EXTERNAL MANAGEMENT AUDITING OF COMPANIES
- A SURVEY OF BANKERS

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DECLARATION

I hereby declare that this thesis has been composed by myself and is the result of research carried out by myself.

ABSTRACT

An external management audit is defined as an independent examination of an organisation resulting in a statement to external users on the performance of the management function. External management auditing has links with, but also important differences from external financial auditing, internal operational auditing and management consultancy. The reasons for conducting external management audits are considered particularly in relation to the accountability of corporate management in society and the interests of various potential user groups. External management auditing is not merely a proposal but a reality with examples such as the Indian cost audit.

Given the lack of British empirical evidence on users' views of external management auditing, bankers were surveyed to determine whether or not they would express any demand for external management audit reports on companies. A postal questionnaire was sent to a sample of 466 branch managers and head office staff in the three Scottish joint-stock banks with a resulting 63% response rate. Over 85% of respondents agreed that they would find the external management audit report useful in their corporate lending decisions and would always or sometimes use the external management audit report as part of the information on which to assess corporate management. The respondents considered that the external management audit report should include assessments both of the general management function and of the individual business functions. The responding bankers did express a demand for external management audit reports.

A sample of 354 bankers with experience of corporate overdraft decisions received a simulation exercise involving an overdraft decision. The response rate was 58% and the main conclusion of this simulation exercise was that the addition of an adverse external management

audit report did have a statistically significant effect on the responding bankers' corporate overdraft decision outcomes. The results of both the questionnaire survey and the simulated overdraft decision show that bankers would be interested in receiving, and would use, external management audit reports on their customer companies.

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TO MY PARENTS

CONTENTS

LIST OF TABLES

CHAPTER 1

ROOTS OF EXTERNAL MANAGEMENT AUDITING

Objectives of thesis

This thesis has three main objectives. The first is to explore the meaning of external management auditing in order to have a basis for developing a questionnaire survey on external management auditing. This will involve considering the links of external management auditing with external financial auditing, internal operational auditing and management consultancy. Furthermore, the reasons for external management auditing together with proposals for and actual examples of external management audits will also be examined. The second objective is to survey by postal questionnaire one out of several potential user groups, namely bankers, to determine whether or not any demand exists for external management audit reports on companies and, if so, what information they would like included in such reports. The third objective is to attempt to determine, by means of a simulation exercise, whether or not such an external management audit report (based on the findings of this questionnaire survey) would have a significant effect on the corporate overdraft decisions of bankers.

Introduction

> An external management audit is an independent examination of an organisation resulting in a statement to external users on the performance of the management function.[1]

The above definition of an external management audit is the one which will be used throughout this thesis which concentrates on the external management audit of one particular type of organisation namely the limited liability company. However, examples will be drawn from beyond the corporate sector to illustrate certain developments in external management auditing. Furthermore, at the very beginning it should be admitted that a lack of agreement exists on terminology and definitions in this area.

Comprehensive auditing - as exemplified in the title of the Canadian Comprehensive Auditing Foundation established in 1980 - is only one of several phrases which may be used with the same meaning as the above definition of external management auditing. Other phrases sometimes used synonymously with external management auditing include expanded scope auditing, value for money auditing, performance auditing, efficiency auditing and operational auditing. Terms such as operational auditing and management auditing must therefore be interpreted in context. Indeed one survey[2] found the terms management auditing and operational auditing to be synonymous. However, Churchill and Cyert[3] have distinguished between these two terms with the operational audit being conducted, by an internal auditor, FOR the company management; and the management audit being conducted, by an external auditor, OF the company management for external users such as shareholders and bankers. This distinction will be made in this thesis.

One common characteristic of management auditing and the other alternative terms listed above is that they all include the word 'auditing'. In the definition of an external management audit at the beginning of this chapter, auditing is linked with the management function. However, the term 'external audit' has been used for so many years in the context of an opinion by an independent professional accountant on the financial statements produced by the management of the organisation that this is considered by many to be its only meaning. For example, the 1978 Cohen Report of the American Commission On Auditors' Responsibilities emphasised this relationship between auditing and accounting:

> 'Auditing involves an independent examination to determine the propriety of accounting processes, measurements and communication. Stated simply, the accountant prepares financial information; the auditor checks it. The distinction, however, cannot be made in practice. To perform his function, the auditor must continually evaluate accounting activities and presentations; he must be, and is, trained as an accountant <u>and</u> an auditor.'[4]

Similarly, the explanatory forword to the British auditing standards and guidelines links auditing with accounting by means of the financial statements:

> 'An audit is the independent examination of, and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation.'[5]

Therefore, to help place external management auditing in perspective and to consider some of its roots, a brief review will be made of external financial auditing including a comparison between these two types of auditing.

<u>External financial auditing</u>

The basic idea of auditing can be traced back to Mesapotamia in 3,600 B.C.[6] However, Woolf has suggested:

> 'Auditing, as we understand it now, has its roots two or three hundred years ago, in the first division of interests between those engaged in a business undertaking (the enterpreneurs) and those who made the finance available without necessarily becoming directly involved in day-to-day management.'[7]

In order to compare external management auditing and external financial auditing, this discussion will be restricted to the external audit of the financial statements of limited liability companies.

Historically the corporate form of organisation and in particular limited liability companies are relatively recent phenomena. The growth of joint-stock companies was restricted by the collapse of the South Sea Company. Court concluded:

> 'After 1720, the foundation of joint-stock companies was controlled by the so-called Bubble Act of that year, a panic measure passed by Parliament as a direct consequence of the public scandal caused by the collapse of the South Sea Company. This law prohibited the formation of new joint-stock companies unless sanctioned by private Act of Parliament or Crown charter. The law stood unrepealed until 1825.'[8]

After the repeal of the 'Bubble Act' the number of joint-stock companies increased and the Trading Companies Act of 1834 gave the Board of Trade power to grant incorporation to companies, conferring legal powers but not limited liability.

Until 1844 no statutory company audit existed but the 1844 Joint Stock Companies Act required all incorporated companies to have their balance sheet audited. Between 1856 and 1862 a series of Acts conferred full legal power and limited liability on all joint-stock companies on registration. In relation to these Acts Checkland found:

> 'This very great increase in new projects called into being a frightening number of new companies, under limited liability, in the years 1863 and 1864. The new principle invaded most parts of banking, commerce, transport and industry.'[9]

This new principle of limited liability meant, of course, that if a company failed, the shareholders' financial liability was restricted to the amount of capital which they had originally subscribed to that company.

Prior to this increase in the number of limited liability companies, the 1856 Companies Act repealed the audit provision of the 1844 Act and it was not until the

1900 Companies Act that the audit of the balance sheet was again required by law. Between 1844 and 1856 the practice was to appoint a shareholder to conduct an audit but by 1900 it was common practice to appoint a professional auditor to act on behalf of all the shareholders.[10] Nevertheless, it was not until 1948 that the Companies Act required the auditor to be professionally qualified and this Act required that, in addition to the balance sheet, the profit and loss account must also be audited.

The main reason for this brief historical review of the statutory audit of the financial statements of limited liability companies is to emphasise the comparatively recent development of the external financial audit of companies. It is only during the last 140 years that the statutory external financial audit has developed and it is only since 1948 that the current British statutory audit requirement for limited liability companies has been in existence. Furthermore, as Shaw has argued:

> 'Auditing, which is to do with accounting and accountability is equally socially responsive .... The present conventional view of the audit role will similarly be modified and developed in response to inevitable social change.'[11]

External management auditing is one such possible future development. Two such past modifications and developments in external financial auditing with implications for external management auditing are the changes in the objectives of the company audit and the greater consideration given to the future of the company being audited.

Firstly, the objectives of the statutory company audit have changed over time. Lee[12] has summarised the changes in the British company audit objectives from 1840:

Period	Primary Objectives	Secondary Objectives
1840-1880	Detection of fraud and error	
1881-1900	Detection of fraud and error	Verification of financial accounting records' accuracy
1901-1920	Detection of fraud and error	Verification of financial accounting records' accuracy Attesting credibility of financial statements
1921-1940	Detection of fraud and error Verification of financial accounting records' accuracy	Attesting credibility of financial statements
1941-1960	Verification of financial accounting records' accuracy Attesting credibility of financial statements	Detection of fraud and error
1961-	Attesting credibility of financial statements	Detection of fraud and error

This summary highlights that the company audit objective of the detection of fraud and error has moved from being a primary to a secondary objective. External financial auditing of limited liability companies has developed from a need to protect shareholders - particularly in situations where the shareholders are divorced from the management of the company. The shareholders wish confirmation that the managers are accounting fairly to them.

The emphasis of the external financial audit has been on the honesty of the stewardship whereas the efficiency of the stewardship has been neglected. For example, the external financial auditor will not report to the shareholders that the resources of the company have been used inefficiently as long as such resources have been accounted for fairly. In contrast, the external management auditor is interested in 'the performance of the management function' and would comment on the inefficient use of corporate resources. In his survey of the perceptions of company financial management regarding the external financial audit Lothian concluded his study with a quotation from one respondent who voiced the general feeling as follows:

> 'It's high time the professional bodies channelled some of these resources into helping the finance director work towards corporate solvency and profitability on which we, and our auditors, ultimately depend.'[13]

In summary, the external management auditor is interested in the efficiency of management's stewardship of the company's resources as distinct from simply the honesty of that stewardship.

A second development in external financial auditing which has implications for external management auditing is the greater consideration being given to the future of the company being audited. External financial auditors have been criticised for concentrating on the past and ignoring the future. In recent years external financial auditors have been forced to pay more attention to the future with changes such as inflation accounting, post balance sheet events, the 1981 Companies Act requiring the auditor to review the directors' report and the question of whether or not a company is a going concern.

With regard to the going concern concept, the external financial auditor must assess whether 'the enterprise will continue in operational existence for the foreseeable future'.[14] This means that the auditor will review cash flow forecasts, a process which involves assessing the reasonableness of management's assumptions about the future such as forecast sales, costs, capital expenditure and dividends. To decide whether or not a company is a going concern, the external financial auditor must use his judgment about the future. This is an interesting development from the viewpoint of the external management audit because the external management auditor will need to consider the future to be able to comment on 'the performance of the management function'.

External financial and external management auditing have other similarities. Firstly, in both types of auditing the auditor must be independent of the management of the company. This means that the auditor is independent in terms of his attitude of mind and because of this external financial auditors have attempted to ensure that they are seen to be independent by including certain rules in their ethical guide. For example, one such rule is that the recurring fees paid by one client or group of connected clients should not exceed 15% of the gross fees of the practice. If the auditor is not independent of the management of the company, the auditor's opinion would mean little. The auditor must be objective and unbiased.

Secondly, the final product of both the external financial audit and the external management audit is a report to users outside the company. Thirdly, both types of audit opinion require the collection of evidence which in terms of the external financial auditing standards and guidelines is described as 'relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom'.[15] It can be seen, therefore, that some of the roots of external management auditing lie in the field of external financial auditing. However, despite the above similarities, external financial auditing differs from external management auditing in several important respects.[16]

Firstly, as already mentioned, external financial auditing concentrates on the past and the present whereas external management auditing concentrates on the present and the future. The external management auditor will look at past management decisions but from the point of view of the decision process to highlight any weaknesses in this process which might cause problems for the company in the future. This highlights a second difference in that the external financial audit is primarily protective whereas the external management audit is primarily constructive. The external financial auditor aims to protect the shareholders by ensuring that the management of the company account fairly to them through the annual financial statements. In contrast the external management auditor aims to highlight any weaknesses in the performance of the management function so that such weaknesses can be improved.

Thirdly, the external financial auditor relies on financial information as the primary source of evidence whereas the external management auditor relies on both financial and operational information as primary sources of evidence. The external financial auditor may use operational information but only so far as it relates to the financial information (eg. stock valuation). However, the external management auditor is interested in operational information for its own sake such as market share, productivity measurements or labour turnover statistics. Fourthly, the external financial auditor determines whether adequate controls and procedures are being followed whereas the external management auditor determines whether corporate resources are being used efficiently and effectively. This is linked to the fifth difference with the external financial auditor emphasising the verification of profit and the external management auditor emphasising the improvement of profit and the achievement of other corporate objectives.

In summary, the differences between the external financial audit and the external management audit are greater than their similarities. The external financial audit is restricted in scope with its opinion on the truth and fairness of a company's financial statements compared to the broader external management audit with its opinion on the performance of the management function. The production of annual financial statements forms only one part of the corporate management function. Indeed it can be argued that external management auditing has as close links with internal auditing as with external financial auditing. Internal operational auditing is another of the roots of external management auditing.

Internal auditing

Internal auditors have existed in one form or another for many centuries and in limited liability companies internal auditors were originally employed by the management to check internal financial reports such as the monthly accounts. However, the literature and practice of internal auditing have extended beyond this checking of internal financial reports. For example, in the British literature the book by Chambers[17] entitled 'Internal Auditing' illustrates how internal auditing has developed with chapters on 'internal auditing and risk management' and 'operational auditing with reference to research and development'. The Institute of Internal Auditors, which was not established until 1941 in the United States of America, has issued the following definition:

> 'Internal auditing is an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation.'[18]

This definition would encompass internal financial auditing but it is also much broader than simply internal financial auditing because in recent years operational auditing has become an increasingly important part of internal auditing.

From a 1973 survey The Institute of Internal Auditors concluded:

> 'An operational audit is a future-oriented, independent, and systematic evaluation performed by the internal auditor for management of the organisational activities controlled by middle and lower-level management for the purposes of improving organisational profitability and increasing the attainment of other organisational objectives.'[19]

This definition of an internal operational audit has similarities with that of an external management audit. For example, both types of audit are 'future-oriented' and concerned with a 'systematic evaluation of organisational activities'. Similarly, the purpose of both an internal operational audit and an external management audit include 'improving organisational profitability and increasing the attainment of other organisational objectives'. Some of the roots of external management auditing lie in the field of internal operational auditing.

Nevertheless, the differences between internal operational auditing and external management auditing are important. Firstly, the above definition of an operational audit includes an 'independent evaluation' but in this case the internal operational auditor is only independent of 'middle and lower-level management' and not independent of top management because the internal operational auditor is employed by the company and reports to top management. In contrast the external management auditor should be independent even of top management because he is not an employee of the company. Secondly, as already mentioned, the internal operational auditor conducts the audit FOR the company management whereas the external management auditor conducts an audit OF the company management for external users such as shareholders and bankers. The objective of the internal operational auditor is to serve the needs of management whereas the external management auditor aims to meet the needs of external users. Thirdly, top management will usually direct the internal operational auditors to examine certain parts of the company whereas the external management auditors will decide for themselves the parts of the company on which they will concentrate. The external management auditor has greater freedom of action than the internal operational auditor.

Despite these important differences between the two types of auditing, some of the roots of external management auditing stem from internal operational auditing. The growth in internal corporate operational auditing in recent years may be one source of pressure for external management auditing in the future. A survey[20] of internal auditing in the United Kingdom in the mid 1970s did not specifically cover operational auditing. However, an indication of the extent of operational auditing was given in a 1979 international survey[21] which showed that the internal audit departments concerned spent approximately half of their efforts on operational audits and approximately half on financial audits. In addition, a 1977 American survey of internal auditing concluded:

> 'The majority of companies interviewed report that, over the past ten years the trend has been towards increased and broadened operational audits.'[22]

Furthermore, Chambers has argued:

> 'The adoption of operational auditing and efficiency and effectiveness auditing has been by means of a reallocation of effort away from financial and compliance auditing.'[23]

An important reason for the growth of operational auditing has been that, increasingly, managers cannot directly oversee all operations, because of the increase in size and complexity of companies. For example, with the growth of multinational companies, managers have become responsible for units located throughout the world. The internal operational auditor has filled a role as the eyes and ears of top management. The external management auditor could fulfil a similar role for users outside the company.

An internal operational audit is not usually conducted exclusively by accountants but by a multidisciplinary team. For example, in the American survey[24] already mentioned, 95% of the companies employed one or more non-accounting specialists as internal auditors with expertise in various fields such as EDP, statistics, engineering, general management, marketing, economics, production, purchasing and law.[25] Similarly, it is generally agreed that a multidisciplinary team will be required to conduct an external management audit. This implies that external management auditing is about management in addition to being about auditing. In particular management consultancy is another of the roots of external management auditing.

Management consultancy

Even during the twentieth century very different views on management have been proposed by writers such as Argyris, Drucker, Follett, Herzberg, Likert, Mayo, McGregor, Simon, Taylor, Trist and Woodward.[26] To consider just three examples, Taylor emphasised the importance of time and motion study and considered mainly repetitive tasks while regarding the employee generally as a tool similar to a machine. In contrast, Mayo stressed the importance of factors such as the informal organisation, social values and group interaction while the emphasis by Argyris was on the lack of congruency between the needs of healthy individuals and the demands of the formal organisation. The variety of management practices is also illustrated by the different types of management leadership which have been proposed such as situational, functional, bureaucratic, charismatic and leadership by objectives to name only a few.

The present state of the management literature implies that, depending upon the particular circumstances of each company, many different types of management practice may fall into the category of good management. It can be suggested that management principles and practices are at present as well - or as poorly-developed as accounting principles and practices. However, this problem of the range of accounting principles and practices has not stopped the external financial auditor from reporting his opinion on the financial statements of companies and, therefore, the problem of the range of generally accepted management principles and practices need not necessarily deter the external management auditor.

The analogy can perhaps be drawn between good management and good health. Both are easier to recognise when seen, than to define in advance. Similarly, even the best management and the fittest individual have areas of relative weakness. The external management auditor may be able to act in much the same way as the general medical practitioner, by identifying the problem areas and, if necessary, suggesting that specialist advice be sought. Depending upon the particular problem, this might mean the management consultant. Indeed the management consultant (with skills such as analysis and problem identification) could be a valuable member of the external management audit team.

External management auditing and management consultancy have certain similarities. For example, both the auditor and the consultant come from outside the company although both require the cooperation of the company's employees. One advantage of both the external management auditor and the management consultant is their objectivity. Furthermore, both also share the advantage of having seen the operations and management of many other companies. Indeed, both the external management auditor and the management consultant may have been involved with another company in the same industry.

Furthermore, Falk has suggested:

> 'Absolute objectivity, a disinterested approach, and, above all, the precious ingredient of untrammelled time have combined to make responsible management consultancy an important new profession.'[27]

The same argument of 'untrammelled time' could be applied to external management auditing. Is external management auditing, therefore, the same as management consultancy?

The answer is generally in the negative for three main reasons. Firstly, the external management auditor would be employed by a third party such as shareholders whereas the management consultant is usually employed by the management of the client company. Secondly, the management consultants' report is generally only available to those within the company and not to any external group. Thirdly, very often the management of a company hire management consultants for their advice in relation to a particular problem whereas, in contrast, the external management auditor would decide on which areas to report.

