

Determinants of Demand for Voluntary Financial Statements among SMEs: Evidence from Vietnam

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Abstract

The purpose of this paper is to identify the factors affecting the decisions of managers of small and medium enterprises (SMEs) in Vietnam to utilize external financial audit service. The theoretical lens of the paper based on Principal Agency Theory and Theory of Reasoned Action (TRA). A structured questionnaire survey of 116 SMEs was employed, preceded by a small number of preliminary in-depth interviews with auditors and SMEs' managers to have a pilot test. The result shows that SMEs are more likely to have an external financial audit if they have some typical features: It is becoming larger in terms of size and the directors consider that the audit has a relatively benefit outweigh its cost and a copy of statutory accounts to the banks or other providers of finance is required. The research also found that there has been a trend of using external financial audit service which is resulted in the recommendation of SME's individual accountants and audit firms. Based on the results, some suggestions have been given to regulatory agencies and auditing firms as well for promoting the voluntary audit of financial statements for SMEs in the context of Vietnam.

Keywords: SMEs, Financial statement audit, Vietnam

1. Introduction

According to the report of Vietnam Chamber of Commerce and Industry (VCCI) on the development of Small and Medium Enterprises (SMEs), almost all Vietnam enterprises are classified as small and medium scale. When it comes to the number of employees, in total 348,342 enterprises in 2016 there were 324,377 small and medium-sized firms which accounted for 97.7% and estimated to the end of 2016 there were 600,000 firms currently performing. In the national economy, SME plays an important role especially in creating jobs and increasing incomes for employees as well as critically support services industry. To some extent, SMEs are the mainstay of the local economy and significantly contribute to the national GDP. These are also the target group that attracted special attention from the Government and international institution. For instance, the World Bank has approved more than 10 billion dollars supporting program for SMEs in developing countries during the period from 2009 to 2014 and \$1.3 billion dollars in 2015.

Despite the fact that the important role of SME in the national economy, these type of firms are currently dealing with many difficulties as: firstly, SMEs are not able to ensure the investors' confidence. Hence, it is difficult for them to attract capital and expand production scale as well as market expansion. The number of Vietnam firms dissolved in 2016 is 60.7 thousand firms which have increased 11.9% compared to 2015 and 12.5% compared to 2014 respectively (VCCI, 2017). Secondly, revenue and profit of SMEs tend to decrease, following the increasing rate of bankruptcy enterprises. Generally, this situation will adversely affect the business result as a whole. Ultimately, the performance of SME is much lower than the figure for the entire sector.

In order to resolve this situation, SMEs should implement management control in both financial and nonfinancial activities. One of the most useful management control is auditing which is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. (Arens, 2014). SMEs can improve their operations by engaging the services of professional auditors because the professional auditor can assist SMEs operating in a competitive environment to harmonize operational considerations within long-term plans to enhance their survival. However, most SMEs are managed by their owners, who do not realize the necessity of the professional services as they might not see the need for proper financial reporting information. Hence, almost all SMEs may find that is difficult to raise their capital from external sources. External sources such as investors, banks, stockholders and lenders who rely on the financial statements to make economic decisions look to the audit report as an indication of the state's liabilities. Also, the owner-managers who

keep the business under no pressure to prepare audited financial statements, believe that the benefit of the financial statement audit cannot outweigh the cost itself.

In addition, most of the owner-managers of SMEs lack basic accounting knowledge, and they believe that they are able to control the daily businesses, as such, the possibility of fraud occurring is low.

On the other hands, the auditing firms are not much interested in making their professional services to SMEs because these typical businesses hardly expose their financial records only if it is required. However, SMEs have appeared to be a potential market.

Several studies have been taken in developed countries such as the United Kingdom, Australia, Sweden but there are very few researchers examined what determines the demand for voluntary audit services among SMEs in the context of Vietnam. The existing studies on this topic do not address in detail the factors influencing the decision of using financial statement audit. The theoretical background also appears no evidence to explain the meaning underneath. As a result, this paper finds relevance in fulfilling the research gap and investigates the internal and external factors that could affect owner-managers of SMEs to use financial statement audit service willingly. This research also contributes to the literature a more comprehensive approach to applying some theories to explaining the problems.

