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Agency Theory And Demand For Audit By Small Businesses

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Abstract

It is mandatory for small companies in Malaysia to carry out an audit regardless of their size. Only sole proprietors and partnerships are exempted from this audit, as they are enacted under different regulations. This study aims to examine the characteristics of these small businesses and their demand for voluntary audit from the agency theory perspective. The data for the study were obtained from primary sources. About 100 questionnaires were distributed to sole proprietors and partnerships in Malaysia, however only 62 samples were usable for the purpose of the study. Interviews were also conducted to obtain further insight of the variable under study. Independent t-tests were employed to compare the characteristics between the groups. The results of the study indicate that businesses, which have higher managerial ownership among Malaysian small businesses, demand significantly less audit voluntarily compared to those businesses, which have lower managerial ownership. The sole-proprietors also appear to demand significantly less voluntary audit compared to partners in the partnerships. This may be because they view themselves as the monitoring mechanism in their businesses, which reduce the need for audit, as they are also the owners of the businesses. In addition, the result also indicates that businesses, which have more employees, would significantly demand more voluntary audit compared to those with less employees. This result is consistent with agency theory, which posits that as the number of agents (employees) who manage the businesses increases the demand and need for audit would also arise. In addition, the results also suggest that those small businesses, which are larger and have more liabilities would voluntarily demand more audit compared to those, which are smaller and have less liabilities.

Keywords: Agency theory, voluntary audit, small businesses, sole-proprietors, partnerships.

■1.0 INTRODUCTION

Traditional agency theory suggests that firms that operate under a single owner-manager can typically be considered as zero owner-manager agency costs (Jensen and Meckling, 1976; Ang et al., 2000). And it is argued that as sizes of the firms get bigger and the owner manager cannot manage on his own, he may appoint more managers / agents to help him managing the firms. This would then lead to agency problems in the firms. When agency problems exist, Niskanen et al. (2010) claim that demand for audit service would increase as audit acts as a monitoring mechanism to monitor the agents.

Most studies focus on the agency relationships and agency problems in public listed firms. However Ball and Shivakumar (2005) argued that there are important differences between small and private businesses and these large and public listed companies. One of the reasons is, besides the auditors, the public firms are also monitored by the stock market and various stakeholders, but the small businesses are not subject to such market (Nazir et al, 2014). Niskanen et al (2010) claim that these small businesses attempt to mitigate these agency problems by demanding voluntary audit when agency problems increase in their businesses.

In Malaysia, only companies are supposed to have their accounts audited, but it is not mandatory for sole-proprietors and partnerships to have their accounts audited. However, there are sole-proprietors and partnerships that are willing to have their financial statement audited even in an unregulated setting (Collis; 2005; Kaur and Kurt, 2008). It is claimed that firm-specific incentives (agency and contracting costs) can motivate sole traders and partners to demand voluntary external auditing (Francis, Khurana, Martin and Pereira, 2005). In a study by Kaur and Kurt (2008), partnership firms demand for voluntary audit because partners can focus on their core businesses. Engaging auditors enables partners to free themselves from additional burden and time to maintain the accounting affairs of their businesses (Kaur and Kurt, 2008). Thus, this study is conducted to examine the demand for audit by these small businesses, as most of previous studies focused on the demand for audit by large and listed companies, and less attention and limited research is carried out for small businesses. This study contributes and provides an insight about the demand for audit from the agency theory perspective, by small businesses in Malaysian business setting which is claimed to be very concentrated, and act as a basis to motivate other researchers to investigate the agency problems in small businesses.

The remainder of the paper is structured as follows. Section 2 gives a review of the relevant literature. Section 3 describes the sample and methodology used for the study. Section 4 presents and discusses the empirical results and, finally section 5 provides the conclusions of the study.

2.0 LITERATURE REVIEW

According to the agency theory by Jensen and Meckling (1976), owners who manage wholly-owned firms will make operating decisions which maximise their utilities. They will derive benefits from pecuniary returns and the utilities generated by various non-pecuniary aspects of their entrepreneurial activities such as personal relations with employees (Jensen and Meckling, 1976). When the shareholders and directors are the same people, it appears no meanings for auditors to report to the shareholders that the directors and the management have prepared the annual financial statements in a true and fair view (Salleh, Rose, Kumar and Jaafar, 2008). Owners of the business firms have direct control over the day-to-day management, and financial statements are being prepared either by them or under their direct supervision (Basu, 2007). They may not be good in bookkeeping, and they accept that their books are somewhat vulnerable to criticism or in a mess. Thus, they do not need auditors to tell them that the stewardship of their own assets has been acceptable which in return requires twice of the cost in the preparation of their partnership accounts (Cox, 1992).

