

Have changes made it easier for the small business auditor to succeed?

GAAS and the Small Business Auditor Ten Years Later

By Allan Karnes, James B. King and Robert B. Welker

A study ten years ago indicated that the small business auditor felt like a small player in the big league. A 1991 study was undertaken to see if that attitude has changed.

Nearly a decade has passed since zealous attention was focused on the GAAS application problems encountered by auditors of small business enterprises. AICPA's Auditing Research Monograph No. 5, *Audit Problems Encountered in Small Business Engagements*, D. D. Rayburn, 1982, identified ownership/management dominance, internal control deficiencies, and a lack of effective policy making bodies as well as other small business characteristics that hamper the auditor's ability to comply with GAAS. In an April 1982 article published in *The CPA Journal*, "GAAS and the Small Business Audit," the authors found similar results based on a study conducted in 1981. In addition, the small business auditors who participated in the 1981 study reported that GAAS was unresponsive to their needs, that GAAS was developed for large audit clients, and that the profession did not provide sufficient guidance with respect to their small business audit client problems.

Before the aforementioned study was published, the Cohen Commission (1978) had considered the question of a separate set of GAAS for small business audits, but decided there should be no differences in the standards that apply to the performance of audits, whether they are of public or private entities. That

same year, the Auditing Standards Board (ASB) appointed the Review of Existing Auditing Standards Task Force. The task force concluded that GAAS were appropriate for all businesses, but that small business auditors should be provided more explicit guidance on how to implement the standards. The AICPA responded with what can be called an "educate and advocate" policy to communicate small business auditor concerns to the standard setting bodies and provide GAAS application guidance for the small business auditor.

Now, 10 years later, it is appropriate to re-examine the small business audit environment and small business auditor opinions concerning GAAS application problems to determine if the AICPA has effectively addressed the concerns and problems of the small business auditor. The AICPA's "educate and advocate" policy will be described first.

"EDUCATE AND ADVOCATE": A TWO-PRONGED POLICY

The "educate and advocate" policy is designed to help the small practitioner with small business GAAS application problems by providing special guidance (educate) and giving the small practitioner a stronger voice (advocate) within the profession.

Educate. The objective of the "educate" prong of the policy was to expand the small business auditor's ability to cope with GAAS application problems.

The re-examination shows that communication with small business auditors improved and the level of services to small audit firms expanded. A reading of

current AICPA catalogs shows that new continuing education courses and seminars were developed to address audit problems peculiar to small businesses. New guides, designed expressly to enhance the local practitioners' ability to perform small business engagements effectively and efficiently, have been published by both professional and private organizations. The profession also provides non-authoritative literature to assist small business auditors.

Practical guidance is provided by the Auditing Standards Division's Audit Procedures Study entitled *Audits of Small Businesses*. An AICPA periodical, *The Practicing CPA*, is devoted to issues facing local firms. In addition, the profession strives to heighten the small business auditor's awareness of the availability of centralized professional resources, such as the AICPA Library and the Technical Information Service.

State CPA societies should not be overlooked as a significant source of education and information to assist the small business auditor.

Advocate. The objective of the "advocate" prong of the policy was to expand the voice of small practitioners in the profession. By giving them more input, the standard setting process would be more responsive to problems faced by auditors from smaller firms.

The Private Companies Practice Section (PCPS) of the AICPA was established in 1977. One of its objectives was to provide a conduit through which members could easily channel their input on professional matters. Since its inception,