The two main objectives of the study as follows: (i) Ascertain the theoretical framework of the demand for voluntary financial statement audit among SMEs in Vietnam. (ii) Investigate the determinants of demand for voluntary financial statement audit among SMEs in Vietnam.

2. Literature Review

The recent literature in this area is broadly basing on two main perspectives of Agency Theory and Theory of Reasoned Action (TRA). Agency theory explains the need for an audit stems for the delegations of the authority to manage a business by the principals (owners) to agents (managers). The fundamental purpose of an audit is to inform shareholders about how the directors managed the company's finances on behalf of the shareholders. Hence, the audit plays an important role to help the shareholders, as well as stakeholders, have involved in a decision making the process of, for examples; investment, finance or trade with the company. Agency theory addresses the relationship wherein a contract the principal engages another person to perform some service on behalf which involves delegating some decision making authority to the agent. The separation of ownership and control leads to information asymmetry and affects the owner's (the principal) ability to effectively monitor if the management (the agent) has acted in their best interests (Jensen and Meckling, 1976).

In order to reduce the information asymmetric as well as to enhance the verifiability of the financial statements prepared by the management, it is necessary for firms to acknowledge the benefit and value of an audit. ICPAS (2000), Aziz (2002) provides evidence that countries such as the United Kingdom (UK), United States of America (USA), Australia and several countries in the Europe have exempted small firms from the annual compulsory audit requirement. For instance, in the USA, there is no statutory audit requirement for firms other than listed firms. In the case of ASEAN region, other countries have different legislation of audit exemption. Effective from June 2004, Singapore firms with a turnover of less than \$5 million are exempted. On the other hand, Malaysia continues to legally require all firms to be annually audited with no exemption.

The popular scholars basing on agency theory for instance of Watts and Zimmerman (1983), Chow (1982) had applied the relationship between the agency costs and the demand for financial statement audit to describe voluntary audit phenomenon in the early of 14th century, five hundred years before UK Government launched the law. Chow (1982) examined 165 listed firms in New York Stock Exchange (NYSE) and found that the gearing ratios as well as the debt structure affected to the decision of having an audit. The greater the gearing ratio is, the more effect of external stakeholders to a company leads to the demand of having reliable financial information.

The first and major reason why some small firms need auditing is to help control the conflict of interests between managers, shareholders and external users (Taurigana and Clarke, 2000). Agency theory (Jensen and Meckling, 1976) suggests that the directors are willing to bear the cost of the audit to support agency relationships with principals (the owners) where there is information asymmetry. In small (non – family) firms the principals are anyone who distant from the actions of management and is unable to verify them, for instance, the external shareholders, lenders, and creditors. The audit provides the external users of financial statements reasonable assurance that the reports are prepared in compliance with accounting

standards and ensure the credibility of its information. Analysis of the 1999 survey conducted by Collis et al. (2004) provided evidence of several factors influencing the demand for a voluntary audit. The result found that turnover could represent firm size, but that size is not important as the directors' perceptions of the value of audit in terms of improving the quality of information and providing a check on internal records. Agency relationships in this case with (non – family) owners and external users (lenders, creditors) were also significant influences on the demand for the audit. The survey also reported that the director's educational profile was an influential factor.

In Vietnam, there are many small firms managed by their owners. Therefore in this case when the small firm expands its scale may lead to the exposure of high risks, for instance, firms inherent risks (the likelihood of a material misstatement arising) and control risk (the likelihood of the accounting control detecting any material misstatement). The owner-manager may want an independent check on internal controls reduces the chance of material errors. Collis (2003) found that 50 percent of respondents considered that audit helped to protect against fraud and as the size of the company grew, they would consider having a voluntary audit. The audit process also includes checks to identify the existence of fraud and to assess the adequacy of the company's internal control (Davies, 2004). Haapamaki et al. (2012) conducted research in public and private firms showing that they are aware of the benefits that the audit gives the enterprises such as improve credit rating, reduce risks and attract external investors.

A small firm can improve its performance internally and externally by engaging the services of a professional accountant that may include the auditor to audit the business (Samson et al., 2012). Audits of small and medium firms may not even have kept a better accounting record at all but for tax purposes (Olatunji, 2013). In a study conducted by the Accounting and Corporate Regulatory Authority in Singapore on the decline in revenue by small and medium practices, it revealed that the advertisement of a professional accounting firm was a key reason for reducing demand for audit services in SMEs (ACCA, 2011). For this scenario, the theory of reasoned action (TRA) which was developed by Fishbein and Ajzen in 1967 will help us to explain the relationship between attitude and behaviors within the human activity.