It is claimed that demand for voluntary audit decreases as managerial ownership increase (Tauringana and Clarke, 2000). In addition, owner-managers are not comforted at employing accountants to prepare abbreviated accounts which will cost them even more (Cox, 1992). Cox also highlighted that rigorous audit procedures will lead to qualified audit reports as there are poor quality records and significant owner-manager involvement in running the businesses. The clients will have to bear additional costs to negotiate with auditors so as to get mutual agreement (Cox, 1992). Since the internal control system in a small company cannot be made more reliable without incurring additional costs, most companies compensate for such deficiencies with an increase in supervisory controls, and the addition of personnel to make segregation of duties possible has become a burdensome extra cost for them (Norris, 1984 cited by Chung and Narasimhan, 2001).

Size can be measured through turnover, total assets and number of employees (Tauringana and Clarke, 2000). Size, as measured by turnover, is an important factor in predicting whether the directors consider the cost of having a voluntary audit will outweigh the management and agency benefits (Collis, 2005). Turnover might be proxying for cost in the cost-benefit analysis (Collis, 2005). Measured relative to revenue, the compliance costs in Malaysia is regressive that they increase in decreasing firm sizes (Loh, Ariff, Ismail, Shamsher & Ali, 1995). Small companies incur disproportionate costs compared to large companies, suggesting that larger companies are more able to afford higher audit costs (Tauringana and Clarke, 2000). Larger companies are likely to be audited voluntary because as they grow in size, the volume of transactions increase, and mistakes are more likely to occur in accounting data and the financial statements (Tauringana and Clarke, 2000). Further, the economic transactions and the accounting systems have become very complex (Porter, Simon and Hatherly, 2003, pp. 10). Therefore, there is a growing need for the financial statements to be examined by an independent qualified auditor, who has the competence and expertise to understand the entity's business, its transactions, and its accounting systems (Porter at. al., 2003). Moreover, the larger the companies are, the more likely they are to have external funding (Collis, 2003).

According to Schmidt (1952), being small in size, the business entities have little or no access to the organised security markets. He added that the owners or shareholders (for companies) depend heavily on their initial capital upon personal savings, borrowings by friends or relatives, investment by business associates (such as partners), upon retained earnings or long-term bank credit for funds to prosper their businesses. It is claimed that gearing ratio are statistically vital to explain a company's option for audit or not (Tauringana and Clarke, 2000). It is argued that the greater is the number of different accounting measures in a firm's debt covenant, the higher is the probability that the firm requires audit voluntarily (Chow, 1982). Highly geared companies need more external audit since the banks require the independent third party to provide reasonable assurance on the figures in the financial statements (Mustapha and Che Ahmad, 2011b). Banks can be assured of the credibility and fairness of audited financial information before providing small firms the requested finance (Arrey and David, 2008).

3.0 RESEARCH METHODOLOGY

The data for the study were collected using primary sources. Questionnaires were distributed to 100 small and medium enterprises throughout Malaysia. However, only 62 questionnaires were returned and usable for the purpose of the study. The questionnaire used in this study is adopted from Collis (2005) and Fadzly and Ahmad (2003). In addition, five owners and partners of the businesses were randomly selected for interviews to better understand the issue under study.

Data were checked for normality as parametric tests were employed. Independent t-tests were run to compare the characteristics of the groups.

4.0 RESULTS AND DISCUSSIONS

4.1 Descriptive Statistics

Table 1 presents the profile of the respondents involved in the study. Out of 62 respondents participate in the survey, 46 respondents (74%) are owners / partners, and 16 respondents (26%) are managers who do not have any shares in the business. About 66% of the respondents are male and 34% are female. Majority of the respondents (42%) aged between 41 to 50 years old, about 23% aged between 51-60 years old, only 3 of them (5%) aged more than 60 years old and the others aged 40 years old and below. Close to 39% of the respondents have secondary education as their highest education level, another 32% have diploma or bachelor qualification, while another 24% have primary school qualification. Only one of them has postgraduate qualification and two respondents have professional qualification. About 31% of them have been in business between 11-20 years, 8% and 3% of them have been in business between 21-30 years and 31-40 years respectively.

