

# **Statutory Auditing and Performance of Small and Medium Scale Enterprises in Lagos State, South West-Nigeria**

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DOI: 10.6007/IJARBSS/v6-i9/2282 URL: <http://dx.doi.org/10.6007/IJARBSS/v6-i9/2282>

### **ABSTRACT**

Small and medium Scale Enterprises are gaining increasing prominence in the developing economics as a driver of economic growth. However, studies has shown that several of these enterprises prematurely die, before they can achieve their goals due to poor management arising from inadequate, weak, undependable accounting and financial information as well as absence of regular auditing and risk assessment.

The purpose of this research is to access the impact of statutory Auditing of Small and Medium Scale Enterprises on their performance. The sample for the study comprises of 100 SMEs operators and 25 practicing public accountants purposively selected across the three Senatorial districts in Lagos State South West, Nigeria, using stratified sampling techniques to ensure that only those who are knowledgeable about issues under consideration were selected. The primary data for the study was gathered from a combination of Survey questionnaire and semi-structured interviews of key Informants. Data captured from the study were analyzed through descriptive statistical methods, while the two hypotheses formulated for testing in the study were tested using the Pearson Product Moment Correlation Coefficient and Student's t-test.

Finding from the study reveals that absence of standard accounting system and detailed financial records has been a major impediment to Statutory Auditing of many SMEs, and by extension negatively affect their performance as they find it difficult to convince stakeholders (creditors, supplier, tax authorities etc.), that there has been regular oversight by an independent expert into the affairs of the firms. The finding further revealed that this can be eliminated through adoption of sound accounting System that conforms to International Auditing Standards. It was therefore recommended that SMEs should be encouraged to adopt and embrace sound accounting system. More so, the cost of Installing and operating such system should be minimized so as to encourage the SMEs to keep extensive documentations requirement of auditing Standard.

**Keywords:** Statutory Auditing, Accounting System, Performance, Small and Medium Enterprises.

### **1.1 Introduction**

Small and Medium Enterprises (SMEs) is perhaps the most important sector of any economy not just in the higher number of people employs but in its contribution to the GDP, tax revenue and fast dissemination of technology. In counties such as Indonesia, Indian and Taiwan, SMEs contribute over 40% to the GDP growth of respective counties. In developed economy of Europe and America, SMEs make up 94 percent of all business in these counties. Hence, the SMEs role in employment and national economic growth are substantial.

Berry et al 2001 outlined three reasons why developing countries should pay attention to SMEs. This includes:

- i. SMEs performance is better on creating productive labour
- ii. The productivity increase through investment and changing technology
- iii. SMEs has more flexibility than big companies.

Inspite of these sector contributions to sustainable development, poverty alleviation and employment generation, there are still some problems that limit the potentials of SMEs in Nigeria to grow particularly in the area of book-keeping, internal control, auditing and risk assessment.

### **1.2 Statement of the Research Problem**

The place of auditing in any business, irrespective of its size cannot be overemphasized. International Standards on Auditing (ISAs) require close examination of an entity and its environment, including the entity's control environment and internal control. Auditors are required to assess how management identifies and mitigates risk as part of the audit-risk assessment. Audit of Small and Medium Enterprises have proven to be among the most worrisome for professional accountants because of the inadequacy of the internal controls (Olatunji, 2013). Except for statutory demand, small and medium enterprise hardly give serious thought to process of sound accounting system, risk assessment and auditing hence the imminent and untimely collapse of many of these establishment.

### **1.3 Research Objectives**

The main objective of this study is to assess the impact of Statutory Auditing on the performance of Small and Medium Scale Enterprises (SMEs) in Lagos State, South West Nigeria. Specifically, the objectives of the study are summarized as follows:

- (i) To examine if inadequacy of financial records can significantly affect the statutory auditing of Small and Medium Scale Enterprises.
- (ii) To investigate if absence of regular Statutory Auditing will significantly affect performance of Small and Medium Scale Enterprises.

