

The Small Business Audit: Problems Faced by Auditors in Selected SADC Countries

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Abstract

Auditing lends credibility to financial statements of enterprises. The Southern African Development Community (SADC) has committed itself to the promotion of Small Businesses in member countries. This implies that auditors will become more involved with Small Businesses as a result of their expected growth and expansion. However, small businesses are said to have characteristics that cause difficulties to their auditors. This study investigates the characteristics of small businesses in three SADC countries, problems auditors of small businesses in those countries face, frequency of occurrence of those problems, and their impact on auditing. The findings suggest that characteristics of small businesses in the selected SADC countries are similar to those of small businesses in other countries. Many of twenty-three problems suggested to auditors rarely occurred, or occurred only occasionally. However, some problems are considered to have an important effect on auditing.

Introduction

A principle purpose of independent auditing is to form an opinion on the accuracy, reliability and fairness of representations in the financial statements of enterprises, and to make this available to external users. According to Chow (1982), controlling the conflict of interests among firm managers, shareholders, and bondholders is a major reason for engaging auditors. Small businesses (i.e. not more than 10 shareholders) purchase auditing services

mostly because they would like to acquire credit from banks. It has been established that bankers seek audited financial statements in their lending decisions (Kitindi, 1997, Kitindi et. al, 2000).

The first motivation of this study is the concern that small businesses, when electing to be audited, present problems to their auditors not experienced in the audit of larger enterprises. Reasons provided relate to the difference in scale on which small and large enterprises operate, and which is often reflected in their respective audit requirements. Proprietors of small businesses do appreciate the need for preparing accounts, but they generally consider the auditing function as having marginal benefits.

The second motivation for the study relates to the growing importance of small businesses in the Southern African Development Community (SADC) region. The study focuses on the SADC countries – Botswana, South Africa and Tanzania – where some data on small businesses are available. Also, related studies as this one have been conducted in individually in two of the three countries. The inclusion of South Africa was seen as a likely source of rich data in the subject.

According to official data, some 56,300 small businesses operate in Botswana, engaging 125,000 employees including the proprietors (Government of Botswana, 1998a). Small and Medium Enterprises contribute an estimated 30%-45% of GDP compared to 38%-48% contributed by large firms (Government of Botswana, 1998b). In South Africa, such enterprises contribute 44.8% toward private sector employment and an estimated 32.7% of GDP, compared to 55.2% and 67.3% that large firms contribute towards employment and GDP respectively (Horwitz et al, 2000). Estimates by DED of the percentage labour force engaged in micro and small businesses in urban Tanzania range from 38% to 56% and small businesses contribute about 50% of industrial products' GDP (Kirumba, 2000). With the growth of the Small Business sector, auditors will find themselves involved with more small clients, and if indeed these clients present audit problems, it becomes a matter of concern for the accounting profession.

This paper presents and discusses the findings of surveys that focused on the problems of applying audit standards to small audit engagements. The next section consists of a review of some pertinent literature on the subject matter, after which the research method is described. Findings are detailed thereafter, and conclusions are provided.

Literature Review

Auditing Standards and Audit of Small Businesses

The problems encountered during the audit of small businesses have not occurred recently. It has long been argued that the size of operations and the small number of employees in small businesses poses challenges in the designing of a system of internal control for these enterprises. Among the inherent problems of small businesses are the absence of or insufficient segregation of duties because of the small number of employees, simple record keeping, limited internal controls and the potential for management override (Grollman and Colby 1978; IFAC 1998). These attributes, which are typical of small businesses, affect the auditor's work.

It was due to a consideration of the inherent problems in the audit of small businesses that the announcement of the release of new auditing standards in the UK provoked outcries from many scholars and practitioners in the UK. They believed that application of the new standards to small businesses would be onerous and would result in auditors issuing qualified audit reports on a frequent basis, thereby making the audit work and the resultant report of little value.

Davison (1979) and English (1979) strongly argued for the abolishment of the small Business audit or at least pronouncing it as being non-mandatory. The basis of this argument was that financial statements of small businesses do not have wide readership. Often, it was the banks and credit grantors, including trade creditors, and, where applicable, credit rating agencies, who were interested in financial statements of small businesses.

Sherwood (1979) and Mottershead (1979), on the other hand, believed an audit was a price that companies had to pay for the benefits of limited liability, and that some people relied upon the accounts of small businesses. These people would need to be assured that the accounts give a true and fair view, and therefore the audit of small businesses should be retained.