Therefore, the development of external management auditing has roots in external financial auditing, internal operational auditing and management consultancy. However, these three activities also differ considerably from external management auditing. Why has external management auditing developed at all? The following chapter considers the reasons for this development.

CHAPTER 2

REASONS FOR EXTERNAL MANAGEMENT AUDITING

Accountability

Several reasons have been suggested for conducting external management audits and these will be considered using quotations from various sources. For example, Foster has concluded:

> 'I started with the old presumption of a divergence of interest between shareholders and management which led to the logical, if idealistic, conclusion that all joint stock companies should be subject to periodic efficiency auditing.'[1]

This is the reason of performance evaluation of corporate management on behalf of the shareholders.

In the context of external financial reporting, the Corporate Report considered other user groups as well as shareholders and concluded:

> 'Having reviewed the rights and needs of user groups we conclude that corporate reports may be able to contribute to user information needs in:
>
> (a) Evaluating the performance of the entity.
>
> (b) Assessing the effectiveness of the entity in achieving objectives established previously by its management, its members or owners or by society. This includes but is by no means limited to, compliance with stewardship obligations.
>
> (c) Evaluating managerial performance, efficiency and objectives.'[2]

The emphasis in external management auditing would be on (b) and (c) above namely on the efficiency and effectiveness of managerial performance. It is recognised that a company's performance may at times be affected by factors outwith the control of management. This is why external management auditing would concentrate on the performance evaluation of corporate management. As with the Corporate Report, NIVRA in Holland has widened this idea beyond shareholders to other user groups:

> 'A growing belief was expressed that it would become essential for users of financial statements to be adequately informed with respect to decision-making processes.'[3]

In his book 'The Board and Management Audit' Washbrook, like Foster, has started from this divergence of interests between shareholders and management and has argued:

> 'What is needed in the modern situation of professional managers and administrators who are not the complete, or even the substantial owners of a business, is some form of overall management and administration audit as an independent assessment of the soundness of the business unit and its ability to face the business problems of the future. The results should be for the benefit of the shareholders, the stock exchanges and the general investing public.'[4]

Both Foster and Washbrook begin from the divergence of interests between the shareholders and managers which is the underlying reason for the external financial audit and take this argument to its logical conclusion which implies an external management audit. However, Washbrook has developed the reason for external management auditing from performance evaluation of corporate management to an assessment of the ability of the company to face the business problems of the future. By its nature such an assessment with regard to the future would be very subjective on the part of the auditors but might be of use to different user groups.

Taking the future into account Baden has given another reason for conducting external management audits on limited liability companies:

'It may be some time before the results of bad management become reflected in the accounts, and by then it may be too late for the shareholders to do anything about it .... The intention is not only to protect the outside or minority shareholders, who may be completely indifferent and apathetic, but also to prevent the inefficient and wasteful use of national resources.'[5]

Baden has broadened the argument from the viewpoint of the shareholders to the viewpoint of society and the waste of finite resources. At present what happens when a management team is inefficient? Little pressure can be exerted on such inefficient management except in the extreme cases of a take-over bid or receivership.

In suggesting a further reason for conducting external management audits, Flint has developed this theme of society's viewpoint:

> 'Referring to the private sector, the development of the concepts of the operational audit and the management audit are important as further illustrations of the operation of the interaction of ethical standards, social values and environmental circumstances to develop the audit to monitor conduct and performance as measured against the perceived norms.'[6]

This raises the whole question of accountability which has received increasing attention during recent years. For example, Tricker has suggested:

> 'The independence of outside directors, audit committees, non-executive director reports and similar ideas are also being developed. These are all reflections of the search for an accepted concept of accountability.'[7]

The external management audit is one of the 'similar ideas' which is being developed in this 'search for an accepted concept of accountability'.

In the North American context Churchill et al have argued:

> 'We may think of "comprehensive audit" as representing the ultimate extension from preoccupations with financial accounting and opinion audits, as in the past and present, to a future in which ALL phases of management will be subject to audit as part of an external (ultimately comprehensive) accountability for corporate behaviour.'[8]

The above 'comprehensive audit' can be equated with an external management audit. Steckmest has clarified one of the reasons for the necessity of such 'external accountability for corporate behaviour':

> 'While large corporations have become quasi-public in their nature, they are governed essentially as private institutions and therefore should be made more accountable to a variety of interests.'[9]

In the British context Sherer and Kent have made this link very explicit between external management auditing and accountability not only to the shareholders but also to other participants such as bankers, employees, consumers, government and the local community:

> 'However, the interpretation placed on management auditing in this book emphasises the potential role that a management audit has within the accountability process between an organisation and its external participants.'[10]

This emphasis on accountability not only to the shareholders but also to other user groups could be an important source of pressure for companies to have external management audits.

<u>User groups</u>

The above reasons for external management auditing emphasise that the basic objective underlying the idea of the management audit is to attempt to fulfil the need for additional data which external users may combine with existing data to evaluate a company's performance. What evidence do we have that external users are interested in a report on the performance of the management function? First of all we have the views of authors such as Campfield:

> 'There is every indication that, in the future, the various publics - investors, taxpayers, creditors, labour unions, etc - will be clamouring for more "independent" evaluation of managers' performances.'[11]

Burton has developed a similar theme to Campfield:

> 'Investment analysts today recognise that the evaluation of management is of crucial importance and, at the same time, extremely difficult for any outsider .... Similarly, stockholders - particularly those who control large holdings in trust for others - may want more assurance that their capital is being effectively used. Finally, there is an increasing tendency for the public to feel that corporate management has the responsibility of using assets under its control effectively as a service to society as well as its own stockholders.'[12]

Evidence is also available from some empirical surveys.[13] For example, in a survey of financial analysts in the United States of America, Mautz[14] found that the analysts identified 'managerial ability' as the second most important company characteristic out of a list of six. Similarly, in another American survey Baker and Haslem[15] found that individual investors ranked 'the quality of management' as the second most important factor out of thirty-three factors. In a survey of investors conducted this time in Australia by Chenhall and Juchau[16] 'the quality of management' was ranked fourth in importance out of thirty-seven factors. In another Australian survey of shareholders in the early 1970s, Beck asked specifically about external financial auditing and 71% of the respondents agreed with the statement that 'you expect the work of the auditor to give you assurance that management is efficient'.[17] How many other users think that the existing external financial audit report is giving an 'assurance that management is efficient'?

In addition to the above empirical evidence certain arguments can be advanced why various user groups might be interested in a report on the performance of the management function. The percentages of the total market value of shares in U.K. companies held by different categories of shareholders in 1963, 1975 and 1981 changed as follows:[18]

	1963	1975	1981
	%	%	%
Individuals	54	37	28
Insurance companies	10	16	21
Pension funds	6	17	27
Unit trusts, investment trusts and other financial companies	13	15	10
Other investors	17	15	14
	100	100	100

This table shows the decline in the percentage of the total value of shares held by individual investors and the increase in the percentage held by institutional investors - particularly the pension funds and insurance companies. At present institutional investors make assessments of the performance of the management function from many sources including published financial statements and informal meetings with the top managements of companies. The external management audit report could provide another piece of the total picture which the institutional investor is seeking. Of course the individual investor would also be interested in the external management audit report but it is more difficult for the individual investor, compared to the institutional investor, to bring pressure either to introduce such audits or, if such audits are introduced, to influence the performance of the management function.

An argument can also be advanced that the external management audit could prove to be a useful tool for bankers. In the lending decision a crucial factor is the ability of the borrowing company to pay the interest and to repay the loan in the future and this will depend at least partly on the future performance of the management function. This decision by bankers about the ability of a company to repay a loan may therefore be aided by an external management audit report.

A similar argument can be applied to creditors. Suppliers have a continuing relationship with a company and are interested in its ability to pay existing and future debts. Furthermore, suppliers are almost always unsecured creditors whereas the banker may have some security from the company. Therefore it is important for suppliers to be able to anticipate problems with their major customers so that credit may be withdrawn or at least reduced. An external management audit report might help suppliers to identify potential problem customers.

Other user groups might combine the external management audit report with the existing data available to them. For example, trade unions, employees and potential employees of a company are particularly interested in the long-term prospects of that company and the external management audit report could be a useful source of information. Various governmental agencies, such as the Department of Industry, might be interested in the overall picture presented by external management audit reports. These reports taken together would reflect on the general state of British corporate management.

In this chapter various reasons have been suggested why external management audits might be conducted. Perhaps the most persuasive of these reasons is the accountability of the corporate management to the various external user groups. This implies the evaluation of corporate management performance in terms of the efficiency of the stewardship of that company's resources. However, this chapter has also illustrated that the external management audit can be interpreted in various ways for example Foster with 'periodic efficiency auditing', NIVRA with 'information about decision-making processes' and Washbrook with an 'overall management and administration audit'. Such variety is not surprising with external management auditing being at a relatively early stage of development in historical terms. The following chapter therefore considers some specific proposals and examples of external management auditing to clarify some of the possible aspects of the performance of the management function on which the external management auditor could report.

CHAPTER 3

PROPOSED AND ACTUAL EXAMPLES OF EXTERNAL MANAGEMENT AUDITING

Using the definition that an external management audit is an independent examination of an organisation resulting in a statement to external users on the performance of the management function, a number of proposals and actual examples can be found with at least an element of external management auditing. Some of these proposals for external management audits in the private sector will be considered first because many of the actual examples of external management audits have been influenced by these proposals.

Proposals for external management auditing

Two proposals were developed over many years during the first half of the twentieth century in both the United States and Great Britain by Benedict and Rose respectively. Benedict in the early 1900s discussed a measurement and rating system which culminated in his 'Yardsticks of Management'[1] in 1948. Benedict listed his yardsticks in great detail but his major divisions of management analysis were weighted as follows:

50 points	Corporate and financial factors
50 "	Integrated management plan
40 "	Product design and engineering
30 "	General accounting
20 "	Publicity and advertising
15 "	Toolmaking
10 "	Public relations
5 "	Storeroom facilities

The great detail of Benedict's yardsticks can be seen from the fact that he listed over 140 subdivisions in his management analysis.

In Great Britain a similar approach to that of Benedict was suggested by Rose[2] in 1932 in his book entitled 'The Management Audit'. It is interesting that both Benedict in the United States and Rose in Great Britain developed their ideas on management auditing over many years. Rose argued that 'the management audit would concern itself with the whole field of activities of the concern from top to bottom'.[3] The survey proposed by Rose covered the following areas:

1. Organisation chart
2. General management
3. Production:
   (a) Buying
   (b) Planning
   (c) Process
   (d) Storage
   (e) Inspection
   (f) Internal transport and dispatch
   (g) Buildings and layout
4. Distribution:
   (a) Sales records
   (b) Sales policy
   (c) Service
   (d) Publicity
   (e) Sales control
5. Product development and market research
6. Accounts and finance
7. Legal and secretarial
8. Personnel and industrial relations.

Rose, however, emphasised that the management auditor would not question the general policy of the organisation. The objective of Rose's management audit was to check the means by which such policies were implemented.

Both Benedict and Rose developed their proposals for external management audits in great detail during the first half of the twentieth century. Since the late 1960s a number of proposals for external management audits have been put forward by Burton, Langenderfer and Robertson, Robertson and Clarke and Burton and Fairfield in the United States and by Baden, Rhys Williams, Bishop and Washbrook in Great Britain. For example, in 1968 Burton[4] proposed an external management audit with the emphasis on the development of management performance standards to evaluate the procedures and results of organisations. Burton suggested that a first step would be the development of a managerial control measure and he outlined the following possible classification of areas of managerial control:[5]

1. Organisation control
2. Planning and information systems
3. Asset management
4. Marketing system
5. Production system

All of the above categories were further subdivided into four more specific aspects of managerial control.

Management control is also one of the five main topics in Langenderfer and Robertson's[6] 1969 proposal for 'A Theoretical Structure for Independent Audits of Management'. To date this is probably the most complete attempt at a theoretical approach to management auditing. Langerderfer and Robertson put forward nine hypotheses of independent management auditing and concluded:

> 'Thus the topics of management representations, decision systems, management control, standards of rational management, and comprehensive disclosure remain as potentially fruitful areas for investigation. At the very least, existing knowledge of these concepts could be integrated more fully into the management audit concept.'[7]

Robertson and Clarke[8] later researched the first of these topics namely 'Verification of Management Representation: A First Step Toward Independent Audits of Management' which was published in 1971. Management representations were defined as 'all informational disclosures that management currently presents to the public, with the exception of pictures and the traditional audited financial statements'.[9] Robertson and Clarke considered that insufficient evidence existed for verifying the annual report content taken as a whole, but they suggested that generally accepted financial auditing procedures could be used as a starting point for an audit of management representations. Robertson and Clarke concluded:

> 'Management-related auditing will remain in the theoretical realm until the concepts and problems are tested in practice.'[10]

It is interesting that these various proposals for external management audits should be published in the United States in the late 1960s and early 1970s. However, Burton in particular has maintained his interest in external management auditing and in 1982 in an article entitled 'Auditing Evolution in a Changing Environment' Burton and Fairfield[11] proposed:

> 'A second product which might be developed is an independent audit of various management processes and functions which focus on the efficiency and effectivess with which tasks are accomplished... A management audit product might also deal with decision making systems rather than achieved results ... Outside parties have a legitimate interest in managerial performance which goes beyond the results presented in the financial statements.'[12]

However, it is not only in the United States that proposals have been put forward for external management audits. Several British proposals have also been made since the 1960s.

In 1968 Baden[13] was considering the situation from the viewpoint of the shareholders and argued that shareholders could do little in a situation where the management of a company are inefficient except hope for a takeover bid. Baden therefore suggested:

> 'There would seem to be no <u>prima facie</u> reason why the efficiency of management should not be capable of assessment by some impartial third party, and a report on this made to shareholders.'[14]

This proposal for an external management audit was in fact developed by Sir Brandon Rhys Williams, M.P., who in 1969 attempted to introduce a form of statutory external management audit.

The private Members' Bill of Rhys Williams[15] would have enabled a shareholders' representative committee to make a formal inquiry into the efficiency of the company's operations. The exact terms of the reference of inquiry would have been settled by the committee appointed. However, section 6(1) of this Bill defined a management audit as 'an inquiry into the advisability of any of the policies of the directors in furthering the objects of the company as defined in the memorandum, or into the efficiency with which they are securing the execution of those policies'. This Bill failed owing to a lack of Parliamentary time although it successfully completed the House of Commons Standing Committee stage. The journal, 'The Accountant' of July 26th 1969, commented:

> 'The significant fact is that the Bill made as much progress as it did; and while, no doubt, it may be claimed that the opposition of influential bodies such as the allied accountancy bodies and the Chartered Secretaries was effective, the simple fact was that the Bill attracted a lot of sympathetic notice, not least in the House of Commons.'[16]

The above quotation implies that in 1969 the British accountancy bodies were opposed to this type of external management audit.

Given this opposition from the British accountancy bodies it is ironic that in 1974 Bishop[17] proposed that an external management audit could be developed from the existing statutory financial audit function. One part of Bishop's proposal for an 'operations audit' was that the auditors' report to directors on the adequacy of the internal control procedures should also be included in the audit report given to shareholders. However, Bishop also suggested:

> 'As part of the statutory audit, the larger firms of accountants often review the cash flow and profits forecast in order to satisfy themselves that the value of the company's assets should be viewed as a continuing entity. This function and an extension of the review to include the total management information system should become a statutory requirement, and be called the operations audit.'[18]

Bishop developed this argument and concluded that auditors should report on the effectiveness and adequacy of the management information system to the shareholders.

Bishop and the other British proposals already mentioned considered the external management audit to be very much for the benefit of the shareholders of the company. Washbrook's[19] proposal in 1978 takes a similar viewpoint with the results of the external management audit being used for the benefit of the shareholders and the general investing public. Washbrook proposed a wider form of external management audit than that suggested by Bishop namely an overall management and administration audit. Washbrook in fact concluded:

> 'I should like to think that the audit of directors as managers and administrators will become a legal requirement.'[20]

Washbrook viewed the external management audit in the same light as the existing external financial audit.

These are some of the American and British proposals for external management audits of companies. Although these proposals generally begin from the viewpoint of the shareholders, the details of the proposals are diverse but two general themes can be identified. The early proposals of Benedict and Rose concentrate on the efficiency of management and this theme can be seen also in the proposals of Burton and Fairfield, Baden and Rhys Williams. However, Burton and Fairfield and Rhys Williams combine this theme of the efficiency of management with a second theme of the effectiveness of management and the proposals of Bishop and Washbrook also develop this theme of the effectiveness of management. These, therefore, are some of the proposals for external management audits and some actual examples will now be examined.

Actual examples of external management auditing

Many of the developments in external management auditing have taken place in the public sector which provides more examples at present than the private sector. Henley has emphasised the similarities between the public and private sectors in this field:

> 'The public and private sectors share the need for a common approach to some aspects of efficiency, for example cost control and the pursuit of value-for-money and common techniques could be applied therein.'[21]

Therefore, some public sector examples both in North America and Great Britain will be considered.

(a) Public sector

In the area of governmental auditing, the U.S. General Accounting Office provides one of the most complete existing examples of external management auditing. The Congress created the General Accounting Office (G.A.O.) in 1921 to maintain fiscal accountability over appropriated funds. The G.A.O. has evolved into the control arm of the Congress. The Comptroller General heads the G.A.O. and is appointed by the President for a 15 year term subject to removal only by the action of the Congress. The staff of the G.A.O. consists of approximately 3,000 auditors with a large percentage being non-accountants. The Comptroller General prepares an annual report for Congress summarising the results of the year's audit and review activities.

In 1972 the G.A.O. issued 'Standards for Audits of Governmental Organisations, Programs, Activities and Functions' and these Standards state:

> 'The full scope of an audit of a governmental program, function, activity or organisation should encompass:
>
> (a) An examination of financial transactions, accounts, and reports, including an evaluation of compliance with applicable laws and regulations.
>
> (b) A review of efficiency and economy in the use of resources.
>
> (c) A review to determine whether desired results are effectively achieved.'[22]

These three types of audit conducted by the G.A.O. are generally known as:

(a) Financial and compliance audits
(b) Economy and efficiency audits
(c) Programme results (or effectiveness) audits.

The G.A.O. Standards also include a specific reporting standard stating that copies of the reports should also be made available for public inspection. Indeed the G.A.O. issues a monthly list of its reports with summaries of the main findings.

