

# Evaluating the independent review's impact on access to bank finance and consequent SME sustainability

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## **ABSTRACT**

If asked to consider the contributions of business to socio-economic welfare, one's thoughts inevitably wander in the direction of major, household name, corporations. The value-add of small and medium sized enterprises (SMEs) is often overlooked. The fact however, is that the SME business sector contributes substantially to global GDP and more than substantially to global job creation. The health and prosperity of all economies are thus directly dependent on a vibrant, expanding SME sector. It is therefore of crucial importance for global economic prosperity that the SME phenomenon is nurtured and supported to ensure the survival and sustainability thereof.

As important as a healthy and growing SME sector may be, it is a commonly accepted truth that SMEs face a menagerie of challenges in their day to day business involvement, of which access to finance is one of the most commonly accepted, and potentially crippling. As such, SMEs regard banks as the go to provider of financing. Banks, on the other hand, have always regarded SMEs as higher risk lenders than bigger corporations. To abridge this risk, banks have historically relied on audited financial statements to mitigate the risk-related concerns they may have had. Audited financial statements gave banks the assurance, and peace of mind, that the information provided by SMEs during a loan application was at least a fair reflection of the position of the business at that point in time. Banks are more comfortable granting loans based on accurate and dependable financial information.

The playing field in South Africa has however changed recently with the advent of the new Companies Act, No. 71 of 2008. The new act introduced the independent review as an alternative to the statutory audit. SMEs now have to choose between doing a less expensive independent review, while potentially sacrificing the goodwill banks have shown to audited financial statements during lending processes, or a full-fledged audit at a significantly higher cost, but with the benefit of keeping the banks positive during loan applications. This research paper delves into how much value SMEs should place on audited financial statements since the introduction of the new Act, when applying for bank financing.

To address this predicament the research attempts to establish whether banks still place reliance on audited financial statements when evaluating loan applications. This is done by investigating the information banks require from SMEs when applying for financing. The research then

compares these findings to the attitudes and perceptions of SME owners towards the requirements, in terms of audited financial statements, imposed on them by banks when applying for financing.

As mentioned earlier, banks have historically relied on audited financial statements to provide reasonable assurance that financial information is accurate. The fact that audited financial statements have effectively fallen by the wayside, inevitably means that banks will start to view financial information provided by SMEs as opaque and asymmetrical. History shows us that accounting was born out of the need merchants had to record their transactional activities. As such, accounting has provided the solution the business domain requires, and to the extent that accounting has survived for centuries as the language of business. It then follows that a basic skillset in accounting, the language of business, may be what bridges the perception gap between perceived asymmetrical information and perceived accurate information. The research thus further investigates what SMEs can do to circumvent negative perceptions in terms of their financial information. This is done by investigating the attitudes of SME owners towards accounting as a more prolific tool by which the perception of asymmetrical information can be dispelled.

The research will be of great value to SMEs by providing guidance concerning the decision between whether to audit or have an independent review done. It will further be of value in terms of investigating alternative ways of replacing the goodwill lost by potentially not providing banks with audited financial statements during loan applications. If this research can improve the success rate of SME bank loan applications in a small way, it will have accomplished much in the quest for economic sustainability of SMEs.

**Key words:**

Accounting history, accounting proficiency, audit, bank financing, bookkeeping, contemporary business, double entry accounting, independent review, record keeping, SME finance, SME sustainability, accounting, language of business.

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## REMARKS

The reader is reminded of the following:

- This PhD thesis is presented in the article format in accordance with the policies of the North-West University's Faculty of Economic and Management Sciences and comprises four (4) research articles, two (2) of which have already been published/accepted in DHeT accredited peer-reviewed journals as indicated, and the remaining two (2) have already been submitted to peer-reviewed journals as indicated.
- In the instance of an article format PhD thesis, the Faculty of Economic and Management Sciences' Regulation E.9.3 requires that the thesis consists of at least three (3) articles, of which at least one (1) publishable article must already have been submitted to a DHeT accredited peer-reviewed journal for evaluation purposes.

# CHAPTER 1

# 1. INTRODUCTION

## 1.1. Background

The accounting profession is not a modern-day phenomenon. In reality, the first evidence of accounting practices is thousands of years old with the earliest evidence of a full double-entry bookkeeping system dating as far back as the Farolfi ledger of around the year 1300. Other evidence indicates that crude accounting methods were also used in the Babylonian Empire by the pharaohs of Egypt as far back as 4500 B.C. and in the Code of Hammurabi around 2250 B.C. (Advison, 2012; DeSantis, 2012; Gurskaya *et al.*, 2012).

As old as the accounting discipline may be, its impact on the contemporary business environment and the modern entrepreneur is hard to deny. Some of the world's most renowned and successful businessmen and entrepreneurs acknowledge that they regard accounting methodologies and principles as key contributors to their success, for example:

- **Charles Thomas Munger**, investment manager and vice-chairman of Berkshire Hathaway Corporation, says of accounting:

*“Obviously, you have to know accounting. It’s the language of practical business life. It was a very useful thing to deliver to civilization. I’ve heard it came to civilization through Venice which of course was once the great commercial power in the Mediterranean. However, double-entry bookkeeping was a hell of an invention.”* (Munger, 1994; Principles of Accounts, 2010)

- **Warren Edward Buffett** says of accounting:

*“You have to understand accounting and you have to understand the nuances of accounting. It’s the language of business...”* (Buffet & Clark, 2008).

Considering these views, it may be argued that accounting has indeed evolved over the years into *the language of business*. Almost all business-related activities are measured using accounting principles and practices that have evolved over the centuries. There is a symbiotic relationship between being active in the modern business environment and adopting the principles and practices of accounting. On the one hand, financial transactions and performance

are measured by applying accounting principles and practices, while, on the other hand, if there were no business activities or financial transactions, accounting and all its principles would be of little use to anybody.

Accounting principles help the stakeholders in the business community achieve common ground when dealing in the business world. This globally understood *language of business* is often the basis of most financial decision-making processes. To complement these processes, auditing was introduced as a means to ensure that the users of financial information could reasonably rely on the information that they were provided with. Historically, audited financial information gave banks adequate assurance that they could rely on such information to extrapolate the ratios and risk assessment tools they use in evaluating applications for financing (Grant Thornton, 2008; Pitcher Partners, 2010).

The advent of the new Companies Act, No. 71 of 2008 in South Africa has brought about the abolishment of the statutory audit requirement for qualifying companies and has introduced the new concept of the *independent review* (Act, 2008). Small and medium-sized entities (SMEs) are often dependent on bank financing to ensure their sustainability (Ayyagari *et al.*, 2012; World Bank, 2013). Banks have historically mitigated their risk when evaluating an application for finance by depending on audited financial statements (Accountancy Asia, 2011; Pitcher Partners, 2010; SAICA, 2010). With SMEs no longer required to have an audit performed, financial service providers may decide to compensate somehow for no longer being able to evaluate a loan application on a historically important, risk mitigating method, namely the audit.

According to Johannson (2005), up to 60% of the gross domestic product (GDP) of most national economies worldwide can be attributed to SMEs. According to statistics provided by New Zealand's Ministry of Economic Development (2005), SMEs represent up to 95% of all enterprises. PriceWaterhouseCoopers (2012) also acknowledges that a large portion of their global business is SME related. With SMEs being such a large contributor to the economy, and being very dependent on banking finance, it is paramount for SME owners and managers to understand what their position is concerning the value, or not, of the independent review to their business.



## **1.2. Accounting and audit value to SMEs**

Jones and Abrahams (2007) argue that there has been a change in the role of the accountant. The contemporary accountant is required to make a transition from the *counter of wealth* to the *creator of wealth and influencer of strategy* (Siegel *et al.*, 2010). Similarly, accounting has also evolved from a record-keeping system to a system that can potentially create wealth and as such influence not only strategy, but also sustainability. The SME is now required to find the balance between centuries-old accounting theory and the requirements of the modern-day business environment. In this regard, a very important requirement, and challenge for achieving business success, is obtaining access to finance.

Research conducted by Schutte and Buys (2011) on the financial statements set by SMEs based on the standards as prescribed by International Financial Reporting Standards (IFRS), measured against the use of those financials by the SMEs in their business environment, found that the financial statements of SMEs are not used primarily for management purposes. Owner-managers of SMEs do not necessarily have the skills to interpret such financial statements with any degree of usefulness (Schutte & Buys, 2011; Baskerville & Cordery, 2006). The financials therefore have little to no use to SMEs in terms of managerial contributions. Collis and Jarvis (2000) found that SMEs' financial statements were primarily used for tax purposes and to acquire financing from banks and other third parties.

Since the introduction of audit exemptions in Singapore, the number of audits required by SMEs dropped from 75 000 in 2004 to 41 000 in 2007 (Grant Thornton, 2008). This implies that SME owner/managers have largely viewed the statutory audit as of little value to their business and have therefore opted for the independent review option. This fact is largely attributable to the perception that audits, and the compliance requirements thereof, are too expensive compared to the value obtained. However, the SME owner/manager needs to also weigh this cost against the potential negative impact that unaudited financials may have on the SME's ability to raise financing from banks.

## **1.3. Rationale for the study**

SMEs have historically looked to banks and other financial institutions for finance to bridge cashflow constraints and fund growth, especially during times of economic difficulty. SMEs are largely dependent on receiving financing to ensure their sustainability (Ayyagari *et al.*,

2012; World Bank, 2013). However, such financing has often not been easy to come by for SMEs (OECD, 2009).

Under current South African legislation, SMEs have the option to choose between an independent review and a conventional audit. The cost of an audit compared to the cost of an independent review will be one of the main considerations for SMEs when deciding which route to follow. Cost wise, the internal compliance required during a financial year in preparation of the annual audit can be a very expensive exercise. The cost factor will be exacerbated if SMEs do not perceive there to be any internal value in the audit process as mentioned earlier. SMEs can therefore be forgiven for preferring to go the independent review route and thereby saving substantial costs and time. What SMEs may not consider, however, are the additional hidden costs that may ostensibly be imparted onto SMEs when audited financial information is not available to support a financing application. For instance, banks may:

- request more information to be presented, which may then not be available and will have to be produced externally at a potentially high cost;
- justify the perceived risk of asymmetric information by raising interest rates;
- justify the perceived risk of asymmetric information by attaching stricter terms to the loan;
- justify the perceived risk of asymmetric information by requiring more collateral; or
- decline the application all together.

All of the above actions may have far-reaching ramifications on the sustainability and growth of SMEs. It is therefore crucially important for SME owner-managers to know and understand whether the choice between an independent review and conventional audit will have any negative ramifications as far as accessibility to banking finance is concerned.

#### **1.4. Research problem**

The ability of SMEs to grow and be sustainable is very dependent on their access to finance (Beck *et al.*, 2005; World Bank, 2013). Banks have historically often regarded SMEs as more of a risk than big corporations when it comes to granting finance (The Conversation, 2012; Haynes *et al.*, 1999). One may speculate on the reasons for this, but Dell’Ariccia and Marquez (2004) believe asymmetrical information is an important contributing factor. The fact that

SMEs are more vulnerable to the pitfalls of asymmetric information is due, by and large, to information opaqueness (Berger & Udell, 1998).

This asymmetrical and opaque information would historically have led to SMEs undergoing a more rigorous scrutiny process when applying for bank loans than larger corporations would be subjected to. With the advent of the independent review and the accompanying abolishment of the statutory audit requirement for qualifying companies, banks may become more stringent in their evaluation processes to compensate for the perception that unaudited financial information may be less reliable than audited financial information. It is even possible that banks may regard the risk of lending to SMEs as such a risk that they will still insist on audited financial statements to be submitted, regardless of the changes to the Act. SMEs that have chosen to use the independent review may find that banks are not as forthcoming with financial backing as may have been hoped for.

Based on the above, a dual-natured primary research problem can therefore be formulated as follows:

- Has the advent of the independent review impeded SME access to bank finance?
- Can SMEs improve the success rate of financing applications and thereby, consequently, their sustainability?

In order to answer the primary research problem, the following sub-questions can be identified:

- Has the evolution of accounting theory and practice changed the original purpose and role of accounting as a valuable and relevant business tool to the contemporary SME?
- What value do South African banks place on audited financial statements when considering funding applications from SMEs?
- What perceptions do SME managers-owners have regarding the value banks attribute to audited financial statements when applying for bank finance?
- What are SME owner-managers' views on the importance of accounting as a tool in achieving sustainability?
- What are the distinguishing differences between an audit and an independent review and the implications of selecting one above the other?

## 1.5. Research objectives

The primary objective of this study is to investigate whether the independent review has made bank financing harder to come by for SMEs. This objective will be reached by conducting:

- A critical review of how early accounting practices developed into modern-day accounting theory and the extent to which it has maintained its relevance to SMEs;
- An investigation into whether banks still place value on audited financial statements when evaluating applications for finance by SMEs;
- An investigation into the perceptions of SME owner-managers as to the requirements banks impose on them in terms of audited financial statements when applying for bank financing;
- A critical review of the value better accounting and managerial skills may have towards improving a bank's risk assessment predispositions when evaluating loan applications;
- An investigation into the perceptions that SME owner-managers have concerning their understanding of basic accounting principles and the intrinsic value accounting may have to their business sustainability; and
- A literature review of the difference between an audit and an independent review and the impact on SMEs when choosing one above the other.

The result of this research will be of great value to SME owners and managers for the following reasons:

- The research may assist SMEs to make informed decisions on whether an audit or an independent review is of more value to their business as far as raising bank finance is concerned.
- The research may provide insight into the value that accounting systems and skillsets may have in terms of mitigating negative risk perceptions that banks may cherish towards an SME.
- By realising that accounting developments and practices may have a direct impact on their business and therefore their sustainability, SMEs may be able to make better informed decisions when analysing the future accounting requirements that their businesses may require.

- The research may also cast light on what banks regard as more important when analysing financing applications from SMEs. SMEs will therefore be able to better prepare their applications in future.

## **1.6. Research methodology**

In order to meet the above objectives, both literature and empirical studies will be undertaken. Firstly, during the literature study phase, relevant published research in journals and academic databases such as Research Gate, Google Scholar and Oxford Reference Online will be accessed. The objective of the literature study will be to evaluate the actuality of the problem statement in the contemporary business environment and to then extrapolate the applicable information within a South African context.

Secondly, the empirical study will consist out of two general stages, aimed at collecting data from two population groups, namely banks as the finance provider on the one hand, and the SMEs as the finance receiver on the other hand. In terms of the South African banks, there are, according to the South Africa Reserve Bank (SARB), currently 10 locally controlled South African bank institutions (excluding branches of foreign banks, which typically do not provide financial services to SMEs). Fin24 (2016) reported that out of the above-mentioned banks and representative banks, in terms of bank assets, 89.2% of the market share is held by five (5) banks collectively, with relevant research data of four (4) of these five (5) big banks being analysed as participants in the project. In terms of the SME participants, a selection of 60 participants was identified and included in the SME analysis.

More detail regarding the research design and methodology is provided in Chapter 2.

## **1.7. Overview of the study**

Chapter 1: Introduction

This chapter provides the research background and high-level motivation of the study, and included the following:

- Introduction;
- Background to the study;

- Accounting and audit value to SMEs;
- Rationale why the study was conducted;
- Problem statement;
- Research objectives;
- Research methodology;
- Literature study;
- Empirical study;
- Overview of the study.

## Chapter 2: Research methodology

This chapter will provide an explanation and justification of the research design and the research methodology used in the overall study.

Chapter 3 (article 1): The future of accounting's past: A reflection on its contemporary relevance

This chapter will comprise a literature review of the first appearance of accounting practice and its development into modern-day accounting theory. A discussion on whether accounting theory has maintained its historically intrinsic characteristics as a tool for the advancement of trade and business transparency and the impact of the evolution of accounting on SME sustainability will be conducted.

Chapter 4 (article 2): The impact of the independent review on SME access to bank finance: The case of South Africa

This chapter will review and discuss previous research into the importance of access to finance to the ability of SMEs to be sustainable and to be able to function as going concerns. The chapter will review and discuss previous research on the value banks afford to audited financial statements when assessing bank loan applications by SMEs. The chapter will investigate the requirements that banks advertise as necessities that SMEs should have available when applying for financing. The research intends to establish whether audits of financial statements will carry more weight with banks than an independent review when applying for financing.

Chapter 5 (article 3): An SME owner-manager's perception of the advent of the independent review: A South African perspective

This chapter will review and discuss previous research into the value of bank finance to the sustainability of SMEs. The chapter will also discuss proficiency in accounting principles as a means of partially mitigating perceived risk factors that banks attribute to SMEs. The chapter will focus on the findings of the empirical study done on the views and perceptions of SME owner-managers as to:

- their perception as to the requirement, or not, from banks to provide audited financial statements when applying for financing;
- the type of financing SMEs most often rely on;
- the perception SME owner-managers have of their own proficiency in basic accounting principles;
- the value SME owner-managers ascribe to accounting as a discipline; and
- the value SME owner-managers ascribe to accounting as a managerial tool used on a daily basis as a contributor to SME sustainability.

Chapter 6 (article 4): Independent review or audit? The SME decision and related accounting issues worth pondering

This chapter will take a holistic view of the research that was conducted. The main focus of the chapter will be a literature review of the qualities and differences of both the statutory audit and the newly conceived independent review and their value-add to SMEs. To achieve a truly meaningful holistic view of these attributes, the chapter will start with a brief reminder of the historic significance of the origin of accounting as a business tool. The discussion will touch on the significance of SMEs in the global economy and the value of bank financing to the sustainability of SMEs. The chapter will also recap the research findings of the previous chapters.

## Chapter 7: Conclusion and recommendations

This chapter will provide a summary in light of the objectives of the study and discussions and arguments developed in the preceding chapters. The chapter will summarise the overall study, draw conclusions and develop recommendations based on the findings of the research. Limitations of the research as well as further areas of studies will also briefly be discussed.

### **1.8. Summary**

The objective of this chapter was to provide a high-level justification of the research project. This has been done by providing the research motivation, the research problem together with the detailed objectives to be achieved in addressing the stated research problem. The next chapter will provide a discussion and explanation of the research design and methodology followed in the study.



## **CHAPTER 2**

## 2. RESEARCH METHODOLOGY

### 2.1. Background

This chapter describes the philosophical postulations underlying this research project. It also elaborates on the research method and methodology applied, by taking a look at basic fundamental research approaches, concepts and philosophies as a point of departure to elucidate the research postulations followed in this study.

The Oxford Advanced Learner's Dictionary of Current English (1985) defines research as an "investigation undertaken in order to discover new facts". Henning *et al.* (2005) elaborate on this by saying that research attempts to improve knowledge by investigating literature and doing empirical studies. Consequently, research is a unique contribution to the ever-expanding accumulation of knowledge and as such it intends to expand knowledge, encourage discourse and promulgate advancement. To achieve this, research needs to be able to explain its contributions within the realms of logic and credibility. The philosophical assumptions underlying this research project are based on an epistemology that accepts the synergistic value of social constructs. This research is therefore undertaken based on the underlying research philosophy adhered to, the research design adopted and the research methodology utilized. The research *design* and *methodology* aim at achieving the research objectives in a clear and concise way. The essential differences between research design and research methodology can be described as follows:

- **Research design:** Parahoo (1997) describes research design as "a plan that describes how, when and where data are to be collected and analyzed", while Blumberg *et al.* (2008) describes it as an activity-based strategy, derived from the research questions. It therefore attempts to pilot the selection of the procedures and activities of the researcher. The research design is thus a collection of all the methods used by a researcher to achieve the defined research objectives during a research study.
- **Research methodology:** Crowther and Lanchester (2009) defines the methodology as the research approach utilized by a researcher in a research study. Henning *et al.* (2004) concurs by saying that it is the way a researcher goes about solving his research question(s). The research methodology thus describes the systematic way by which the research will be carried out and presented.

More detailed aspects around the design and methodology followed in this research, are highlighted below.

## 2.2. Research design

Based on the above, one can therefore say that research design describes the research philosophies underpinning the research study. Before starting any research project, the researcher needs to consider the inherent theories and philosophies of the research project. A research philosophy is the conviction of the researcher in regards to the method(s) in which data should be collected, analysed and distributed. According to Livesey (n.d.), three, linked yet different, philosophical paradigms define society at large. These are i) ontology (what society knows to be true); ii) epistemology (what society believes to be true) and iii) methodology (knowledge society wants to pursue). It can therefore be argued that research thus attempts to alter what society *believes* to be true to what society *knows* to be true. Ontology and epistemology are very philosophical concepts, while methodology is considered practical in nature and encompasses the methods and techniques used in obtaining knowledge (Henning *et al.*, 2004). In order to achieve the philosophical construct of creating reality, methodology is needed to bridge philosophy with reality.

There are different theoretical paradigm frameworks in which research can be conducted, for example, Myers *et al.* (1998) and Henning *et al.* (2004) identify three theoretical paradigms, namely the positivist, interpretivist and critical frameworks. More recently however, Blumberg *et al.* (2011), elaborate on their own perspective of paradigm frameworks, and classifies such frameworks into i) a positivist framework, ii) a post-positivist framework, which can be further divided into interpretivism and critical theory frameworks and iii) a realism framework, which serves as a *go-between* for positivism and post-positivism. These frameworks can be described as follows:

- **Positivism:** Druckman (2005) considers positivists as researchers that study quantifiable information via analytical interpretation. Positivists thus seek to establish reality through phenomena that can be individually researched and that will render the same results if the research is repeated. According to Vosloo (2014) *quantitative* research fits into the positivist paradigm (see below).

- **Post-positivism:**
  - **Interpretivism:** Blumberg *et al.* (2011) holds that interpretivists study phenomena in real-life environments with the intent of interpreting such results. They acknowledge that their interpretation of research reality may be only one of various interpretations of reality - as such they seek to find solutions to problems. According to Vosloo (2014) *qualitative* research methods fit more readily into the interpretive paradigm (see below).
  - **Critical Theory:** Blumberg *et al.* (2011) also holds that this approach believes that by reasoning about research problems, critical thinking can be stimulated which in turn will lead to reality being challenged and societies becoming open to accepting new versions of reality.
- **Realism.** Blumberg *et al.* (2011) regards realism as a philosophy that embraces aspects of both positivism and interpretivism (or then aspects of post-positivism). Realists see all aspects of society as synergistic, and as such they believe in a holistic approach to research.

Furthermore, there are, according to Kumar (2011), two main research philosophies in the domain of research namely, i) basic research, (also called fundamental or pure research), and ii) applied research. Firstly, in terms of *basic research*, Palys (n.d.) and The Business Dictionary (2017) define it as driven by the curiosity to investigate a phenomenon, and to increase knowledge by discovering new facts pertaining to that body of knowledge, not necessarily to create new knowledge. It is a study of basic principles and the occurrence thereof (Rajasekar *et al.*, 2013). Secondly, in terms of *applied research*, Palys (n.d.) says that it is driven by a desire to solve problems, to improve something or to invent something new. It attempts to find solutions to problems by using accepted theories and principles (Rajasekar *et al.*, 2013). Based on the above, business research (as is found in this study) is typically neither purely basic research, nor purely applied research. Business research is rather a combination of both approaches as it tries to discover new facts concerning business related issues and improve business practices (Zikmund *et al.*, 2013).

