

Full Length Research Paper

Small and medium auditing entities: Specific and outlook

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In this article, we intend to examine the importance of external audit on the reliability of financial statements issued by small and medium-sized entities. We study the impact of auditor size on the procedures of the entity, the different types of risks they may face, an additive in the exercise of engagement and expression of his responsibilities after the audit opinion. The article is structured in three parts: the first part we performed an econometric analysis to study the evolution of GDP and the number of small and medium sized entities in Romania, for example, we chose the period 2000 to 2007 to define a univariate regression model. In the second part, we present some aspects of the environment in which small and medium-sized entities operating in Romania, supplemented by results of investigations. Then, we analyzed the general risks related entity specific risks, related to the nature of operations, the materiality, the continuity of the operation-specific factors that impact SMEs and scope of an audit. In the last part of the article, we present findings on the usefulness of the external auditor's report, especially regarding the decision to grant bank loans of small and medium enterprises.

Key words: Small and medium-sized entities, audit risk, materiality, going concern.

INTRODUCTION

Methodological norms based on 1005 International Auditing "special considerations for auditing small entities" will analyze how these provisions apply to small entities in Romania features. The first finding is the fact that the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB) are applicable to auditing small entities, how the application of certain requirements of ISA is influenced by the size of the audited entity subject to the Methodological Norms 1005.

Need to develop separate recommendations for small entities deriving their just large share of all economic entities in both numbers and in terms of their contribution to GDP. According to official data, the average density of SMEs in services is approx. 70 SMEs per 1,000 inhabitants in EU countries (according to "Annual Report

2008 Small and Medium Enterprises") with a total of 23 million active registered SMEs in EU countries. They are approx. 99% of all enterprises (European Commission-European portal for SMEs, www.ec.europa.eu).

Also, using data published by the Ministry of Small and Medium Enterprises, Commerce, Tourism and Liberal Professions and "SME Report 2008" (Table 1) we will customize the analysis taking into account existing national regulations.

Although, you can see the increase SMEs in Romania during 2000 to 2007 and an increasing trend of GDP, the correlation between the two variables indicates a direct linear dependence between the two sizes. Graphical representation of the evolution of GDP and the number of small and medium sized entities in Romania during 2000 to 2007 (Figure 1) is instructive in this regard.

In other words, you can define a linear regression model between the explanatory variable "number of Small and Medium Enterprises" and explained GDP variable on which to determine GDP created by SMEs, and possibly to predict the size of GDP based on small

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Table 1. Evolution of GDP – number of small and medium enterprises (SMEs) in Romania during 2000 to 2007.

Year	GDP (million RON)	Number SMEs
2000	80.377	412.429
2001	116.769	412.332
2002	151.475	415.491
2003	190.335	459.369
2004	246.469	404.300
2005	288.176	434.847
2006	344.536	463.504
2007	404.769	487.628

Data source: National Bank, Monthly Bulletin December 2007, Statistics section: nominal data, current prices.

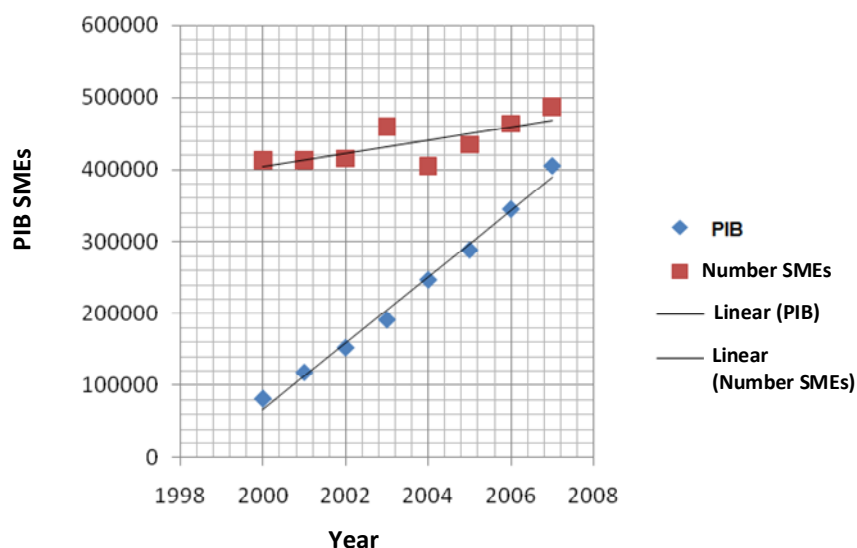


Figure 1. Evolution of GDP – The proportion of small and medium enterprises (SMEs) in Romania during 2000 to 2007.