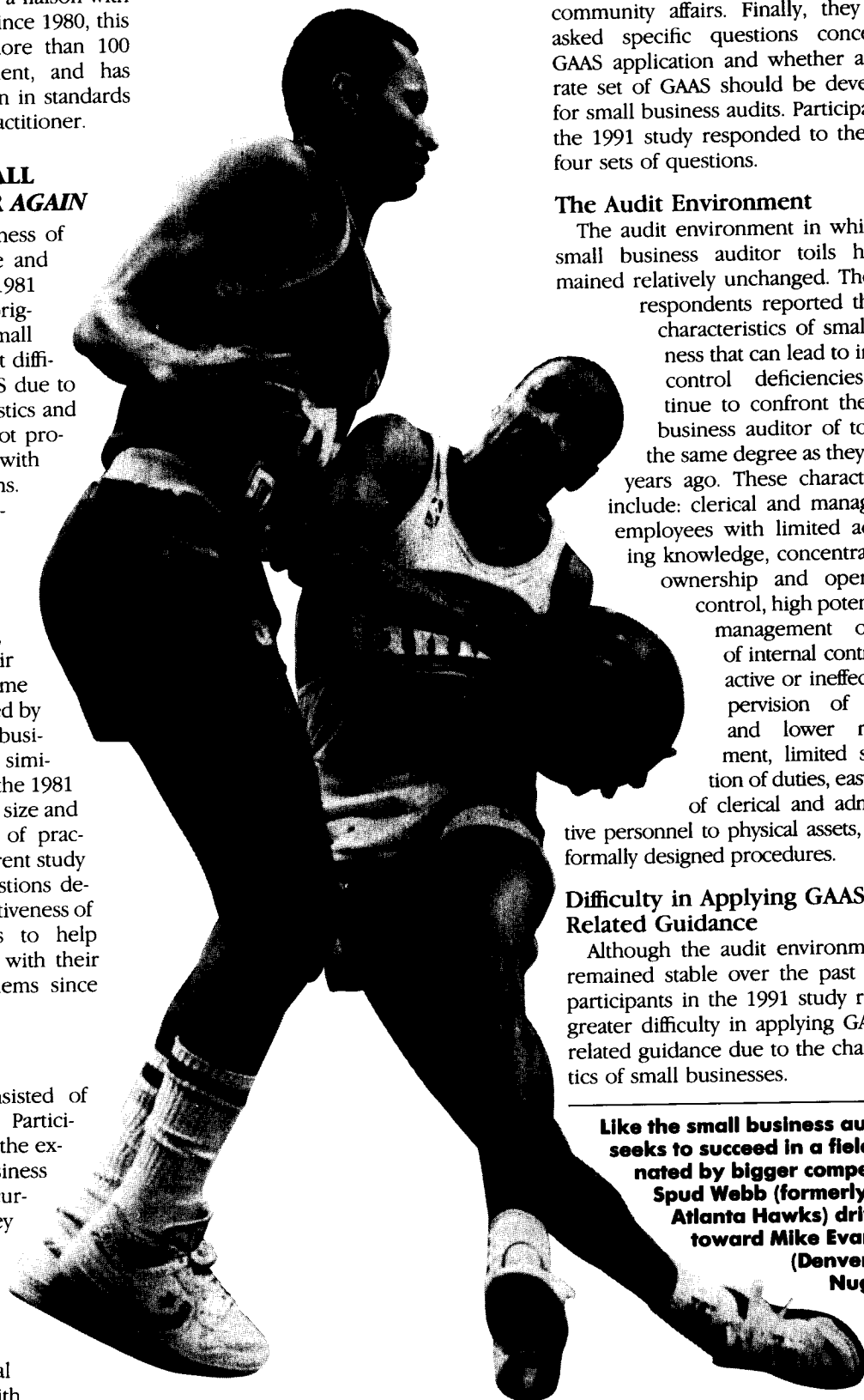
the PCPS has served as an advocate for the viewpoint of small and regional firms. It formed the Technical Issues Committee (TIC) to act as a liaison with standard setting bodies. Since 1980, this committee has issued more than 100 formal letters of comment, and has championed the reduction in standards overload for the small practitioner.

FOCUS ON THE SMALL BUSINESS AUDITOR AGAIN

To assess the effectiveness of the profession's "educate and advocate" policy, the 1981 study was updated. The original study reported that small business auditors found it difficult to comply with GAAS due to small business characteristics and felt the profession did not provide adequate guidance with respect to their problems. In addition, the small business auditors who participated in the study thought that GAAS was developed for large audit clients and, as a result, was unresponsive to their needs. In 1991, the same instrument was completed by a like number of small business auditors who were similar to the participants in the 1981 study with regard to firm size and geographic distribution of practice. In addition, the current study included additional questions designed to assess the effectiveness of the profession's efforts to help small business auditors with their GAAS application problems since 1981.

THE 1991 STUDY

The 1991 study consisted of four sets of questions. Participants were asked about the existence of six small business characteristics in their current audit clients. They were then asked to measure the effect those characteristics had on internal control. They were also asked whether the legal risks associated with



small business audits were increased due to other services performed for those clients and due to personal association with those clients in social and community affairs. Finally, they were asked specific questions concerning GAAS application and whether a separate set of GAAS should be developed for small business audits. Participants in the 1991 study responded to the same four sets of questions.

The Audit Environment

The audit environment in which the small business auditor toils has remained relatively unchanged. The 1991 respondents reported that the characteristics of small business that can lead to internal control deficiencies continue to confront the small business auditor of today to the same degree as they did 10 years ago. These characteristics include: clerical and management employees with limited accounting knowledge, concentration of ownership and operational control, high potential for management override of internal controls, inactive or ineffective supervision of middle and lower management, limited segregation of duties, easy access of clerical and administrative personnel to physical assets, and informally designed procedures.

Difficulty in Applying GAAS and Related Guidance

Although the audit environment has remained stable over the past decade, participants in the 1991 study reported greater difficulty in applying GAAS and related guidance due to the characteristics of small businesses.