Building hereon, both basic and applied research can be either i) *quantitative* research, which relies on quantitative data in the form of numbers and figures or ii) *qualitative* research, which relies on deriving quality, unambiguous, information in the form of words, descriptions, sentences and narratives (Rajasekar *et al.*, 2013; Blumberg *et al.*, 2008). Pertinent to this study, qualitative research is suited for studies where meaning to an individual is of importance

(Grinnell, 1988), and attempts to explore in-depth nuances of information using smaller, controllable samples (Fox *et al.*, 2007). It is therefore deemed appropriate for this study as the research is based on perceptions and opinions of banks and SME owner-managers. It is thus based on the analysis of words and experiences rather than the analysis of numbers.

In conclusion, this research project is therefore considered as qualitative business research in its essence, and thus falls within the ambit of the interpretive paradigm, although elements of positivism may be observed.

### **2.3. Research methodology**

Although the researcher is guided by his elected research paradigms, this does not change the fundamental essence of a proper research methodology. As alluded to earlier, the research methodology describes the detailed procedures and mechanisms to be used to complete the research successfully. Research methodology therefore needs to maintain credibility by always being coherent, valid, objective and lucid (Bajpai, 2011). To attain this, the research methodology needs to explain the techniques and processes to be employed in attaining research objectives and conclusions clearly, concisely and meticulously. In order to successfully achieve the stated research objectives of this study, the researcher adopted both a literary research study as well as an empirical research study. These have been conducted as follows:

#### **2.3.1. Literature study**

The objective of the literature study is to obtain a theoretical foundation of the phenomenon being researched so that the current study could be put in context of previously completed research (Parahoo, 1997). Rajasekar (2013) is of the opinion that no research can be completed unless a literature study on the research subject has been undertaken and believes the literature study benefits the researcher in that it:

- Helps refine and define the research problem;
- Ensures a deeper level of understanding of the research problem;
- Helps the researcher obtain theoretical and practical insights into the research problem;
- Helps to establish the relationship between the current research and prior research; and,

- Indicates whether the research is still of value as the problem under consideration may have been resolved by previous research.

During the literature study phase of this project, relevant published, subject-appropriate journals and academic databases such as Research Gate, Google Scholar and Oxford Reference Online have been accessed and perused in order to evaluate the actuality of the problem statement in the contemporary business environment and to then extrapolate the applicable information in a South African context, and then more specifically the following focus areas:

- The first area of study focussed on how early accounting practices developed into modern day accounting theory and whether it has maintained its originally intended characteristics as a beneficial tool to business management.
- The second area of study explored how banks, as primary providers of finance, evaluate and scrutinize applications for financing by SMEs. The value attributed to audited financial statements, as opposed to the recently introduced independent review, on loan application evaluation methodologies has also been discussed.
- The third area of study focussed on literature discussing the importance of bank financing to SME sustainability as well as the global realization of the difficulties SMEs face in accessing bank financing.
- The fourth area of study was to glean the perspectives of SME owner-managers concerning their experiences in terms of the requirements banks impose when assessing loan applications, especially the value placed on audited financial statements.
- A review on the requirements of an audit compared to the requirements of an independent review has also been done to provide the necessary background concerning the value add of each engagement type to the SME.
- The study further explored the perspectives of SMEs concerning the value and utilization of accounting in the modern business environment.

The knowledge gleaned from the literature study formed the foundation of the empirical study and will therefore be integrated into the various chapters as applicable.

### 2.3.2. Empirical study

The empirical research phases of this study considered data collection from two population groups, namely the i) banks as the SME finance providers, and ii) the SMEs as the finance receivers. The data collection approach was based on the use of questionnaires administered on applicable samples, using a structured interview protocol.

#### 2.3.2.1. Sampling

Blumberg *et al.* (2008) describes a population as a group possessing specific, identifiable, characteristics, with a sample being a sub-group of the population that possesses the same, specific, identifiable characteristics and is thus considered as representative of the larger group. Researchers use sampling to investigate phenomena in smaller, more manageable groups (or samples) from which inferences can be made concerning the larger group. Sampling inherently implies forsaking certainty in favour of probability (Westenholz-Bless & Achola, 1988) and is a recognised research technique when following a qualitative research approach. Bailey (1982) classifies sampling into two categories namely probability sampling and non-probability sampling. On the one hand, *probability sampling* implies that each participant has the same chance of being selected as any other participant - sample selection is usually done randomly. On the other hand, *non-probability sampling* includes:

- **Purposeful sampling:** When sampling is done to ensure the participants can add value to the purpose of the research.
- **Convenience sampling:** Participants are chosen because of the convenience they bring to achieving the research objective in terms of cost, time or applicability.
- **Volunteer sampling:** When participants self-select themselves into the sample group, for example an on-line poll.

In the context of this study, the unlikelihood that the participants in this research (SMEs and banks) would be willing to openly and honestly divulge relevant, and perhaps confidential, information is regarded as a significant hindrance to the integrity of this research. Convenience sampling is therefore considered as the most applicable and desirable way of obtaining an acceptable and representative sample for purposes of this study. Convenience sampling is, according to Baumberg (2012) and Terre Blanche *et al.* (2008), considered an appropriate approach when a targeted, identifiable population is available, and when time, resources and

respondent availability are potential hindrances in the sampling and interviewing processes. The sample for this research will thus be chosen using convenience sampling where participants who are available and willing to participate are chosen without any prior rationale.

When deciding on the sample size for the research, the theory of saturation, as put forward by Glaser and Strauss (1967), was considered. They describe theoretical saturation as the point where further case studies on a selection of samples does not provide any new evidence that will affect the extrapolation of an underlying hypothesis to a population. Ritchie *et al.* (2003) reiterate this sentiment and add that due to the labour-intensive nature of qualitative research, large samples are often simply impractical. Glaser and Strauss (1967) expand this line of argument by stating that when qualitative samples become too large, they tend to become repetitive and redundant. Gerson and Horowitz (2002) agree with this view when suggesting that a qualitative research sample size should be in the size order of 60, to adequately draw convincing conclusions. Anything more than 150 interviewees, they feel, will produce too much data to be able to analyze effectively and within reasonable time constraints. Various qualitative researchers support the notion of a smaller, controllable sample size, with the sample sizes ranging from as few as 12 to around 60 (Adler & Adler, 2012; Baumberg, 2012; Brannen, 2012; Ragin, 2012; Guest *et al.*, 2006; Gerson & Horowitz, 2002; Warren, 2002).

As indicated there are two population groups from which data needed to be collected, namely the banks and the SMEs. In terms of each group, the following are pertinent to the selection of the participants:

- Firstly, in terms of the banks, the objective was to investigate whether South African banks still place value on audited financial statements. Since there are only a small number of banks in South Africa, which in turn are highly regulated, the four biggest banks in South Africa, representing 82% of the banking market share of South Africa (The Banking Association of South Africa, 2014), were identified and included in the sample.
- Secondly, in terms of the SMEs, a database of a registered, external, auditing firm with a national footprint of SMEs, active in diversified trades, was used as the population from which a convenience sample of 60 participating SMEs was selected. A sample of 60 was decided on as an acceptable sample size from which statistically relevant inferences could be made. Yearly research published by the World Bank shows that the



specific research problem being studied (i.e. SMEs' finance conundrum) is a universal one and is not substantially influenced by country, demographic area, language, culture, gender, ethnicity or financial market structure (World Bank, 2013). Thus, in the sampling of SME owner-managers and banking institutions this diversified sample should statistically be representative of the broader, average SME population in South Africa.

The value of sampling to this research project is encapsulated in Albert Einstein's words of wisdom:

*"Not everything that can be counted counts, and not everything that counts can be counted".*

### **2.3.2.2. Data collection and analysis**

Hartley (2004) emphasises that the purpose of data collection is to be able to conduct the research systematically. Interviews are the most common method of data collection in qualitative research and are nothing more than structured conversations leading to data extrapolation. How much data is extrapolated depends on the questionnaire and whether the interviewer picks up important nuances from the subject during the interview (Monette *et al.*, 2008). Again, based on the two population groups from which data is to be collected, the following:

- Firstly, in terms of the banks as finance providers, the applicable information requirements were collected from their respective websites, and analysed. This data was then further supplemented by obtaining hard copy applications available from the banks themselves, and informational requirements clarified by discussions with relevant loan officers.
- Secondly, from the SME population's perspective, the empirical study was based on questionnaires completed during interviews with the owner-managers of participating SMEs. The first portion of the questionnaire was a Likert 5-point scale type enquiry, while the second portion was an in-depth, personal interview. The Likert scale assumes that each statement on the scale has equal importance as far as echoing a respondent's attitude in terms of the question asked (Kumar, 2011; Terre Blanche *et al.*, 2008). As the question may draw various emotional responses from participants, it is believed that set questions with set answers will provide more reliable results. Where deemed

necessary, structured interviews have been conducted to elaborate on various aspects of the questionnaire. Questionnaires previously used in similar research and comparable environments (i.e. research investigating SME access to financing by the European Union, 2013; Ackah & Vuvor, 2011; the European Commission, 2009; and Mutezo, 2005), have been consulted and adapted to gauge the range and style of questions to be used to ensure a successful, valid and accurate interview process.

#### 2.3.2.3. *Validity and reliability*

For research to be valid and reliable, the research needs to be defensible, acceptable, and convincing. According to Trochim and Donnelly (2006), validity describes the ability of the research conclusion to stand up to scrutiny, and is therefore an indication of the quality of the research design and methodology. According to Bryman and Bell (2007), validity is the ability of a research design to test what it was designed to test, whereas reliability refers to the accuracy and consistency of the research design. To attain validity and reliability in this study, the following research design audit trail was established and adhered to:

- Interviews have been conducted by the same researcher as to ensure consistency;
- Data were continuously analyzed as it were generated to ensure timeous detection of anomalies;
- Quality control of the research has been done via the promoter of this thesis;
- External statisticians have been used to analyze, extrapolate and interpret the data gathered;
- Data have been analyzed by way of a credible analytic tool, namely the Statistical Package for Social Sciences (SPSS);
- Conclusions drawn have been measured against the literature study to ensure consistency and historic compatibility; and
- Cronbach's alpha was used to establish internal consistency.

In terms of the last concept mentioned above, the concept of Cronbach's alpha is a widely used and highly regarded measure of internal consistency of research data, which Sekaran and Bougie (2010) describe as the degree with which research items are correlated with each other. If data items obtained during research gathering influence each other, their internal consistency

will be high. Adefioye (n.d.) explains that researchers generally accept the following values in terms of Cronbach's alpha:

- The value is expressed as a number between 0.00 and 1.00;
- A value of 0.00 indicates no consistency while a value of 1.00 indicates a perfect consistency; and
- Acceptable consistency is regarded as a value between 0.70 and 0.90.

Finally, expert statisticians have been approached to assist with the analysis of the obtained data and to consequently extrapolate the statistically relevant correlations and to calculate Cronbach's alpha.

## **2.4. Research ethics**

When undertaking research, the researcher will do well to be guided by the words *primum non nocere*, translated as *first, do no harm*, as found in the Hippocratic oath (Collins, n.d.). Just as medical doctors need to care for the well-being of their patients, any researcher should be guided by ethical considerations to not bring harm to the participants of the intended research. Tseng *et al.* (2010) defines ethics as the human philosophy underpinning the value determination of right and wrong, acceptable and unacceptable. In this regard Henning *et al.* (2004) states that these ethical considerations include informed consent, guarantees in terms of privacy and confidentiality, conflict of interest considerations, honesty, correct and timely information, doing no harm and debriefing. The value of the research should never outweigh the value of the ethical boundaries of morality the researcher must adhere to. To this effect, all participants partook voluntarily in the study, and they always had the option to withdraw at any point in time, or not to answer any question should they have chosen not to.

## **2.5. Summary**

The objective of this chapter was to present the researcher's attitude and thought processes towards the research undertaken. In so doing the research approach in terms of research design and methodology was elaborated on. The research design serves as a fundamental and conceptual approach to the research, or the ambit of the philosophical paradigms within which the research will be construed - the research blueprint, if you will. The methodology describes how this research has been conducted to ensure the successful completion of the study in terms

of the research paradigm established by the research design. This intrinsically implies adherence to the purpose of the research, the level of the research, the type of research and the approach to the research, while keeping the necessary ethical considerations in mind at all times.

As from the next chapter, the various articles making up the research, are provided.

## CHAPTER 3: RESEARCH ARTICLE 1

**Title:** The future of accounting's past: A reflection on its contemporary relevance

The reader is requested to take note of the following:

- This article was *published* in the following peer-reviewed and DHeT accredited academic journal as follows:
  - Coetzee, F. & Buys, P. 2015. The future of accounting's past: A reflection on its contemporary relevance. *Philosophia*, LIX (3):5-18. (IBSS & Scopus / ISSN: 1221-8183)
- The article has been written in line with the journal's submission guidelines for articles which are included in **Annexure A** on page - 139 -.
- The first page of the article as published in the journal appears in **Annexure B** on page - 140 -.
- The article was researched and written by the first author (Coetzee, F) as the PhD candidate and primary author, while the second author (Buys, P) fulfilled a reviewer function thereto as the PhD project's promoter.

**Title**

The future of accounting's past: A reflection on its contemporary relevance

**Abstract**

Contemporary corporate history demonstrates that, though accounting is acknowledged as the language of business, there are more and more cases where this language becomes an incomprehensible foreign language. The objective of accounting as promulgated by accounting regulators is characterized by large volumes of complex principles, which none but the most specialised accounting professionals can interpret. This very often results in many classes of accounting information users not being able to properly understand the message being conveyed.

This paper aims to reflect on the primary objective of accounting by considering its historic evolution from its ancient roots as a record keeping function, through its bookkeeping phases up to when it actually began to resemble accounting as we know it in the contemporary business environment. Throughout this reflection, consideration is given to its intended purpose for the specific time period under consideration. The paper concludes that even though accounting has evolved much in its perceived objectives, the complexity of the contemporary business environment contributed to complex accounting principles and practices. Nonetheless, the key purpose of accounting should never be lost, that being that it is the language of business and as such it must be understandable to business stakeholders.

**Key words:** Accounting history, contemporary business, double entry accounting, bookkeeping, record keeping.

### **3. THE FUTURE OF ACCOUNTING'S PAST: A REFLECTION ON ITS CONTEMPORARY RELEVANCE**

#### **3.1. Introduction**

Accounting history is not typically considered as a topic that would grab anybody's attention. For most business professionals, and perhaps even many accountants, the first reaction would probably be to frown upon the actual value of a reflection on the evolution of accounting. The immense value accounting has brought to the development of society is not often acknowledged or even realized. As non-grandeur as the historic development of accounting may be, the impact accounting has had on the contemporary business environment is hard to deny. To this effect, Buys (2011) states that accounting is more than just the *bookkeeping of business activities* or the *application of accounting standards*, but is rather to be seen as an important role-player in the global economy. As such accounting's influence extends into many spheres of human society.

Von Goethe (1795) expresses his high regard for the order accounting brings to the affairs of the business owner when he says it "is among the finest inventions of the human mind." The fact that accounting has established itself as a key element in the global business world is also reinforced by Munger (1994), then Vice-Chairman of Berkshire Hathaway Corporation (the famous Warren Buffett-company) when stating that it is "the language of practical business life" and that it "was a very useful thing to deliver to civilization". Buffet and Clark (2008) are of the opinion that any prudent business person has to "understand the nuances of accounting". Taking cognizance of these views, one can safely infer that the proper understanding and use of accounting in contemporary society should not be viewed as a nice to have business luxury, but rather as a need to have business necessity.

One might then ask how a reflection on accounting history may contribute to current accounting practices and theories. Huxley (1959) answers this question when he says that the (false) perception that people cannot learn from the lessons of the past is probably one of the more important lessons that history can teach. To this end, Gomez (2008) warns that the evolution of accounting history should not be discarded as of *no relevance* to contemporary accounting practices, but the history of accounting should rather be used as a benchmark for the purpose and ultimate goal thereof. In support hereof, Buys and Cronje (2013) state that

early civilisations recognised the significance of resource management and wealth creation accountability, and that accounting played a key role in the recording and reporting of resource consumption.

The impact of accounting on the world of business is undeniable and not under scrutiny in this paper. However, whether accounting as a discipline has remained relevant and useful to contemporary business owners and managers, is a more significant topic of investigation. Schutte and Buys (2011) conducted research on Small and Medium Enterprise (SME) financial statements based on International Financial Reporting Standards (IFRS) as promulgated by the International Accounting Standards Board (IASB), measured against the use of such financial statements in their specific business environment. They found that the financial statements are not primarily used for business management purposes. They also found that many owner-managers of businesses do not necessarily have the skills to interpret complex IFRS-based financial statements with any degree of usefulness to their daily business-decisions. In support hereof, Baskerville and Cordery (2006) are of the opinion that accounting standards such as IFRS may be too complex and difficult for *general purpose users* to understand. The importance of this investigation is therefore encapsulated in the conundrum that if accounting is indeed the *language of business*, as referred to earlier, what happens to those business owners who cannot *speak the language*?

Building on the analogy that accounting is the *language* of business, one can refer to IFRS as the *dialect* all business owners are compelled to speak. A business dealing with banks, credit providers or investors that cannot *speak the language* may face unnecessary obstacles in its business activities and growth potential. Yamey (1994) holds the view that the basic principles of double entry bookkeeping have stayed intact and virtually unchanged for more than 500 years. This implies that the business world has regarded accounting as useful enough for it to be around for 500 years. However, at the same time a shadow has been cast on how relevant complex accounting standards have made accounting to the modern business owner.

### **3.2. Research problem and methodology**

In consideration of the aforementioned, reflecting on the *when*, the *where*, the *why* and by *whom* of accounting may seem rather superfluous and irrelevant. The answer however, possibly lies in a more existentialistic approach to the accounting phenomenon. This paper intends to



reflect on the historically intended purpose of accounting in pondering the question of how relevant accounting has remained as a business tool in the contemporary business environment. To find possible answers to this question one would need to start by placing the evolution of the accounting phenomena, and the value it has already imparted, into perspective.

In justification of this paper's research methodology, Probert (1999) is of the belief that the critical (meta-science) framework may successfully be exploited in the research of interlacing disciplines, in this instance focussing on accountancy and history. In the context of this paper, a critically interpretive reflection will attempt to evaluate some of accounting's pre-suppositions. There is thus less concern with the factual contemporary accountancy aspects, but rather with the historical level of aspects in the evolution of accountancy from its infancy to its current status. By plotting the occurrences through the annals of history of business *needs development* we can establish a possible timeline of necessities that were the root driving forces in the evolution of accounting, and then not only to consider the *when* and *where* of accounting history, but also the *why* and by *whom*.

### **3.3. The evolution of accounting**

#### **3.3.1. Introduction**

Edwards (1960) emphasises that the development and evolution of accounting started with the necessity to satisfy a specific need that was present at a certain time in a certain place. The bartering of property between parties, for example, necessitated the recording of such property exchanges for purposes of legal and historic reference. Various authors have come to the conclusion that accounting, in one form or another is as old as civilization itself with several archaeological findings supporting this premise (Goldberg, 1974; Hopwood & Johnson, 1986; Hopwood, 1987). Parker (1977) and Funnell (1996) go as far as to say that primitive trade routes dating as far back as 9500 BC suggest that merchandising and trading may even have existed before civilisation as we perceive it today. Sylph (2007) mentions that some of the earliest written records found in Egypt and Mesopotamia, dating back as early as 2000 to 3300 BC, indicate tax recordings. Some accounting historians believe that *accountants* may even have invented writing (Parker, 1977).

When delving into the historic past one must bear in mind that any reference to *bookkeeping* or *accounting* in these records is not a direct implication of accounting systems and methodologies as we know it today, but rather as fleeting as a reference to stock piling of food reserves and the like.

For the purpose of this paper we will take a look at some of the earliest occurrences of accounting principles and the emergence of the double entry accounting system, in order to reflect on the driving forces behind the development of double entry accounting. According to Thompson (2003) one should view early accounting as the keeping of records to establish the rights and obligations of participants to a transaction. Edwards (1960) classifies the development of accounting into sequential phases as follows:

- Record keeping: The preserving of documents as evidence of a business transaction.
- Bookkeeping: The analysis, classification and recording of business transactions, as the basis for financial reporting.
- Accounting: Bookkeeping with additional summaries and control functions.

We will reflect on the development of accountancy based on these broad phases of development.

### **3.3.2. Record Keeping**

Going back to the dawn of civilization makes tracking a specific phenomenon difficult. People of ancient times were for all intent and purposes illiterate in relation to contemporary society, thus making historical proof difficult to find, identify and even interpret. This being said, there are still instances where evidence of transactional recordings has been found (Goldberg, 1974; Hopwood & Johnson, 1986; Hopwood, 1987). It would seem that ancient societies faced similar problems as contemporary society as far as record keeping, control and verification are concerned. Based on the evidence gained of ancient Babylon, indicating the recording of commercial transactions as well as dealings of government and temples, Edwards (1960) deduces that record keeping was most likely mainly used by i) political leaders and government officials primarily for taxation purposes; and ii) the wealthy who needed to know that they could trust their slaves and subordinates.

This necessitated varying versions of transactional recording and auditing. Alexander (2002) highlights the fact that this was a more complex task than one would imagine as an effective accounting system was not yet available, writing was mastered by few, writing materials were expensive and financial systems were non-existent.

One can safely assume that *record keeping* principles did not have a single point of creation, but was rather a solution for a specific need existing within a specific society at a specific point in time. Although the exact origins of record keeping are unknown, some of the earliest known records of commerce can be traced back to the Babylonian and Assyrian empires between 4000 and 5000 years before the appearance of double entry accounting (Alexander, 2002). The famous Code of Hammurabi, King of the First Dynasty of Babylon, was produced during this time, estimated at around 2285 to 2242 BC (Edwards, 1960; Salisu, 2014). It contains many references to the rules of conducting business. Harsh penalties and punishments were prescribed for parties who did not adhere to these business codes which Alexander (2002) believes necessitated the keeping of accurate records in order to prevent disputes.

As much as the Code of Hammurabi is regarded as the earliest proof of a transactional recording system, it is not the *only* early proof of such a system there is. In the ancient ruins of the City of Jericho, an ancient accounting system was found providing evidence of a priest keeping records of the livestock (Mattessich: 1989). Furthermore, archaeologists found written tax records on clay tablets in the Egyptian tomb of King Scorpion I, dating as far back as 3000 BC (Johnson & Kaplan, 1987). Thompson (2003) refers to papyrus records dating back to the period 1552 to 1080 BC, providing lists of offerings made to the gods, entombed with the Pharaoh. Although Egypt was a developed civilisation with the advantage of papyrus availability, Alexander (2002) believes that their accounting abilities never progressed further than an ability to make lists, in which the content of stockpiles and storehouses were meticulously recorded. Alexander (2002) believes that the lack of an accurate monetary measuring unit doomed the Egyptian empire's accounting systems to no more than *list making and verification*.