Table 1 Profile of respondents

			N	Percent
1	Position in business	Owners/ partners	46	74.19
		Manager	16	25.81
2	Age	21-30	10	16.13
		31-40	9	14.52
		41-50	26	41.94
		51-60	14	22.58
		61-70	3	4.83
3	Education level	Primary	15	24.19
		Secondary	24	38.71
		Diploma/Bachelor	20	32.26
		Master/PHD	1	1.61
		Professional qualification	2	3.23
4	Gender	Male	41	66.13
		Female	21	33.87
5	Years in business	0-5 years	20	32.25
		6-10 years	16	25.81
		11-20 years	19	30.65
		21-30 years	5	8.06
		31-40 years	2	3.23

Table 2 presents the profile of the businesses involved in this study. Out of the 62 businesses, about 60% are sole proprietors and 40% are partnerships. More than majority of the businesses (79%) have the owners to manage the businesses. The total assets in 23 (37%) of the businesses are more than RM 100,000, and those in 39 (63%) businesses have assets worth less than or equal to RM100,000. About 32 (52%) of the businesses generate sales of less than or equal to RM 100,000, and the balance (48%) have sales of more than RM100,000. About 41 (66%) of the businesses have total liabilities of less than or equal to RM50,000, and the balance (34%) have total liabilities of more than RM50,000.About 34 businesses employed one to four full-time employees to run the business, another 18 businesses operate their business with 5 to 19 full-time workers. There is one business employed more than 20 full-time employees. And 9 businesses do not have any full-time employees except owner-managers.

Table 2 Profile of sample businesses

			N	Percent
1	Type of business	Sole proprietorship	37	59.70
		Partnership	25	40.30
2	Total shares held by owner-managers	< 50% shares	13	20.97
		≥ 50% shares	49	79.03
3	Total assets (RM)	≤ RM 100,000	39	62.90
		> RM 100,000	23	37.10
4	Total sales (RM)	≤ RM 100,000	32	51.61
		> RM 100,000	30	48.39
5	Total number of full-time employees	None	9	14.52
		1- 4 employees	34	54.84
		5- 19 employees	18	29.03
		≥ 20 employees	1	1.61
6	Total liabilities (RM)	≤ RM 50,000	41	66.13
		> RM 50,000	21	33.87

4.2 Independent T–Tests

The independent t-test is utilised to test the differences between the means of two independent groups (Ho, 2006, pp. 41). Table 3 shows the independent t- tests for the study. The second row of Table 3, shows that there is a significant difference between those businesses which have higher managerial ownership and those that have lower managerial ownership in terms of their demand for voluntary audit (t-statistics= -3.298, p = 0.000). Businesses which have lower managerial ownership have significantly higher demand for voluntary audit (Mean= 3.1026) than those which have higher managerial ownership (Mean= 2.4898). This result may be explained by the fact that Malaysian businesses are concentrated and actively managed by their owners, and when the shareholders and directors are the same people, it appears that there is no meaning for auditors to report to the shareholders that the directors and the management have prepared the annual financial statements in a true and fair view (Salleh, Rose, Kumar and Jaafar, 2008). This result is also consistent with the previous studies by Chow (1982) and Tauringana and Clarke (2000) which claim that the demand for voluntary audit decreases as managerial ownership increase. Interestingly, this result is also consistent with a study by Mustapha and Che Ahmad (2011a) which examine owner-manager and agency cost relationship in large and listed companies in Malaysia.

The third row of Table 3, shows that there is a significant difference in their demand for voluntary audit between sole proprietorships and partnerships (t-statistics= 2.390, p = 0.020). Partnerships have significantly higher mean in their demand for voluntary audit (Mean= 2.8467) than sole proprietorships (Mean= 2.4640). This result is also supported by the interviews which are conducted in this study. Two sole-traders (Mr. C and Miss A) who are interviewed claim that they prepare, manage and check the accounts themselves. Thus, they do not see the need to demand for an audit. Another sole-trader, Mr B is in the opinion that, “A partnership firm should adopt voluntary audit because the auditor from the outside party is more independent and fair to examine the accounts. Big companies which consist of many shareholders should also be audited”. This finding support the fact that partnerships have more than one owner, which may have more agency problems between the partners.

Table 3 Independent t- tests results

Variables	N	Mean	Standard deviation	T-statistics	P value
Managerial ownership:					
< 50% shareholdings	13	3.1026	0.62929	-3.298	0.000
≥ 50% shareholdings	49	2.4898	0.58670		
Type of businesses:					
Partnership	25	2.8467	0.61599	-2.390	0.020
Sole-proprietor	37	2.4640	0.62005		
Have Total employees of:					
≤ 3 staff	30	2.4111	0.56347	2.571	0.013
> 3 staff	32	2.8125	0.65821		
Have Total assets of:					
≤ RM100,000	39	2.5128	0.57403	1.711	0.092
> RM100,000	23	2.7971	0.72117		
Have Total sales of:					
≤ RM100,000	32	2.4635	0.58158	2.009	0.049
>RM100,000	30	2.7833	0.67118		
Have Total liabilities of:					
≤ RM50,000	41	2.5000	0.57373	2.082	0.042
>RM50,000	21	2.8492	0.71668		

