Audit problems encountered in small business engagements; Auditing research monograph, 5

D. D. Raiborn

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AUDIT PROBLEMS ENCOUNTERED IN SMALL BUSINESS ENGAGEMENTS

by D.D. Raiborn
Statement of Policy

This auditing research monograph has not been approved, disapproved, or otherwise acted on by the Auditing Standards Board, the membership, or the governing body of the American Institute of Certified Public Accountants. Therefore, the contents of the study, including the recommendations, are not official pronouncements of the Institute.

Auditing research monographs are published by the Auditing Standards Division of the American Institute of Certified Public Accountants. The monographs are intended to provide background material and informed discussion that should help in reaching decisions on significant auditing problems.

Individuals and groups are invited to express their views with supporting reasons on the matters in this monograph. Comments, which should be sent to the Institute’s director of auditing research, will be treated as public information unless a writer requests that his comments be confidential.
AUDITING RESEARCH MONOGRAPH

5

AUDIT PROBLEMS ENCOUNTERED IN SMALL BUSINESS ENGAGEMENTS

by D. D. Raiborn, CPA, DBA
Bradley University

Sponsored by
Oppenheim, Appel, Dixon & Co.

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Foreword

This is the fifth publication in the Auditing Research Monograph series. The series, published by the Auditing Standards Division of the American Institute of Certified Public Accountants, was undertaken in the belief that research is helpful in defining and solving significant practice problems related to the assurance function. The other studies in the series have been The Auditor's Reporting Obligation (1972), Behavior of Major Statistical Estimators in Sampling Accounting Populations (1975), Internal Accounting Control Evaluation and Auditor Judgment (1981), and The Market for Compilation, Review, and Audit Services (1981).

One of the primary objectives behind publishing Auditing Research Monograph 5 is to stimulate additional research in auditing a small business. Audit Problems Encountered in Small Business Engagements is a comprehensive study of a neglected research area. The study was originally a doctoral dissertation that was later rewritten as an Auditing Research Monograph.

Numerous practitioners provided comments and assistance at various stages of the project. The dissertation was sponsored by Oppenheim, Appel, Dixon & Co., Certified Public Accountants.

The study, in my opinion, is a valuable contribution to auditing research.

New York, N.Y. September 1982

DAN M. GUY
Director of Auditing Research
Preface

The economic significance of the small business is often underestimated. Because small businesses lack visibility, the setting of accounting and auditing standards is likely to focus on large companies. I undertook this study to provide empirical evidence on the nature, frequency, and importance of problems encountered by the auditor in implementing auditing standards in small business audit engagements. I hope the results will assist the profession in recognizing the needs of auditors of small businesses.

I would like to express my appreciation to Oppenheim, Appel, Dixon & Co. for their financial support of this project, specifically Mr. Albert L. Schaps. In addition, I would like to acknowledge the contributions of Dan M. Guy, Marilyn Zulinski, and Brian Kintish of the American Institute of Certified Public Accountants, Dr. M. Herschel Mann of Texas Tech University, and the members of the AICPA Review of Existing Auditing Standards Task Force. I would like to thank the research participants for their time and consideration and Caterpillar Tractor Company of Peoria, Illinois, for its financial assistance in typing the manuscript.

D. D. RAIBORN, Peoria, Illinois
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Highlights

The following highlights summarize the major issues and findings of this study. This section is presented to allow readers to gain an overview of the study and to focus their attention on chapters of particular interest.

Chapter 1: Overview

Generally accepted auditing standards are valid regardless of the size of the audited business; however, the operating environment of the small business may pose certain implementation problems. Reports of both the Commission on Auditors' Responsibilities and the AICPA Special Committee to Study the Structure of the Auditing Standards Executive Committee recommended that special provisions be made to meet the needs of small businesses.

Chapter 1 provides a synopsis of the auditing problems encountered in small business engagements and the objectives of this research.

Chapter 2: Characteristics of the Small Business

This chapter discusses various definitions of a small business, including those of the Small Business Administration and the Committee for Economic Development. Definitions of publicly and nonpublicly held businesses are also discussed. For purposes of this study, a small business is defined as one possessing some or all of six characteristics that have potential audit significance:

- Concentration of ownership or operational control is in the hands of one or a few individuals, creating owner/manager dominance.
- Management personnel or employees have limited accounting knowledge.
- Management believes that it cannot or need not hire employees having accounting knowledge.
- A higher potential for management override of internal accounting controls exists.
- Internal control deficiencies result from—Limited segregation of functions within the accounting system because of the small number of employees.
Easy access by clerical and administrative personnel to physical assets.
Informally designed procedures (planning, budgeting, accounting, and reporting) dependent upon management style.

- The firm has an inactive or ineffective policy-making body.

Chapter 3: Problems Encountered in Applying GAAS in a Small Business Audit

This chapter discusses the applicability of generally accepted auditing standards to audits of small businesses. The chapter explains various implementation problems, which are summarized from issues addressed in the auditing literature, personal interviews with CPAs, letters received by the AICPA, and discussions with the AICPA Review of Existing Auditing Standards Task Force.

Chapter 4: Research Design and Method

This chapter presents the methods of data collection and analysis used in the research study. CPAs nationwide were mailed questionnaires to determine the frequency of occurrence and importance of small business audit problems. Of the 1,431 practice offices that were contacted, 739 responded, representing a response rate of 52 percent. Ninety-two percent of the respondents represented practice offices of thirty or fewer professionals. Chi-squares, analysis of variance, and descriptive statistics were used to analyze the data.

Chapter 5: Research Findings: Significant Small Business Audit Problems

The study produced a number of significant findings:

- The personnel assigned to audits of small businesses are more experienced than those assigned to larger audits.

- Widespread confusion exists about the auditor’s study and evaluation of internal accounting control. Over 66 percent of the respondents indicated that they would perform compliance tests of internal accounting controls even if a preliminary evaluation indicated that they could not rely on the control system.

- In a small business environment, auditors generally cannot rely on internal accounting controls, including owner/manager controls, to restrict substantive tests.

- Small business clients’ attorneys often provide CPAs with incomplete responses to requests for information on litigation, claims, and assessments.
• Forty-five percent of the respondents indicated that, at least occasionally, they accept management's representations as audit evidence when completeness of recorded transactions cannot otherwise be substantiated.

• Approximately 25 percent of the responding CPAs frequently encounter difficulty in communicating the contents of the client representation letter required by SAS 19.

• Auditors generally encounter difficulty in applying analytical review procedures in the small business audit, particularly during audit planning to identify areas requiring special attention and during the audit as a substitute for certain other direct tests of balances.

• Related-party transactions do not cause significant problems in the small business audit. Respondents do not have significant difficulty in determining the existence of related parties, nor do they encounter significant client resistance to disclosing related-party transactions.

• Auditors of small businesses generally do not perform management functions or encounter other situations that impair their independence.

Chapter 6: Relationships Between Client Characteristics, CPA Firm Characteristics, and Small Business Audit Problems

Two primary characteristics describe a typical small business: concentration of ownership or operational control in one or a few individuals (owner/manager dominance) and limited segregation of duties.

There are few significant relationships between small business characteristics and small business audit problems. However, the frequency and importance of the audit problems tended to decrease when they were categorized by CPA practice office characteristics, such as practice office size and audit revenues. Generally, small CPA practice offices believe that problems related to small business audits occur more frequently and are more important to the completion of the audit than do large CPA practice offices and those with proportionately more audit revenue.

Some respondents showed confusion between generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP) and cited problems in applying accounting standards as examples of auditing issues.

Chapter 7: Summary, Conclusions, and Recommendations

The AICPA should consider offering illustrative guidance for the most troublesome problems documented in this study in a manner that
provides widespread exposure to the profession to ensure that smaller CPA offices are aware of the guidance. In particular, guidance needs to be provided concerning internal accounting controls of the small business, including owner/manager controls.

The accounting profession should continue to study the difficulties associated with small business audits and should provide additional guidance, as necessary, on performing such audits efficiently and effectively. As an initial investigation of such problems, this study was broad and general in scope, but it has identified significant problems for which further research is needed.
Overview

Because large businesses are more visible than small ones, the economic significance of small businesses is often underestimated. Yet businesses with fewer than 100 employees account for 41 percent of all paid employment. Ninety-five percent of the businesses in operation have fewer than twenty employees.\(^1\) Clearly, small business is a major factor in the U.S. economy.

Accordingly, the accounting profession should recognize the information needs of small business management, investors, and creditors. Accounting and auditing standards should encourage meaningful communication of financial information to these users.

Statement of the Problem

Auditing standards appear to have been developed for large rather than small businesses.\(^2\) A review of pronouncements of the Auditing Standards Board (ASB), Statements on Auditing Standards, shows that many auditing pronouncements address topics that apply only to large businesses, mainly because the standard setters respond to pronouncements of the Financial Accounting Standards Board (FASB) or requirements of the Securities and Exchange Commission (SEC). For example,

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2. In this study the term *auditing standards* includes the ten generally accepted auditing standards and the Statements on Auditing Standards, which are interpretations of the ten generally accepted standards.
SAS 27, *Supplementary Information Required by the Financial Accounting Standards Board*, SAS 28, *Supplementary Information on the Effects of Changing Prices*, SAS 33, *Supplementary Oil and Gas Reserve Information*, and SAS 40, *Supplementary Mineral Reserve Information*, were issued in response to FASB pronouncements, such as FASB Statement 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, FASB Statement 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies*, and FASB Statement 33, *Financial Reporting and Changing Prices*. These auditing pronouncements provide guidance on the auditor’s responsibilities in regard to supplementary information, which, as comprehended in FASB Statements 19, 25, and 33, must be provided only by large public entities or entities filing with the SEC. Therefore, these Statements on Auditing Standards apply primarily to audits of large businesses.

Auditors of small businesses may come to expect auditing pronouncements to apply primarily to audits of large businesses, and they may become so conditioned that they read a large business bias into all auditing statements. For example, SAS 39, *Audit Sampling*, applies to audits of all businesses and discusses both nonstatistical and statistical sampling; yet, an auditor of a small business may ignore the pronouncement because he believes that it is inapplicable to audits of small businesses.

Even when a Statement on Auditing Standards is not actually biased in favor of large business audits, certain characteristics of the small business may cause the auditor difficulty in applying the statement in small business audits. Therefore, the auditor perceives such standards as being designed for large business audits. The focus of this study is whether the standards, in their present form, actually serve the purposes of the audit; that is, do they provide guidance to the auditor on requirements for the expression of an opinion?

Generally, auditing standards are valid regardless of the size of the audited business, even though the small business environment may pose certain implementation problems for the auditor. The Commission on Auditors’ Responsibilities addressed such problems in its 1978 report:

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3. FASB Statement 19 specified certain disclosures that apply to public and nonpublic companies. FASB Statement 25 permits non-SEC registrants to disclose reserve quantities as supplementary information outside the financial statements.

4. The phrase *small business audits* is used for convenience throughout this study instead of the longer, more precise *audits of the financial statements of small businesses*.

Variations in the size and nature of an entity will dictate variations in specific audit practices and procedures, as contrasted to auditing standards. Present guidance on the application of auditing standards to audits of different size entities is inadequate.\(^6\)

The commission argued that implementation guidance should focus on entity size (large versus small) as opposed to entity type (public versus nonpublic):

More attention should be accorded to the possible effect of variations in audit clients on the nature and extent of audit procedures; additional guidance specifically applicable to audits of smaller entities should be given.\(^7\)

Although the commission made no mention of it, the timing of auditing procedures could also differ between large and small businesses. Small businesses with inadequate segregation of accounting duties may require more year-end audit tests than large entities with adequate segregation of duties and better internal accounting control, which tend to permit more interim testing.

The 1978 Report of the Special Committee of the AICPA to Study the Structure of the Auditing Standards Executive Committee (the study of the structure of AudSEC) recommended that standards and procedures promulgated by the Auditing Standards Board "make special provision, where appropriate, to meet the needs of small enterprises."\(^8\)

The Auditing Standards Board has responded to these recommendations in two ways. It established the AICPA Task Force on Review of Existing Auditing Standards to consider whether auditing standards are responsive to the needs of auditors of smaller businesses and to develop additional guidance, if necessary. The task force has identified certain small business audit problems, and the ASB is studying alternative forms of communicating guidance. The ASB also revised the transmittal letter accompanying all exposure drafts of proposed Statements on Auditing Standards to specifically request comments on the effect of the proposal on small businesses.

**The Lack of Professional Guidance for Small Business Audits**

The problem of applying auditing standards in small business engagements is compounded by a lack of guidance in the professional literature.

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7. Ibid.
Problems troubling practitioners who audit small businesses have not been systematically examined; both domestic and foreign literature discuss small business audit problems in a piecemeal fashion. No empirical evidence exists that the problems addressed in the literature are pervasive.

The subject has received sparse attention from practitioners, editors, academicians, and the professional standard-setting bodies. The literature is noticeably void of an operational definition of a small business that would distinguish it from a large business. Neither foreign nor domestic organizations have reached specific conclusions regarding reliance on owner/manager controls or innovative auditing procedures when limited segregation of accounting duties exists. Domestic literature is primarily concerned with internal accounting control and audit procedures; foreign literature relates primarily to the types of audit reports that should be issued when specific small business audit problems exist.

Research Objectives

The primary purpose of this study is to provide a systematic examination of CPAs' problems in applying generally accepted auditing standards (GAAS) in small business engagements. I sought to identify the problems and to determine their frequency and importance. I then searched for correlations between the audit problems and the characteristics of the small business and of the CPA firms that audit them. Finally, on the basis of my research findings, I proposed implementation guidelines for the application of generally accepted auditing standards in small business audits.

In this study, I defined audit problems as situations in which the auditor had difficulty applying GAAS. The problems arise because conditions inhibit the auditor's ability to achieve his objective, which is to reach a level of assurance that warrants the expression of an opinion on the financial statements. The problems involve difficulties in implementation rather than basic differences in the operations of large and small businesses.

This study does not address audit problems that relate to large businesses. Implementation problems encountered in small business


audits and large business audits may be similar, but their causes may differ. For example, audit problems of small businesses often relate to the small number of employees, whereas audit problems of large businesses usually relate to other reasons, such as collusion of employees or management or the processing of complex transactions.

Certain audit problems are not included in this study, either because of their pervasiveness or because the AICPA is currently reviewing the topic. Issues pertaining to audit sampling and the effect of computer systems on small business audits are omitted from the study.

**Significance of This Study**

The study is a primary research effort that addresses the need for guidance on the application of auditing standards in audits of small businesses, as called for by the Commission on Auditors' Responsibilities and the study of the structure of AudSEC. The study also responds to the needs of the AICPA Task Force on Review of Existing Auditing Standards, which studied implementation problems associated with small business audits. The ASB will review the results of this study to determine if additional guidance is needed.

The research project could provide a basis for AICPA pronouncements affecting CPAs' services to small businesses. The recommendations may influence decisions by the AICPA regarding whether an implementation guide should be issued to assist the CPA in auditing small businesses, whether current auditing standards need to be revised, whether interpretations of auditing standards are needed, and whether future auditing standards should specifically address small business audit concerns.

The issuance of formal guidance by the AICPA should reduce the uncertainty and difficulty in applying GAAS in the small business audit and should increase the effectiveness and efficiency of audit engagements involving small businesses. This, in turn, may reduce audit costs.

**Research Method**

To identify and classify small business audit problems, I reviewed the literature, interviewed practicing CPAs, reviewed letters received by the AICPA Task Force on Review of Existing Auditing Standards, and met with members of the task force. This stage of the research focused on determination of the major uncertainties and difficulties that CPAs have in applying auditing standards to small business audits.

I developed a questionnaire incorporating twenty-three audit problems identified in the preliminary research stage. The questionnaire was
designed to identify common characteristics of the small business and to determine the prevalence and importance of problems encountered in small business audits. Problems were ranked according to their significance value, which is a numerical product of a frequency-of-occurrence factor and an importance factor, as indicated by the respondent in the questionnaire.

The questionnaire was reviewed by the task force, personnel of CPA firms with members currently on the Auditing Standards Board, and other practicing CPAs. The questionnaire was pretested to determine difficulty, the time needed to complete it, clarity, lack of bias, and required level of knowledge.

Analysis of the questionnaire responses required descriptive statistics, chi-squares, and analysis of variance (ANOVA). I used the descriptive statistics to determine the most significant auditing problems; I used chi-squares to test for the existence of relationships between auditing problems and small business characteristics, and I used ANOVA to analyze differences in CPAs’ perceptions of small business audit problems when the perceptions were categorized by certain CPA practice office characteristics.

**Organization of the Study**

The organization of this monograph reflects the development of the research project. First, in chapter 2, I describe the characteristics that describe small businesses, and I examine the relationship between these characteristics and audit considerations.

In chapter 3, I identify and classify the auditing problems encountered by CPAs in applying GAAS in small business audits. This chapter presents the results of the initial research phase, in which I surveyed the literature and interviewed practicing CPAs.

Chapter 4 reviews the research method, including the sample selection, questionnaire design, and tests of hypotheses for problem frequency and importance.

Chapters 5 and 6 analyze the questionnaire data. The significant audit problems are discussed in chapter 5; chapter 6 then explores the relationships between those audit problems and the characteristics of both small businesses and CPA firms.

Chapter 7 summarizes the research study and suggests guidance to aid the CPA in implementing GAAS. Chapter 7 concludes with recommendations for future research.
Before I could begin systematic research into the problems encountered in small business audits, I had to establish an appropriate definition of a small business. I first reviewed existing definitions of small business.

Definitions of a Small Business

Most accounting literature focuses on the distinction between public and nonpublic firms. Accounting Principles Board (APB) Opinion 28, Interim Financial Reporting, defines a publicly traded company as one whose securities trade in a public market, either on a stock exchange (domestic or foreign) or in the over-the-counter market (including securities quoted only locally or regionally). According to APB Opinion 28, "When a company makes a filing with a regulatory agency in preparation for sale of its securities in a public market, it is considered a publicly traded company for this purpose."[1]

Financial Accounting Standards Board Statement 21, Suspension of the Reporting of Earnings Per Share and Segment Information by Nonpublic Enterprises, defines a nonpublic enterprise as an enterprise other than one "whose debt or equity securities trade in a public market on a foreign or domestic stock exchange or in the over-the-counter

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market (including securities quoted only locally or regionally); or that is required to file financial statements with the Securities and Exchange Commission. An enterprise is no longer considered a nonpublic enterprise when its financial statements are issued in preparation for the sale of any class of securities in a public market.  

Both of these statements consider enterprises whose stock is traded to be public companies. However, the definition of nonpublic enterprise incorporated in APB Opinion 28 excludes all companies filing with regulatory agencies in preparation for the sale of securities; FASB Statement 21 excludes from nonpublic entities only those companies filing with the Securities and Exchange Commission (SEC), whether or not the filing is related to the sale of securities.  

Statement on Standards for Accounting and Review Services (SSARS) 1, Compilation and Review of Financial Statements, as amended by SSARS 2, Reporting on Comparative Financial Statements, defines a nonpublic entity from the same perspective as APB Opinion 28; all companies who file with regulatory agencies in preparation for the sale of securities in a public market are excluded from nonpublic entities. Entities that file with regulatory agencies for rate-setting or other purposes could still be nonpublic. The statement also excludes from the definition of a nonpublic entity any subsidiary, corporate joint venture, or other investee controlled by a public entity.  

These distinctions do not adequately describe the business environment that is relevant to auditing small businesses. The nonpublic-versus-public delineation primarily classifies an entity according to the distribution of its securities, which fails to address internal characteristics of different-sized entities. Two businesses can be publicly held yet require totally divergent audit approaches because of internal characteristics related to size. The entity’s accounting and administrative controls are the critical factors affecting audit work.  

A definition relating to size is given by the Small Business Administration (SBA). The SBA defines a small business as one that is independently owned and operated and not dominant in its field of operations. The definition further specifies quantitative limits on small businesses, which vary across industries, in an attempt to recognize different labor and capital requirements. For example, a manufacturing enterprise is small if it has 250 employees or less, but a household appliance enterprise is small if it has 500 employees. Retail stores and service firms with annual net sales or receipts of $1 million to $5 million are considered small, while

wholesale firms with annual net sales of $5 million to $15 million are small by SBA standards.  

The SBA has set quantitative limits in defining a small business in order to apply its credit-granting policies. Quantitative limits must be revised continually, however, because of inflation. A qualitative definition of a small business is more stable over time and less sensitive to economic pressures and other external influences. For these reasons, a qualitative definition is preferable.