The ancient Roman Empire, owes its accounting contribution to individual households, which were required to submit regular reports on their receipts and expenditures and overall financial position for tax purposes. The Empire eventually also had its own budget in which it managed its taxes, revenues and expenditures (Alexander, 2002). Evidence indicates that Roman record

keeping reached a higher degree of accuracy than either that of the Babylonian or Egyptian civilizations, and as such they were noted for their administrative abilities (Edwards, 1960).

In the Far East, China used accounting mainly as an evaluation system to test the efficiency of governmental programs and the civil servants who administered such programs (Alexander, 2002). The Chinese accounting system only showed some progression during the Chao Dynasty of 1122 to 256 BC, but remained quite stagnant in terms of development until the advent of double entry accounting in the 19<sup>th</sup> century (Alexander, 2002; Thompson, 2003; ten Have, 1976).

The Athens of 600 to 500 BC was centred around state controlled temples and the average Greek had little use for accounting knowledge other than knowing whom he owed or who owed him (ten Have, 1976; Thompson, 2003). Nonetheless, the Greek civilization made a valuable contribution to accountancy by introducing coined money (Alexander, 2002). For the double entry system to be able to work efficiently a uniformly recognized valuation method was necessary, it needed a *token* that had a standardised value and was applicable to any transaction. Alexander (2002) is of the opinion that the ancient Greek banking systems were more advanced than in other societies of that era. Bankers kept record books of accounts, loaned out money, and even transferred cash from one bank to another for their clients.

Based on the above it is seen that during these ancient periods the need for record keeping was driven by political, religious and military powers. Thus, the need for control over resources of various kinds necessitated the development of record keeping. Part of our initial research problem statement was to identify the *why* accounting was used and by *whom* it was used. The former has been established, i.e. to keep track of resources. The latter has also been established, i.e. by political, religious and military powers. We need, however, to try and equate the record keeping of ancient times with the modern business environment if we are to extract any value from the lessons taught by history. As such it may be argued that it is reasonable to suggest that the political, religious and military powers of ancient times can be compared to the modern business owner. Assets and resources were being managed by subordinates for the exclusive right of use and ownership of these powers. The businessmen, including those in an SME context, of our time conduct their business in the same manner, i.e. assets and resources are managed by subordinates, or by themselves, for the exclusive right of use by the owner of the business. It is therefore argued that accounting's initial steps in history were thus taken for the purpose of self-enrichment and wealth creation.

### 3.3.3. Bookkeeping

During the Medieval period, bookkeeping was localized under the feudal system and its structured societies (Alexander, 2002). Whittow (2010) is of the opinion that economic growth in Europe was initiated by the existence of free peasantry. Peasant farmers were starting to contribute largely to the resources of their surrounding areas which triggered the move towards a feudal system, which can be seen as an economic, political and social system, all wrapped up in one, in which land was provided by the *government* in return for services to be rendered. These services could be in the form of protection of the realm, working of the lands or the like. It also necessitated keeping track of services rendered in lieu of the lands held. The system required was one of calculating earnings and the accompanying taxes to be levied on such earnings. Bookkeepers were expected to not only keep record of the revenues, but also the expenses.

According to Alexander (2002), when William the Conqueror invaded England in the 11<sup>th</sup> century, he took possession of all properties on behalf of the King, and he surveyed all real estate in order to calculate the taxes due. The record of this survey and tax calculation is known as the Domesday Book. The oldest known accounting record in the English language is the Pipe Roll, also referred to as the Great Roll of the Exchequer, which encapsulates a description of all rents, fines and taxes. Although one might argue that this process can be likened to nothing more than the keeping of records, there is a distinction. In this era of development, the underlying earnings and expenses needed to be calculated first to establish a basis for the calculation of taxes due. One can then also assume that a form of verification may have been required to prove the amounts earned or spent.

Towards the end of the medieval period manufacturing started to become specialised and dynamic changes occurred in trade and commerce under the guild system, necessitating the creation of a more formalised and accurate bookkeeping system (Edwards, 1960). Alexander (2002) is of the opinion that Italy, during the Renaissance (14<sup>th</sup> to 16<sup>th</sup> century), is widely regarded as the place where modern accounting developed. Italy became a leading commercial nation and was looking for better ways of calculating their profits. Italian commerce started to use *capital* and *credit* on an increasing scale, which necessitated a reliable system that could serve as a system of record keeping and bookkeeping.

The transition from *single* entry to *double* entry bookkeeping can clearly be seen in the records of the Datini Company of Prato. During the period 4<sup>th</sup> February 1383 to 31<sup>st</sup> January 1399 documented transitions were found that show the move towards a double entry accounting system. These documents show the move from an old register, where recording took place in paragraphs, to a new, double-sided register, including as many as 600 auxiliary sub-books (Arlinghaus, 2004). Thus, the birth of the double entry system of accounting as we know it today was at hand and the rules of transactional recording for commerce and trade were about to change forever.

Again, we need to equate the bookkeeping of the medieval times with the modern business environment. In the medieval economy, the hierarchy of the economic activity would be from the landlord, as owner of the land and economic activities, to the King, as beneficial recipient of income due to his position. Although the king had no direct interest in the activities of the landlord, he was entitled to a portion of the profits generated. In modern terms one can see the peasant farmers as employees of a business owner. The landlord as the business owner who is driven to make profits for his own, direct benefit, and for the indirect benefit of the king. As was the case in record keeping, bookkeeping is also founded on business needs in which transactional records are the proof of economic prowess. Accounting's next step in history is thus a move away from direct application for the business owner only. Reporting is now required not only for the landlord's benefit, but for the benefit of a third party, the king, as well.

#### **3.3.4. Accounting**

With international trade expanding and trade routes to the east becoming more popular during the time of the Crusades, it is very likely that the evolution of double entry accounting was due to various influences, from various cultures, becoming intertwined (Lauwers & Willekens, 1994). The transition from a *bookkeeping* system to an *accounting* system occurred when *a set of books* was no longer just a repository for notes to be referred to when settling accounts (Edwards, 1960). The very first use of a complete double entry bookkeeping system was the Farolfi ledger of 1299 to 1300 (Gurskaya *et al.*, 2012). The ledger contained debits and credits and accompanying journals. A few years later the art of accounting had expanded and we find the first complete set of double entry accounting books. The books of account of Soranzo and Brothers of Genoa in 1340 not only make use of debits and credits and journal entries, but also use profit and loss and capital accounts (Edwards, 1960). According to Edwards (1960) and

Lauwers and Willekens (1994) the ledgers were being closed off, profits calculated and balances carried forward on a yearly basis. As commerce moved into a more capital intensive era, investments in business ventures became more prevalent. This is seen in large corporations like the British East India Company of the late 17<sup>th</sup> century. A decision was made by the company to pay profits to their investors, and not a return on capital invested (Edwards, 1960). This created the problem of distinguishing between capital and income. More advanced and accurate accounting methods were required and demanded. And so, the era of bookkeeping had evolved into the era of accounting.

Thompson (2003) believes a social desire for legitimacy of merchants and their trading reputations contributed largely to the requirement for a reliable accounting system. A major step towards double entry accounting was the introduction of Arabic numerals. Alexander (2002) deduces that there were 7 main factors that contributed to Italy being predisposed to the development of the double entry bookkeeping system, namely:

- Private property: Italy's commercial setup allowed the transfer of private property, which required the ability to track such changes.
- Commercial trading: Large volumes of trading with multiple clients necessitated a system that could adequately deal with the high transactional volumes.
- Writing: Proper accounting documentation and recording required a high level of writing skills to be able to record various transactions and their values.
- Mathematical competency: The Arabic numerical system allowed for the means to effectively calculate and record the relative values of transactions.
- Money: Currency filled the need for a common denominator of value between parties when negotiating a particular trade.
- Availability of credit: As the use of credit transaction started to become more common, the need to keep track of these debts became imperative.
- Capital employment: The ability to keep track of transactions while keeping capital transactions separate, became of vital importance as merchants started trading by using agents and partnerships.

Although all these factors existed at various times and various places across the globe, they were never all present at the same time in the same place, in such a manner that the double entry accounting system would be the result (Alexander, 2002; Johnson & Kaplan, 1987).

At the forefront of the evolution of accounting as we know it today, are two names of significant historic value, namely Benedetto Cotruguli and Luca Pacioli. Although historically Luca Pacioli is often credited as *being the father* of double entry accounting, it was Benedetto Cotruguli who was the first person to write about the double entry accounting system. In 1458 Benedetto Cotruguli wrote *Delia Mercatura et del Mercante Perfetto* (Of Trading and the Perfect Trader). Although his work was not published until 1573, it is the oldest known manuscript on double entry accounting (ten Have, 1976). Frater Luca Pacioli, on the other hand, published his book *Summa de Arithmetica, Geometria, Proportioni et Proportionalita* (roughly translated as *Everything About Arithmetic, Geometry and Proportion*) in 1494 (Alexander, 2002). This is the first known version of a printed reference to double entry accounting and is regarded by many as the basis of modern accounting (Fogo, 1905; McCarthy *et al.*, 2008). Pacioli was however familiar with the work of Benedetto Cotruguli and credited him with the origination of the double entry system (Alexander, 2002). It is interesting to note that Pacioli's book, which primarily dealt with mathematics and included chapters on bookkeeping, was not written as a book explaining *new* ideas, but rather as a book explaining and elaborating on *existing* ideas. Warsono-bin-Hardono (2013) takes this to be an indication that double entry bookkeeping, in some form or another, had been in common use by the time Pacioli wrote his treatise. More importantly in the context of this paper, Pacioli presents practical *business* rules and does not explain the philosophy behind the system. One can assume that Pacioli must have felt that only the rules needed to be elaborated on.

Sangster (2010) is of the opinion that the double entry accounting system was necessitated by the fact that Italy's commerce had developed into a system where business people started using agents and partnerships to trade with. Tracking performance and profits had become an exercise of utmost importance and a reliable method of record keeping was needed. The seven factors referred to above, as mentioned by Alexander (2002), were starting to come together in Italy. Through the publication of Pacioli's treatise on 10 November 1494 by Gutenberg, a unified double entry version of accounting was created (Sangster, 2010; Alexander, 2002). The spread of Pacioli's work ensured that by 1800, the Venetian way of double entry bookkeeping was the standard across Europe (Gleeson-White, 2012).

Again, we need to equate the accounting of this era with the modern business environment. Of great importance to the accounting of this era is that the main focus of accounting had significantly moved towards third party reporting. Investors and shareholders were direct



stakeholders in the profits of business. Where the king in medieval times had a detached interest in the profits of business, the shareholders had a direct, vested interest in the performance of business. This is directly comparable to the modern business environment. The contemporary business is often also exposed to situations of multiple shareholders. Furthermore, most businesses are also reliant on third party financing in some way or another.

Accounting's final step is thus a move even further away from managerial use by business owners. Accounting has evolved into a tool with which to create transparency for direct stakeholders (shareholders) and indirect stakeholders (investors and financiers).

### **3.4. Concluding discussion: The dawn of a new era of accounting**

According to Lauwers and Willekens (1994) the industrial revolution and the rise of capitalism were driving factors in the development of accounting theory in the 19<sup>th</sup> and 20<sup>th</sup> centuries. With large amounts of capital being needed as investment in large business ventures, private ownership changed to a legal framework where ownership was separated from the operations of the business. With greater investments however, came a greater need for accountability. This ultimately led to the more stringent accounting and business disclosure regulations and a growing need for independent attestation of external accounts by auditors. Commenting on the direction in which accounting has developed; Chambers (1999) is of the opinion that, with the advent of complex accounting standards, accounting frameworks and the so-called Generally Accepted Accounting Principles (or GAAP), "accountants have insulated themselves from the world of affairs by a cocoon of their own making". The concern is that although such accounting frameworks and complex accounting standards are only empirical observations based on perceived business practices, it does in effect govern not only the development of accounting theory and accounting research, but also accounting dogma. One needs to ask whether contemporary accounting, as a discipline born out of necessity with a demand for practicality, may have been theorized into impracticality?

The intention of this review was to explore the annals of accounting history to reveal not only the *when* and *where* of accounting evolution, but also the *who* and the *why* of accounting's development. What has become clear is that the initial development of accountancy was based on a needs analysis by the users of accounting information. The later stages of development became more complicated as reporting to third parties became more prevalent. We therefore

argue that the purpose of accounting was to provide reliable knowledge, and that this knowledge had to be reliable to all users. Currently, the level of reliability may depend on the user's understanding of the complex intricacies of the underlying accounting standards. The original purpose of accounting was to assist the business owner; the current use however has evolved into more of a third-party reporting mechanism. As stated, the initial research objective was to reflect on whether accountancy has lost its relevance as far as its usefulness to business owners is concerned. As earlier referred to, business owners, and perhaps specifically in this context, SMEs, feel that the complex accounting theory involved in current accounting practice has little to no use to them in their day to day commercial dealings (Schutte & Buys, 2011; Baskerville & Cordery, 2006; Collis & Jarvis, 2000).

In contemplation of the historical and orderly objective of accounting to offer useable information to all stakeholders, a too constricted emphasis of accounting can be condemned. In the contemporary business environment, accounting's function is becoming less a singular business language, and more a corporate information depository. Stakeholders cannot escape the fact that despite their views on the usefulness of accounting practice and information, it may be a necessary evil they need to bear. Whether they are applying for finance, submitting tax returns, attracting investments or merely carrying on their daily trade, they will not be able to escape the need for robust accounting systems. One should not make the mistake of judging the usefulness of accounting by its complexity. Just because something is complex does not mean it is not useful. Its usefulness can be found in what it helps the business owner achieve.

What has our journey through the evolution of accounting then been in aid of in the context of the contemporary business environment? We have learnt that although accounting may never lose its business relevance, its intended purpose may have changed to a more or lesser extent. Accounting has evolved beyond the point of specific usefulness to the owner, to a point of intended usefulness to (certain) external third parties. Without entering into a discussion on the necessity or not of a set of complex accounting standards, one cannot help but consider whether the new era of accounting may have strayed from the historic pathway envisaged by Luca Pacioli when double entry accounting was presented to the world. Be that as it may, double entry accounting has proven to be an exceptionally resilient and dynamic discipline.

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## CHAPTER 4: RESEARCH ARTICLE 2

**Title:** The impact of the Independent Review on SME access to bank finance: The case of South Africa

The reader is requested to take note of the following:

- This article was *accepted* at the following peer-reviewed and DHeT accredited academic journal as follows:
  - Coetzee, F. & Buys, P. 2017. The impact of the Independent Review on SME access to bank finance: The case of South Africa. *Banks and bank systems*, 12(1). (Scopus & ABDC / ISSN: 1816-7403).
- The article has been written in line with the journal's submission guidelines for articles which are included in **Annexure C** on page - 141 -
- The first page of the proof copy of accepted publication is included in Annexure D on page - 142 -.
- The article was researched and written by the first author (Coetzee, F) as the PhD candidate and primary author, while the second author (Buys, P) fulfilled a reviewer function thereto as the PhD project's promoter.

**Title:** The impact of the Independent Review on SME access to bank finance: The case of South Africa

**Abstract**

It is accepted that SMEs are major contributors to global employment and GDP. Similarly, SMEs' reliance on bank finance to maintain financial and operational sustainability is also globally accepted. In 2008, the Companies Act of South Africa was amended to scrap the statutory audit requirement for qualifying entities, with the aim of alleviating the administrative burden of SMEs and increasing their sustainability potential. As sound as this strategy may have been, a grey area arose in that banks may still insist on audited financial statements. This study investigates the question as to whether South African banks still consider audited financial statements as key in evaluating SME bank finance applications. This was done by analysing the major banks' requirements per their policies and follow-up discussions with loan officers. Contrary to expectations, the *historic focus* per audited financial statements was considered of much less importance than progressive *future-oriented* management statements and reports.

**Keywords:** Audit, independent review, SME finance, SME sustainability

**JEL Classification:** M13, M41, M42, M48



## **4. THE IMPACT OF THE INDEPENDENT REVIEW ON SME ACCESS TO BANK FINANCE: THE CASE OF SOUTH AFRICA**

### **4.1. Introduction**

“Double, double toil and trouble; fire burn, and cauldron bubble” the witches cackled in Shakespeare’s *Macbeth* (Shakespeare, 1985, 4.1:10).

If we did not know any better, one may be excused for thinking Shakespeare was bemoaning the plight of the small and medium enterprises (SMEs) of old. The SMEs drive for sustainability, is a topic of substantial interest to contemporary academic management researchers and practitioners. In the South African context, the Global Entrepreneurship Monitor found that the entrepreneurial activity (often the SME domain) in South Africa has dropped by 34% in the 10 years leading up to 2014 (GEM, 2014). This research also found that entrepreneurial confidence is very low compared to the rest of sub-Saharan Africa. This translates into a perception that entrepreneurs are often not confident that they can successfully start a sustainable business in South Africa, which does not inspire much confidence in South Africa’s SME market.

According to the Bankseta (n.d.), in order for SMEs to be sustainable in the contemporary global market environment, they have to be able to:

- i) attract and retain skilled managers and personnel;
- ii) access their intended markets;
- iii) build customer relationships;
- iv) access the best-suited technologies;
- v) access sufficient production capacities;
- vi) be attentive of their role in social and economic development; and
- vii) access finance and credit.

An interesting point to ponder when scrutinising the above, is that attracting skilled personnel, gaining access to markets, accessing technologies and having sufficient production capacities are all dependent on the SME having adequate access to finance, which may lead us to assume that access to finance may well be *the major constraint* faced by contemporary SMEs.

The above is reiterated by Ayyagari *et al.* (2012) and Beck *et al.* (2005) who all consider the ability of SMEs to grow and be sustainable to be very much dependent on their access to finance. Banks, however, have historically often regarded SMEs as of a higher risk profile than larger corporations, especially when it comes to granting finance (Mazaroll, 2012; Haynes *et al.*, 1999). Therefore, when applying for bank finance, SMEs historically underwent a more rigorous scrutiny process, which entailed mitigating risk by requiring audited financial statements in order to extrapolate the required risk assessment tools when assessing applications for finance (SAICA, 2010). As such, audited financial information has historically been used to provide banks with better assurances of reliance on SME financial information.

In the contemporary South African business environment, the advent of the new Companies Act, No. 71 of 2008 (referred to as the Act hereafter) has brought about the abolishment of the statutory audit requirement for qualifying companies (typically then SMEs) and has introduced the new concept of the ‘independent review’ (Act, 2008). According to SAIPA (2011), an independent review is an engagement by which an accountant, external to the entity, provides a limited assurance review on a set of financial statements. Under current legislation, qualifying entities have the option to choose between either i) an independent review or ii) a conventional audit. This has caused a dilemma for SMEs. Choosing the independent review route will save them a substantial amount on auditing fees, but might jeopardise their access to bank funding. The flip side of the coin is to bear the cost of a more expensive audit fee in the hope of improving their chances of accessing bank funding. As important as bank funding may be to SMEs, the cost of an audit, compared to the cost of an independent review, will surely be a major consideration when deciding which route to follow.

Abor and Quartey (2010) and Bankseta (n.d.) estimate that more than 90% of formal business entities in South Africa are SMEs, while contributing up to 57% of the national GDP and as much as 61% of employment. Taking i) the value that SMEs contribute to South Africa’s economy into account, ii) the fact that South Africa is currently struggling with unemployment, and iii) the plight of the SME to be sustainable, it is evident that having adequate access to funding needs to be taken very seriously (Claymore, 2016; Bernstein, 2016).

## **4.2. Literature review**

### **4.2.1. Defining the SME concept**

Even though the concept of *Small and Medium Enterprises* (SME) is globally acknowledged, there does not seem to be a singular definition as to what an SME actually is. Notwithstanding, in terms of its characteristics, Malhotra *et al.* (2007) refer to independent business entities that have an owner-manager structure, while also expressing the opinion that the number of employees is the most common way of defining whether an entity is classified as an SME or not. Mahembe (2011), in turn, comments that SMEs are defined either with reference to the number of employees, or to the value of annual turnover, or a combination thereof. The World Bank (2002; 2004) in turn, classifies SMEs as business entities with a maximum of 300 employees, less than U\$15 million in annual turnover and less than U\$15 million in assets.

In a South African survey by FinMark (2010), SMEs were defined as business entities with an owner who is at least 16 years old, generates an income through small business activities and employs fewer than 200 employees. Falkena *et al.* (2001) extend this definition within a South African context by adding a turnover not exceeding ZAR<sup>1</sup>50 million. Even though it is evident that different economic regions may have their own definition of what an SME is, what does remain constant, is the fact that the intended *thing* being defined remains the same, i.e. a business entity that is *smaller* than the so-called big companies and corporations. For the purpose of this paper, SMEs will be viewed as a business entity that is a closely held business entity, i.e. with an owner-manager organisational structure with fewer than 200 employees.

### **4.2.2. The economic role of SMEs**

Economists and business experts agree that SMEs are very often key drivers of economic growth through job creation, increased exports and imports, and increasing production volumes (Mahembe, 2011; Ayyagari *et al.*, 2007). Furthermore, SMEs internationally seem to have a standard pattern of involvement in economies, for example:

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<sup>1</sup> ZAR being South African rand and the local currency. At the time of writing the exchange was approximately U\$1 = ZAR13.40.

- SMEs in Japan employ approximately 69% of the domestic workforce and contribute approximately 60% to the GDP (Robu, 2013).
- SMEs in the European Union employ up to two-thirds of the domestic workforce and contribute up to 52% to GDP (Robu, 2013).
- SMEs in the United Kingdom employ approximately 60% of all private sector employment and contribute 47% to all private sector turnover (FSB, 2016).
- SMEs in Canada employ up to 70% of the total private workforce, while contributing between 25% and 41% of the GDP (Industry Canada, 2013).
- SMEs in the United States of America employ approximately 58% of the private workforce and contribute approximately 65% to the GDP (Robu, 2013).
- SMEs in South Africa account for as much as 91% of formal business, contribute up to 57% to GDP and employ close to 61% of the domestic workforce (Abor & Quartey, 2010).

It is therefore obvious that the sustainability of the SME sector should be of paramount importance to policy-makers, economists and academics globally. A flourishing SME sector should ultimately contribute to stimulated economic growth and job creation. The inverse, however, is also true. If SMEs are not enabled to be sustainable, the economic repercussions on the (un-)employment and GDP levels can be crippling. If financing is considered to be one of the most important factors impeding SME growth, economic policy and regulations *must* endeavour to make access to funding less inhibiting to SMEs.

#### **4.2.3. The importance of bank finance**

Malhotra *et al.* (2007) state that literature on corporate finance indicates that the lack of finance is a key obstacle to company growth. Wattanapruttipaisan (2003) extends this viewpoint to an SME perspective and states that access to finance is one of the main reasons why SMEs often struggle. According to Mills and McCarthy (2014), bank loans (as a form of finance) have always been of crucial importance to SMEs. Research also indicated that more than 80% of SMEs regard banks as their primary source of business funding (NFIB, 2012; Mahembe, 2011). However, although bank finance seems to be the most preferred source of SME financing, Mazanai and Fatoki (2012) found that only approximately 30% of SME financing applications are eventually approved.

