MANDATORY AUDIT OF SMALL BUSINESS IN MALAYSIA: OWNERS’ PERSPECTIVES

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ABSTRACT

This paper reports on a survey of small businesses in Selangor and Kuala Lumpur on the perceived benefit of the statutory audit. The study finds that nearly half (44%) of the sample companies would not continue to have their accounts audited if not legally required to do so. However, the sample companies generally agreed that audit can provide a check on internal control or accounting records. The location, age, ownership structure, education level and relationship with accounting cost were the factors found to significantly affect the owners’ perception of the need for annual audit by small companies. This is the first study that uses location, education level and relationship with accounting cost as the variable to test the perceptions of business owners towards a mandatory annual audit of financial statements.

Field of Research: Statutory audit, Malaysian small business, business location, audit exemptions.

INTRODUCTION

In Malaysia all businesses incorporated under The Companies Act, 1965 are required by Section 174(1) of the Act to appoint an auditor whose responsibility is to report to members of the company on the financial statements of the company. This requirement does not waive the need for audited accounts to be presented at the company’s annual general meeting for businesses which are managed by owners themselves. It appears to be an anomaly for owner managers to prepare financial statements for themselves and have the auditors examine the financial statements so that auditors can report back to the same party preparing the financial statements. As audited accounts are only prepared at the end of the financial year such information is less useful for manager owners as how can a manager know what is going on in the business if he has to wait till the annual audited accounts are presented? An efficient and effective manager would need timely information and not wait for 12 months before having
the information. The audit is also a cost of incorporation. All auditors must carry out an audit in accordance with approved accounting standards. The audit of small businesses has been seen as a relatively high audit risk area entailing a greater amount of work and therefore incurring higher costs to the business (Paul and Bainbridge, 1991). If audit is costly and not cost beneficial to the audit report addressee, would small business owners choose not to have an audit if an option is given for exemption?

In 1997 the Company Commission of Malaysia formed a working group to look into reforms of business regulations to make regulations more business friendly. One of the outcomes of the initiative was a survey of what directors of small companies think of the annual statutory audit. The resulting documentation, Consultative Document 7 (CD7), reports that almost equal numbers chose not to have an audit if exempted. However, the paper did not examine characteristics which are associated with wanting an exemption or not. It is therefore the objective of this paper to examine what manager/owners of small companies perceive as the benefits of an annual audit and the characteristics of the business and owners associated with the perceptions. Small businesses or SMEs (defined as having full-time employees not exceeding 50 or annual sales turnover not exceeding RM5 million) contribute 31% of the nation’s Gross Domestic Product (GDP), 56% to total employment and 19% of the country’s exports making SMEs an important driver of the country’s economic growth (SME Annual Report 2009/10). The costs of audit for a company includes not just the audit fees but also other costs of planning and carrying out the audit in accordance with approved auditing standards, accounts preparation to comply with the relevant financial reporting framework, review and checking compliance with the Companies Act, 1965. This paper contributes to the debate on mandatory audit for small business and can assist the regulators in deliberating the alternatives to audit if business is to be conducted in a more conducive regulatory environment. The rest of the paper is organized as follows. The next section discusses the literature followed by a description of the data collection and analysis method. The paper then discusses the findings of the study before concluding.

