

## THE SMALL AND MICRO ENTERPRISE AUDIT IN TANZANIA: IS IT WORTH THE EFFORT? EVIDENCE FROM AN EXPLORATORY STUDY

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**Abstract:** The audit of small and micro-enterprises has, for a long time, been of concern to many academics and practitioners alike. Arguments have abounded as to whether the small enterprise audit was worthwhile or not. Though both views existed, it was apparent that small enterprise auditors did face problems in the small audit, albeit in different forms and magnitude. Some countries allow small enterprises to go unaudited. In the UK, a financial reporting standard for smaller entities has been promulgated in an attempt to mitigate some of the problems.

This paper presents findings of an exploratory study conducted in Tanzania in relation to problem met by small and micro-enterprise auditors. The study was motivated by the fact that, whereas elsewhere the small audit problem is apparent and being dealt with in various ways, in Tanzania there is an apparent lack of knowledge to any problems and their effect on the auditor's work. The study thus sought, *inter alia*, to confirm the existence of small audit problems, the nature of their incidence, and their impact on the audit work. This was done by soliciting responses to a number of potential audit problems. The results suggest that most of the problems investigated did not occur frequently although some were significant to the auditor's work. A tentative conclusion is that, though small enterprises in Tanzania have similar characteristics to those elsewhere, the incidence of SME audit problems is perceived differently in the country.

*Key words:* internal controls, small and micro enterprises, auditing standards, accounting standards.

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### INTRODUCTION

#### General Introduction

Enterprise financial statements are meant to enable people obtain an understanding of enterprises state of affairs. The detailed scrutiny of accounts and financial statements of enterprises through auditing is generally accepted as a means by which their truth and fairness can be determined. One need for such a scrutiny is to form an opinion on the accuracy, reliability and the fairness of representations in the financial statements. The main objective of auditing is to enable the auditor to report on the truth and fairness of the financial position shown by the balance sheet, of the profit or loss shown by the profit and loss account, and of any other information required to be disclosed in the financial statements.

Section 132 of the Companies Ordinance (Cap. 212) of the Laws of Tanzania requires that all companies registered under the Ordinance appoint an auditor at each annual meeting to hold office until the next annual general meeting. The annual general meeting is important for large enterprises as it provides the shareholders an opportunity to meet and

deliberate on issues concerning their investment. Enterprises without a diversified ownership rarely have the need for annual general meetings. Typically, these are relatively much smaller in terms of number of employees, assets owned and turnover. The ownership of small and micro enterprises (SMEs) is usually concentrated in a few hands a single person, a family, or a small group of people with common interests.

A major reason for hiring audit services in large firms is to help control the conflict of interests among firm managers, shareholders, and bondholders (Chow, 1982). Other reasons include complying with institutional requirements, operational efficiencies and for internal control purposes in those cases where the auditor is considered less likely to collude with employees of the client company. With small and micro enterprises, other than for institutional and legal requirements, the motives for purchasing auditing services are rooted in their desire to acquire credit from banks. Bankers make use of audited financial statements in their lending decisions (Kitindi 1997). It is this aspect that also makes it necessary for sole proprietorship to have their accounts audited. The provisions of the Companies Ordinance (Cap. 212) do not cover sole traders because they are not limited liability companies. Nevertheless they are subject to

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auditing for bank loans' purposes.

Voices have been raised elsewhere to the effect that the audit of SMEs poses problems to auditors that are not experienced with large enterprises. This is due to the difference in scale on which SMEs and large enterprises operate, and which is often reflected in their respective audit requirements. While appreciating the need for preparing accounts, SME proprietors generally consider the auditing function as having marginal benefits. However, auditing has an important role for large enterprises as it reflects on the stewardship of the company management.

The Tanzanian economy comprises a substantial number of small, medium-sized and micro enterprises. However, the accounting profession in the country has apparently not given adequate consideration to differences between SMEs and large enterprises. The profession has put forth several standards and guidelines for both accountants and auditors, SMEs are apparently doomed to obtaining only qualified opinion reports.

