2 x 2 contingency table.

6.9 Summary and conclusion

In collecting the data for this research, due consideration was paid to different methods of data collection, in particular, surveys of SC accounts, directors and auditors.

The pilot study helped to clarify a number of ambiguities in the wording of the questionnaires and identified the marked difference in the knowledge of the directors and auditors, which subsequently enhanced the final draft of the questionnaires.

Postal questionnaires were used to ascertain the views of directors and auditors of SCs about certain SCFR issues. Owing to the topicality of the debate, with sponsorship by CUBS and the support of the LSCA, satisfactory response rates were achieved for both surveys, the findings of which are reported in Chapters 8 and 9 respectively.

The next Chapter considers the main findings of the survey of accounts.