numbers active (according to data from the Register of Commerce) with the following form:

$$Y_i = T_i + X_i + \mu,$$

Where: Y_i – GDP is created in him; T_i – You are free time and quantify the influence of regression model non-simple (univariate) of GDP; μ – This is the residual variable.

Furthermore, period, characterized by strong influences of other factors, especially the negative effects of financial crisis on business in a vulnerable economy like Romania, is inconclusive any forecast of GDP by the number of active SMEs.

It can be noted that while GDP registered an upward trend in Romania during 2000 to 2007 (Figure 2), the number of Romanian SMEs active in the same period an increase until 2003 (that is, 459,369 active SMEs), then the number drops to a the minimum period in 2004 (that

is, 404.300 SMEs), registering what is called a break of slope.

CHARACTERISTICS OF SMALL ENTITIES

1005 Methodological attributes in the normal sense of "small entities" are given a set of quantitative characteristics such as turnover, balance sheet total number of employees and qualitative elements such as:

1. Concentration of ownership and management and
2. Few sources of income, the accounting simple, limiting internal controls.

Restoring global economy is also important for improving social protection policies, increasing social dialogue and collaborating with non-profit organizations to raise awareness through social marketing programs (Serban, 2011; Serban et al., 2011).

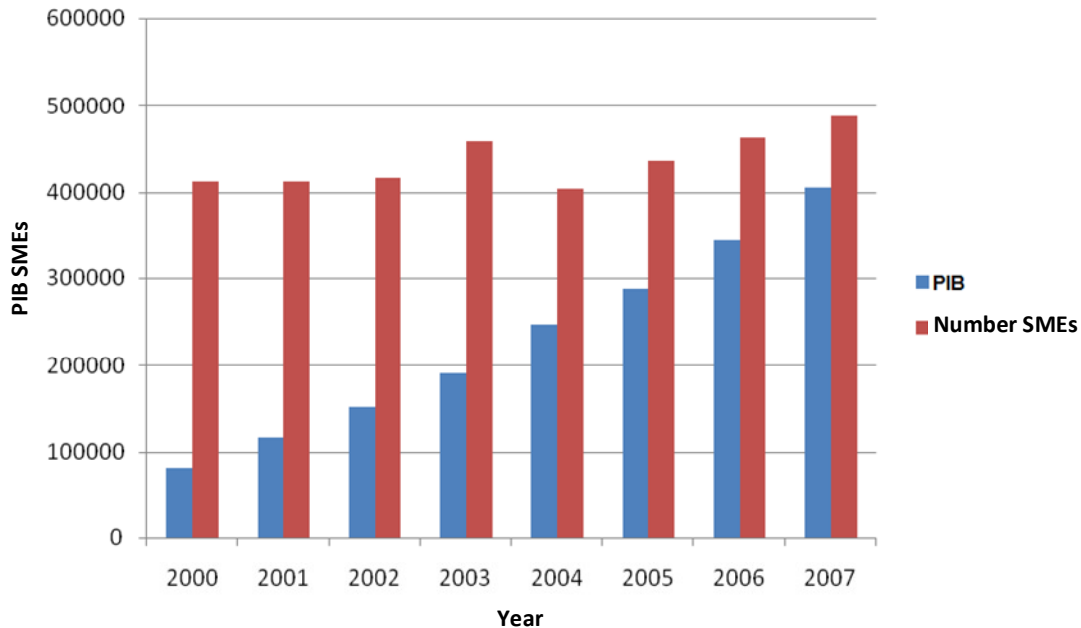


Figure 2. GDP and the number SMEs in Romania during 2000 to 2007.