This paper presents and discusses the findings of an exploratory study whose main objective was to obtain an understanding of the nature of the problems encountered by SME auditors in Tanzania. Specific objectives of the study were to determine the common characteristics of the SME audit problems in Tanzania, to determine the frequency of occurrence of the small audit problems, and to test whether the problems have a significant impact on the audit work.

## **APPROACH OF THE PAPER**

After this introductory section, a brief discourse on accounting internal controls and the internal control system is given. Thereafter, a review of some pertinent literature on the subject matter is provided, after which the procedures adopted in gathering and analysing the data are enumerated. Empirical findings are detailed out after the methodology. Conclusions and some recommendations are made at the end.

### **Auditing and the Internal Control Structure**

In the conduct of audits, auditors often rely on the existence of internal controls in determining the extent and magnitude of tests to perform. Internal control is the system of financial and other controls established by management to

ensure the business of the enterprise is conducted in an orderly and efficient manner, adherence to management policies, safeguard the assets and secure the completeness of and accuracy of the records. This is an important matter for the auditor because of cost implications. Often, if existing internal controls are reliable, and if they have been operating as desired on a consistent basis, the auditor can choose to reduce substantive tests and perform instead more compliance tests. Since the former involve more detailed testing, the small enterprise auditor will be interested in keeping the cost of the audit at an affordable level to the client, who may not be in a position to meet the cost of an expensive audit.

However, the auditor is also interested in reducing the possibility of litigation. Users of financial statements usually refer to the professional opinion of the auditor on the assertions made in the statements. Litigation can occur in case a user who placed reliance on audited statements incurs a loss which otherwise he would not have incurred. The auditor therefore has to satisfy himself that he has sufficient evidence to formulate an opinion, something that is difficult with small enterprises due to the close involvement of the manager in the day to day activities of the business.

Other than the dependence on internal controls, auditors are guided by auditing standards, which prescribe the basic principles and practices that they, as members of a profession, are expected to follow in the conduct of an audit and apply whenever an audit is carried out. In addition, financial reporting standards guide the preparation of financial statements for reporting purposes, and auditors are required to ensure that the accounting standards are adhered to in the preparation of the statements they are auditing. Thus the work of the auditor will be determined by the auditing and financial accounting standards, and the internal controls instituted by the client. The existing standards therefore impact on the conduct of audit within a country.

## **LITERATURE REVIEW**

### **Application of Auditing Standards to Small Audit Engagements**

A review of the literature indicates that audit problems posed by SMEs have an early origin. Three decades ago, Morgan (1966) stated that

the size of operations and the small number of employees in small enterprises posed a problem in designing a system of internal control for such enterprises. This called for ingenuity and creative thinking that could make the most of the restricted conditions under which the enterprise operates. Internal controls are the primary means by which owners of enterprises can reasonably assure themselves of control over their assets and resources. Their link to auditing arises due to the fact that auditors often rely on the existence of an effective system of internal controls to make decisions on audit tests.

According to Grollman and Colby (1978), SME internal controls are different because they are affected by special problems inherent therein. These problems symbolise the characteristics of the typical SME which include little or on segregation of duties due to the small number of employees, simple record keeping, limited internal controls and the potential for management override (IFAC 1998). These characteristics of small enterprises are said to influence the auditors work.

The announcement of the release of new auditing standards in the UK spurred a flurry of literary activity in the seventies. It was felt that application of the new standards to SMEs would be difficult and would result in a majority of these enterprises receiving qualified audit reports as a matter of routine, thereby rendering the audit work and the resultant report useless. Most of the literature at that time focused on whether the small enterprise should have an audit, an audit review, or no audit at all.

There were strong views that the small audit should be abolished or made non-mandatory (Gemmel 1977, Davison 1979 and English 1979). This position was probably inspired by consideration of the view of the expected users of financial statements from SMEs. It is generally accepted that users of financial statements include current and prospective investors, banks and other loan creditors, trade creditors, government, trade unions and/or employees, and the general public. This cliché is usually used in relation to corporate financial statements, where the nature of the enterprise and its operations usually qualify it to be categorised as a large enterprise. Large enterprises have a diverse ownership because the shares are open to the public. Due to this openness to the public and the wide distribution of shares, the shareholders entrust the

management of the affairs of the enterprise to a board of directors and management. It would be rare indeed for shareholders of a public company to be involved in the day activities of the firm.