Like the small business auditor seeks to succeed in a field dominated by bigger competitors, Spud Webb (formerly of Atlanta Hawks) drives toward Mike Evans (Denver Nuggets).

This difficulty affects the auditor's ability to comply with the standards dealing with the internal control structure.

Although some small business characteristics can have a positive effect on internal control, such as the owner being close to operations having a positive effect on the safeguarding of assets, the existence of the small business characteristics in an audit client will usually indicate a weak internal control system.

The impact of dealing with the internal control structure is perceived as greater now than it was 10 years ago. The

increase in perceived difficulty was substantial for two of the most common internal control problems faced by small business auditors: 1) owner/manager dominance in the daily operations of the business, and 2) limited segregation of functions within the accounting system.

These results may be attributed to many factors that have contributed to increased risk to the auditor. For instance, the profession has experienced a substantial growth in litigation stemming from audit engagements. This trend may make small business auditors particu-

larly cautious, since they are performing audits in environments with internal control deficiencies.

A substantial majority of the participants in both studies agreed with the following statement:

"Any reduction in the effectiveness of auditing small businesses because of inadequate internal accounting control is largely offset by the ability to establish a 'feel' for a smaller audit and the ability to singly carry out a fully comprehensive work program."

It appears that although the participants in the 1991 study reported greater difficulty applying GAAS and related guidance due to the characteristics common to their clients, they still feel able to perform an audit for a small business client by relying on substantive testing and a "feel" for the audit that would not be possible with large audit clients. In effect, this may indicate that many small business auditors may be employing a *de facto* small business GAAS.

Then All is Well?

Given the fact that small business audits are performed in a different manner than large business audits, are small business auditors comfortable with their situation? Apparently not. Nearly 85% of the participants agreed that legal risks in auditing small businesses are materially increased because of the inadequacies of internal control usually characteristic of small businesses. It appears that due to the current state of GAAS, i.e., no differentiation in standards based on size of client, small business auditors feel they have no choice but to rely on substantive testing and their "feel" for the audit to perform a small business audit, and to perceive that they face materially increased legal risk because of client's inherently weak internal control.

Independence

It is not uncommon for a small business auditor to provide extensive non-audit services to an audit client, such as write-up work, MAS, business tax planning and compliance, representation before regulatory agencies and creditors, and personal tax and estate planning. It is also not uncommon for the small business auditor and the client to interact socially and to be members of the

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same community organizations. This is especially true if the client and the small business auditor reside in the same community.

Because of the often close relationships between small business auditors and their clients, it can be challenging for the small business auditor to comply with the second general standard:

"In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors."

In addition, AU Sec. 220.03 states that:

"Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence."

Maintaining independence in appearance can be especially difficult. The 1991 participants were somewhat more concerned about legal risks arising from independence problems associated with small business clients than the 1981 participants, but the differences were not significant. It is possible that the overall increase in auditor litigation affected the 1991 participants to a greater degree.

Applicability and Application of GAAS

Majorities (72% in 1991 and 69% in 1981) felt that existing GAAS were not responsive to the needs of small business auditors and that only the concerns of large businesses were taken into account in the development of GAAS and related guidance (86% in 1991 and 71% in 1981). It appears that small business auditors may be feeling disenfranchised. Their needs and concerns are apparently not being met by the ASB.

Majorities (78% in 1991 and 82% in 1981) were also in favor of a separate set of GAAS for small business clients, and believed a separate set of GAAS for small business clients would be operationally feasible (58% in 1991 and 63% in 1981). Although there was a slight drop in the percentage of respondents favoring a separate set of GAAS and those believing that a separate set of GAAS would be operationally feasible, it is clear that most respondents were in favor of some type of change.

In following up the 1981 study, it was

discovered that the minority was highly vocal. They were fearful that the development of a separate set of GAAS for small business audits would lead to second-class citizenship for small practitioners and that small business audit clients would be able to apply pressure for lower audit fees. Those concerns continue today.

As an alternative to dual audit standards for small and large businesses, a small business qualification has been suggested as a way of limiting the liability of the small business auditor and informing the user of audited small business financial statements about the special characteristics of small businesses and their effect on internal control. Chartered Accountants in England and Wales can add the following paragraph to their small business audit reports:

"In common with many businesses of similar size and organization, the company's system of internal control is dependant upon the close involvement of the directors/ managing director (who are major shareholders). Where independent confirmation of the accounting records was therefore not available, we have accepted assurance from the directors/managing director that all the company's transactions have been reflected in the records."

There is growing support for a similar small business qualification among small business auditors in this country. Whereas half of the respondents in the 1981 study favored a small business qualification of the standard audit report, 59% did so in 1991.

Assessment of "Educate and Advocate"

In addition to updating the 1981 study, the 1991 participants were asked four questions designed to assess the effectiveness of the profession's "educate and advocate" policy. Based on the responses, the efforts of the AICPA on behalf of the small business auditor appear to be missing the mark.