The Committee for Economic Development (CED) defines a business as small if it has two or more of the following features: (1) independent management (usually the owners), (2) owner-supplied capital, (3) mainly local operations, and (4) relatively small size within the industry. The CED definition concentrates on general market characteristics of the small business and does not address characteristics that have potential audit significance. For purposes of this study, therefore, the CED definition proves inadequate.

**Small Business Characteristics Having Potential Audit Significance**

For purposes of this study, a small business is defined as one possessing some or all of the following characteristics:

- Concentration of ownership or operational control is in the hands of one or a few individuals, creating owner/manager dominance.
- Management personnel or employees have limited accounting knowledge.
- Management believes that it cannot or need not hire employees having accounting knowledge.
- A higher potential for management override of internal accounting controls exists.
- Internal control deficiencies result from—
  Limited segregation of functions within the accounting system because of the small number of employees.

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Easy access to physical assets by clerical and administrative personnel.

Informally designed procedures (planning, budgeting, accounting, and reporting) dependent on management style.

- The firm has an inactive or ineffective policy-making body.

Ownership and Manager Dominance

Management of a small business is often dominated by an individual who also has an ownership interest in the business. The owner/manager's personality is often inseparable from the operations of the business. His leadership style is the leadership style of the entire company, not just a unit within the company. His knowledge of business is the knowledge the business possesses. The owner/manager has a strong sense of independence of outside control. The combination of his leadership style, independence, and ability to control creates a manager-dominated environment. Therefore, the manager's ability and willingness to establish accounting control is critical to the auditability of the business.

The involvement of the owner/manager may compensate for an otherwise weak internal accounting control system. Lack of involvement of the owner/manager, however, may cause the business to be unaudit-able.

Limited Accounting Knowledge

A second characteristic of many small businesses is the limited accounting knowledge of the owners, managers, and other employees. A small business does not have the benefit of the collective knowledge of many personnel, as does the larger business.

The entrepreneurial tendency of the small businessman is to focus on sales, marketing, and company growth. The small businessman may be complacent regarding financial matters or may have an inadequate knowledge of significant internal accounting controls. Complacency or inadequate accounting knowledge may lead to financial decisions that are detrimental to the small business. Many small firms fail because management does not recognize the limitations of watching sales while it neglects control over expenses and capital expenditures.

Management Attitude Toward Controls

The attitude of the owner/manager towards establishing and supervising internal accounting controls can affect the auditability of an entity.

Management that is not control oriented may be indifferent or neglectful of the business's accounting control system. A cavalier attitude towards internal accounting controls may impair the auditability of the small business.

Management Override of Internal Accounting Control

Another small business characteristic that compounds the already complex topic of auditor reliance on internal accounting controls is the potential for management override of controls. For example, management may instruct subordinates to bypass certain prescribed controls. The owner could instruct the bookkeeper to prepare a check to an unknown creditor that he could then cash for himself. The bookkeeper generally has no authority to question the lack of supporting documentation or the owner/manager's motives.

In one respect, owner/manager involvement potentially can strengthen controls by promoting separation of duties. If the accounts receivable clerk opens the mail, prepares the deposit, posts credits to the accounts receivable ledger, prepares the monthly receivable trial balance, and mails customer statements, the clerk can misappropriate cash and conceal it by lapping or misfooting the accounts receivable balance. The owner/manager who performs some of these functions helps to segregate incompatible duties.

On the other hand, the owner/manager usually has the authority to override prescribed procedures. There is often no review of management performance since many small businesses have no supervisory level above management. The higher potential for management override of internal accounting controls is a recognized limitation in the small business environment.

Internal Accounting Control Deficiencies

Internal accounting control deficiencies in small businesses may result from (1) limited segregation of duties, (2) easy access to both accounting records and physical assets by administrative and clerical personnel, or (3) informally designed procedures.


An important aspect of internal accounting control is segregation of duties, but in many small businesses accounting duties are limited to a few individuals. For example, a small business with only two office employees may have difficulty segregating custody of cash, recordkeeping for cash, and authorization for cash expenditures. Even when segregation of duties appears to be adequate, the informal nature of procedures often results in deviations from prescribed duties.

The auditor’s inability to rely on internal accounting control in many small businesses causes uncertainty in the audit approach. Limited segregation of duties tends to be a pervasive weakness that may preclude any audit reliance on internal accounting control and force the auditor to presume a high risk of errors and irregularities if the inadequate segregation places an individual in a position to perpetrate and conceal errors and irregularities.\(^\text{12}\) The auditor often compensates for the limited segregation of duties by relying on owner/manager involvement or by extending his substantive tests of transactions and balances.

Limited segregation of duties may create an environment in which clerical and administrative personnel have easy access to financial records and physical assets. This characteristic results from the small number of employees. Many companies cannot afford to hire, or do not believe it is cost-beneficial to hire, the personnel necessary to separate the handling and recording of cash receipts or disbursements. If the same employee is responsible for preparing checks, recording cash disbursements, and reconciling bank accounts, the person may omit recording a check and prevent the discovery of the act. Prevention of perpetration and concealment of irregularities involves assignment of asset custody, recordkeeping, and authorization of transactions to different employees.

Internal accounting control deficiencies may also result from informally designed recordkeeping procedures. Informal recordkeeping does not necessarily lead to inadequate records but does increase the potential for errors and fraud. These can also occur in formally documented systems, but in a documented system the auditor at least knows who is responsible for the work and how the task is to be performed. Adequate financial records are essential to the auditability of financial statements. A business with weak internal accounting controls can be audited, but a firm with inadequate accounting records may be unauditable.

**Inactive or Ineffective Policy-Making Body**

Many small businesses do not have an active policy-making body (such as a board of directors). Businesses that do have a supervisory level above management may find that the supervisors have little interest in

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overseeing the operations of the company because they have a limited financial background, do not understand the need for supervision of the owner/manager, or do not have the time to devote to such functions. Many times the supervisory level above management is not a policy-making body but, rather, a group of persons whose names are listed as directors so that the small business can obtain a charter to incorporate.
This chapter discusses the difficulties encountered in applying generally accepted auditing standards in audits of small businesses. I begin by presenting background information on the auditing standards, concentrating on the question of whether they adequately serve the needs of the small business audit. Then, taking each one of the standards, I explain the implementation problems reported by small business auditors. I identified these problems by reviewing the auditing literature, interviewing practicing CPAs, reviewing letters received by the AICPA Task Force on Review of Existing Auditing Standards, and attending task force meetings.

The Framework of Generally Accepted Auditing Standards

Development of auditing standards dates back to 1917, when the American Institute of Accountants, the predecessor of the American Institute of Certified Public Accountants, published a memorandum on balance sheet audits for the Federal Trade Commission. Yet, it was not until 1938, when the McKesson and Robbins investigation demonstrated that CPAs need more practical guidance, that the AICPA Committee on Auditing Procedure was established. In October 1938 the first Statement on Auditing Procedure was issued.
Statements on Auditing Procedure were superseded by Statements on Auditing Standards in 1972. The statements, which are enforceable by the AICPA under rule 202 of the AICPA Code of Professional Ethics, are issued by the Auditing Standards Board, a component of the AICPA Auditing Standards Division. Currently, the board consists of fifteen members: five representatives of the eight largest CPA firms, five representatives from medium-sized firms, four representatives from local firms, and one academic member.

Explicit Application of GAAS in Small Business Audits

The ten generally accepted auditing standards (GAAS) and Statements on Auditing Standards attempt to cover audit situations involving both large and small businesses. As a result, they suffer from a lack of specificity.

The Commission of Auditors' Responsibilities criticized the tendency to make guidance as general as possible.1 In particular, the commission noted that auditors of smaller entities needed more specific implementation guidance. "Present guidance on the application of auditing standards to audits of different size entities is inadequate."2 The commission dismissed the criticism that authoritative pronouncements fail to differentiate by type of business; rather, it concluded that the pronouncements should differentiate businesses by size.

These criticisms were supported by the Report of the Special Committee of the AICPA to Study the Structure of the Auditing Standards Executive Committee, which recommended that auditing standards "make special provision, where appropriate, to meet the needs of small enterprises."3

Both studies implied that some auditing standards, as currently expressed, demonstrate a large business perspective. For example, Statement on Auditing Standards 1, section 320, provides guidance on the study and evaluation of internal accounting control. The bulk of the section applies only if a business has established a system of accounting controls, one of which is segregation of duties. Although the standard anticipates some control weaknesses, it presumes that controls do exist. Small businesses, however, often have limited segregation of duties and, therefore, inadequate accounting control, which makes standards such as SAS 1, section 320, difficult to implement. The standard provides

2. Ibid, p. 133.
minimal guidance on an audit approach when controls are very limited, and it provides little guidance regarding whether the auditor can rely on owner/manager controls or regarding the effect of such reliance on the nature, extent, and timing of audit tests.

Recent organizational changes at the AICPA are attempts to better serve small practitioners. The accounting and review services committee is now a senior technical committee of the AICPA. Originally a subcommittee of the ASB, the committee was established to reconsider AICPA pronouncements applicable to the CPA's association with unaudited financial statements of nonpublic entities. The committee was established because of a need for more guidance than the ASB had provided.

In another organizational change, the AICPA Division for CPA Firms was established by a resolution of the AICPA Council on September 17, 1977. Two membership sections for CPA firms were established: the private companies practice section (PCPS) and the SEC practice section (SECPS). One of the objectives of the PCPS is to "provide a better means for member firms to make known their views on professional matters, including the establishment of technical standards."4

During the interview stage of the research, I encountered some sentiment from interviewees that the composition of the Auditing Standards Board provides the opportunity for a large-firm bias. The perception may result from the fact that large CPA firms, which tend to audit large businesses, are more vocal than small firms. Large CPA firms have research staffs that allow them to prepare their views more thoroughly and persuasively. The board responds to the more vocal members, hence the perception that large CPA firms have more influence over auditing issues. However, Pearson, Lindgren, and Myers examined the voting patterns of the auditing standards executive committee (AudSEC), the predecessor of the ASB, and preliminarily concluded that there is no evidence to suggest that large firms vote as a bloc.5

Some CPAs believe that certain auditing requirements should be eliminated for small business audits. They believe that if a certain Statement on Auditing Standards is not relevant to the small business audit, the auditor should be exempt from it.

Most CPAs have rejected this concept. The Commission on Auditors’ Responsibilities concluded that "there should be no differences in the standards that apply to the performance of audits, whether the audits are of public or private entities."6

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4. AICPA, Division for CPA Firms Private Companies Practice Section Peer Review Manual (New York: AICPA, 1979), p. 3.
Existing Auditing Standards also agrees that a separate set of generally accepted auditing standards is not needed.

An alternative approach, endorsed by the task force, concentrates not on exempting CPAs from applying current standards but on the need for more explicit guidance for applying the standards in small business audits. As I indicated in chapter 1, most CPAs' problems involve the implementation of GAAS, not the concepts contained in GAAS.

The necessary first step is to identify the implementation problems that practicing CPAs encounter. The remainder of the chapter examines the difficulties involved in applying each of the ten generally accepted auditing standards and various Statements on Auditing Standards.

### The General Standards

The first three standards, known as the general standards, deal with the independent auditor's personal qualifications:

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.7

Technical proficiency and exercise of due professional care relate to the auditor, not the client, and they should not be affected by the size of the audited business. On the other hand, the small business auditor may need guidelines for handling situations that may jeopardize his independence.

The problem is that the independence standard involves not just the auditor and his mental attitude but his relationship with the enterprise that he is auditing. Rule 101 of the AICPA Code of Professional Ethics states the following:

A member or a firm of which he is a partner or shareholder shall not express an opinion on financial statements of an enterprise unless he and his firm are independent with respect to such enterprise.8

Any conflict of interest should cause a CPA either to refuse the engagement or to disclaim an opinion on the financial statements.

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Such strict independence may be harder to maintain in a small business environment. Auditors of smaller businesses frequently encounter difficulties in three areas: (a) frequent social and professional contact between the CPA and the client, (b) the auditing of accounting work previously performed by the auditor, and (c) the implicit delegation of management decisions to the auditor.

Frequent Social and Professional Contact

Some critics believe that frequent social and professional contact with clients may impair the auditor's objectivity. Other CPAs claim that frequent contact with clients enables the auditor to obtain a high level of confidence about a client's integrity because of exposure to the daily operation of the client's business and personal affairs. Philip Piaker considers the relationship between the small business and the CPA to be far more intimate, less formal, and characterized by more frequent contact than the relationship between a CPA and a large client. He believes the relationship between the CPA and the client is crucial to the problems of the small business engagement.

Auditing of the CPA's Own Accounting Work

CPAs often provide manual or automated bookkeeping services to clients who are of insufficient size to employ an adequate internal accounting staff. In a large business, employees will have prepared the underlying information that is summarized in the financial statements, but many small businesses lack the accounting expertise necessary to record, classify, and summarize transactions or to prepare financial statements. The auditing of accounting work performed by the CPA may impair the CPA's independence.

When a CPA performs bookkeeping services, he must assess whether the performance of accounting services would "cause his audit to be lacking in a review of mechanical accuracy or [whether] the accounting judgments made by him in recording transactions may somehow be less reliable than if made by him in connection with the subsequent audit." Guidance on maintaining independence is given by ethics interpretation 101-3, which is quoted at the top of page 20.

1. The CPA must not have any relationship or combination of relationships with the client or any conflict of interest which would impair his integrity and objectivity.

2. The client must accept the responsibility for the financial statements as his own. . . . the client must be sufficiently knowledgeable of the enterprise's activities and financial condition and the applicable accounting principles so that he can reasonably accept such responsibility, including, specifically, fairness of valuation and presentation and adequacy of disclosure. When necessary, the CPA must discuss accounting matters with the client to be sure that the client has the required degree of understanding.

3. The CPA must not assume the role of employee or of management conducting the operations of an enterprise. For example, the CPA shall not consummate transactions, have custody of assets or exercise authority on behalf of the client. . . .

4. The CPA, in making an examination of financial statements prepared from books and records which he has maintained completely or in part, must conform to generally accepted auditing standards. The fact that he has processed or maintained certain records does not eliminate the need to make sufficient audit tests.13

Delegation of Management Decisions to the Auditor

In addition to bookkeeping services, management advisory services may be performed by the CPA who subsequently performs an audit. Management often views the auditor as an expert advisor in nonaccounting areas, such as labor relations, computer systems, and marketing studies. In such cases, management may also implicitly delegate decisions to the auditor.

Critics have charged that such activities may impair the auditor's independence; however, the Commission on Auditors' Responsibilities reviewed the controversy over management services and found only one instance in which the auditor's independence had been compromised.14 Perhaps the results of the commission's study indicate that independence is impaired more in appearance than in fact.

K.J. Sharp has suggested a resolution for situations in which a CPA firm provides both auditing and either accounting or management advisory services.15 He advocates assigning the work to two separate teams. Some smaller CPA firms, however, lack sufficient personnel to staff two separate divisions, one to provide accounting services and the other to provide solely auditing services.

13. Ibid.
The Field Work Standards

The second group of standards provides the independent auditor with guidance on how to perform the audit:

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.16

Planning and Supervision

The need to perform audit tests on or after the balance sheet date because of doubts concerning the reliability of internal accounting controls is a constraint to planning the small business audit. In the audit of a larger business, the auditor may be able to perform many tests before year end due to strong internal accounting controls.

Large businesses have internal audit staffs and accounting personnel who can help locate invoices and correspondence or prepare certain financial information. This assistance may not be available when the CPA audits a small business. In planning the timing of his tests, the auditor must consider the effect that absence of certain client assistance has on his work.

Finally, more experienced personnel are needed at the lowest level to audit a small business. An informal recordkeeping system and weaknesses in internal accounting control increase the possibility that transactions will go unrecorded. Personnel with sufficient audit experience are needed to assess the completeness of recorded transactions, to apply analytical review procedures, and to detect errors that could affect the reliability of the financial statements. The audit of a small business requires fewer personnel and therefore has fewer levels of supervision and review than the audit of a large business, but, since the auditors’ work is subject to less supervision and review, the lower level personnel must be more experienced than those in large business audits.

Evaluation of Internal Accounting Control

Internal control encompasses both administrative and accounting controls. Administrative control includes the plan of organization and the procedures and records that are concerned with the decision processes

16. AICPA, Statement on Auditing Standards 1, sec. 150.02.
leading to management's authorization of transactions. Accounting control comprises the plan of organization and the procedures and records concerned with the safeguarding of assets and the reliability of financial records. Accounting control is designed to provide reasonable assurance that—

a. Transactions are executed in accordance with management's general or specific authorization.
b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
c. Access to assets is permitted only in accordance with management's authorization.
d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.¹⁷

The study and evaluation of existing internal accounting controls may be significantly affected by characteristics of the small business. The small business often does not have sufficient personnel or financial expertise to implement an effective system of internal accounting control. Accounting functions may be performed by only two or three employees; therefore, one employee may have both asset custody and recordkeeping responsibilities. As a consequence, many small businesses lack one of the most important control features, adequate segregation of duties. The lack of segregation of duties often means an inadequate accounting control system.

To compensate for control deficiencies, an auditor may decide to rely on owner/manager controls.

**Nature of Owner/Manager Controls.** The AICPA Task Force on Review of Existing Auditing Standards has defined owner/manager controls as follows:

An owner/manager control is either a primary or secondary control that is performed by an owner, manager, or other employee having responsibility for achieving the objectives of the entity and the authority to establish the policies and make the decisions by which such objectives are to be pursued. Such control procedures are designed to achieve, or contribute to the achievement of, one or more objectives of internal accounting control.¹⁸

Primary control procedures are designed to achieve specific control objectives; secondary control procedures include administrative controls that contribute to the specific control objectives. An example of a primary control procedure is the reconciliation of bank accounts; an example of a secondary control procedure is comparison of recorded transactions and account balances with expected results based on budgets, standard costs, or prior experience.\textsuperscript{19}

CPAs are divided in their opinions on whether owner/manager controls can compensate for an inadequate segregation of employee duties, since there often are no independent controls over management. Herbert Stelzer states that the scope of administrative functions, such as budgets, cash projections, internal reports, and quality control, can strengthen internal accounting control.\textsuperscript{20} Meigs, Larsen, and Meigs suggest that the auditor encourage installation of internal accounting control procedures that are practical for the small business. When accounting duties cannot be adequately segregated, the owner should participate in certain functions.\textsuperscript{21} Alvin Arens and James Loebbecke state that the major controls in a small business are the duties performed by the owner/manager.\textsuperscript{22}

William Grollman and Robert Colby believe that the limitations of an internal accounting control system can be offset by executive controls when the executive—

Effectively uses accounting information in budgeting, planning, and day-to-day managing of the business.

Seeks explanations for discrepancies between the accounting information with which he is provided and his expectations based on his knowledge of the business.

Is aware of the potential meaning of unusual items, customer complaints, etc., which come to his attention.

Enlists nonaccounting employees (e.g., receptionists, secretaries) to perform certain accounting control functions on a part-time basis where the segregation of duties is important.

Requires his prior authorization of certain (types or amounts) of transactions or his personal approval before or when payment is made.\textsuperscript{23}

\textsuperscript{19} AICPA, Statement on Auditing Standards 30, \textit{Reporting on Internal Accounting Control} (New York: AICPA, 1980), \textsuperscript{¶¶} 23–24.


If these conditions are satisfied, Grollman and Colby believe that executive control, if strong and well placed, compensates for otherwise weak internal accounting controls. The weakness in the Grollman and Colby position is that three of the five situations are examples of secondary controls that can only be tested by inquiry and observation, which are less reliable than detailed compliance tests; therefore, they may not provide sufficient assurance of the accuracy and reliability of the accounting records.

Reliance on Owner/Manager Controls. The professional literature does not present a definitive position concerning reliance on owner/manager controls. SAS 1, section 320, discusses the involvement of the owner/manager:

Accounting control procedures may be performed by personnel in any appropriate organizational position. In smaller organizations such procedures may be performed by the owner-manager. In these circumstances, however, some of the limitations discussed in paragraph 34 may be particularly applicable.24

Paragraph 34 of section 320 discusses the inherent limitations that the auditor should recognize in considering the potential effectiveness of any accounting control system. Specifically in relation to the owner/manager involvement, the statement cautions that procedures designed to ensure the execution and recording of transactions in accordance with management's authorizations may be ineffective against errors or irregularities perpetrated by management.