#### 4.2.3.1. Accessibility of bank finance: An SME perspective

In interviews with various accounting firms, the ICAEW (2009) found that partners were often of the opinion that their SME clients found access to finance difficult. The severity hereof was described as from *fairly difficult* to the belief that *banks just were not lending anymore*. There is a saying that *the bank will loan you as much money as you want as soon as you can prove that you do not need the loan*. Although this statement may be considered as facetious, the OECD (2009) nonetheless considers access to finance as one of the most significant challenges for SMEs' sustainability.

- From a global perspective, the overwhelming consensus is that SMEs are indeed facing tough credit conditions (European Union, 2002). Maudos (2013) endorses this view by providing the following international data:
  - In Portugal, 45% of SMEs considered banks as being reluctant to provide credit, while 38% of Irish SMEs shared this viewpoint.
  - In Spain, as much as 27% of SMEs indicated that access to finance is their most serious problem, while more than 57% considered the banks as being reluctant to provide credit.
  - In Greece, as much as 31% of SMEs indicated that access to finance is their most serious problem, while 49% considered the banks as being reluctant to provide credit.
  - Although not as severe, 10% of German SMEs and 13% of French SMEs indicated that access to finance is their most serious problem.
- From a South African perspective, accessing finance is also one of the main constraints listed by several surveys and SME studies (Mahembe, 2011; Berry *et al.*, 2002; Fatoki & Garwe, 2010; Chimucheka & Rungani, 2011). Research conducted by Fatoki and Asah (2011) indicated that 91% of SMEs surveyed, stated that they needed external finance from a commercial bank for i) working capital (40%), ii) to invest in fixed assets (57%), and iii) for business acquisitions (3%). Notwithstanding such needs, only 39% successfully applied for finance.

From the above statistics, we can gauge that financing constraints are not unique to certain countries or even demographic areas, but is in fact, a global phenomenon.

#### 4.2.3.2. *Availability of bank finance: A bank perspective*

While SMEs may be of the opinion that banks are simply not making finance available, bankers blame i) SME owners for a lack of demand for credit products and ii) the regulators for requiring more stringent criteria when approving SME loans (Wiersch & Shane, 2013). As such, it may very well be that banks make less credit available because they themselves are struggling to raise funds and are also taking some strain due to inter-bank lending constraints (OECD, 2009). Not only has the recent global economic crises compounded SME sustainability difficulties, by creating a drop in demand for goods and services across the board, but also placing strain on bank finance availability by tightening credit terms. This has caused access to funding in the SME market space to become very tight (SBA, 2011).

Mills and McCarthy (2014) confirm this trend when they argue that banks are often either too strict when considering funding applications or are outright unwilling to provide funding. In defence of the banking sector, one can argue that the high failure rate of SMEs may be a reason why access to credit is difficult, as the risk profile of SMEs is somewhat tarnished (Mazanai & Fatoki, 2012). There are of course several other reasons why SMEs may find access to finance harder, which, according to Malhotra *et al.* (2007), include i) the unpractical policies in the financial sector (e.g. higher interest rates), ii) the lack of SME-related expertise at banks, iii) the inherent higher risks associated with SMEs, and iv) information asymmetries, such as no statutory requirement for audited financial statements. These reasons are supplemented by Mazanai and Fatoki (2012) who identify i) high administrative costs of small-scale lending, ii) asymmetric information, iii) high risk perception, and iv) lack of collateral as key reasons why banks may be reluctant to give loans to SMEs.

#### 4.2.3.3. *The SME finance gap*

A key reason for the discrepancy between what SMEs seem to be claiming, and what banks are rebutting with, could be attributed to a *finance gap*. Simply put, it implies that there are a number of viable SMEs that are unable to obtain funding from banks. This financing gap, according to Mazanai and Fatoki (2012), can be as large as 80% in OECD countries and as large as 90% in non-OECD countries. Asymmetry of information is a key aspect impeding SMEs in accessing bank finance (Stiglitz & Weiss, 1981). This implies that banks have to evaluate applications without understanding the dynamics of an SME's business model and performances, leaving them to make *best guess* evaluations in such applications. Obviously,

with banks not being in the *risk-taking business*, it will lead to decisions under moral hazard and adverse risk conditions (Mazanai & Fatoki, 2012).

Turton and Herrington (2012) and Mahembe (2011) state that South African SMEs have constrained access to the financing they need. A survey done by FinMark (2010) indicates that although an average of 84.4% of SMEs applied for bank loans, only 33.3% of these loans were successful. This data supports the perception that there is a real, significant finance gap in South Africa.

#### **4.2.4. The relevance of audits to SMEs accessing bank finance**

##### *4.2.4.1. To audit or not to audit?*

The preceding discussions have established that access to finance is, i) of paramount importance to ensure SME sustainability, ii) that problems related thereto is a universal problem, iii) that bank financing, *per se*, is a crucial part of the SME financing culture and iv) that there is a perception that banks are too strict in their lending criteria. Banks, on the other hand, are of the opinion that unsuccessful financing applications are to be blamed on various external factors that influence their risk assessments and analysis of the applicant's information. With the abolishment of the statutory audit requirement for qualifying companies in South Africa the question that needs to be answered is whether this will further increase the problem of asymmetric information and thereby further impede an SME's chances of obtaining access to financing?

Research conducted by Berger and Udell (2006) concluded that banks are very active users of financial statements and will more often than not require financial statements when considering an application for financing – be it audited, reviewed or merely compiled by suitably certified/licensed accountants. Nevertheless, there seems to be conflicting viewpoints on the aspect of the value banks may, or may not, attribute to audited financial statements.

- On the one hand, it is argued that the role of an audit is to give the users of the financial statements a reasonable assurance that the information is presented reliably and fairly. Collis *et al.* (2013) state that financial institutions in South Africa often require *audited* financial statements when considering loan applications. Wignaraja and Jinjark (2015) also found that audited financial statements had a mostly positive effect on bank loan

applications, while Tsai and Hua (2009) and Kim and Elias (2008) found that audited financial statements had a positive effect on the interest rates attached to approved finance applications.

- In somewhat conflicting findings, Wright and Davidson (2000) indicate that the auditor's attestation did not have an effect on the bank's decision-making process. Furthermore, Kim and Elias (2008) found that during interviews with senior lending officers, audited financial statements were often not required. Although this may be because smaller banks may fashion their loan criteria on a more personal, *soft* approach i.e. knowledge about the owner and the business, the fact remains that audited financial statements were not required. In contrast, larger banks may tend to focus more on *hard* information, i.e. information that can be verified somehow. Studies have further found that the attestation report only comes into play when it indicates a situation in direct contrast to healthy financial statements (Guiral-Contreras *et al.*, 2007).

#### 4.2.4.2. *The value of an audit*

Berger and Frame (2005) raise the point that one of the reasons larger business entities may find access to finance easier is because their information is not regarded as opaque, as is the case with smaller business entities. An important reason for this is because larger firms have access to audited financial information on a regular (statutory) basis. SMEs, on the other hand, tend to suffer from opaque information, which puts them in the precarious position of providing the lenders with enough information to satisfy lending requirements. Therefore, due to SME information often being regarded as opaque and asymmetric, banks may be more reluctant to approve loan requests if audited financial statements are not provided. Because the information is regarded as *third-party reviewed*, a loan officer may regard audited financial information as of greater importance when checking for reliable information (Le, 2012; Kim & Elias, 2008; Feschijan, 2008).

Taking it one step further, research conducted by Wignaraja and Jinjara (2015) and Mahembe (2011) found that business entities using *external* audit reports were more likely to have credit available and have a better chance of successfully applying for loans. Furthermore, a survey done by IFAC (2010) confirmed that lenders highly value audited financial statements and regard the audit function as key in reducing information asymmetry. In further support of the audit importance within this context, one of the methods used by banks to evaluate loan



applications is called *financial statement lending*, in which loans are evaluated primarily based on the financial statements of the borrower. This obviously requires trustworthy financial statements, which audited financial statements as such provide. For SMEs with transparent financial information, this method provides some distinct advantages, and the opaque information dilemma is nullified (Berger & Udell, 2004).

The above arguments support the premise that audited financial statements may be advantageous to SMEs. As sound as this reasoning may be, the changes to the auditing landscape brought about by the Act would have forced banks to adapt and modify their approach to SME lending practices. The question is, to what extent?

### **4.3. The purpose of the paper**

With the advent of the independent review and the abolishment of the statutory audit requirement for qualifying companies in South Africa, banks may become more stringent in their evaluation of bank finance applications to compensate for the perception that unaudited financial information may be less reliable than audited financial information. In evaluating finance applications, therefore, banks may i) request more information to be presented, ii) justify the perceived risk by raising interest rates, iii) attach stricter finance terms, iv) require more collateral, or v) even decline the finance application outright. All of the above actions may have far-reaching ramifications as far as the sustainability of SMEs is concerned. It is therefore crucially important for South African SMEs' owner-managers to understand whether the choice between an independent review and a conventional audit will affect their business negatively as far as accessibility to bank finance is concerned. SMEs may very well be caught between a rock and a hard place in that if they decide not to audit their financial statements, the SMEs might end up with devastating cashflow challenges. The inverse is also possible and an SME might choose to audit its financial statements at great cost, but have a bank that does not place much value on whether the financial statements are audited or not when assessing credit applications. With acknowledgement to William Shakespeare (1977, 3.1:55), one might summarise the problem SMEs face by asking: "To audit or not to audit, that is the question?"

#### **4.4. Research method**

Within the context of South African SMEs, and in light of the aforementioned, this paper's research problem focuses on whether it is prudent for SMEs to have their financial statements audited or not. The purpose of this investigation was to determine the value that South African banks place on audited financial statements when considering funding applications from SMEs. In order to establish this, the informational requirements from four of the biggest banks in South Africa were analysed. According to data published in 2014, these four banks represented 82% of the banking market share of South Africa at the time (The Banking Association of South Africa, 2014). Loan application information applicable to SMEs were obtained from banks' websites, supplemented by hard copy applications available from the banks themselves. The information required for an SME to apply for a loan in terms of these loan applications was subsequently scrutinised, and clarified by discussions with relevant loan officers.

The remainder of the article will therefore reflect on whether audited financial statements hold any advantage to South African SMEs in applying for bank finance, before providing some concluding remarks.

#### **4.5. Results**

It was indicated earlier that banks would historically request audited financial statements when assessing loan applications. With the advent of the new Act and the introduction of the independent review as an alternative to the statutory audit, it is unclear how banks have adapted their lending requirements. Are audited financial statements still a *make or break* consideration in lending decisions by banks?

From a South African perspective, the following table provides a summary of the essential responses of the banks to the proposed application as far as the financial information required.

Description	Bank 1	Bank 2	Bank 3	Bank 4
Audited financial statements	No	No	No	No – possibly for new clients
Independently reviewed financial statements	Yes	Yes	Yes	Yes
Cashflow statement	Yes	Yes	Yes	Yes
Management statements	Yes	No – unless financial statements are dated	No – unless financial statements are dated	No – unless financial statements are dated
Business plan	Yes	Yes	Yes	No
Financial information of directors/members/partners	Yes	Yes	Yes	Yes
Security required	Yes	Yes	Yes	Yes

**Table 4.1: Bank requirements in consideration of SME finance application**

In consideration of the above information, the following:

- **Audited financial statements:** None of the banks insisted on audited financial statements as a prerequisite.
- **Independent review financial statements:** Although the banks required financial statements, there was no insistence on audited financial statements and independent review statements were acceptable.
- **Cashflow projection:** All the banks required cashflow projections.
- **Management statements:** All the banks required the most recent management statements.
- **Business plan:** Three of the four banks may require business plans if deemed necessary, indicating that this was something regarded as giving valuable insight into the business operations of the SME.
- **Financial information for directors, members and/or partners:** All the banks indicated the financial position of stakeholders as an important consideration.
- **Security requirement:** All the banks required adequate availability of suitable collateral.

Therefore, it may be deduced that South African banks have become more risk adverse and are leaning away from relationship lending and more towards a *risk-based lending* strategy. If one

scrutinises the above requirements more intently, one finds that historic information (i.e. audited financial statements) is less prevalent than current and future information (i.e. cashflows, management accounts and owner security). For an SME to have a bank consider its funding application favourably, it will have to be able to indicate i) that adequate security is in place, including the financial position of key stakeholders, and ii) that repayment of loans can be reasonably guaranteed from an anticipated cashflow perspective.

#### **4.6. Conclusion and future research**

South African policy-makers have attempted to ease the regulatory burden of SMEs by abolishing the statutory audit, which placed a burden on SMEs in terms of fees, accounting systems and timeframe pressures. This change in the Act, as well intended as it may be, had the potential of creating a *damned if you do, damned if you don't* situation. SMEs could easily get caught up between what the new Act requires as far as financial reporting is concerned versus what financial institutions may require as far as access to finance is concerned.

This paper focused on the potential impact on SMEs' accessibility to bank finance in light of doing away with the statutory audit for qualifying entities. In investigating this potential impact, both a literary study and empirical investigation were conducted. A review of relevant published research indicated the following key points:

- SMEs play a crucial role in the economy of most countries throughout the world.
- Even on a global scale, access to finance is a major concern for SMEs, and they mostly rely on banks as an important source of external funding for their operations.
- Banks seem to have tightened their lending criteria, and have historically favoured audited financial statements as supportive when considering related SME fund applications.

Notwithstanding the above indications, the results section of this study indicate that audited financial statements may have lost its appeal as a key reliance criterion for banks when assessing finance applications. The investigation into the banks' requirements indicated the following:

- Banks currently view *historical information*, as provided in the audited financial statements, of lesser value in comparison to the *current and future anticipated* performance

of the SME. This is seen in the emphasis placed on current management accounts and cashflow projections.

- The ability to provide adequate security also seems to carry more weight than the historical information portrayed by financial statements. Consequently, the requirement for key stakeholders to declare their personal financial position as part of credit application processes is needed.

Seen in light of the above, it may be argued that, after the 2008 credit crisis (Stout, 2011), banks have perhaps become more risk adverse and will almost to a fault only lend money if enough security has been made available by the applicant, supported by its sustainability vision, not its historical successes.

From the above, we can infer that banks have adapted to the requirements of the Act and no longer insist on audited SME financial statements, and do accept independently reviewed financial statements. Armed with this knowledge, SMEs can now make more informed decisions as to whether they want to bear the financial burden of an audit engagement. Although cases may differ from bank to bank, and from client to client, the overall consensus from banks seems to be that audited financial statements are no longer a prerequisite for a successful loan application. It seems, against expectations, that audited financial statements are no longer *the bogeyman* causing SMEs to lie awake at night. Although the question of how to access bank funding still remains for most SMEs, at least to audit or not to audit is not the question anymore.

This research acknowledged that the problem of accessibility to finance is a global SME problem and the invaluable contribution SMEs have on global employment and GDP levels. This being said, it is important to bear in mind that the approach of banks towards the value of audited financial statements in terms of SME financing applications was restricted to a South African perspective. Banks in different countries may have different views on the value of audited financial statements.

The research was also localised on bank funding applications. The conclusions drawn may therefore not be applicable to other avenues of SME funding. As such, the research in no way tries to indicate that an audit has lost all value to SMEs. The value of an audit may still be found in various other applications, such as providing accurate management decision-making,

potential tax-saving benefits, prevention of theft and corruption in an organisation, and the structuring of equity transactions.

The research also looked at the problem from a bank perspective. Future research can be undertaken to investigate the same problem from an SME perspective - it may be that what the banks preach in terms of the requirements may not be what they practice when SMEs apply for funding.

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## CHAPTER 5: RESEARCH ARTICLE 3

**Title:** SME perceptions of the independent review and accounting skills on bank financing: A South African perspective

The reader is requested to take note of the following:

- This article has been *submitted* to the following peer-reviewed and DHeT accredited academic journal as follows:
  - Coetzee, F. & Buys, P. 2017. SME perceptions of the independent review and accounting skills on bank financing: A South African perspective. *Banks and bank systems*, (Scopus & ABDC / ISSN: 1816-7403).
- The article has been written in line with the journal's submission guidelines for articles which are included in **Annexure C** on page - 141 -.

The article was researched and written by the first author (Coetzee, F) as the PhD candidate and primary author, while the second author (Buys, P) fulfilled a reviewer function thereto as the PhD project's promoter.

**Title**

SME perceptions of the independent review and accounting skills on bank financing: A South African perspective

**Abstract**

Access to bank financing is regularly rated as one of the biggest obstacles to SME sustainability. With the introduction of the independent review as an alternative to the statutory audit, banks may have inevitably lost their risk assessment reassurance that audits provided. Previous research found that banks have adjusted to this situation by no longer insisting on audited financial statements. The research undertaken in this study aims to firstly investigate SME owner-managers' perceptions about what banks require when assessing bank loan applications, and secondly to gauge SME owner-manager's attitudes towards the value they perceive accounting may contribute to their sustainability. It was found from an SME perspective, that an independent review is the current way to go, and that many SME owner-managers consider their own accounting skills, as the language of business, to be lacking. This could potentially have repercussions by contributing further to asymmetric financial information, and thus limiting successes in obtaining finance.

**Key terms:** Accounting proficiency, audit, bank financing, independent review, SME sustainability

**JEL Classification:** M13, M41, M42, M48

## **5. SME PERCEPTIONS OF THE INDEPENDENT REVIEW AND ACCOUNTING SKILLS ON BANK FINANCING: A SOUTH AFRICAN PERSPECTIVE**

### **5.1. Introduction**

Ask any business owner why he/she is in business, and you are likely to hear a hearty rendition of “*Money makes the world go round*”, as in the Broadway musical *Cabaret* (Kander, 1965). For many small and medium enterprises (SMEs) around the world, no words ring truer. The plight of SMEs globally to attain and achieve sustainability is a much-explored topic and is often regarded as the entrepreneurial domain of the world economy (GEM, 2014). However, to make their world go around, SMEs do need money (as per the Kander reference above). This *need* is corroborated by Ayyagari *et al.* (2012) and Beck *et al.* (2005) who all consider SMEs’ sustainability to be unequivocally concomitant to their ability to access adequate finance. Mills and McCarthy (2014) is of the opinion that bank loans have traditionally been important to SMEs. Unfortunately, banks have also historically regarded SMEs as potentially high-risk clients (Haynes *et al.*, 1999), and historically would have been subjected to a rigorous risk assessment process. This process, more often than not, leads to banks requiring audited financial statements from SMEs (SAICA, 2010).

A problematic situation arose in the contemporary South African business environment, with the advent of the new Companies Act, No. 71 of 2008 (hereafter the Act). Before the implementation of the new Act, SMEs (trading in a company format) had no option but to undergo an annual statutory audit. With the abolishment of the statutory audit requirement for qualifying entities, audited financial statements are no longer required. As such, a new era has seen the light in South Africa, which effectively allows qualifying entities to choose between either i) an independent review or ii) a conventional audit. Griffin (2014) explains that an audit is done in accordance with generally accepted auditing standards, whereas an independent review is done in terms of the standards for accounting and review engagements. As such, the objective of an audit is to give reasonable assurance that the financial statements as a whole are fairly presented. An independent review does not attempt to give such an assurance, but only gives a limited assurance that no material issues were identified during the review procedures undertaken. The concern is thus whether the SME that chooses not to follow the

conventional audit route, may run into problems when trying to access bank finance, since banks may not be keen to base their risk assessments on a *limited* assurance rather than a *reasonable* assurance.

Building on the above, according to Fatoki and Garwe (2010), the inaccessibility of finance opportunities is second only to (accounting) education and training when evaluating the reasons for low SME sustainability. Rajaram (2008) concurs and found that the lack of accounting skills is a contributing factor to the poor performance of SMEs in South Africa, and he postulates that possessing some basic accounting skillset may augment sustainability and profitability within the SME sector, to the extent that access to financing may become less arduous.

## **5.2. Literature review**

### **5.2.1. Perspectives on small and medium enterprises**

#### *5.2.1.1. Background*

Different economies and institutions have different perspectives of the business characteristics applicable to an SME. Typically however, Malhotra *et al.* (2007) refers to SMEs as *independent* business entities that have an owner-manager structure, while Mahembe (2011) also brings the *number of employees* and *financial size* aspects into the equation. In a South African survey by FinMark (2010), SMEs were defined as privately-held business entities that, among other, employ fewer than 200 employees and has a turnover of less than ZAR50 million<sup>2</sup>. For the purpose of this paper therefore, SMEs are defined as business entities that falls within the criteria of the FinMark definition.

SMEs are globally considered to be important economic contributors that play an important role in terms of job creation and stimulating economic growth (The Business Place, 2009).

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<sup>2</sup> ZAR being South African rand and the local currency. At the time of writing the exchange rate was approximately US\$1 = ZAR13.60.



SMEs locally in South Africa and internationally seem to have a positive pattern of involvement in economies as is illustrated in the table below.

Country	GDP Contribution	Employment creation as % of domestic workforce.
Japan (Robu, 2013)	60%	69%
European Union (Robu, 2013)	52%	66%
United Kingdom (FSB, 2016)	47%	60%
Canada (Industry Canada, 2013)	41%	70%
USA (Robu, 2013)	65%	58%
South Africa (Abor & Quartey, 2010)	57%	61%

**Table 5.1: SME economic relevance**

In light of the above, a thriving SME economic sector should inadvertently contribute tremendously to a thriving local economy, which in turn should positively impact on society in general. It is thus of vital importance that SMEs be equipped and empowered as proficiently and expediently as possible.

#### 5.2.1.2. *The importance of bank finance*

As far back as 2004, Nieuwenhuizen and Groenewald (2004) claimed that the main obstacle to South African SME sustainability was accessing bank financing. What makes this even more significant is that these claims were made before the credit crunch of 2008. According to the European Union (2013) the current economic environment has brought the plight of the SME, concerning ever tightening credit accessibility, to the forefront again.

The NFIB (2012), reported that over 85% of SMEs used bank finance in one form or another. Furthermore, according to the European Union (2013) and the Office of Advocacy (2014), SME bank financing is used for various reasons, including i) as start-up business financing, ii) working capital purposes such as inventory acquisition and cash position strengthening, and iii) in expanding business operations inclusive of property, plant and equipment acquisitions. The European Commission, in collaboration with the European Central Bank, conducted research on the access to finance of SMEs in the European Union (European Commission, 2008) and published the following:

- Access to finance was the second biggest obstacle experienced by SMEs, after finding customers.
- Banks were the most frequently used source of external financing.
- Bank loans comprised 85% of all loans issued during the period of the research.
- Bank finance was typically in the form of overdrafts, equipment financing and bank loans.
- SME owner-managers considered financing from banks as difficult to access.
- Almost a third of SMEs did not receive the financing they had planned for.

From a more locally South African perspective, research conducted by Mazanai and Fatoki (2012), Mahembe (2011) and Turner *et al.* (2008) found that South African SMEs considered access to financing as a significant obstacle to the sustainability of their businesses, and that only between 25% and 30% of bank finance applications are eventually successful.

