Problems of the Small Business Audit

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HEADNOTE: Applying auditing standards to a small business proves difficult for many CPA's—particularly the aspects of independence and internal controls. The authors have a number of useful suggestions for the auditor of these enterprises.

The audits of small businesses present unique challenges to a practitioner in relation to the standards of independence and the study and evaluation of internal accounting control. Although authoritative pronouncements have covered these topics, their application to small business engagements may appear confusing.

Independence

The standard of independence is often difficult to apply in the small business audit because of the extensive close involvement of the practitioner with the client. For example, frequently, the auditor may serve as a consultant and also provide accounting services (write-up work).

While the AICPA allows accounting services to be performed without impairing independence, the practitioner must take certain steps, as outlined by Interpretation 101-3, *Accounting Services*, of Rule 101, Independence, in the *Code of Professional Ethics* to ensure independence. All four of the following conditions must be met to retain independence when the auditor is also providing other accounting services:

- The CPA must not have any relationship with the client that would impair independence.
- The client must accept primary responsibility for the financial statements.
- The CPA must not assume the role of employee or of management.
- The CPA's examination must conform to generally accepted auditing standards.

A few observations about the application of this interpretation may be helpful in assessing the role of independence of the auditor in (1) providing write-up work; (2) in serving as a consultant or advisor; (3) in the preparation of financial statements; and (4) in performing managerial functions.

Independence and Write-up Work

The SEC does not permit accounting services such as write-up work to be performed if the accountant subsequently audits the statements. Under SEC rules, these services would constitute a violation of independence. These restraints do not affect most small businesses because their securities are not registered with the SEC. The AICPA, in

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Interpretation 101-3, has accepted a more pragmatic approach in permitting the accounting services without impairing independence. The client, and hence society, would most likely have to pay more in fees, if the write-up work were completed by one practitioner and the audit done by another. Also, if two practitioners were involved with the same client, either or both could be continually attempting to encroach, inadvertently or deliberately, on the other's service. Although such efforts are not in violation of the Code of Professional Ethics, the engagement could become disruptive and would not be in the public's best interest.

The scope and depth of this write-up work varies. The client may present the auditor with check book, bank statements, and receipts, and request an audit. Is such an engagement feasible, or is independence impaired because of the need to construct an accounting system? The engagement may be accepted if the auditor can prepare a double entry spread sheet and determine that the appropriate balances are fairly stated.

. . . is independence impaired . . . (by) the need to construct an accounting system?

Many small business audits may involve a concentration of duties where the secretary-bookkeeper-treasurer records entries on the cash basis and needs the auditor to book the appropriate deferral and accrual entries to convert the system to the accrual basis. Closing entries are also journalized by the auditor.

Regardless of the extent of write-up work provided by the auditor, the client still must accept responsibility for the statements.

Auditor Independence and the Role of Consultant

In the audits of small businesses, the practitioner frequently serves as an advisor or consultant. This role may even be essential to the viability of the entity. Adequate documentation of this role and its impact on independence must be found in the work papers. They should illustrate that the auditor—now consultant—acted in the capacity of presenting and explaining alternatives to the client and that final responsibility for a decision remained with the client. Anything less may leave the practitioner open to criticism that he has assumed a management role. The practitioner may find himself in litigation when a bankrupt client later alleges that the practitioner's decision caused the entity's demise and that the client was only following the directives of the auditor. If delineation of such responsibility is unclear and cannot be substantiated in the work papers, the position of the auditor may be tenuous. The impact of auditor independence in a management consulting engagement is difficult to assess because, although no explicit managerial role may have been assumed, as in accepting a check signing responsibility, litigation results may conclude that such a position was implicit.

Independence and the Preparation of Financial Statements

The auditor of small businesses frequently prepares the financial statements as part of the engagement. The lack of sophistication in the client's accounting system, as well as the client's lack of understanding of the measurement and disclosure requirements of GAAP, encourages such preparation. The fact that the financial statements are prepared by the auditor may be both an aid and a hindrance. For example, when the auditor is free to journalize any adjusting entries, these adjustments can produce fair financial statements. There is no disagreement between auditor and client on materiality because the practitioner "books whatever entries he considers essential." Although these statements may indeed be fair ones, the question of impairing independence in such an engagement must be resolved. Again, the client must be informed of his ultimate responsibility.

Independence and Assuming a Role of Management

The extensive involvement of the auditor demands that he avoid certain procedures which may be considered a role of management.

The auditor cannot be designated as check signer while the client is on vacation and cannot be charged with check signing responsibilities when no checks are anticipated. These conditions may impair the appearance of independence. The *client* should sign all checks and indicate the payee. If the amount is unknown, the practitioner can complete the amount without impairing independence. If it is essential to designate such check signing responsibilities in the absence of the client, the client's lawyer may be considered for such responsibility.