Relevance of Accounting Standards to Small Businesses

In the USA the major concern was about whether or not generally accepted accounting principles (GAAPs) were relevant to small businesses and the effect these principles had on the audit of small businesses. It was argued that accounting and auditing pronouncements made by the Financial Accounting Standards Board (FASB) and the Auditing Standards Board (ASB) respectively had not adequately taken into account the routine activities of accountants of small businesses (Lund 1978 and Benis 1978).

Campbell (1981) investigated the possibility of instituting separate accounting standards for small businesses 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 small businesses. Her results, corroborated later by Bushong (1995), were that, except for leases, the other standards could be modified or abandoned without any impact in the decision processes of bank officials. This provided additional support for the modification of standards applicable to small businesses.

In the UK, Carsberg et al. (1985) argued that exempting all companies below a certain size from all accounting standards had no justification. They suggested that only small businesses to which the standards had minor importance could be exempted. O'Brien (1995) and Hunt (1995) argued that standards imposed too much compliance cost on their small clients. Barker and Noonan (1996) claimed that accounting standards existing in Ireland were not particularly burdensome on small companies there, and that the idea of dual standards was generally disliked. They further argued that there was a problem with small businesses complying to accounting standards and the removal of the audit requirement for small businesses was the most favoured way in which the burden to practitioners of financial reporting could be eased.

Raiborn (1982) found that auditors in the US ignored certain standards when they encountered difficulty or uncertainty in applying generally accepted auditing standards (GAAS) during the audit of small businesses. They also interpreted standards according to the client's or their own best advantage.

One explanation of the above problem is the familiarity that the small business auditor eventually has with the owner. According to Grollman and Colby (1978), auditors of small businesses usually know the dominant owner. This is usually the case if the auditor also writes the client's books of accounts. In the latter case, Simunic (1984) suggests that a conflict of interest can arise because the auditor would be auditing his or her own work, causing a loss of objectivity.

A modification of standards applicable to small businesses was the only solution to problems faced by auditors. This has been addressed in the UK by a financial reporting standard for smaller entities (FRSSE), which was issued in 1997 (Wilkin, 1999). The standard is a response to the concerns raised since the seventies. This standard is applicable to financial statements of entities incorporated under companies' legislation and that are entitled to

exemptions available in the legislation for small businesses when filing accounts with the Registrar of Companies in the UK. The objective of the FRSSE is to ensure that those small business to which the standard applies provide in their financial statements information about the financial position, performance and financial adaptability of the entity that is useful to users in assessing the stewardship of management and for making economic decisions with due recognition of the fact that users' needs with respect to financial statements of small businesses are different from that for other businesses. Small businesses applying the FRSSE are exempt from complying with other UK accounting standards.

Research Method

Data Collection

This study draws from results of three different surveys conducted in the three countries. In all three cases, questionnaires were used to elicit the views of auditors in there on the problems they encountered when auditing small firms. The questionnaire was designed to collect data on frequency of occurrence and importance of the suggested audit problems. Five-point Likert-scales were used to indicate frequency and importance.

Data Analysis

Descriptive data analysis was adopted. Frequency of occurrence and importance of the problems were determined on the basis of frequency and importance means respectively, computed from the scored scales for each of the 23 problem-questions. Scores for frequency of occurrence were multiplied by those of importance of the problem to obtain an index of the problem level. This "problem level index" is presented in rank order for each of the types of problems specified in the survey instrument.

Findings

Response Rates

A total of 58 questionnaires were received. In comparison to the number of questionnaires distributed, this represents a response rate of about 40%. Some 86 questionnaires, which are almost 60% of the total sent out, were not received. All 58 questionnaires received were used in the analysis.

Attributes of Small Businesses

Auditors were asked to select from a list of eight characteristics, those that described their small audit clients. Table 1 summarises the characteristics and the responses.

Table 1: Summary of Small Audit Client Characteristics

<i>SN</i>	<i>Characteristic</i>	<i>Number</i>	<i>%</i>
1.	There is a concentration of ownership or operational control in one or few individuals	51	89.5
2.	There is a limited segregation of functions within the accounting system because of the small number of employees	48	84.2
3.	Management personnel or employees have limited accounting knowledge	40	70.2
4.	There is a great potential for management to override internal accounting controls	36	63.2
5.	Record-keeping systems are often informal and documentation of transactions is inadequate	36	63.2
6.	Management does not hire or is unable to hire employees having accounting experience or formal accounting training	33	57.9
7.	Clerical and administrative personnel have easy access to assets	28	49.1
8.	There is an inactive/ineffective policy-making body (e.g. Board of Directors)	26	45.6

The results show that about 90% of the respondents believe that ownership and/or operational control of small businesses is concentrated in one or a few individuals and that segregation of functions within the accounting system is limited. By implication, small businesses are typified by an owner-dominated management. An owner-manager may not consider it useful to install internal controls in the enterprise.