### **1.4. Statement of Hypothesis**

In realization of the afore-mentioned objectives, the following hypotheses were tested.

H<sub>1</sub>: There is no significant relationship between inadequacy of financial records and the Statutory Auditing of Small and Medium Scale Enterprises.

H<sub>2</sub>: There is no significant relationship between regular statutory Auditing and the performance of Small and Medium Scale Enterprises.

## **2.0 Review of literature**

### **A. Small and Medium Enterprises (SMEs)**

Several attempts have been made by scholars, researcher, local and international agencies, as well as business association to define small and medium Enterprises (SMEs). This suggests that there is no universally accepted definition that could include the diversity and variety of small and medium enterprises.

However, within the context of management science, the issue of definition is very important and need to be clearly addressed in order to give direction and perspective for the concept under consideration. The search for a standard definition of SMEs produces definition, which vary from country to country because the difference in industrial management, strategies and depending on the capitalization, level of employment and method of production among other criteria.

According to Small and Medium Industries Equity Investment Scheme (SMIEIS). (An initiative of the banker's committee) SMEs is defined as an enterprises with total capital employed not less than N1.5million but not exceeding N200million including working capital but not excluding cost of land and/or with staff strength of not less than 10 and not more than 300.

The Central Bank of Nigeria (2004) defined a Small Scale Enterprises as one whose capital investment does not exceed N5million (including land and working capital) or whose turnover is not more than N25million annually.

The Nigeria Council of Industries (NCI) makes an interesting classification in their attempt to define SMEs. According to NCI definition, three distinct industries can be grouped under SMEs umbrella:

- Cottage industry which they defined as an industry whose cost including working capital but excluding cost of land is not more than N1million and a labour force of not more than 10 workers.

- A small scale industry – An industry whose total cost including working capital but excluding cost of land in over N1million but not more than N40million and labour force of between 11 – 35 workers.
- Medium Industry – An industry whose total cost including working capital but excluding cost of land in over N40million but not more than N150million with labour force of between 36 – 100 workers.

Thus, it can be seen from the above definitions that variations / differences exist from one institution to another in Nigeria. However for the purpose of this study the definition of Central Bank of Nigeria (2004) is adopted.

#### B. Auditing

The general definition of an audit is an evaluation of a person, organization, system, process, enterprise, project or product. Audits are performed to ascertain the validity and reliability of financial information provided by the managers of the reporting entity and the assessment of the entity Internal Control System. In a practical terms audit seeks to provide reasonable assurance that financial statements are free from material errors.

The audit function has a long history in the western world and as contributed to the efficient development of established economics. International Standard on Auditing (ISAs) requires close examination of an entity and its environment, including the entity's control. Auditors are required to assess how management identifies and mitigates risk as part of the audit risk assessment.

For an organization to be efficient and effective and be able to achieve its desired objectives, it need to have amongst other good leadership, competent manpower, adequate resources and good measures of internal control (Abu-Saeed and Kabir, 2012). Cornor (1979) said that internal control is considered important in an organization either public or private should take adequate steps considered necessary to establish and sustain an effective internal control system with a view to ensuring effectiveness, efficiency and economical operations.

#### C. Relevance of Audit to SMEs

A critical look into many SMEs operation reveals that owners are involved in daily management of the business. They exercise financial and other controls personally. However when the business grow to a point where the owner can no longer make all the operational decisions, they are forced to put in management and controls. This is a particularly vulnerable stage for any business and may carry on for an extended period during the growth phase (Baker Tilly, 2010). During this period an audit can add considerable value in identifying controls, management and system issues as well providing regulatory oversight.

The needs of other parties who are also interested in the financial position of an SME is another major need for SMEs Audit. For example, the tax office obtains assurance from an audited set of financial statement provided with a tax return. Banks and finance providers are always influenced by the existence or otherwise of audited financial information when considering funding application. Evidence of audit delivers the message that there has been regular external oversight by an independent expert into the affairs of the SME.