Implementation

Independence is essential to the auditability of any entity. If the small business is not auditable, a compilation engagement is the only alternative; the compilation report must disclose the lack of independence. The accountant, as long as he is not associated with the financial statements on an audit or review basis, can provide other services without assessing the impact of independence.

The practitioner should not rely on a written statement from the client stating that the conditions described in Interpretation 101-3 have been met unless the client understands his assertions. Such statements are frequently made in the client letter of representation prepared by the auditor. A practitioner may respond that the client has little interest in an explanation and may not possess the knowledge to understand such an explanation. Without an explanation, the required letter of representation could be labeled as self-serving. Such letters may lack credibility when the auditor writes the statement and the client signs "anything the audi-

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tor places in front of him." If the auditor wishes to obtain such representations, he should carefully explain the representations the client is making. The AICPA has prepared a brochure titled "The Representation Letter—An Important Communication Between Management And The Independent Auditor," which may assist the small business client in understanding a representation letter.

Internal Control

Internal control is often more limited in small businesses than in large corporations. This limitation may be the result of three principal attributes: limited segregation of functions, the impact of close personal relationships, and a lack of knowledge of proper control procedures by the owner/manager. Many small businesses cannot afford the luxury of segregation of functions. Fewer employees, long-term employment and closer working conditions build stronger personal relationships which may encourage compromises of the internal control system. The lack of formal internal control awareness by the owner/manager may hamper the implementation of a strong internal control system.

The auditor cannot be designated as check signer. . . .

The effects of limited internal controls on the audit effort are manifested in three areas: (1) the auditability of the small business; (2) the possibility of over auditing may exist if more than a passing review of internal controls is made; and (3) the assertion of completeness may be difficult to substantiate.

Auditability

The auditability of the small business should be carefully reviewed. The client must possess an accounting system to be audited. An accounting system, in its most simplistic state, requires consistent processing and recording of transactions. Can the "shoe box" engagement, where the client presents the CPA with a mass of checks and receipts with little or no record-keeping available, be audited? The answer may be yes, if the CPA prepares a double entry spread sheet to record such transactions. In like manner, a single entry system, if converted to a double entry one, may be auditable. The CPA would prefer that the accounting system encompass internal accounting controls with a segregation of functions, but frequently must be satisfied with less.

If the client has never been audited, the CPA may have several alternatives relating to his association with the financial statements. If it is impracticable to substantiate beginning balances, a balance sheet audit may be an alternative. Such an engagement should be directed at a single statement as contrasted with an engagement involving a client-imposed limitation of scope. The auditor must have access to all transactions and financial records when auditing a single statement.

Another alternative may be to issue a "split level" report where the practitioner expresses different levels of assurance on different statements. For example, the auditor may express an opinion on the balance sheet and no, or limited assurance (compilation or review) on the remaining statements.

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Scope limitations imposed by the client may require special consideration by the small business auditor. The authoritative literature suggests that a material client-imposed restriction of scope automatically results in a qualification or a disclaimer depending on the pervasiveness of the limitation. The possibility of an unqualified opinion may exist in an engagement involving scope limitations, if the auditor can accept the client's reasons for the limitations, knows the client well enough, and can gather sufficient competent evidence by other means. An example is a client's suggestion that the auditor not confirm dues receivable to a country club with elderly members. This particular suggestion was made because of the resulting confusion and misunderstanding generated by the confirmation. The auditor accepted such a restriction because he was able to observe subsequent collection of the dues prior to sign off. The auditor did not agree to such a request without securing permission and understanding from the board of directors of the club. A second example of a client imposed restriction of scope dealt with a client who was building a condominium complex where the auditor needed individual confirmation of agreement to occupy. The client was able to present contracts, but in this engagement the CPA refused to accept the restriction because of the inability to perform other substantive procedures to compensate for lack of confirmation.

In the first example, many practitioners may conclude that such a restriction is acceptable because of the limited exposure to liability, the reason not to confirm, and the availability of alternative procedures to gather evidence. The latter example poses far more serious problems and considerable additional risk.

Over Auditing

Paragraph 2, 49-.58 of *SAS* 43, *Omnibus Statement on Auditing Standards* addresses the possible course of action if the auditor concludes that a substantive test audit approach

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is preferable to a division of the audit effort between a study and evaluation of internal accounting controls and a subsequent reduction of substantive tests. After obtaining an understanding of the control environment and the flow of transactions, the auditor need only document his decision to proceed with a substantive test approach.

The auditor of small businesses with limited internal controls should realize the mininum requirements in addressing internal controls, so that the audit effort can be made in the most efficient manner. Assuming auditability, the auditor can proceed with a substantive test approach if he does not intend to rely on the internal control system. Completion of an internal control questionnaire (ICQ) and compliance testing are not required with such an approach.

. . . many audit engagements may currently involve over-auditing.