Non-segregation of functions within the enterprises is a direct contradiction of the requirements for a proper internal control system. About 84% believe there is limited segregation of functions within the accounting system due to a small number of employees. Adequate segregation of duties is not feasible if there is a restriction in the number of accounting personnel employed, and when the owner-manager wants to have control over all facets of the enterprise.

Some 70% of the respondents suggested that management personnel or employees of their small audit clients have limited accounting knowledge. This also leads to poor record keeping, and probably contributes to the non-institution of proper internal accounting controls in small businesses. Over 63% of the respondents believe that small businesses had record keeping systems that were often informal, and that documentation of transactions was inadequate. The potential problem to the auditor in this case is loss of a reliable audit trail, if any existed.

An equal number of the auditors indicated that there is a great potential for management override of internal controls in the small Business they audited. This is a direct result of concentration of ownership in the owner-manager. Whereas an owner-manager may find no need for proper internal controls, any internal controls installed may easily be ignored, rendering them ineffective and useless. For the auditor, it will be difficult to contemplate reducing the

extent of substantive tests due to uncertainty during the internal control evaluation phase of the audit.

About 60% of the auditors suggest that managers of their small clients do not hire or are unable to hire employees with accounting experience or formal accounting training. It seems that owner-managers do not employ full-time qualified accountants. The state of their record keeping is often, as a result, poor and unreliable. Small businesses make use of external accountants, often their auditors, to sort out the accounting information and prepare financial statements.

Ease of access to assets by clerical and administrative personnel, and the presence of an inactive or ineffective policy-making body, or lack of such body, characterised fewer small businesses. About 49% of the respondents confirmed that there was ease of access to assets, and about 45% confirmed the presence of an inactive or ineffective policy-making body. A reason for the former could be the small number of employees in a small Business and the tendency towards domination by the owner. Being the owner's lifeline, assets are likely to be closely guarded, although in some cases there may be only a minimum number of assets. Most small businesses are insufficiently large to require a formal policy-making body. Typically, the owner-manager makes all strategic and tactical decisions.

These findings concur with the characteristics of small businesses, as suggested by Grollman and Colby (1978). These characteristics are that small businesses are owned by a single individual or a few individuals who control their operations, and that management usually sees no need to hire employees with accounting knowledge, or believe it is not cost effective for the enterprise. They suggest further that there exists a higher potential for management override in small businesses, and that small businesses usually lack an active and effective policy-making body like a board of directors. The International Federation of Accountants also mentions these characteristics in its Exposure Draft issued in April 1998. The conclusion is that small businesses exhibit similar characteristics wherever they exist, regardless of cross-border geographical location.

Frequency of Occurrence of Small-Audit Problems

The auditors were asked to indicate how frequently twenty-three audit problems occurred. Table 2 below summarises the resulting mean scores on the frequency of occurrence of five problems in small client audits that occurred at least occasionally.

Table 2: Summary Means for Frequency of Occurrence of Small Audit Problems

<i>SN</i>	<i>Question</i>	<i>'Frequent' % Response</i>	<i>Frequency Mean</i>
1	Insufficient documentation of owner-manager controls	35.7%	3.6
2	Reliance on management representations as audit evidence when completeness of recorded transactions cannot otherwise be verified	37.9%	3.2
3	Assignment of more experienced personnel to the Small Business audit	36.2%	3.2
4	Difficulty in applying analytical review procedures in planning the audit	29.1%	3.2
5	Difficulty on applying analytical review procedures during the audit to replace other direct tests of balances	21.1%	3.0

About 36% of the respondents reported that they frequently faced difficulties arising from insufficiently documented controls when they wanted to test such controls. However, the mean-score of 3.6 suggests that, on average, this problem occurred occasionally. The auditors also reported as an occasional problem, with a mean score of 3.2, the reliance on management representations as audit evidence occasional problem. This, however, was a frequent problem to about 38% of the respondents. About 36% reported that they assigned more experienced personnel to a small business audit than would be assigned to a larger audit. The mean score of 3.2, however, suggests that overall this was occasionally the case.

Other problems that occurred occasionally include the difficulties in applying analytical review procedures both at the audit planning stage and during the audit itself. The former had a mean score of 3.2 while the latter had a mean score of 3.0. It would appear these were not major problem to many. In both cases, less than 30% reported encountering these problems on a frequent basis.