A former Director of the G.A.O., Herbert,[23] has written a book partly based on the work of the G.A.O. entitled 'Auditing the Performance of Management'. In this book Herbert argues:

> 'And whereas the purpose of auditing the performance of management used to be to ensure compliance with laws, policies and regulations, the primary purpose

> today is to improve managerial performance, to determine whether an organisation, activity or program has been managed economically, efficiently or effectively.'[24]

It is perhaps rather too easy to discuss economy, efficiency and effectiveness without defining these terms. Dewar[25] has attempted to distinguish between these three terms in the following diagram:

```
Actual Input ———> Efficiency ———> Actual Output
(Resources)       (Productivity)   (Results, Product etc)
     ↑                                   ↑
  Economy                          Effectiveness
     ↓                                   ↓
Planned Input                      Planned Output
```

Even in this helpful diagram perhaps the distinction between efficiency and effectiveness is clearer than the distinction between economy and efficiency.

In addition to the G.A.O's economy, efficiency and effectiveness audits at the national level in the United States, external management auditing is also expanding at the individual state level. For example Brown, Williams and Gallagher have argued:

> 'In 1938 there were five states where sole post-audit responsibilities rested with an appointive legislative auditor; the number changed to eight in 1951, 15 in 1960 and 25 in the late 1970s. There are now over 40 states in which the audit function is part of the legislative branch. Performance auditing is closely correlated with the increased role of the appointed auditor.'[26]

Such performance audit reports are generally available to the public.

American education is another public sector area where external management audits have been attempted.

For example, an independent performance audit of a school district was completed in September 1979 for a group of citizens and industrialists in Columbus, Ohio. The consultants defined their task as being 'an external, objective and systematic review of available and retrievable data developed by the school district to determine how well it has developed its objectives, managed its resources and obtained the results that it desires'.[27] Such an audit examined both the efficiency and the effectiveness of the school district. A further example illustrating the possible range of external management audits is the performance audit of the Department of Public Safety in the City of Sunnyvale[28] conducted by Peat Marwick Mitchell & Co. in 1974.

Since the early 1970s the American Institute of Certified Public Accountants (A.I.C.P.A.) has shown an active interest in external management auditing in the public sector. For example, in 1973 the A.I.C.P.A. issued 'Auditing Standards Established by the G.A.O - Their Meaning and Significance for CPAs'[29] and in the Management Advisory Services Guideline Series in 1977 the A.I.C.P.A. issued 'Guidelines for CPA Participation in Government Audit Engagements to Evaluate Economy, Efficiency and Program Results'.[30] These Guidelines emphasised the distinction between external financial and management auditing in the public sector:

> 'The CPA should keep in mind the following significant distinction between financial auditing and engagements to evaluate efficiency, economy and program results. While there are some variations encountered in conducting financial audits, a practitioner skilled in examining accounting records, financial statements and internal controls should encounter few material differences in the skills and knowledge required of him when moving from one government entity to another. This is not true for evaluation of economy, efficiency and effectiveness.'[31]

American accountants are very much involved in external management auditing in the public sector.

A similar situation to the United States prevails in Canada.[32] The Auditor General Act of Canada of 1977 requires the Auditor General of Canada to report, like the G.A.O. in the United States, where:

(1) Money has been expended without due regard to economy and efficiency.

(2) Satisfactory procedures have not been established to measure and report the effectiveness of programmes where such procedures could appropriately and reasonably be implemented.

In Canada the Canadian Comprehensive Auditing Foundation (C.C.A.F.) is one of the world's leading organisations in actively promoting the whole area of internal operational and external management auditing. The C.C.A.F. was established in 1980 with the main objective of serving as a focal point for collecting and communicating comprehensive auditing knowledge and experience.

The C.C.A.F. organises a methodology interchange programme which has included audit guides such as 'Auditing of Efficiency'[33] and 'Auditing of Procedures for Effectiveness'[34] One of the C.C.A.F's publications has stated:

> 'When comprehensive audit reports are made available to the public, taxpayers obtain assurance that their elected or appointed representatives, or the governing body will be kept informed as to whether the organization's mandate is being pursued in an economic, efficient and effective manner. The public is given information to help it judge whether resources are being managed with due regard to value for money.'[35]

As in the United States, the amount of external management auditing is increasing in the Canadian public sector.

Similarly, in Great Britain we have many examples of external management auditing in the public sector. In

Great Britain we have had a Comptroller and Auditor General of the Exchequer and Audit Department but the range of audits has been narrower than the G.A.O. in the United States with the main emphasis being on financial auditing with some compliance and efficiency audits but almost no effectiveness audits.[36] However, in January 1984 a new National Audit Act came into force and this established the National Audit Office with the Comptroller and Auditor General as its head and with staff being transferred from the Exchequer and Audit Department. Section 6(1) of the National Audit Act reads as follows:

> 'The Comptroller and Auditor General may carry out examinations into the Economy, Efficiency and Effectiveness with which any Department, Authority, or other body to which this section applies, has used its resources in discharging its functions.'

Macrae has pointed out:

> 'The Exchequer and Audit Department used to devote a little over a quarter of its time to such exercises and, given the current encouragement to increase the proportion of time spent on such work, it will be interesting to see the effect of this on resources.'[37]

This example of the National Audit Office is therefore very recent but it can be expected to be an increasingly important example of external management auditing in the British public sector.

The Competition Act of 1980 allows Monopolies and Mergers Commission to conduct external management audits in the public sector. Under Section 11 of this Act the Monopolies and Mergers Commission can be directed to investigate certain public bodies including the nationalised industries on the basis of efficiency and costs and the service provided. Hatch and Redwood[38] have pointed out that the first reference made under this Act was British Rail's commuter services in London and the South East with this report being published in October 1980.

Local authorities are also experimenting with a form of management audit where a firm of management consultants prepares a report on the local authority which is available to the general public. For example, two such studies have been commissioned for Cheshire County Council[39] and Hereford and Worcester County Council.[40] 'Value for Money', a report on behalf of Cheshire County Council, was made by PA Management Consultants in 1979. Although the trade unions did not cooperate with the consultants, the findings of this study included criticisms of Cheshire's committee system, the over-lapping and over-extended services and a failure to adjust to a falling demand. Peat, Marwick, Mitchell & Co. and Coopers & Lybrand in 1980 completed a manpower review of Hereford and Worcester County Council reviewing this authority's corporate processes and its organisation and procedures. The consultants' reports were presented to several interest groups and were publicly debated. Hereford and Worcester County Council committed itself to implement most of the consultants' recommendations.

Several local authorities are now experimenting with such external management audits which are very much one-off studies. However, the 'Standards for the External Audit of Local Authorities and Other Bodies in Scotland'[41] require the annual external audit to include value for money auditing. Similarly, Section 15(1) of the Local Government Finance Act of 1982 reads as follows:

> 'In auditing any accounts required to be audited in accordance with this part of this Act an auditor shall by examination of the accounts and otherwise satisfy himself ... (c) that the body whose accounts are being audited has made proper arrangements for securing Economy, Efficiency and Effectiveness in its use of resources.'

In legislation affecting the public sector, the 3 Es (economy, efficiency and effectiveness) are taking their place alongside the financial audit. 'The Code of Local Government Audit Practice for England and Wales'[42] expands on this requirement for value for money auditing by the external auditor.

At The Institute of Cost and Management Accountants' 1983 National Conference on 'Value Assurance' Sir Kenneth Sharp[43] made an interesting comparison between the requirements of the 1983 National Audit Act and the 1982 Local Government Finance Act. In relation to the National Audit Act Sharp argued:

> 'It is interesting to note two important points. Firstly the word "examinations". There is no suggestion that the C & AG is auditing; secondly the use of the past tense. The examinations are to be directed to how the body has used its resources. There is no suggestion that this is other than a retrospective review of past performance.'[44]

In contrast, in relation to the 1982 Local Government Finance Act Sharp pointed out:

> 'This phraseology carries a much stronger recognition that it is the duty of management actively to "secure" the three Es with a view to the future, in contrast to the National Audit Act which has much more the ring of a post-mortem.'[44]

The amount of management auditing being carried out in the local government sector can be seen from two publications namely the Price Waterhouse 'Value for Money Auditing Manual'[45] and the C.I.P.F.A. et al 'Local Government Value for Money Handbook'[46] which contain over one hundred examples. These can be classified as external management audits because the results are available to those outside the organisation being audited - for example via the Audit Commission. It is interesting that in Volume 1 of the 'Local Government Value for Money Handbook' all the examples were submitted by local authorities but Volume 2 included contributions from such firms as Coopers & Lybrand, Ernst & Whinney, Finnie Ross Allfields, Hay Management Consultants, Inbucon, Peat Marwick Mitchell & Co, Price Waterhouse and Thornton

Baker. The general conclusion is that external management auditing is very much on the increase in the public sector both in the United States and Great Britain.

This trend is also evident in other countries. In a United Nations publication 'Public Auditing Techniques for Performance Improvement' the representative from the World Bank noted that 'performance auditing had become a universal concern of Governments and Supreme Audit Institutions.'[47] In addition the 'Lima Declaration of Guidelines on Auditing Precepts' stated:

> 'The traditional task of Supreme Audit Institutions is to audit the legality and regularity of financial management and of accounting. In addition to this type of audit, the importance and significance of which is undisputed, there is another type of audit which is oriented towards performance, effectiveness, economy and efficiency of public administration.'[48]

Phrases such as value-for-money auditing and the 3 Es (economy, efficiency and effectiveness) have been helpful in promoting external management auditing. External management auditing is expanding in the public sector but what about the private sector of the economy?

(b) Private sector

In the North American private sector it is perhaps appropriate to begin with two examples which would fall into the public sector in Great Britain namely hospitals and utilities. In the United States 'utilisation reviews' are conducted which involve the audit of a hospital by an independent Professional Standards Review Organization. This utilisation review has been described as 'a tool to control and direct medical professionals in hospital administration contexts.'[49]

In North America an external management audit of utilities is also becoming more common. Tanaka has suggested that pressures exist on 'utilities to justify both to the public and to regulatory commissions that they are operating effectively, and that the requested rate increases are legitimate'.[50] For example, in Canada the accounting firm of Clarkson Gordon have conducted a value-for-money audit of Ontario Hydro.[51] In the United States, for example, external management audits have been carried out on Consolidated Edison by Arthur D. Little, Detroit Edison by Theodore Barry & Associates, Duke Power Company by Booz Allen and Niagara Power and Light by Arthur Young & Co.[51]

However, these two examples of external management auditing of hospitals and utilities are relatively recent. In contrast, in the 1920s the Northwestern Mutual Life Insurance Company[52] of Milwaukee adopted byelaws to establish an examining committee of five policyholders. This committee could examine any aspect of Northwestern's operations and could issue independent reports to the other policyholders. This system has been operating for over fifty years. In 1940 we have another example in the insurance field with the 'Outline for a Management Audit'[53] by the Policyholders Service Bureau of the Metropolitan Life Insurance Company. This outline consisted of a checklist of questions on fundamental management policies and practices.

A very important type of external management audit was developed by Martindell,[54] of the American Institute of Management, in 'The Scientific Appraisal of Management'. The following points system was used by the American Institute of Management[55] as a comparative guide:

	Optimum Rating	Minimum Rating For Excellence
Economic function	400	300
Corporate structure	500	375
Health of earnings	600	450
Service to stockholders	700	525
Research and development	700	525
Directorate analysis	900	675
Fiscal policies	1,100	825
Production efficiency	1,300	975
Sales vigour	1,400	1,050
Executive evaluation	2,400	1,800
	10,000	7,500

The detailed questionnaire of the American Institute of Management, which has been used extensively, contains over 300 questions. The basic objective was to appraise the overall performance of management.

Another type of external management audit which has been proposed and also carried out is the social audit. In 1955, Bowen argued for 'independent outside experts who would evaluate the performance of the business from the social point of view'.[56] Abt Associates, for example, commissioned eight successive annual social audits in the 1970s 'to estimate the social performance of Abt Associates in relation to our four constituencies: clients, community, stockholders and staff'.[57]

From the accounting point of view an interesting external management audit originating in the United States is the peer review where one professional accounting firm reviews the work of another such firm. At first such peer reviews did not fall into the category of external management audits because the results were not disclosed outside the firm being reviewed. However, in the United States this situation has changed. The American Institute of Certified Public Accountants (A.I.C.P.A.) has established a division for CPA firms and has created two sections within this division namely a Securities and Exchange Commission (S.E.C) Practice Section and a Private Company Practice Section. One condition of the S.E.C. Practice Section is a mandatory periodic peer review by another CPA firm with a public report being issued stating the conclusions and recommendations of the review. The A.I.C.P.A. has established standards for such peer reviews and CPA firms which do not satisfactorily pass a peer review cannot remain a member of the S.E.C. Practice Section.

American public accountants have also become involved in management auditing in the private sector although sometimes they do not fall into the category of external management audits because no statement is available for external users. Edds has suggested that 'public accountants first undertook to get involved in operational auditing in the late 1960s'.[58] Three publications illustrate this involvement of American accountants. Firstly, in 1972 two members of a CPA firm Lindberg and Cohn published 'Operations Auditing',[59] secondly in 1980 the A.I.C.P.A. published 'Operational Auditing by CPA Firms'[60] and, thirdly, in 1982 the book by Flesher and Siewert 'Independent Auditor's Guide to Operational Auditing'[61] contained twelve chapters of detailed audit programmes to aid the independent auditor. However, these publications were basically aimed at the external auditor participating in a form of consultancy which was closer to an internal rather than an external audit. Nevertheless, Flesher and Siewert recognise the possibility of external management auditing:

> 'The report should be addressed to the persons who made the arrangements to have the audit performed. This could include a senior officer, the board of directors or even a third party.'[62]

However, it must be admitted that the examples of external management auditing in the North American private sector are not that numerous although they appear to be on the increase. The examples in Great Britain are even fewer than in North America. It is extremely difficult to find examples of external management audits in the British private sector. One unusual type of example is provided by Sayle[63] with his assessment of the quality assurance management systems of companies. Certain British government agencies also carry out activities in relation to companies which can be viewed as having at least elements of an external management audit. Factory, alkali and water board inspectors all audit companies from a specific viewpoint and make known any adverse findings to those outside the company. For example, factory inspectors audit the safety function of management and if their findings are sufficiently important, factory inspectors can order a plant to close until the management rectifies the safety problems.

Another British example, which stretches the meaning of external management auditing to its very limit, is when a prospectus for the issue of shares is released it includes a profit forecast. The rules of the Stock Exchange[64] require that the auditor and any reporting accountant must comment on this profit forecast by addressing a report to the directors. This Accountant's Report which is included in the prospectus gives:

(1) An indication in general terms of the work carried out such as a review of accounting bases and of the calculations on which the profit forecast is based.

(2) An expression of an opinion as to whether forecasts are properly compiled on the basis of assumptions made by the Board, and whether the figures are presented on a basis consistent with normal practices.

This second part of the Accountant's Report can be viewed as having some of the elements of an external management audit. For example, it is an independent examination resulting in a statement to external users on the performance of at least one small part of the management function. However, the Accountant's Report is as much an external financial audit as an external management audit. The basic conclusion is that external management audits are rare in the British private sector.

External management audits in the private sector, however, are conducted elsewhere than in Great Britain and North America. For instance, since the seventeenth century Swedish and Finnish external auditors have been required to decide whether the managers of an organisation have adequately fulfilled their responsibility for administration. Today the Swedish and Finnish company audit reports include the statement 'that the board of directors and the managing director be granted discharge from liability for their management for the period covered by the annual report'. Nevertheless, Bomeli's argument of 1964 still applies today that 'meeting the requirements of the Corporation Acts in Sweden and Finland, which have grown out of a long history requiring comments regarding management performance does not really produce an opinion regarding the efficiency of management'.[65]

Another European country where examples of external management audits can be found is Holland. In 1978 the Netherlands Instituut van Registeraccountants published a committee report on management audit and this report contained a small survey consisting of 43 questionnaires with 24 respondents. An interesting finding was that the principals for the management audit investigation were as follows[66]:

Top management	19
Supervisory directors	15
Government	9
Lenders	3
Trade unions	2
Other	3

Although the first category of top management and perhaps even the second of supervisory directors would fall under the heading of internal management auditing, the remaining 17 cases provide evidence of external management audits being conducted in Holland. If the supervisory board is classified as an external user group, then Germany also provides an example of external management auditing. Baden has described how:

> 'In Germany the auditor's report to the supervisory board of an A.G. includes comments on sales and production volumes, capacity and utilisation of plant, work-force, etc. mainly in comparison with the preceding year; expansion plans and other financial plans are also discussed.'[67]

This German example illustrates some of the topics on which an external management auditor could comment.

Moving beyond North America and Europe, the Indian Companies Acts were originally modelled on the British Companies Acts but they have developed in their own distinctive way. In 1965 an amendment to the 1956 Indian Companies Act was passed to incorporate a cost audit. As a result, some members of the Institute of Cost and Works Accountants of India now concentrate on this statutory cost audit[68] which can be described as a form of external management audit. During 1978, 707 cost audits were initiated in 25 different industries (although 457 of these audits were in the cotton textile industry) with the average length of cost audit report being approximately 20 pages (excluding appendices). Several Indian authors such as Rao[69] and Shome and Banerjee[70] describe the cost audit in terms of efficiency, productivity, added value and socio-economic benefits. The objects of the Bill introducing the requirement to maintain proper costing records referred to the 'efficiency audit' which is a term usually associated with this management audit type of approach.

In addition, the Cost Audit (Report) Rules of 1968 include requirements for the Indian cost auditor to act as an external management auditor, for instance:

1. The cost auditor may give 'comments on the incentive schemes, if any, with particular reference to its contribution towards increasing productivity and its effect on cost of production'.[71]

2. Under the section entitled Auditor's Observations and Conclusions the cost auditor may report on:

(a) 'the adequacy or otherwise of budgetary control system, if any, in vogue in the company';

(b) 'suggestions for improvements in performance, if any, for example, by -

(i) rectification of general imbalance in production facilities;

(ii) fuller utilisation of installed capacity;

(iii) concentration on areas offering scope for cost reduction and increased productivity;

(iv) improved inventory policies'.[72]

During a short visit to India cost auditors quoted me several examples of findings contained in cost audit reports. One example was a firm which added water as an input process in order to add hydrogen. The cost auditor asked why the waste oxygen was not collected. After further work, the cost auditor found that with a small amount of additional expenditure the oxygen could be collected and sold at a reasonable profit. Examples such as this fall into the category of external management audits. In another example the external management auditor reported not only that the recommended stock levels for raw materials were being exceeded but also that, in the auditor's opinion, these recommended stock levels were too high.

In relation to the Indian cost audit Prasad has argued:

> 'External cost audit highlights the following features for the benefit of the shareholders or taxpayers:
>
> (a) Efficiency or otherwise of management;
>
> (b) Proper utilisation of resources;
>
> (c) Productivity of labour, material and machines;
>
> (d) Weak or strong points in the organisation.'[73]

There are similarities between the above German example and the Indian cost audit with their emphasis on sales and production volumes, utilisation of the plant and the work-force.