Establishment of small entities in Romania is regulated by Law no. 346/14 July 2004 to stimulate the creation and operation of SMEs by updating the law 346/2004 (Law 175/2007) was done to align national legislation with the requirements of EC Recommendation 2003/361/EC concerning the definition of the SME unit, as follows: the criteria for classification of an entity in SME are given by the cumulative fulfillment of the conditions on the annual average number of employees under 250 and achieve a net annual turnover of up to 50 million equivalent in lei or holding assets totaling to 43 million euros according to the latest approved financial statements. Depending on the annual average number of employees, SMEs can be classified as: micro (fewer than 10 employees), small (with fewer than 50 employees) and medium-sized enterprises.

Audit approach small entities based on risk assessment involves the application stage to accept the mission and formalization of relations with the client, the provisions of International Standard on Auditing ISA 315, "Understanding the entity and its environment and assessing the risks of material misstatement."

The risk of significant misrepresentation in the account balances, classes of transactions, disclosures and the financial statements of an entity identified by the auditor than in the subsequent background design procedures (tests and tests of details substantive operations balances). The reason the client wants an audit of financial statements, is the starting point in identifying risks. Business risk, a major risk of small entities in Romania in 2010, may be an indication of the environment in which they operate their activity.

According to the source "SME Annual Report 2008", a survey among SME owner-managers, the major problems that they face are:

1. Lack of resources (69.8%)
2. Limited access to credit (39.5%)
3. Lack of clients (38.2%)
4. Competition (75%)
5. Promotion-company market failure (54%).

Unfortunately, in Romania, the situation has continued for years to come. In this case, ISA 315, mentioned previously, paragraph 12, present procedures for awareness of the entity and its environment, the audit evidence obtained preliminary assessment of underlying risks of material misstatement.

The issue of Romanian entrepreneurs, as evidenced in the results of that survey is similar to running their business entrepreneurs and other meridians, for example, Italy (Sarno, 2005), United Kingdom, Poland (Watkins and Road, 2000) and Croatia (Pejic-Bach, 2003).

Cash requirements may be considered as a reason for a small entity requests a financial audit (as the documentation to bank loans). The high level of credit risk assumed by banks financing of SMEs and the impact of risk on the interest charged by them, was also an object of study (Castaneda and Luna, 2008).

A comparative analysis between commercial credit and bank credit, as sources of finance for SMEs, has revealed the need to adopt a mix of operational and financial policies to reduce the cost of financing (Rodriguez, 2005).

AUDITING ENTITIES SMEs: PARTICULARITIES

Accounting information as a raw material external financial audit has been analyzed in terms of its quality and the role of accounting information in decision-making by the entrepreneur. Although, many studies have highlighted that the financial statements produced by SMEs are intended mainly tax authorities (Bajan-Banaszak, 1993; Lavigne, 1999), not least regarding management accounting practices are applied (Raymond, 1995; Nobre, 2001; Van Caillat; 2002; Chapellier, 1994) especially by entrepreneurs who have a high level of training, in particular, economic (Chapellier, 1994).

Applicability of international-referential Audit Standards, for small and medium entities of state attention of filmmakers survey Direction Générale du Marché intérieur et des Services Commission. Synthesis of survey results, published in March 2010 (portal ec.europa.eu) and attended by 89 respondents belonging to a wide range of stakeholders is revealing: "a clear majority of respondents in favor of enforcement in carrying out statutory audit ISA of all companies, including small entities for which audit is required."

The auditor's decision to take over as a new customer or contractual relationship with existing customers, formalized by letter of engagement (according to ISA 210 "Terms of the engagement") will be taken only in compliance with the Code of Ethics of IFAC. Auditor independence, both in relation to client and related party (as ISA 550 "Related Parties"), the risk of self-revision is the most common situations in which the auditor may find a small entity (often services for filing statements outsourced financial expertise and audit firms) and measures applicable safety related auditor's reasoning.

Risk assessment procedures provided in ISA 315 include visits to locations held by the client, observation, inspection, request for information on reliability, customer reputation, lifestyle of the owner (according to IAPS 1005). Particularly important at this stage consider the auditor's information on owner-manager's reputation (according to the terminology of IAPS 1005) because "each organizational unit is a direct reflection of its management" ("Principles of Leadership" - Peter Drucker).