3. Theoretical Framework

3.1. Theories

There are several theories that may explain the demand for audit services. In short, according to Hayes et al. (2005), there is four audit theories namely (i) the policeman theory, (ii) the lending credibility theory, (iii) theory of inspired confidence, and (iv) agency theory.

The policeman theory claims that the auditor is responsible for searching responsible for searching, discovering and preventing fraud. However, more recently the main focus of auditors has been to provide reasonable assurance and verify the truth and fairness of the financial statements. The detection of fraud is, however, still a hot topic in the debate on the auditors' responsibilities, and typically after events where financial statement frauds have been revealed, the pressure increases on increasing the responsibilities of auditors in detecting fraud.

Developed *the lending credibility theory* which is seen from the management point of view where the author suggested that the management of a firm uses their audited financial statements to enhance the stakeholder's faith in the management. Stakeholders along with others sometimes have to make their judgment based on the financial statements and are therefore obliged to have faith that the audited financial statements is fair and trustful in the matter of the economic situation of the company they want to invest in. However, there are other theories such as the "*efficient market theory*" that states that the lending credibility theory and the information that the auditor gives in the financial statements do not necessarily form as a primary basis for investors' investment decisions.

Theory of inspired confidence (Theory of rational expectations) (Limberg, 1932) addresses both the demand and the supply of audit services. The demand for audit services is the direct consequence of the participation of third parties (interested parties of a company) in the company. These parties demand accountability from the management, in return for their investments in the company. Accountability is realized through the issuance of periodic financial reports. However, since this information provided by the management may be biased, and outside parties have no direct means of monitoring, an audit is required to assure the reliability of this information. With regard to the supply of audit assurance, suggests that the auditor should always strive to meet the public expectations. The principles of Limberg's theory are especially relevant in this phase of the development of the audit function. "*We have a particular need in our*

current environment to try to understand and to appreciate the social significance of auditing and the implications concerning in which way an audit should be performed.”

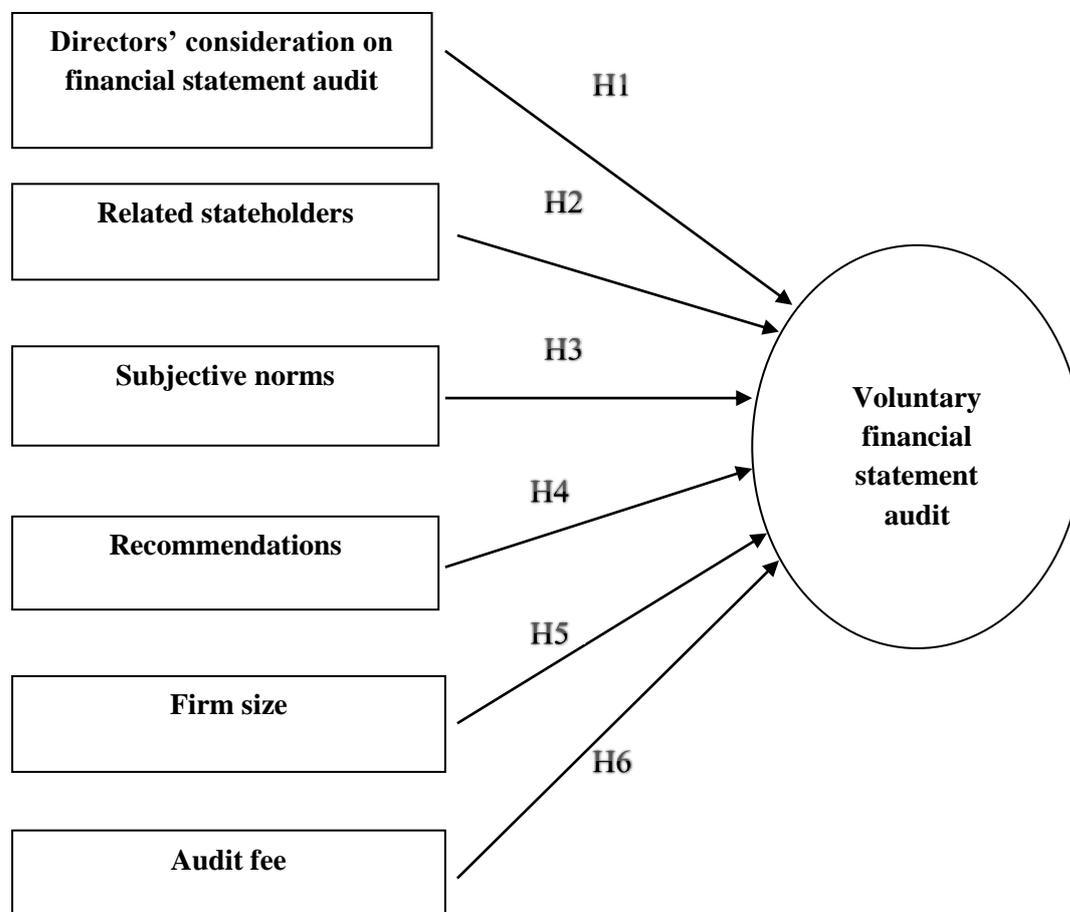
Agency theory (Watts and Zimmerman 1978, 1986a, 1986b) suggests that the auditor is appointed in the interests of both the third parties as well as the management. A company is regarded as a web of contracts. Several groups (suppliers, bankers, customers, employees, etc.) make some kinds of contribution to the company for a given price. The task of the management is to coordinate these groups and contracts and try to optimize them: low price for purchased supplies, high price for sold goods, low-interest rates for loans, high share prices and low wages for employees. In these relationships, management is the agent, which tries to gain contributions from principals (bankers, shareholders, employees, etc.).