In testing internal accounting control, the auditor must exercise judgment regarding the nature and extent of the tests. Professional literature indicates that the auditor may rely on owner/manager controls, but the auditing standards offer no guidance on the study and evaluation of such controls. CPAs need guidance on whether reliance is appropriate, when it is appropriate, and what procedures could be used to test for management override of the controls.

Audit Evidence

To perform an audit in compliance with GAAS, the auditor must obtain sufficient evidence regarding representations contained in the client's financial statements. Evidence consists of the underlying accounting data and other corroborating information available to the auditor, such as documents supporting transactions, books of original entry, general and subsidiary ledgers, worksheets, and other documents that corroborate

24. AICPA, Statement on Auditing Standards 1, sec. 320.35.
assertions in the financial statements. The evidence may be either internal or external.

The only stipulation is that the evidence must be "competent." "To be competent, evidence must be both valid and relevant." Validity is a function of the circumstances under which evidence is obtained; for example, external information provides greater reliability than internal information. Data developed under an adequate system of accounting control are more reliable than information produced by an inadequate accounting control system, and direct information is more persuasive than indirect information.

Sufficiency of evidential matter must be determined by the auditor’s professional judgment. The auditor must consider the amount and kind of evidence required to support an informed opinion. In many cases the auditor finds it necessary to rely on evidence that is persuasive rather than convincing; however, the auditor may not form an opinion until he has obtained sufficient evidence to remove substantial doubt. He must issue a qualified opinion or a disclaimer if in his evaluation the evidence is insufficient.

Because of the need for sufficient, competent evidential matter, the maintenance of accurate accounting records is extremely important to the small business. Accurate accounting records are required for a company to be auditable. If internal accounting control deficiencies exist, a company may still be auditable; however, a company with inadequate or inaccurate accounting records may not be auditable.

Alan Largin suggests that the failure of many small businesses to maintain adequate records contributes to the collapse of thousands of companies each year. Therefore, adequate records are important not only to the audit process but to the very survival of the company.

The small business’s recordkeeping functions may be informal, incomplete, and inaccurate. Smaller businesses with informal procedures may fail to document board of directors’ meetings, authorization of transactions, credit approval, and purchase orders. Informal, incomplete, or inaccurate records may force the auditor to extend his substantive testing to achieve the competency and sufficiency of evidence required for an opinion on the client’s financial statements.

Informal recordkeeping increases the potential for unrecorded or inaccurately recorded transactions. The auditor may choose to use management representations as a source of evidence if these representations are consistent with corroborating evidence. Management repre-

sentations are internal evidence and, when used without other corrobo­
rating evidence, are less reliable than external evidence. Management
representations are a part of evidential matter but "are not a substitute
for the application of those auditing procedures necessary to afford a
reasonable basis for his opinion on the financial statements."28 SAS 19,
Client Representations, states that "unless the auditor's examination
reveals evidential matter to the contrary, his reliance on the truthfulness
of management's representations is reasonable."29 However, the auditor
must refrain from forming an opinion if he has substantial doubts
regarding the representations in the financial statements.

The Reporting Standards
The last group of auditing standards, the reporting standards, are also
affected by the characteristics of the small business. The four reporting
standards require the following:

1. The report shall state whether the financial statements are presented in
   accordance with generally accepted accounting principles.
2. The report shall state whether such principles have been consistently
   observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as
   reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the
   financial statements, taken as a whole, or an assertion to the effect that an
   opinion cannot be expressed. When an overall opinion cannot be expressed,
   the reasons therefor should be stated. In all cases where an auditor's name
   is associated with financial statements, the report should contain a clear-cut
   indication of the character of the auditor's examination, if any, and the
   degree of responsibility he is taking.30

Conformity with generally accepted accounting principles and their
consistent application may be more difficult to determine in the small
business audit because of the informal records and accounting control
systems. Inadequate recordkeeping may also make it harder for the
auditor to determine whether disclosure of relevant information is ade­
quate. Evaluation of the adequacy of disclosure is further complicated by
the lack of accounting and financial reporting knowledge possessed by
the small business management and employees.

28. AICPA, Statement on Auditing Standards 19, Client Representations (New York:
   AICPA, 1977), ¶ 2.
29. Ibid, ¶ 3.
30. AICPA, Statement on Auditing Standards 1, sec. 150.02.
According to the CPAs interviewed, these problems are relatively minor in comparison with the difficulty encountered in justifying an unqualified opinion on the financial statements of the small business. The auditor of a small business with inadequate internal accounting control may not feel confident in expressing an unqualified opinion on the financial statements because, even though no explicit manipulation of financial statements was found, the inadequate internal accounting control system increases the potential for manipulation. In certain audit situations, the absence of corroborating evidence to support management representations contained in the financial statements also may make the auditor uncomfortable about issuing an unqualified opinion.

Most audit problems involving informal recordkeeping procedures, inadequate accounting controls, and acceptance of management representations are audit evidence issues, not reporting issues. Therefore, the AICPA is concentrating its efforts on the auditability of an entity and the completeness of audit evidence. An AICPA task force has been formed to consider the need for guidance on (1) considerations affecting the auditability of an entity and related tests of evidential matter and (2) whether satisfaction of the completeness objective of evidential matter necessitates some reliance on internal accounting control. The task force will develop guidance to amend SAS 1, section 320, if necessary. The efforts of this task force are directed to all entities, not just small businesses, although small business issues may be discussed.

Although the U.S. perspective is that these small business audit problems are audit evidence issues, professional organizations of other countries have dealt with them as reporting issues. The Canadian Institute of Chartered Accountants, the Auditing Practices Committee of the Consultative Committee of Accountancy Bodies, the Institute of Chartered Accountants in England and Wales, and the Irish Institute of Chartered Accountants have proposed or recommended reporting formats that express limited assurance in small business audits. The efforts of this task force are directed to all entities, not just small businesses, although small business issues may be discussed.

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For example, the Institute of Chartered Accountants in England and Wales allows a qualified "subject to" opinion for small businesses when the auditor must accept the assurances of management about the completeness or accuracy of the accounting records. The scope paragraph is similar to the standard scope paragraph of an unqualified opinion. The second paragraph reads as follows:

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 major 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.32

Statements on Auditing Standards

Although Statements on Auditing Standards are formally distinct from the ten generally accepted auditing standards, they are enforceable under the AICPA Code of Professional Ethics, rule 202. The auditor has the same ethical responsibility for the Statements on Auditing Standards as for the ten generally accepted auditing standards. Therefore, most practitioners refer to auditing pronouncements and the ten generally accepted auditing standards as "auditing standards."

In some cases, auditors experience difficulty applying certain Statements on Auditing Standards in small business audits. The following often prove troublesome:

SAS 6—Related Party Transactions
SAS 12—Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments
SAS 19—Client Representations
SAS 20—Required Communication of Material Weaknesses in Internal Accounting Control
SAS 23—Analytical Review Procedures

Related-Party Transactions

Before Statement of Financial Accounting Standards 57, Related Party Disclosures, was issued, SAS 6, Related Party Transactions, provided the

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32. Institute of Chartered Accountants in England and Wales, Auditing Standards and Guidelines, p. 55. The "subject to" opinion used in England and Wales for reporting on small businesses would be a scope limitation in the United States, and an "except for" opinion would be issued.
guidance on related-party disclosures. SAS 6 requires the auditor to identify related-party transactions and satisfy himself regarding their substance, accounting, and financial statement disclosure. Related parties include the reporting entity and its affiliates; principal owners, management, and members of their immediate families; entities for which investments are accounted for by the equity method; and any party with which the reporting entity may deal when one party has the ability to influence significantly the management or operating policies of the other, to the extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Related-party transactions include transactions between a parent company and its subsidiaries, its principal stockholders, or other affiliated businesses. Examples of related-party transactions that could involve questionable substance are interest-free borrowing or lending, selling of assets at a price significantly different from their market value, or making of loans with no scheduled repayment terms.

Because of small businesses' informal recordkeeping, weak internal accounting controls, or lack of board of directors' minutes, related parties may be difficult for the auditor to identify. The existence of related parties and related-party transactions is difficult to determine when the auditor must rely heavily on inquiry of management. In these circumstances, the auditor is exposed to increased risk.

CPAs may need additional guidance for identifying related-party transactions, evaluating the substance of the transactions, and corroborating management's representations regarding the existence of related parties and related-party transactions.

Inquiry of a Client's Lawyer

SAS 12, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments, requires the auditor to obtain evidence regarding the existence of a "condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments." The statement acknowledges that the auditor ordinarily does not possess legal skills and therefore cannot make legal judgments. The auditor should request the client management to authorize a letter of inquiry to the client's lawyers for purposes of obtaining evidence about these matters.

33. FASB, Statement of Financial Accounting Standards 57, Related Party Disclosures (Stamford, Conn.: FASB, 1982).
Many small businesses do not retain lawyers on a permanent basis, and the statement offers no guidance for such situations. The AICPA Technical Practice Aids offer the necessary guidance in these circumstances:

The auditor may express an unqualified opinion even though he has not obtained a letter from legal counsel of the company. The auditor should obtain written representation from Company A that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation.36

If the auditor has no evidence of outstanding legal matters, and the client has not consulted an attorney, the auditor is not required to confirm with a consulting attorney the absence of litigation.37

A second problem relating to SAS 12 is that lawyers often provide apparently deficient responses. Legal language, such as meritorious defenses or without substantial merit, may be difficult to interpret in terms of auditors' needs, and a response consisting of such language may prove deficient for his purposes. The problem is compounded when small business management is unaware of the auditor's specific needs since management provides instructions to the attorney regarding his response. Therefore, deficient responses are often the result of inadequate instructions. SAS 12 does not offer adequate guidance on evaluating or taking appropriate action on deficient responses from the client's attorney.

A third problem deals with the illustrative letter to legal counsel presented in the appendix to SAS 12. Management is expected to describe asserted pending or threatened litigation, detailing (1) the nature of the litigation, (2) the progress of the case, (3) how management is responding, and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate of potential loss. Except for details about the progress of the case, all these matters are also required for unasserted claims. Small business management may not be able to provide such information. An illustrative letter requesting the lawyer to prepare a description of all material asserted litigation, claims, and assessments, such as the one illustrated by Dan M. Guy, might be helpful, but the AICPA has not issued such guidance.38

37. Ibid, sec. 8340.10.
Management Representation Letter

SAS 19, *Client Representations*, requires the independent auditor to obtain written representations from management regarding inquiries or assertions made by management in the financial statements. The following are examples of typically requested client representations:39

- Management is responsible for the fair presentation of the financial statements.
- Management has made available all financial records.
- There are no irregularities involving management.
- There are no violations of laws or regulations whose effects should be considered for disclosure.

Small business managers exhibit considerable misunderstanding about the purpose of the representation letter.40 The client may not understand the need for such a letter in view of the audit procedures performed by the CPA. Small businesses with limited accounting knowledge tend to believe that they hire auditors to perform certain accounting services and to verify the accuracy of the financial statements. The owner/manager often does not understand that even though the auditor may have prepared the financial statements, management is still responsible for them. When the auditor prepares the statements or performs other accounting services, the owner/manager views it as contradictory to sign a statement that management is responsible for the financial statements.

Possibly the auditor could alleviate management fears by providing definitions for technical terms, such as *irregularities* and *unasserted claims*. Other modifications might include management representations about the proper segregation of business and personal items, capital account transactions, and acknowledgement of the auditor’s recommended adjusting journal entries.41

Material Weaknesses in Internal Accounting Control

SAS 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, requires the auditor to communicate material weak-

nesses in internal accounting control to senior management and the board of directors or its audit committee. A material weakness in internal accounting control is defined by SAS 1, section 320.68, as amended by SAS 30, *Reporting on Internal Accounting Control*:

>a condition in which the specific control procedures or the degree of compliance with them do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.42

SAS 20 does not require the communication to be written (although, if the auditor elects to communicate weaknesses orally, the communication must be documented in the audit workpapers), but it does require that communication be made whether or not corrective action is practicable. Many small businesses have internal accounting control deficiencies that are not practicable to correct. SAS 20 does not illustrate how these weaknesses may be communicated in a manner that is meaningful to small business management. Practitioners also believe that it is redundant and an unjustified expense to repeat annually the same internal accounting control problems when correction is not cost-beneficial. SAS 20 is essentially a defensive document designed to protect the auditor. Evidence that weaknesses were communicated to management avoids negligence litigation claiming that management was not aware of weaknesses that ultimately were responsible for financial loss. The AICPA may have to reconsider the statement’s relevance to small business audits or expand it to provide guidance to auditors of small businesses.

**Analytical Review Procedures**

SAS 23, *Analytical Review Procedures*, provides guidance to the auditor when he applies analytical review procedures, which are substantive tests of financial statement information made by a study and comparison of relationships among data. Analytical review procedures include the comparison of financial statement information with data from prior periods, with anticipated results, and with industry information; the study of expected financial relationships; and the study of relationships between financial and nonfinancial information. These tests may be used by the independent auditor in three different stages of the audit:43

- In the initial planning stage to determine financial statement areas that will require more or less attention than they received in the last audit

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42. AICPA, Statement on Auditing Standards 30, Appendix.
• During the examination as a substitute for direct tests of account balances

• At or near the end of the audit as an overall test of reasonableness for selected items or financial statement relationships

My interviews with CPAs indicated different levels of understanding about the nature, purpose, and practical application of analytical review procedures. SAS 23 is general in nature, whereas the auditing profession appears to need specific auditing guidance regarding how analytical review procedures can be applied at various stages during the audit and regarding the risks associated with the use of these procedures. SAS 23 discusses the nature of analytical review procedures and when they may be performed, but it only briefly mentions the integration of tests of details of transactions and balances and analytical review procedures and refers the auditor to SAS 1, section 320.73, for additional guidance. No specific examples are provided.

SAS 23 addresses factors that should be considered when applying analytical review procedures, such as the nature of the entity, the scope of the engagement, and the reliability of financial information. Although these factors involve general audit risks, the statement does not address the risks of an inappropriate conclusion based on the results of these procedures. If they do not yield the expected financial statement relationships, these procedures provide an indication that the auditor may need to extend his testing; but if the results do provide the expected relationships, an auditor cannot automatically restrict his other audit procedures because financial statement errors can still exist.44

The confusion about the risk of using analytical review procedures in small business audits is evidenced by the existence of two contrasting schools of thought among auditors. One school suggests that analytical review procedures are inherently more risky than other substantive procedures that test account balances or transactions directly. Therefore, in audits of entities with limited segregation of duties and weak internal accounting control, analytical review procedures may provide less competent evidence than would direct substantive tests of account balances and transactions.

The other school of thought suggests that the risk of using analytical review procedures may be offset by the value of these tests in an environment with limited segregation of duties.45 These procedures may contribute to greater understanding and assurance of the accuracy and


45. Defliese et al., Montgomery's Auditing, p. 145.
reliability of the financial statements by providing a cumulative reduction in the level of uncertainty as each expected relationship is confirmed. This school, therefore, would replace certain tests of account balances and transactions with analytical review procedures, whereas the other school would perform only limited analytical review procedures in audits of small businesses with limited segregation of duties.

Evidence of Uncertainty in the Accounting Profession

In interviews with practicing CPAs, I found that they tend to ignore certain standards when they encounter difficulty or uncertainty in applying GAAS in small business audits. Also, they tend to interpret standards according to the client’s or their own best advantage or to apply certain standards in a manner that places form over substance. Since standards set the minimum level of performance, some CPAs are performing unacceptable work. For example, some auditors erode SAS 20 by interpreting “material weaknesses in internal accounting control” to mean only those weaknesses that are cost-beneficial to correct.

Thus, the interviews both helped me to identify specific audit problems and reinforced my awareness of the need for precise guidance on small business audits.

Identification of audit problems was not enough, however; I needed to examine the audit problems discussed in this chapter in terms of frequency of occurrence and importance to the completion of the audit. Chapter 4 will explain how I conducted this research.
Research Design and Method

This chapter reviews the methods of data collection and analysis used in this research study. The chapter explains the methods that were used to identify potential audit problems for inclusion in the questionnaire; it describes the design of the questionnaire, and it discusses the selection of the population sample to which the questionnaire was mailed. Data analysis procedures are also discussed.

Audit Problem Identification

I identified small business audit problems by reviewing the professional literature, interviewing partners of CPA firms engaged in small business audits, and reviewing letters received from CPAs by the AICPA Review of Existing Auditing Standards Task Force. Interviews were conducted in Chicago, New York, Arlington, Dallas, Fort Worth, Houston, Lubbock, and Plainview, Texas. The twenty-two interviews provided insight into the major implementation problems encountered in audits of small businesses.

Questionnaire Design

There were three stages in the design of the questionnaire: (1) initial preparation, (2) pretest, and (3) revision. After identifying the audit problems, I designed a questionnaire to determine the frequency of occurrence and the importance of the audit problems.
The questionnaire is divided into four sections:

Section I. General Information
Section II. Questions Related to Audit Problems
   A. Questions Related to Frequency
   B. Questions Related to Importance
Section III. Questions Related to Audit Approach
Section IV. Information on Responding CPA Practice Offices

The questionnaire is reproduced in Appendix A.

Initial Preparation of the Questionnaire

Section I. Section I solicited information on the respondent's title and public accounting experience. In addition, respondents were asked to indicate the number of hours required to complete the typical small business audit and to select from a list of characteristics those attributes that describe their typical small business audit clients.

Section II. Section II of the questionnaire gathered information on frequency and importance of various audit problems encountered by the CPA. This section used a Likert-type scale that allowed the CPA to express his views on both frequency and importance of small business auditing problems. A series of statements was presented that required the respondent to indicate the frequency with which he encounters various problems. Frequency was measured by the following scale points:

1. NEVER .................. — The audit problem NEVER OCCURS.
2. RARELY .................. — The audit problem occurs LESS THAN 25% of the time.
3. OCCASIONALLY ........... — The audit problem occurs 25-50% of the time.
4. FREQUENTLY ............. — The audit problem occurs 51-75% of the time.
5. USUALLY .................. — The audit problem occurs MORE THAN 75% of the time.

The scale points for importance of various auditing problems were—

1. UNIMPORTANT ............. — The audit problem has NO EFFECT on your ability to complete the audit.
2. SOMEWHAT IMPORTANT ... — The audit problem has a SLIGHT EFFECT on your ability to complete the audit.
Respondents were instructed to judge importance by three factors:

1. Uncertainty in the application of generally accepted auditing standards (GAAS) in the small business audit;
2. Changes in the audit approach or procedures due to the special characteristics of the small business;
3. The issuance of an audit opinion that is different from the one that would have been issued had the audit problem not existed.

Sections III and IV. Section III posed several questions related to the audit approach in the small business engagement. This section included closed and open-ended questions to obtain information on how the CPA audits a small business. Section IV collected data on the characteristics of practice offices that responded to the questionnaire. This information was used to determine how attitudes toward small business audit problems are affected by the following respondent characteristics: (1) practice office size, (2) amount of practice office revenues, (3) years that the practice office has been in existence, and (4) hours required to audit the typical small business client.

Questionnaire Pretest Procedures

The initial questionnaire was administered to twenty-two CPAs. The characteristics of the pretest group correspond reasonably well with those of the final respondents. The pretest was designed to determine ambiguities in wording, incompleteness of a question, difficulties in responding to the questions, and completion time. Each pretest reviewer was asked to submit a written list of suggestions for improving the questionnaire. The items in the questionnaire were then reviewed for (1) applicability to the research objectives, (2) clarity, (3) lack of bias, (4) knowledge level demanded of the respondent, and (5) sensitivity (for example, whether a respondent firm is a member of the private companies practice section or the SEC practice section of the AICPA).
The pretest was administered, either by mail or in person, to the following groups:

- Audit personnel of the CPA firms with representatives serving on the Auditing Standards Board
- Audit personnel of the CPA firms with representatives serving on the AICPA Task Force on Review of Existing Auditing Standards and without representatives on the Auditing Standards Board
- Certain practitioners in Lubbock, Texas (who were also interviewed after they completed the questionnaire)
- Several academicians

Only minimal adjustments were made to the questionnaire as a result of the pretest findings. Definitions were added for certain technical terms used within a question; certain questions were omitted because of time constraints; certain categories used in a question were redefined; and the wording of certain questions was made more direct.