At this stage three limitations of the Indian cost audit as an external management audit should be mentioned. Firstly, although the cost auditor is appointed at the Annual General Meeting, the cost auditor's report does not go to the shareholders of the company but instead to the Company Law Board with a copy to the top management of the company. However, under a 1974 amendment, extracts from a cost audit report may be brought to the attention of the Annual General Meeting. Secondly, the Indian cost auditor concentrates on only certain defined aspects of corporate management's performance. Thirdly, the time allowed for the cost audit is very short being basically only thirty days. Indeed Ramaiya[74] questions whether it is possible to conduct a cost audit as envisaged in the Indian Companies Act within the stipulated time. The answer to this question lies in the contents of the cost audit reports produced to date. Nevertheless, despite such limitations the Indian cost audit is, in my opinion, one of the best existing examples of external management auditing in private sector, although in the management auditing literature the Indian cost audit is almost completely ignored. Obviously the economic situation, culture and environment are very different in India and Great Britain, nevertheless this Indian example is particularly interesting because the Indian Companies Acts have been developed from the British Companies Acts.

Conclusions

The above proposed and actual examples illustrate many possible forms of external management auditing. Perhaps the main conclusion of this chapter is the variety of examples which can be classified under the heading of external management auditing. One common theme throughout many of the proposed and actual examples of external management auditing both in the public and private sectors is the assessment of the efficiency and effectiveness of management. However, the variety remains wide and has ranged from product design to internal transport, from asset management to management control, from decision-making systems to management representations, from management information systems to administration and from utilisation reviews to fiscal policies. At its existing stage of development, external management auditing is still very broad and very flexible. Many new developments have taken place in the last twenty years. During this period more developments in external management auditing have taken place in North America than in Great Britian and almost all of these developments have happened in the public sector rather than in the private sector.

Some reasons can be suggested for the predominance of the public sector in the field of external management auditing. Firstly, in recent years the public sector has faced increasing pressure to justify the resources being used and to provide value for money. Both internal operational auditing and external management auditing have been useful responses to such pressure. In particular external management audit reports provide evidence to those outside the public sector organisation on how efficiently and effectively resources are being used within that organisation. Secondly, the output of many public sector organisations is difficult to measure. External management auditing has been one way of developing performance indicators in the public sector.

Thirdly, in contrast to the public sector, the success of companies in the private sector is still very much judged by their profitability. Earnings per share remains an important performance indicator. In recent years with the liquidity problems of many companies the use of profitability as the only measure of a company's performance has been questioned. Furthermore, users have begun to realise the flexibility of the accounting measurement involved in determining a company's profitability. Nevertheless, profitability remains the predominant performance indicator in the private sector. Fourthly, companies face possibilities such as bankruptcy or take-over bids which are not real alternatives for many public sector organisations.

Fifthly, companies have developed their internal operational auditing capabilities. Corporate management would generally prefer to keep their problems to themselves rather than have the extra pressure of external users asking informed questions about what is happening within a company and perhaps even being critical of a company's top management. The reasons for external management auditing discussed in chapter two have not yet gained sufficient support either to persuade corporate managements to choose to undergo voluntarily external management audits or to persuade Parliament to legislate for compulsory external management audits. For example, institutional investors still generally prefer to switch investments rather than become involved in helping the management of companies with severe problems. Similarly, the ideas of accountability and the efficiency of management's stewardship have not yet gained sufficiently wide support to force change in the private sector as has happened in the public sector.

Another reason for the lack of development of external management audits in the private sector could be that various user groups have shown no interest in any form of external management audit. The fact that certain of these management audits have been conducted for many years in other countries implies that some external users find such audits useful in their decision-making process. In contrast, some external management audits have started and ceased, and other have not progressed beyond the proposal stage. What, therefore, do various user groups think of some form of external management audit? The following chapter considers the results of empirical surveys in this area of external management auditing.

CHAPTER 4

SURVEYS OF OPERATIONAL AND MANAGEMENT AUDITING

Several surveys have been conducted in the areas of both internal operational auditing and external management auditing. The internal operational auditing surveys are of interest because of the implications of their findings for external management auditing. The existing surveys are mainly American and - as with most areas of accounting empirical research - one major problem is the diversity of the studies making it difficult to draw general conclusions.

Internal operational auditing surveys

(a) Extent of internal operational auditing

Several American surveys give an indication of the extent of internal operational auditing but the existing British surveys (such as Santocki[1] and the Institute of Internal Auditors[2]) do not give a satisfactory corresponding figure for Great Britain. As already mentioned, in the United States a 1977 Research Report from the Conference Board by Macchiaverna concluded:

> 'The majority of companies interviewed report that, over the past 10 years, the trend has been toward increased and broadened operational audits.'[3]

However, comparing their 1975 and 1979 surveys (covering mainly the United States and Canada) the Institute of Internal Auditors found:

> 'The percentage of time devoted to financial audits versus operational audits continues to be approximately 50%.'[4]

Details of the number surveyed and the response rate for each survey cited in this chapter are given in note 27.

In his British survey, Santocki[5] used the term 'management audit' to cover both internal operational auditing and external management auditing but from the replies it became apparent that almost all the respondents had equated this term with internal operational auditing. Therefore, the 34% who replied that their organisation had been subject to management audit provided some evidence that internal operational audits are being conducted in Great Britain.

In an attempt to overcome the definitional problem illustrated by the Santocki study, in a survey of controllers of the 200 largest industrial corporations in the Fortune 500 list San Miguel, Shank and Govindarajan[6] divided internal audits into a useful matrix with the following results:

Types of Audit Data

	Financial	Non-Financial	% of Total Time	
Compliance - Internal	35.9%	22.0%	57.9%	Compliance = 70.2%
Compliance - External	7.3%	5.0%	12.3%	
Efficiency	7.0%	9.2%	16.2%	Efficiency & effectiveness = 29.8%
Effectiveness	5.6%	8.0%	13.6%	
	55.8%	44.2%	100.0%	

This matrix highlights the problem of what type of audit actually should be included under the heading of internal operational auditing. One possible definition would be to include the entire non-financial column and the efficiency and effectiveness components of the financial column giving a total of 56.8%. These surveys demonstrate that - particularly within North America - operational auditing forms a considerable percentage of total internal audit efforts.

(b) Nature of internal operational auditing

The nature and main characteristics of operational auditing have been the subject of investigation by several researchers. For example, in three separate surveys of internal operational auditing by Denis[7], Macchiaverna[8] and Santocki[9], very strong support was given to the task of evaluating control systems:

	% of Respondents Agreeing with Statement		
	Denis	Macchiaverna	Santocki
Evaluate control systems	97%		
Evaluate adequacy of systems, procedures and controls		98%	
Appraise management systems of planning and control			88%

Of course, 'evaluating control systems' is also a characteristic of internal financial auditing and it would be interesting to know exactly what the respondents perceived as 'control systems'. Were they the same as internal control systems (with the emphasis on financial systems) or were they broader to include other systems such as production control and quality control? Certainly, in Santocki's survey, the 'management systems of planning and control' suggest that at least these respondents were thinking of more than the financial auditor's internal control systems.

Some other statements which were strongly supported as being characteristic of internal operational auditing included:

	% of Respondents Agreeing with Statement	
	Denis[10]	Santocki[11]
Identify problem areas	97%	
Identify existing and potential weaknesses in all functions and operations within an organisation		94%
Evaluate group policies	75%	
Appraise business organisation structure		89%
Appraise overall results to determine if the objectives of the business are being met		81%

It is significant that the two highest response rates (97% and 94%) in two separate studies relate to the identification of existing and potential problem areas by the internal operational auditors.

The three other responses in the above table illustrate at least partly non-financial aspects of operational auditing. Similarly, in the Macchiaverna[12] study, the following percentages of the 282 companies replying audited various non-financial activities and functions:

	%
Management information systems	67
Production	62
Personnel	60
Marketing/advertising	53

Again these responses emphasise the central importance of the audit of the management information systems (compare the above emphasis on planning and control systems) for internal operational auditing.

Given the terminology problem even within internal auditing itself, it is interesting that the Institute of Internal Auditors[13] included within its questionnaire a series of characteristics which the respondents identified with particular types of internal auditing. From the point of view of this thesis, the most relevant distinction was between internal financial and operational auditing. Over 80% of the respondents agreed with the following characteristics:[13]

	Internal Financial Auditing	Internal Operational Auditing
	%	%
Safeguard company assets	88	
Check accuracy and reliability of accounting records	94	
Promote operational efficiency		92
Increase organisational profitability		85
Increase organisational efficiency		85
Increase organisational effectiveness		81

The verbs in these phrases illustrate an important difference in emphasis between financial and operational auditing with the protective nature of financial auditing implied by 'safeguard' and 'check' and the constructive nature of operational auditing suggested by 'promote' and 'increase'.

The above survey findings on internal operational auditing have relevance for external management auditing. These surveys illustrate the widespread nature of internal operational auditing (particularly in North America), the experience gained by operational auditors during their evaluation of control systems (in the broadest sense of that phrase), their audit of various activities which financial auditors would generally ignore and their identification of existing and potential problem areas in an organisation. Although the external management audit has different objectives from the internal operational audit, this experience of internal operational auditors could prove extremely useful for the development of external management auditing - especially in relation to audit approach and techniques. However, some surveys have also been conducted on external management auditing.

External management auditing surveys

Several surveys have been conducted with the objective of discovering accountants' opinions about external management auditing. Interestingly, fewer surveys have sought the opinions of user groups. The need and demand for the external management audit has often been assumed without any evidence being produced in support of such an assumption. Nevertheless, the existing surveys provide some further insights into the external management audit.

(a) Accountants' Opinions

Four separate American surveys have asked Certified Public Accountants (C.P.A.s) their opinions of the external management audit. Norgaard[14] interviewed partners and managers in C.P.A. firms on whether the public accounting profession should become involved in external management auditing. Her conclusion was a lack of consensus among these accountants on this issue. In general these C.P.A.s held the view that the external management audit is an extension or modification of the traditional audit and not an extension of the special management services engagement. It would have been interesting to know whether the potential users of such external management audit reports would have taken the same view.

In a similar conclusion to that of the Norgaard survey, Imke[15] found a lack of support for the idea of the external management audit. From a survey - including both public accountants and controllers - Imke concluded:

> 'Attesting to the efficiency of a company's management, or 'management audits', is not an appropriate application of the attest function of C.P.A.s, according to the accountants who participated in the survey.'[16]

The main reason for this lack of support for the external management audit could be traced to the perceived absence of practical and meaningful standards of measurement.

The findings of a study by Moscove[17] lend support to the hypothesis that C.P.A.s do not favour an external management audit and do not consider such an audit to be feasible. In Moscove's[18] survey less than one-third of the C.P.A.s thought it feasible for the auditor to attest to non-financial information and only one-quarter of them considered it desirable for non-financial information to be included in the audit.

The survey with the highest percentage level of support from C.P.A.s for the external management audit (over 50%) is that of Smith, Lanier and Taylor[19] but this survey suffers from a low response rate of 19% with only 19 C.P.A.s replying. In addition to C.P.A.s, the Smith et al survey included controllers, financial analyst and mutual fund managers. Only 34 controllers responded to this questionnaire and less than 20% of them considered that a need existed for C.P.A.s to attest to the management function today.[20] From these four surveys of accountants it can be concluded that American accountants in general do not consider that public accountants should conduct external management audits.

(b) Management Consultants

One of the earliest surveys relating specifically to external management auditing was carried out by Miller[21] for his 1959 doctorate. Miller assumed that management consultants would be the most appropriate group to conduct such audits and in a survey of them he obtained the following results about their methods of conducting external management audits:[22]

(1) One third of the management consultants replying expressed the belief that the management audit is basically conceptual and therefore not reducible to analysis by check list criteria.

(2) Just under one-third used no formal check lists but developed a type of check list as a means of facilitating completeness as the management consulting engagement progressed.

(3) Approximately one-sixth used check lists.

(4) Approximately one-sixth of those replying possessed a management consulting speciality unrelated to management auditing.

It is perhaps surprising that so many American management consultants had assignments in the 1950s which were at least related to the external management audit.

(c) <u>Users' Opinions</u>

Both management consultants and accountants could produce external management audit reports but what do the potential users of such reports think about the external management audit? Two of the surveys already mentioned, namely Smith et al[19] and Moscove[17], included certified financial analysts and mutual fund managers as respondents. Smith et al[23] asked both groups whether there is a need for C.P.A.s to attest to the management function today. Approximately half of both the financial analysts (44%) and the mutual fund managers (55.6%) agreed that the need for such an audit existed at present. Another important finding of the Smith et al survey was that 'the audit should cover both performance and means'.[24] The means utilised by management included information and control systems, policies, procedures and organisation structure.

The Moscove[17] survey found stronger support among security analysts for a particular type of external management audit than the Smith et al survey. More than 70% of the security analysts - compared to less than 20% of C.P.A.s - classify non-financial information as important for the purpose of advising on investments especially:

(1) Future research plans

(2) Overall evaluation of managerial efficiency and effectiveness in operating the business.[25]

Furthermore, Moscove concluded:

> 'Security analysts think it is feasible for the auditor to examine and attest to non-financial information ... Security analysts favour non-financial information being examined and attested to in the audit function.'[26]

Conclusions

This chapter highlights the lack of British empirical evidence even in the field of internal operational auditing and particularly in the field of external management auditing. The empirical evidence which is available shows that the experience of internal operational auditors would be useful for external management auditing particularly in the areas of evaluating organisational efficiency and effectiveness and of assessing corporate management information systems.

From the users' surveys considered it can be very tentatively suggested that users see a greater need for external management audits than do accountants. However, perhaps the major conclusion in this area of users' opinions of external management audits is the general lack of empirical evidence. In addition, the empirical evidence which is available is American and is restricted to a limited number of user groups. The question posed in the previous chapter namely what do various user groups think of some form of external management audit remains unanswered. Therefore, it seemed important to attempt to survey at least one user group in Great Britain to begin the long process of determining whether or not any demand for external management audit reports can be identified in Great Britain. The following chapter describes the reasons for choosing bankers as the user group to be surveyed and the way in which the questionnaire survey was developed.

CHAPTER 5

DEVELOPMENT OF QUESTIONNAIRE SURVEY

Choice of user group

In Chapter 1 it was argued that several user groups such as shareholders, financial analysts, bankers, creditors, trade unions and various governmental agencies might be interested in external management audit reports. Of this list of user groups institutional shareholders, financial analysts, bankers and creditors regularly use corporate financial statements as part of the information on which they base their decisions and are therefore familiar with the financial audit report. All four groups would rank high on the priority list for being surveyed about external management auditing.

An important reason for choosing bankers as the group to be surveyed on external management auditing is the results of research into the financial audit report. First of all it should be admitted that the results of almost all the existing empirical studies[1] on the use of the financial audit report suggest that it ranks low in terms of usefulness in comparison with other items in companies' annual reports. For example, Epstein[2] in a survey of American shareholders found that the auditor's report was ranked as the least useful in a list of eight items in the annual report namely the income statement, balance sheet, funds flow statement, footnotes, auditor's report, president's letter, essay and pictorial material. Similarly, in a British survey of shareholders of one particular company, Lee and Tweedie[3] found that the auditor's report is the least read of seven items in the annual report namely chairman's report, profit and loss account, directors' report, balance sheet, notes to the accounts, statistical data and auditor's report.

Nevertheless, accepting this relatively low ranking for the financial audit report, which group of users read the financial audit report most carefully? Three studies can help us to answer this question. Firstly, Brenner[4] has surveyed financial analysts, shareholders and bank loan officers. Brenner asked about various items in the annual report and the results for the financial audit report were as follows:[5]

	Bankers	Financial analysts	Shareholders
	%	%	%
Read very carefully	43	32	14
Read somewhat carefully	27	29	24
Did not read carefully	20	26	27
Did not read	7	11	25
No answer	3	2	10
	100	100	100

In Brenner's survey, therefore, of the three user groups the bankers read the financial audit report most carefully.

A second study in 1977 for the Commission on Auditors' Responsibilities by Fess and Ziegler[6] also surveyed the same three groups namely bankers, financial analysts and individual shareholders. Fess and Ziegler asked 'how carefully do you read the auditor's report' and the results were as follows:[7]

	Bankers	Financial analysts	Individual shareholders
	%	%	%
Carefully	69	28	27
Hurriedly	31	70	57
Note that it is there	-	2	16
	100	100	100

Therefore, according to this Fess and Ziegler study, bankers read the auditor's report most carefully of the three groups surveyed with financial analysts in second place.

This study by Fess and Ziegler confirmed the findings of the Brenner survey that bankers read the financial audit report of companies more carefully than either financial analysts or shareholders. Of course, the Fess and Ziegler study concentrated on individual shareholders and it could be argued that institutional shareholders might be more interested in the financial audit report than individual shareholders. A third two-part survey by Lee and Tweedie in Great Britain would support such an argument. For example, interviewing 301 private shareholders in a very large public company, Lee and Tweedie[8] asked respondents to state the attention which they paid to each section of annual reports; and interviewing 231 institutional shareholders (such as insurance companies, pension funds, investment trusts, unit trusts and also stockbroking firms) Lee and Tweedie[9] asked respondents whether or not they read various sections of the annual report and if the answer was yes, the respondents were then asked whether they read that particular section thoroughly or read it briefly for interest.

The results from these two separate studies for the auditor's report were as follows:

	Private shareholders[10]	Institutional shareholders[11]
	%	%
Read thoroughly	16	38
Read briefly for interest	36	38
Not read at all	48	24
	100	100

According to these two Lee and Tweedie studies, institutional shareholders read the auditor's report more thoroughly than private shareholders. Very tentatively, therefore, it can be suggested that these three empirical surveys imply that in terms of reading the financial auditor's report carefully the order is:

1. Bankers
2. Institutional shareholders and financial analysts
3. Private shareholders.

It should be emphasised that the above research about careful reading of the financial audit report does not necessarily mean that this report is understood by users. After summarising the results of eighteen empirical surveys related to the understanding of the financial audit report, Estes has concluded:

> 'The general view that bankers and security analysts understand the auditor's role and report better than do shareholders is confirmed.'[12]

One example of bankers' understanding of the financial audit report has come from Libby[13] in his experiment using different audit reports with 30 Chicago audit partners from five 'Big 8' C.P.A. firms and 28 commercial loan officers from five large banks in Chicago. Libby found no significant differences between the auditors and bankers and concluded:

> 'This general finding of no large differences implies that fears of miscommunication of the messages intended by audit reports to more sophisticated users may not be justified.'[14]

When considering the results of Libby's survey, the small sample and the top management level of the bankers involved must be remembered. Nevertheless, these various empirical studies show that bankers read the financial audit report more carefully than financial analysts, institutional shareholders and private shareholders; and also bankers understand the financial auditor's role and report better than shareholders.