In contrast, shareholders of SMEs are usually few: often, an individual, perhaps with the spouse, and occasionally, a couple or so other persons. Here, an owner-manager situation occurs, and this owner-manager dominates over the affairs of the enterprise. The difference between large and small enterprises as regards users of financial statements is that, whereas in the former the shareholder is considered an external user, in the latter the owner is not external. For all practical intents, the only external users of financial statements from SMEs are the banks and credit grantors, including trade creditors, and credit rating agencies. For tax purposes, however, the government is interested in financial statements of all enterprises, large and small.

However, there was equally strong opposition to the abolishment of mandatory audits of small enterprises. It was argued that the small enterprise audit should be maintained; that it was a price that companies are relied upon by some users, who will need to be assured that the accounts do give a true and fair view (Sherwood 1979 and Mottershead 1979).

Shaw (1978) opposed the suggestion that audit reviews be performed instead of fully-fledged audits. He argued that a thin line separated review work and audit work. First the review procedure would not validate or enhance the status of the financial report or the degree of accountability being rendered by the company concerned. Secondly, the two, that is, an audit and a review, were likely to be confused with one another. This, according to Shaw (1978), is dangerous and undesirable as people might mistake a review as an assurance, which it is not. He was of the opinion that either audits are maintained, or there is none at all, and that in the case of some companies being exempted from the statutory audit, it could still take place to meet the requirements of a major lender, or a government agency or an individual significant investor.

#### **Application of Accounting Information Reporting Standards to SMEs**

In the US, concern was on the applicability of generally accepted accounting principles (GAAPs) to SMEs and their effect on SME

audits. It was argued that the accounting and auditing pronouncements by the Financial Accounting Standard Board (FASB) and the Auditing Standards Board (ASB) respectively had not given adequate consideration to the routine activities of accountants of SNEs (Lund 1979, Benis 1979), and that SMEs were being overburdened by excessive administrative and accounting costs in order to comply with irrelevant rules, a reference to GAAPs (Chazen and Benson 1978). Spencer, Stiner and Grant (1979), while agreeing with their compatriots in the US, had differing views, with Spencer favouring similar audits for both small and large enterprises and the other two a modification in audit approach for small enterprises. Campbell (1981) investigated the possibility of instituting separate accounting standards for small enterprises in respect to earnings per share, deferred income taxes, leases, and inflation-adjusted information on the decision processes of loan officers, who are major users of financial statements of SMEs. Her results, corroborated later by Bushong (1995), were that, except for leases, standards with respect to the others could be modified or abandoned without any impact in the decision processes of bank officials. These findings tent additional support for the modification of standards applicable to SMEs.

Initial attempts in the eighties to resolve the issue of accounting exemptions for small enterprises in Ireland and the LTK were resisted somewhat by the regulating bodies there. In Ireland, it was felt that accounting standards existing at that time were not particularly burdensome on small companies and the concept of dual standards was generally disliked (Barker and Noonan, 1996). Carsberg et al. (1985) suggested that, in the case of the UK, there was no justification for exempting all companies below a certain size from all accounting standards, although consideration could be given to the exemption of SMEs in those cases where standards had minor importance to them.

O'Brien (1995) and Hunt (1995) advocated a cost-benefit view in Ireland. Costs were described in the context of the disproportionate benefit which users of SME financial statements are said to derive when compared with the benefit which users of larger enterprises derive from the statements. They argued that the standards imposed too much compliance cost on their small clients.

In the USA, Raiborn (1981) investigated the criticisms of small enterprise auditors that pronouncements of the ASB were not responsive to their needs. She found that many auditors were seemingly unclear as to the definition, purpose, and need for compliance tests in small business audits. They also had difficulties in defining, documenting, and relying on owner manager control to reduce substantive testing. Although other problems were encountered, auditors had more problems with regard to internal accounting controls.