**Sample Design and Selection**

The population sampled for questionnaire mailing was 29,500 CPA practice offices in the United States, as listed by the AICPA data base for mailing of SAS exposure drafts. Many CPA firms have multiple offices, each of which is a practice office; thus, a firm with multiple offices could be selected more than one time in the sample. I needed a sample size that would be sufficient to enable unbiased generalization of the results and to meet the assumptions of the statistical tests that were used. A systematic selection of every twentieth item from a random starting point resulted in a sample size of 1,475 practice offices. This sample size is adequate to provide the minimum expected cell frequency of five items, as required for the chi-square analysis.¹

**Survey Response**

In October 1980 the American Institute of Certified Public Accountants mailed a letter to all CPAs in the sample to notify them that the questionnaire was forthcoming. The letter advised CPAs that the AICPA was sponsoring a research project on small business audit problems and

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emphasized the importance of a response. The letter is presented in Appendix B.

When the letter was mailed to the CPAs, the AICPA discovered that forty-four addresses were out of date and that new ones were not available. Therefore, the original sample size of 1,475 was reduced to 1,431.

The questionnaires were mailed on November 7, 1980; second requests were mailed on December 12, 1980. At the cutoff date of January 31, 1981, 739 questionnaires had been returned, resulting in a response rate of 51.6 percent. Of the 739 questionnaires returned, 200 were not completed, according to the questionnaire instructions, because the CPAs performed no audit work. Of the remaining 539 questionnaires, 526 were usable responses, five were incomplete, and eight were unusable because the respondents’ clients were from specialized industries. The complete summary of questionnaire responses is presented in figure 4.1.

![Figure 4.1](image)

**Summary of Questionnaire Response Rates**

<table>
<thead>
<tr>
<th>Category</th>
<th>Number</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Usable responses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>First request</td>
<td>422</td>
<td>29.5</td>
</tr>
<tr>
<td>Second request</td>
<td>104</td>
<td>7.3</td>
</tr>
<tr>
<td></td>
<td>526</td>
<td>36.8</td>
</tr>
<tr>
<td>No audit clients</td>
<td>200</td>
<td>14.0</td>
</tr>
<tr>
<td>Incomplete response for data analysis</td>
<td>5</td>
<td>.3</td>
</tr>
<tr>
<td>Performs only governmental audits</td>
<td>8</td>
<td>.5</td>
</tr>
<tr>
<td></td>
<td>739</td>
<td>51.6</td>
</tr>
<tr>
<td>No response</td>
<td>692</td>
<td>48.4</td>
</tr>
<tr>
<td></td>
<td>1,431</td>
<td>100.0</td>
</tr>
</tbody>
</table>

The response rate was excellent for a mail questionnaire. The expected response rate was 50 percent. Because the actual and expected response rates were approximately equal, I did not try to obtain additional responses after the second mailing.

**Respondent Demographics**

Figure 4.2 portrays respondent demographics. Partners of CPA firms and sole proprietors represented over 80 percent of the total respondents.
## Figure 4.2
### Summary of Respondent Demographics

<table>
<thead>
<tr>
<th>Respondent's Title</th>
<th>Number</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner</td>
<td>223</td>
<td>42.4</td>
</tr>
<tr>
<td>Sole proprietor</td>
<td>204</td>
<td>38.8</td>
</tr>
<tr>
<td>Manager</td>
<td>49</td>
<td>9.3</td>
</tr>
<tr>
<td>Private corporation</td>
<td>29</td>
<td>5.5</td>
</tr>
<tr>
<td>No response</td>
<td>21</td>
<td>4.0</td>
</tr>
<tr>
<td></td>
<td>526</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Practice Office Size</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole practitioner</td>
<td>130</td>
<td>24.7</td>
</tr>
<tr>
<td>1–10 professionals</td>
<td>271</td>
<td>51.5</td>
</tr>
<tr>
<td>11–30 professionals</td>
<td>82</td>
<td>15.6</td>
</tr>
<tr>
<td>31–50 professionals</td>
<td>17</td>
<td>3.2</td>
</tr>
<tr>
<td>51–70 professionals</td>
<td>10</td>
<td>1.9</td>
</tr>
<tr>
<td>71–90 professionals</td>
<td>4</td>
<td>.8</td>
</tr>
<tr>
<td>More than 90 professionals</td>
<td>9</td>
<td>1.7</td>
</tr>
<tr>
<td>No response</td>
<td>3</td>
<td>.6</td>
</tr>
<tr>
<td></td>
<td>526</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number of Years Practice Office in Existence</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 6</td>
<td>127</td>
<td>24.2</td>
</tr>
<tr>
<td>6–10</td>
<td>120</td>
<td>22.8</td>
</tr>
<tr>
<td>11–15</td>
<td>57</td>
<td>10.8</td>
</tr>
<tr>
<td>16–20</td>
<td>39</td>
<td>7.4</td>
</tr>
<tr>
<td>21–25</td>
<td>57</td>
<td>10.8</td>
</tr>
<tr>
<td>26–30</td>
<td>37</td>
<td>7.0</td>
</tr>
<tr>
<td>31–35</td>
<td>30</td>
<td>5.7</td>
</tr>
<tr>
<td>36–40</td>
<td>10</td>
<td>1.9</td>
</tr>
<tr>
<td>41–45</td>
<td>6</td>
<td>1.2</td>
</tr>
<tr>
<td>46–50</td>
<td>10</td>
<td>1.9</td>
</tr>
<tr>
<td>More than 50</td>
<td>29</td>
<td>5.5</td>
</tr>
<tr>
<td>No response</td>
<td>4</td>
<td>.8</td>
</tr>
<tr>
<td></td>
<td>526</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Percentage of Audit Revenues to Total Revenues</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 6%</td>
<td>49</td>
<td>9.3</td>
</tr>
<tr>
<td>6–25%</td>
<td>245</td>
<td>46.6</td>
</tr>
<tr>
<td>26–45%</td>
<td>120</td>
<td>22.8</td>
</tr>
<tr>
<td>46–65%</td>
<td>66</td>
<td>12.5</td>
</tr>
<tr>
<td>66–85%</td>
<td>37</td>
<td>7.0</td>
</tr>
<tr>
<td>More than 85%</td>
<td>6</td>
<td>1.2</td>
</tr>
<tr>
<td>No response</td>
<td>3</td>
<td>.6</td>
</tr>
<tr>
<td></td>
<td>526</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Years Public Accounting Experience</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>15.6 years</td>
<td></td>
</tr>
<tr>
<td>Range</td>
<td>1–50 years</td>
<td></td>
</tr>
</tbody>
</table>

40
The majority of the respondents (51.5 percent) were from practice offices with one to ten professionals. The next largest category comprised sole practitioners (24.7 percent).

At first glance, there might appear to be an inconsistency in the number of sole proprietors responding (204) and the number of sole practitioners responding (130). A sole practitioner primarily practices in an office by himself, whereas sole proprietorship is a form of ownership. A respondent may be a sole proprietor and practice with others, which might place him in the sole proprietor category and in the one-to-ten-professionals category.

The respondents’ average public accounting experience was 15.6 years, with a range of one to fifty years. Practice offices representing the majority of respondents (57.8 percent) had been in existence for less than fifteen years. Approximately 16 percent of responding practice offices had been in existence longer than thirty years.

The largest responding group of CPAs (46.6 percent) represented practice offices that generate audit revenues (exclusive of tax and systems work) of 6 to 25 percent of total revenues. This category represents practice offices for which audits are not the primary source of revenues.

Tests for Nonresponse Bias

I applied several procedures to examine potential nonresponse bias and content validity of the research design. First, a second mailing was sent to those who did not respond to the first request. Then, selected characteristics of the first wave were compared with those of the second wave. The five characteristics compared were the respondent’s total years of public accounting experience, the number of hours required to complete the typical small business audit, the size of the practice office, practice office revenues, and the number of years the practice office has been in existence.

Next, I telephoned a sample of twelve CPA practice offices that did not respond. Ten of the twelve said that they had no time to complete the questionnaire; one said that he had only tax clients and therefore did not respond, and one said that he had no interest in the project. The sample of twelve nonrespondents provides insight into the probable cause of nonresponse.

A geographical comparison showed that a representative proportion of respondents from each geographical area did reply. A comparison of CPAs sampled from each state with the respondents from each state resulted in a response range from 33 to 100 percent. An acceptable response was received from each state.
The first wave resulted in 422 usable responses, and the second wave resulted in 104 usable responses. The total response rate was 51.6 percent.

Figure 4.3 tabulates the comparative values used to investigate nonresponse bias. The respondents' average total years of public accounting experience was 15.8 years for the first wave and 14.8 years for the second wave. The two groups showed no differences in CPA practice office characteristics. The geographical comparison showed that no state had a response rate below 33.3 percent; therefore, there is no apparent geographical bias in the responses that would impair generalization to the entire sample population. Appendix C summarizes the geographical distribution of the sample and comparable response rates.

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Mean of First Wave</th>
<th>Mean of Second Wave</th>
<th>Category Represented</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total years public accounting experience</td>
<td>15.8</td>
<td>14.8</td>
<td>n/a</td>
</tr>
<tr>
<td>Audit hours required to complete the small business audit</td>
<td>3.7</td>
<td>3.8</td>
<td>81–120 hours²</td>
</tr>
<tr>
<td>Practice office size of the respondent</td>
<td>2.1</td>
<td>2.2</td>
<td>1–10 professionals</td>
</tr>
<tr>
<td>Number of years the practice office has been in existence</td>
<td>3.7</td>
<td>3.9</td>
<td>11–15 years</td>
</tr>
<tr>
<td>Audit revenues as a percent of total revenues</td>
<td>2.6</td>
<td>2.6</td>
<td>6–25%</td>
</tr>
</tbody>
</table>

1. The means given for first and second waves for all but the first category, experience, are expressed in terms of questionnaire category means; the numbers have no inherent value.
2. Other categories can be referenced in the questionnaire that is contained in Appendix A.

Generally, lack of response to a questionnaire study results from apathy or a fear of expressing ignorance. I did not investigate the extent to which these factors may have contributed to the nonresponses.

I do not believe that the nonresponses affect the conclusions or validity of this study.
Figure 4.4
Development of Significance Values

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Unimportant (1)</th>
<th>Slightly Important (2)</th>
<th>Moderately Important (3)</th>
<th>Important (4)</th>
<th>Extremely Important (5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Never (1)</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Rarely (2)</td>
<td>2</td>
<td>4</td>
<td>6</td>
<td>8</td>
<td>10</td>
</tr>
<tr>
<td>Occasionally (3)</td>
<td>3</td>
<td>6</td>
<td>9</td>
<td>12</td>
<td>15</td>
</tr>
<tr>
<td>Frequently (4)</td>
<td>4</td>
<td>8</td>
<td>12</td>
<td>16</td>
<td>20</td>
</tr>
<tr>
<td>Usually (5)</td>
<td>5</td>
<td>10</td>
<td>15</td>
<td>20</td>
<td>25</td>
</tr>
</tbody>
</table>

Note: The shaded area indicates values that are considered significant; that is, the values are greater than or equal to 8.0.

Data Analysis Procedures

I performed various statistical tests on the data that I collected from the questionnaire, particularly in regard to the significance variable. The statistical tests involved chi-square and analysis of variance. Readers with an interest in statistics should consult my unpublished dissertation, "An Empirical Study of Audit Problems Encountered With Small Business Engagements," for a discussion of these procedures; I shall spare other readers the technical considerations. In this section I confine myself to a discussion of the significance variable.

Audit problems were examined in terms of frequency of occurrence and importance to the completion of the audit. Neither frequency nor importance alone measures the practical significance of a specific auditing problem. A problem can occur but not have audit importance if it does not have an effect on the procedures performed or the audit opinion expressed. Conversely, if a problem has a potential material effect on the audit opinion or procedures but occurs infrequently, there is little recurring benefit to the auditor in considering the potential problem in planning the audit. Significant areas of concern are those problems that occur frequently and are also important.

For each completed questionnaire returned by the respondents, I multiplied numerical scale points for frequency by numerical scale points for importance to produce a compound significance variable. To be significant, a particular audit problem must receive a mean value for significance of eight or more scale points. Thus, to be significant, as defined in this study, a problem must either occur at least rarely (2 points) and be at least important (4 points) or be at least slightly important (2 points) and occur at least frequently (4 points). Possible combinations of scale points are presented in figure 4.4.

The mean value of computed significance is used to quantify the respondents' apparent difficulty with a particular auditing problem. The higher the significance mean, the greater difficulty encountered by the auditors. The audit problems from section II of the questionnaire were then ranked in order from those causing the most difficulty to those causing the least difficulty.
Research Findings: Significant Small Business Audit Problems

This chapter analyzes the data from section II of the questionnaire. The data contained in sections I, III, and IV of the questionnaire are analyzed in chapter 6.

This chapter discusses the audit problems in terms of significance values. For discussion purposes the problems are grouped by audit area:

- Internal accounting control
- Owner/manager control
- Assignment of audit personnel
- Analytical review procedures
- Management representations
- Response from the client’s attorney

Of the twenty-three audit problems in section II of the questionnaire, fourteen proved to be significant; the remaining problems received significance means of less than 8.0 and, thus, merit only cursory discussion. A summary of frequency, importance, and significance means is presented in figure 5.1. This table refers to problems only by number; figure 5.2 serves as a key, listing the question topics.

Appendixes D and E present detailed category distributions of frequency and importance, as indicated by the respondents. I have chosen to omit that information from this chapter in order to make it more
readable. For further statistical information, the reader should refer to "An Empirical Study of Audit Problems Encountered With Small Business Engagements," a 1981 unpublished dissertation by Debra D. Raiborn.¹

Figure 5.1
Frequency, Importance, and Significance Means for Small Business Audit Problems

<table>
<thead>
<tr>
<th>Question Number</th>
<th>Frequency Mean¹</th>
<th>Importance Mean²</th>
<th>Significance Mean³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q9</td>
<td>3.8</td>
<td>3.0</td>
<td>12.2</td>
</tr>
<tr>
<td>Q4</td>
<td>2.9</td>
<td>3.7</td>
<td>11.1</td>
</tr>
<tr>
<td>Q7</td>
<td>3.4</td>
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<tr>
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<td>3.2</td>
<td>3.3</td>
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<td>Q11</td>
<td>3.3</td>
<td>3.2</td>
<td>10.4</td>
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<td>10.3</td>
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<tr>
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<td>3.3</td>
<td>10.0</td>
</tr>
<tr>
<td>Q15</td>
<td>2.6</td>
<td>3.7</td>
<td>9.9</td>
</tr>
<tr>
<td>Q13</td>
<td>2.9</td>
<td>3.2</td>
<td>9.1</td>
</tr>
<tr>
<td>Q12</td>
<td>2.9</td>
<td>3.1</td>
<td>8.8</td>
</tr>
<tr>
<td>Q16</td>
<td>2.6</td>
<td>3.4</td>
<td>8.5</td>
</tr>
<tr>
<td>Q14</td>
<td>2.5</td>
<td>3.5</td>
<td>8.7</td>
</tr>
<tr>
<td>Q8</td>
<td>2.7</td>
<td>3.1</td>
<td>8.1</td>
</tr>
<tr>
<td>Q3</td>
<td>2.7</td>
<td>3.1</td>
<td>7.7</td>
</tr>
<tr>
<td>Q18</td>
<td>2.2</td>
<td>3.5</td>
<td>7.7</td>
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<td>2.3</td>
<td>3.2</td>
<td>7.5</td>
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<tr>
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<td>2.2</td>
<td>3.4</td>
<td>6.9</td>
</tr>
<tr>
<td>Q19</td>
<td>2.3</td>
<td>3.0</td>
<td>6.4</td>
</tr>
<tr>
<td>Q21</td>
<td>2.4</td>
<td>2.6</td>
<td>5.9</td>
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<tr>
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<td>2.7</td>
<td>5.5</td>
</tr>
<tr>
<td>Q23</td>
<td>2.0</td>
<td>2.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Q22</td>
<td>2.2</td>
<td>2.3</td>
<td>5.1</td>
</tr>
</tbody>
</table>

1. Numerical values for frequency ranged from 5.0 for usually to 1.0 for never. The values presented are means for all respondents.
2. Numerical values for importance ranged from 5.0 for extremely important to 1.0 for unimportant. The values presented are means for all respondents.
3. Numerical values for significance were computed as the product of frequency and importance values. Potential values for significance are 1, 2, 3, 4, 5, 6, 8, 9, 10, 12, 15, 16, 20, and 25. A mean value of 8.0 was used to divide audit problems into significant and nonsignificant groups. The significance means presented are those of all respondents. The frequency means times the importance means will not equal the significance means because significance values were calculated for individual respondents, then summed.

¹ Copies of the complete study may be obtained from University Microfilms, Inc., Ann Arbor, Michigan.
| Q1. | Delegation of management functions to the auditor. |
| Q2. | The audit of accounting work previously performed by the CPA. |
| Q3. | Failure of the client to maintain controls over data processed by the CPA. |
| Q4. | Assignment of more experienced personnel to the small business audit. |
| Q5. | Difficulty and uncertainty encountered in relying on internal accounting control over sales, accounts receivable, and cash receipts. |
| Q6. | Difficulty and uncertainty encountered in relying on internal accounting control over purchases, accounts payable, and cash disbursements. |
| Q7. | Difficulty and uncertainty encountered in relying on internal accounting control over inventories. |
| Q8. | Difficulty and uncertainty encountered in relying on internal accounting control over payroll. |
| Q9. | Compliance testing of accounting controls when a preliminary evaluation determined that reliance cannot be placed on the system. |
| Q10. | Reliance on owner/manager controls to restrict the extent of substantive auditing procedures. |
| Q11. | Insufficient documentation of owner/manager controls. |
| Q12. | Difficulty in applying analytical review procedures in planning the audit. |
| Q13. | Difficulty in applying analytical review procedures during the audit. |
| Q14. | Difficulty in applying analytical review procedures at or near the end of the audit. |
| Q15. | Acceptance of management representations as audit evidence when completeness of recorded transactions cannot otherwise be verified. |
| Q16. | Difficulty in communicating the contents of the representation letter as required by SAS 19. |
| Q17. | Difficulty in determining the existence of related parties. |
| Q18. | Client resistance to disclosing related-party transactions. |
| Q19. | Failure of the small business to retain a lawyer. |
| Q20. | Inadequate response by the lawyer regarding litigation. |
| Q21. | Communication of material weaknesses in internal accounting control. |
| Q22. | Communication problems caused by the lack of a supervisory level above small business management. |
| Q23. | Communication of audit findings to other interested parties. |

Note: These problems are summarized from the detailed version of the questions included in Appendix A.
Internal Accounting Control

Questions related to internal accounting control can be summarized as follows:

1. Application of compliance tests when a preliminary evaluation indicates that reliance cannot be placed on internal accounting control (question 9, with a significance mean of 12.2)

2. Difficulty and uncertainty encountered in relying on internal accounting controls over—
   a. Sales, accounts receivable, and cash receipts (question 5, with a significance mean of 10.5)
   b. Purchases, accounts payable, and cash disbursements (question 6, with a significance mean of 10.3)
   c. Inventories (question 7, with a significance mean of 10.9)
   d. Payroll (question 8, with a significance mean of 8.1)

Compliance Tests of Internal Accounting Control

After obtaining an understanding of a client’s accounting system, the auditor makes a preliminary evaluation of the internal accounting control system to determine if reliance can be placed on the system. If the preliminary evaluation indicates that reliance cannot be placed on internal accounting control, there is no need to test compliance with individual controls since the auditor will not rely on the accounting control procedures even if they are being applied as prescribed.

A total of 42 percent of the respondents indicated that they usually test internal accounting controls even when a preliminary evaluation indicates that reliance cannot be placed on any particular control procedures. “Usually” is defined in the questionnaire to mean more than 75 percent of the time. Another 24 percent of the respondents indicated that they frequently test compliance under such circumstances.

These findings indicate that a majority of the auditors are performing unnecessary procedures in the small business audit. This may indicate that auditors of small businesses with inadequate internal accounting control are auditing these companies as they would audit entities with adequate internal accounting control systems; it may indicate that they have difficulty understanding and implementing SAS 1, section 320, on internal control and believe that compliance tests are always required, or it may mean that they do not distinguish properly between compliance tests and substantive tests of transactions.

Evidence of difficulty in applying the internal control standard is provided by the significance value of 12.2, which was the highest for any of the audit problems.
Reliance on Internal Accounting Controls Over Sales, Receivables, and Cash Receipts

Controls over these areas include procedures to ensure that goods recorded as sold are actually shipped, that customers are billed for shipments, that goods are shipped only to approved credit risks, that invoices are correctly prepared and recorded, and that collections are deposited and recorded.