**LITERATURE REVIEW**

*Costs-Benefit*

The main argument for audit exemption is to remove the mandatory audit burdens and associated costs from smaller companies. Harvey (1996) suggests that the size of the enterprise impacts on the costs of producing financial statements, so that the costs are proportionally higher for small companies. As the nature and size of many small companies do not justify the costs involved, the conventional audit remains an expensive anachronism for small company (Cox, 1992). According to Yew (2000), as a result of removal of audit requirement, the accountant could switch attention to needier areas such as computerization, debt management and budgeting, in a real value for money service for small business clients. Since the internal control systems of small companies are not as extensive and complete as the large companies, auditors cannot rely on the system to make audits more effective and efficient. Thus, internal control is considered a high audit risk area (Paul and Bainbridge, 1999). The internal control system in the small company cannot be made more reliable without incurring additional cost, deficiencies being compensated with an increase in the supervisory controls. Then, a burdensome additional cost possibly arises from the addition of personnel to make duty separation. Therefore, audit of these companies could be more costly and substantive.
Page (1984) introduced a three-tier size classification of companies\(^1\) and the option for small companies to file ‘modified accounts’, and his sample was selected across the complete size range of active and independent companies. The study finds that 15% of respondents would dispense with the audit if the statutory requirements were removed. However, the profession’s views on the most appropriate level for audit exemption are diverse (Archer, 1999; Graham, 1999; Langard, 1999; Masters, 1999). In favor of raising the turnover threshold, Mitchell (1999) used organization’s statistics to argue that ‘92% of accountants responding to a Small Practitioners Association survey supported exemption for all private, owner-managed, small limited companies’. On the other hand, Beckerlegge of the ACCA supports maintaining present levels: ‘The inescapable fact is that the government’s proposals advocate the removal of the audit but not the requirement for the directors to deliver true and fair annual financial statements. Since 90% of the work is done by accountants in the compliance function, therefore it is foolish to take away the value-added aspect which is comes with the audit’ (Beckerlegge, 1999, p. 21).

Although there has been much debate about potential cost savings, little empirical evidence has been collected. Page (1981) found that the majority of auditors’ response to his survey (64%) anticipated a reduction in fees of up to 25% if no audit were performed. Pratten (1998) found that the average reduction in fees among the 16 companies he studied was 15%, but this figure does not take account of the additional help sought from the accountant in preparing the accounts. The suggestion that cost savings may be offset by other chargeable work is supported by the MORI survey (ACCA, 1998), which found that most auditors expect to be able to compensate for lost audit fee income from small company clients with a turnover of around £1m. It seems logical to suggest that the higher the cost of the audit, the greater the savings if it were discontinued. In a study of large companies in the USA that examined the demand for reviews of quarterly performance prior to filing with the Securities and Exchange Commission (SEC), Ettredge, Simon, Smith and Stone (1994) found that cost savings are a particular incentive in firms with complex activities, such as a large number of business segments, foreign operations or assets tied up in stock and debtors. These characteristics are not likely to be key features of small, private companies. The lack of consensus in the academic literature and accountancy press on the appropriate level for exemption from the audit in the UK indicates that the size thresholds used in company legislation may not adequately capture the demand for the audit in small companies. This is further demonstrated when agency factors are considered.

**Agency**

According to Jensen (1976), agency theory is another factor that would influence the balance between the costs and benefits of the audit. Agency theory assumes that the company consists of an interest of contracts between the owners of company (the principals) and the management (the agents) who are empowered with manages and controls the resources. As the result in the study of Jensen (1976), the basis of agency theory is the agents have more information than principals and that this information asymmetry unfavorably affects the principals’ ability to control effectively whether their interests are being properly served by agents. Due to the information asymmetry, the demand for audited financial statement arises

\(^1\) The three tiers were ‘small’, ‘medium’ and ‘large’.
on the assumption that human nature is weak, greed, untrustworthy and in need of some kind of checking (Power, 1997). From agency perspectives (Jensen and Meckling, 1976), both principals and agents will act rationally and use contracting process to maximize their wealth.

The agency rationale is more suitable to apply in large companies where there are external shareholders and the audited accounts play an agency role in the relationship between shareholders (the principal) and managing director (the agent). However, if the agency rationale applied in small companies, a principal who is distant from the actions of management is unable to verify them, such as an external shareholder, lender or other creditors. According to Power (1997), except the external users, the information asymmetry may also be present amongst internal shareholders if they lack the necessary skills to interpret financial information. Thus, demand for the audit may not be dependent on size because ‘even in the very smallest company disputes can arise between shareholders and the audited accounts can be an essential protection’ (Freedman and Goodwin, 1993, p. 128). However, the nature of small companies are typically family-owned and owner-managed, so there is little delegation of control, and the risk of internal and external moral hazard is considerably lower than large companies (Bolton, 1971; Carsberg et al., 1985; Collis and Jarvis, 2000). The survey conducted by Page (1984) revealed that only 9% of respondents would continue to have their accounts audited principally for the benefit of their shareholders. In addition, according to Norbert (2003), in respect of owner-managed ownership and management of the company’s assets belong to the same person. Therefore, the question arises from whether the annual statutory audit is justified by the auditor is merely reporting information to the same person acting in a different role. Furthermore, the study of English (1978, p.5) raises the question about the raison d’être of the statutory audit by arguing that where shareholders are also directors, the statutory audit only serves “to tell Mr and Mrs A (as shareholder) that they, Mr and Mrs A (as directors) have not misled or cheated them”.