Internal control mechanisms of a small entity may not include, for example, segregation of duties, but this deficiency can be corrected by daily surveillance conducted directly by the owner-manager. In this case, the audit procedure is applicable for assessment of internal control established in observing the control entity.

ISSUES TO THE APPLICATION OF ISA 320 "MATERIALITY OF AUDIT"

Reducing audit risk can be done by establishing an acceptable materiality level appropriate to require the use

of judgment greater for small entities. "Flair" auditor has a wider field of development when the client is in the small category.

Thus, entities, statistical sampling methods, the extrapolation of results from the sample to the population are less applicable (not based on law of large numbers), consider preparing a more effective audit plan that test items are set by selecting and testing samples for small values of 100% of items exceeding a certain amount considered meaningful to the auditee.

Significant risk of distortion of financial statements, the risk of overvaluation of assets auditor may "respond" by defining procedures to obtain adequate evidence on which they could formulate an opinion based on the fair value of assets used as collateral bank (possibly using the services of an expert appraiser, according to ISA 620 "Using the activities of an expert"). It is also absolutely necessary to identify all related parties in the case of stocks that are available to third parties as collateral, whose use is restricted for various reasons, or to identify risks of "siphoning" of income between the parties affiliated.

In situations mentioned previously, to reduce the risk of audit requires full testing of the elements without taking into account the materiality level determined by procedures implemented by the audit firm. Although the auditor's responsibility is limited to material misstatements due to fraud and / or error (according to ISA 240 "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements") qualitative aspects of materiality are no less important, for small entities reduced volume of transactions makes it possible, when used licensed software for data processing, reduction or elimination of distortions in the financial statements.

For many small entities, is more profitable to use service organizations instead of financial ones. The auditor statements have, in this case, the obligation to apply the procedures under ISA 402, "Audit Considerations related entities working with service organizations".

Auditor statements are relevant to the nature of client relationships and professional accounting firm of the service can become very significant internal control implemented by the service, especially if the auditor intends to use accounting data for the application of analytical procedures to test the completeness, accuracy of records.

Limiting the scope of the audit will be avoided by stating the auditor's unlimited access to all the records in the letter of accounting firms misiune. Information about it is accessible to the auditor by professional bodies in rural economists, legal practitioners, and in press.

BUSINESS CONTINUITY

Economic risk of the auditor if the continuity of a small entity for at least 12 months of each financial year cannot

be observed can be reduced by implementing the procedures provided by ISA 570 "Going Concern".

Problems identified by the "SME Annual Report 2008" impact on business continuity are a small entity in Romania might add, specifically the current period, reduced purchasing power of population, level of training (positive correlation between experience frameworks management and survival of small entities mentioned in the report quoted) state of infrastructure, excessive taxation (flat tax) and financial blockage.

Analysis of cash flows (even if the entity is not required to prepare such a situation, according to updated OMF 3055/2009) and net flow originating separately from the operation and financing of investments can provide important clues on the activities of consumer / generator of cash. For longer periods of time, a comparative analysis and cash flow statement of profit and loss may be relevant in identifying fraudulent financial reporting risks if significant differences (given the calculated costs charged to the profit and loss and have no impact on cash depreciation and adjustments for impairment of value) and systematic data exist between the two documents.

CONCLUSIONS

Owner-manager's direct interest in the smooth running of business in conjunction with the auditor's interest to minimize audit risk and the result can converge to materialize the cooperation between the parties as recurring audits, though the auditor may render some pieces of advice. Even in these circumstances, the auditor's attitude of professional skepticism is necessary.

Financial communication between small and medium entities and external users is a key function of enterprise (business), even a means of promoting goods and market entity. The credibility of financial statements, issued by an entity, is viewed as informational support for external accounting reality. For auditors, preserve owners are small or medium sized entities, analyzing leverage of external funding to attract resources (increasing efficiency invested equity due to the difference between internal rate of return of capital and bank interest rate).

This is a decisive preliminary step in the decision to call the financing credit. Mostly, widespread in Romania are small entities through grant funding, at least for now.

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