Of the four groups highlighted at the beginning of this chapter, the empirical studies cited have not included creditors. Research is lacking in relation to creditors and accounting in general and auditing in particular. In my opinion it would be extremely worthwhile to survey creditors not only about their use of the financial audit report but also about their opinions on the external management audit report. Obviously the management audit report is very different from the financial audit report with different objectives, differences in length and different content and, therefore, the degree of interest shown by various user groups in the management audit report may be very different from the interest shown in the financial audit report. Consequently, the ranking of user groups by their care in reading the management audit report may be very different from the ranking for the financial audit report. User groups high on the list for surveying about external management auditing would include institutional investors and financial analysts (from the above empirical evidence) and credit managers. Nevertheless, the empirical evidence relating to the financial audit report suggests that bankers would be a reasonable user group to survey first in relation to external management auditing.

Another reason for choosing to survey bankers about external management auditing is the fact that it is generally accepted that bankers themselves try to assess corporate managements. For example, Cohen, Gilmore and Singer[15] have proposed the following model of how American bankers analyse business loan applications:

> 'An overall credit rating, S_1, is derived from three subsidiary factors; (1) a rating of management competence, F1; (2) an outside credit rating, F_2; (3) a rating based on the results of the bank's financial analysis, F_3.'[16]

Cohen, Gilmore and Singer have also suggested how bankers can rate the competence of management:

> 'The rating of management competence, F_1, is provided as input to the model. It depends on such considerations as: (i) the ability of the firm's management to recognize change and take appropriate action; (2) the extent of forward planning in the firm, partially indicated by the existence of regular forecasts, budgets, and product analysis programs; (3) marketing trends in the industry, indicating whether the firm is holding its own, getting ahead or slipping behind its competition; (4) the relation of the firm's present product lines to products offered by other firms in the industry; (5) the extent to which the firm's management has succeeded in the past in getting improvements made within the organization and in meeting competition; (6) the management's overall stewardship of the firm.'[17]

In their final credit rating Cohen, Gilmore and Singer input the management competence factor into their model as high, average or marginal.

Egginton[18] provides evidence that British bankers assess corporate managements when he discusses the well-known banking guideline known as 'the three C's' which states that bankers should ensure that a borrower satisfies the conditions of 'character, capability and capital'. Egginton emphasises that in the corporate lending field, bankers must assess the management of a company:

> 'Incompetent management is a potent recipe for financial disaster, and bankers understandably give a high priority to satisfying themselves that the management of a borrowing firm appears reasonably competent. This issue is, of course, related to "character and capability" which occupied two-thirds of the three C's.'[19]

To assess the competence of the management of a company Egginton suggests that a banker may consider 'the management's experience, qualifications, enthusiasm and apparent grasp of industrial and financial problems, with the related question of continuity raising the opposing dangers of a "one-man band" or too frequent management changes'.[20] My discussions with bankers confirmed that they are extremely interested in the competence of corporate managements. Therefore, because bankers try to assess the management of companies and because they read the financial audit report carefully, it seemed reasonable to choose bankers as the first user group to be surveyed about external management auditing.

Being based in Edinburgh the most obvious bankers to choose for this survey were those in the three Scottish joint-stock banks namely the Bank of Scotland, the Clydesdale Bank and the Royal Bank of Scotland. At the time of this survey in 1983 the Trustee Savings Bank Scotland had only recently started to lend to companies and it was considered that it would not have the experienced staff of the three Scottish joint-stock banks and, therefore, the Trustee Savings Bank Scotland was excluded from this survey. The three Scottish joint-stock banks were approached and all agreed to participate in this research project.

Hypotheses

The primary objective of this survey was to determine whether or not branch managers and head office lending officials in the Scottish joint-stock banks would express any demand for external management audit reports on companies and, if so, what information they would like included in such reports. The two main research instruments considered were interviews and a postal questionnaire. Although the head office lending officials of the three Scottish joint-stock banks are based mainly in Edinburgh and Glasgow with a few in London, the branch managers are spread throughout the country. Therefore, in order to include a random sample of a reasonable number of branch managers and given the time and cost constraints, a postal questionnaire was the research instrument chosen.

Originally the questionnaire was restricted to questions on external management auditing but my pre-survey discussions with bankers and others suggested that questions about financial auditing were necessary. For example, one original hypothesis was:

> Bankers consider that the management audit report would be useful in relation to their lending decisions about limited liability companies.

However, without a similar hypothesis about the financial audit report, the results for the management audit report would lack a benchmark. In effect a comparative approach between the financial audit report and the management audit report was adopted in this questionnaire. Furthermore, in the early stages from discussions with some bankers it emerged that the distinction between small and large limited liability companies might be important. Some bankers thought that the answers could be different for small and large companies. My discussions with bankers suggested that the size of company was a more important factor for them than whether it was a public or private company. These developments are reflected in the following hypotheses to be tested.

The first hypothesis is:

1. Bankers claim to read the financial audit report of their customer companies.

It was decided to begin with hypotheses about the financial audit report because the bankers would be familiar with such reports. This hypothesis is expressed in terms of 'bankers <u>claim</u> to read' because, with a postal questionnaire, we rely on the bankers' answers rather than on checks to determine whether or not bankers actually did read the financial audit report of their customer companies. This first hypothesis is also expressed in terms of 'bankers claim to <u>read</u> the financial audit report' because bankers could read this report without actually acting on it.

The second hypothesis considers the use of the financial audit report:

> 2. Bankers consider the financial audit report to be useful in relation to their lending decisions about both small and large limited liability companies.

In all nine hypotheses the term 'bankers' is used to cover both groups of branch managers and head office lending officials. This second hypothesis is a development from the first hypothesis. If bankers claim <u>not</u> to read the financial audit report of their customer companies, the assumption is that such reports are not useful. However, if bankers claim to read financial audit reports, are these reports useful to the bankers? This hypothesis is expressed in terms of 'their lending decisions' which would cover both bankers' loan and overdraft decisions. This hypothesis can be divided into two in relation to small companies and large companies. The criteria used to differentiate between small and large companies are derived from the 1981 Companies Act's[21] criteria which in turn are derived from the European Economic Community's Fourth Directive. The 1981 Companies Act's criteria are turnover of £1,400,000, balance sheet total of £700,000 and 50 employees. In this survey a large limited liability company was defined as one 'which equals or exceeds at least two of the following three criteria:

1. Turnover £2 million
2. Balance sheet total assets £1 million
3. Average number of employees 50'.

A small limited liability company was also defined in terms of not exceeding (or equalling) two of the above three criteria.

These first two hypotheses relate to the financial audit report and the following three hypotheses concentrate on bankers' assessment of management. The third hypothesis to be tested is:

> 3. Bankers claim to assess management when making their lending decisions about both small and large limited liability companies.

As with the first hypothesis, this third hypothesis is expressed in terms of 'bankers claim'. Furthermore, this hypothesis is in terms of assessing the management of companies rather than assessing individual managers. This hypothesis is important for external management auditing because if bankers claim <u>not</u> to assess the management of companies when making corporate lending decisions, then a primary objective of the external management audit report might be of little interest to bankers.

The fourth hypothesis develops the area of how bankers assess corporate managements:

> 4. Bankers claim to use a range of financial and non-financial information in assessing management for both small and large limited liability companies.

From discussions with bankers and others, originally five specific items of information were included in this fourth hypothesis namely:

(a) Annual financial statements

(b) Financial audit report

(c) Qualifications of management

(d) Practical experience of management

(e) Bankers' personal knowledge of management.

Accountants would not think of assessing management from the financial audit report but some bankers at least do just that. It was difficult to express succinctly the information which bankers obtain by meeting the management of a company and gaining an overall impression. After many attempts this was expressed as the 'bankers' personal knowledge of management'. However, it was decided to omit such detail from this fourth hypothesis and make it more general by referring to 'a range of financial and non-financial information'.

The final hypothesis on bankers' assessment of corporate management takes an even more general approach than the fourth hypothesis:

> 5. Bankers consider that they do not always have sufficient information to make an adequate assessment of management for both small and large limited liability companies.

This fifth hypothesis assumes that the results support the third and at least part of the fourth hypothesis and concentrates on the sufficiency of the information which bankers have to make assessments of corporate managements. If the results do support this fifth hypothesis, this could imply that the external management audit report might be of interest to bankers.

After these five hypotheses on the financial audit report and bankers' assessment of corporate management, the remaining four hypotheses relate specifically to external management auditing. The sixth hypothesis is:

> 6. Bankers consider that the management audit report would be useful in relation to their lending decisions about small and large limited liability companies.

When considering the management audit report we move away from what bankers actually do in practice and turn to their opinions about the management audit report. With both the financial audit report and the management audit report, the qualifying adjective 'external' was originally included in these hypotheses but in the context of bankers this seemed an irrelevant addition. Furthermore, both the financial audit report and the management audit report would need to be defined in the actual questionnaire derived from these hypotheses. These definitions are discussed in detail later in this chapter. This sixth hypothesis can also be compared with the above second hypothesis on the financial audit report. This is an example of the comparative approach mentioned above between the financial and management audit reports.

At present the corporate financial audit report is required by law, paid for by the company and conducted annually. Continuing this comparative approach between the financial and management audit reports, the seventh hypothesis is:

> 7. Bankers consider that the management audit of both small and large limited liability companies should be:
>   (a) Required by the banks
>   (b) Paid for by the company
>   (c) Conducted annually.

This hypothesis is framed in terms of the management audit being required by the banks rather than by the law because this survey is directed specifically at bankers but, like the financial audit, the management audit would be paid for by the company and conducted annually.

These sixth and seventh hypotheses are at a very general level but the eighth hypothesis concentrates on the possible content of the management audit report:

> 8. Bankers consider that the management audit report for both small and large limited liability companies should include assessments both of the general management function and of the individual business functions.

This hypothesis divides the previous assessment of management into two separate aspects namely, firstly, assessment of the general management function (including such areas as company objectives, corporate structure and management information system) and, secondly, assessment of the individual business functions (including such functions as purchasing, production, marketing and personnel). This should give some indication of the type of information which bankers would like to see included in management audit reports.

The ninth and final hypothesis returns to the comparative approach between the financial and management audit reports:

9. Bankers consider that the management audit report would be more useful than the financial audit report in relation to their lending decisions about both small and large limited liability companies.

This hypothesis also links hypotheses two and six and, because this survey concentrates on management auditing, is expressed in terms of the management audit report being more useful to bankers than the financial audit report in relation to their corporate lending decisions. The postal questionnaire could now be designed on the basis of these nine hypotheses.

Questionnaire

After several drafts, which benefited from the comments of some senior bankers and from colleagues at the University of Edinburgh and elsewhere, a questionnaire was tested in a pilot study with six bankers. After taking into account the feedback from this pilot study, a final questionnaire was developed. For the convenience of the reader this questionnaire is included in a pocket on the cover of this thesis so that the following comments can be read together with the questionnaire.

(a) Covering letters

With any postal questionnaire one major problem is the possibility of a very poor response rate. For this reason, instead of simply sending out questionnaires to bankers, it was decided to approach the three Scottish joint-stock banks to seek their cooperation. This research project was explained to all three banks and the Royal Bank of Scotland in particular made the point that each year they received many research requests which are mostly rejected but they considered this particular project to be of sufficient interest to allow their staff to participate. Therefore, in addition to giving me their comments on the draft questionnaire, each of the three banks agreed to include a covering letter with my questionnaire. The main reason for this was to assure recipients of the questionnaire that their head office had given me permission to send this questionnaire to their staff.

The advantage of such a covering letter is that it may encourage recipients of the questionnaire to reply but the disadvantage is the possible bias that it may introduce if such recipients think that this is a directive from head office. The three covering letters included minor differences in their wording and were signed by the following officials:

1. William Anderson, Staff Training Courses Manager, for the Bank of Scotland.
2. Campbell Harvey, Deputy General Manager - Administration, for the Clydesdale Bank.
3. Norman Lang, Assistant General Manager - Branch Department, for the Royal Bank of Scotland.

To try to reduce any bias caused by these covering letters, the letter from each of the three banks emphasised that the individual bankers were under no obligation to complete this questionnaire and that the personal opinions of the individual bankers were being sought rather than any perceived bank opinion. Copies of these letters from the three banks are included in Appendix A.

Despite this helpful covering letter from the banks, it was important for the response rate that my first page letter caught the interest of the reader. Therefore, to attract the attention of the readers so that they would be sufficiently interested to complete and return the questionnaire, my covering letter contained several points. Firstly, the letter began by emphasising that bankers are major users of corporate financial audit reports so that bankers could relate to a type of corporate auditing with which they would be familiar. Secondly, reference was made to the Rhys Williams'[22] proposal in Parliament that a management audit would be appropriate for companies. This introduced the term 'management audit' and also indicated that we were considering a proposal for an additional type of audit. Thirdly, a general definition of a management audit was given relating it to users outside the company (such as bankers) and defining it simply as 'a report on the performance of management'. A more detailed definition of a management audit was included within the questionnaire. Fourthly, the basic reason for this questionnaire was given namely 'to evidence bankers' opinions about this proposal on management auditing'. This emphasised that the questionnaire was seeking the opinions of bankers.

Fifthly, to encourage the readers of this covering letter to complete the questionnaire, five specific points were made:

(a) This was a short questionnaire which could be answered mainly by ticking the appropriate box.

(b) Their cooperation was crucial for the success of this project.

(c) A stamped addressed envelope was enclosed.

(d) Respondents did not need to reveal their name and they could not be personally identified from the questionnaire.

(e) A copy of the results of this survey would be sent to those respondents who asked for this.

Finally, at the foot of this covering letter it was noted that The Institute of Cost and Management Accountants was sponsoring this research project. This might indicate to the bankers that this research project had possible, long-term, practical benefits. Similarly, although the University of Edinburgh address was given at the top of the letter it was signed as John Innes, Chartered Accountant because bankers would generally have had more contact with accountants than with academics. Each letter was addressed individually with the name of each recipient and each letter was also signed personally to avoid the impression of a circular letter. On the back of this covering letter were the definitions of the terms used in the questionnaire.

(b) Definitions

To ensure a reasonable response rate, one constraint on this questionnaire was to keep it as simple and as short as possible while at the same time meeting its objective of determining whether or not bankers would express any demand for external management audit reports on companies and, if so, what information they would like included in such reports. Therefore, it was decided to keep the formal definitions in the questionnaire to a minimum but from my discussions with bankers three definitions were considered necessary. Firstly, the distinction was made between a small and a large limited liability company. As mentioned in the above section on hypotheses, my discussions with certain bankers suggested that the size of the company being audited might affect certain of the answers. In order to keep the definition reasonably simple, the criteria used in the 1981 Companies Act were rounded up to the nearest £million to give the following three criteria:

1. Turnover £2 million
2. Balance sheet total assets £1 million
3. Average number of employees 50.

A small limited liability company was defined as one which does not exceed (or equal) two of these three criteria and a large limited liability company as one which equals or exceeds at least two of these criteria.

After defining small and large limited liability companies, a definition of the financial audit report was given. Although bankers can be expected to be familiar with the financial audit report, this definition was necessary to distinguish the financial audit report from the proposed management audit report. The adjective 'proposed' was used to qualify the management audit report to emphasise that this type of report was only at the proposal stage and bankers, therefore, would not have seen such a report. The definitions of the financial audit report and the proposed management audit report were structured to be comparative:

Financial audit report

'a report, containing an independent opinion on the annual financial statements of a limited liability company, prepared by a professional accounting firm and included at present with the financial statements of your limited liability customer companies'.

Proposed management audit report

'a report, containing an independent opinion on the performance of the management of a limited liability company, prepared by a professionally qualified team and included with the financial statements of your limited liability customer companies'.

Two similarities between these two definitions are that, firstly, both consist of 'a report containing an independent opinion' and, secondly, both reports would be 'included with the financial statements of your limited liability customer companies'. Originally a definition of independence was included in terms of the auditor being independent of the management of the company but several bankers suggested that this was unnecessary given the fact that bankers are aware of the situation with the financial auditor and also that 'an independent opinion' appeared in both definitions. The reason for having these two similarities was so that the responding bankers could relate the proposed management audit report to something with which they were familiar. The disadvantage was that the management audit report would not necessarily be included with companies' financial statements.

However, the above definitions highlighted two important differences:

<u>Financial audit report</u>

1. Opinion on the annual financial statements
2. Prepared by a professional accounting firm

<u>Proposed management audit report</u>

1. Opinion on the performance of the management
2. Prepared by a professionally qualified team.

These two differences suggest the wider scope of the proposed management audit report compared to the narrower financial audit report with its concentration on the annual financial statements and with its accounting emphasis. In addition an extra sentence was added to the definition of the proposed management audit report to clarify to the bankers what was meant by a management audit report:

'This report would include detailed comments on whether the management have used the resources of the limited liability company efficiently and effectively.'

The possibility of including a specimen management audit report was considered but rejected for two reasons. Firstly, this would have lengthened the questionnaire and complicated this section on definitions. Secondly, one objective of this questionnaire was to try to determine what information bankers would like included in the proposed management audit report. If a specimen management audit report had been given in the questionnaire this might have biased the bankers' answers to the question asking which areas they would like specifically reported upon in a management audit report.

(c) Questions

In designing the questions the advice of several authors[23] was taken into account. For example, Belson has advised that the following should be avoided in question design:

'(1) loading up the question with a lot of different or defining terms;

(2) offering long alternatives (as possible answers to a question);

(3) the use of words that are not the usual working tools of the respondent;

(4) giving the respondent a difficult task to perform;

(5) giving the respondent a task that calls for a major memory effort;

(6) offering alternatives that could <u>both</u> be true.'[24]

The problem of the order of the questions was at least partially solved by including the questions on the financial audit report first before those on the management audit report. Two further problems in any questionnaire are validity and reliability. Bailey has pointed out that the problem of validity is to ensure that 'the measuring instrument is actually measuring the concept in question, and not some other concept'.[25] This questionnaire was scrutinised carefully not only by bankers and myself but also by other academics[26] with experience in designing such questionnaires.

The problem of reliability in a questionnaire is to try to ensure that the measuring instrument is reliable. Bailey has argued:

> 'The difficulty in checking for reliability is that when the same question is repeated in a single questionnaire as a consistency check, with no time lag, the respondent tends to see it as a "trick" question.'[27]

In designing this questionnaire, no question was included twice but question 16 was as follows:

> Do you consider that the management audit report would be more useful than the financial audit report in helping you to make your lending decisions about small/large limited liability companies?

This question 16 was deliberately linked with previous questions (in the form of statements to which respondents had five alternative answers) on the financial and management audit reports namely:

3 and 4 — In general you find the financial audit report useful in helping you to make your lending decisions about small/large limited liability companies.

and

10 and 11 — You would find a management audit report useful in relation to your lending decisions about small/large limited liability companies.