These provisions are interesting in light of conclusions presented in Auditing Research Monograph No. 5, *Audit Problems Encountered in Small Business Engagements.* 66 percent of the respondents indicated that compliance testing has been completed in engagements where the substantive test approach had already been selected. If such a practice is widespread, one could conclude that many audit engagements may currently involve over auditing. Such an approach would be effective but very inefficient.

One possible reason for such a response rests with practitioners' not designating a test of transactions as a compliance test, a substantive test, or a dual purpose test. A test of transactions can be any of these. An auditor, who summarily concludes that all tests of transactions are compliance tests, when in reality such tests are substantive tests, would have answered the survey erroneously.

A second possibility may involve other reasons for compliance testing. For example, the auditor may want to find weaknesses in internal accounting controls for communication in a management letter (AU Sec. 343) or in a report on internal accounting control (AU Sec. 642). Completion of an ICQ and compliance testing may indicate or confirm such weaknesses.

Another reason for compliance testing may be to provide familiarity with the accounting system and with any internal accounting controls to the beginning staff. By completing an ICQ and compliance testing, the beginning staff accountants can gain additional understanding of the accounting system.

Completeness of Transactions

SAS 31, *Evidential Matter*, Sec. 326, requires the auditor to address the assertion of completeness along with the assertions of existence, rights and obligations, presentation and disclosure, and allocation and valuation. These assertions are made by the client and must be supported by the auditor. The completeness assertion is concerned "with whether all transactions and accounts that should be presented in the financial statements are so included." The topic of completeness merits discussion for several reasons. *Audit Problems Encountered in Small Business Engagements*, states that 45 percent of the respondents to a survey of local accounting firms indicated that "at least occasionally, they (practitioners) accepted management's representations as audit evidence when completeness of recorded transactions could not otherwise be substantiated." This is disturbing because the auditor most often prepares the letter of representation in which the small business client makes such statements. A statement from a preliminary meeting of the ASB's Task Force on Completeness concluded "that the assertion of completeness is not addressed in most small business engagements." The ASB has only begun to address the topic, and it will be some time before an exposure draft is circulated.

Different views exist on what evidence is required to support the client's assertion of completeness. Some auditors would require the client's accounting system to incorporate those internal accounting control procedures necessary to ensure the recording of all transactions. This requirement would be difficult in many small business engagements where there is limited segregation of functions. Without the extensive involvement of the owner/manager in performing accounting and control procedures, substantiation of the completeness assertion may be impracticable where one encounters the consolidation of secretary, bookkeeper, and treasurer responsibilities. If such a view prevails, many small business audit engagements will be unacceptable. In this situation, the acceptability of such an engagement on a compilation or review basis would be questionable. The denial of these services could deprive the client of needed financial resources and bring financial problems. For pragmatic reasons, such a conclusion will probably not be presented for exposure.

. . . the assertion of completeness is not addressed in most small business engagements.

Another approach to substantiating the client's assertion of completeness is that the assertion can be substantiated through the use of appropriate analytical review procedures. After determination of the appropriate ratios, comparisons and relationships, the auditor can conclude that a sufficient number of transactions have been recorded to ensure fairness of presentation of the resulting statements. This view is more palatable, but will require the auditor to develop skill in the application of analytical review procedures.

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Owner/Manager Involvement

Many practitioners may conclude that because the business entity is so small, no internal accounting controls can exist. If the owner/manager is willing to become involved and informed, internal accounting controls can be introduced. Such simple procedures as requiring the owner/manager to sign checks and then to mail them after review for amount, legitimacy of payee, and appropriate address can enhance internal controls. All payments, except for petty cash, should be in the form of checks. Cash payments should not be made from cash receipts. Checks should be numbered, accounted for, and should not be made payable to cash. If cash receipts are a problem, the client may wish to consider the arrangement for a lock box system with a bank. The bank statement can be forwarded directly to the auditor for his reconciliation. The procedures are simple but do require the involvement and interest of the client as well as some guidance by the auditor. The AICPA's *Auditing and Accounting Manual* provides an expansive ICQ for small and medium size firms. These procedures are readily adaptable to most accounting systems.

It must be acknowledged that with involvement of the owner/manager comes the ever-present opportunity to override the accounting system. Such a possibility should be resolved when the auditor determines the auditability of the client. One would be remiss, however, to conclude that no internal accounting control procedures can exist within the small business.

Conclusions

The audit of small businesses is essential to their operation. Some common characteristics of small business audits are found in most engagements. Much authoritative literature has been published in the recent past, and the ASB is currently addressing topics which will impact these engagements. This article had addressed two topics in small business audit engagements, offered suggestions and solutions where they exist, and offered awareness and analysis where finalization of the authoritative literature is not complete. The practitioner must exert more initiative to seek guidance and to develop innovative adaptations of the literature to small business audit engagements. Ω

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