Apparently, SMEs may be plagued with inadequate and/or inaccurate accounting records. However, according to Raiborn (1982:25), the inadequacy of internal accounting controls and the absence of corroborating evidence to support management representations in their own are minor problems compared to the difficulty in justifying an unqualified opinion. This was a reiteration of the belief that a small enterprise audit is likely to result in a qualification, an undesirable outcome if too often,

However, on the basis of Barker and Noonan (1996), SME compliance to accounting standards was a big problem, imposing too great a burden on the practitioners, and that the removal of the audit requirement was the most favoured way in which the burden of financial reporting could be mitigated. Perhaps not surprisingly, but interesting nevertheless, Raiborn (1982) found that auditors in the US tended to ignore certain standards when they meet with difficulty or uncertainty in applying generally accepted auditing standards (GAAS) in SME audits. They also tended 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. This was clear indication of unacceptable work being performed by small enterprise auditors. Standards set the minimum level of performance to be met and a departure from the standard may not be desirable.

A reason that could lead to such a situation is the familiarity that the small enterprise auditor eventually has with the owner. Auditors of SMEs usually know the dominant owner (Grotiman and Colby, 1978). This is more so if the auditor also writes the books of accounts of the client. In the latter case, a conflict of interest can arise because the auditor would be auditing his own work, which would make him lose objectivity

(Simunic, 1984). Although it was earlier shown that the effect of client size did not significantly affect the perception users had of the auditor's independence (Pany and Reckers, 1980), provision of both accounting and auditing services is bound to have an impact on auditor's independence.

A modification of standards applicable to SMEs appears to be the only solution to problems faced by auditors. Such modification, or exemption, would reduce the cost of enforcing adherence to standards by SMES. It would also lead to a more effective conduct of audit work by reducing or eliminating most of the problems that auditors faced in such engagements. Of importance would be the reduced litigation risk that auditors would have to face by not issuing a qualified audit report. It is worth noting that, in the case of the UK, a financial reporting standard for smaller entities (FRSSE) was released in November of 1997 (Wilkin 1998), and which is updated, the update to be effective in March of 1999.

## METHODOLOGY

### Design and Administration of the Questionnaire

The questionnaire was designed to capture the frequency of occurrence and the importance of the audit problems. Five-point Likert-scales were used to indicate frequency, ranging from scale point 1 - 'Never' - to scale point 5 - 'Usually', and to indicate importance ranging from scale point 1 - 'Unimportant' - to scale point 5 - 'Extremely Important'. The questionnaire was administered between July to August 1998. The questionnaire from the last respondent was received by November 1998.

### Sampling

The sampling frame was a list of Authorised Auditors registered with the NBAA as at June 1998 and obtainable from the NBAA Head Office in Dar es Salaam. Respondents comprised both audit firms and individual auditors. The list had 50 individuals and 91 firms registered.

A sample comprising 46 auditing firms was selected on the basis of information on their physical address and accessibility. This was necessary as the questionnaire was to be hand delivered to the respective offices. The list of

registered individual auditors was analysed further to exclude those who were represented in the selected firms. Two individual auditors known not to be affiliated to any audit firm and therefore not included in the sampled firms were added to the sample. Finally, ten other firms that were not physically accessible were added to the sample. The questionnaire was sent to these ten by post, The total sample thus comprised of 58 potential respondents located in Dar es Salaam, Mwanza, Shinyanga and Arusha. Except for the individuals purposefully selected, all other selections were on a random basis.

### Data Collection

Primary data for the study was collected by means of a structured questionnaire. The questionnaire was mostly hand-delivered to each of the audit firm and individuals taken in the study, except for ten questionnaires that were dispatched through the post. Responses were encouraged by physical follow-up with the study subjects as well as telephone calls were occasionally made to encourage to encourage responses.

Secondary data was extracted from literature obtained from various sources including the NBAA and TAA head offices, and from libraries and training institutions.