This combination of questions, therefore, could reveal a respondent with inconsistent answers - for example replying that the management audit report would be more useful than the financial audit report while also answering that the financial audit report is useful but the management audit report is of no use.

Comments from various bankers and colleagues together with feedback from the pilot questionnaire enabled me to correct certain problems such as questions which were ambiguous. However, the final questionnaire can be viewed in terms of the comment by Schuman and Presser:

> 'When scrutinized, almost every survey question is subject to criticism.'[28]

Hopefully, the above process has helped at least to reduce such criticism.

In the final questionnaire the first eight questions concentrated on financial auditing and existing lending decisions while questions nine to seventeen concentrated on management auditing. However, the management auditing questions included more sections within each question. The following Table 1 illustrates the links between the hypotheses and the questions in the questionnaire:

TABLE 1

Hypotheses and questions

Hypothesis (or reason for question)	Question
FINANCIAL AUDIT REPORT	
1. Bankers claim to read the financial audit report of their customer companies.	1. Do you read the financial audit report on the financial statements of your customer companies?
	2. Have you used the financial audit report as part of the data on which you have based any of your lending decisions to small/large limited liability companies?
2. Bankers consider the financial audit report to be useful in relation to their lending decisions about both small and large limited liability companies.	3 and 4. In general you find the financial audit report useful in helping you to make your lending decisions about small/large limited liability companies

FINANCIAL AUDIT REPORT	
To determine whether or not the bankers wished more information from the financial audit report and to link with question 8 on the adequacy of existing information.	5. Do you consider that the financial audit report could contain more information?
ASSESSMENT OF MANAGEMENT	
3. Bankers claim to assess management when making their lending decisions about both small and large limited liability companies.	6. Do you assess management when making your lending decisions about small/large limited liability companies?
4. Bankers claim to use a range of financial and non-financial information in assessing management for both small and large limited liability companies.	7. Do you use any of the following information in assessing management for small/large limited liability companies: (a) annual financial statements? (b) financial audit report? (c) qualifications of management? (d) practical experience of management? (e) your own personal knowledge of management? (f) any other information (please specify)?

Hypotheses and questions (continued)

ASSESSMENT OF MANAGEMENT	
5. Bankers consider that they do not always have sufficient information to make an adequate assessment of management for both small and large limited liability companies.	8. Do you consider that sufficient information is available to you at present to make an adequate assessment of management?
MANAGEMENT AUDIT REPORT	
6. Bankers consider that the management audit report would be useful in relation to their lending decisions about both small and large limited liability companies.	9. Would you use a management audit report as part of the information on which you would assess the management of small/large limited liability companies?
	10 and 11. You would find a management audit report useful in relation to your lending decisions about small/large limited liability companies.

Hypotheses and questions (continued)

MANAGEMENT AUDIT REPORT

7. Bankers consider that the management audit of both small and large limited liability companies should be:	12. Do you consider that a management audit for small/large limited liability companies should be:
(a) required by the banks	(a) voluntary? required by the professional accounting bodies? required by law? required by the banks?
(b) paid for by the company	(b) paid for by the company? paid for by the government? paid for by the users (eg. bankers)?
(c) conducted annually	13 and 14. For small/large limited liability companies how often do you think that a management audit should be conducted?

Hypotheses and questions (continued)

MANAGEMENT AUDIT REPORT

Hypothesis	Question
8. Bankers consider that the management audit report for both small and large limited liability companies should include assessments both of the general management function and of the individual business functions.	15. Which, if any, of the following areas would you like specifically reported upon in a management audit report for small/large limited liability companies? (a) Assessment of: company objectives efficiency and effectiveness of management in achievement of company objectives organisational structure budgetary control system management information system other (please specify) (b) Assessment of performance of management of the individual functions: finance purchasing production marketing personnel training

Hypotheses and questions (continued)

MANAGEMENT AUDIT REPORT	15. (b) Assessment of performance of management of the individual functions: accounting computing research and development other (please specify)
9. Bankers consider that the management audit report would be more useful than the financial audit report in relation to their lending decisions about both small and large limited liability companies.	16. Do you consider that the management audit report would be more useful than the financial audit report in helping you to make your lending decisions about small/large limited liability companies?
To seek any additional comments on management auditing.	17. Please use the space below for any additional comments which you may wish to make on management auditing.

The comparative approach between the financial audit report and the management audit report can be seen from the following similar questions:

Financial audit report	Management audit report
Question 3	Question 10
" 4	" 11
" 7b	" 9
" 16	" 16

The final page of the questionnaire asked for personal details about some background variable.

(d) Background variables

Some similar research studies involving bankers and the financial audit report (such as Winters[29], Brenner[30] and Estes and Reimer[31]) did not ask respondents for any background details but Libby[32] in his bankers' survey did. Other research studies involving shareholders (such as Lee and Tweedie[33] and Estes[34]) have also collected background information from respondents. For this survey on external management auditing, it was considered important to request background details from respondents, firstly, to determine the characteristics of a 'typical' respondent and, secondly, to check whether any answers might be related to background variables such as the age of respondents. However, it was decided to restrict the number of background variables to eight because too long a list might have affected the response rate.

In choosing the eight background variables for this survey, consideration was given to those collected by Libby[35], Lee and Tweedie[36] and Estes[37] in their postal surveys:

Libby

(Bankers)

1. Age
2. Years of experience
3. % of customers
4. Bank
5. Highest degree earned

Lee and Tweedie

(Private shareholders)

1. Sex
2. Age
3. Accounting experience
4. Occupation

Estes

(Shareholders and professional investors)

1. Years of business experience
2. Credit hours in accounting courses
3. Credit hours in finance and investment courses
4. Years of college completed
5. Market value of investments in corporate stock
6. Market value of investments in corporate bonds
7. Market value of other securities
8. Number of stock transactions in the past two years
9. Frequency of evaluating stocks or advising investors
10. Sex
11. Age
12. Familiarity with Dow Jones Industrial Average
13. Investment attitude.

Obviously several of the above variables (such as occupation and market value of other securities) were irrelevant for this particular study. However, using the above lists as a starting point and based on my discussions with bankers together with feedback from the pilot questionnaire, the following eight personal details were identified as being of possible importance:

1. Age
2. Sex
3. Number of years employed by a bank
4. Number of years using financial information
5. Qualifications
6. Types of banking experience
7. Small limited liability companies as customers
8. Large limited liability companies as customers.

These questions on the personal details of respondents were included as the last page of the questionnaire.

Selection of sample

With the Royal Bank and the Bank of Scotland being the largest two banks in terms of assets and taking into account time and cost factors, it was decided to survey 150 branch managers from those two banks and 100 from the Clydesdale Bank. The six branch managers in the pilot survey were excluded from the population of branch managers for the purpose of this sample. This survey sample as a percentage of the population of branch managers in the three banks is given in Table 2.

TABLE 2

Population and sample of branch managers

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
Population of branch managers	377	309	453	1,139
Number of branch managers surveyed	150	100	150	400
% of branch managers surveyed	40%	32%	33%	35%

This gave a total sample of 400 branch managers from a population in the three banks of 1,139 branch managers making a sample of 35%. The percentage of branch managers surveyed from the Bank of Scotland at 40% was higher than the other two banks and this has arisen because it was decided to sample the same number of branch managers from the Bank of Scotland and the Royal Bank of Scotland (both larger than the Clydesdale Bank) and to use round numbers in the sample (100, 150 and 400) rather than the same percentage for all three banks. The three banks supplied a full list of branch managers and a random sample was taken for each bank. Details of these samples are given in Appendix B.

All three banks also agreed that all their head office lending officials would receive a questionnaire. The head office lending officials supervised the lending of a number of branch managers on a regional basis. It was decided to survey all the head office lending officials because of the relatively small number involved and because of their specialist experience in the corporate lending field. Table 3 summarises the number of bankers surveyed.

TABLE 3

Number of bankers surveyed

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
Head office staff	21	15	30	66
Branch managers	150	100	150	400
Total number surveyed	171	115	180	466

The questionnaire with my covering letter and with the letter from the bank was posted during 1983 to all 466 participants in the survey. The questionnaires were designed (or marked) so that from the returned questionnaires the bank and category (head office or branch manager) of each respondent could be identified. This chapter has outlined the development of the questionnaire survey and its results are discussed in the following chapter.

CHAPTER 6

RESULTS OF QUESTIONNAIRE SURVEY

Response rates

In asking the three banks for their assistance with this research project, it was stated at the beginning that this could be a two-stage project namely a questionnaire followed by a simulated lending decision. The results of this first stage questionnaire would determine whether or not this second stage of a simulated lending decision would be conducted. Therefore, in my initial approach to the three banks it was stated that no follow-up letters would be sent in order to avoid bankers selected for this project receiving possibly four different letters. This decision to forego the follow-up letters was not taken lightly because it would almost certainly mean a lower overall response rate. Nevertheless, the more important point was to secure the co-operation of all three banks and this was achieved.

Despite this lack of a follow-up letter the number of responses and the response rates for each bank were acceptable as shown in Table 4.

TABLE 4

Number of respondents and response rates

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
Number of head office respondents	13	10	14	37
Number of branch manager respondents	95*	71	92	258*
Total number of respondents	108*	81	106	295*
% response from head office staff	62%	67%	47%	56%
% response from branch managers	63%	71%	61%	65%
% total response	63%	70%	59%	63%

*4 responses were blank with a covering letter

Babbie has expressed the following opinion about surveys' response rates:

> 'I feel that a response rate of 50 percent is adequate for analysis and reporting. A response rate of at least 60 percent is good. And a response rate of 70 percent or more is very good .... these are only rough guides and they have no statistical basis.'[1]

Given the response rates of recent postal surveys on auditing topics in Great Britain (such as Santocki[2] with 10%), the nature of the topic being researched and the fact of no follow-up letter, an overall response rate of 63% was in Babbie's terms 'good'. The overall response rate for each of the three banks varied from 59% for the Royal Bank of Scotland to 70% for the Clydesdale Bank but even 59% is in Babbie's terms 'adequate'. One characteristic common to all three banks was the fact that the percentage response from head office staff was lower than that from branch managers. In particular the 47% response from the Royal Bank of Scotland head office staff was relatively low although it may be explained by the fact that at the time of the survey, a reorganisation of head office staff had recently taken place at the Royal Bank of Scotland. However, overall the response rate was reasonable. Furthermore, from the number of detailed comments on the returned questionnaires it was apparent that many respondents had spent a considerable amount of time on completing the questionnaire. One hundred and three respondents (35% of all respondents) also indicated a continuing interest in this project by requesting a copy of the results of the survey. A copy of the results of this survey sent to such respondents is given in Appendix C.

Preparation for analysis

When the completed questionnaires were received, the date of receipt was noted on them. These dates were later grouped into weeks to indicate the week of receipt. 48%

of the completed questionnaires were received in the first week, 33% in the second week, 12% in the third week and only 7% in the fourth week or later. The completed questionnaires were grouped by bank and within each bank were numbered in the date order of receipt as shown in Table 5.

TABLE 5

Numbering of questionnaires

Number	Bank
001 - 104	Bank of Scotland
105 - 185	Clydesdale Bank
186 - 291	Royal Bank of Scotland

The four uncompleted questionnaires each with a covering letter explaining why the questionnaire could not be completed (for example because of illness) were excluded from any further analysis.

A master questionnaire was coded for punching and the coded answers to the questions for the 291 usable questionnaires were key-punched and verified. In fact 90 columns were required for the answers (with each individual answer contained in one column), 3 columns for the number of each questionnaire and 3 columns for the following:

1. name of the bank;
2. week in which completed questionnaire was received;
3. head office or branch respondent.

This gave a total of 96 columns on the print-out. A manual check between the completed questionnaires and the computer print-out also revealed errors which were corrected to give the final computer files on which a statistical analysis was carried out. The Statistical Package for the Social Sciences (S.P.S.S.) was used to analyse the data. Some respondents who had no large limited liability corporate customers did not answer the questions relating to such companies. It was decided that the best form of presentation for the following analysis would be to exclude such missing answers (in other words the answers given would total 100%) and to show also the number of respondents for each question. Therefore, with 291 respondents having returned usable questionnaires, the number of missing answers can be calculated from any of the following tables. For example, when 278 respondents are shown as having answered a particular question, this means that 13 respondents did not answer that question.

Background variables

As discussed in Chapter 5 one reason for asking respondents for background details was to determine the characteristics of a 'typical' respondent. The following sections summarise the results for each of the background variables in this survey.

1. Age

As can be seen from Table 6, 50% of respondents were in the 40 to 49 age range. Indeed 67% of respondents were under 50 years old and 33% were 50 and older.

TABLE 6

Age of respondents

	n* = 278 %
Under 30	-
30 - 39	17
40 - 49	50
50 - 59	32
60 and over	1
	100

*In all the Tables n indicates the number of respondents answering that particular question out of a possible maximum of 291 respondents.

2. Sex

Of the 269 respondents answering this question all except one were male. This is not surprising in the context of Scottish branch managers and head office lending staff although the point had been made during my discussions with bankers that female branch managers do exist and this was the reason for including sex as a background variable.

3. Number of years employed by a bank

Table 7 shows that 90% of respondents had been employed by a bank for at least 20 years. The respondents were almost equally divided into those who had been employed by a bank for under 30 years (51% of respondents) and those employed by a bank for over 30 years (49% of respondents). Indeed the age profile of respondents (Table 6 above) and the following Table 7 suggest that a number of respondents joined a bank straight from school and that particular bank has been their only employer during their working life.

TABLE 7

	Number of years employed by a bank n = 277 %
Under 5	-
5 - 9	1
10 - 19	9
20 - 29	41
30 and over	49
	100

4. Number of years using financial information

As we have seen from Table 7, 90% of respondents had been employed by a bank for at least 20 years but Table 8 shows that only 21% of respondents had been using financial information for at least 20 years. This suggests that many respondents may have worked their way up through the banking structure from the bottom rather than joining the bank at a relatively senior level.

TABLE 8

	Number of years using financial information n = 277 %
Under 5	4
5 - 9	24
10 - 19	51
20 - 29	17
30 and over	4
	100

5. Qualifications

A large number of respondents (102) did not answer this particular question which may mean that such respondents had no paper qualifications. However, of those answering this question, 92% gave their only qualification as being as Associate of the Institute of Bankers (A.I.B.).

TABLE 9

	Qualifications n = 189 %
A.I.B.	92
A.I.B. + other qualification	6
Fellow of the Institute of Bankers	2
	100

6. Banking experience

All respondents who answered this question had more than one type of banking experience. Table 10 shows the number of respondents who had experienced these various types of banking.

TABLE 10

	Respondents with banking experience
	n
Personal	275
Commercial	257
Agricultural	202
Industrial	189
Fishing	63
Other	25

Assuming that those respondents who did not answer this question had no experience of these various types of banking (obviously an unrealistic assumption), this would still mean that 88% of the 291 respondents to this questionnaire had commercial banking experience and 65% had industrial banking experience.

7 and 8. Customers

A large limited liability company was defined in the questionnaire as one 'which equals or exceeds at least two of the following three criteria:

1. Turnover £2 million
2. Balance sheet total assets £1 million
3. Average number of employees 50.'

Almost all respondents (97% of the 276 bankers answering this question) had small limited liability companies as customers but only 60% of the bankers answering this question had large limited liability companies as customers. The important fact for this survey was that almost all respondents had experience of limited liability companies as customers and were therefore able to answer this questionnaire with their background of practical experience.

Summary of background variables

In summary a 'typical' respondent to this questionnaire was over 40 years old, male, employed by a bank for at least 20 years, a user of financial information for at least 10 years, an Associate of the Institute of Bankers and experienced in the commercial and industrial banking fields with limited liability companies as customers.

Non-response bias

In almost every survey some members of the initial sample will not return their questionnaires and therefore non-response bias becomes a potential problem. One test for non-response bias is to compare the characteristics of the respondents with the characteristics of the population. In informal discussions with my top management contacts in the three banks, no surprise was expressed at the above 'typical' respondent to this questionnaire. However, to be a reliable test, a statistical analysis of the backgrounds of all branch managers and all head office lending officials in the three banks would have been required and such an analysis was not available.

A second test for non-response bias was therefore conducted by comparing the early and late respondents to this questionnaire. This is based on the summary of findings by Oppenheim[3] that respondents who send in their questionnaires late are roughly similar to non-respondents. One problem with this test is to decide when is sufficiently late to assume that such respondents are similar to non-respondents. It was decided that the 141 respondents whose completed questionnaires were received in the first week could be compared with the 55 respondents whose questionnaires were received in the third week and later. When the early and late respondents are compared in percentage terms in Table 11, it must be remember that the late respondents totalled only 55. With the relatively small number of late respondents and to enable a fair comparison to be made between the early and late respondents, the no answers are included in the percentages in Table 11.

TABLE 11

Comparison of early and late respondents

	Respondents in first week		Respondents in third week and later	
	n = 141	%	n = 55	%
Bank				
Bank of Scotland		30		24
Clydesdale Bank		30		38
Royal Bank of Scotland		40		38
		100		100
Category of respondents				
Head office		16		11
Branch		84		89
		100		100
Background variables				
Age				
Under 30		1		-
30 - 39		18		9
40 - 49		45		54
50 - 59		32		35
60 and over		1		-
No answer		3		2
		100		100

	Respondents in first week		Respondents in third week and later	
	n = 141	%	n = 55	%
Sex				
Male		92		93
Female		1		-
No answer		7		7
		100		100
Number of years employed by a bank				
Under 5		-		-
5 - 9		1		-
10 - 19		9		7
20 - 29		38		40
30 and over		49		51
No answer		3		2
		100		100
Number of years using financial information				
Under 5		5		-
5 - 9		20		23
10 - 19		52		47
20 - 29		16		22
30 and over		4		4
No answer		3		4
		100		100
Qualifications				
A.I.B.		62		60
A.I.B. + other qualification		3		6
F.I.B.		3		-
None given		32		34
		100		100

	Respondents in first week		Respondents in third week and later	
	n = 141	%	n = 55	%
Banking experience				
Personal		94		98
Commercial		88		93
Agricultural		69		75
Industrial		69		69
Fishing		20		29
Other		11		7
Small limited liability companies as customers				
Yes		96		91
No		2		2
No answer		2		7
		100		100
Large limited liability companies as customers				
Yes		62		57
No		34		36
No answer		4		7
		100		100

Table 11 illustrates that the early (first week) and late (third week and later) respondents had very similar background in terms of age, sex, number of years employed by a bank, number of years using financial information, qualifications, banking experience and limited liability companies as customers. Two minor differences between the early and late respondents were:

(1) 30% of the early respondents were from the Clydesdale Bank against 38% of the late respondents.