No problem was encountered frequently. Only five out of the 23 problems, or 18.5%, occurred occasionally. The remaining 81.5% either rarely occurred, or never did. This leads to the conclusion that the prevalence of audit problems is not widespread. Most of the problems rarely occurred or never did. Thus, a small business audit in the three SADC countries is not perceived by auditors to be problematic.

Index of Small Businesses Auditing Problems

An index for the problems to auditors was determined by combining information on frequency of occurrence and importance of the problem to the auditors. The most problematic had an index score of 12.4. The ranks of questions in their order of importance are summarised in Table 3.

Table 3: Summary of Significant Audit Problems Reported by Respondents

<i>QN</i>	<i>Problem</i>	<i>Problem-Level Index</i>
11.	Insufficient documentation of owner-manager controls	12.4
4	Assignment of more experienced personnel to the Small Business audit	11.3
15.	Acceptance of management representations when recorded transactions cannot be verified	11.2
12.	Difficulty in applying analytical review procedures in planning the audit	11.0
10.	Reliance on owner-manager controls to restrict the extent of substantive auditing procedures	10.0
16	Reliance on management representations as audit evidence when completeness of recorded transactions cannot otherwise be verified	10.0
13.	Difficulty in applying analytical review procedures during the audit to replace other direct tests of balances	9.6
14.	Difficulty in applying analytical procedures near the end of the audit	9.2
3.	Inadequate client control over record counts and other controls over write-up work done	8.5
18.	Client resists disclosing related party transactions	8.3
2.	Audit of write-up work done for client by auditor	8.2
5.	Reliance on internal accounting controls over sales, debtors and cash receipts	8.2
9.	Compliance testing internal accounting controls when they cannot be relied upon	8.2
8.	Reliance on internal accounting controls over payroll	8.1

Insufficient documentation of owner-manager controls

This was encountered occasionally. Its effect on the completion of the audit is of moderate importance, but with an index of 12.4, it is considered the most substantial. Small businesses are not in a position to institute elaborate means of documenting the system of controls. Since the owners are often the managers, the owner-managers disregard the need for such documentation. It is also possible that they deliberately ignore this so as to avoid or evade taxation. Insufficiency of documentation implies that compliance tests are minimised.

Assignment of more experienced personnel to the small client audit

This ranked third in frequency of occurrence but was the second most significant audit problem. Auditors occasionally assigned more experienced audit personnel to the small client audit. Over 36% of the respondents reported doing so frequently. Its index of 11.3 implies that auditors see the need to assign senior audit staff to the small audit, but do not necessarily do so. Senior auditors add to the cost of audit. Few small businesses have the ability and will to incur costs that are not reimbursable.

Acceptance of management representations as audit evidence

Auditors did occasionally rely on management representations as audit evidence. The index of 11.2 makes this the third most significant problem and suggests that, when completeness of recorded transactions cannot be ascertained through documentary evidence, the acceptance of management representations is important. The level of the problem also suggests that, in

the case of small businesses, auditors need evidence of any type, even if it has to be obtained from management itself. The results for this problem indicate a difference in perception by auditors from the three SADC countries. This problem does not seem to be a major one in Botswana as it did not feature in the study conducted there (Kitindi et. al, 2000). It was, however, considered a major problem in Tanzania (Kitindi 2000). The inclusion of this problem in these results is a result of a strong influence by data on Tanzania.

Difficulty in applying analytical review procedures in planning the audit

Only 29.1% of the respondents indicated that they frequently had difficulties in applying analytical procedures at the audit planning stage. The index of 11.0 suggests that auditors consider the use of analytical procedures at that stage to be important.

Reliance on owner-manager controls to restrict the extent of substantive auditing procedures

None of the auditors reported that they could rely on owner-manager representations to reduce substantive auditing procedures on a frequent basis. However, this problem affects the ability to complete the audit, hence the index of 10.0. Inability can arise due to a lack of documentation of controls, or the potential for management override, i.e. a mistrust of the owner-manager. It could also be due to lack of proper guidance in the auditing standards.

Reliance on management representations as audit evidence when completeness of recorded transactions cannot otherwise be verified

This was the second most frequent problem reported by the auditors. 38% of them actually indicated that this was a frequent problem. This is indeed a significant problem (problem-level index is 10.0) as, under normal circumstances, management representations are among the less reliable evidence an auditor would depend on as there is always the possibility of misrepresentations. In the case of small business audits, auditors have little choice other than to accept such representations as part of evidence gathered. This was not considered a major problem in Tanzania, but it was in Botswana. However, its index was not very high in the Botswana study. That it now ranks sixth with a higher index than in the Botswana study points to a South African influence. One can assume it's high importance in the South African environment.