### Data Analysis

Data collected from the study was quantified and analysed. Descriptive data was analysed by use of descriptive statistics. Frequency of occurrence of the problems was determined on the basis of frequency means computed from the numerical score points for each problem-question in the form of a five-point Likert scale. The numerical scale points for frequency of occurrence were multiplied by those of importance of the problem to obtain compound significance means. Individual significance was determined by the highest two numerical scale points (4 and 5 in each case). When combined, a significant combination would be either of frequency or importance attaining a minimum mean score of 4, and the problem being discernible, i.e. either a minimum of rare frequency of occurrence or a minimum of slight importance (2 scale points in each case). The minimum combined numerical scale points were thus 8.

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problems. The resulting mean scores on the frequency of occurrence of four problems in small client audits that occurred at least occasionally are summarised in Table 3.

Table 3: *Summary Means for Frequency of Occurrence of Small Audit Problems*

Question No.	Response %	Frequency Mean
1. Acceptance of management representations as audit evidence when completeness of recorded transactions cannot otherwise be verified;	48.3	3.3
2. Insufficient documentation owner/manager controls;	48.3	3.2
3. Assignment of more experienced personnel to the SME audit;	41.4	3.1
4. Reliance on owner/manager controls to restrict extent of substantive auditing procedures	37.9	3.0

On the basis of the results, auditors have to rely on management representations as audit evidence due to inability to verify the completeness of recorded transactions. This problem was mentioned by 48.3% of the respondents as occurring frequently. On the average, the frequency mean score of 3.3 suggests that this problem occurs occasionally. Similarly, insufficiently documented owner-manager controls cause difficulty for the auditor intending to compliance test such controls.

Again, 48.3% of the respondents said the problem occurred frequently. On the average, however, this problem occurs occasionally, with a frequency mean score of 3.2. Another problem that occurs occasionally is the need to assign more experienced audit personnel to the SME audit compared to a large audit. Only 41.1% of the auditors suggested that it is a frequently encountered problem. The frequency mean was 3.1. Finally, 37.9% of the auditors indicate that they are frequently able to rely on owner-manager controls in the SME to reduce the extent of substantive audit procedures. The frequency mean for this problem was nevertheless 3.0, suggesting that on the average the problem was encountered only on occasions.

Generally, the low frequency means suggest

that the frequency of occurrence of the audit problems mentioned is not high. High frequency would have been the case if a particular problem was able to score a frequency mean of 4.0. The remaining 19 problems rarely occurred or never did. Apparently, auditors do face problems in the SME audit, but not often.

### Significance of SME Auditing Problems

Given the low means obtained for frequency of occurrence, it was considered necessary to determine the significance of the problems to the auditors. This was achieved by combining information of frequency of occurrence and importance of the problem to the auditors.

Of the twenty-three problems posed to the auditors, only nine were significant, receiving significance means of 8.0 and above. Table 4 summarises the questions that attained a significant mean in their order of significance.

Table 4: *Summary of significant audit problems reported by respondents*

Problem	Significance Mean
1. Insufficient documentation of owner-manager controls;	11.4
2. Acceptance of management representations as audit evidence when completeness of recorded transactions cannot otherwise be verified;	11.2
3. Assignment of more experienced personnel to the SME audit;	10.7
4. Difficulty in communicating the contents of representation letter as required by TSAS No. 1;	10.1
5. Compliance testing of accounting controls when a preliminary evaluation determined that reliance could not be placed on the system;	9.1
6. Reliance on owner/manager controls to restrict extent of substantive auditing procedures;	8.9
7. Difficulties in applying analytical review procedures in planning the audit;	8.6
8. Difficulties and uncertainties encountered in relying on internal accounting controls over sales, accounts receivable and cash receipts;	8.4
9. Difficulties and uncertainties encountered in relying on internal accounting controls over payroll.	8.2

## FINDINGS

### Survey Response Rates

The total number of questionnaires collected was 29, representing a response rate of 50 percent. A summary of response rates is shown in Table 1.

**Table 1: Summary Questionnaire Response Rates**

The response was enhanced by the fact that most of the questionnaires were administered and followed-up in person. Of the mailed questionnaires, only four questionnaires, or 40 percent of the total mailed, were received.