Small businesses with limited personnel often have difficulty implementing the separation of duties to ensure that controls over sales, accounts receivable, and cash receipts exist. Therefore, it is not surprising that only 25 percent of the respondents indicated that they frequently or usually rely on internal accounting control over sales, accounts receivable, and cash receipts for the purpose of restricting the extent of substantive tests. However, 44 percent of the respondents indicated that reliance on this cycle of internal control is important or extremely important to the completion of their audit.

The overall significance ranking for this audit problem was fourth, with a significance mean of 10.5.

Reliance on Internal Accounting Controls Over Purchases, Payables, and Cash Disbursements

The audit problem concerning reliance on internal accounting control over purchases, accounts payable, and cash disbursements was ranked number seven. Internal accounting control over these areas involves assurance that purchases are authorized, that goods ordered are received, that goods received are properly stored, that cash disbursements are properly supported and approved, and that all liabilities incurred are recorded. Adequate control over these areas requires an appropriate segregation of authorization, recordkeeping, and asset custody.

Only 25 percent of the respondents indicated that they could frequently or usually rely on internal accounting controls over purchases, accounts payable, and cash disbursements. The overall significance mean was 10.3, which supports the preliminary proposition that difficulties are encountered in relying on these internal accounting controls.

Reliance on Internal Accounting Controls Over Inventories

The second standard of field work requires a proper study and evaluation of internal accounting control as a basis for restricting other audit procedures. Internal accounting control over inventories provides for physical safeguards over the flow of goods; adequate controls over records containing quantities, costs, and transfers of inventory; and authorization over inventory transactions.
Only 18 percent of the respondents report that they frequently or usually place reliance on internal accounting controls over inventories of the small business for purposes of restricting the extent of substantive tests. The inability to rely on internal accounting controls over inventories could be due to the informal records of the small business, the owner/manager’s lack of accounting knowledge regarding control over inventories, or the difficulty of separating custody of goods from the recordkeeping for inventory.

Reliance on Internal Accounting Controls Over Payroll

Components of an internal accounting control system over payroll include procedures to ensure that employees are paid only for work performed, that pay rates are properly authorized, that deductions are properly authorized and computed, that payments are not made to fictitious employees, and that payroll checks are signed by authorized personnel.

Almost half of the respondents frequently or usually rely on controls over payroll, and the significance mean was only 8.1. Payroll is an area in which owner/manager involvement can be an effective control. Because of the small number of personnel employed, the owner/manager of a small business typically knows his employees, when they are on the job, and the number of hours worked. These attributes may explain why respondents have comparatively little difficulty relying on controls over payroll.

Documentation of and Reliance on Owner/Manager Controls

Question 10 addresses the auditor’s ability to rely on owner/manager controls to restrict the extent of substantive tests. Only 29 percent of the respondents indicated that they could frequently or usually rely on owner/manager controls for the purpose of limiting substantive tests, but 49 percent responded that reliance on these controls was important or extremely important to the completion of the audit. The significance mean for this audit problem was 10.0.

The inability to rely on owner/manager controls could result from a lack of guidance in the auditing standards, general misunderstanding of the CPA’s responsibility when reliance is placed on owner/manager controls, the lack of documentation of the controls, or the potential for management override of these controls. Guidance on the review, testing, evaluation, and reliance on owner/manager controls may improve the efficiency and effectiveness of small business audits.

If owner/manager controls are sufficiently documented, the auditor can test for compliance with such controls. Forty-two percent of the respondents indicated that they frequently or usually encounter insuffi-
ciently documented owner/manager controls when they intend to test compliance with such controls for the purpose of relying on them. The overall significance mean for this audit problem was 10.4, with frequency and importance factors contributing equally to the significance measure.

The evidence indicates that practitioners are encountering difficulties relying on internal accounting controls in small businesses. Of all the problems addressed in the study, the inability to rely on internal accounting controls, including owner/manager controls, was the most pervasive. Reliance on internal accounting controls in certain areas, such as payroll, may cause less difficulty than in other areas.

**Assignment of Audit Personnel**

As determined by the ranking of significance mean values, the second most significant small business audit problem concerns the assignment of audit personnel to the small business engagement. The significance ranking of 11.1 for question 4 is primarily attributable to the respondents' belief that the assignment of more experienced personnel is important. Sixty-four percent of the respondents believe that the assignment of more experienced people is important or extremely important to the completion of the small business audit; yet, only 47 percent indicated that they frequently or usually assign more experienced personnel to such audits. The apparent discrepancy may result from a firm's lack of experienced auditors with insights into potential audit problems, common accounting relationships, and areas in which accounting errors frequently occur.

This discrepancy implies that respondents recognize the importance of assigning more experienced personnel but do not always do so. If this is so, auditors may be violating generally accepted auditing standards. The auditor is required to possess adequate technical training and proficiency; therefore, if more experienced personnel are required for the small business audit, they should be assigned to the engagement. If the proper level of personnel is not assigned to the audit, the CPA firm is exposed to potential legal liability or, at a minimum, various audit inefficiencies.

**Analytical Review Procedures**

Analytical review procedures are designed to help the auditor gain an understanding of the client's business, plan the engagement, and identify unexpected accounting relationships. Analytical review procedures may be performed at the beginning of an engagement to plan the audit, during the audit to replace other tests, and near the end of the audit as an overall review. The questionnaire includes three questions relating to the difficulties encountered in applying analytical review procedures to small
business audits; the questions involve the three stages in which analytical review procedures are used.

In Planning the Audit

SAS 23, *Analytical Review Procedures*, provides only general guidance on the use of analytical review procedures in planning the audit. For instance, SAS 23 does not provide examples of the use of such procedures as attention-getting techniques or as substitutes for other substantive tests, nor does it discuss the risks of using these procedures or how their use affects the auditor’s subsequent work.

Forty percent of the respondents indicated that the ability to use analytical review procedures in audit planning is important or extremely important, and only 28 percent indicated that they frequently or usually encounter difficulty in using analytical review procedures as a planning tool (question 12). Thus, CPAs do not appear to have great difficulty using analytical review procedures in the planning stages.

These results, however, may not be conclusive. It is possible that analytical review procedures are being used in the planning stages as direct evidence that accounts or transactions are not materially misstated; therefore, the CPA does not extend tests of these accounts. Since analytical review procedures represent indirect tests, errors in accounts and transactions could exist that would not be discovered by such procedures if the errors did not produce unexpected fluctuations.

During the Audit

Analytical review procedures are used during the audit as a substitute for other procedures and to indicate errors in the financial statements. Twenty-six percent of the respondents indicated that they frequently or usually have difficulty applying analytical review procedures during the audit of a small business (question 13). The problem occurred less frequently than did difficulty in using analytical review procedures to plan the audit, but the problem was ranked higher in terms of importance.

At the End of the Audit

Analytical review procedures are applied at the end of the audit to provide an overall test of reasonableness of the financial statement data. Difficulty in applying analytical review procedures near the end of the audit received a significance value of 8.7 (question 14). Only 12 percent of the respondents indicated that they frequently or usually encounter difficulty in applying these procedures, but 60 percent of the respondents indicated that the procedures are important or extremely important. Of the three uses of analytical review procedures, respondents had difficulty least frequently when they were part of an overall review; however, this usage received the highest importance ranking of the three.
Management Representations

Management representations are obtained to complement the auditor's other auditing procedures. In some cases, procedures designed to corroborate management representations are limited. SAS 19, *Client Representations*, states, "Unless the auditor's examination reveals evidential matter to the contrary, his reliance on the truthfulness of management's representations is reasonable."²

This study addresses two areas of management representations: (1) the acceptance of management representations as audit evidence when completeness of recorded transactions cannot otherwise be substantiated (question 15) and (2) the difficulties encountered in communicating to management the contents of the representation letter required by SAS 19 (question 16).

Management Representations as Audit Evidence

Forty-five percent of the respondents indicated that, at least occasionally, they accepted management's representations as audit evidence when completeness of recorded transactions could not otherwise be substantiated. Sixty-three percent of the respondents indicated that the ability to accept management representations is important or extremely important to the completion of the audit. As an indicator of the relevance of management representations, the importance mean value of 3.7 was the highest mean value of any audit problem investigated in this study. These results indicate that auditors of small businesses need evidence provided by management representations.

The Management Representation Letter

SAS 19 requires the auditor to obtain written representations from management, including management's acknowledgement of its responsibility for the financial statements; availability, completeness, and propriety of financial and nonfinancial data; and several other assertions in which management attests to accounting matters and related aspects of company operations. Many owner/managers of small businesses believe that the auditor is responsible for the financial statements, since often the auditor has prepared the client's financial statements. Therefore, the owner/manager is reluctant to sign a letter stating that he is responsible for statements prepared by the auditor.

Fifty percent of the respondents indicated that the client's understanding of management representations and their purpose is important or extremely important to the completion of the audit, but only 23 percent of

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the respondents indicated that they frequently or usually encounter difficulty in communicating to management the contents of the representation letter. The audit problem is considered significant primarily because of the high importance mean.

A Response From the Client's Attorney

SAS 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, provides guidance for identifying such information. The auditor’s primary means of corroborating the information furnished by management is a letter of inquiry sent to the client’s lawyer. The client sends the letter requesting the lawyer to provide the auditor with information concerning litigation, claims, and assessments (LCAs). In general, small businesses have relatively simple financial, accounting, and legal matters, which reduces the need for continuing legal counsel.

The questionnaire addresses two audit problems related to the auditor’s responsibility for obtaining these assertions: (1) existence of legal counsel (question 19) and (2) the inadequate response from client’s legal counsel (question 20).

Existence of Legal Counsel

The question relating to retention of legal counsel did not prove to be a significant audit problem. The question received a significance mean of only 6.4 and is, therefore, reviewed in the section on “Nonsignificant Small Business Audit Problems.” Although the lack of legal counsel was mentioned many times in the prequestionnaire interviews, the problem is not causing as much difficulty as the interviews suggested.

Existing authoritative literature does not address a client’s lack of legal counsel; however, sections 9320.07 and 8340.10 of the AICPA *Technical Practice Aids* offer guidance to the CPA when an audit client has not retained legal counsel. Many CPAs, though, are not familiar with the existence of the AICPA *Technical Practice Aids*, which provide nonauthoritative guidance, because they are not published in the *Journal of Accountancy* as are auditing and accounting standards.3

Inadequate Response From Client’s Legal Counsel

Thirty-five percent of the respondents indicated that they frequently or usually received an inadequate response from attorneys when requesting the information required by SAS 12. Fifty-five percent of the respondents indicated that the incomplete response had an important or extremely

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3. TPAs are available by subscription or bound publication from the AICPA.
important impact on their audit work. The problem received an overall significance mean of 10.4.

SAS 12 gives guidance to the auditor when the lawyer refuses to respond or when the lawyer is unable to respond but provides no guidance on how to evaluate the adequacy of the lawyer's response and provides limited follow-up procedures to be applied for a deficient response. The SAS presumes that the lawyer will respond in accordance with the American Bar Association policy statement appended to the SAS, but this may not be the case. A deficient response is one that does not adequately address LCAs or one that omits information that the auditor needs to fulfill his responsibility under SAS 12. Guidance is needed by the CPA on evaluating the adequacy of the lawyer's response.

**Nonsignificant Small Business Audit Problems**

The remaining nine problems proved nonsignificant on the basis of significance mean values. These nine problems received values of less than 8.0.

The nonsignificant audit problems involve the performance of accounting services (questions 1, 2, and 3), related-party transactions (questions 17 and 18), the retention of legal counsel by the small business (question 19), communication of material weaknesses in internal accounting controls that are not cost-beneficial to correct (question 21), and communication of audit results to a level above operating management (questions 22 and 23).

The group of nonsignificant problems was rated fairly low in terms of frequency of occurrence. The audit problems do occur, but not often enough to create a significant problem. In each case, the audit problems in this group received higher means for importance than for frequency. Accordingly, the percentage of respondents in the *important* and *extremely important* categories was greater than the percentage of respondents in the *frequently* and *usually* categories. Figure 5.3 summarizes the frequency, importance, and significance means for this group of audit problems.

**Issues Related to Auditor Independence**

When the auditor also performs accounting services for the client, his objectivity as an independent party may be impaired. Questions 1, 2, and 3 deal with such situations. In each of these questions, the majority of the respondents indicated they never or rarely encountered the audit problems. In questions 1 and 3, however, the majority of the respondents indicated belief that the potential occurrence of the problems is important or extremely important. A possible reason for the high importance rating
Figure 5.3
Frequency, Importance, and Significance Means of Nonsignificant Audit Problems

<table>
<thead>
<tr>
<th>Question Number</th>
<th>Frequency Mean</th>
<th>Response to Frequently/Usually Categories</th>
<th>Response to Important/Extremely Important Categories</th>
<th>Significance Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>2.7</td>
<td>32%</td>
<td>3.1</td>
<td>43%</td>
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<tr>
<td>18</td>
<td>2.2</td>
<td>9%</td>
<td>3.5</td>
<td>56%</td>
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<td>17</td>
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<td>3.2</td>
<td>42%</td>
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<td>1</td>
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<td>56%</td>
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<tr>
<td>19</td>
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<td>36%</td>
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<td>38%</td>
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<td>21</td>
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<td>22%</td>
<td>2.6</td>
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<td>22%</td>
</tr>
<tr>
<td>22</td>
<td>2.2</td>
<td>11%</td>
<td>2.3</td>
<td>17%</td>
</tr>
</tbody>
</table>

could be the exposure these issues have received in the professional literature and among certain professional groups and committees reviewing self-regulation of the accounting profession.  

Related-Party Transactions

Interviews with CPAs involved many discussions about the difficulties encountered in determining the existence of related parties and client resistance to disclosing related-party transactions. The results of the questionnaire, however, indicated that less than 10 percent of the respondents frequently or usually encounter these two audit problems.

Existence of Legal Counsel

Another audit problem in the nonsignificant group involves whether a lawyer should be retained by the small business solely for purposes of responding to a request concerning litigation, claims, and assessments. When interviewed, several CPAs commented that many small businesses do not retain lawyers; therefore, they did not know how to apply SAS 12. However, 64 percent of the questionnaire respondents indicated that small business clients frequently or usually retain a lawyer who is available to respond to a request for information concerning litigation, claims, and assessments (question 19). Only 38 percent of the respondents indicated

that the audit problem is important or extremely important to the completion of the audit.

Cost-Benefit Considerations in the Communication of Material Weaknesses

Communication of material weaknesses in internal accounting control is required by SAS 20, Required Communication of Material Weaknesses in Internal Accounting Control. Interviews with CPAs revealed situations in which these weaknesses are not communicated because they are not cost-beneficial to correct. SAS 20, however, does not provide exemptions on the basis of a cost-benefit test, although the standard does allow summarized communication of weaknesses for which management does not believe corrective action is practicable. Some auditors may be unaware of this alternative.

Communication of Audit Results to Anyone Other Than Management

Another audit problem discussed in interviews with CPAs was the lack of a supervisory level above small business management to which the auditor could communicate certain audit findings, such as fraudulent acts by management. Both the importance and frequency responses to this audit problem were relatively low, indicating that the lack of a level above management to which audit findings could be communicated is not a significant audit problem.

CPAs were also asked if they encountered difficulty in deciding whether to communicate certain audit findings to interested parties other than management—for example, minority stockholders or limited partners. There appears to be little difficulty in this area, since this question produced the next-to-lowest significance mean.

Summary

Fourteen auditing problems out of the twenty-three problems investigated in the study proved to be significant. The problems receiving the highest significance mean values occur frequently and are important to the completion of an audit. The less significant auditing problems were ranked lower, primarily because they occur less frequently.

Audit problems involving internal accounting control all proved to be significant. The greatest difficulty encountered is the application of compliance tests when a preliminary evaluation indicates that the auditor cannot rely on the internal accounting control system. The sequence of other problems involving internal accounting control, based on significance rankings, was inability to rely on (2) control over inventories, (3)
control over sales, (4) control over purchases, (5) owner/manager controls, and (6) control over payroll.

Validity of the use of both frequency and importance as components of significance is evidenced by the weak relationship between the two variables, as determined from pairwise correlation. In twelve of the twenty-three relationships, frequency and importance were inversely related. Therefore, both frequency and importance are needed to describe the dimensions of small business audit problems.

Validity of the significant-versus-nonsignificant distinction used in this study was partially confirmed by the fact that, with the exception of the problems concerning legal counsel, groups of related audit problems proved to be either all significant or all nonsignificant. The significant-versus-nonsignificant distinction was also supported by the fact that respondents could distinguish between frequency and importance, as was evidenced by the disparity between frequency and importance ratings for certain questions.

This chapter has reviewed the significance means of individual audit problems. Chapter 6 relates the audit problems to characteristics of the audit client and the CPA firm.
Relationships Between Client Characteristics, CPA Firm Characteristics, and Small Business Audit Problems

This chapter identifies the prevalent characteristics of the respondents’ small business audit clients and discusses relationships between these characteristics and the audit problems documented in chapter 5. Chi-square tests were used to analyze the relationships.

In addition, I used analysis of variance procedures to determine whether certain CPA practice office characteristics may have an effect on the significance means computed for the various small business audit problems. This chapter also summarizes the results of these tests.

The chapter also presents information from section III of the questionnaire, related to selected matters of audit approach for the small business engagement.

**Small Business Characteristics**

Respondents were asked to select, from a list of eight characteristics, those that described their small business audit clients. Figure 6.1 summarizes the replies. More than 90 percent of the respondents selected concentration of ownership or operational control in one or a few individuals and limited segregation of duties as descriptive of their small business audit clients.
Figure 6.1
Characteristics of the Typical Small Business Audit Client

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Number</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is concentration of ownership or operational control in one or a few individuals.</td>
<td>487</td>
<td>93</td>
</tr>
<tr>
<td>There is limited segregation of functions within the accounting system because of the small number of employees.</td>
<td>475</td>
<td>90</td>
</tr>
<tr>
<td>There is a greater potential for management override of internal accounting controls.</td>
<td>390</td>
<td>74</td>
</tr>
<tr>
<td>Management personnel or employees have limited accounting knowledge.</td>
<td>357</td>
<td>68</td>
</tr>
<tr>
<td>There is an inactive or ineffective policy-making body (e.g., Board of Directors).</td>
<td>231</td>
<td>44</td>
</tr>
<tr>
<td>Clerical and administrative personnel have easy access to assets.</td>
<td>222</td>
<td>42</td>
</tr>
<tr>
<td>Management does not hire or is unable to hire employees having accounting experience or formal accounting training.</td>
<td>212</td>
<td>40</td>
</tr>
<tr>
<td>Recordkeeping systems are often informal and documentation of transactions is inadequate.</td>
<td>135</td>
<td>26</td>
</tr>
</tbody>
</table>

Concentration of ownership usually results in owner-dominated management. In the small business, management's knowledge regarding accounting and finance is usually not as extensive as it is in larger firms having more personnel. If management's lack of accounting knowledge results in an attitude toward control that is cavalier, the auditor's ability to rely on internal accounting control may be impaired.

Limited segregation of duties may eliminate one of the most important attributes of internal accounting control. This characteristic may create situations in which incompatible functions are performed by employees or by the owner/manager. SAS 30, *Reporting on Internal Accounting Control*, states that the accountant should presume a high risk of irregularities if inadequate segregation of duties places an individual in a position both to perpetrate and to conceal irregularities. SAS 1, section 320, "The Auditor's Study and Evaluation of Internal Control," provides
guidance that applies primarily when segregation of duties exists, which means that in small business audits the auditor may have difficulty applying SAS 1, section 320.

Seventy-four percent of the respondents indicated that potential management override of internal accounting control characterizes their small business clients. The existence of this characteristic causes uncertainty when the auditor evaluates internal accounting control for purposes of restricting substantive tests.

Sixty-eight percent of the respondents indicated that their clients' management or employees have limited accounting knowledge. Consequences of this characteristic may vary from an impairment in communication between the client and the auditor because the client does not understand the matters involved to management's inability to develop and enforce good internal accounting control.