An external audit of a SME draws to the attention of the SME's directors, the need to understand their roles and responsibilities under cooperate legislation and particularly regarding the need to maintain their business as a going concern and to give due consideration to the prevention of insolvent trading. An independent audit indicates to all stakeholders that an independent expert has examined these business practices, thereby giving them some protection in respect of these considerations.

In terms of books and records keeping, wood (1979) observed that many small business can have all the information they want by merely keeping a cashbook and having some form of records, not necessarily in double entry system (Vickery and Menders, 1973; Olaoye, 2012). This according to Olatunji (2013) is an aberration and requires a conversion to double entry system for a meaningful Auditing (Adebisi and Azeez, 1999, Onaolapo et al, 2011).

### **3.0 Research Method**

This study employed survey design and content analysis. Primary data was generated through administration of structured questionnaire and semi-structured interview, whereas secondary data on the other hand, was generated through content analysis. Structured questionnaire was used to collect the primary data. The questionnaire was structured on a 5 point likert-scale arranged in four sections: A-D covering total of 20 questions.

The sample size for the study was purposely selected using stratified sampling methods to ensure that only those who are knowledgeable about issue under consideration were selected for the study.

The Cochran (1963) infinite population formula was adopted to drive a sample size of 125 (Consisting of 100 SMEs operators and 25 practicing public Accountants) out of which 118 questionnaires were returned and accepted for analysis, interpretation and for hypotheses testing.

The two hypotheses formulated for testing in the study were tested using descriptive statistical methods such as the Pearson Product moment correlation coefficient and student's t-test so as to determine whether to accept or reject the mill hypothesis.

### **4.0 Results**

Two hypotheses were tested in this research.

#### **Testing of Hypothesis 1**

There in no significant relationship between inadequacy of financial records and Statutory Auditing of Small and medium Scale Enterprises

Option on Research question 2	X Point	Y Response	XY	X <sup>2</sup>	Y <sup>2</sup>
SA	5	51	255	25	2601
A	4	38	152	16	1444
U	3	6	18	9	36
D	2	14	28	4	196
SD	1	9	9	1	8
Total	ΣX=15	ΣY=118	ΣY <sup>2</sup> =462	ΣX <sup>2</sup> =55	ΣY <sup>2</sup> =4358

**Source: Field Survey (2016)**

Where X represents value assigned to Likert scale i.e. strongly agree (5) agree (4) undecided (3) disagree (2) and Strongly disagree (1) Y is the response pattern to the research question 1.

Correlation coefficient r

$$r = \frac{n \sum xy - \sum x \sum y}{\sqrt{n \sum x^2 - \sum (x^2)} \sqrt{n \sum y^2 - (\sum y)^2}}$$

$$r = \frac{5(462) - 15(118)}{\sqrt{5(55) - 225 \times 5} \sqrt{4358 - (118)^2}}$$

$$= \frac{540}{621} = 0.87$$

The value above shows that there is strong relationship between the two variables.

To test level of significance of the Relationship between the two variables, The t-test statistics was employed and the formulae in thus

$$t - \text{Cal} = r$$

With n-2 degree of freedom

Where r = Correlation coefficient.

$$t = 0.87 \sqrt{\frac{3}{1 - (0.87^2)}}$$

$$t = \frac{1.50}{0.49}$$

$$t - \text{cal} = 3.06$$

Therefore the calculated t value is 3.06. From the t-table the critical value of t with (5-2) degree of freedom at 0.05 level of significance is 2.35.

**Decision Rule**

Reject H0: if t-cal ≥ tab

Since t-cal (3.06) is greater than t-tab (2.35) it means rejecting the null hypothesis which says that “there is no significant relationship between inadequacy of financial records and statutory auditing of Small and Medium Scale Enterprises. Hence the alternative hypothesis was accepted.