### Characteristics of SMEs

From a list of eight characteristics, the auditors were asked to select those that described their small audit clients. The characteristics and responses are summarised in Table 2.

**Table 2: Summary characteristics of the typical small audit client.**

Characteristic	No.	%
1. Concentration of ownership or operational control in one or a few individuals;	24	82.8
2. Limited segregation of functions within the accounting system because of the small number of employees;	21	72.4
3. Management personnel or employees have limited accounting knowledge;	20	69.0
4. Record keeping often informal and documentation of transactions is also inadequate;	19	65.5
5. Great management potential overrides internal accounting controls;	15	51.7
6. Management doesn't or is unable to hire employees with accounting experience or training in accounts;	14	48.3
7. Administrative and clerical staff have easy access to assets;	12	41.4
8. Inactive or ineffective policy-making body (e.g. Board of Directors)	12	41.4

Over 80% of the respondents believe that their small audit clients have concentration of ownership or operational control in one or a few individuals. Over seventy percent think there is limited segregation of functions within the accounting system in the typical SME. These two characteristics have important implications

for the work of the auditor. The first characteristic leads to an owner-dominated management. In the absence of specific knowledge of the owner's character and integrity, reliability of internal controls may be questionable. Limited segregation of functions, on the other hand, is a direct violation of one of the pillars of internal control. It may lead to a situation where employees or the owner-manager will perform duties that are incompatible in terms of internal control requirements. A dishonest employee or owner-manager is thus able to commit and cover up irregularities.

That management personnel or employees of SMEs have limited accounting knowledge was supported by 69 % of the respondents. This probably explains the lack of proper internal accounting controls in SMEs as well as the informal record keeping system and inadequate documentation of transactions, confirmed by 65.5 % of the respondents. The potential problem for the auditor in the latter case is an insufficient or absence of audit trail.

51.7 % of the respondents suggested the respondents suggested the existence within small audit clients of a great potential for management override of internal controls. This prevents the auditor from reducing the extent of substantive tests to perform due to uncertainty at the internal control evaluation stage.

Inability to hire employees with accounting experience or formal accounting training, ease of access to assets by clerical and administrative personnel, and an inactive or ineffective policy-making body were confirmed by fewer respondents. In all three cases, however, more than forty percent of the respondents did indicate that these traits characterised their small audit clients.

These findings concur with the following characteristics of small enterprises suggested by IFAC (1998):

- There is concentration of ownership and management in a small number of individuals;
- There are limited internal controls/segregation of duties; and
- There exists a potential for management override of internal controls.

### Frequency of Occurrence of Small Audit Problems

The auditors were asked to indicate the frequency of occurrence of twenty-three audit



if analytical procedures at that stage is deemed important. Application of analytical procedures at the audit planning stage is therefore not a major problem for auditors.

#### *Difficulties and Uncertainties Encountered in Relying on Internal Accounting Controls over Sales, Accounts Receivable and Cash Receipts*

Only 20.7% of the auditors indicate that they are frequently able to rely on Internal accounting controls over sales, accounts receivable and cash receipts. The significance mean of 84 nevertheless points to the fact that reliance on such controls is important for the completion of the audit. This is an area that needs adequate differentiation of duties, and this is a problem with SMEs.

#### *Difficulties and Uncertainties Encountered in Relying on Internal Accounting Controls Over Payroll*

Only 31% of the auditors indicate that they are frequently able to rely on 'internal accounting controls over payroll. The significance mean however is 8.2, which suggests that such reliance is perceived as having a significant effect on the audit. The low reliance on controls over payroll is an indication of the general recognition of internal control weaknesses in the SMEs. There is, however, another facet to it; although the owner-manager knows his/her employees, the low reliance on such controls may suggest auditors are cautious with respect to the intentions of the owner-manager. Hence reliance is limited to the extent that sufficient information is available on the character of the owner-manager.

## CONCLUSIONS AND RECOMMENDATIONS

### Conclusions

The Tanzania economy comprises a substantial number of small, medium-sized and micro-enterprises. The contribution of these SMEs to the economy can not be ignored. SMEs are said to have characteristics that are different from large enterprises. The results of this study enable us to conclude that SMEs have the same characteristics wherever they are operating. There is no uniqueness of SME characteristics in Tanzania.

