

Audit Evidence and Small and Medium Enterprises (SMEs) Failure

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ABSTRACT

Audit evidence includes all tests carried out, questions asked, results obtained, and information gathered by an auditor during an audit assignment. The sufficiency and appropriateness of audit evidence cannot be overemphasised, as it ensures that the auditor gives a sound judgment. This study specifically examined whether auditors stick to the evidence they gathered during an audit assignment, whether managements adhere to the advice provided by auditors, and whether failed small and medium enterprises (SMEs) were audited. The population of the study is business owners, business managers of SMEs, auditors and accountants. The study was analysed using the chi-square (χ^2) model. Results of the analysis show that management does not adhere to audit advice completely, auditors do not adhere to audit evidence, and most of the failed SMEs were not audited. The research concluded that the failure or success of SMEs lies greatly in the hands of the management, and that SMEs should not fail if they are audited. It was recommended that the management respect the audit advice provided. Auditors of SMEs should provide more quality evidence and adhere to it strictly. SMEs are encouraged to carry out audit practices, especially medium-scale businesses. Also, considering the strategic nature of SMEs, the government should provide the incentive of free audit services to SMEs.

Keywords: Audit Evidence, SMEs Failure, Audit Advice, Audit

Introduction

The strategic role in the creation of employment and the unrestricted supply of tailored services positioned Small and medium-sized enterprises (SMEs) at the nucleus of practically all economies of the globe [1]. For the avoidance of doubt, enterprises that engage between 10 and 49 employees with a capital base that ranges from 5 million to 50 million Naira are classified as small-scale businesses. Those that engaged between 50 and 199 employees, and a capital base that range from 50 million to 500 million Naira, are classified as medium scale businesses [2,3]. SMEs, with emphasis on the small scale, carry out a number of activities, which requires them to adopt accounting principles, concepts, and conventions. Also, the services of other branch of accounting are engaged as and when due. However, this study limits concentration to audit and audit evidences as it affects SMEs activities.

Before an auditor makes a report, a good number of audit procedures are carried out in order to gather sufficient and

appropriate audit evidence that backs up the expressed opinion. These evidences refer to information gained by the audit institution and or auditors to typify the state of items of audit and delineate the ground for audit submission [4]. In other word, it refers to the indispensable fact behind the figures of the financial statement and report prepared and presented by the clients' management; gather by the auditor to advance a reliable audit opinion. The strategic nature of the audit evidences and eventually opinion submitted, erupted the thinking - whether audit evidences can help in reducing SMEs failures. To this end, the following objectives are considered indispensable imperatives for this study:

- Ascertain if management of SMEs adhere to auditors' advice,
- Establish if auditors adhere to audit evidence,
- determine if failed SMEs were audited.

Literature Review

SMEs are non-subsidary, independent firms which employ fewer employees. It is owned and operated by an individual or a group of individuals, as a sole proprietorship, partnership,

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or corporation. SMEs are dynamic, growth-oriented, and innovative. It constitutes the larger portion of businesses in Nigeria. when they face distress or are incapable of operating, it ultimately reduces the chances of job opportunities available to the populace, thereby rendering citizens unemployed. SMEs are virtually the backbones of various economies. The failure of SMEs in Nigeria will most likely lead to a reduction in the country's gross domestic product (GDP) [2,3].

Small and medium-scale enterprises in Nigeria are confronted with daily challenges that reduce their level of productivity and failure. The rate of SMEs failure are on the increase due to factors that are identified as:

- **Financing Hurdles:** lack of adequate funding or working capital has been identified as one of the reasons why small businesses fail. Most often, a business owner is intimately aware of how much money is needed to keep operations running on a day-to-day basis, including funding payroll; paying fixed and variable overhead expenses, such as rent and utilities; and ensuring that outside vendors are paid on time. However, the required funds are scarcely available at the disposal of the SME owner, such that business opportunities are not utilised.
- **Inadequate Management:** Another identified reason small businesses fail is lack of business acumen on the part of the management team or business owner. In some instances, a business owner is the only senior-level person within a company, especially when a business is in its first year or two of operation. Also, the death of the owner might be the end of the business.
- **Ineffective Business Planning:** Small businesses often overlook the importance of effective business planning before opening their doors. A sound business plan should include, at minimum: a clear description of the business; current and future employee and management needs; opportunities and threats within the broader market; capital needs, including projected cash flow and various budgets; and the overall review, or audit of books of accounts, procedures and performance. To avoid pitfalls associated with business plans, entrepreneurs should have a solid understanding of their industry and competition before starting a company.