(2) 20% of the early respondents had banking experience of the fishing industry against 29% of the late respondents.

Neither difference has important implications for non-response bias.

In addition to comparing the early and late respondents on the basis of background variables, an attempt was made to examine any differences in their replies to the questionnaire. Again the early respondents were defined as those whose questionnaires were received in the first week and the late respondents as those whose questionnaires were received in the third week and later. Excluding the background variables, 77 'questions' requiring a separate answer can be identified in the questionnaire when parts of various questions and the split between small and large companies are considered. Details of these 77 'questions' are given in Appendix D. The null hypothesis to be tested for each of these 77 'questions' (which can be described as H_oQ1 to H_oQ77 for reference) are:

H_oQ1 Bankers' answers to question 1 are not significantly related to early or late respondents.

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H_oQ77 Bankers' answers to question 77 are not significantly related to early or late respondents.

Using S.P.S.S. the 77 cross-tabulations were calculated. Schuman and Presser have suggested:

> 'A probability of less than .10 is ordinarily regarded as borderline, $p < .05$ as significant and $p < .01$ as highly significant.'[4]

This suggestion of Schuman and Presser will be adopted and the 5% significance level will be used generally as a cut-off point when describing the results of this survey. Furthermore, the following two rules of thumb suggested by Yeomans for the chi-square test will also be used when analysing the results of this survey:

> 'As a working rule, the chi-square test should not be used if any expected frequency is less than one, or if more than 20 per cent of expected frequencies are less than five.'[5]

As to be expected with such a large number of cross-tabulations, some chi-squares were significant at the 5% level. Details of these cross-tabulations significant at the 5% level and meeting the two rules of thumb of Yeomans[5] are given in Table 12.

TABLE 12

Cross-tabulations of 'row' by early and late respondents significant at 5% level

Row	n	χ^2	df	p
1. Consider that financial audit report could contain more information for large companies	168	6.73	2	.03
2. Use qualifications of management in assessing management for small companies	196	7.21	2	.03
3. Would like assessment of performance of production function specifically reported in a management audit report for small companies	187	7.76	2	.02

(Note: n = number of respondents answering that particular question

χ^2 = chi-square or corrected chi-square where necessary

df = degrees of freedom

p = significance)

A much higher percentage of the late respondents (69%) than of the early respondents (46%) considered that the financial audit report for large companies could contain more information. Regarding the second cross-tabulation above, the main difference was that 65% of early respondents against 44% of late respondents sometimes use the qualifications of management when assessing management. However, if we combine the 'sometimes' and 'always' answers, 97% of early and 95% of late respondents either always or sometimes use the qualifications of management when assessing management. By combining these two answers, the difference between early and late respondents becomes less important. The third cross-tabulation above is significant mainly because 7% of early against 21% of late respondents did not wish the assessment of the performance of the production function specifically reported upon in a management audit report for small companies. Nevertheless, we have no reason to reject almost all the null hypotheses H_oQ1 to H_oQ77. In summary, the differences between the answers of the early and late respondents do not suggest any important non-response bias. Therefore, considering also the above informal comparison of the characteristics of the sample with the characteristics of the population, and taking into account the results of the comparison of the characteristics of the early and late respondents, we have no evidence to suggest that the respondents were not reasonably representative of the total sample.

Detailed results of survey

The reliability of the answers is a problem in any questionnaire. As discussed in Chapter 5 questions 3, 10 and 16(a) were logically linked for small companies and questions 4, 11 and 16(a) for large companies. Questions 3, 4, 10 and 11 each had six possible answers (including no answer) and questions 16(a) and 16(b) each had five possible answers (including no answer). With 291 respondents and questions on both small and large companies, this gave a total population for this reliability check of 582 but 147 of these 582 were excluded.[6] Of the remaining 435, 65 inconsistencies could be identified with 17 respondents having inconsistencies about both small and large companies which meant that 48 respondents had at least one inconsistency in their answers to these questions. However, these 65 inconsistencies would be classified as follows:

49	minor inconsistencies on ranking scale[7]
16	major inconsistencies on ranking scale[8]
65	

Therefore, 16 major inconsistencies could be identified and 10 of these 16 came from five respondents which implied that 11 respondents out of 291 accounted for all 16 major inconsistencies. Therefore, the conclusion of this one check is that the answers of the responding bankers appear to be generally reliable.

Before considering the overall results of this questionnaire survey, various subsets of the respondents will be considered to attempt to identify any significant differences.

(a) Results by bank

The detailed results of this survey by bank by question are given in Appendix F. To determine whether the answers of the bankers of any one of the three banks were statistically significantly different, the null hypothesis to be tested for each of the 77 questions listed in Appendix D (which can be described as H_oBQ1 to H_oBQ77 for reference) are:

H_oBQ1 Bankers' answers to question 1 are not significantly related to a particular bank.

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H_oBQ77 Bankers' answers to question 77 are not significantly related to a particular bank.

The 77 cross-tabulations were calculated and the three chi-squares significant at the 5% level and meeting the two chi-square rules of thumb of Yeomans[5] are given in Table 13.

TABLE 13

Cross-tabulations of 'row' by bank significant at 5% level

Row	n	χ^2	df	p
1. Consider that financial audit report could contain more information for large companies	241	10.41	4	.03
2. Use financial audit report in assessing management for small companies	288	22.16	4	.00
3. Use any other information in assessing management of large companies	72	11.01	4	.03

Table 13 omits three significant cross-tabulations.[9] Regarding the above significant cross-tabulations, firstly, a larger percentage of the Clydesdale Bank's respondents (41%) compared to the respondents of the other two banks (22% for both the Bank of Scotland and the Royal Bank of Scotland) did not consider that the financial audit report could contain more information for large companies. Secondly, 51% of the Bank of Scotland's respondents compared to 26% of the Clydesdale Bank's respondents and 31% of the Royal Bank of Scotland's respondents sometimes use the financial audit report in assessing the management for small companies. The third cross-tabulation can be ignored with only 72 out of 291 respondents answering this particular question. Although there are differences, which are statistically significant at the 5% level between a few answers of the bankers from the three banks, we have no reason to reject almost all the null hypotheses H_0BQ1 to H_0BQ77. The overall conclusion is that the bankers' answers in this survey are not generally significantly related to a particular bank.

(b) Results by head office officials and branch managers

We have the problem of small numbers with only 37 head office respondents in total from the three banks.

Accepting this problem, would the answers of head office respondents be statistically significantly different from those of the branch managers? The null hypothesis to be tested for each of the 77 questions listed in Appendix D (which can be described as H_oSQ1 to H_oSQ77 for reference) are:

H_oSQ1 Bankers' answers to question 1 are not significantly related to head office or branch manager respondents.

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H_oSQ77 Bankers' answers to question 77 are not significantly related to head office or branch manager respondents.

Again the cross-tabulations were calculated for all 77 questions and the only two cross-tabulations which were significant at the 5% level and met the two chi-square rules of thumb of Yeomans[5] are given in Table 14.

TABLE 14

Cross-tabulations of 'row' by head office and branch respondents significant at 5% level

	n	χ^2	df	p
1. Used financial audit report as part of data on which based lending decisions to large companies	236	4.29	1	0.04
2. Use your own personal knowledge of management in assessing management for large companies	216	6.43	2	0.04

Perhaps as to be expected a larger percentage of the branch manager respondents (29%) compared to head office staff respondents (11%) have not used the financial audit report as part of the data on which they have based their lending decisions to large companies. Regarding the above second cross-tabulation, 42% of head office staff respondents compared to 58% of branch manager respondents always use their own personal knowledge of management in assessing the management of large companies. However, if we combine the always and sometimes answers we find that 90% of head office staff respondents compared to 98% of branch manager respondents always or sometimes use their own personal knowledge of management in assessing the management of large companies. By combining these two answers the difference between the head office and branch manager respondents becomes less important. In the answers to these three questions differences which are significant at the 5% level did exist between the head office and branch respondents but we have no reason to reject almost all the null hypotheses H_oSQ1 to H_oSQ77. No major overall differences can be identified between head office and branch respondents.

(c) Results by small and large companies

The questionnaire was designed so that all questions (except question 1) required two separate answers for small and large limited liability companies. In other words the 77 questions in Appendix D become 38 comparative questions in relation to small and large companies. This distinction between small and large companies had been made because in my early discussions with bankers, they suggested that the answers to some questions could be different for small and large companies. Therefore, would the answers for small companies be statistically significantly different from the answers for large companies? The null hypothesis to be tested for each of the 38 questions listed in Appendix D (which can be described as H_oCQ1 to H_oCQ38 for reference) are:

H_oCQ1 Bankers' answers to question 1 for small companies are not significantly related to the answers to the same question for large companies.

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H_oCQ38 Bankers' answers to question 38 for small companies are not significantly related to the answers to the same question for large companies.

The cross-tabulations were calculated for the 38 questions and, although many suffered from the problem of small numbers when calculating the chi-square, all were significant at the 5% level and most were significant at the 1% level. A selection of these cross-tabulations are given in Table 15 for illustration:

TABLE 15

Selection of cross-tabulations of 'row' for small companies by 'row' for large companies significant at 1% level

Row	n	χ^2	df	p
1. Used financial audit report as part of the data on which based lending decisions	236	92.48	1	.00
2. Consider that financial audit report could contain more information	240	243.81	4	.00
3. Assess management when making lending decisions	236	53.30	2	.00
4. Like assessment of organisational structure specifically reported in a management audit report	220	221.55	4	.00

Row	n	χ^2	df	p
5. Like assessment of performance of management of computing function specifically reported in a management audit report	216	223.80	4	.00

The general conclusion is that we have to reject the null hypothesis that bankers' answers to the questions for small companies are not significantly related to the answers for large companies. The results of this questionnaire show that the distinction between small and large companies is very much less important than that suggested by my early discussions with bankers and by the pilot questionnaire. This conclusion is consistent with the recent finding of an American survey by Stanga and Tiller:

> 'The conclusion of the study is that the informational needs of bank loan officers do not differ substantially between large public companies and small private companies.'[10]

Unfortunately this study by Stanga and Tiller was not available at the time when my questionnaire survey was being developed.

(d) Results by background variables

As mentioned in Chapter 5, in addition to determining the characteristics of a 'typical' respondent, background information was collected from respondents in order to check whether any answers might be related to background variables such as the age of respondents. The questions on the personal details of respondents covered age, sex (which can be ignored with only one female respondent), number of years employed by a bank, number of years using financial information, qualifications, banking experience, small and large limited liability companies as customers. The null hypotheses to be tested for each of the 77 questions listed in Appendix D (which can be described as $H_oVQ1(a)$ to $H_oVQ77(\ell)$) are:

$H_oVQ1(a)$ to $H_oVQ1(\ell)$ Bankers' answers to question 1 are not significantly related to:

(a) Age (under 50 years old or 50 years and over).

(b) Number of years employed by a bank (under 30 years or 30 years and more).

(c) Number of years using financial information (under 10 years or 10 years and more).

(d) Qualifications (stating a paper qualification or not).

(e) Agricultural banking experience (with or without).

(f) Commercial banking experience (with or without).

(g) Fishing banking experience (with or without).

(h) Industrial banking experience (with or without).

(i) Personal banking experience (with or without).

(j) Other banking experience (with or without)

(k) Having small limited liability companies as customers (or not)

(ℓ) Having large limited liability companies as customers (or not).

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$H_oVQ77(\ell)$ Bankers' answers to question 77 are not significantly related to having large limited liability companies as customers (or not).

This gave a total of 924 null hypotheses to be tested. The cross-tabulations were calculated for all 924 and the 34 chi-squares significant at the 5% level and meeting the two chi-square rules of thumb of Yeomans[5] are given in Appendix E together with some comments. However, the conclusions about the background variables can be summarised in four main points. Firstly, three of the above twelve background variables (namely personal banking experience, other banking experience and having small limited liability companies as customers) produced no cross-tabulations significant at the 5% level. This was partly because of the small number of respondents who did not have personal banking experience, who did have other banking experience and who did not have small companies as customers.

Secondly, using the background variable of qualifications, 13 out of 77 cross-tabulations were significant at the 5% level with six of these 13 cross-tabulations being significant at the 1% level. Furthermore eight of these 13 cross-tabulations were in relation to the same four questions for both small and large companies. Therefore, we have evidence to reject 13 null hypotheses that bankers' answers to those 13 questions are not significantly related to qualifications. In particular a larger percentage of respondents with paper qualifications (compared to respondents without qualifications) would like the following specifically reported in a management audit report:

1. assessment of company objectives for both small and large companies;
2. assessment of organisational structure for both small and large companies;
3. assessment of the performance of the management of the following functions:
   (a) purchasing for large companies
   (b) production for large companies
   (c) accounting (small difference see Appendix E for details) for small companies

(d) computing for small companies

(e) research and development for small and large companies.

Thirdly, after qualifications the second most important background variable (in terms of null hypotheses rejected at the 5% level of significance) was industrial banking experience with ten null hypotheses rejected. Of these ten null hypotheses rejected, five were significant at the 1% level. In particular a larger percentage of respondents with industrial banking experience (compared to respondents without such experience) have used the financial audit report as part of the data on which they have based their lending decisions to small and large companies and also consider that the financial audit report could contain more information for both small and large companies. Furthermore, a larger percentage of respondents with industrial banking experience (compared to respondents without such experience) assess management when making their lending decisions about large companies.

Fourthly, the only other background variable with five or more null hypotheses rejected at the 5% level of significance was that of age. With the background variable of age three of the five significant cross-tabulations arose when a greater percentage of respondents under 50 years old (compared to respondents 50 years old and over) expressed a desire for assessments of the performance of the management of the accounting, computing and research and development functions to be specifically reported in a management audit report for small companies. In summary, we have no evidence to reject the vast majority of the 924 null hypotheses $H_oVQ1(a)$ to $H_oVQ77(\ell)$. The background variables of sex, number of years employed by a bank, number of years using financial information, agricultural banking experience, commercial banking experience, fishing banking experience, personal banking experience, other banking experience, having small and large limited liability companies as customers can be regarded as relatively unimportant for this survey. The two most important background variables for this survey in terms of the number of null hypotheses rejected are qualifications and industrial banking experience.

Overall results for all three banks

The detailed results of this questionnaire survey by bank by question are given in Appendix F but the following sections summarise the results of this survey in relation to the nine hypotheses developed in Chapter 5. The questionnaire was divided into two parts namely existing lending decisions and management auditing and the results of the survey will be discussed under these two general headings.

1. Existing lending decisions

(a) Financial audit report

The hypotheses to be tested are given in the previous chapter and the first was:

> H_1 Bankers claim to read the financial audit report of their customer companies.

Only one out of 291 respondents replied that he never read the financial audit report of his customer companies with 93% of respondents always and 7% sometimes reading it. Hypothesis H_1 is clearly supported by this evidence. This result is consistent with the Fess and Ziegler[11] study (discussed in the previous chapter) where all the bankers claimed to read the financial audit report. Also, in the Brenner[12] study only 7% of bankers claimed not to read the financial audit report. The results of these two American studies taken together with the results of this British survey suggest that bankers are at least one user group which claim to read the financial audit report. However, did the bankers in this survey find the audit report useful?

The second hypothesis was:

> H_2 Bankers consider the financial audit report to be useful in relation to their lending decisions about both small and large limited liability companies.

In fact 85% (of 290 respondents) stated that they had used the financial audit report as part of the data on which they had based their lending decisions to small limited liability companies. For large limited liability companies the figure was 74% of 236 respondents. The respondents to questions on large companies were generally fewer than the respondents to questions on small companies because 110 respondents did not have any large companies as customers and some of these 110 respondents did not answer the questions on large companies.[13] However, 76 of these 110 respondents did answer this particular question and if these 76 answers are excluded, 81% (of 160 respondents) stated that they had used the financial audit report as part of the data on which they had based their lending decisions to large companies.

The questionnaire requested details of the typical occasions on which respondents had used the financial audit report. The comments were extensive and two typical examples were:

> 'Qualification had led to enquiries which have led to a request for bank support being declined.'

> 'A qualified report has led to a more comprehensive appraisal and in some cases to withdrawal of credit lines.'

Specific circumstances given by respondents included liquidity problems, stock valuation, long-term work-in-progress valuation and research and development. Indeed the most usual could be classified as follows:

(1) 49 respondents stated that the financial audit report played a part in any lending proposal whether it was a new one or a renewal.

(2) 59 respondents mentioned specifically that a qualified audit report could be used for further action (such as explanation from Directors).

These answers and comments provide evidence about how often bankers use the financial audit report as part of the data on which they base their lending decisions.

Questions 3 and 4 were also related to H_2 and the answers are summarised in Table 16.

TABLE 16

Financial audit report useful in helping to make lending decisions about:

	SMALL companies n = 291 %	LARGE companies n = 238 %
Strongly agree	15	20
Agree	66	57
Uncertain	11	14
Disagree	8	9
Strongly disagree	-	-
	100	100

Table 16 reveals that 81% and 77% of respondents found the financial audit report useful in helping them to make their lending decisions about small and large companies respectively. With any postal questionnaire the results must be interpreted with care. It would be interesting to compare, for example, the results in Table 16 with the results of an interview survey of bankers asking the same question. Nevertheless, together with the number of examples given by respondents of occasions when they had used the financial audit report, Table 16 provides evidence that bankers have found the financial audit report useful in helping them to make lending decisions about companies.

Despite this high percentage of respondents who found the financial audit report useful, 59% of 286 respondents still considered that it could contain more information for small companies and 51% of 241 respondents considered the same for large companies. In the open-ended comments section to this question 15 respondents requested an opinion on the 'quality' of stocks and debtors and details of preferential creditors (a disclosure point). This desire for more information in the financial audit report would help to ensure that it was perceived to be more useful. However, the above answers undoubtedly support H_2 that 'bankers consider the financial audit report to be useful in relation to their lending decisions about both small and large limited liability companies'.

(b) Assessment of management

The third hypothesis was:

H_3 Bankers claim to assess management when making their lending decisions about both small and large limited liability companies

Table 17 summarises the results.

TABLE 17

Assess management when making lending decisions about:

	SMALL companies		LARGE companies	
	n = 291	%	n = 236	%
Always		89		69
Sometimes		11		28
Never		-		3
		100		100

Again the evidence supports H_3 although it is interesting that bankers appear to assess the management of large companies less often than the management of small companies. This result remains the same even if the 76 respondents who answered this question but do not have large companies as customers are excluded. When these 76 respondents are excluded, the percentages for large companies remain almost the same with 69% of the 160 respondents answering always, 29% answering sometimes and 2% answering never. Indeed the exclusion of these 76 respondents makes little difference to almost all the following percentage results and these respondents (who have answered a question about large companies without having such companies as customers) will be specifically mentioned in the rest of this chapter only if their exclusion makes a material difference of plus or minus five per cent to any result.