A reason why SME accessibility to funding has become such a conundrum seems to have become a matter of perception. On the one hand the bankers are adamant that SMEs and regulators are to blame for the funding problems being experienced, while on the other hand, the SMEs blame i) banks for unachievable collateral requirements and ii) regulators for effectively forcing banks to make loans more difficult to get (Wiersch & Shane, 2013). This is echoed by Wignaraja and Jinjark (2015) who approximate that 60% of SMEs worldwide are financially inhibited by funding constraints and Dalberg (2014) who estimates that 75% of new SMEs who apply for bank finance are rejected.

With banks being more risk averse since the 2008 financial crisis, assessing the creditworthiness of SMEs has become even more important. This is however no mean feat, as information asymmetry becomes an ever-increasing obstacle. Many SMEs have inadequate financial systems allowing banks no transparency as to the true financial position of the business (Mills & McCarthy, 2014). Whether one likes to admit it or not, the fact that banks are confronted with extensive banking regulations and statutory oversight is not by their own choice. Taking the above findings slightly further, Nieman and Neuwenhuizen (2009) found that startup SMEs fail within the first two years due to i) the inaccessibility to bank funding, and ii) cash flow problems attributable to a lack of financial management skills. More recent research by Turton and Herrington (2012) confirms this when they found that the two main contributing factors to the poor performance of SMEs in South Africa are i) accessibility to funding and ii) poor management skills.

### 5.2.2. The accounting conundrum

Kesseven (2012) raises the point that there are both external and internal factors that may contribute to SME sustainability. Although *external* factors are typically uncontrollable by the SME, they may have more control over *internal* factors such as organisational, management and financial abilities, which in turn may directly contribute to an SME's ability to convince banks of their sustainability.

Some of the world's most renowned and successful businessmen and entrepreneurs acknowledge that they regard accounting methodologies and principles as key contributors to their success, as illustrated by the following quotes:

*“Obviously, you have to know accounting. It's the language of practical business life...”*

*(Munger, 1994)*

*“You have to understand accounting and you have to understand the nuances of accounting. It's the language of business...”*

*(Buffet & Clark, 2008).*

Why does the metaphor of accounting being the *language of business* hold such significance? Bloomfield and Noyes (2008) explains by drawing a very insightful parallel between accounting and language:

*“People communicate through written natural languages by selecting words from a standard vocabulary, combining them in meaningful ways ...”*

*“People communicate through accounting reports by selecting accounts from a standard vocabulary, combining them in meaningful ways ...”*

Keeping the above in mind, accounting therefore needs to be able to, in a meaningful manner, communicate aspects that factually portray the economic realities of the business entity. Nevertheless Haron *et al.* (2013) as well as Sian and Roberts (2009) found that SME owner-managers seldom have any formal training in accounting and are subsequently often perplexed by the complexity of accounting reports. This lack of knowledge concerning the basic principles and nuances of accounting mostly translates into a misguided notion that accounting has no value to add. Because the SME lacks accounting knowledge, it is often disregarded in

the business. It is this combination of inadequate accounting *communication* skills, which according to Chimucheka and Rungani (2011), exacerbates the sustainability challenges already facing SMEs.

SMEs however are dependent on bank financing, and banks in turn rely heavily on financial information in their lending evaluation process. With banks, already reluctant to take risks in the SME financing space, providing asymmetric information will not aid the cause. Various research projects conducted by Haron *et al.* (2013), Amidu *et al.* (2011) and Osuala (2009) support assertions that some level of accounting sophistication can provide a level of mitigation in convincing finance providers of management savvy present within the entity, and thus also reduce risk levels specific to such an entity. We can thus infer that an SME's probability of accessing bank financing will increase if management has a better understanding of accounting principles and its value added to the business itself.

### **5.3. Research objectives and method**

When assessing a loan application, banks will undoubtedly require some kind of financial statement from the SME in order to evaluate potential associated risks. Unless the SME can provide such a financial statement, banks may mitigate their risk by either rejecting the application or by tightening the terms of the loan agreement (Dalberg, 2014). With audited SME financial statements potentially no longer required when applying for bank finance, the question becomes what SMEs can do to negate the banks' high-risk perception. Therefore, in order to empower SMEs, this article will, as its *first research problem*, investigate whether SME owner-managers agree with the premise of the Act that audited financial statements no longer hold any advantage to SMEs in applying for bank finance. Furthermore, as a *related second research problem*, the article will also consider the perception of SME owner-managers as to their own accounting prowess in their battle for sustainability.

An empirical survey investigates the two objectives in mind namely i) the experiences and attitudes of SMEs owner-managers regarding the necessity of audited financial statements in obtaining bank finance, and ii) the SMEs owner-managers' perception of their own accounting skillset and the value of accounting knowledge in their own contexts. Finally, some concluding remarks will also be provided.

In terms of the research approach used, this study is based on a tabulated questionnaire completed during interviews with the owner-managers of participating SMEs, in which section 1 was in a Likert 5-point, strongly agree - strongly disagree, format, while section 2 was in an in-depth personal interview format. The format and questions of the Likert scale and questionnaires were drawn from similar surveys that were previously conducted during SME access to finance research (European Union, 2013; Ackah & Vuvor, 2011; European Commission, 2009; Mutezo, 2005). The questionnaires were slightly adapted to better target and analyse topics pertinent to this study.

To undertake the empirical study, a qualitative research approach, using convenience sampling, has been employed. Convenience sampling is considered an appropriate approach when a targeted, identifiable population is available, and when time, resources and respondent availability are potential issues in the sampling and interview process (Baumberg, 2012). Both Adler and Adler (2012) and Warren (2002) are of the opinion that a (interview-based) qualitative sample size should be approximately 30 interviewees. Baumberg (2012) and Brannen (2012) however argue that more interviews are necessary and suggest that there should be approximately 40 interviews. Ragin (2012) again, is of the opinion that a more appropriate number of interviews is 50, whereas Gerson and Horowitz (2002) consider 60 interviews to be adequate to draw convincing conclusions. In this specific study therefore, the SME database of a (registered) external auditing firm with a national footprint was used as the targeted population from which the sample was drawn. A sample of 60 participants from various parts in South Africa and from various industries was selected. The only common denominator is that all participants are considered SMEs per the applied SME definition (see below).

Before taking a closer look at the research results of this study, it is important to be cognisant of the fact that these results are based on *perceptions*. The information gleaned from the SME owner-managers has not been tested with concrete empirical, *right-or-wrong* test criteria. Instead the information is based on what the SMEs *perceived* their experiences to be. For example, when asked what their perceived knowledge of accounting was, the answers were recorded as what they believed the reality to be. A test was not administered to prove their perceptions right or wrong. To ensure the reliability of the questionnaires, Cronbach's Alpha was calculated. The questionnaires testing for the first objective had a Cronbach's Alpha of 0.754, and as this is higher than 0.7 the questionnaire was accepted as reliable. The

questionnaires testing for the second objective had a Cronbach's Alpha of 0.742, and as this is also higher than 0.7 the questionnaire was also accepted as reliable.

#### 5.4. Empirical results

As indicated earlier, the first objective of this analysis is to examine the extent to which SME owner-managers agree with the supposition that audited financial statements are not essential in obtaining bank finance anymore. With the ever-increasing sophistication of accounting requirements for financial statements, the second objective focusses on the views of the SME owner-managers regarding their own accounting skillsets and their perceived value of accounting to their business.

Firstly, in terms of demographics, figure 1 below indicates the geographic distribution of the participants across the South African provinces, while figure 2 indicates the spread of participants as per their industry sector.

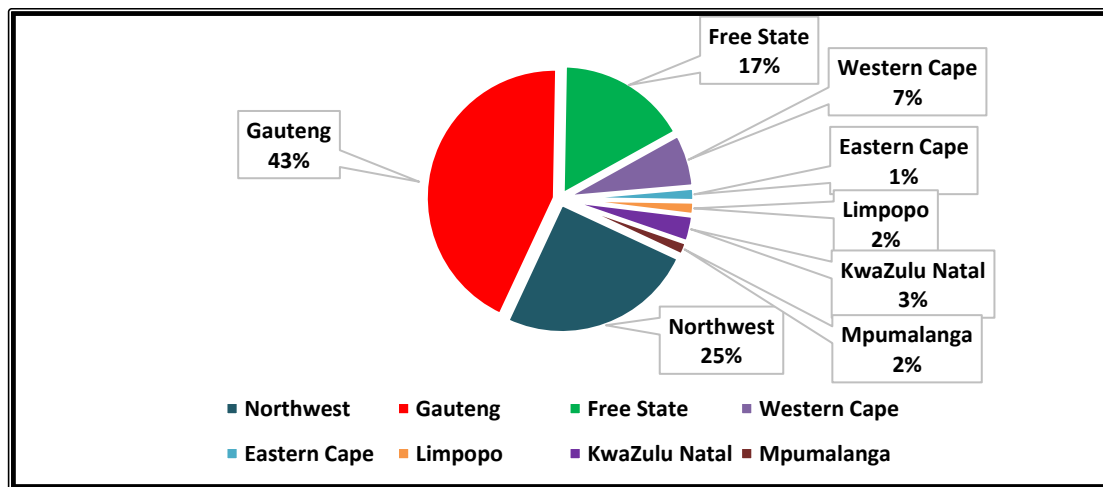
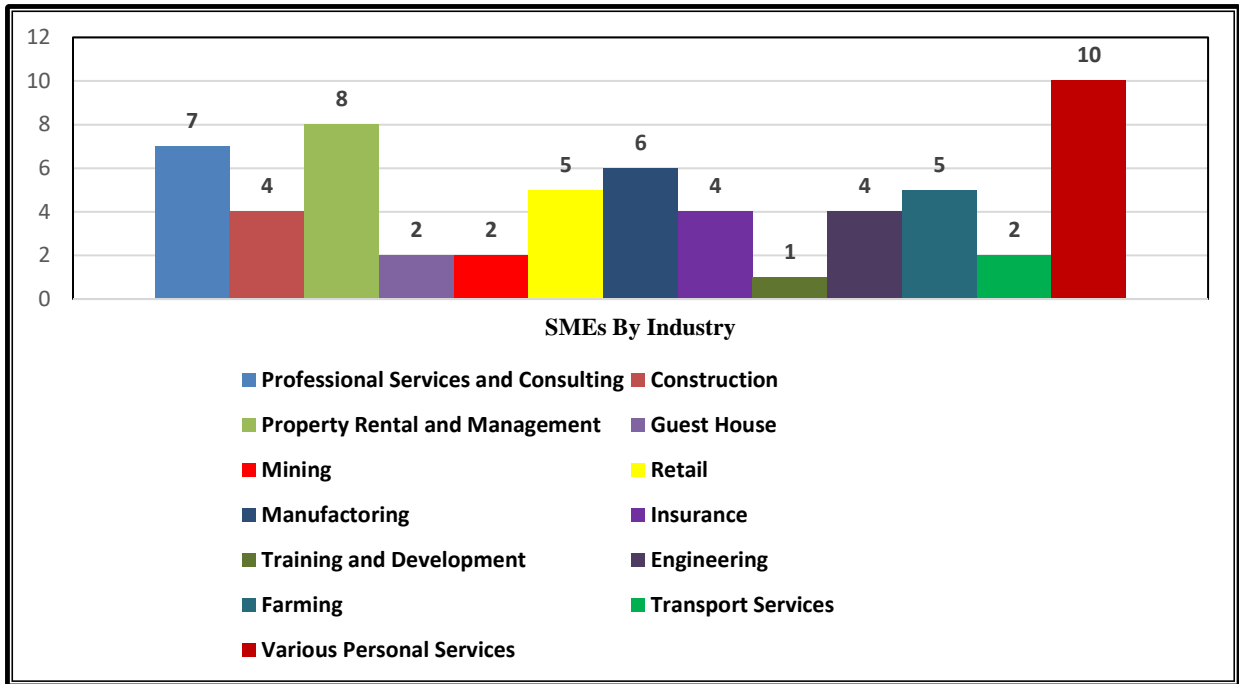


Figure 5.1: Participant geographic demographics

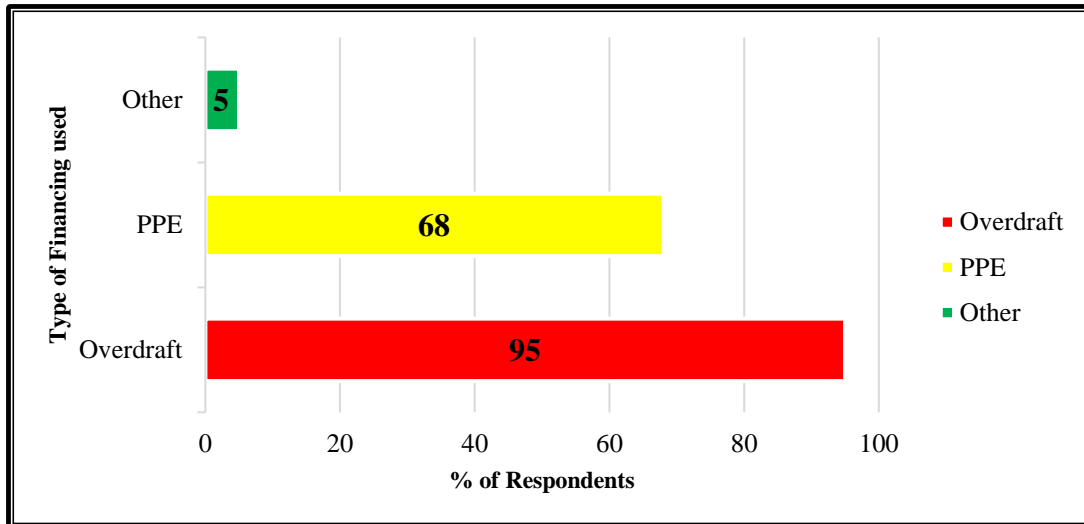


**Figure 5.2: Participant industry demographics**

It can thus be seen that the participants are spread widely across both the country and diverse industries. The common denominator among the participants is only the fact that they are all SMEs. Secondly, in terms of the detailed requirements pertinent to this study, the questionnaires were structured in such a manner to glean the following pertinent information:

***What types of finance are used?***

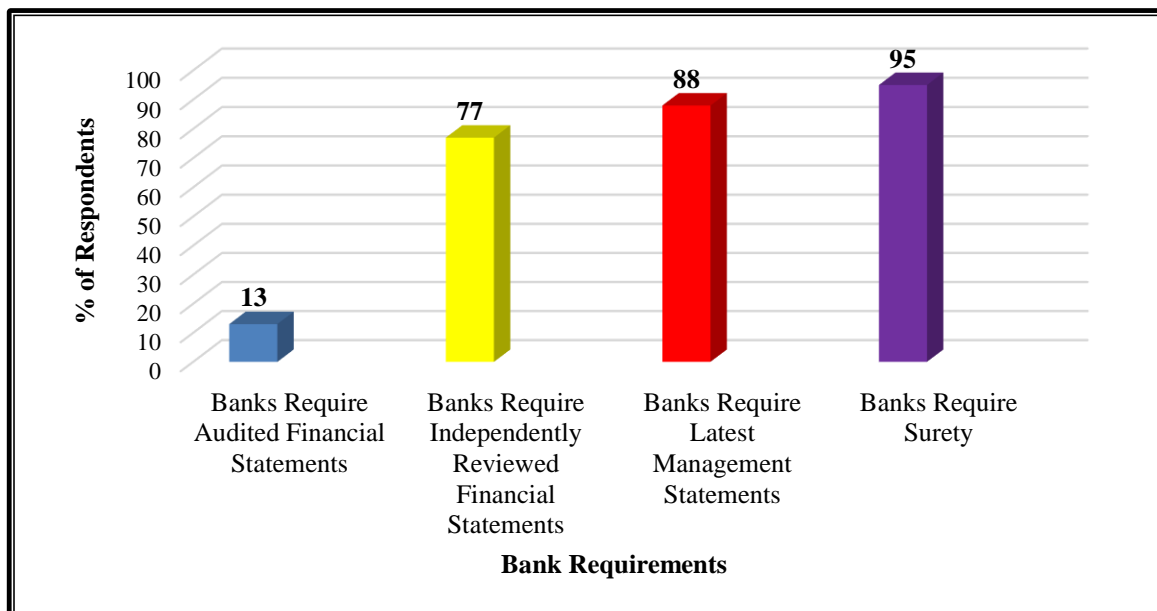
The figure below indicates the most commonly used types of finance SMEs rely on.



**Figure 5.3: Popularity of financing options**

The research found that overdrafts (95%) and property, plant and equipment (or asset) finance (68.33%) are the most commonly used financing structures. Other financing options (5%) included bank guarantees issued on behalf of SMEs.

***What information do the banks require when applying for finance?***



**Figure 5.4: Information requirements**

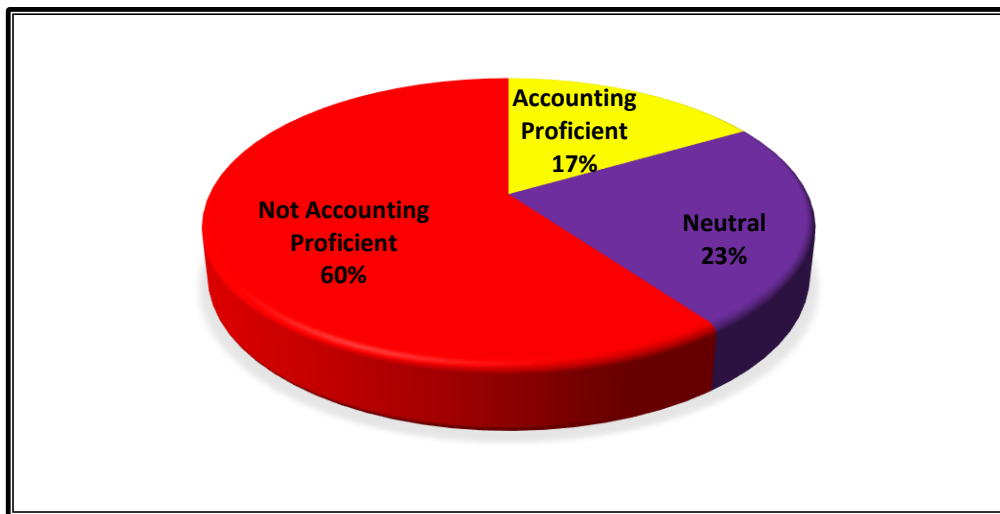
These results corroborate the premise of the Act in that audited (historical) financial statements are of lesser importance in gauging SMEs future sustainability and South African banks



(should) no longer insist on audited financial statements when assessing SME bank loan applications. Only 13% of participants were of the opinion that banks still require audited financial statements from them. These participants however, are entities (e.g. financial services) that are required by the Act to have audits done due to their public interest scores. Their opinion of needing audited financial statements may thus have been tainted, as they have to supply audited financial statements by default due to other legal requirements, rather than due to a specific request from the bank. Furthermore, 77% of participants were of the opinion that independently reviewed financial statements were sufficient, while interestingly, as much as 88% of participants perceived current management statements of importance, and 95% of participants perceived that availability of surety was regarded as important.

***What is the SME's perception of their understanding of basic accounting principles?***

The figure below shows the perceptions of SME owner-managers as to their accounting skillsets.



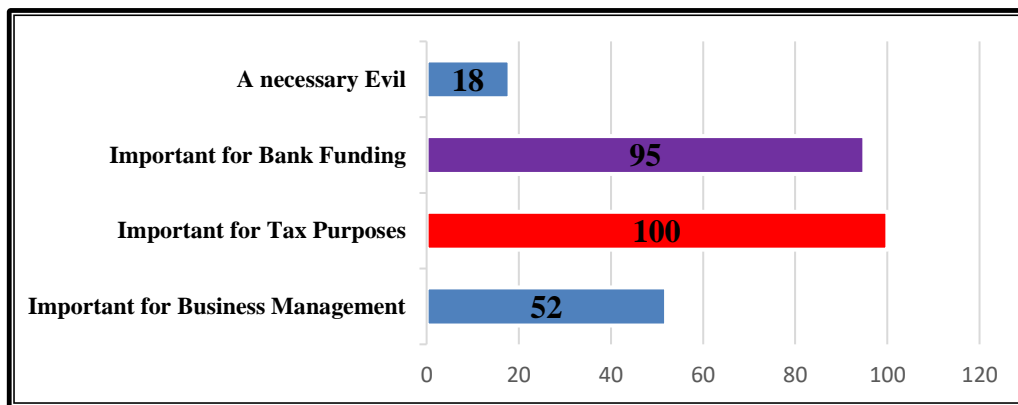
**Figure 5.5: Perceptions on accounting efficiency**

The research found that only 17% of SME owner-managers were confident that they had adequate knowledge of accounting principles. The research further found that 60% of managers were of the opinion that they had little to no understanding of basic accounting principles, with 23% being unsure of their basic accounting knowledge. It would be reasonable to assume that those SMEs that were unsure of their accounting proficiency were a closer correlation to those admitting to a lack of accounting proficiency than to those SMEs that were confident of their accounting proficiency. For the sake of argument therefore, this means that a large majority of

SME owner-managers are of the opinion that they are not proficient in the understanding of basic accounting principles.

***What is the SME's view on the importance of accounting?***

In terms of perceived importance, the figure below presents the following findings.

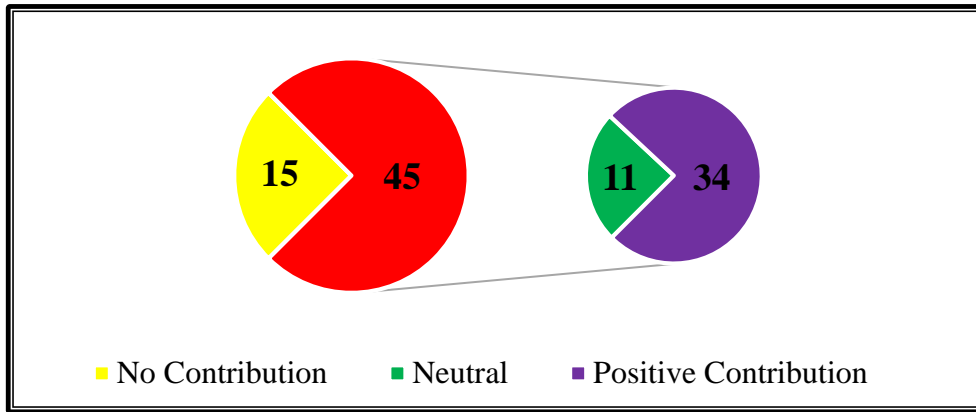


**Figure 5.6: Perceptions on the importance of accounting**

Although owner-managers admitted that they lack basic accounting skills, and would have preferred having an adequate accounting skillset, only 52% actually envisaged using accounting more constructively in their day to day operations. The majority of owner-managers regard accounting as a tool to adhere to statutory tax requirements (100%) and as a requirement when bank financing is required (95%).

***Do SMEs believe accounting is beneficial to their sustainability efforts?***

In terms of the perceived contribution accounting makes to SME sustainability, the figure below presents the following findings.