**Testing of Hypothesis 2**

Option on Research question 2	X Point	Y point	XY	X <sup>2</sup>	Y <sup>2</sup>
SA	5	54	270	25	2916
A	4	32	128	16	1024
U	3	6	18	9	36
D	2	13	26	4	169
SD	1	13	13	1	169
Total	ΣX=15	ΣY=118	ΣXY=455	ΣX <sup>2</sup> =55	ΣY <sup>2</sup> =4314

Source Field Survey (2016)

$$r = \frac{n \sum XY - \sum X \sum Y}{\sqrt{n \sum x^2 - \sum (x^2)} \sqrt{n \sum y^2 - (\sum y)^2}}$$

$$r = \frac{5(455) - 15(118)}{\sqrt{5(55) - (15)^2} \sqrt{5(4314) - (118)^2}}$$

$$= \frac{505}{618} = 0.82$$

The coefficient of 0.82 indicates that there is a strong positive relationship between the two variables.

To test for the significance of the relationship between the two variables, the student’s t-test statistics will be used and it is given by:

$$t\text{-cal} = r \sqrt{\frac{n-2}{1-r^2}}$$

$$= 0.82 \sqrt{\frac{5-2}{1-(0.82)^2}}$$

$$= 0.82 \sqrt{\frac{3}{1-0.67}}$$

$$= t\text{-cal} = 2.62$$

Decision Rule

Reject H0: if t-cal ≥ t-tab

From the t-tab with 0.05 level of significance, the critical value is 2.35. However, since the computed t-value of 2.62 is greater than the critical value of 2.35, the null hypothesis ( $H_0$ ) is rejected and the alternative hypothesis accepted. Therefore, the study concluded that there is a significant and positive relationship between regular statutory Auditing and the performance of Small and Medium Scale Enterprises.

## **Summary and Conclusion**

### **5.0 Summary of Findings**

This research empirically examined the impact of statutory Auditing on Small and Medium Enterprises performance in Lagos State, south West Nigeria.

The summaries of major findings of this research are as follows:

- (a) Inadequacy of financial records significantly affects the statutory Auditing of Small and Medium Scale Enterprises in Lagos State, South West Nigeria.
- (b) Absence of regular statutory Auditing significantly affects the performances of Small and Medium Scales Enterprises in Lagos State.
- (c) Many of the SMEs firms surveyed do not have a standard accounting department
- (d) Where accounting department exists, unqualified personnel are engaged to record cash received and paid, make banking payment and a little bit of book keeping
- (e) External Auditors in many instances have to prepare the accounts from scratch with inadequate information.
- (f) Many of the firms surveyed considered statutory audit, unnecessarily overhead necessitated by law.
- (g) Audit recommendations on internal control weakness, accounting systems were never implemented
- (h) The same anomalies are raised year after year by the external auditors with little or no improvement.
- (i) Due to the closeness of the auditors and the owner/manager, the management reports prepared after the audit exercise are usually an unqualified report, certifying that all is well with company (even when it is not so)

### **5.1 Conclusion and Reflection**

The need for auditing in promoting good performances in Small and Medium Enterprises in Nigeria has been successfully studied in this research work. It was observed that many SMEs are not able to keep extensive documentation requirements of auditory standards. Hence, the application of auditing and accounting standard to the operation of SMEs raised an onerous obligation.

The position of this paper is that “an audit is an audit” and that auditing standards can be applied to entities of all size.

Findings from the study also reveals that effective and proper accounting system has a profound impact in successful auditing of Small and Medium Enterprises and by extension on the performances of the firms. In light of the above findings the following recommendations are made:



- (1) SMEs should be encouraged to adopt and embrace sound accounting system
- (2) The cost of installing and operating such systems should be minimized so as to encourage the SMEs to keep extensive documentation requirement of auditing standards.
- (3) Auditors in the audit of SMEs should adopt methodologies that will adequately capture the accounting and reporting needs of the enterprise.
- (4) Auditor involved in the audit of SMEs should be bold and courageous enough to comment properly on the peculiarities of the firm in the audit report, if necessary give qualified report.
- (5) Professional Accountancy bodies and national standard setters should come up with practical auditing standard that will focus on risks associated with auditing of SMEs.

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