The word 'audit' is a generic word which means to examine something thoroughly [5]. defined Audit as an independent, objective assurance and a consulting activity that is designed to add value and improve an organisation's operations. Audit or auditing is the independent examination of the financial statement of an organisation with a view of expressing an opinion and making a report that the financial statement shows a true and fair view, or otherwise. Audit is an independent, objective assurance and also consulting activity that is designed to add value and improve an organisation's operations [5].

According to Aguolu, the qualities of an auditor entail the characteristics an auditor should possess in gathering audit evidence pertaining to an audit assignment [6]. The auditor should possess the following attributes to ensure the reliability of the audit evidence gathered: Independence, Honesty, Objectivity, Technical competence and Confidentiality.

According to Kenton, Audit evidence is the information collected for review of a company's financial transactions, internal control practices and other factors necessary for the certified public accountant [7]. Audit evidence refers to information or data used or collected by auditors as part of their audit work so that they can form their opinion on whether or not financial statements are prepared in all material respects and follow the applicable financial reporting framework.

Some features of audit evidence include:

- **Reliability:** Evidence obtained by the auditor is persuasive rather than conclusive.
- **Sufficiency:** Sufficiency is the measure of quantity. Audit evidence is sufficient when they are available in an adequate quantity.
- **Relevance:** whether the audit evidence obtained by the auditor is relevant or not depends on the purpose of the audit procedures.
- **Source:** Audit evidence obtained within the enterprise is known as an internal source. Evidence obtained from outside the enterprise is known as an external source. An external source is considered more reliable [6].

Aldhizer and Cashell believe that audit evidence is classified as: physical evidence, oral evidence, documentary evidence, confirmations (third-party representation), and analytical procedures [8]. By physical evidence, this is the examination of the quantitative existence and qualitative status of the tangible assets and other items reflected in the balance sheet [9]. Oral evidence relates to oral information obtained by interviewing different people within the entity or beyond, who know well enough the conditions and other specific issues that have developed audited transactions and operations, and is widely used as primary evidence in auditing [10]. The documentary evidence relates to the traditional paper-based information, and recently this has been refined to include any type of recorded information, such a computer or video, or audio [11]. The confirmatory evidence relates to those written statements as a result of the requests made to third-party organisations and individuals, such as lawyers, letters and specialist reports [12]. And the analytical procedures relate to the substantive analytical procedures to obtain assurance that accounts are fairly stated, detect fraud and error in transactions and account balances, and provide evidence about audit objectives [13].

Audit helps SMEs identify their weaknesses and how they can work towards these weaknesses in order to ensure that they are able to get the best possible results. Audits for SMEs can also help companies to improve their accounting practices. When an audit is conducted, it can be seen that companies are able to properly evaluate the options that they have when it comes to different accounting software. Some important internal audit have in SMEs are: the role of internal audit ensures the correctness and reliability of financial and operating information, as a mechanism of review and reporting exists. Internal audits identify areas for optimising resources and saving costs. The internal audit serves as a major tool for detection and especially prevention of fraud in SMEs. This is well well-known fact that SMEs are many times more prone to fraud than large organizations.

Theoretical Review

The policeman theory: This theory asserts that the auditor is responsible for searching, discovering, and preventing any fraudulent activity. The auditor acts as a policeman, focusing on arithmetical accuracy and on the prevention and detection of fraud. The auditor acting as a policeman is saddled with the responsibility of: responding promptly to his audit assignment, interviewing any relevant individual in a bid to ascertain audit evidence, observing and inspecting all assets of the entity as well as its corresponding accounts, etc. Although the auditor seeks to provide reasonable assurance and an independent, true and fair view of the financial statements, he has a duty of care to the end users of audit reports and should consider risks of material misstatements due to fraud when calculating audit risk.

Lending Credibility Theory: This suggests that the primary function of the audit is to add credibility to the financial statements. In this view, the service that the auditor is rendering to the clients is credibility. Audited financial statements are seen to have elements that increase the financial statement user's confidence in the figures presented by the management (in the financial statement). The users are perceived to gain benefits from the increased credibility; these benefits are typically considered to be that the quality of investment decisions improves when they are based on reliable information.