3.2. Conceptual Framework

This study on the determinants of the demand for financial statement audit can be conceptualized in a framework explaining the relationship between the independent variable factors and dependent variable outcomes.

The relevant theoretical frameworks which adapted to explain the issue of demand for professional services in the context of auditing area are the Agency theory and Theory of Reasoned Action (TRA).

The conceptual framework can be identified as below:



The analysis of literature review draws on some of the key findings and tests the six hypotheses set out. The variables in the study will be explained as follows:

Voluntary financial statement audit is the dependent variable in the analysis and consists of two groups. The first group contains firms where the directors would have the accounts audited on a voluntary basis even if the company was not legally required to do so. The second group contains firms where the directors would not have the accounts audited if the company were free to choose. Non – responses are excluded.

Directors' view on financial statement audit represents a factor that captures whether the directors perceive the benefit of an audit as providing a check on accounting records and systems, improving the quality or the credibility of the financial information and having a positive effect on the company's credit rating score respectively.

H1: The likelihood of directors choosing a voluntary audit increase with perceptions that there is more benefit outweigh cost when having an audit

Related stakeholders represent agency relationships with shareholders and capture whether the company is wholly family – owned. This factor also represents agency relationships with shareholders and captures whether there are external shareholders. The external stakeholders such as a bank or other providers of finance have a strong impact on the statutory accounts. It is a dummy variable and is used to test H2.

H2: The likelihood of directors choosing a voluntary audit increases with perceptions that are influenced by related stakeholders.

Subjective norms and *Recommendations* represent the factors in accordance with TRA. Subjective norm captures the attitude gives the director's opinion about whether the action is positive or negative.

H3: The likelihood of directors choosing a voluntary audit increase with perceptions that their subjective norm encourages them to do so.

Recommendation describes the social effect of directors' decision.

H4: The likelihood of directors choosing a voluntary audit increase with social impact on them to do so.

Firm size represents size factors in the analysis and captures total assets/equity on Balance Sheet measuring under Decree 56/2009.

H5: The likelihood of the directors choosing a voluntary audit increases with size, as measured by total assets/equity.

Audit fee represents factors relating to the cost a director needs to take into account for decision. It is the total cost that a company spends when using auditing services. Audit service fees will be competition among auditing firms. Directors will weigh the costs and benefits received when using the service. If directors are aware that the cost of money is not significant or worthy of receiving the benefits they are willing to use the service

H6: The likelihood of the directors choosing a voluntary audit does not increase with audit fee.