Nearly half of all respondents had no opinion whether the PCPS was doing a good job representing their interests or whether it was effective in making auditing standards and related guidance responsive to their needs. This is some-

what surprising. One would expect members of a group to have an opinion about the efforts of a body charged with the responsibility of advocating that group's viewpoint—especially a body active in the fight against a major complaint of small business auditors, that of standards overload. The recent reorganization of the AICPA to give PCPS the responsibility to represent and be the spokesperson for all small and medium-sized firms should help reduce complaints of this kind.

"Educate and advocate" is to help the small business auditor with small business problems.

Among respondents having opinions on this matter, the response was negative. Thirty-eight percent felt the PCPS was not doing a good job representing small accounting firm interests to the ASB and 42% felt the PCPS was not effective in making new standards and guidance responsive to the needs of the small business auditor. These results may indicate that PCPS and TIC are doing a poor job making constituents aware of their efforts. The nature and frequency of standards releases over the past 10 years may have persuaded small business auditors that their concerns are being ignored by standard setters.

It is not enough to know the profession has increased small business auditors' voices and placed some small practitioners on policy boards. What is important is whether that voice has been effective in impacting decisions. Most small business auditors pay attention only to the outcome of the policy setting process. If that outcome results in more standards that do not reflect the characteristics of their clients, skepticism is likely.

The education prong of the profession's policy did not fare well with respondents either. A full 52% felt that AICPA sponsored courses have not had a significant impact on their small business GAAS application problems. Twenty percent of the respondents did feel the courses were helpful, though. On its face, it appears that the education part of AICPA's efforts to help the small business auditor have not been very successful. This result should be interpreted cautiously, however. Perhaps a substantial

number of respondents have not attended a course designed to help the small business auditor. It is also possible that some respondents attended a course they simply did not like, or the course they attended was taught in an ineffective manner.

The final question put to respondents was designed as an overall measure of the efforts of the profession to help small business auditors with GAAS application problems. It appears that the AICPA's educate and advocate policy has not been successful. A statistically significant 67% disagreed with a statement indicating that smaller CPA firms have fewer problems meeting GAAS currently than they did 10 years ago.

THE JURY IS STILL OUT

Although it is too early to pass final judgment on the AICPA's educate and advocate efforts on behalf of the small business auditor, it does appear that the small business auditor continues to struggle with GAAS application problems. The expectation gap SAs of recent

years have not made the process any easier. In fact, the problems appear to have become more intense. Small business auditors may feel they are facing a "no win" situation. Due to the nature of their clients, practice monitoring programs, and higher CPE costs, they are experiencing higher audit costs. Because of the increase in malpractice litigation, the cost of professional insurance is beyond the capacity of some small firms. If left unchecked, small firms may opt out of the audit business. Small businesses could lose the option of having their audit performed by the local firm. Solutions will not come easy. Following are some practical recommendations that may warrant consideration.

Revisit the Question of Small Business GAAS

Although the profession rejected the concept of a separate set of GAAS for small business audits, that decision was premised on the assumption that the GAAS application problems of the small business auditor could be rectified through other means. Apparently that assumption is flawed. If anything, small business auditors appear to have as many if not more problems applying GAAS despite the educate and advocate policy. Concerns about a separate set of GAAS for small business audits—such as creating the impression of a lower-class audit, creating a second class of auditors, and pressure for lower audit fees—could be adequately addressed by educating small business clients and financial statement users. It can be argued that armed with GAAS that are based on characteristics common to small businesses, small business auditors would carry out higher quality audits.

If a separate set of GAAS for small business audits still proves objectionable, then a task force should be appointed to consider whether small business exceptions should be incorporated within current GAAS.

Small Business Qualification to the Standard Report

If small business auditors continue to struggle with GAAS application problems, a small business qualification to the standard report could at least offer some liability protection. Again, an education policy for the small business cli-

ent and financial statement user should forestall any perception problems.

Accessibility to Technical Support

Unlike large firms, many small firms cannot afford technical support staff. To assist small firms, the AICPA might consider making its central resources (e.g., AICPA Library and Technical Information Service) more accessible to the small business auditor. Perhaps regional or state sites could be utilized.

State CPA Societies—A More Active Role

Although the profession has taken steps to increase small business auditor input into the standard setting process, perhaps a more direct method of providing that input should be developed. Small business auditors are more likely to be active in their state and regional societies than in the PCPS. Each state society should be allowed to establish a liaison with the standard setting bodies. This would insure that the views of the small practitioner were actually put before the standard setting bodies.

As stated, there are no easy answers. It must be remembered, however, that CPAs who practice in small firms are the backbone of the profession. They deserve the attention of the profession to find solutions to their problems. Ω

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