A number of problems have been cited as affecting somewhat the work of SME auditors in Tanzania. In general, auditors are expected to encounter problems of some sort in the conduct of their assignment irrespective of size of the client 'The issue is whether the problems have any particular significance on the outcome of the auditors' work. None of the problems posed to the auditors in this study was encountered more than occasionally. The second conclusion then is that, although auditors do face some problems in their conduct of SME audits, the frequency with which these problems are encountered is not sufficiently high. Most of the problems rarely occur, or at most are only occasional. The significance of the problems arises only due to their importance in the audit work. This however does not provide sufficient ground to equate SME audits to large audits.

These conclusions should be considered as tentative. The exploratory nature of the study does not provide sufficient evidence to make firm conclusions. To do so, a broader study that will consider broader issues involved in auditing, and especially small enterprise audits would need to be undertaken.

### Recommendations

One concern that practitioners and others have is the effect of applying auditing standards as currently prescribed to the small audit client. One of the effects of applying the standards is on the kind of opinion that financial statements get from the auditors. Due to inadequacies in the standards, the tendency is for auditors to play 'it safe' by qualifying the statements. A recommendation of this study is to have the standards reviewed, possibly with the intention of prescribing standards that will apply for small client audits. Most practitioners are of this opinion, and this is a challenge to the National Board of Accountants and Auditors in Tanzania.

It is also suggested that a broader study be undertaken that will, among other things, also identify specific parts of the current standards that need to be reviewed to cater for small audit clients. The exploratory nature of this study precluded an in-depth investigation of broader issues involved in SME audits. The proposed study is also expected to embrace issues related to the use of financial statements of small and micro-enterprises by outsiders to the enterprises.

***Insufficient documentation of owner/manager controls***

This problem was encountered occasionally, but the significance mean of 11.4 for this problem suggests that it is considered to be important by the auditors SMES, who as would be expected, are not in a position to institute elaborate means of documenting the system of controls. Since in many cases the owners are the managers, the need for such documentation eludes the owner-managers. This insufficiency of documentation implies that compliance tests are minimised.

***Acceptance of Management Representations as Audit Evidence***

This problem, which attained the highest frequency of occurrence mean score, is after combining the scale points relegated to second place. Its significance mean of 11.2, however, suggests that auditors do need evidence provided by management representations. In the absence of any other documentary evidence this apparently, is a logical conclusion.

***Assignment of more Experienced Personnel to the SME Audit***

This is the third most significant audit problem, and was third in frequency of occurrence. Auditors do occasionally encounter this need, and to them it is of moderate importance. Forty-one percent reported facing this need occasionally. It is however of moderate importance and therefore does not much affect the completion of the audit work. Its significance mean of 10.7 implies that auditors do recognise the need to assign senior audit staff to the SME audit, but do not necessarily do so. Senior auditors do add to the cost of audit, and as has been reported by a respondent, SMEs may not be in a position to meet the costs of a fully-fledged audit. Understandably, few firms would be willing to incur costs that were not reimbursable.

***Difficulties in Communicating the Content of the Representation Letter***

This problem rarely occurred, but the significance mean of 10.1 is apparently an indication that it is considered to be of importance to auditors. This problem is related to the requirement that the client signs the letter

of representations signifying his confirmation of assertions made by him to the auditor. Though the problem of communicating the contents of the letter to management is not encountered of term, its high significance means suggests that it is important that the client management documents his representations, and hence, to the completion of the audit.

***Compliance Testing of Accounting Controls When a Preliminary Evaluation Determined that Reliance Cannot be Placed on the System***

Auditors rarely perform compliance tests when a preliminary evaluation has indicated that the system of internal accounting controls cannot be relied upon. There would be no need because the accounting control procedures will not be relied upon anyway, even if they are being applied as prescribed. However, the significance mean for this problem is 9.1. i.e auditors consider compliance testing as being of importance to the completion of the audit. Under the circumstance, an inconsistency of some sort is evident here. If indeed this aspect was important for the audit, the expectation should have been more frequent tests performed. It is likely that the question was answered in isolation. Compliance tests will be important in an audit, but possibly not in the audit of SMEs.