Management

Another factor affecting the demand for external audit is the need of management for a regularly check on internal controls to reduce the chance of material misstatements. Typically, the likelihood of a material misstatement arising (inherent risk) and the likelihood of the accounting control detecting any material misstatement (control risk) in small companies may be high. A survey conducted by ACCA (1998) indicates that almost 40% of selected small companies consider that the information provided in audited financial statements is useful to the business itself. The more specific reasons for having a voluntary audit are to improve the efficiency for the operation of the company (Page 1984) because it is a good practice; for continuity for past; because the effect of profit-related pay scheme provided to management; or because the advice of their accountant (Pratten, 1998).

Alternatives for the Statutory Audit

According to Shaw (1978), the only alternative to statutory audit is “no audit”. The study of Davison (1980, p. 42) showed a similar attitude as it stated that “surely, the proper alternative is no audit at all”. Furthermore, Shaw (1978) stated that any changes should be give the priority directed by exempt companies from an annual audit requirement rather than introduces a new form of assurance services if company legislation is to be amended. However, according to Langard (1999, as cited in Seow, 2001), the adoption of audit
exemption might open the floodgates for adverse selection, where the companies that may benefit most from, or mostly need, the statutory audit may choose for an exemption. Moreover, ACCA (2000) argued that the audit deregulation might have an impact on the auditing profession in the sense that small audit practitioners may no longer be in a position to train audit staff, leading to the creation of the oligopoly of audit service providers. In Malaysia, that is about 92% (1,400) accounting firms are small proprietorships or two-partner outfits which mainly rely on audit as the source of income (Lee, 2003). As a result, the deregulation of statutory audit might be an unusual threat to them. The study by Salleh, Rose, Kumar and Jaafar (2008) showed practitioners were overwhelmingly against the proposed audit exemption in Malaysia. A less costly form of assurance services suitable for owner-managed companies have been suggested by Stewart (2000) is the independent professional review. However, the review engagement is different from the audit in the scope of work undertaken (Auditing Practices Board, 2000). Moreover, Davison (1980) argued that if the public interest does not require the law to impose a full audit on small companies, then there is no justification for imposing a review requirement on such companies. According to Page (1991), a review may not be sufficiently distanced from an audit by the users, such that it might further widen the audit expectation gap.

Hypotheses development

The first three hypotheses relates to the key characteristics of business that would affect the small companies’ perceptions on the perceived value provided by an audit. The first hypothesis is based on the size factors to test the effect on the small companies’ perceptions on the perceived value provided by an audit. According to Jill (2004), the economic rationale implicated in the audit deregulation that the cost of the audit falls disproportionately on small companies. Thus

Hypothesis H1: There is a positive association between company size and maintaining the annual audit.

The location of small companies may influence the owners’ perception on perceived value of audit. Firth (1997) used location as a variable in his study. Bennet and Smith (2003) posit that business clients prefer professional firms that are close to their office. The reasons for the preference are: the proximity of the firms could provide more effective and efficient market. In Malaysia, major commercial areas are the Klang Valley, Johor Bahru and Penang. So,

Hypothesis H2: There is an association between the location of the company and the perceived value of audit.