4. Research Methodology

A questionnaire survey design was adopted for this study. The researcher made use of primary data to achieve their result. The data were collected through the administration of a purposely structured questionnaire to respondents. The sample size included the total of 125 SMEs firms in Vietnam which is not legally required having audited financial statements. The survey was conducted via postal focused on the owners-managers, accountants of SMEs to determine what extent they appreciate the importance of audit services to their businesses. As a result, the number of response was 116. Finally, the data collected was synthesized using descriptive statistics by applying SPSS 20. A logistic regression model was conducted with the dependent variable is voluntary financial statement audit which is coded 0 if the answer is No and 1 if the answer is Yes, while the independent variables are Directors' consideration on financial statement audit, Related stakeholders, Subjective norm, Recommendations, Firm size, and Audit fee.

The model specifications are as follows:

$$\text{Ln} \frac{P(Y=1)}{P(Y=0)} = B_0 + B_1 \text{DIVIEW} + B_2 \text{RESTAKE} + B_3 \text{SUBNORM} + B_4 \text{RECOM} + B_5 \text{AUDFEE} + B_6 \text{SIZE} (1)$$

Whereas:

DIVIEW is Director's view on benefits of financial statement audit

RESTAKE is Related Stakeholders

SUBNORM is Subjective Norm

RECOM is Recommendation

AUDFEE is Audit Fee

SIZE is the size of company

The probability of (Y=1) or (Y=0) according to X_i as following:

$$E\left(\frac{Y}{X_i}\right) = \frac{P}{1 - P} = e^{B_0 + B_1X_1 + B_2X_2 + \dots + B_iX_i} \quad (2)$$

5. Results and Discussions

Primary data were collected via postal. Copies of the structured questionnaire were delivered to 125 respondents, and the validly returned of responses are 116. The directors of 51 firms (44%) indicated that the firms' financial reports had been audited in 2016 while the number of firms whose the financial reports had not been audited in 2016 is 65, accounting for 54% of the total sample.

Table 3: Audit Decision by Vietnam SMEs in 2016

Decision	Number of firms	%
Not audited	65	54
Voluntary audit:	51	46
<i>Because there are benefits in doing so</i>	12	
<i>Because the firm was close to the threshold of big – sized company</i>	10	
<i>Shareholders require audited accounts</i>	18	
<i>Banks/ lenders require audited accounts</i>	9	
<i>The audit revealed fraud in the past</i>	1	
<i>The cost of an audit was not a major burden</i>	1	
Total	116	100

In order to explain the reasons for not having accounts audited in 2016, the directors/ managers of SMEs have shown the following reasons.

Table 4: Reasons for Not having audit decision by Vietnam SMEs in 2016

Reasons	Number of firms	%
The size of firm is too small	14	22
It is not compulsory required by Government	5	8
The director is an owner of the firm	4	6
Accounting system is working effectively	33	51
Having no information on any audit firms	3	4
Audit fee is rather high	6	9
Total	65	100

Table 5: Logistic Regression Result on Demand for Financial Statement Audit

		Variables in the Equation					
		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 ^a	DIVIEW	6.506	1.668	.031	1	.011	27.978
	RESTAKE	.399	.608	.429	1	.001	1.490
	SUBNORM	.042	2.293	1.832	1	.000	.045
	RECOM	0.293	5.703	1.301	1	.000	1.341
	AUDFEE	-3.142	.877	.002	1	.002	1.043
	SIZE	4.325	3.017	2.055	1	.022	9.596
	Constant	-3.143	15.856	1.353	1	.005	.000

a. Variable(s) entered on step 1:DIVIEW, RESTAKE, SUBNORM, RECOM, AUDFEE, SIZE.

According to the equation 2, the probability of using financial statement audit services is calculated as below.