The remaining small business characteristics were selected less frequently. Less than 45 percent of the respondents indicated that their small business clients had an inactive or ineffective policy-making body, easy access to assets by clerical personnel, management inability to hire employees with accounting experience, or informal recordkeeping systems and inadequate documentation of transactions. The low response (26 percent) to the last trait probably stems from the absolute wording in the questionnaire: "documentation of transactions is inadequate." I believe that if conditional wording had been used, such as "documentation of transactions may be inadequate," a greater percentage of respondents would have selected this characteristic.

Additional small business characteristics specifically submitted by the respondents generally expanded on characteristics already listed in the questionnaire, addressed audit problems rather than characteristics, or were mentioned by only a few respondents.

The empirical evidence from this phase of the research supports the definition of a small business developed by the AICPA Task Force on Review of Existing Auditing Standards. According to the task force and this research, the primary characteristics of a small business are concentration of ownership or operational control and limited segregation of duties. The remaining six characteristics are secondary in nature and may often result from the occurrence of the first two.

Small Business Characteristics and Small Business Audit Problems

I used the chi-square statistic to test for the existence of relationships between small business characteristics and auditing problems. This test compares observed frequencies with those expected if no relationship exists; the computed chi-square value increases as the deviations
between expected and observed frequencies increase. Limited segrega-
tion of duties, informal recordkeeping, higher potential for management
override, and an inactive or ineffective policy-making body are small
business characteristics statistically related to certain small business
audit problems.

The first characteristic, limited segregation of duties, is statistically
related to the inability to rely on internal accounting control over sales,
accounts receivable, and cash receipts; to the inability to rely on internal
accounting control over purchases, accounts payable, and cash dis-
bursements; and to compliance tests of internal accounting control when
a preliminary evaluation indicates that the auditor cannot rely on internal
accounting control. These relationships are summarized in figure 6.2. The
measures of association, however, are not strong; the highest phi statistic
is .15. (The phi statistic takes on the value of zero when no relationship
exists and the value of +1 when the variables are perfectly related.)

The fourth characteristic, involving informal recordkeeping proce-
dures, is statistically related to six audit problems: the client’s failure to
maintain independent controls over write-up work performed by the CPA,
reliance on owner/manager control, difficulties encountered by the CPA
in communicating to the client the contents of the representation letter,
client resistance to disclosing related-party transactions, and difficulties
encountered in communicating information to a level above management
or to persons other than management, such as minority stockholders or
limited partners. It is consistent that management with informal record-
keeping systems would not be concerned with establishing control over
the CPA’s write-up work, since it is not concerned about the formality of
its own recordkeeping procedures. Also, if management’s attitude is such
that formal recordkeeping procedures are not important, the manage-
ment is likely to have a casual attitude toward controls in general;
therefore, in the business with weak recordkeeping systems, auditors
may have difficulty relying on owner/manager controls to reduce sub-
stantive tests. The connection with difficulties in communicating the
contents of the client representation letter can be explained by manage-
ment’s uneasiness about certain representations required by SAS 19,
Client Representations, such as management’s acknowledgement of its
primary responsibility for financial statements and availability and com-
pleteness of financial records.

The significant relationship between client resistance to disclosing
related-party transactions and informal recordkeeping may result from
the informal manner with which the owner/manager operates the busi-
ness. Related-party transactions may reflect personal tax considerations;
for example, the owner/manager may own a building and lease office
space to the company. The owner/manager may resist disclosing such
information or may erroneously account for the transaction because of its
informal documentation.
Figure 6.2
Statistically Significant Relationships Between Small Business Characteristics and Small Business Audit Problems

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Audit Problem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited segregation of duties</td>
<td>*Inability to rely on internal accounting controls over sales, accounts receivable, and cash receipts</td>
</tr>
<tr>
<td></td>
<td>*Inability to rely on internal accounting controls over purchases, accounts payable, and cash disbursements</td>
</tr>
<tr>
<td></td>
<td>*Performance of compliance tests when internal accounting controls are unreliable</td>
</tr>
<tr>
<td>Potential for management override</td>
<td>Client resistance to disclosing related-party transactions</td>
</tr>
<tr>
<td>Ineffective policy-making body</td>
<td>No communication of material weaknesses in internal accounting control if they are not cost-beneficial to correct</td>
</tr>
<tr>
<td>Informal recordkeeping systems</td>
<td>Failure of client to maintain independent control over accounting work of the CPA</td>
</tr>
<tr>
<td></td>
<td>*Whether to rely on owner/manager controls</td>
</tr>
<tr>
<td></td>
<td>*Difficulties in communicating to management the contents of the client representation letter</td>
</tr>
<tr>
<td></td>
<td>Client resistance to disclosing related-party transactions</td>
</tr>
<tr>
<td></td>
<td>Communication of certain audit findings when no supervisory level exists above operating management</td>
</tr>
<tr>
<td></td>
<td>Communication of certain audit findings to minority stockholders</td>
</tr>
</tbody>
</table>

*Indicates an audit problem having a significance mean of 8.0 or more.

Finally, the lack of an effective board of directors causes communication difficulties for the auditor. In the small business there often is no level above operating management to which weaknesses in internal accounting control may be communicated; therefore, weaknesses are more likely to persist.

The other two small business characteristics that exhibited significant relationships to audit problems are higher potential for management
override and the inactive or ineffective policy-making body. The former is statistically related to client resistance to disclosing related-party transactions. There is a logical relationship between the higher potential for management override and resistance to disclosing an event. Both situations are likely to occur in an environment dominated by the owner/manager.

An inactive or ineffective policy-making body is statistically related to the problem of communicating material internal accounting control weaknesses that are not cost-beneficial to correct. SAS 20, Required Communication of Material Weaknesses in Internal Accounting Control, requires that the auditor communicate material internal accounting control weaknesses, whether or not management believes corrective action is practicable, but it appears that there is a tendency not to communicate such weaknesses when the small business policy-making body is ineffective or inactive. The phi statistic of .16382 is one of the strongest calculated between the small business characteristics and auditing problems.

In general, there are few significant relationships between client characteristics and small business audit problems. Informal recordkeeping is significantly related to six problems; limited segregation of duties is significantly related to three problems, and higher potential for management override and an inactive or ineffective policy-making body are related to one problem. Only eleven of a possible 184 relationships are statistically significant.

**CPA Firm Characteristics and Small Business Audit Problems**

I examined four characteristics of CPA firms to determine whether they had an effect on audit problem significance means: practice office size, the length of time the practice office had been in existence, the percentage of audit revenues to total revenues, and the average number of hours required to complete the typical small business audit. Section IV of the questionnaire classifies the respondents by these four characteristics. Appendix A indicates the percentage of respondents by category. Using these four characteristics, I performed one-way analysis of variance to test twenty-three exploratory hypotheses designed to determine whether CPA firm characteristics had an effect on the audit problem significance means.

**Practice Office Size**

Appendix F lists significance means for each of the twenty-three auditing problems for four categories of practice office size. Nine of the twenty-three tests involving the characteristics of practice office size are significant; that is, significant mean values of audit problems investigated
in these nine questions differed among the various practice office sizes. These nine questions dealt with the ability to rely on internal accounting control over sales, accounts receivable, and cash receipts, over purchases, accounts payable, and cash disbursements, and over inventories; performance of compliance tests when a preliminary review has determined that the auditor cannot rely on internal accounting control; assignment of more experienced personnel at the lower audit levels to the small business audit; acceptance of management representations as audit evidence; client resistance to disclosing related-party transactions; the client’s retention of a lawyer to respond to the CPA’s request for information on litigation, claims, and assessments; and communication of material weaknesses.

When significance means are categorized by practice office size for these nine problems, the significance means definitely tend to decrease as the size of the practice office increases. For the question related to compliance tests of internal accounting controls when a preliminary evaluation indicates that the controls are unreliable, the significance mean for sole practitioners was 14.3, whereas for practice offices with over thirty professionals the significance mean was 4.8. Larger firms are having significantly less difficulty in determining that compliance tests are unnecessary when a preliminary review has determined that the auditor cannot rely on the internal accounting control system. Only one question, related to client resistance to disclosing related-party transactions, demonstrated an increasing trend in significance means, indicating that larger CPA firms ranked the audit problem more significantly than smaller CPA firms.

Smaller practice offices may have more difficulty than large practice offices for several reasons. They have fewer qualified and experienced personnel to conduct the audit work. They have fewer, if any, research or resource personnel to address problems arising from implementation of auditing standards in the small business engagement or special audit areas (such as computer services). They also have fewer supervisory personnel to supervise staff auditors or, conversely, fewer staff auditors to support supervisory personnel.

**Audit Revenues**

Four of the twenty-three audit problems exhibit statistically significant relationships with audit revenues. As shown in Appendix G, significance means, when categorized by audit revenues, decrease as the percentage of audit revenues to total revenues increases for all four statistically significant relationships. The relationships are between audit revenues and (1) the inability to rely on internal accounting control over sales, accounts receivable, and cash receipts, (2) the inability to rely on internal accounting control over purchases, accounts payable, and cash dis-
bursements, (3) the inability to rely on internal accounting control over inventories, and (4) the unnecessary performance of compliance tests when the auditor cannot rely on internal accounting control. These four audit problems all involve inability to rely on internal accounting control in the small business engagement. These four relationships emphasize the pervasiveness of problems involving internal accounting controls.

The higher significance ranking by firms with proportionately less audit revenues could occur for two reasons. Practice offices with proportionately less audit revenues may have fewer audit clients and, therefore, less experience in resolving problem areas; and practice offices with proportionately less audit revenues may also have smaller clients with pervasive audit problems, such as very limited segregation of duties.

The four audit problems that are significant in terms of audit revenues are also significant in terms of practice office size. The correlation between these two variables is .41.

Age of the Practice Office and Audit Hours

Tests of practice office size and audit revenues resulted in more significant relationships than did tests of the length of time the office had been in existence or the average number of hours required to complete a small business audit. The length of existence of the practice office appears to bear little relationship to the various small business audit problems. Only one problem, performance of compliance tests when the auditor will not rely on internal accounting control, is statistically related, and the degree of association is minimal. There is no consistent trend among the various categories of number of years of practice office existence.

Significance means for questions 9 and 18 are statistically related to the number of audit hours required for the small business engagement. Client resistance to disclosing related-party transactions (question 18) is statistically related to both audit hours and practice office size, exhibiting an increasing trend in significance means as audit hours and practice office size increase, which is opposite the general trend. Audits performed by larger practice offices and those that take longer to complete may cross a threshold in which the client is involved in more complex transactions yet is still considered a small business.

It is important to note that question 9, concerning compliance tests when the auditor will not rely on internal control, which ranked as the most significant problem, is statistically related to all four CPA practice office characteristics (size, length of existence, audit revenues, and audit hours). Testing compliance with internal accounting control when reliance cannot be placed on the system is an area causing uncertainty for all CPAs, although the problem is more significant for smaller practice offices and offices with proportionately less audit revenues. When trends
in significance means between audit problems and CPA firm characteristics occur, generally, the trend is for significance means to decrease as practice office size and revenues increase.

Selected Issues of Audit Approach for the Small Business Engagement

Sixty percent of the respondents indicated that their firms use internal control questionnaires especially designed for small business engagements. The questionnaire is used primarily to document internal accounting control but is also used to aid in designing substantive tests, to identify material accounting control weaknesses, and to provide other services to the client.

In the typical small business engagement, auditors spend only 20 percent of their time reviewing, testing, and evaluating internal accounting control. Yet, the majority (53 percent) of the respondents believe that they overaudit the small business client. According to respondents, reasons for this overauditing are excessive substantive testing of balances and transactions, excessive requirements of generally accepted accounting principles, excessive compliance testing of internal accounting control, unnecessary requirements of generally accepted auditing standards, and other implementation problems with Statements on Auditing Standards.

Only 22 percent of the respondents indicated that they could rely on owner/manager controls for purposes of reducing substantive tests. The majority of the respondents, when asked how this reliance affected their audit tests, cited procedures related to the extent of testing. Respondents indicated that they reduce the extent of their audit tests when the owner/manager compensates for limited segregation of duties by performing certain accounting functions, that they perform more analytical review procedures to reduce the number of transactions reviewed, and that they are able to use smaller samples when the involvement of the owner/manager reduces the number of errors in accounting populations.

An interesting finding is that 38 percent of the respondents indicated that their objective in studying and evaluating internal accounting control is not to determine if substantive tests can be restricted. Transactions are tested primarily to determine the frequency and materiality of errors. These results may indicate confusion over technical terms and may indicate that the confusion is causing unnecessary testing. If a CPA does a substantive test of transactions and calls it a compliance test, he may merely be using the wrong term. However, if tests are applied in addition to those that are necessary to satisfy the objectives of a substantive test because the accountant incorrectly believes that he must perform
compliance tests even if he does not plan to rely on the control procedures being tested, then he is overauditing.

Despite the fact that 70 percent of the respondents do not rely on internal accounting controls because of the higher potential for management override, the majority of the respondents do not encounter difficulty in determining the appropriate audit opinion. Difficulties that are encountered involve going-concern situations, limited segregation of duties, lack of sufficient evidence, higher potential for management override, CPA independence, and lack of authoritative guidance.

Forty-four percent of the respondents indicated that they believe a separate set of GAAS is needed for small business audits. Some of the reasons given by the respondents related to requirements of accounting pronouncements rather than auditing pronouncements. Because the disclosure requirements regarding leases may be burdensome for small businesses, the client may resist providing the disclosures; the auditor, however, must ensure that the client provides adequate disclosure if he intends to issue an unqualified opinion. The conflicting roles may affect the client-auditor relationship. Therefore, in the auditor’s mind the conflicts, resulting from requirements of accounting pronouncements, become audit problems.

In general, the findings from section IV of the questionnaire reaffirmed the difficulties that auditors have in relying on internal accounting control as a basis for restricting other audit work.
Summary, Conclusions, and Recommendations

My study was designed to provide information about audit problems encountered in small business engagements. I sought to identify such problems and to determine their significance; I also sought to determine if relationships exist between the auditing problems and either small business characteristics or certain characteristics of CPA firms. Finally, for those problems determined to be significant, I intended to propose implementation guidelines for the application of generally accepted auditing standards to small business audits.

The independent auditor examines financial statements to express an opinion about whether they present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. The auditor must perform his examination in accordance with generally accepted auditing standards, which consist of ten standards and the interpretations of those standards expressed in Statements on Auditing Standards. The standards and related interpretations apply to all audits, regardless of the size of the enterprise.

The environment in which the small business operates may create certain problems in the implementation of generally accepted auditing standards. The Commission on Auditors' Responsibilities and the committee to study the structure of AudSEC concluded that special provisions are needed in the auditing pronouncements to meet the needs of small enterprises. The AICPA Auditing Standards Board is currently considering the need for guidance on small business audit problems.
Research Design and Method

To identify and clarify potential small business audit problems, I reviewed the professional literature, interviewed practicing CPAs, reviewed letters received by the AICPA Task Force on Review of Existing Auditing Standards, and met with task force members. I then developed a questionnaire incorporating twenty-three of the audit problems identified in the preliminary research stage. The questionnaire was designed to identify common characteristics of small businesses and to determine the frequency and importance of problems encountered in small business audits. Problems were ranked according to significance mean, which is a numerical product of a frequency-of-occurrence factor and an importance factor, as indicated by each respondent to the questionnaire. The questionnaire was pretested to determine difficulty, completion time, clarity, lack of bias, and the knowledge level demanded of the respondent.

I then mailed the questionnaire to a sample of 1,431 CPA practice offices. I received 739 responses—a response rate of 51.6 percent.

Analysis of the replies required descriptive statistics, chi-square analysis, and analysis of variance (ANOVA). I analyzed descriptive statistics to determine the most significant auditing problems; I used chi-square analysis to test for the existence of relationships between audit problems and small business characteristics, and I used analysis of variance to determine the effect that CPA practice office characteristics have on the audit problems' significance means.

Audit Problems Investigated

According to preliminary research, the following problems appeared to cause difficulty and uncertainty in the audits of small businesses:

• Independence issues resulting from the performance of other accounting services for the small audit client
• The need for more experienced personnel at lower levels of the audit
• Whether to place reliance on internal accounting controls for purposes of restricting the extent of other auditing procedures in the areas of sales, accounts receivable, and cash receipts; purchases, accounts payable, and cash disbursements; inventories; and payroll
• Performance of compliance tests of internal accounting controls when a preliminary evaluation determined that reliance cannot be placed on such controls
• Insufficiently documented owner/manager controls and whether
reliance can be placed on owner/manager controls to restrict the extent of substantive audit procedures

- Difficulties encountered in applying analytical review procedures

- Difficulties encountered in communicating the contents of the client representation letter and the inability to rely on management representations as sufficient, competent audit evidence

- Difficulties encountered in determining the existence of related parties and management’s resistance to disclosure of related-party transactions

- The absence of continuing legal counsel from which the auditor may request confirmation of information pertaining to litigation, claims, and assessments or inadequate response received from the client’s attorney

- Communication of material weaknesses in internal accounting control when management believes that corrective action is not practicable, communication of audit findings to minority stockholders, and difficulties in communicating information to a level above operating management

As a result of these difficulties, some CPAs ignore certain standards, interpret other standards to the client’s best advantage, or apply some standards in a manner that places form over substance. Since generally accepted auditing standards and Statements on Auditing Standards establish the minimum level of auditing performance, the profession cannot tolerate any situation that causes noncompliance with the standards. Any significant uncertainty or practical difficulty in implementing the standards should be remedied either by amendment of the existing standards or by interpretive guidance.

**Significant Audit Problems**

For each questionnaire, I computed numerical values for the significance of each of the twenty-three audit problems. A specifically constructed variable designed to measure relevance of a particular auditing problem, the significance value was calculated as the product of a value for frequency and a value for importance. I then ranked the audit problems by significance means. Those problems having means equal to or greater than 8.0 were deemed to be significant.

Fourteen of the twenty-three audit problems had significance means of 8.0 or more. The significant audit problems, identified by question number and significance mean, can be categorized as follows:

71
1. Internal accounting control
   A. Performance of compliance tests when a preliminary evaluation determined that reliance cannot be placed on internal accounting control (Q9—12.2)
   B. Difficulty and uncertainty in relying on internal accounting control over—
      (1) Sales, accounts receivable, and cash receipts (Q5—10.5)
      (2) Purchases, accounts payable, and cash disbursements (Q6—10.3)
      (3) Inventories (Q7—10.9)
      (4) Payroll (Q8—8.1)

2. Owner/manager controls
   A. Decisions about reliance on owner/manager controls (Q10—10.0)
   B. Inadequate documentation of owner/manager controls (Q11—10.4)

3. Uncertainties about analytical review procedures
   A. In planning the audit (Q12—8.8)
   B. During the audit (Q13—9.1)
   C. Near the end of the audit (Q14—8.7)

4. Management representations
   A. Difficulties in communicating the purpose and contents of the client representation letter to management (Q16—8.8)
   B. Acceptance of management representations as audit evidence (Q15—9.9)

5. Inadequate response from the client’s legal counsel (Q20—10.4)

6. Assignment of audit personnel (Q4—11.1)

### Relationships Between Client Characteristics, CPA Firm Characteristics, and Small Business Audit Problems

From a list of eight characteristics, respondents were asked to indicate those that described their small business audit clients. These eight characteristics and twenty-three audit problems were tested for the existence of significant relationships.

Eleven of the 184 possible relationships proved to be significant; figure 7.1 summarizes these relationships. Only one audit problem related to more than one small business characteristic: question 18, which is significantly related to two characteristics. Therefore, the results of these tests provide little insight into the resolution of the significant auditing problems identified by this study.

I also examined four CPA firm characteristics to determine whether they had an effect on the audit problems’ significance means. These
Figure 7.1
Statistically Significant Relationships Between Small Business Characteristics and Small Business Auditing Problems

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Audit Problem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited segregation of duties</td>
<td>Inability to rely on internal accounting control over sales, accounts receivable, and cash receipts</td>
</tr>
<tr>
<td></td>
<td>Inability to rely on internal accounting control over purchases, accounts payable, and cash disbursements</td>
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<tr>
<td></td>
<td>Performance of compliance tests when the auditor cannot rely on internal accounting controls</td>
</tr>
<tr>
<td>Potential for management override</td>
<td>Client resistance to disclosing related-party transactions</td>
</tr>
<tr>
<td>Ineffective policy-making body</td>
<td>No communication of material weaknesses in internal accounting control if they are not cost-beneficial to correct</td>
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<tr>
<td>Informal recordkeeping system</td>
<td>Failure of client to maintain independent control over the CPA's accounting work</td>
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<td>Communication of certain audit findings when no supervisory level exists above operating management</td>
</tr>
<tr>
<td></td>
<td>Communication of certain audit findings to minority stockholders</td>
</tr>
</tbody>
</table>

Characteristics were (1) practice office size, (2) audit revenues in relation to total revenues, (3) the number of years the practice office has been in existence, and (4) hours required to audit the typical small business.