According to Geenguizen (1995), it is expected in organizational sociology that the newly started companies face relatively large risks due to lack of organizational experience and cohesion. Likewise, a new small company is expected to face a high risk to maintain their business. Any deregulation may need a lot of resources to restart and plan all over again. On the other hand, established firms are shown as more capable to overcome any existence of uncertainty and risk based on their experience. Therefore,

Hypothesis H3: There is an association between the company’s age and the perceived value of audit.
The next two hypotheses relate to the agency factors that would affect the small companies’ perceptions on the perceived value provided by an audit. Simunic and Stein (1987) contend that agency costs increase in proportion to the size and complexity of the firm’s operations. Therefore, such costs are expected to be less significant in small firms where operations are less complex than in large firms. The fourth hypothesis arises from the ownership pattern will affect the agency costs. So,

**Hypothesis H4:** There is an association between the ownership pattern and the perceived value of audit.

According to Collis, Jarvis, and Skerratt (2004), likelihood of the directors choosing a non-mandatory audit increases if the company has agency relationships with lenders. So,

**Hypothesis H5:** There is an association between financial structure and the perceived value of audit.

The last three hypotheses relate to management factors in connection with the directors’ or managements’ level of knowledge or beliefs about the costs and benefits of the audit that would affect the small companies’ perceptions on the perceived value provided by an audit. The sixth hypothesis relates to management factors in connection with the directors’ education level toward the perceived value of audit. Collis et al. (2001b) find that directors with a degree, professional/vocational qualification or who had studied/trained in business or management subjects were more likely to choose a voluntary audit. This suggests that educational profile may be a proxy for formal knowledge of the costs and benefits of the audit. Thus,

**Hypothesis H6:** There is a positive association between education level of owner and the perceived value of audit.

The seventh hypothesis arises from the proposition that small companies are more concerned with “saving costs” rather than seeing the benefit of spending on audit. Not having an audit not only removes the cost burden but it also saves costs on having to maintain accounting records to suit the needs of the auditors. Therefore,

**Hypothesis H7:** There is a negative association between accountancy fees paid and the perceived value of audit.
Thus, the theoretical framework for this study is expressed as:

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Hypothesis Tested</th>
<th>Dependent Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company Size</td>
<td>H1</td>
<td>Perceived Value Of Audit</td>
</tr>
<tr>
<td>Location</td>
<td>H2</td>
<td></td>
</tr>
<tr>
<td>Company’s Age</td>
<td>H3</td>
<td></td>
</tr>
<tr>
<td>Ownership Pattern</td>
<td>H4</td>
<td></td>
</tr>
<tr>
<td>Financial Structure</td>
<td>H5</td>
<td></td>
</tr>
<tr>
<td>Education Level of Owner</td>
<td>H6</td>
<td></td>
</tr>
<tr>
<td>Accountancy Fees</td>
<td>H7</td>
<td></td>
</tr>
</tbody>
</table>

**Data collection and analysis**

**DATA COLLECTION AND ANALYSIS**

Data for the study was collected by personal interviews with owners and directors of small and medium companies in Selangor. The questionnaire covered questions related to different aspects of the use of audited accounts by the directors, basic information about the respondents’ demographics and perceived benefit of audit, if any. 50 small businesses were selected with 25 located in non-city area using convenient sampling and 25 in city area. The companies selected must have less than 50 full-time employees and less than 4 shareholders. Pearson Chi-square test was conducted to measure the extent of relationship between the
dependent variable (NMAUDIT) and each of the independent variables (SIZE, LCTN, AGE, FAMILY, EDUCTN, BANK and ACFEES).

RESULTS AND DISCUSSION

Majority of respondents are in services sector (42%) in city area. This is because the survey for city area is focused on Berjaya Times Square, Pudu and Cheras so the majority respondents would be more on services providers. However, for the non-city area, the respondents which conducted manufacturing business (28%) were more than services provider (16%). 72% had a degree, a professional or vocational qualification and/or had studied/trained in business or management subjects. Therefore, this educational profile of the respondents revealed that they would have both tacit and formal knowledge with which to weigh up the costs and benefits of the audit and answer the questionnaire. A total of 27 companies (representing 54% of the sample) indicated that they have obtained external funding from bank in addition of the capital invested by the shareholders and retained profit. The self-finance contributed by the loans from family, friends and directors themselves provide funds to the total of 23 companies. This corroborates pervious research that banks are the main external source of finance to small companies (Cosh and Hughes, 2000). However, this study highlights the importance of personal loans from family, friends and directors themselves. These sources of finance are used in 46% of companies. Thus, the larger the company, the more favorable to seek external finance than family and this has been confirmed by the previous research that larger companies are more likely to seek external finance than smaller companies (Cosh and Hughes, 2003). The summary of the key characteristics of respondents are shown in Table 1.