**Figure 5.7: Perceptions on accounting contribution to sustainability**

The research found that out of 60 participants, 15 (25%) felt accounting had no contribution to make. Of the remaining 45 participants, as much as 34 (56.7%) were positive about the value accounting could add to their sustainability, while 11 (18.3%) were neutral in their view concerning the attributable value of accounting. If viewed as SMEs that are either *negative* or *not negative* towards accounting, one finds that 75% of SMEs are not negative towards the potential inputs accounting may have in their business and subsequent sustainability. This corresponds with research done by Chimucheka and Rungani (2011) under SMMEs in East London, South Africa, who found that 73% of participants were of the opinion that a lack of financial management skills was a threat to their sustainability.

### ***Correlations gleaned from the research***

Spearman's rho correlations were extrapolated from the data gathered from the questionnaires. According to Cohen (1988), correlations, positive or negative, that are between 0.10 to 0.29 indicate a small effect. Correlations from 0.30 to 0.49 indicate a medium effect and correlations from 0.50 and up indicate a large effect. Although various correlations with low, medium and large statistically significant effects were calculated, only a few with more relevant and statistically larger effects will be discussed further. The following Spearman's rho correlations are especially pertinent:

Spearman's Rho		Understanding Accounting	Importance of Accounting	Accounting is a necessary evil
Understanding Accounting	Correlation Coefficient	1.000		
	Sig. (2-tailed)			
	N	60		
Importance of Accounting	Correlation Coefficient	.545**	1.000	
	Sig. (2-tailed)	.000		
	N	60	60	
Accounting is a necessary evil	Correlation Coefficient	-.447**	-.595**	1.000
	Sig. (2-tailed)	.000	.000	
	N	60	60	60
Accounting is valuable for management purposes	Correlation Coefficient	.547**	.804**	-.490**
	Sig. (2-tailed)	.000	.000	.000
	N	60	60	60

\*\* Correlation is significant at the 0.01 level (2-tailed) \* Correlation is significant at the 0.05 level (2-tailed)

**Table 5.2: Spearman Rho correlations**

The table above indicates the following:

- SME owner-managers who have a basic understanding of accounting are also convinced of the importance of accounting to their business sustainability, ( $r = 0.545$ ; large effect).
- SME owner-managers who have a basic understanding of accounting are also convinced that accounting can play an important management role in their business, ( $r = 0.547$ ; large effect).
- SME owner-managers who do not understand accounting have a negative correlation to the view on the importance of accounting and think that accounting is nothing more than a necessary evil ( $r = -0.447$ ), they also do not believe accounting is important for business sustainability ( $r = -0.595$ ; large effect) or that accounting can contribute to business management ( $r = -0.490$ ; medium effect).
- Those SME owners who understand the importance of accounting also believe that accounting can have a valuable contribution as a management tool ( $r = 0.804$ ; large effect).

## 5.5. Concluding discussion

The literature study undertaken brought to the forefront the dilemma the new Act has created for South African SMEs between choosing an expensive audit or a cheaper independent review alternative, perhaps at the peril of sacrificing a bank's goodwill. The purpose of this research was to investigate whether the local SMEs have embraced the independent review, and whether they consider accounting knowledge and skills to be potentially conducive in their sustainability quests. After closer analysis of the research data we can draw various conclusions pertaining to the research problems, including:

- From a South African point of view, audits for SMEs seem to have made the extinction list and SMEs may actually prefer the independent review route because it is more cost effective and has less of an administrative burden.
- The research further confirms that many South African SME owner-managers do not regard themselves as accounting literate and that they regard themselves as being on the lower end of the scale of knowledge of basic accounting principles.
- The research further confirms that South African SME owner-managers are divided on the value accounting can offer their business, with 52% seeing the daily operational value of accounting to their business and only 18% seeing no value whatsoever. If one considers that 83% of owner-managers perceived that they didn't have sufficient knowledge of accounting, one may infer that, although 52% would have liked to use accounting in their business, they cannot and thus will not, because they simply lack the necessary accounting insights.

The research brings some insight into the much-speculated topic of the value of audited financial statements to SMEs in terms of the loan application processes. What the research has also brought to light is that SMEs do not have to be *cannon fodder* when applying for loans. By augmenting their business environment with basic accounting skills, they can potentially improve their chances of favourable loan applications while simultaneously increasing their chances at sustainability. It was earlier indicated that SMEs are a very important part of global economic progress. There is no doubt that SMEs face many challenges on a day to day basis, and that we should regard the acumen SMEs demonstrate year in and year out with high regard. However, there are areas of business, where SMEs need to step up and show their resilience.

They need to consider improving their accounting skillsets. They need to learn the language of business.

Limitations and future research arising from this research could include the evaluation of whether an improvement in accounting skillsets will i) improve the loan approval rate of SMEs and ii) improve the sustainability of SMEs. Further research may also be required as to what basic accounting skills are necessary to constitute being proficient in accounting in terms of SME sustainability requirements.

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Act *see* South Africa

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## CHAPTER 6: RESEARCH ARTICLE 4

**Title:** Independent Review or Audit? The SME decision and related accounting issues worth pondering

The reader is requested to take note of the following:

- This article has been *submitted* to the following peer-reviewed academic journal as follows:
  - Coetzee, F. & Buys, P. Independent Review or Audit? The SME decision and related accounting issues worth pondering. *Negotia*, (Submitted) (ISSN: 1224-8738).
- The article has been written in line with the journal's submission guidelines for articles which are included in **Annexure E** on page - 143 -.
- The article was researched and written by the first author (Coetzee, F) as the PhD candidate and primary author, while the second author (Buys, P) fulfilled a reviewer function thereto as the PhD project's promoter.

**Title**

Independent Review or Audit? The SME decision and related accounting issues worth pondering

**Abstract**

SME accessibility to finance is widely regarded as a crucial contributing factor to sustainability. It is also generally accepted that access to finance is considerably more difficult for SMEs than for larger corporations. The statutory audit of financial statements for qualifying SMEs in South Africa has been abolished and replaced with the option to do an independent review of the financial statements. The primary research problem being investigated in this study is whether the lack of audited financial statements has negatively affected SME access to bank financing. This is done by testing the perspectives of SME owners / managers in this regard. The secondary research problem looks at mitigating action SMEs can take to improve their risk profile during a banks assessment of a loan application. Knowledge of basic accounting principles has been identified as a potential mitigating factor by various researchers. This study gains insight into the views and perceptions of SME owners / managers pertaining to their perceived accounting knowledge and or skillsets.

**Key words:** Accounting proficiency, audit, independent review, SME finance, SME sustainability

**JEL Classification:** M13, M41, M42, M48

## **6. INDEPENDENT REVIEW OR AUDIT? THE SME DECISION AND RELATED ACCOUNTING ISSUES WORTH PONDERING**

### **6.1. Introduction**

*“It’s a troublesome world. All the people who are in it, are troubled with troubles almost every minute.”* (Geisel, 2016).

Although the above quote by ‘Dr Seuss’ may have been directed at a younger audience, it does encapsulate the day to day strife of the contemporary small and medium enterprise to become sustainable. The concept of a *Small and Medium Enterprise* (SME) is globally recognized, denoting business entities that are not classified as big (corporate-type) business organisations. Although there are various opinions as to the defining characteristics of what constitutes an SME, Mahembe (2011) expresses the view that it is practical to define an SME by its relative small number of employees, or by its relative small annual turnover, or by a combination of the two. Surveys done by the World Bank (2015) have found that SMEs play a definitive role in many global economies, but more so in developing economies - taking only formal SMEs into account, they contribute up to 33% of GDP in such developing economies. If one was to add informal SME statistics to these numbers, the SME contributions to GDP would be substantially higher. Furthermore, according to the World Bank (2015) most jobs (approximately 80%) in emerging markets are created by SMEs. From a South African perspective, SMEs constitute as much as 91% of formal businesses and further contribute roughly 57% to the local GDP and 61% to the domestic workforce (Abor & Quartey, 2010). With contributions as significant as these, it is imperative that the SME sector is nurtured and supported by all and sundry in order to sustain and enhance their economic and societal impact globally.

Notwithstanding its importance, there is a myriad of problems facing SMEs on a daily basis, such as inaccessibility to external financing, a competitive business environment, a lack of technical, financial and managerial skills, a lack of research and developmental infrastructure, an unskilled labour force, many tax and statutory administrative burdens, and various other internal and external factors (Yoshino & Taghizadeh-Hesary, 2016; IRMSA, 2015). As daunting as all these challenges may seem, various authors have found that one of the greatest obstacles to SME sustainability, is their struggle to obtain bank finance (Malhotra *et al.*, 2007;

Wattanapruttipaisan, 2003; Ayyagari *et al.*, 2012; Beck *et al.*, 2005; World Bank, 2013). Without finance availability, SMEs cannot be innovative and expansive and will remain stagnant and even unsustainable. In this regard, Mills and McCarthy (2014) found that bank loans are a crucial method of finance utilized by many SMEs. In fact, more than 80% of SMEs consider banks as a key source of business funding (NFIB, 2012; Mahembe, 2011). With this in mind it is disconcerting, from an SME perspective at least, to note that only approximately 30% of SMEs that apply for bank loans, are eventually approved (Mazanai & Fatoki, 2012; Mahembe, 2011; Turner *et al.*, 2008). The success of a bank loan application has historically been dependent on the submission of audited financial statements, which banks relied upon during the application review process (Grant Thornton, 2008; Pitcher Partners, 2010).

Access to finance has been made difficult by the fact that banks have historically regarded SMEs as a greater risk than big corporations as far as debt is concerned (The Conversation, 2012; Haynes *et al.*, 1999). To mitigate this risk, banks would put SMEs through a more rigorous screening process, which included the requirement for audited financial statements (Accountancy Asia, 2011; SAICA, 2010; Pitcher Partners, 2010). However, in South Africa, a new Companies Act, No. 71 of 2008 (referred to the Act hereafter), brought about the abolishment of the *statutory audit* requirement for qualifying companies in favour of the so-called *independent review* alternative thereto (Act, 2008). A similar fate has befallen statutory audits in countries such as the USA, the UK, Australia, Canada and Singapore where mandatory audits are no longer required for all companies (Salleh *et al.*, 2008; Abdul Aziz, 2002). With the advent of these *lesser requirements*, SMEs (including South African SMEs) are left with a difficult decision. Do they keep on doing an audit (at a higher cost) and improve their chances at obtaining bank finance, or do they opt for the cheaper independent review and run the possible risk of having their loan applications rejected?

## **6.2. Research problem and methodology**

As stated above, the implementation of the Act in South Africa led to a conundrum for SMEs in that audits are no longer required for qualifying companies, while banks in fact have historically placed substantial reliance on audited financial statements to aid in evaluating loan applications. Therefore, this article takes a closer look at the views and perceptions of SMEs pertaining to the choice the new Act has laid before their door, i.e. that of the audit versus independent review.

In order to come to a holistic understanding of the issue, a mixed method research approach was followed. Firstly, a literature review considers i) the development and importance of accounting and ii) the potential shortcomings and benefits of an audit versus an independent review. Secondly, the literature study is supplemented with empirical surveys from i) a bank perspective on bank finance approval requirements for SMEs, via surveys of the four largest SME finance providers in South Africa, and ii) an SME perspective on bank finance approval requirements from banks, via surveys of 60 SME entities throughout South Africa. The article ends with some concluding remarks and final comments.

### **6.3. Development and importance of accounting**

#### **6.3.1. A historic departure**

A glance at the historic development of accounting when trying to gauge the effect of an *audit* versus an *independent review* engagement may seem rather counterintuitive, but it does provide a good foundation into the realities of SMEs. From an accounting perspective, the decision an SME has to make between an audit or an independent review is more far reaching than just the access to finance quandary. It cuts into the very fabric of the value accounting offers to SME sustainability and growth. In this regard, Buys (2011) views accounting as a value adding necessity and not merely a *bookkeeping activity*. Emphasizing this very viewpoint, Warren Buffet holds accounting, and the knowledge thereof, in such high esteem that he refers to accounting as *the language of business* and a discipline that every shrewd business person should *understand* (Buffet & Clark, 2008).

Accounting developed because there was a specific need that was present at the right time in the right place (Edwards, 1960). Effectively we can say that accounting developed and evolved because commerce developed a specific need that kept on evolving. Edwards (1960) also theorizes that accounting did not develop randomly, but rather in logical and consecutive phases. These phases were:

1. Record keeping, i.e. preserving of documents to substantiate transaction legality;
2. Bookkeeping, i.e. progression of record keeping in that transactions are recorded and reported; and



3. Accounting, i.e. progression of bookkeeping in that transactions are substantiated, recorded, reported, summarized and subjected to control mechanisms.

The theory that the accounting developmental process can be equated to a specific need that developed and evolved, correlates nicely with the opinion raised by Sangster (2010) when he says that the double entry accounting system was necessitated (*need*) by the fact that Italy's commerce (*specificity*) had developed (*development*) into a system where business people started using agents and partnerships to trade with (*evolution*). The evolution of accounting theorem did not stop with Luca Pacioli, often considered as *the father* of double entry accounting (ten Have, 1976), when he published his book *Summa de Arithmetica, Geometria, Proportioni et Proportionalita* (roughly translated as *Everything About Arithmetic, Geometry and Proportion*) in 1494 (Alexander, 2002). This publication has been regarded as the basis for modern day accounting theory for many decades (Fogo, 1905; McCarthy *et al.*, 2008). As specific needs developed, accounting adapted and improvised. Warsono-bin-Hardono (2013) argues that accounting's initial purpose was to provide and reproduce reliable information, originally, to be of value to all relevant stakeholders. This purpose may unfortunately have left the initial premise of *reliable information for all* in the past. Currently, the reliability extracted from accounting is very much dependent on the user's understanding of complex accounting standards and principles. For SME owners therefore, the choice between audit or independent review should start with the question: "Where do I get the most useful, reliable and helpful information?"

### **6.3.2. Audit versus independent review**

The implementation of the Act in South Africa had very good intentions in that its objectives included the creation of flexibility in the organisation of companies, a less burdensome regulatory environment, the promotion of efficiency and transparency in corporate governance, and bringing the local company legislation in line with international developments.

Significant to auditors, accountants and SMEs alike was the introduction of the *independent review* as an alternative to a *statutory audit*, which can bring about a potential cost saving in auditor fees, i.e. in preparing and maintaining audit files, and in administrative fees i.e. company regulatory requirements (Othman *et al.*, 2013). Nevertheless, there have been reservations as to the trade-off between helping SMEs save costs and burdensome

administrative compliances and the value an audit may hold (Othman *et al.*, 2013), including the following:

- Third parties such as banks, taxation authorities and shareholders may still require audited financial statements as a means of acquiring the necessary assurance as to the reliability of assertions made in the financial statements.
- Furthermore, where an SME's owner is also the manager, the manager would essentially be reporting to himself. Valuable third party insight and advice into the SME's dealings, which could have been gleaned from an audit, may now fall by the wayside.

Qualifying SMEs, in terms of the new Act, now have to choose between staying with a statutory audit, or having an independent review done. The following table gives a systematic comparison to high-light key differences between the two engagement types.

Attribute	Audit	Independent review
Assurance level	Reasonable assurance about the absence of material misstatements.	Limited assurance about the absence of material misstatements.
Objective	Reasonable assurance about the fair presentation and absence of material misstatements. An audit opinion is provided regarding the level of assurance.	Limited assurance enabling a basis for reporting whether any material issues arose from the procedures conducted.
Internal control investigation	Yes	No
Test internal control effectiveness	Dependent on audit strategy and risk assessment	No
Third party verification	Yes	No
Procedures in support of assurance requirements	Yes	No
Financial statement preparation is a management responsibility	Yes	Yes
Fraud investigation	No	No
Performs inquiry and analytical procedures.	Yes	Yes
Performs verification and substantive procedures.	Yes	No
Practitioner credentials	Registered public auditor	Lesser requirement of being a registered accountant
Cost implications	Involves the most work and risk and thus the cost is substantially higher.	Not as labor or risk intensive and thus a substantially lower cost implication.

**Table 6.1: Audit versus Independent Review**

*(Adapted from: AICPA, 2015; Kennelly, 2012; Mann Weitz & Associates, 2012)*

Based on the above, it is obvious that an independent review is not only a cheaper alternative, but is less intrusive into the operations and activities of the entity. In the South African context therefore, consideration is now given to the specific requirements that would allow an entity to

qualify for an independent review as opposed to an audit. Regulation 26 of the Act prescribes the method that should be used to determine whether a statutory audit is still mandatory or whether an independent review may be used. Shev (2012) explains that the method by which this determination is made is based on calculating the entity's so-called *Public Interest Score* (PIS), which is essentially calculated by allocating points in the following manner:

- One point for each employee (based on the average number of employees as defined in the Labour Relations Act No. 66 of 1995) that worked at the company during the financial year under review.
- One point for every ZAR 1 million<sup>3</sup> (or portion thereof) in turnover generated during the financial year under review.
- One point for every ZAR 1 million (or portion thereof) of third party liability the company had at yearend of the financial year under review.
- One point for every individual who directly or indirectly held a beneficial interest in the issued shares of the entity during that year.

Using the above points calculation, further inter-related criteria points are considered to determine whether an entity is considered a qualifying entity for and independent review, or whether it should still conduct an audit, as illustrated in the table below:

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<sup>3</sup> ZAR (or South African Rand) is the local currency. At the time writing the exchange rate was approximately ZAR 13.20 to USD 1.00.

<b>Public Interest Score</b>	<b>Management structure</b>	<b>Accounting record compilation</b>	<b>Audit vs Independent Review</b>
< 100	Owner	<i>(Not Applicable)</i>	None
< 100	Non-owner	<i>(Not Applicable)</i>	Independent review
100 to 349	Owner	Internal	Independent review
100 to 349	Owner	Independently	None
100 to 349	Non-owner	Internally	Audit
100 to 349	Non-owner	Independently	Independent review
350 +	<i>(Not Applicable)</i>	<i>(Not Applicable)</i>	Audit required

**Table 6.2: Summarised audit versus independent review requirements**

*(Adapted from: SAICA, 2012; CQS, 2012)*

What further complicates the decision to choose between an audit or an independent review for SMEs, is the fact that the PIS calculation may fluctuate from year to year (Shev, 2012), which will result in the auditing requirements in terms of the Act also potentially changing from year to year. In instances such as these, the initial cost saving benefits of not performing an audit may be negated. With no continuity in the audit engagements, it may be difficult for auditors to place reliance on previous financial statements and thus verifying the opening balances may require more time and effort from auditors, thereby making the audit even more expensive than what a continuous engagement might have been. Some of the major benefits and disadvantages between the two options that are important for SMEs to consider, are provided in the table below:

Audit	Independent review
Audit work is more rigorous and contains more in-depth procedures which may provide management with valuable information that can contribute to the SMEs sustainability efforts.	It is less rigorous and thus substantially cheaper than a statutory audit and is less administratively burdensome.
It gives a higher level of assurance that the financial statements are a fair reflection of the business.	It is an easier process, thus saving the SME time spent with the reviewer.
The requirement to review internal controls can provide useful recommendations to management.	Gives a moderate form of assurance to stakeholders and third parties that the financial statements have been reviewed by an independent person.
More onerous process which can be time consuming and can place a large administrative burden on the SME.	Less depth of work. Thus, not producing as much value to management in the form of feedback and recommendations.
Much costlier than an independent review.	No requirement to review internal controls or produce a management letter.

**Table 6.3: Audit versus independent review considerations**

(MacIntyre, 2015)

Based on the above therefore, the audit exemption decision is an important consideration in an SME's sustainability consideration. Careful thought and contemplation is required from SME owners to choose what is best in terms of their company's vision and mission.

#### **6.4. Bank perspective on SME audited financial statements**

As much as access to finance is regarded as a key threat to SME sustainability, banks are not too keen to take the blame for the lack of finance availability. Wiersch and Shane (2013) found that banks attribute the perception that banks are not lending money to factors such as a lack of demand for credit from SMEs, asymmetric information from SMEs and the inability to show how loans were going to be repaid. According to OECD (2009) tougher regulations are often imparted on banks, which then get passed on to clients. Berger and Udell (2006) found that

banks often use *financial statements* when considering loan applications. The question that needs answering therefore is whether *audited* financial statements improve the chances of SMEs getting loan applications approved.

To answer this question in a South African context, the applicable requirements from the four largest banks, which according to the Banking Association of South Africa (2014) represent approximately 82% of the banking market share, were obtained and analysed. The relevant loan application information was collected from their websites, supplemented by hard copy applications available from the banks themselves. Finally, the informational requirements were also clarified by discussions with loan officers at the different banks. The research found that the South African banks have essentially adapted to the new Act by no longer requiring SMEs to submit audited financial statements, but that statements such as (and confirmation of) the i) cash flow statements, ii) management statements, iii) business plans and iv) the provision of security are currently of more importance in evaluating loan applications. Therefore, a conclusion can be made that historical financial information, such as audited financial statements, is becoming of lesser importance compared to more current information, such as cash flow statements, business plans, management accounts, and especially some form of security – all indicating the SMEs' ability to make the required repayments.

## **6.5. SME perspective on accounting and audited financial statements**

Based on the research done as referred to in the previous section concerning the importance banks place on audited financial statements, further research was conducted to gauge the view of SMEs pertaining to the same scenario, in other words what the SMEs' perceptions are regarding the importance of audited financial statements. In doing so the SME database of a (registered) external auditing firm with a countrywide footprint was used to withdraw the sample from, resulting in 60 participants spanning the country and covering various industries.

The research indicated that the SME owners concurred with the finding that South African banks no longer insist on audited financial statements when assessing loan applications. The research further indicated that SME owner-managers believe surety (95% of participants) and current management statements, including cash flow statements (88% of participants) are of more importance to bank loan approval processes than the availability of audited financial statements.

This leads us to the inevitable question of how SMEs can improve their chances of having loan applications granted by banks? With audited financial statements no longer required, and banks circumspect of asymmetrical information, it stands to reason that the more ‘reasonable’ information SMEs can present to banks, the more likely banks will be to accept such information as reliable. This in turn should improve SMEs’ chances of convincing banks of their sustainability and lower risk assessments during loan applications. Sian and Roberts (2009), Chimucheka and Rungani (2011) and Haron *et al.* (2013) all agree that SMEs, more often than not, lack basic accounting knowledge. This lack of accounting acumen can lead to asymmetric information being produced and supplied by SMEs, as a lack of understanding and value attribution leads to an indifferent attitude towards accounting. The following table is an extract of some of the more relevant statistical effects with medium to high correlations as per Pearson’s statistical analysis.

<b>Pearson’s Correlation</b>		<b>Understanding Accounting</b>	<b>Importance of Accounting</b>	<b>Accounting is a necessary evil</b>
Understanding Accounting	Pearson Correlation Sig. (2-tailed) N	1  60		
Importance of Accounting	Pearson Correlation Sig. (2-tailed) N	.597** .000 60	1  60	
Accounting is a necessary evil	Pearson Correlation Sig. (2-tailed) N	-.477** .000 60	-.664** .000 60	1  60
Accounting is valuable for management purposes	Pearson Correlation Sig. (2-tailed) N	.547** .000 60	.768** .000 60	-.490** .000 60

\*\*Correlation is significant at the 0.01 level (2-tailed) \*Correlation is significant at the 0.05 level (2-tailed)

**Table 6.4: Pearson’s correlation analysis**



The following statistically significant correlations found using Pearson's correlation analysis, include i) the SME owner-managers with a basic understanding of accounting correlate positively to the view that accounting is important to their business sustainability, ii) that SME owner-managers with a basic understanding of accounting correlate positively to the view that accounting can play an important managerial role in their business, iii) that SME owner-managers with little or no understanding of accounting correlate negatively to the views on the importance of accounting, the importance for business sustainability and the possibility that accounting can contribute to business management, and iv) that SME owner-managers who understand the importance of accounting correlate positively with the view that accounting can have a valuable contribution as a management tool.