Empirical Review

Okafor (2012) analyzed the financial management practices of small firms in Nigeria impacted on their profitability, growth and survival. Accounting systems, financial management information, working capital management and budgeting practices were evaluated. The study advised to employ the services of qualified accountants in order to upgrade their financial management practices and enhance their overall performance. Similarly, Agyei & Kofi Nicholas in their study revealed that most small-scale businesses do not keep proper financial records and do not effectively manage their inventory and payables [14].

On the record-keeping efforts of SMEs, Rahamon and Adejare (2014) investigated the effect of accounting records kept by the Small-Scale Enterprises. Found that there is a significant relationship between accounting records and small-scale firms' performance. They concluded that proper record-keeping would lead to better financial performance of the Small-Scale Enterprises. Although it increases the chances of an increase in the business operation and achievement of success, and the provision of necessary information to enable the control of cash in the business.

Odeyile and Kingsley found that sufficiency of audit evidence had a negative but insignificant relationship with the audit report, while reliability of audit evidence had a positive coefficient sign but an insignificant relationship with the audit report [15]. This is so because there is no mathematical formula, nor a specific model, in order to evaluate the quality of audit evidence.

Jarboh drew attention to the specific need to focus on audit evidence in particular, relating to the quality and quantity of evidence utilised to complete the professional opinion report

[11]. Ooghe and Waeyaert also recognised the management and entrepreneur characteristics as the reason for the failure of SME, and emphasised the following characteristics: motivation, qualities, skills, and personal characteristics [16].

Amoako et al in their research paper found that most of the SMEs do not keep complete accounting records as a result of numerous factors, such as: lack of bookkeeping skills on the part of owners or managers, and the high cost involved in adopting a good accounting system. They do not prepare annual reports at the end of the year.

Dasgupta and Sanyal argue that a small business failure occurs gradually with a series of small failures culminating in final, absolute failure; therefore, it is not a sudden occurrence [17].

Kofi et al [14]. in their study revealed that the non-existence of proper book-keeping and basic accounting procedures in Small Scale Enterprises in Africa. Most Small Business Entities did not present a financial statement for tax assessment, due to poor financial record-keeping. High cost of hiring the service of a trained accountant, lack of knowledge about financial reports and their importance to the business and lack of computerised accounting systems were the challenges faced by the small-scale enterprises.

Zahra, in her study, examines the causes of failure of SMEs, where she takes into account different individual factors. The results of her research show that the personal characteristics of failed business owners/managers show significant differences in the level of some personal characteristics [18].

Franco and Haase conducted qualitative research in order to identify factors for poor performance and failure of SMEs [19]. In their study, they concluded that a lack of entrepreneurial qualification is a major difficulty in starting and managing their firms.

Liao recognised the importance of individual characteristics of the owners/managers of SMEs as a reason for the failure of SMEs [20].

Methodology

The survey research design was adopted for this study. This design was used to enable the researcher to get a wide range of responses and opinions from various respondents. The data used were qualitative. Data were sourced primarily from surveys and inquiries. The population for this study consists of owners, managers, and auditors of SMEs in the Metropolitan cities of Enugu State in Nigeria. The choice of these parties is necessary because of the information at their disposal about any SME venture. The sampling technique used in this study was the convenience sampling technique. This technique is a non-probability sampling technique, where options are sampled simply because they are a convenient source of data for the researcher. The technique used is the chi-square test. This is used when there is categorical data for one independent variable, to compare an observed frequency distribution to a theoretical expected frequency distribution. Thus, the Chi-square formula is:

$$X^2 = \frac{\sum (Fo - Fe)^2}{\sum Fe}$$

Where:

X^2 = Chi-square

Fo = Frequency observed or Actual frequency

Fe = Frequency expected or theoretical frequency.

$\sum$ = Summation

Data Presentation and Analysis

The data presented below shows the information gathered from the distributed questionnaire. The expected frequencies are the figures represented in brackets (). These were derived from the formula:

$$x = \frac{\text{Row sum of observed frequency} \times \text{Column sum of the observed frequency}}{\text{Table sum}}$$