When classified by practice office size, analysis of significance means for audit problems resulted in nine significant relationships. In general, there was a decreasing trend in the magnitude of significance means as the size of practice office increases. Analysis of the audit-revenue attribute and the various audit problems resulted in four statistically significant relationships, all involving internal accounting control. In gener-
al, practice offices with proportionately more audit revenues ranked the audit problems less significantly.

**Significant Findings**

The study produced a number of significant findings:

- Concentration of ownership or operational control in one or a few individuals (owner/manager dominance) and limited segregation of duties characterize more than 90 percent of small business audit clients.

- Some respondents confused generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP); they cited problems in applying accounting standards as examples of auditing issues.

- Generally, CPAs from smaller practice offices ranked small business audit problems as more frequent and more important to the completion of the audit than did CPAs from large practice offices and offices with proportionately more audit revenue.

- Personnel assigned to audits of small businesses usually have more experience than personnel assigned to larger businesses.

- Widespread confusion exists about the auditor’s study and evaluation of internal accounting control. Over 66 percent of the respondents indicated that they would perform compliance tests of internal accounting controls even if a preliminary evaluation indicated that they could not rely on the system.

- In a small business environment, auditors generally cannot rely on internal accounting controls, including owner/manager controls, to restrict substantive tests.

- CPAs often receive incomplete responses to requests for information on litigation, claims, and assessments from the small business client’s attorney.

- Forty-five percent of the respondents indicated that, at least occasionally, they accept management’s representations as audit evidence when completeness of recorded transactions cannot otherwise be substantiated.

- Approximately 25 percent of the responding CPAs frequently encounter difficulty in communicating the contents of the client representation letter required by SAS 19.
• Auditors generally encounter difficulty in applying analytical review procedures in the small business audit, particularly in planning the audit to identify areas requiring special attention and during the audit as a substitute for certain other direct tests of balances.

• Related-party transactions do not cause significant problems in the small business audit. Respondents do not have significant difficulty in determining the existence of related parties, nor do they encounter significant client resistance to disclosing related-party transactions.

• Auditors of small businesses generally do not perform management functions or encounter other situations that impair their independence.

Validity of Study Results
I could not confirm the validity of this study by comparing it with similar studies because there have been no comparable studies. A 1980 study by Welker, Anderson, and Dycus did involve small business audit problems, but the direction of their study was not sufficiently similar to this one to allow a comparison of results.

Certain observations can be made about the relationship between this study and the literature discussed in chapter three. The literature generally discusses small business audit problems on the basis of the author's personal experiences, experiences related to the author by practitioners, or logical application of auditing standards to small business audits. The findings of this study, on the other hand, are based on empirical research. This study provides empirical information about the occurrence and importance of many audit problems that receive only general discussion in professional pronouncements, journals, and textbooks. Finally, the empirical results of this study do not provide strong evidence contrary to prior expectations.

Guidance for Evaluating Internal Accounting Control
There are three aspects of internal accounting control that present problems in small business audits: (1) compliance testing when the auditor does not rely on the internal accounting control system, (2) difficulty in relying on internal accounting control over various transaction cycles, and (3) reliance on owner/manager controls. This section addresses the first two problem areas; owner/manager control receives a separate discussion.
Compliance Testing When the Auditor Does Not Rely on the System

The research study determined that the most pervasive audit problem is the performance of compliance tests when a preliminary evaluation has determined that the auditor does not intend to rely on the internal accounting control system. Many CPAs misunderstand the definition, purpose, and application of compliance tests in the small business audit. Further guidance is needed to clarify the definitions and use of compliance and substantive procedures so that auditors may better understand the purposes of these tests.

Compliance tests are designed to provide reasonable assurance that accounting control procedures are being applied as prescribed.\(^1\) Substantive tests are tests of transactions and account balance details and analytical review procedures that seek to obtain evidence about the validity and propriety of transactions and balances.\(^2\) Tests of details of account balances and transactions may accomplish the objectives of both tests.

Difficulty in distinguishing between compliance and substantive tests may also result from imprecise definitions of important terminology. Auditing standards should distinguish between (1) reliance on internal accounting controls for purposes of determining auditability of an entity and (2) reliance on internal accounting controls for purposes of restricting substantive audit procedures. Some CPAs may define auditability tests as compliance tests, while others define compliance tests as procedures performed to restrict the extent of substantive testing. Similarly, some auditors consider tests of transactions to be compliance tests, but such tests are substantive procedures to the extent that they corroborate recorded dollar amounts. In general, compliance tests are not required if the auditor does not rely on controls to reduce substantive tests; this concept is not clearly understood by practicing CPAs.

Interpretive guidance and clarification of the relationship between compliance and substantive tests could remedy these misunderstandings.

Difficulty in Relying on Internal Accounting Control

The study indicated that auditors have difficulty relying on internal accounting control over (1) inventories, (2) sales, accounts receivable, and cash receipts, (3) purchases, accounts payable, and cash disbursements, and (4) payroll. Respondents indicated that certain cycles are easier to rely on than others. For example, respondents had much more

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2. Ibid, sec. 320.70.
difficulty relying on internal accounting control over inventories than they
did relying on controls over payroll. Small business accounting control
systems often develop in an evolutionary fashion; areas over which
internal accounting controls are of most concern to management receive
attention first. Payroll is an area of particular importance to many small
businesses, which could explain why respondents had the least difficulty
placing reliance on internal accounting control over that area.

Further guidance may be needed on different types of audit tests for
small business engagements to enable the auditor to rely on internal
accounting control of such entities. Before such guidance can be issued,
more information must be obtained regarding the specific problems
involved in relying on internal accounting control over transaction cycles
of small business clients.

Guidance for the Study and Evaluation of
Owner/Manager Controls

SAS 1, section 320, states that the owner/manager may perform certain
accounting control procedures but provides little guidance regarding
reliance on such controls. An entire statement could be issued that deals
with (1) the definition of owner/manager controls, (2) the control
environment of an owner/manager-dominated entity, (3) the effect of
such controls when considering the auditability of small businesses, (4)
whether reliance can be placed on primary or secondary controls
performed by the owner/manager, and (5) the risks of relying on
owner/manager controls.

Definition of Owner/Manager Controls

For purposes of proposed guidance, owner/manager controls can be
defined as either primary or secondary control procedures performed by
someone who has an ownership interest in the firm, has responsibility for
establishing policies, or makes decisions involving the goals of the firm.
To be effective, such controls must achieve four accounting control
objectives: Transactions must be executed in accordance with manage­
ment’s authorization; they should be recorded to permit preparation of
financial statements in conformity with GAAP or other applicable criteria
and to maintain accountability for assets; access to assets must be
permitted only in accordance with management’s authorization; and
recorded accountability for assets must be compared periodically with
existing assets, with appropriate action taken with respect to any
differences.

In addition to the four control objectives, the auditor should also
assess whether the objectives of the owner/manager are compatible
with the auditor’s objectives. The auditor should evaluate such compatibility for each significant class of transactions. For example, do the objectives of the owner/manager regarding the validity of recorded sales transactions protect against the recording of invalid, illegal, or duplicate sales transactions?

Control Environment of the Owner/Manager-Dominated Entity

The auditors of businesses that operate under the dominance of owner/managers must evaluate the potential for management override of owner/manager controls. Consideration of the small business control environment is necessary in the evaluation of the potential for owner/manager override of controls.

SAS 30, *Reporting on Internal Accounting Control*, discusses control environment considerations. For example, the statement discusses the entity’s organizational structure, such as the duties of the board of directors and the audit committee. However, since many small businesses operate without boards of directors or audit committees, these considerations are not particularly helpful for auditors of small businesses. The statement also lists other factors that affect the control environment, such as management supervision of the internal accounting control system and competence of personnel, but does not elaborate on them.

Additional guidance is needed in several areas. One is control consciousness. Does the owner/manager convey to employees an attitude that controls are important and are not to be deviated from? Another area involves organizational structure. Even in a small business, some segregation of duties can exist. Does the structure of the organization maximize segregation of duties and minimize incompatible functions?

Design of the internal accounting control system poses several questions. Is the internal accounting control system designed to prevent errors and irregularities or does it merely detect them? Does the owner/manager understand basic control concepts? Are areas easily susceptible to errors and irregularities carefully supervised? What happens when the owner/manager is away? Does he subsequently review transactions that occurred while he was gone?

Auditors also need guidance for assessing the competence of personnel. Are employees performing only tasks that they have the ability to perform? Do they support the company’s goals? What are their working relationships with the owner/manager?

Lastly, further guidance should address the auditor’s evaluation of the owner/manager. Is the owner/manager competent to perform the managerial duties for which he is responsible? Does the owner/manager have a high level of integrity? Is he overly optimistic regarding financial matters? Does he pay his debts on schedule? Given the inherent potential
of management override, what is the auditor's assessment of the probability that management override has occurred?

**Evaluation of Auditability Controls**

Auditability controls are those designed to provide assurance that financial statement data are captured accurately and completely. Auditability controls, for example, include procedures that ensure against loss or duplication of source documents or procedures for comparison of source documents with recorded amounts.

A company is not auditable unless financial statement data are recorded completely and accurately. Tests of auditability controls are not unique in the small business audit, but they may provide the auditor with assurance about the entity's control consciousness.

**Reliance on Owner/Manager Controls**

In general, if owner/manager controls are well placed and designed to meet the four objectives of internal accounting control previously expressed in "Definition of Owner/Manager Controls," if owner/manager objectives are compatible with the objectives of the auditor, and if no management override is encountered, the auditor may justify some reliance on owner/manager controls. The reliance placed on such controls will vary from minimal to moderate. If the probability of management override is high, the auditor should not rely on the controls.

Guidance on this subject should address whether reliance can be placed only on primary controls performed by the owner/manager or also on secondary controls. Information obtained from a review of secondary controls may be less precise and less effective than primary controls in detecting errors or irregularities, but some reliance may still be placed on them. Perhaps, the auditor should rely on secondary controls only to increase assurance that data were recorded completely, but not to restrict substantive tests.

The more constrained audit situation occurs when there are few adequately structured primary controls, such as appropriate segregation of duties. In such cases the auditor may rely on secondary controls to determine auditability but not to reduce the extent of substantive tests. The fact that the owner/manager reviews budgets and performs other secondary controls may provide some assurance to the auditor or reduce his uncertainty but does not provide evidence that the financial statements are fairly presented in accordance with generally accepted accounting principles.

**Risks of Reliance on Owner/Manager Controls**

If the auditor does place some reliance on owner/manager controls, there are certain risks that he should consider.
Incompatible Functions. By involving himself in the routine accounting functions, the owner/manager may be performing incompatible functions. Incompatible functions are those that place any person in a position to perpetrate and conceal errors or irregularities in the normal course of duties. Accordingly, the auditor should identify internal accounting control areas where procedures performed by the owner/manager are incorporated with procedures performed by other employees, thereby providing a check on the owner/manager.

Potential for Management Override of Internal Accounting Control. For explanatory purposes, a distinction is made between primary controls exercised by the owner/manager in the same capacity as an employee and employee-segregated controls. An owner/manager who reviews and approves invoices is as much a part of the internal accounting control system as the employee performing the same functions. When either an owner/manager or an employee does not perform his accounting functions, the person has deviated from prescribed procedures. However, when an owner/manager is not a part of the internal accounting control system and he causes an employee to deviate from prescribed procedures, the owner/manager has overridden internal accounting controls.

An entity with a dominant owner/manager has an increased potential for management override of internal accounting controls. The potential for management override is an inherent limitation in all audits; however, management override may be easier to initiate or more difficult to determine when few employees are involved. The auditor of a small business must assess the probability that management override has occurred. The auditor may consider the owner/manager's integrity in his evaluation, but owner/manager dominance is not prima facie evidence that integrity is lacking. Integrity and owner/manager dominance are two attributes that must be evaluated separately. The auditing literature states that given no evidence to the contrary, and if the audit is performed with due professional care, the auditor may assume that management has not overridden internal accounting controls. As a practical limitation, however, the potential for management override of such controls may allow only minimal reliance on them for purposes of restricting tests of transactions and account balances or analytical review procedures.

3. SAS 1, sec. 320.36.
4. Potential for management override relates to the possibility that override of controls could occur. Probability of management override relates to an assessment of the likelihood that override of controls has occurred.
**Inherent Limitations.** The auditor should consider inherent limitations when evaluating the effectiveness of owner/manager controls. Inherent limitations include deviations from prescribed procedures by an owner/manager or an employee, management override of prescribed procedures performed by employees, mistakes in judgment, carelessness, and collusion.

**Guidance for Analytical Review Procedures**

The research study determined that auditors have difficulty applying analytical review procedures in the small business engagement. The degree of difficulty was fairly consistent for all three audit stages in which analytical review procedures can be applied.

An effective form of practical guidance to auditors regarding analytical review procedures would be illustrative case studies. Illustrations of uses of analytical review procedures in the small business audit could apply the concepts presented in SAS 23, *Analytical Review Procedures*. Specific examples of the use of analytical review procedures as attention-getting devices in the planning stage and as replacements for other substantive tests during the audit could reduce the confusion regarding the usefulness of these procedures in small business audits.

A section in the recommended guidance should also address the risks inherent in the use of analytical review procedures:

Extant research reveals that the predictive ability of various mathematical techniques utilizing ARPs are probably not adequate for purposes of reducing beta risks. That is, the absence of unusual fluctuations may not represent adequate evidence to cause the auditor to limit other substantive tests; however, the presence of unexpected fluctuations should normally result in an expansion of other substantive tests.

One way to reduce uncertainty regarding the use of analytical review procedures in the small business audit would be to clarify the risks that are involved. Planning risk relates to misdirected audit effort; substitution risk relates to the incorrect acceptance of materially misstated amounts (beta risk). These concepts could be explained by use of examples, illustrations, and, possibly, short audit cases.

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6. Beta risk is the probability that an account balance will be accepted as correct when the balance is materially in error. ARP is an abbreviation for analytical review procedure. SAS 39 refers to beta risk as the "risk of incorrect acceptance."

Other Recommendations

The four remaining significant small business audit problems for which recommendations are appropriate involve (1) the client representation letter, (2) the use of management representations as audit evidence, (3) deficient response from the client’s attorney with respect to litigation, claims, and assessments, and (4) assignment of experienced audit personnel to the small business audit.

The Client Representation Letter

Respondents indicated difficulty in communicating to management the contents of the management representation letter. SAS 19, *Client Representations*, presents an illustrative representation letter. Some of the representations in the illustrative letter are broad and may cause problems if management does not understand all matters included in the representation. For example, SAS 19 includes as a representation a statement concerning plans or intentions that may affect the carrying value or classification of assets and liabilities. Small business management may not understand which plans and intentions could materially affect the carrying value or classification of assets and liabilities. Clearer wording is needed.8

In the small business audit, additional modifications to the illustrative representation letter may be needed. Management might need to acknowledge the auditor’s recommended adjusting entries, as well as whether the adjustments have been posted. Management might also acknowledge that material internal accounting control weaknesses were communicated orally by the auditor. The letter might contain a representation that business and personal items are properly separated for financial statement purposes. The AICPA should provide sample management representation letters for use in small business audits.

SAS 19 does not illustrate the definitions of terms that have technical meanings understood only by those who are proficient in accounting and auditing. Examples of definitions should be provided for the auditor’s use in communicating the contents of the letter to management. Although definitions for such terms as irregularities, loss contingencies, unasserted claims, assessments, and collective and individual levels of materiality may exist elsewhere in accounting and auditing literature, they need to be codified and perhaps illustrated in the literature addressing client representations.

Use of Management Representations as Audit Evidence

According to respondents, the use of management representations as audit evidence is important when other evidence about the completeness of recorded transactions cannot be obtained. Forty percent of the respondents indicated that they at least occasionally rely on this form of management representation. Other respondents may believe that the low level of assurance offered by internal evidence, such as management representations, precludes their usefulness as audit evidence. Without corroborating evidence, the only available support for financial statement items would be internal, and internal evidence may lack sufficiency and competence.

If an assertion is material, it requires stronger evidence; all reasonable doubt should be eliminated:

The more material the proposition under consideration the stronger must be the evidence upon which judgment rests, varying from a merely persuasive preponderance for immaterial propositions to compelling or near compelling evidence for material propositions.9

SAS 19, Client Representations, requires the auditor to obtain written representation to provide confirmation regarding assertions in the financial statements. The standard states that in some cases when corroborating evidence is limited the auditor may not be able to obtain corroborating information through audit procedures other than management representations (for example, management’s intentions to dispose of a segment).

The standard provides for some reliance on management representations when no other form of evidence can be expected to exist because the assertion relates exclusively to management’s intent to act or not to act. The standard, however, does not allow reliance on management representations merely because there is a lack of corroborating evidence for matters on which documentation could be expected to exist. To the extent that the auditor remains in substantial doubt about such representations, he must express a qualified opinion or disclaimer of opinion.

Inadequate Response From the Client’s Attorney

Another significant difficulty encountered by the auditor of a small business involves deficient responses from the client’s attorney. The perception of inadequate response may be caused by several factors. The language used by attorneys, such as meritorious defenses or without substantial merit, is difficult to interpret in terms of auditors’ needs. Also,

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management may give the attorney inadequate instructions. Deficient responses may also be caused by the method of inquiry; perhaps there are better methods than the lawyer’s letter to determine information regarding litigation, claims, and assessments.

The AICPA is studying areas in which additional guidance regarding lawyers’ letters is needed. One specific area under consideration is the means of improving inquiry techniques for small business audits.

**Assignment of Audit Personnel**

Generally accepted auditing standards require that the examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor. The audit team for large entities generally involves multiple levels of authority and supervision. An audit with three or four levels of review can use less experienced personnel effectively at lower levels of responsibility. Small business audits typically require fewer audit personnel and consequently fewer levels of supervision; therefore, more experienced audit personnel are needed at the lower levels.

Guidance should address differences in the assignment of lower-level personnel to audits of large and small entities. The guidance should enumerate evaluation criteria for the assignment of audit personnel. The study shows that the majority of respondents believe that the assignment of more experienced personnel to the small business audit is important; therefore, this quality control consideration should be addressed in whatever form of guidance is appropriate.

**Areas for Additional Research**

This research represents an initial attempt to determine empirically the significance of selected small business audit problems. The major focus was necessarily general in nature; therefore, there are specific problems warranting additional study. Several studies could be undertaken relating to the difficulties in determining whether to rely on internal accounting controls in the small business. One could investigate whether CPAs confuse compliance tests with substantive tests in practice or whether the problem is primarily one of semantics. Additional research may be needed to confirm the findings of this study regarding how frequently auditors rely on owner/manager controls and how such reliance affects the extent of substantive tests.

Another research task could be to examine and compare specific small business audit approaches. Determination of differences between small business and large business audit approaches could be helpful. Specifically, the study should probe variations in the nature, extent, and timing of audit procedures and the reasons why the differences exist.
Internal accounting controls often evolve in the small business. Research needs to be undertaken regarding the stages of evolution for each audit cycle and whether tendencies exist for management to develop internal accounting controls over certain cycles in a universal or random manner.

The study determined that analytical review procedures are important to the small business audit. A research study could provide evidence on whether such procedures are used more often in certain stages of the small business audit than in the large business audit and whether the procedures are actually used to restrict the extent of other audit tests.

An entire study could be devoted to matters of efficiency in the small business audit. The profession needs to develop creative auditing procedures that can maintain or reduce small business audit fees.

Finally, this study indicated that smaller CPA practice offices ranked audit problems as more significant than did larger practice offices. Reasons for this difference should be investigated. The study should consider whether the differences are caused by the characteristics of the smaller firm, such as developmental stage problems accompanying smaller, younger CPA firms, or whether the differences relate to the type of client the smaller CPA firms service.

I hope that this study has provided a framework for further investigation of small business audit problems.
Appendixes
APPENDIX A

Questionnaire for Analysis of Audit Problems Encountered With Small Business Clients

This research project is sponsored by the
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

INSTRUCTIONS

Please read the enclosed material, answer the questions that follow, and return the completed questionnaire in the enclosed envelope. Your participation in this project is very important and will be appreciated. If you have no audit clients, indicate this fact on the unanswered questionnaire and return it in the enclosed envelope.