The research indicates that the value accounting can have as a managerial tool and as a contributor to SME sustainability is directly correlated with the SME's understanding of accounting and of the perception of its importance. Likewise, the lack of basic accounting knowledge is directly, although negatively, correlated with the perception that accounting can add value to SME sustainability.

## **6.6. Conclusion**

The value the SME sector contributes to national GDP and job creation globally is irrefutable. As such, it is in the best interest of worldwide economic welfare for SMEs to be sustainable, progressive and economically viable. These goals however, are constantly being challenged due to the very competitive and unforgiving milieu in which SMEs operate. They are faced with various challenges ranging from exchange rate pressures, employment requirements, keeping abreast of technological advances to competing against big corporate role-players. Among all the adversities SMEs face however, few have a more direct and prolific influence on SME sustainability than access to finance.

The research conducted corroborated the findings from earlier research that held that banks no longer require SMEs to submit audited financial statements, when applying for loans. At first glance, this may seem to be a positive development for SMEs. The initial thought would be that SMEs will shake off a costly and administratively burdensome requirement. As banks abandon the requirement of audited financial requirements, and the accompanying reasonable assurance of accurate financial information, banking regulations are continuously tightening in

terms of stringent loan processes. SMEs are however not helpless in these times. Research from various sources found that SMEs often do not have a basic grasp of accounting principles and methodologies. The research conducted in this study confirms this conclusion. Most SMEs are trying to survive in a financial arena, without having any financial acumen. Various researchers have suggested that by addressing shortfalls in basic accounting knowledge, banking fears concerning sustainability and affordability may very likely be appeased.

SMEs can learn from these results. Empowering themselves with knowledge, in this case the language of business – accounting, purports to hold significant advantages for their business sustainability and expansion. As Rohn (2016) said:

*“You must either modify your dreams or magnify your skills.”*

In terms of limitations, this research did not test the accounting knowledge of SME participants in depth. Perceptions were rather tested. Further research as to the level of actual skillsets is required. Further research into the basic accounting skills SMEs will find useful in their daily business dealings will be of great value as well.

## 6.7. References

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## **CHAPTER 7**

## 7. SUMMARY AND CONCLUSION

### 7.1. Background

It is widely accepted, and seldom disputed, that small and medium enterprises (SMEs) are a driving force in many economies throughout the world, and that they contribute significantly to employment creation as well as to the GDP levels of the countries in which they are economically active. Within a South African context, it is estimated that more than 90% of formal business entities are SMEs, with an approximated contribution to the South African GDP as high as 57%, while its contribution to national employment are estimated at close to 61% of all employment opportunities. The value that SMEs add on a daily basis to the global economy is so significant that losing or inhibiting these contributions is nothing less than flirting with economic and social disaster.

The unfortunate reality is that SMEs' sustainability worldwide is under serious threat. It is another rarely disputed fact that SMEs are dependent on the accessibility of finance as a driving force for growth, innovation and ultimately its continued sustainability. However, various studies have found that *accessing* bank finance is one of the major obstacles to SME sustainability. The fact that SMEs find it harder to access bank financing than larger corporations do, is essentially due to SMEs producing and providing asymmetrical and opaque (business and financial) information to banks when applying for loans. This automatically raises the perceived risk banks attribute to SMEs and thereby making approving finance applications that much more difficult. To mitigate this perceived risk, banks have historically relied on audited financial statements to provide a semblance of reasonable assurance that the financial information they are using to evaluate internal loan risk is free of material misstatements. In this way, the asymmetrical nature of SMEs' financial information could have been moderated.

This *modus operandi* has, however, been challenged with the adoption of a new Companies Act, No. 71 of 2008 (Act), in South Africa. The advent of the new Act has brought about the abolishment of the statutory audit requirement for qualifying companies and has introduced the concept of the *independent review*. The significance hereof being that, whereas an audit gives a reasonable assurance that financial statements are a fair representation, an independent review only gives a limited assurance thereto. Herein lies the challenge for SMEs. Being cognisant of

the fact that banks have historically relied on audited financial statements when considering loan applications, SMEs now have to weigh audit expenses and administrative burden against potentially improved loan approval success rates. As SME financing is such a prevalent and important topic, the focus of this study was to investigate whether audited financial statements still hold value to SME accessibility to bank finance, considering the requirements of the new Act.

## **7.2. Research problem and objectives**

Seen in light of the above, and as indicated in Chapter 1 in section 1.4 on page - 5 -, the search in this study was undertaken under the premise of the following primary research question, namely:

Has the advent of the independent review impeded SME access to bank finance?

In order to adequately answer this broadly defined research question, the following secondary research questions have been identified (as per chapter 1 on page - 7 -):

- Firstly, it is important to understand the essential purpose of accounting as the *business language*. Therefore, an objective was to reflect on what the historically intended purpose and role of accounting was, and whether it has remained relevant as a business tool in the contemporary SME business environment.
- Secondly, the advent of the independent review needs to be considered from the perspective of the finance providers, i.e. the banks. Therefore, a second objective was to gauge the value that South African banks place on audited financial statements when considering funding applications from SMEs.
- Thirdly, building on the above objective, the independent review needs to be considered from the perspective of the finance receivers, i.e. the SMEs. Therefore, a third objective was to gauge what the SME owner-managers' perceptions were regarding the premise of the Act that audited financial statements no longer hold any advantage to SMEs in applying for bank finance. Furthermore, building hereon, consideration also needed to be given to the SME owner-managers' views on the importance of accounting in contributing to their bank finance access abilities.
- Finally, from a holistic perspective, consideration had to be given to the pragmatic evaluation of the independent review itself. Consequently, the final objective is, based

on the findings of the previous three objectives, to reflect on what an independent review in actuality entails, as opposed to an audit, and what the implications of selecting one above the other are.

The primary objective of this study is therefore essentially encapsulated in a holistic understanding of the potential impact of the advent of the independent review, and the importance of accounting as business tool on SMEs' ability to attract bank financing.

### **7.3. Research synopsis and discussion**

#### **7.3.1. Research method and approach**

In an attempt to shed light on the value of an audit to SMEs, in terms of accessing bank financing, a multi-pronged research approach was followed, consisting of both i) literature and empirical study components, and ii) encompassing both quantitative and qualitative approaches. The research was conducted as follows:

- Firstly, a reflective historic view and literature study of the emergence and development of accounting as a discipline were undertaken.
- Secondly, published loan application documentation from four (4) major South African banks was scrutinised and supplemented with discussions with loan officers in order to establish the banks' requirements in terms of supporting documentation.
- Thirdly, a sample of sixty (60) SMEs from across the country, and representing diverse industries, was identified and interviewed to i) gain insight into their perspectives in terms of what banks require from them when applying for financing, and ii) gauge their perceptions on the importance of accounting in their quest for sustainability.
- Finally, a reflective literature study, supplemented with the findings from the bank and SME empirical studies, was conducted to obtain a holistic view of the realities of the advent of the independent review within the context of the South African SME.

The data collected from the above questionnaires and interviews were statistically analysed using the SPSS software package, for correlations, exceptions and occurrences. The statistically significant data were used to draw conclusions and recommendations. A more specific synopsis of each objective is presented below.

### 7.3.2. The future of accounting's past

The focus of this research objective was to ultimately contribute value, enlighten and enrich the sustainability sphere of the phenomenon known as the SME. Literature has shown that a major constraint to the access of bank financing is the asymmetrical and opaque nature of information produced by many SMEs. With accounting being referred to as *the language of business*, and bank loan assessments relying heavily on financial information, which is produced via accounting methodologies, one can reason that accounting may very well be one of the culprits in SME financing woes. However, accounting is generally regarded as a system designed to bring order and transparency. To understand why this order and transparency may not always be reflected, one needs to go back to the annals of history to track the origin and evolution of accounting as a discipline. By doing this, we may be able to identify, and rectify, why SMEs have landed on a divergent course as far as accounting, as a valuable managerial tool, is concerned. In this regard, understanding the historic development of accounting as a discipline is an important component in analysing the mindset of SMEs towards accounting. Undeniably, the attributes of accounting as a discipline are due to a historically influenced developmental process.

When considering whether accounting still holds relevance to the contemporary SME, the first thought that comes to mind is the impact that the introduction of accounting standards, such as IFRS, may have had on accounting's relevance. These standards are continuously and dynamically evolving and changing and may appear to be unnecessarily complex and cumbersome. Historically, though, literature reminds us that the evolution of accounting was due to a specific necessity aimed at solving a specific need that was present at a specific time in a specific place.

We found that accounting developed in sequentially, identifiable phases. These phases were:

- Record keeping: The preserving of documents as evidence of a business transaction.
- Bookkeeping: The analysis, classification and recording of business transactions as the basis for financial reporting.
- Accounting: Bookkeeping with additional summaries and control functions.

Record keeping did not have a single point of origin. Different societies must have experienced similar problems (the need to record evidence of trade), which they each addressed in their own

unique way. The need to record evidence of *day-to-day* trading has not changed and this necessity still prevails today.

The evolutionary process ensured that a more detailed system of recording was required, which led to the transition from *single-entry* to *double-entry* bookkeeping. The first use of auxiliary accounts was seen during this transition. The need to assign more detail to transactions and to be able to group and classify transactions are again traits that are still required in today's contemporary business environment.

Accounting's next evolutionary step was the first step in the wrong direction in terms of the value that accounting holds for SMEs. Until this point, accounting's main function was in service of the business owners and partners. The next step in the accounting evolution, however, was in service of third parties. The transition from a *bookkeeping* system to an *accounting* system occurred towards the end of the 15<sup>th</sup> century. This transition occurred because reporting needed to be done to third parties such as shareholders and investors. The contemporary SME is also exposed to the need for external reporting to the likes of shareholders, investors and banks. This necessitated a far more transparent, accurate and analytic system of accounting.

From the research, it is clear that the drivers that necessitated the origination and evolution of accounting are still present today. The shift between being relevant and being perceived as irrelevant may rather be found in current complex accounting regulations, which have created the perception that there are no basic accounting principles for the layman to fall back on. The created perception of accounting is that one either uses IFRS or one uses nothing. With no middle ground, the average SME has been convinced that accounting cannot be used as a valuable business tool. One should not, however, make the mistake of judging the usefulness of accounting by the complexity of contemporary regulations. The usefulness to the SME is to look past the professed complexities and fall back to the historic values of recording, classifying, analysing and summarising transactional data in an orderly and transparent way.

### **7.3.3. The impact of the independent review on SME access to bank finance**

Prior research has indicated that an estimated 80% of SMEs regard banks as their primary source of business financing. Although bank financing is the preferred source of financing among SMEs, research also found that as few as 30% of SMEs that apply for financing have

their applications eventually approved. SMEs have blamed banks for not lending and for making lending requirements virtually impossible to adhere to. Banks have rebutted by claiming that:

- there is a diminished demand for credit from SMEs;
- tighter lending conditions were not by choice, but due to stringent loan criteria forced down on them by regulators;
- banks are more risk adverse due to the high failure rate of SMEs; and
- SMEs themselves are to blame for unapproved loans due to asymmetrical and opaque information accompanying loan applications.

Historically, banks have relied on audited financial statements to mitigate the risks involved with SME lending practices. Under current legislation, however, SMEs have the option to not have an audit done, but rather to opt for an independent review. The cost of an audit as well as costs associated with the internal compliance required during a financial year in preparation of an annual audit can be a driver for SMEs to rather abandon the audit option. The cost factor, however, will be exacerbated if SMEs do not perceive there to be any internal value in the audit process. The only potential value SMEs could derive from an audit is an improved chance at successfully applying for bank financing because of the risk-mitigating value that audited financial statements can provide. If SMEs do decide to not have an audit done, it will imply that banks have to evaluate loan applications without the reasonable assurance that the information they are basing their decisions on is fairly presented and free of material misstatements. Banks will therefore have to make loan decisions based on *best guess* scenarios and under moral hazard. The literature study has established that access to finance is a major constraint faced by SMEs in the contemporary business environment. Losing their access to finance will consequently have disastrous consequences to an SME. The choice between an audit and an independent review, at the risk of losing their bank financing, is therefore a crucial SME decision.

The research problem in this chapter was whether banks still place value on audited financial statements when assessing loan applications from SMEs. In achieving this, four (4) of the big banks in South Africa, with a combined asset value representing in excess of 80% of the market, were used to investigate this question. Loan applications were obtained from each bank and the requirements per bank analysed.

The following is a summarised table of this analysis:

Description	Bank 1	Bank 2	Bank 3	Bank 4
Audited financial statements	No	No	No	No – potential requirement for new clients
Independently reviewed financial statements	Yes	Yes	Yes	Yes
Cashflow statement	Yes	Yes	Yes	Yes
Management statements	Yes	No – unless financial statements are out dated	No – unless financial statements are out dated	No – unless financial statements are out dated
Business plan	Yes	Yes	Yes	No
Financial information of directors/members/partners	Yes	Yes	Yes	Yes
Security required	Yes	Yes	Yes	Yes

**Table 7.1: Bank requirements in consideration of SME finance application**

The above research shows that none of the four (4) major banks insisted on audited financial statements as a requirement when applying for funding and that they do approve of financial statements set in terms of an independent review. All the banks were adamant though about the availability of sureties. From the above, we can draw the conclusion that banks have adapted to the requirements of the Act and no longer insist on audited financial statements when assessing credit applications. Although cases may differ from one bank to another, and from one client to another, the overall consensus seems to be that audited financial statements are no longer a prerequisite for a successful loan application.



#### **7.3.4. SME perceptions of the independent review and accounting**

As mentioned earlier, published literature confirmed that access to finance is widely regarded as one of the biggest obstacles to SME sustainability. Banks are regarded as the biggest funding organ to SMEs with approximately 85% of SMEs indicating that they use bank finance in one form or another. The literature further indicated that SMEs' sustainability is unequivocally concomitant to their ability to access adequate financing. The research undertaken in this study confirmed the conclusion of the previous objective in that the SME owner-managers corroborated the view that banks no longer insist on audited financial statements when considering loan applications. In summary:

- 77% of participants were of the opinion that independently reviewed financial statements were acceptable;
- 88% of participants perceived current management statements as an important requirement; and
- 95% of participants perceived the availability of securities as important for a successful loan application.

The study also revealed that the most likely way for SMEs to break the stigma that their information is asymmetrical and opaque is for SME owner-managers to improve their basic accounting and managerial skillsets. Researchers hold the view that banks may be more at ease with the financial information if they know that sound business practices, based on sound accounting and managerial skills, were underlying the business to be funded. Within the South African context, therefore, the research indicated that:

- 17% of SME owner-managers were confident that they had adequate knowledge of accounting;
- 60% of them were of the opinion that they had little to no understanding of basic accounting principles;
- 23% are unsure of their basic accounting knowledge;
- 52% of SME owner-managers envisaged using accounting more constructively in their day-to-day operations.

Deepening the analysis somewhat, the data indicated that there is a direct correlation between having a basic knowledge of accounting and understanding the value of accounting. Similarly,

there is an inverse correlation between not having a basic knowledge of accounting and understanding the value of accounting. SME owner-managers who see no value in accounting also have no knowledge of basic accounting principles. While researching the history of accounting, it was found that SMEs may have lost faith in the value accounting has to offer them in a practical business environment. The results of this research reiterate those sentiments. SMEs, for the larger part, understand and believe that accounting has value to add, and that they would use accounting more if they were able to. Implicitly, one can therefore assume that they perceive accounting as too complex and complicated for them to use on a daily basis. With accounting being nothing less than a universal language used in business globally, SMEs will do themselves no harm in empowering themselves with the basic principles and jargon of accounting.

#### **7.3.5. Independent review or audit? The SME decision and related accounting issues worth pondering**

With the implementation of the new Companies Act, No. 71 of 2008 (Act), qualifying SMEs were placed in a situation where they needed to evaluate their business needs and decide which engagement (i.e. audit or independent review) suits them best. As such, the research confirmed the essential differences to the extent that an audit is more expensive, more detailed and provides higher assurance levels than an independent review. However, the manner by which an entity is considered as a qualifying entity for an independent review may change from year-to-year based on its annual *PIS* calculation. This may have profound implications as to whether the independent review would actually be a less cumbersome and costly alternative.

With banks no longer enforcing audited financial statements during loan applications, the choice will essentially boil down to personal preference and the intrinsic value SME owner-managers believe is part and parcel of an audit.

#### **7.4. Concluding discussion**

The research undertaken in this study has answered the primary research question in that it has been established that the advent of the independent review does not necessarily impede SMEs' access to bank finance. It was found that banks do not require audited financial statements when considering SME loan applications and SME owner-managers do not perceive the

independent review as negatively affecting their access to bank finance *per se*. The research has, however, brought new and valuable insights to the fore that warrant further discussion.

Although it was found that SMEs do not need to audit their financial statements, the fact remains that disregarding accounting in their businesses is a risk that they take at their own peril. The literature brought to light the incredible impact accounting has had on society over a period of centuries. As such, accounting has been referred to as “*among the finest inventions of the human mind*”, as “*the language of practical business life*” and as “*a very useful thing to deliver to civilization*”. For accounting to have merited such accolades is no small feat and denotes its intrinsic value to business over the last few centuries.

There is a symbiotic relationship between being economically active in the modern business environment and adopting the principles and practices of accounting. Without business transactions, accounting would become redundant, and without accounting, business management would become almost unfeasible. As such, SMEs need to acquaint themselves with the basic principles of accounting. If SMEs are unable to embrace accounting as a management asset, they will be left making crucial business decisions, based on delinquent financial information.

For the contemporary SME to meet the requirements of the modern business world, such as banks, customers and investors, it has to make a mind shift to not see accounting as irrelevant, but to rather seek what is relevant in accounting – after all, it is the language of business.

## **7.5. Limitations and future research**

Much research has been undertaken investigating the effect of access to financing constraints on SMEs. Being such a vital topic and of such crucial importance to SMEs, more research is required as to how SMEs can mitigate the asymmetric and opaque information perceptions associated with SMEs. Further research and recommendations may also be required in terms of what basic accounting skillsets are necessary to constitute being proficient in accounting in terms of SME sustainability requirements. In this regard, one may also consider measuring the perceived accounting knowledge against the actual accounting knowledge of SME owner-managers.

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## 9. ANNEXURE A: AUTHOR GUIDELINES: STUDIA UBB PHILOSOPHIA

### STUDIA UBB. PHILOSOPHIA

#### Indications for Authors

##### A. General indications

- The texts proposed for publication must be previously unpublished in that language.
  - Concerning a future re-publication, the author must mention the first publication in Studia UBB. Philosophia.
  - The manuscripts can be submitted as follows: 3 printed copies and one electronic version, or via email as attachment, in Word Document format (.doc) or Rich Text Format (.rtf).
  - The texts cannot be longer than 75.000 characters, including spaces and footnotes for articles, and 25.000 characters for article reviews and commentaries
  - The texts can be written in English, French, German
  - The articles should be accompanied by a short abstract written in English (maximum 700 characters)
  - The unpublished manuscripts will not be returned to the authors.
- Responsibility for the views expressed in this journal remains solely with the authors.

##### B. The authors are required to write the texts conformingly the following norms:

###### 1. Body Text

Times New Roman, at 12 points, justified, at 1,5 lines

###### 2. chapter titles and other sections

a) titles: Times New Roman, at 14 points, Bold

b) subsections: Times New Roman, at 12 points, Bold

###### 3. Quotations

a) If the quotation is less than 3 lines long, it can be given in the text

b) If the quotation is more than 3-4 lines long, it is indicated apart as it follows:

– Font 11, no quotation marks; Paragraph Indent left text 5 mm, Indent right text 5 mm, Spacing before 6 pt, Spacing after 6 pt.

4. Quotations marks: accordingly to the orthographical rules of the language in wich the article is written

###### 5. References in the footnotes (PLEASE USE FOOTNOTES ONLY!)

Font: Times New Roman, at 10 points

###### 6. Bibliography

a) books:

<Author>, <Title>, <publishing company>, <year>.



# 10. ANNEXURE B: ARTICLE 1 AS PUBLISHED: STUDIA UBB PHILOSOPHIA

STUDIA UBB. PHILOSOPHIA, Vol. 60 (2015), 3, pp. 5-18  
(RECOMMENDED CITATION)

## THE FUTURE OF ACCOUNTING'S PAST: A REFLECTION ON ITS CONTEMPORARY RELEVANCE

FRANÇOIS COETZEE<sup>1</sup>, PIETER BUYS<sup>2</sup>

**ABSTRACT.** Contemporary corporate history demonstrates that, though accounting is acknowledged as the language of business, there are more and more cases where this language becomes an incomprehensible foreign language. The objective of accounting as promulgated by accounting regulators is characterized by large volumes of complex principles, which none but the most specialised accounting professionals can interpret. This very often results in many classes of accounting information users not being able to properly understand the message being conveyed. This paper aims to reflect on the primary objective of accounting by considering its historic evolution from its ancient roots as a record keeping function, through its bookkeeping phases up to when it actually began to resemble accounting as we know it in the contemporary business environment. Throughout this reflection, consideration is given to its intended purpose for the specific time period under consideration. The paper concludes that even though accounting has evolved much in its perceived objectives, the complexity of the contemporary business environment contributed to complex accounting principles and practices. Nonetheless, the key purpose of accounting should never be lost, that being that it is the language of business and as such it must be understandable to business stakeholders.

**Keywords:** *Accounting history, contemporary business, double entry accounting, bookkeeping, record keeping.*

### 1. BACKGROUND

#### 1.1. Introduction

Accounting history is not typically considered as a topic that would grab anybody's attention. For most business professionals, and perhaps even many accountants, the first reaction would probably be to frown upon the actual value of a reflection on the evolution of accounting. The immense value accounting has

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# 11. ANNEXURE C: AUTHOR GUIDELINES: BANKS AND BANK SYSTEMS

## Requirements to the manuscripts

### 1. Abstract preparation guidelines

- 1.1. The abstract (200-250 words) should reflect the conceptual content of the article. In the abstract the author should give a brief overview of research importance, describe the subject matter and the aim of research, its methodology as well as highlight the most significant results of research.
- 1.2. Journal of Economic Literature (JEL) classifications that can be found at [http://www.aeaweb.org/jel/jel\\_class\\_system.php](http://www.aeaweb.org/jel/jel_class_system.php), and a few key words about the manuscript are necessary.
- 1.3. Font - Times New Roman; text size - 12 pts, line-spacing - one-and-a-half.
- 1.4. All tables and figures should be editable.