**TABLE 1: CHARACTERISTICS OF RESPONDENTS**

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Number of Respondents</th>
<th>Percentages (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Company Age</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Newly Established</td>
<td>27</td>
<td>54</td>
</tr>
<tr>
<td>Established</td>
<td>23</td>
<td>46</td>
</tr>
<tr>
<td><strong>Ownership Structure</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Owners are not related</td>
<td>27</td>
<td>54</td>
</tr>
<tr>
<td>Family-owned business</td>
<td>23</td>
<td>46</td>
</tr>
<tr>
<td><strong>Owners’ Education Level</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-educated</td>
<td>14</td>
<td>28</td>
</tr>
<tr>
<td>Educated</td>
<td>36</td>
<td>72</td>
</tr>
</tbody>
</table>
External Sources of Finance

<table>
<thead>
<tr>
<th>Source</th>
<th>Self-financed</th>
<th>Bank finance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>23</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>46</td>
<td>54</td>
</tr>
</tbody>
</table>

**Perceived Benefits of Audit**

In order to examine the perceived benefits of the audit, respondents were asked to rate how strongly they agreed on a scale of 1 to 5 where 1 = strongly disagree and 5 = strongly agree on eight statements describing the benefits of an audit. As reported in Table 2 below the main benefits of audit are that audit can provide a check internal control/accounting records (66% strongly agree), provides assurance to the bank and other lenders (50% agree) and improves quality of the financial information (43% agree). These findings has been confirmed by pervious research which shows that companies fall into two distinct groups with differering needs (Collis et al., 2003b). In addition, 42% of respondents believed that the audit helps to improve credibility of the financial information and 46% that it provides assurance to shareholders. Besides that 34% of respondents agreed that audits helps protect against fraud.

**TABLE 2: PERCEIVED BENEFITS OF AN AUDIT**

<table>
<thead>
<tr>
<th>BENEFITS OF AUDIT</th>
<th>AVERAGE SCORE</th>
<th>RANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good check on accounting records/internal control</td>
<td>3.92/5</td>
<td>1</td>
</tr>
<tr>
<td>Helps protect against fraud</td>
<td>2.96/5</td>
<td>6</td>
</tr>
<tr>
<td>Improves quality of annual accounts</td>
<td>3.35</td>
<td>3</td>
</tr>
<tr>
<td>Gives assurance to shareholders</td>
<td>3.27</td>
<td>5</td>
</tr>
<tr>
<td>Gives assurance to bank and other lenders</td>
<td>3.5</td>
<td>2</td>
</tr>
<tr>
<td>Gives assurance to suppliers and trade creditors</td>
<td>2.31</td>
<td>7</td>
</tr>
<tr>
<td>Can improve company’s credit standing</td>
<td>2.19</td>
<td>8</td>
</tr>
</tbody>
</table>
Results for Tests of Hypotheses

Chi-square test was used on hypotheses 1-7. As shown in Table 3 below H1 and H5 are rejected as results show there is no significant association between wanting an audit and factors of company size and company financing structure.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Hypothesis</th>
<th>Results (p-value)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size</td>
<td>H1</td>
<td>0.678 NOT Sig</td>
</tr>
<tr>
<td>Location</td>
<td>H2</td>
<td>0.041 SIG</td>
</tr>
<tr>
<td>Age</td>
<td>H3</td>
<td>0.035 SIG</td>
</tr>
<tr>
<td>Family</td>
<td>H4</td>
<td>0.006 SIG</td>
</tr>
<tr>
<td>Bank</td>
<td>H5</td>
<td>0.647 Not Sig</td>
</tr>
<tr>
<td>Education</td>
<td>H6</td>
<td>0.002 SIG</td>
</tr>
<tr>
<td>AFee</td>
<td>H7</td>
<td>0.000 SIG</td>
</tr>
</tbody>
</table>