Results of this questionnaire survey will be communicated to the AICPA only in summary form. Individual firm responses will not be communicated to the AICPA.

If you would like to receive a complimentary executive summary of the research results, please complete the following:

NAME__________________________________________________________________________________
ADDRESS______________________________________________________________________________

Address comments or questions to:
D.D. Raiborn, Texas Tech University (806)742-2097
P.O. Box 4320, Lubbock, Texas 79409
QUESTIONNAIRE FOR ANALYSIS OF AUDIT PROBLEMS ENCOUNTERED WITH SMALL BUSINESS CLIENTS

The questionnaire consists of the following parts:

I. General Information
II. Questions Related to Audit Problems
III. Questions Related to Audit Approach
IV. Information on Responding CPA Practice Offices

I. GENERAL INFORMATION

1. Your title:
   - No response: 21 (4.0%)
   - sole proprietor: 204 (38.8%)
   - manager: 49 (9.3%)
   - partner: 223 (42.4%)
   - private corp.: 29 (5.5%)

2. Total years public accounting experience
   \[ X = 15.62 \]
   Place an 'X' in the appropriate blank that indicates the average number of hours required to complete the audit for your typical small business client.

   - less than 40 hrs.: 59
   - 41-80 hrs.: 125
   - 81-120 hrs.: 123
   - 121-160 hrs.: 59
   - 161-200 hrs.: 51
   - 201-240 hrs.: 201
   - 241-280 hrs.: 124
   - 281-320 hrs.: 123
   - 321-360 hrs.: 32
   - 361-400 hrs.: 3
   - Over 400 hrs.: 15

   \[ X^* = 3.71 \]

3. Place an 'X' in the appropriate blank that describes what you consider to be characteristics of your typical small business audit client. In completing the questionnaire, please respond to the questions with these characteristics in mind.
   - A. There is a concentration of ownership or operational control in one or a few individuals.
   - B. There is a greater potential for management override of internal accounting controls.
   - C. Management personnel or employees have limited accounting knowledge.
   - D. Management does not hire or is unable to hire employees having accounting experience or formal accounting training.
   - E. There is a limited segregation of functions within the accounting system because of the small number of employees.
   - F. Clerical and administrative personnel have easy access to assets.
   - G. Recordkeeping systems are often informal and documentation of transactions is inadequate.
   - H. There is an inactive or ineffective policy making body (e.g., Board of Directors.)
   - I. List other characteristics that are applicable.

4. Place an 'X' in the appropriate blank that describes what you consider to be characteristics of your typical small business audit client. In completing the questionnaire, please respond to the questions with these characteristics in mind.

   - A. There is a concentration of ownership or operational control in one or a few individuals.
   - B. There is a greater potential for management override of internal accounting controls.
   - C. Management personnel or employees have limited accounting knowledge.
   - D. Management does not hire or is unable to hire employees having accounting experience or formal accounting training.
   - E. There is a limited segregation of functions within the accounting system because of the small number of employees.
   - F. Clerical and administrative personnel have easy access to assets.
   - G. Recordkeeping systems are often informal and documentation of transactions is inadequate.
   - H. There is an inactive or ineffective policy making body (e.g., Board of Directors.)
   - I. List other characteristics that are applicable.

\[ X^* \text{ represents the category mean; } 3.71 \text{ falls between the third category (81-120 hrs.) and the fourth category (121-160 hrs.).} \]

\[ ** \text{Number of respondents who indicated that the characteristic described their small business clients. The corresponding percentages indicate the proportion of total respondents (526) indicating that the characteristic was typical of their small business clients.} \]
II. QUESTIONS RELATED TO AUDIT PROBLEMS

Section A - Questions Related to Frequency

This section addresses the FREQUENCY OF OCCURRENCE of specific auditing problems of the small business. When completing this section please respond to the questions as they relate to your typical small business client. Assume the audit relationship to be continuing, i.e., the audit is not a first time audit. Frequency of a problem will be classified by the following scale points:

1. NEVER ............... — The audit problem NEVER occurs.
2. RARELY ............... — The audit problem occurs LESS THAN 25% of the time.
3. OCCASIONALLY ........ — The audit problem occurs 25-50% of the time.
4. FREQUENTLY ........ — The audit problem occurs 51-75% of the time.
5. USUALLY ............ — The audit problem occurs MORE THAN 75% of the time.

Mark your selection of FREQUENCY in the scale columns to the right of the questions.

EXAMPLE:

<table>
<thead>
<tr>
<th>Question</th>
<th>Frequency</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>How often do your small business clients maintain unreliable accounting records?</td>
<td>3.0</td>
<td>516</td>
</tr>
<tr>
<td>How often do your small business clients delegate management functions to the auditor (e.g., negotiate bank loans, prepare source documents)?</td>
<td>2.2</td>
<td>525</td>
</tr>
<tr>
<td>How often do you audit write-up work (e.g., bookkeeping services) that you previously prepared for the client?</td>
<td>2.7</td>
<td>526</td>
</tr>
<tr>
<td>How often do clients fail to maintain record counts or other types of independent accounting controls over write-up work that you perform for them?</td>
<td>3.0</td>
<td>517</td>
</tr>
<tr>
<td>How often do you assign more experienced audit personnel to the small business audit than you would in a larger audit?</td>
<td>3.2</td>
<td>526</td>
</tr>
<tr>
<td>How often are you able to place reliance on internal accounting controls (e.g., segregation of duties) over sales, accounts receivable, and cash receipts for the purpose of reducing the extent of other auditing procedures?</td>
<td>3.2</td>
<td>525</td>
</tr>
<tr>
<td>How often are you able to place reliance on internal accounting controls (e.g., segregation of duties) over purchases, accounts payable, and cash disbursements for the purpose of reducing the extent of other auditing procedures?</td>
<td>3.4</td>
<td>522</td>
</tr>
<tr>
<td>How often are you able to place reliance on internal accounting controls (e.g., segregation of duties) over payroll for the purpose of reducing the extent of other auditing procedures?</td>
<td>2.7</td>
<td>526</td>
</tr>
<tr>
<td>Assume a preliminary evaluation of internal accounting control determined that reliance cannot be placed on internal accounting control. How often would you compliance test accounting controls under such circumstances? (For purposes of this study, COMPLIANCE TESTS are defined as tests that provide assurance that the accounting control procedures are being applied as prescribed, e.g., verify that checks are recorded in the cash disbursements journal.)</td>
<td>3.8</td>
<td>523</td>
</tr>
</tbody>
</table>

N = Number of responses to question
X = mean value
### II. QUESTIONS RELATED TO AUDIT PROBLEMS

#### Section A: Questions Related to Frequency

<table>
<thead>
<tr>
<th>Question</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1 How often are you able to rely on owner-manager controls in the small business to reduce the extent of substantive auditing procedures performed? (For purposes of this study, SUBSTANTIVE TESTS are defined as tests of details of transactions, direct tests of balances, and analytical review procedures that provide evidence as to the validity and propriety of accounting treatment of transactions and account balances, e.g., trace to verify that the proper amount is recorded, search for potential monetary errors. OWNER-MANAGER controls include approving purchase orders, signing checks, reconciling the bank statement, etc.).</td>
<td>Usually/Occasionally/Seldom/Totally, N = 524</td>
</tr>
<tr>
<td>3.3 How often do insufficiently documented owner-manager controls cause difficulty for the auditor who intends to compliance test such controls?</td>
<td></td>
</tr>
<tr>
<td>2.9 How often do you have difficulty applying analytical review procedures in planning your audit to identify areas requiring special attention?</td>
<td></td>
</tr>
<tr>
<td>2.9 How often do you have difficulty applying analytical review procedures during the audit to replace certain other direct tests of balances that could be performed?</td>
<td></td>
</tr>
<tr>
<td>2.5 How often do you have difficulty applying analytical review procedures near the end of the audit as an overall review of operations?</td>
<td></td>
</tr>
<tr>
<td>2.6 How often are management representations relied upon as audit evidence when completeness of recorded transactions cannot otherwise be verified?</td>
<td></td>
</tr>
<tr>
<td>2.6 How often are difficulties encountered in communicating to management the contents of the representation letter required by SAS No. 19, “Client Representations”?</td>
<td></td>
</tr>
<tr>
<td>2.3 How often do you encounter difficulty in determining the existence of related parties in the small business?</td>
<td></td>
</tr>
<tr>
<td>2.2 How often do you encounter client resistance to disclosing related party transactions?</td>
<td></td>
</tr>
<tr>
<td>2.3 How often do small business clients retain a lawyer who is available for purposes of responding to litigation, claims and assessments as its attorney?</td>
<td></td>
</tr>
<tr>
<td>3.0 How often do you believe that the small business client’s attorney provides an incomplete response to a request for information on litigation, claims and assessments as is warranted?</td>
<td></td>
</tr>
<tr>
<td>2.4 How often do you not communicate material internal accounting control weaknesses because the cost of correction is greater than the benefit that could be realized?</td>
<td></td>
</tr>
<tr>
<td>2.2 In certain cases the auditor may find it necessary to communicate information to a level above operating management (e.g., Board of Directors). How often does the small business without a supervisory level above operating management cause you problems in communicating necessary information?</td>
<td></td>
</tr>
<tr>
<td>2.0 In certain cases audit findings may affect persons other than management (e.g., minority stockholders, limited partners). How often do you encounter difficulty in deciding whether to communicate your audit findings to other interested parties?</td>
<td></td>
</tr>
</tbody>
</table>
II. QUESTIONS RELATED TO AUDIT PROBLEMS
Section B - Questions Related to Importance

The questions in this section are phrased in terms of IMPORTANCE of the audit problem to the completion of your audit (i.e., does the audit problem affect your ability to "get the job done"). IMPORTANCE can be measured in terms of:

1. Uncertainty as to the application of generally accepted auditing standards (GAAS) in the small business audit;
2. Changes in the audit approach or procedure due to the special characteristics of the small business;
3. The issuance of an audit opinion that is different from the one that would have been issued had the audit problem not existed.

When answering these questions, assume a continuing audit relationship exists. Also, in each situation ASSUME THE PROBLEM DOES EXIST, even if you have never encountered the problem. The scale points for IMPORTANCE are:

1. UNIMPORTANT ............... - The audit problem has NO effect on your ability to complete the audit.
2. SOMEWHAT IMPORTANT ...... - The audit problem has a SLIGHT effect on your ability to complete the audit.
3. MODERATELY IMPORTANT ... - The audit problem has AN EFFECT on your ability to complete the audit, but no more so than other problems.
4. IMPORTANT .................. - The audit problem SIGNIFICANTLY affects the completion of the audit.
5. EXTREMELY IMPORTANT ...... - The audit problem has a PERVASIVE effect on the completion of the audit, potentially precluding an unqualified opinion.

EXAMPLE:

How important are reliable, client-prepared accounting records to the completion of your audit?

1. UNIMPORTANT ............... - The audit problem has NO effect on your ability to complete the audit.
2. SOMEWHAT IMPORTANT ...... - The audit problem has a SLIGHT effect on your ability to complete the audit.
3. MODERATELY IMPORTANT ... - The audit problem has AN EFFECT on your ability to complete the audit, but no more so than other problems.
4. IMPORTANT .................. - The audit problem SIGNIFICANTLY affects the completion of the audit.
5. EXTREMELY IMPORTANT ...... - The audit problem has a PERVASIVE effect on the completion of the audit, potentially precluding an unqualified opinion.

EXAMPLE:

How would the delegation to you of management functions (e.g., negotiation of bank loans, preparation of source documents) affect the completion of your audit?

How would your performance of write-up work (e.g., bookkeeping services) affect the completion of your audit?

How would inadequate client control over record counts or other types of independent accounting controls over your write-up work affect the completion of your audit?

How important to the completion of the audit is the amount of experience of the audit personnel assigned to the small business audit?

How does the inability to rely on internal accounting control (e.g., segregation of duties) over sales, accounts receivable, and cash receipts affect the completion of the audit?

How does the inability to rely on internal accounting control (e.g., segregation of duties) over payroll affect the completion of the audit?
II. QUESTIONS RELATED TO AUDIT PROBLEMS

Section B - Questions Related to Importance

3.1 What effect does the inadequate documentation of owner-manager controls of the small business have on the completion of the audit?

3.2 How important to the completion of your audit is the ability to overcome client resistance to disclosing related party transactions?

3.3 How important to the completion of your audit is the acceptance of management representations?

3.4 How important to the completion of your audit is the existence of a level above operating management (e.g. Board of Directors) to which you may communicate information?

3.5 How important to completing your audit is the communication of material internal accounting control weaknesses that are not cost-beneficial to correct?

3.6 How important to completing your audit is the communication of certain audit findings to those other than management (e.g., minority stockholders, limited partners)?

<table>
<thead>
<tr>
<th>IMPORTANT</th>
<th>MODERATELY IMPORTANT</th>
<th>MARGINAL IMPORTANT</th>
<th>NOT IMPORTANT</th>
</tr>
</thead>
<tbody>
<tr>
<td>20.7</td>
<td>28.5</td>
<td>17.5</td>
<td>3.8</td>
</tr>
<tr>
<td>21.9</td>
<td>21.1</td>
<td>27.4</td>
<td>24.9</td>
</tr>
<tr>
<td>16.5</td>
<td>13.7</td>
<td>18.6</td>
<td>9.5</td>
</tr>
<tr>
<td>5.7</td>
<td>3.6</td>
<td>4.9</td>
<td>29.8</td>
</tr>
</tbody>
</table>

N = 525
III. QUESTIONS RELATED TO AUDIT APPROACH

The following questions are presented to determine how the audit approach for a small business differs from the audit of a large business.

1. Rank the following documentation techniques in order of your preference in documenting internal controls in the small business. (Let '1' indicate the technique you use most often.)

<table>
<thead>
<tr>
<th>Documentation Technique</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>No response*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal control questionnaire</td>
<td>60.5%</td>
<td>20.3%</td>
<td>9.1%</td>
<td>10.1%</td>
</tr>
<tr>
<td>Flowcharts</td>
<td>5.1</td>
<td>16.9</td>
<td>51.2</td>
<td>26.0</td>
</tr>
<tr>
<td>Written memoranda</td>
<td>31.2</td>
<td>44.3</td>
<td>12.0</td>
<td>12.5</td>
</tr>
<tr>
<td>Other, please specify</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Does your firm use an internal control questionnaire designed specifically for small business audits?

Yes 59.3 No 39.9 (if answered No, go to #4).

3. If an internal control questionnaire is used, what is it used for?

(A. To document the internal accounting control system)
(B. To help us understand the transactions flow in order to design the appropriate substantive tests)
(C. To identify material accounting control weaknesses to report to the client)
(D. To be of service to the client)
(E. Other, please specify ________________________________)

A. 277 52.7% N = 312
B. 246 46.8
C. 267 50.8
D. 133 25.3
E. 6.0

4. For your typical small business audit, how would you approximate the division of audit work (in percentage of time) between:

A. The study, review, and test of internal accounting control 19.62%
B. All other auditing procedures 79.8%

5. For your typical small business audit, how would you approximate the division of audit work (in percentage of time) between:

A. Interim audit procedures 30.4%
B. Year-end audit procedures 79.6%

6. Do you believe that you over-audit the typical small business client?

Yes 53.2 No 34.5 No Opinion _______ (if answered No Opinion, go to #8)

A. Standards (GAAP) overload 130 24.7%
B. Unnecessary requirements of GAAS 108 20.5
C. Excessive compliance testing of internal accounting control 105 20.0
D. Excessive substantive testing of balances and transactions 186 35.4
E. Implementation problems with GAAS 79 15.0
F. Other, please specify ________________________________

7. List two examples of owner-manager controls that you frequently rely on and the compliance tests used to determine if the controls are effective.

OWNER-MANAGER CONTROLS

<table>
<thead>
<tr>
<th>COMPLIANCE TESTS PERFORMED</th>
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</table>

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*Unless otherwise noted, the number of respondents for each question was approximately 526.
9. Does the reliance on owner-manager controls typically result in reduction of substantive tests?
   Yes 22.1%  No 45.1%  No Opinion 7.0% (if answered No Opinion, go to #11)

10. How are substantive tests reduced? To what extent are they reduced?

11. Do you believe a separate set of generally accepted auditing standards (GAAS) is needed for the small business audit?
   Yes 43.9%  No 46.8%  No Opinion 7.8% (if answered No Opinion, go to #13)

12. Why do you believe a separate set of GAAS is needed?

13. For your small business audit clients, how often do you have difficulty determining the appropriate audit opinion?
   Never 35.9% (if answered never, go to #16)  Rarely 36.3%  Occasionally 22.2%  Frequently 3.8%  Usually 6.4%  Always 8.8%

14. Why do you have difficulty in determining the appropriate opinion?

15. Indicate the extent of your agreement with the following statement.
   In studying and evaluating internal control, our objective is not to determine how substantive auditing procedures can be reduced. We do not test internal control for purposes of relying on the system to produce accurate and reliable financial statement data. We test recorded transactions primarily to determine the frequency and materiality of errors that may have occurred.
   As an overall statement of audit approach for the typical small business client, I
   Strongly agree with the statement 8.9%  Agree with the statement 29.1%  Neither agree nor disagree 8.0%  Disagree with the statement 20.9%  Strongly disagree with the statement 14.4%  No response 18.1%

16. Internal accounting control of small businesses may not be relied upon because: (Mark one or more)
   A. Control procedures are not satisfactory for the specified internal control objectives 49.2%  B. Procedures as specified are not followed 28.5%  C. Higher potential for management override of internal accounting controls 70.0%  D. The audit effort to compliance test is greater than the savings resulting from the reduction of substantive tests 34.0%  E. Other, please specify
   ________________________________________________________________
   ________________________________________________________________
   ________________________________________________________________
   ________________________________________________________________
   ________________________________________________________________
   ________________________________________________________________
   ________________________________________________________________
   ________________________________________________________________

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IV. INFORMATION ON RESPONDING CPA PRACTICE OFFICES

To classify the types of practice offices that responded to the questionnaire, please answer these brief questions.
(Mark only one item per question).

17. Practice office size:
- sole practitioner: 24.7%
- 1-10 professionals: 31.5%
- 11-30 professionals: 15.6%
- 31-50 professionals: 3.2%
- 51-70 professionals: 1.9%
- 71-90 professionals: 0.8%
- over 90 professionals: 1.7%
- No response: 0.6%

18. Number of years your practice office has been in existence:
- less than 5 years: 24.1%
- 5-10 years: 22.8%
- 11-15 years: 10.8%
- 16-20 years: 4.6%
- 21-25 years: 3.0%
- 26-30 years: 10.8%
- 31-35 years: 5.7%
- 36-40 years: 1.1%
- 41-45 years: 1.9%
- 46-50 years: 7.0%
- 51-55 years: 1.1%
- over 50 years: 5.5%
- No response: 0.8%

19. The percentage of audit revenues (exclusive of tax and systems work) to total revenues for your practice office:
- less than 5%: 9.3%
- 6-25%: 46.6%
- 26-40%: 22.8%
- 41-65%: 12.5%
- 66-85%: 7.0%
- over 85%: 1.0%
- No response: 0.6%

Thank you for the contribution of your time and effort.
November 17, 1980

Dear CPA:

The AICPA is sponsoring this research project to assist in identifying problems encountered in small business audits. This research will be used as a basis for an audit guide.

Your office was randomly selected to participate in our research project and your response is very important to the success of the research. We urge you to participate. You should be able to complete the questionnaire in 35 to 45 minutes.

Your individual response will be treated as confidential. In no circumstances will you be identified in the tabulation of results.

Thank you for participating.

Sincerely,

Dan M. Guy
Director of Auditing Research

DMG:ngr
APPENDIX C

Geographical Distribution of Respondents

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### APPENDIX D

**Frequency Response by Category**

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APPENDIX E

Importance Response by Category

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### APPENDIX F

**Significance Means of Small Business Audit Problems Classified by Practice Office Size**

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<th>Question Number</th>
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<th>11–30 Professionals</th>
<th>Over 30 Professionals</th>
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Number of Respondents: 130  271  82  43

*Significant at .01 level.
### APPENDIX G

**Significance Means of Small Business Audit Problems Classified by Relative Amount of Audit Revenues**

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| Number of Respondents | 49 | 245 | 120 | 66 | 43 |

*Significant at .01 level.*
Bibliography