Difficulty in applying analytical review procedures during the audit to replace other direct tests of balances

Generally, this problem was encountered occasionally (frequency mean 3.0). Only 21% of the respondents encountered it on a frequent basis. It is an important problem nevertheless, with an index of 9.6. Analytical procedures can be used to reduce the cost of an audit by reducing detailed audit tests. However, it is probably assumed too risky to reduce detailed tests and therefore analytical procedures may be used as a complementary evidence gathering method. When some tests cannot be performed, no corroborative information is obtained and decisions are made using limited test results.

Difficulty in applying analytical procedures near the end of the audit

In line with the use of analytical procedures during the audit, analytical tests compliment other tests, and the sum of the results enables the auditor to better evaluate the client's financial statements. The impact of such tests conducted towards the end of the audit is not as high as during the audit. By then the auditor would probably have obtained an idea as to what the financial statements represent. This problem and that of relying on analytical procedures during the audit were not considered major problems in Tanzania, but they were considered important in Botswana.

Inadequate client control over record counts and other controls over write-up work done

This was a rare problem. However, its index of 8.5 indicates the importance attached to control over records in relation to the completion of an audit. Records of an entity form the basis of any audit. If control is weak and there is either loss or manipulation of records, it may increase the cost of an audit and impose other encumbrances on the auditor. Again, this was not considered to be a major problem in Botswana. It is therefore an important problem in the other two SADC countries.

Client resists disclosing related party transactions

This was not a frequent problem. An auditor needs to be aware of related party transactions as they may affect the financial information. Reliability of any evidence from third parties would be suspect. A relationship between the client and another party may increase the possibility of fraud. Reluctance to disclose such transactions would adversely affect completion of the audit. With an index of 8.3, resistance to disclose related party transactions was considered an important problem by the respondents.

Audit of write-up work done for client by auditor

This was another non-frequent problem. Its importance arises due to the fact that auditors recognise the conflict of interest that would arise if they were to perform an audit of their own work, in which case the auditors' objectivity would be questioned.

Reliance on internal accounting controls over sales, debtors and cash receipts

This problem was rarely encountered, but it is considered to be a significant problem if it was to occur. Inability to rely on internal accounting controls over the sales cycle can influence the time it takes to finalise an audit assignment.

Compliance testing internal accounting controls when they cannot be relied upon

This problem has an impact because it occurred occasionally. It was not considered important with regard to the completion of the audit, but the auditors occasionally found them having to perform such tests. This would probably be necessary to satisfy themselves that adequate tests are conducted on evidence gathered from the firm.

Reliance on internal accounting controls over payroll

As was the case of controls over the sales cycle, this problem was rarely encountered, but it is considered to be a significant problem if it was to occur. Inability to rely on internal accounting controls over the payroll can influence the time it takes to finalise an audit assignment.

Conclusions

Small businesses play an important role in the economies of the three countries, and in our opinion, the SADC region. Audits of small businesses differ from those of large enterprises due to their inherent characteristics. The results enable us to conclude that small businesses in the three SADC countries have similar characteristics to those typified for small businesses in general.

Auditors in Botswana, South Africa and Tanzania encounter problems of varying nature and magnitude in the conduct of audits irrespective of size of the client. The issue is whether the problems have any particular effect on the outcome of the auditors' work. Only five of the 23 problems presented to the auditors in this study were encountered at least occasionally. None of these problems occurred frequently. Since these comprise less than 22% of the problems, the second conclusion from this study is that auditors do not run

into these problems often enough as to cause serious concern. Over 78% of the problems (18 out of 23) either rarely occurred or never did.

The problem indexes show that 14 of the 23 problems (61%) have an important bearing on the audit. This means that although the listed problems are not met often enough, auditors consider a good number of them important in a small business audit. These findings suggest that auditors should be more cautious when auditing small businesses. Most small businesses are not well organised, with few experienced and well-trained staff. Small businesses will not have sufficient employees to enable segregation of duties. Similarly, a level higher than operating management to which the auditor can communicate information is almost always lacking in small businesses. These problems make it imperative that auditors exercise great care when auditing small businesses.

When the results of this study are compared to the one done in Botswana (Kitindi et al, 2000) and that in Tanzania (Kitindi, 2000), one can discern a difference in perception of the problems among the three SADC countries. Ignoring ranking, of the fourteen problems with a high importance index, six of them were not considered to be major problems in Botswana and five in Tanzania. It is not clear as to why there should be this difference in perception. It is therefore recommended that a study be conducted to establish whether there are environmental factors in the three countries that lead to this difference.

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