***Reliance on Owner-Manager Controls to Restrict the Extent of Substantive Auditing Procedures***

Only 37.9% of the auditors reported that they were frequently able to rely on owner-manager representations to reduce substantive auditing procedures. However, this problem has only a slight effect on the ability to complete the audit. It has a significance mean of 8.9, The inability can arise due to a lack of documentation of controls, or the potential for management override i.e. a mistrust on the owner-manager. But it could also be due to lack of proper guidance in the auditing standards.

***Difficulties in Applying Analytical Review Procedures in Planning the Audit***

Only 34.5% of the auditors indicate they frequently face problems in applying analytical procedures at the audit planning stage. The significance mean of 8.6 suggests that the use

## EFFECTS OF MERGERS AND ACQUISITIONS TO SHAREHOLDERS' WEALTH: EVIDENCE FROM UNITED KINGDOM\*

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**Abstract:** This paper sets out to empirically analyse the impact of mergers and acquisitions on shareholders returns. It uses the U.K. data for 60 companies that were involved in takeovers in the period between 1992-95. The paper assesses stock market response to the announcement of takeover bids for these randomly chosen successful bids in order to establish whether or not it is indicative of gains from mergers. The study finds that there are significant abnormal returns earned by shareholders of the target firms on the month the merger is announced. In contrast, the returns earned by stockholders of the bidding firms were found to be modest. Regarding the post-event study for bidding firms, given the predominant paradigm in finance (i.e., capital market efficiency), the study shows that takeovers have some impact on the stockholders wealth. The paper argues however that despite such negative returns, there no necessary implications of market inefficiency based on the speed with which the information about merger is impounded in the share prices of the bidders.

### INTRODUCTION

In principle, mergers and acquisitions (M and A) involve two companies combining together to form one bigger company than the original ones i.e., the bidder and the target. Many studies have shown that mergers and acquisitions are a major activity within business in many countries and are said to provide significant component of growth for many firms in countries such as the US and the UK (Firth, 1980; and Franks and Harris, 1989). Surely there must be some motives for the management of one firm to get involved in a takeover bid. According to Firth (1980) there are two major theories of the firm that may help explain why companies' management engage in M and A.

These two theories are profit maximisation and maximisation of management utility. These studies argue that companies involved in M and A realise some gains, which lead to increase in profitability. For example, the first theory tends to explain the profitability from takeover to come through synergy as explained by economic gains, through the increased market power, or through removal of inefficiencies in the target firm by injecting superior management.<sup>1</sup>

Mergers and acquisitions of firms in the same industry are therefore justified in terms of the opportunities such developments create for the exploitation of economies of scale. For instance, in many industries costs fall with the size of the plant being employed. Instead of accessing such economies of scale by constructing larger plants, firms find it more feasible to attain such benefits through mergers and acquisitions. Also mergers between firms supplying the same market will increase the level of concentration and the market power of the firms involved, thereby creating monopoly rent. In such cases, value may be created for shareholders at the expenses of the consumers.

The second theory holds that beyond achieving a certain satisfactory level of profits, managers will attempt to maximise their own self-interests, and these do not necessarily correspond to maximising shareholders wealth (Firth, 1980). Jensen and Ruback (1983) show that overall corporate takeovers generate positive gains, that target firm shareholders benefit, and that bidding firm shareholders do not lose. However, Roll (1986) argues that managers of bidding firms are infected by hubris, and so overpay for targets because they overestimate their own ability to run them. This implies that managers of bidding firms pursue personal objectives other than maximisation of shareholders value. He further argues that takeover gains may have been overestimated if they exist at all; and that if there really are no aggregate gains associated with takeovers, or if they are small, it is not hard to understand why their sources are "elusive." Above all, it is not

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<sup>1</sup> This is debatable however, as there are other ways an old and inefficient management can be replaced; eg sacking the whole team.