Results show significant relationship between the dependent variable (NMAUDIT) and the independent variables of LCTN, AGE, FAMILY, EDCATN and AFEES (p≤0.05). However, the result for SIZE and BANK are non-significant (p>0.05). This provides evidence to reject H1 and H5, as there is no significant difference between the audit decision and the company’s size as well as finance structure. Collis et al (2004) find size to be a significant factor possibly because this study uses number of full time employees as a measure of size. This information is more willingly given by respondents compared to size according to Annual Sales (trade secret). Also all respondent firms appear to have the same number of employees ranging from
5-27. The financing structure of the business is not significant unlike the findings of Cosh and Hughes (2003) possibly because many small companies are self reliant for finance from family and close associates and distant themselves from outsiders.

To date, no research conducted uses the location of the respondents to examine the perceptions of owners for small companies towards the non-mandatory audit. Thus, this is a significant contribution of the study. Respondents from city areas have a higher degree of understanding of the importance of audit compared with non-city respondents. In addition, this study finds that unlike respondents from the urban areas, those located in rural areas would seldom meet their auditors. This may be due to the infrastructure in rural areas so the auditors would not often meet their clients and normally they would ask their clients to send the documents needed for audit to them, after which the documents are returned together with the annual report to their clients. This creates a problem of less communication between the auditors and their clients in non-city areas resulting in reduced perceived benefit of the audit. However by relying on the external auditors to also prepare the accounts, the small businesses in non-city areas have inadvertently created a self-review threat to the auditor’s independence and could adversely affect the quality of the audit. It is also a reflection of small business practice whereby owner-managers are not sufficiently accounting literate to produce financial statements in accordance with approved accounting standards hence relying on the auditors’ accounting expertise to produce the financial statements instead. 82% of companies surveyed employed an external accountant to prepare the statutory accounts and this accountant is also likely to be the auditor. Another additional finding of the study is that the incumbent auditors have been in service for 10 years (mode) suggesting that there could be another threat to auditor independence: the familiarity threat.

Managements’ education level is found to be significant, similar to that of Collis et al (2004). Where management is less accounting literate and language (English) could be a barrier in appreciating audited financial statements, management is more likely to leave everything to the auditors to handle distancing themselves from the business of accounting and auditing. Hence auditing and accounting is alien and therefore of no added value. Respondents also feel that if audit is exempted, accounting fees will also decrease and lessen the cost burden of the business. Audit fees are a financial burden in two ways: paying for the audit and paying for maintaining accounts to suit the needs of the audit or the business.

In summary the results of the study show that the owners are likely to have a voluntary audit if the company has the following characteristics: it is located in the city areas and/ or has been newly established its business; it is not wholly family-owned and has shareholders without access to internal financial information; and the owners are educated and/ or view the audit fee would not affect the accountancy costs.

CONCLUSION

This study reports on small businesses’ perspectives on the value of the statutory audit. The study finds that 44% of the respondents would not choose to have a voluntary audit because of lack of added value of the audit to a manager owner business. This study analyses the
characteristics of the business and its owners and its association with the usefulness of the audit. Factors of age, location, ownership structure, education level and relationship with accountancy cost were the factors to positively influence the owners’ perception on the need of annual statutory audit to small businesses. Since there are valid reasons for wanting and not wanting an audit, the regulatory authorities should consider giving an option for those not needing the audit to just having an accountant do a review of the business accounts for filing annual returns. In this way regulators offer a more business friendly solution to small businesses. This study is limited to a relatively small sample of mostly Chinese small business. Future studies may enlarge the sample to include business run by other ethnic groups who may have a different perspective of the statutory audit.

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