Table 6: The Degree of Influence of Variables

Variable	β	EXP (β)	$P_0 = 10\%$ P_1	Increase (Decrease) %	Degree of influence
Director's view on benefits of financial statement audit (DIVIEW)	6.506	27.978	98.7	88.7	1
Related Stakeholders (RESTAKE)	.399	1.490	14.2	4.2	4
Subjective Norm (SUBNORM)	.042	.045	10.4	0.4	6
Recommendation (RECOM)	.293	1.341	12.95	2.95	5
Audit Fee (AUDFEE)	-3.142	1.043	0.5	-9.5	3
Firm size (SIZE)	4.325	9.596	89.4	79.4	2

From the results of the logistic regression model, the author presents six factors influencing the decision to use the financial auditing service including Director's view on financial statement audit, Related Stakeholders, Subjective Norm, Recommendation, Audit Fee and Size. The Table 6 reveals that all independent variables, except the audit fee, had the positive coefficients.

Director's view on financial statement audit is the most influential factor. The hypothesis H1 is accepted. This proves that if SME's owners are fully aware of the benefits of using the financial statement audit they will be ready to use the service. This finding is consistent with the findings of Collis (2004) and Collis et al. (2005). In the decision-making process, the SME owner will evaluate the benefits and costs of the IFRS auditing services if they find that the service does not help the unit's operations or benefits. Less than the cost, they will decide not to use the service. The explanations for not using the financial reporting

services is largely due to "Accounting system is working effectively" and "The size of the company is too small" (Table 3).

The size of the company also has an important impact on the decision to use the financial statement audit of SMEs. The hypothesis H5 is accepted. This result is consistent with studies by Carey, Sumnett, and Tanewski (2000), Hay and Davis (2002), Tauringana and Clarke (2000) in New Zealand, Norashikin and Malcom (2012), Rohana and Zubaidah (2013) in Malaysia. It can be argued that size is an important factor as the larger the scale of enterprises, the more likely they are to perform the financial statement audit voluntarily. When a business grows in scale, there is an internal demand of internal governance of the accounting system. At the same time, the need arises to seek the advice of independent auditing professionals. In this case, if the legislature extended the threshold for identifying an SME, mandatory auditing is not required, as the larger in term of size of a company, the more likely it is to use the financial auditing services.

The audit fee is the third most important factor influencing the decision to use the financial auditing services. During the decision-making process, Director's view on financial statement audit is the criteria representing the benefits and the audit fee which is representative of the costs. Research results show that if the audit fee increases, the ability of enterprises to use the financial reporting services would be reduced. This finding supports the viewpoints of Tran and Dao (2015) and Collis (2005). It also means that the hypothesis H6 is accepted.

According to the qualitative and quantitative research, the impact of recommendation factor can be explained as:

The financial auditing service is similar to other goods and services meaning that the buyer has the tendency to consult with the surrounding society to formulate information about the product. The more information he/she gets, the greater intention to buy the product. In the light of research on SMEs, the recommendations mainly come from independent auditors, accountants, clerks, the media company, the Internet and other business owners. It is a case when some SMEs have given the reason "there is no information on auditing firms" (table 3) for not having financial statement audit. The result also proves the acceptance of hypothesis H4.

Related Stakeholder factors have a positive influence on the decision of SME. The hypothesis H2 is accepted. Within the scope of research, stakeholders are understood as the groups that are likely to influence and influenced the operations of the enterprise. The results of this study support the research view of Carey, Sumnett, and Tanewski (2000) and Collis (2005), based on the Agency Theory. This result is also consistent with the results of the research survey when the "the SME's owners - managers will not use the services of financial reporting" (see Table 4).

Subjective Norm has a slight impact on SME's decision. The research findings can be explained that, although SME's owners are knowledgeable about the benefit of the financial auditing services there are not ethical/ legal issues of not having audited financial statements. The hypothesis H3 is accepted.

In short, the findings in this study agrees with that in Collis (2003) which concluded that the company is more likely to have a voluntary audit if it has the following characteristics:

First, it is larger in terms of size (basing on total assets/ equity), and the owners-managers consider that the audit improves the quality of the financial information, has a positive effect on the credit rating score and provides a check on accounting records and systems; and

Second, it is not wholly family – owned has shareholders without access to internal financial information; and

Third, the directors normally give a copy of the statutory accounts to the bank and other providers of finance

The research is carried out for investigating the determinants of demand for voluntarily financial statement audit among SMEs in Vietnam. Based on the findings, it is recommended that owners-managers of SMEs should be properly recognized the importance of financial statement audit to their operations. The Government should make the statutory auditor legal requirement of SMEs' financial statements rather than make it as an option for SMEs.

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