The fourth row of Table 3, shows that there is a significant difference between businesses which have larger number of staff employed to run their businesses compared to those which have smaller number of staff employed in their demand for voluntary audit (t-statistics= 2.571, p =0.013). Businesses which have larger number of staff employed have significantly higher mean in their demand for voluntary audit (Mean= 2.8125) than those with smaller number of staff employed (Mean= 2.4111). This result may be explained by the fact that when there is an increase in the number of staff employed in the businesses (who are the agents), they might do things or make decisions to benefit themselves instead of the businesses, the owners (who are the principals) need to have proper monitoring mechanisms in place. And one of the mechanisms that can be used is audit. This is supported by the response from one of the interviewees: “If at any point of time I need to rely on employees who are outsiders to record high volume of transactions, I may adopt audit” [Mr. C]. This result is also consistent with the notion that the separation of ownership increases agency costs to monitor the agents (Jensen & Meckling, 1976). When the need for information symmetry increases, demand for voluntary audit increases, and vice versa in small companies

The fifth and sixth rows of Table 3, shows that there are significant differences between large and small businesses in term of their demand for voluntary audit. The results appear to suggest that large businesses with more assets and more sales demand more voluntary audit compared to small companies with less assets and sales respectively (t-statistics= 1.711, p = 0.092; t-statistics= 2.009, p = 0.049). Businesses which have higher total assets have significantly higher mean in their demand for voluntary audit (Mean= 2.7971) than those with lower total assets (Mean= 2.5128). Businesses which generate more sales have significantly higher mean in their demand for voluntary audit (Mean= 2.7833) than those which generate lower sales (Mean= 2.4635). These results are also supported by the findings from the interviewees who view the firm size factor as important. A partner claims that “Simple documents are used in my business. There are merely one or two invoices per day. I think I still can handle the records. Big firms with more than two branches, expensive inventories, and high inventory turnover may need to demand for audit" [Madam E]. And, Mr C posits that, "I will not demand audit in the future unless my business grows and have better performance". From these responses, owners perceive that level of activities and volume of transactions are significant factors to affect their demand for audit. These results are consistent with an earlier study which claim that larger companies are likely to demand voluntary audit because as they are growing in size, the volumes of transactions will increase, and mistakes are more likely to occur in the accounting data and the financial statements (Tauringana and Clarke, 2000). In addition, the economic transactions and the accounting systems are also becoming very complex (Porter, Simon and Hatherly, 2003). .

Other interviewees also relate audit to sales and profitability, they commented as follows:

"When total turnover decrease, losses increase, and that could lead to less demand for voluntary audit" [Miss A].

"Small firms that experience losses do not need voluntary audit. Having suffered from losses, mandatory audit adds on burden to those firms" [Mr B].

"Small companies should be exempted from audit to promote their growth and development" [Mr D].

The last row of Table 3, shows that there is a significant difference between businesses which have higher total liabilities compared to those which have lower total liabilities in their demand for voluntary audit (t-statistics= 2.082, $p = 0.042$). Businesses which have higher total liabilities have significantly higher mean in their demand for voluntary audit (Mean= 2.8492) than those with lower total liabilities (Mean= 2.5000). The result is supported by interviewees' opinions. "The need for bank loans is low among small-sized companies as less capital is required if compared to the big corporate" [Mr D]. The result is consistent with Chow (1982), which finds gearing ratio has significant relationship with demand for external auditing and vice versa. In addition, some of the responses also indicate that the businesses demand audit because their banks need their audited account before the loan (liabilities) can be granted to them. They claim that:

"Audit serves as a mechanism of monitoring on behalf of the creditors. Audit enables my company to gain capital easier. Banks can reduce time for investigation on unaudited accounts" [Mr D].

"In the case of loan financing, creditworthiness is granted by banks to businesses with accounts audited by the independent parties. This will speed up the process of approving the loans" [Mr B]

"Banks will require audited accounts if owners apply overdraft facilities"

[Madam E].

■5.0 CONCLUSION

The major purpose of this study is to examine the characteristics of small businesses in Malaysia and their demand for voluntary audit from the agency theory perspective. Among others, the results of the study indicate that businesses which have higher managerial ownership among Malaysian small businesses demand significantly less audit compared to those businesses which have lower managerial ownership. The sole-proprietors also appear to demand significantly less voluntary audit compared to partners in the partnerships. This may be due to the fact that they view themselves as the monitoring mechanism in their businesses which reduce the need for audit as they are also the owners of the businesses. In addition, the result indicates that businesses which have more employees would significantly demand more voluntary audit compared to those with less employees. This result is consistent with agency theory which posits that as the number of agents (employees) who manage the businesses increase, the demand and need for audit would also arise.

However, the conclusions drawn from this study should be interpreted in a limited way as this study has its limitation. The samples collected for the study is small and might not reflect the whole population. Future study can be conducted by collecting more data. In addition, future studies can identify more factors /variables to explain the demand for voluntary audit by Malaysian small businesses.

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