QUESTIONS	SD	D	U	A	SA
Q1	14(3.8)	62(14.6)	17(8.2)	50(60.8)	4(59.6)
Q2	0(3.8)	8(14.6)	21(8.2)	65(60.8)	53(59.6)
Q3	0(3.8)	0(14.6)	1(8.2)	67(60.8)	79(59.6)
Q4	1(3.8)	0(14.6)	2(8.2)	44(60.8)	100(59.6)
Q5	4(3.8)	3(14.6)	0(8.2)	78(60.8)	62(59.6)
Q6	7(2.2)	27(20.8)	36(13)	72(62.4)	5(48.6)
Q7	3(2.2)	61(20.8)	20(13)	55(62.4)	8(48.6)
Q8	0(2.2)	7(20.8)	6(13)	74(62.4)	60(48.6)
Q9	0(2.2)	4(20.8)	0(13)	72(62.4)	71(48.6)
Q10	1(2.2)	5(20.8)	3(13)	39(62.4)	99(48.6)
Q11	5(12.8)	14(33.8)	4(23.8)	79(55.6)	45(21)
Q12	0(12.8)	7(33.8)	7(23.8)	94(55.6)	39(21)
Q13	11(12.8)	36(33.8)	19(23.8)	69(55.6)	12(21)
Q14	16(12.8)	43(33.8)	51(23.8)	32(55.6)	5(21)
Q15	32(12.8)	69(33.8)	38(23.8)	4(55.6)	4(21)

From test of hypotheses one, the P value of the chi-square score (12.6) is =0.7 at a 0.05 level of significance and a DF of 16. Since the p-value is greater than the level of significance, that is, $0.7 > 0.05$, we accept the null hypothesis and conclude that "Management does not adhere to audit advice". The test of hypothesis two shows the P value of the chi-square score (14.9) is =0.5 at a 0.05 level of significance and a DF of 16. Since the p-value is greater than the level of significance, that is, $0.5 > 0.05$, we accept the null hypothesis and conclude that "Auditors do not adhere to audit evidence". From test of hypotheses three, the P value of the chi-square score (14.7) is =0.5 at a 0.05 level of significance and a DF of 16. Since the p-value is greater than the level of significance, that is, $0.5 > 0.05$, we accept the null hypothesis and conclude that "Failed SMEs were not audited"

From the test carried out in hypothesis one, the P value of the chi-square score (12.6) was 0.7 at a 0.05 level of significance and a degree of freedom of 16. The P value was greater than 0.05, which indicated that the null hypothesis should be accepted: "Management does not adhere to audit evidence"

The test carried out on hypothesis two indicated that the P value was 0.5 of the chi square score (14.9) at a 0.05 level of significance and a degree of freedom of 16. The P value was

greater than 0.05, which means that the null hypothesis should be accepted, hence "Auditors do not adhere to audit evidence". This was compared with a review from Jarboh (2006), who saw the specific need to focus on audit evidence relating to the quality and quantity of evidence utilised to complete a professional opinion.

Findings discovered from the test of hypothesis three show that the chi-square score was 14.7, the p-value at the 0.05 level of significance and a degree of freedom of 16 was 0.5. The P value was greater than 0.05, which resulted in the acceptance of the null hypothesis, hence "Failed SMEs were not audited". This finding concurred with the review from Amoako et al (2004), who revealed the failure of SMEs may be due to a lack of accounting skills, use of incomplete records, etc. and not necessarily an audit, since they do not prepare an annual report.

Conclusion and Recommendation

The outcome of the study is that management does not adhere to the auditor's advice, which is a result of dishonest information provided. The adherence to audit evidence by auditors is not done to a great extent. Also, from the findings, it was concluded that the success or failure of SMEs lies greatly in the hands of the management team, especially in cases where they are not being audited. But in cases where they are being audited, an audited SME should not fail

Under accounting as a body of knowledge, audit is seen as a relevant branch. The audit of the entity is carried out for its good, as this will assist the firm in knowing its weak areas and also provide measures to correct these observations. The management of SMEs is therefore encouraged to adhere completely to audit advice. They are advised to provide honest information when requested by the auditor and comply fully with the auditor's advice.

Auditors of SMEs are advised to gather quality evidence and stick to the evidence gathered, as this will greatly support their judgment. An audit is recommended for the survival of SMEs. This could be limited to medium-scale enterprises as they have a wider range of activities. Relevant and honest information is provided, management should adhere to auditor's advice, auditors gather appropriate/sufficient evidence, and adhere to this evidence; no SMEs are expected to fail after an audit has been carried out.

The problem stated in the study included the financial constraints SMEs encounter during their operations, which have hurt development and also limited their potential to drive the nation as expected. Most failed SMEs lacked the capacity in terms of qualified personnel to manage their activities. As a result, they were unable to publish the same quality of financial information as bigger firms do.

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