### 2. The paper main body preparation guidelines

- 2.1. The paper should present the result of independent original research undertaken by the author; it should contain the data never published before.
- 2.2. The paper should contain a clear description of research objective and its subject.
- 2.3. The methodology of research should be described in detail.
- 2.4. The author personal scientific contribution must be grounded in the paper.
- 2.5. The paper should contain basic suggestions on how to solve the problem under study.
- 2.6. American English has been preferred to British English.

### 3. The structure of the paper

- 3.1. The title of the paper.
- 3.2. Below, in the centre of the page the name of the author should be printed. Reference to the author's name should be made at the bottom of the page with the footnote marked by asterisk ("\*\*"). The reference should contain information about the author's degree, position and the place of work as well as contact details (phone number, job or/and personal e-mail).
- 3.3. Below, the text of the abstract should be printed.
- 3.4. After the abstract's keywords and JEL classifications should be printed.
- 3.5. Below the main body of the paper should be placed.
- 3.6. The main body of the paper should be followed by references.
- 3.7. References contain the list of literature referred to given in alphabetical order.
- 3.8. All figures and tables should be printed inside the papers' main body.

### 4. References in the text

- 4.1. All references have to be presented in APA style; using citation generator will make this process faster and easier.
- 4.2. If a referenced source is indexed in Google Scholar or has a doi (CrossRef), the relevant link should be added to this source.

### 5. Manuscript length

- 5.1. The paper should not be less than 2000 words and should not exceed 6000 words.

# 12. ANNEXURE D: PROOF COPY OF ARTICLE 2: BANKS AND BANK SYSTEMS

Banks and Bank Systems, Volume 12, Issue 1, 2017

Francois Coetzee (South Africa), Pieter W Buys (South Africa)

## The impact of the independent review on SME access to bank finance: the case of South Africa

### Abstract

It is accepted that SMEs are major contributors to global employment and GDP. Similarly, SMEs' reliance on bank finance to maintain financial and operational sustainability is also globally accepted. In 2008, the Company's Act of South Africa was amended to scrap the statutory audit requirement for qualifying entities, with the aim of alleviating the administrative burden of SMEs and increase their sustainability potential. As sound as this strategy may have been, a grey area arose in that banks may still insist on audited financial statements. This study investigates the question as to whether South African banks still consider audited financial statements as key in evaluating SME bank finance applications. This was done by analyzing the major banks' requirements per their policies and follow-up discussions with loan officers. Contrary to expectations, the historic focus per audited financial statements was considered of much less importance than progressive future-oriented management statements and reports.

**Keywords:** audit, independent review, SME finance, SME sustainability.

**JEL Classification:** M13, M41, M42, M48.

### Introduction

"Double, double toil and trouble; fire burn, and cauldron bubble" the witches cackled in Shakespeare's *Macbeth* (Shakespeare, 1985, 4.1:10).

If we did not know any better, one may be excused for thinking Shakespeare was bemoaning the plight of the small and medium enterprises (SMEs) of old. The SMEs drive for sustainability is a topic of substantial interest to contemporary academic management researchers and practitioners. In the South African context, the Global Entrepreneurship Monitor found that the entrepreneurial activity (often the SME domain) in South Africa has dropped by 34% in the 10 years leading up to 2014 (GEM, 2014). This research also found that entrepreneurial confidence is very low compared to the rest of Sub-Saharan Africa. This translates into a perception that entrepreneurs are often not confident that they can successfully start a sustainable business in South Africa, which does not inspire much confidence in South Africa's SME market.

According to the Bankseta (n.d.), in order for SMEs to be sustainable in the contemporary global market environment, they have to be able to:

- ◆ attract and retain skilled managers and personnel;
- ◆ access to their intended markets;
- ◆ build customer relationships;
- ◆ access to the best-suited technologies;
- ◆ access to sufficient production capacities;

- ◆ be attentive to their role in social and economic development; and
- ◆ access to finance and credit.

An interesting point to ponder when scrutinizing the above is that attracting skilled personnel, gaining access to markets, accessing to technologies and having sufficient production capacities are all dependent on the SME having adequate access to finance, which may lead us to assume that access to finance may well be the major constraint faced by contemporary SMEs.

The above is reiterated by Ayyagari et al. (2012) and Beck et al. (2005) who all consider the ability of SMEs to grow and be sustainable to be very much dependent on their access to finance. Banks, however, have historically often regarded SMEs as of a higher risk profile than larger corporations, especially when it comes to granting finance (Mazaroll, 2012; Haynes et al., 1999). Therefore, when applying for bank finance, SMEs historically underwent a more rigorous scrutiny process, which entailed mitigating such risk by requiring audited financial statements in order to extrapolate the required risk assessment tools when applying for finance (SAICA, 2010). As such, audited financial information has historically been used to provide banks with better assurances of reliance on business information.

In the contemporary South African business environment, the advent of the new Companies Act, No. 71 of 2008 (referred to as the Act hereafter) has brought about the abolishment of the statutory audit requirement for qualifying companies (typically then SMEs) and has introduced the new concept of the 'independent review' (Act, 2008). According to SAIPA (2011), an independent review is an engagement by which an accountant external to the entity provides a limited assurance review on a set of financial statements. Under current legislation, qualifying entities have the option to choose be-

Francois Coetzee, Pieter W Buys, 2017.  
Francois Coetzee, Ph.D. Candidate, NWU School of Business and Governance, North-West University, Potchefstroom, South Africa.  
Pieter W Buys, Professor, WorkWell Research and NWU School of Business and Governance, North-West University, Potchefstroom, South Africa.

## 13. ANNEXURE E: AUTHOR GUIDELINES: STUDIA UBB NEGOTIA



**We are pleased to  
invite submissions  
of individual papers  
and research  
insights  
for  
Studia Negotia**

### **Authors' Guidelines**

Papers should be original and unpublished, and should not be under publication consideration with any other outlet.

Please include a separate page with the title, the name and the e-mail of the author/ authors for the double-blind review process. The page with the abstract should contain the title, the abstract, the key words and JEL classification.

Please respect the following **paper format** – Word-file:

*Characters: Times New Roman*  
*Line spacing: single*  
*Paper title: 14 pt.*  
*Name of the author/ authors: 12 pt.*  
*Abstract: 10 pt.*  
*Text: 12 pt.*  
*Footnotes: 10 pt.*  
*Margins:*  
*Top: 2.5 cm*  
*Bottom: 2.5 cm*  
*Left: 3 cm*  
*Right: 3 cm*  
*Gutter = 0, Header = 0; Footer = 0,*

The paper's content should follow the structure below:

*1. Introduction and Review of Literature;*  
*2. Material and Method(s);*  
*3. Results and Discussions;*  
*4. Conclusions.*

#### **Citation Requirements:**

Publications should be cited in the text: (Adams, 2006) using the author's name or (Adams and Brown, 2006) citing both authors or (Adams *et al.*, 2006), when there are three or more authors.

At the end of the paper a reference list in alphabetical order should be supplied:

- **For books:** Surname, Initials (year of publication), *Title of the Book*, Publisher, Place of publication. e.g. Baldegger R. (2007), *Management. Strategie, Struktur, Kultur*, Growth Publisher, Fribourg.
- **For book chapters:** Surname, Initials (year of publication), "Chapter Title", Editor's Surname, Initials, *Title of Book*, Publisher, Place of publication, pages. e.g. Calabrese, F.A. (2005), "The Early Pathways: Theory to Practice - a Continuum", in Stankosky, M. (Ed.), *Creating the Discipline of Knowledge Management*, Elsevier, New York, NY, pp. 15-20.
- **For journals:** Surname, Initials (year of publication), "Title of the Article", *Journal Name*, volume, number, pages. e.g. Capizzi, M.T. and Ferguson, R. (2005), "Loyalty Trends for the Twenty-first Century", *Journal of Consumer Marketing*, Vol. 22 No. 2, pp. 72-80.

- **For published conference proceedings:** Surname, Initials (year of publication), "Title of paper", in Surname, Initials (Ed.), *Title of Published Proceeding which may include the place and the date(s) when the conference was held*, Publisher, Place of publication, Page numbers. *e.g.* Jakkilinki, R., Georgievski, M. and Sharda, N. (2007), "Connecting Destinations with an Ontology-based E-tourism Planner", in *Information and Communication Technologies in Tourism 2007 Proceedings of the International Conference in Ljubljana, Slovenia, 2007*, Springer-Verlag, Vienna, pp. 12-32.
- **For unpublished conference proceedings:** Surname, Initials (year of publication), "Title of paper", paper presented at the Name of the Conference, date of the conference, place of the conference, available at: URL if freely available on the Internet (accessed date). *e.g.* Aumueller, D. (2005), "Semantic Authoring and Retrieval within a Wiki", paper presented at the European Semantic Web Conference (ESWC), May 29<sup>th</sup>-June 1<sup>st</sup>, Heraklion, Crete, available at: <http://dbs.uni-leipzig.de/file/aumueller05wiksar.pdf> (accessed on the 20<sup>th</sup> of February 2007).
- **For working papers:** Surname, Initials (year of publication), "Title of the Article", working paper [number if available], Institution or organization, Place of organization, date. *e.g.* Moizer, P. (2003), "How Published Academic Research Can Inform Policy Decisions: the Case of Mandatory Rotation of Audit Appointments", working paper, University of Leeds, Business School, Leeds, March 28<sup>th</sup>.
- **For encyclopedia entries (with no author or editor):** *Title of Encyclopedia* (year of publication) "Title of Entry", volume, edition, *Title of Encyclopedia*, Publisher, Place of publication, pages. *e.g.* *Encyclopaedia Britannica* (1926) "Psychology of Culture Contact", Vol. 1, 13<sup>th</sup> ed., Encyclopaedia Britannica, London and New York, NY, pp. 763, 765-71. (For authored entries please refer to book chapter guidelines above.)
- **For newspaper articles (authored):** Surname, Initials (year of publication), "Title of Article", *Newspaper*, date, pages. *e.g.* Smith, A. (2008), "Money for Old Rope", *Daily News*, January 21<sup>st</sup>, pp. 3-4.
- **For newspaper articles (non-authored):** *Newspaper* (year of publication), "Title of Article", date, page/ pages. *e.g.* *Daily News* (2008), "Small Change", February, 2<sup>nd</sup>, p. 7.
- **For electronic sources:** if available online the full URL should be supplied at the end of the reference, as well as a date when the resource was accessed. *e.g.* Castle, B. (2005), "Introduction to Web Services for Remote Portlets", available at: <http://www-128.ibm.com/developerworks/library/ws-wsrp/> (accessed on November 12<sup>th</sup>, 2007). Standalone URLs, i.e. without an author or date, should be included either within parentheses within the main text, or preferably set as a note (Roman numeral within square brackets within the text followed by the full URL address at the end of the paper).

## **14. ANNEXURE F: QUESTIONNAIRE ON SMALL & MEDIUM ENTERPRISES**

Dear Participant,

I greatly appreciate the time you are affording me to conduct this interview and questionnaire and your participation in this research. This is an academic research project aiming to determine whether the new company's act has impeded access to finance for SMEs. I ask for your objective and honest responses to the questions and discussions based on your perceptions.

As this is nothing more than an academic exercise any and all information and opinions obtained will be treated as highly confidential and will not be disclosed in any manner that will expose you or your company's identity. All questionnaires will be coded so that no data can be linked back to the identity of your company.

### **INSTRUCTIONS:**

Complete the following questions as accurately as possible.

#### **Section A. General Information**

Name of the Company:	
Date of establishment:	
Name of Contact Person:	
Email Address of Contact Person:	
Average number of employees:	
Average annual turnover:	
Province of main economic activity:	

**Economic Sector:**

- Professional services and consulting
- Construction
- Various personal services
- Property rental and management
- Guest House
- Farming
- Mining
- Retail
- Transport Services
- Manufacturing
- Insurance
- Training and development
- Engineering

**Section B: Financing Activities**

**1. This section deals with the types of finance your company uses. Answer the following questions based on your experience, by choosing either “yes” or “no”.**

1.1. Does your company have an overdraft?

Yes     NO

1.2. Does your company have property, plant or equipment financing?

Yes     NO

1.3. Does your company use other forms of financing than those in Q1.1 or Q1.2?

Yes     NO



2. This section pertains to what banks require when you apply for finance. Consider each question carefully and rate each item in terms of your own experience and or perception. There is no right or wrong answer. Draw an 'x' through the rating that best indicates the extent to which you agree with each statement.

1 = Strongly Disagree      2 = Disagree      3 = Neutral      4 = Agree      5 = Strongly Agree

	<b>Financing Activities</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
2.1.	Banks no longer require audited financial statements.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2.2.	Banks require financial statements that have been independently reviewed.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2.3.	Banks require the latest management statements.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2.4.	Banks require sufficient suretyship.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Comments concerning the above questions:


**Section C: SME perceptions on access to bank financing**

3. This section deals with SME perceptions concerning the ease with which bank financing can be accessed. Consider each question carefully and rate each item in terms of your own experience and or perception. There is no right or wrong answer. Draw an 'x' through the rating that best indicates the extent to which you agree with each statement.

1 = Strongly Disagree      2 = Disagree      3 = Neutral      4 = Agree      5 = Strongly Agree

	<b>SME Financing Perspectives</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
3.1.	Getting an overdraft from a Bank is difficult.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3.2.	Getting a property bond from a Bank is difficult.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

3.3.	Getting equipment and vehicle finance from a Bank is difficult.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3.4.	Getting operational cashflow from a bank is difficult.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Comments concerning the above questions:


**Section D: SME Accounting Perspectives**

**4. This section deals with your perceived value of accounting to your business. Answer the following questions based on your experience, by choosing either “yes” or “no”.**

4.1. Is accounting important for business management?

Yes     NO

4.2. Is accounting important for statutory reasons like tax?

Yes     NO

4.3. Is accounting important for bank funding?

Yes     NO

4.4. Is accounting a necessary evil?

Yes     NO

**5. This section deals with your perception as to your accounting prowess. Consider each question carefully and rate each item in terms of your own experience and or perception. There is no right or wrong answer. Draw an 'x' through the rating that best indicates the extent to which you agree with each statement.**

1 = Strongly Disagree      2 = Disagree      3 = Neutral      4 = Agree      5 = Strongly Agree

	<b>Accounting Perspectives</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
5.1.	As owner of an SME you understand the basics of accounting principles.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5.2.	Accounting is important for your sustainability.	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Comments concerning the above questions:


This concludes the questionnaire.

Thank you for your time and feedback. Your participation is highly appreciated.

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date

## 15. ANNEXURE G: RESPONSE FREQUENCY TABULATION

SME CLIENT CODE	Bank Finance Utilized			Likert Scale: Bank requirements:			
	Overdraft	PPE	Other	Audited Financials	Independent Review Financials	Latest Management Accounts	Security: Business and/or Personal
SME 1	✓	✓	✗	5	4	4	5
SME 2	✓	✓	✗	1	3	5	5
SME 3	✓	✗	✗	5	5	4	5
SME 4	✓	✓	✗	5	5	5	5
SME 5	✓	✓	✗	2	3	5	5
SME 6	✓	✗	✗	5	5	5	5
SME 7	✓	✓	✗	5	4	5	5
SME 8	✓	✓	✗	5	4	4	5
SME 9	✓	✗	✗	5	4	4	5
SME 10	✓	✓	✗	5	4	4	5
SME 11	✓	✓	✗	5	5	5	5
SME 12	✓	✓	✗	5	5	5	5
SME 13	✓	✗	✗	5	5	5	5
SME 14	✓	✓	✗	5	5	5	5
SME 15	✓	✗	✗	5	5	5	5
SME 16	✓	✓	✗	5	5	5	5
SME 17	✓	✗	✗	5	4	4	5
SME 18	✓	✓	✗	5	4	3	5
SME 19	✓	✗	✗	1	3	5	5
SME 20	✓	✓	✗	5	5	5	5
SME 21	✓	✓	✓	1	3	5	5
SME 22	✓	✓	✗	5	5	5	5
SME 23	✓	✓	✗	5	4	5	5
SME 24	✓	✓	✗	2	3	5	5
SME 25	✓	✓	✗	5	5	5	5
SME 26	✓	✓	✓	5	5	5	5
SME 27	✓	✓	✗	5	5	5	5
SME 28	✓	✗	✗	5	3	3	5
SME 29	✓	✓	✗	5	5	5	5
SME 30	✗	✗	✗	3	3	3	3
SME 31	✓	✓	✗	5	5	4	5
SME 32	✓	✓	✗	5	5	4	5

SME 33	✓	✓	✗	5	5	4	5
SME 34	✓	✓	✓	1	3	5	5
SME 35	✗	✗	✗	3	3	3	3
SME 36	✓	✗	✗	5	5	4	5
SME 37	✓	✗	✗	5	5	5	5
SME 38	✓	✗	✗	5	5	5	5
SME 39	✓	✗	✗	5	5	4	5
SME 40	✓	✗	✗	5	5	4	5
SME 41	✓	✓	✗	5	5	5	5
SME 42	✓	✓	✗	5	5	5	5
SME 43	✓	✗	✗	5	5	5	5
SME 44	✓	✓	✗	5	5	5	5
SME 45	✓	✓	✗	5	5	5	5
SME 46	✓	✓	✗	5	5	5	5
SME 47	✓	✓	✗	4	5	5	5
SME 48	✓	✗	✗	5	3	3	5
SME 49	✓	✓	✗	2	3	5	5
SME 50	✓	✓	✗	5	5	5	5
SME 51	✓	✓	✗	5	5	4	5
SME 52	✓	✓	✗	5	5	4	5
SME 53	✓	✓	✗	5	5	5	5
SME 54	✓	✗	✗	5	5	5	5
SME 55	✗	✗	✗	3	3	3	3
SME 56	✓	✓	✗	5	3	3	5
SME 57	✓	✓	✗	5	4	5	5
SME 58	✓	✓	✗	2	3	5	5
SME 59	✓	✓	✗	5	4	4	5
SME 60	✓	✓	✗	5	5	4	5

SME CLIENT CODE	Likert Scale: Bank financing is difficult for:			
	Overdrafts	Property Bonds	Equipment and Vehicles	Operational and Project cash flow
SME 1	5	5	5	5
SME 2	3	5	2	5
SME 3	2	5	3	5
SME 4	4	5	5	5
SME 5	3	5	3	5
SME 6	2	5	3	5
SME 7	3	5	4	5
SME 8	4	5	5	5
SME 9	4	5	4	5
SME 10	3	5	3	5
SME 11	3	5	4	5
SME 12	4	5	4	5
SME 13	3	5	4	5
SME 14	4	5	4	5
SME 15	4	5	4	5
SME 16	4	5	5	5
SME 17	4	5	4	5
SME 18	3	5	5	5
SME 19	2	5	3	5
SME 20	2	5	3	5
SME 21	2	5	3	5
SME 22	4	5	5	5
SME 23	3	5	5	5
SME 24	5	5	5	5
SME 25	5	5	5	5
SME 26	2	5	3	5
SME 27	4	5	5	5
SME 28	2	5	3	5
SME 29	5	5	5	5
SME 30	3	3	3	3
SME 31	3	5	4	5
SME 32	3	5	4	5
SME 33	3	5	4	5
SME 34	4	5	4	5
SME 35	3	3	3	3
SME 36	4	5	4	5
SME 37	4	5	5	5
SME 38	4	5	5	5
SME 39	3	5	3	5

SME 40	3	5	3	5
SME 41	4	5	5	5
SME 42	4	5	5	5
SME 43	3	5	4	5
SME 44	3	5	5	5
SME 45	4	5	5	5
SME 46	3	5	4	5
SME 47	5	5	5	5
SME 48	4	5	5	5
SME 49	3	5	3	5
SME 50	4	5	4	5
SME 51	3	5	2	5
SME 52	2	5	3	5
SME 53	2	5	4	5
SME 54	4	5	4	5
SME 55	3	3	3	3
SME 56	5	5	5	5
SME 57	4	5	4	5
SME 58	4	5	4	5
SME 59	4	5	4	5
SME 60	4	5	4	5

SME CLIENT CODE	As manager you understand the basics of accounting	Accounting is important for your business sustainability	Manager's view of the importance of accounting			
			Important for business management	Important for statutory reasons (tax, shareholders)	Important for bank funding	A necessary evil
SME 1	1	2	x	✓	✓	✓
SME 2	4	4	✓	✓	✓	x
SME 3	2	3	x	✓	✓	x
SME 4	4	4	✓	✓	✓	x
SME 5	4	5	✓	✓	✓	x
SME 6	2	4	✓	✓	✓	x
SME 7	3	3	x	✓	✓	x
SME 8	3	3	x	✓	✓	x
SME 9	1	2	x	✓	✓	✓
SME 10	4	2	x	✓	✓	✓
SME 11	5	4	✓	✓	✓	x
SME 12	5	4	✓	✓	✓	x
SME 13	5	4	✓	✓	✓	x
SME 14	5	4	✓	✓	✓	x
SME 15	5	4	✓	✓	✓	x
SME 16	5	4	✓	✓	✓	x
SME 17	1	2	x	✓	✓	✓
SME 18	3	2	x	✓	✓	x
SME 19	4	4	✓	✓	✓	x
SME 20	4	4	✓	✓	✓	x
SME 21	4	5	✓	✓	✓	x
SME 22	1	1	x	✓	✓	✓
SME 23	2	3	x	✓	✓	x
SME 24	2	2	x	✓	✓	x
SME 25	1	2	x	✓	✓	x
SME 26	3	4	✓	✓	✓	x
SME 27	3	4	x	✓	✓	✓
SME 28	4	2	x	✓	✓	✓
SME 29	2	4	x	✓	✓	x
SME 30	4	5	✓	✓	x	x
SME 31	4	4	✓	✓	✓	x
SME 32	4	4	✓	✓	✓	x
SME 33	4	4	✓	✓	✓	x
SME 34	4	4	✓	✓	✓	x
SME 35	3	4	x	✓	x	x



SME 36	3	3	✓	✓	✓	*
SME 37	4	4	✓	✓	✓	*
SME 38	4	4	✓	✓	✓	*
SME 39	2	4	✓	✓	✓	*
SME 40	4	4	✓	✓	✓	*
SME 41	2	3	*	✓	✓	*
SME 42	2	3	*	✓	✓	*
SME 43	4	3	*	✓	✓	*
SME 44	4	3	*	✓	✓	*
SME 45	4	3	*	✓	✓	*
SME 46	4	3	*	✓	✓	*
SME 47	2	2	*	✓	✓	✓
SME 48	1	1	*	✓	✓	✓
SME 49	3	5	✓	✓	✓	*
SME 50	2	5	✓	✓	✓	*
SME 51	2	4	✓	✓	✓	*
SME 52	3	4	*	✓	✓	*
SME 53	5	5	✓	✓	✓	*
SME 54	4	4	✓	✓	✓	*
SME 55	4	2	*	✓	*	*
SME 56	1	1	*	✓	✓	✓
SME 57	1	1	*	✓	✓	✓
SME 58	3	4	✓	✓	✓	*
SME 59	1	2	*	✓	✓	*
SME 60	2	4	✓	✓	✓	*