This result that bankers claim to assess management when making their lending decisions about companies is an important finding in relation to external management auditing. This confirms that bankers try to assess the management of companies which is, of course, a major objective of the external management audit. What information, therefore, do bankers use in trying to assess corporate managements?

The fourth hypothesis was:

> H_4 Bankers claim to use a range of financial and non-financial information in assessing management for both small and large limited liability companies.

The information which bankers claim to use in assessing corporate management can be seen from Table 18.

TABLE 18

Information used in assessing management of:

	SMALL companies			
	n	Always %	Sometimes %	Never %
Annual financial statements	289	76	21	3
Financial audit report	288	61	34	5
Qualifications of management	290	38	58	4
Practical experience of management	289	75	24	1
Personal knowledge of management	287	76	23	1
Any other information	101	37	46	17

	LARGE companies			
	n	Always %	Sometimes %	Never %
Annual financial statements	219	77	19	4
Financial audit report	218	62	32	6
Qualifications of management	219	30	62	8
Practical experience of management	218	59	37	4
Personal knowledge of management	216	56	41	3
Any other information	72	35	42	23

Adding together the percentages in the always use and sometimes use columns to rank the answers in Table 18, the annual financial statements, the practical experience of management and the bankers' personal knowledge of management were the three main sources of information used by bankers in assessing the managements of both small and large companies. The financial audit report came a close fourth in this ranking. Indeed using the percentages in the always use column to rank the answers in Table 18, the ranking would not change for small companies but for large companies the financial audit report would jump from fourth to second place. The use by bankers of audit qualifications may have influenced respondents and those who replied 'always' may mean that when assessing management they always look at the audit report to check that no audit qualification appears.

Only 38% and 30% of respondents always use the qualifications of management in assessing the management of small and large companies respectively. However, it would appear that the use of the qualifications of management may depend on the particular circumstances of companies because, for both small and large companies, the qualifications of management are ranked first in the sometimes use column in Table 18. In Table 18, 23 of the 72 respondents to the question on large companies did not have such companies as customers and if these 23 respondents are excluded the results become 33% always, 49% sometimes and 18% never use any other information in assessing the management of large companies instead of 35%, 42% and 23% as in Table 18.

In this Table the range of other information used in assessing management was very wide. More than ten respondents used the following types of information when assessing corporate managements:

1. Provision of management accounts and budgets;
2. Past track record of management;
3. Results of competitors.

Other types of information used included comments from the financial press, the reputation of the company, the integrity of the directors, company visits and the views of customers. The results of this survey suggest that bankers do use a range of financial and non-financial information in assessing corporate managements. H_4 is generally supported by the evidence.

The fifth hypothesis was:

> H_5 Bankers consider that they do not always have sufficient information to make an adequate assessment of management for both small and large limited liability companies.

The evidence from this survey suggests that bankers are by no means satisfied that sufficient information is always available to them at present to make an adequate assessment of management as shown by Table 19.

TABLE 19

Sufficient information to assess management of:

	SMALL companies n = 291 %	LARGE companies n = 233 %
Always	9	5
Sometimes	79	81
Never	12	14
	100	100

Less than 10% of respondents consider that they always have sufficient information to assess the management of small and large companies although approximately 80% do consider that they sometimes have sufficient information available for both small and large companies. The evidence therefore support H_5. This implies that the external management audit report might be of interest to bankers by giving them more information on which to make assessments of corporate managements. This completed the first section of the questionnaire on the financial audit report.

2. Management auditing

The second section of the questionnaire concentrated on management auditing.

(a) Usefulness

The sixth hypothesis was:

> H_6 Bankers consider that the management audit report would be useful in relation to their lending decisions about both small and large limited liability companies.

Table 20 shows that over 60% of respondents would always use the management audit report as part of the information on which they would assess the management of both small and large companies and a further 36% would sometimes use such a report.

TABLE 20

Use management audit report as part of the information on which you would assess the management of:

	SMALL companies		LARGE companies	
	n = 289	%	n = 251	%
Always		63		62
Sometimes		36		37
Never		1		1
		100		100

With the same question being asked about the financial audit report in the first section of the questionnaire, a comparison between questions 7b and 9 is made in Table 21.

TABLE 21

(a) Use in assessing management of SMALL companies

	Financial audit report		Management audit report	
	n = 288	%	n = 289	%
Always		61		63
Sometimes		34		36
Never		5		1
		100		100

(b) Use in assessing management of LARGE companies

	Financial audit report		Management audit report	
	n = 218	%	n = 251	%
Always		62		62
Sometimes		32		37
Never		6		1
		100		100

The results are very similar. Indeed the cross-tabulations of the individual bankers' answers in Table 21 for the financial audit report by their answers for the management audit report are significant at the 1% level for small companies and at the 10% level for large companies. It appears that both the financial and management audit reports would be used as part of the information on which bankers would assess the management of small and large limited liability companies.

Questions 10 and 11 also related to H_6 and the replies are summarised in Table 22.

TABLE 22

Management audit report useful in relation to lending decisions about:

	SMALL companies		LARGE companies	
	n = 289	%	n = 254	%
Strongly agree		20		20
Agree		68		66
Uncertain		11		13
Disagree		1		1
Strongly disagree		-		-
		100		100

H_6 is certainly supported by the evidence in Table 22 with 88% and 86% agreeing that they would find a management audit report useful in relation to their lending decisions about small and large companies respectively.

A similar question was asked in the first section of the questionnaire regarding the financial audit report and the answers are compared in Table 23.

TABLE 23

(a) Report useful in relation to lending decision about SMALL companies

	Financial audit		Management audit	
	n = 291	%	n = 289	%
Strongly agree		15		20
Agree		66		68
Uncertain		11		11
Disagree		8		1
Strongly disagree		-		-
		100		100

TABLE 23

(b) Report useful in relation to lending decision about LARGE companies

	Financial audit		Management audit	
	n = 238	%	n = 254	%
Strongly agree		20		20
Agree		57		66
Uncertain		14		13
Disagree		9		1
Strongly disagree		-		-
		100		100

Firstly, these results are very similar. Both the financial and management audit reports are viewed by respondents as being equally useful in their lending decisions about both small and large companies. Indeed the cross-tabulations of the individual bankers' answers in Table 23 for the financial audit report by their answers for the management audit report are significant at the 1% level for both small and large companies. Secondly, a slightly larger percentage (approximately 10% more) agree that the management audit report will be useful in relation to their lending decisions about both small and large companies compared to the percentage supporting the financial audit report. Thirdly, almost 10% of respondents disagree that the financial audit report is useful in relation to lending decisions about both small and large companies compared to only 1% with respect to the management audit report.

(b) Requirement, payment and frequency

The seventh hypothesis was:

H_7 Bankers consider that the management audit of both small and large limited liability should be:

(a) Required by the banks
(b) Paid for by the company
(c) Conducted annually.

Table 24 summarises the replies.

TABLE 24

Consider that a management audit should be:

	SMALL companies			
	n	Yes %	No %	Don't know %
Voluntary	235	54	38	8
Required by professional accounting bodies	216	53	33	14
Required by law	241	42	47	11
Required by the banks	226	64	30	6

	LARGE companies			
	n	Yes %	No %	Don't know %
Voluntary	189	39	54	7
Required by professional accounting bodies	188	61	26	13
Required by law	222	59	30	11
Required by the banks	189	69	24	7

Many respondents chose more than one of the alternatives and therefore the results are inconclusive although the largest percentage of respondents support the management audit for both small and large companies being required by the banks. Six respondents commented that when companies enjoy the privilege of limited liability, they should make as much information as possible available to creditors. Another comment made by seven respondents was that a voluntary management audit scheme would only be carried out by good companies.

However, if this requirement question gave inconclusive results, the question of who should pay for the management audit was clear-cut (despite some duplicate answers), namely the company, as can be seen from Table 25.

TABLE 25

Management audit should be:

		SMALL companies		
	n	Yes %	No %	Don't know %
Paid for by the company	233	87	9	4
Paid for by the government	195	12	84	4
Paid for by the users (eg. bankers)	200	6	89	5

		LARGE companies		
	n	Yes %	No %	Don't know %
Paid for by the company	236	91	5	4
Paid for by the government	165	12	82	6
Paid for by the users (eg. bankers)	169	8	86	6

Approximately 90% of respondents consider that the management audit should be paid for by the company. In the open-ended comments section twenty-five respondents suggested that the companies should pay because they will benefit from the management audits. Typical of such comments was the following:

'I consider that a management audit would be of immense value not only to third parties such as bankers etc. but probably more importantly to the management of the companies concerned.'

Another research study would be to ask shareholders and company managements about management auditing and in particular about the benefits for the company and also who should pay for the management audit.

Table 26 shows the answers to the question on the frequency of management audits.

TABLE 26

How often should a management audit be conducted

	SMALL companies		LARGE companies	
	n = 286	%	n = 259	%
Not at all		2		2
Annually		45		56
Every 2 years		29		23
Ad hoc		15		9
Other		7		5
Don't know		2		5
		100		100

Although approximately half of the respondents favour an annual management audit, another quarter prefer every two years. In the comments section, eight respondents gave cost savings as their reason for choosing every two years. In summary, the evidence supports H_7 although the problem of multiple answers to the requirement question in particular must be kept in mind.

(c) Content of reports

The eighth hypothesis was:

> H_8 Bankers consider that the management audit report for both small and large limited liability companies

should include assessments both of the general management function and of the individual business functions.

Table 27 shows strong support for assessments of various aspects of the general management function.

TABLE 27

Areas which you would like specifically reported upon in a management audit report

	SMALL companies			
	n	Yes	No	Don't Know
	%	%	%	%
Assessment of:				
Company objectives	264	84	10	6
Efficiency and effectiveness of management in achievement of company objectives	278	90	5	5
Organisational structure	257	60	24	16
Budgetary control system	281	88	8	4
Management information system	266	68	18	14
Other	44	25	20	55

TABLE 27

	LARGE companies			
	n	Yes	No	Don't Know
	%	%	%	%
Assessment of:				
Company objectives	230	86	8	6
Efficiency and effectiveness of management in achievement of company objectives	235	94	1	5
Organisational structure	226	71	13	16
Budgetary control system	239	89	5	6
Management information system	230	77	11	12
Other	43	33	21	46

Over 80% of respondents wish the following assessments reported in a management audit report for both small and large companies:

1. Efficiency and effectiveness of management in achievement of company objectives
2. Budgetary control system
3. Company objectives.

It is interesting that a larger percentage of respondents would like an assessment of the efficiency and effectiveness of management in achieving company objectives rather than an actual assessment of company objectives reported in a management audit report. Table 27 also shows that 60% or more of respondents would also like an assessment both of organisational structure and of the management information system for small and large companies. The other category included three respondents requesting an assessment of the company's forward plans and three suggesting a comparison with competitors. Other areas mentioned by individual respondents included the effects of changing legislation on the company, productivity and the extent of the involvement of non-executive directors. In summary, bankers consider that the management audit report should include assessments of the general management function.

Table 28 also shows strong support for assessment of the performance of <u>some</u> of the individual business functions.

TABLE 28

Areas to be specifically reported upon in a management audit report

	SMALL companies			
	n	Yes	No	Don't Know
	%	%	%	%
Assessment of performance of management of:				
Finance function	283	95	3	2
Purchasing function	260	66	20	14
Production function	270	81	11	8
Marketing function	272	86	8	6
Personnel function	257	40	45	15
Training function	257	34	49	17
Accounting function	273	86	10	4
Computing function	253	36	38	26
Research and Development function	260	56	26	18
Other functions	39	10	31	59

TABLE 28

		LARGE companies		
	n	Yes	No	Don't Know
	%	%	%	%
Assessment of performance of management of:				
Finance function	240	95	2	3
Purchasing function	222	72	14	14
Production function	231	84	7	9
Marketing function	233	87	6	7
Personnel function	225	49	36	15
Training function	225	44	39	17
Accounting function	233	88	7	5
Computing function	219	52	28	20
Research and Development function	230	73	11	16
Other functions	26	19	31	50

Over 80% of respondents would like a management audit report to include an assessment of the performance of the management of the finance, accounting, marketing and production functions for both small and large companies. Only 70% of respondents asked for an assessment of the performance of the management of the purchasing function for both small and large companies. Furthermore, under 50% of respondents wish a management audit report to include an assessment of the performance of the management of the personnel and training functions for all companies and of the computing function for small companies. These answers give an insight into how bankers view the importance of the various management functions within companies.with the finance function at the top of the bankers' list and the training function at the bottom. Under the other category four respondents mentioned assessments of industrial relations and three suggested stock control. Some respondents also commented on the cost (seven respondents) and the practicability (three respondents) of assessing such a large number of corporate functions but, eight respondents did suggest that to be effective a management audit would need to cover all aspects of management. In summary, bankers consider that the management audit report should include assessments of the performance of the management of at least some individual business functions. H_8 is supported by the evidence.

(d) <u>Management audit v financial audit</u>

The final hypothesis was:

> H_9 Bankers consider that the management audit report would be more useful than the financial audit report in relation to their lending decisions about both small and large limited liability companies.

Table 29 shows that this hypothesis is <u>not</u> supported by the evidence which suggests instead that the management audit report would be as useful as (rather than more useful than) the financial audit report in helping bankers to make their lending decisions. This finding is consistent with the above comparison of answers to questions 3/4 and 10/11 about the usefulness of the two audit reports in relation to bankers' lending decisions.

TABLE 29

Management audit report more useful than financial audit report in helping bankers to make lending decisions about

	SMALL companies n = 287 %	LARGE companies n = 252 %
Yes	24	23
Less useful	24	24
Equally useful	48	47
Don't know	4	6
	100	100

The results for both small and large companies could scarcely be more similar. Indeed examining the individual replies, and excluding the don't know and no answers, only 25 respondents gave a different answer for small and large companies. Table 29 shows that approximately 50% of respondents consider the two reports to be equally useful and the remaining 50% are divided evenly in favour of either the financial audit report or the management audit report.

The open-ended comments section for this question attracted a very large number of responses. With this variety of comments, in addition to classifying them below, a selection of actual quotations is given in Appendix G.

(a) Management audit report MORE useful than financial audit report

Thirteen respondents suggested that the management audit report would be more useful than the financial audit report in helping bankers to assess the future prospects of a company. Six respondents emphasised the importance of the assessment of management and four respondents commented that the management audit report would be more useful simply because of the lack of information in the financial audit report.

(b) Management audit report LESS useful than financial audit report

Ten respondents suggested that good or bad management will be reflected in the financial results and therefore the financial audit report is more important than the management audit report. Three respondents commented that with small companies bankers themselves can assess the management.

(c) Management audit report EQUALLY useful as financial audit report

Twenty respondents commented that the management audit and financial audit reports would be complementary.

The final question was open-ended and asked for any additional comments which the respondents wished to make on management auditing. Many respondents took this opportunity to comment and a selection of indivudual quotations is given in Appendix H. Categorising the comments, eleven respondents emphasised the importance of the quality and selection of professionally qualified staff. Six respondents questioned the cost of the management audit report and four mentioned the problems of determining meaningful yardsticks for the management audit. Judging by the number of comments given, respondents were interested in this questionnaire on external management auditing.

Summary and conclusions

This questionnaire survey produced a 63% response rate with 291 usable replies. The typical respondent was an experienced banker who had been employed by a bank for at least 20 years and had used financial information for at least 10 years. Furthermore, no evidence could be found to suggest that the respondents were not reasonably representative of the total sample. Generally, the respondents' answers were not significantly related either to a particular bank or to the type of respondent (head office or branch manager). In contrast the respondents' answers to the same question for small and large companies were significantly related. The distinction made in the questionnaire between small and large companies proved to be relatively unimportant. Similarly, most of the background variables (except for qualifications and industrial banking experience) could be ignored.

The main findings of this questionnaire survey can be summarised as follows. Firstly, bankers claim to read and use the financial audit report. For example, 93% of respondents claim to always read the financial audit report; and approximately 80% replied that they have used the financial audit report as part of the data on which they have based their lending decisions to both small and large limited liability companies; and 80% have also found the audit report useful in helping them to make their lending decisions about companies.

Secondly, bankers try to assess the managements of both small and large companies. For example, 89% of respondents always assess management when making lending decisions about small companies but only 69% do this for large companies. Thirdly, bankers use a range of financial and non-financial information in assessing corporate managements. For instance, over 50% of respondents always use the annual financial statements, practical experience of management, personal knowledge of management and financial audit report when assessing corporate managements. Fourthly, despite such information, bankers consider that they do not always have sufficient information to make an adequate assessment of corporate managements. For example, less than 10% of respondents consider that they always have sufficient information to assess corporate managements.

These four findings about bankers' use of the financial audit report and bankers' assessment of corporate management suggest that bankers might be interested in external management audit reports. The fifth finding of the questionnaire survey confirms this suggestion because bankers consider that the management audit report would be useful in their corporate lending decisions as part of the information on which to assess corporate management. For instance, over 85% of respondents agree that they would find a management audit report useful in their corporate lending decisions. Furthermore, over 95% of respondents would always or sometimes use the management audit report as part of the information on which to assess corporate management.

The results of this survey were unclear on whether or not a management audit should be required by the banks and on how often such an audit should be conducted. However, a sixth finding was that bankers consider that the company should pay for the management audit. Seventhly, bankers consider that the management audit report should include assessments both of the general management and of the individual business functions. For example, over 80% of respondents wish assessments of the following reported in a management audit report:

(1) Efficiency and effectiveness of management in achievement of company objectives;

(2) Budgetary control systems;

(3) Company objectives;

(4) Performance of the management of the finance, accounting, marketing and production functions.

The eighth, and final, finding is that bankers consider that the management and financial audit reports would be <u>equally</u> useful in helping them to make their lending decisions about companies. The results of this questionnaire survey indicate support for both the financial and management audit reports from the responding bankers. The answers indicate that it is certainly <u>not</u> a question of replacing the financial audit with a management audit. However, despite the fact that bankers have experience of using financial audit reports but not management audit reports, as much support exists for the management audit as for the financial audit. The results of this survey provide evidence that one user group, namely bankers, would be interested in external management audit reports on limited liability companies.

Bankers have expressed a demand for such management audit reports. The findings of this questionnaire survey therefore suggested that it would be worthwhile to continue with the second stage of this project which was a simulated lending decision to try to determine whether or not the addition of a management audit report would have a significant effect on bankers' lending decisions. The management audit report in this simulated lending decision would be based at least partly on the findings of this questionnaire survey. The development of this simulated lending decision is described in the following chapter.

CHAPTER 7

DEVELOPMENT OF SIMULATED LENDING DECISION

The results of this questionnaire survey show support from the responding bankers for the proposed external management audit reports. This is strong evidence in favour of the external management audit but it could be suggested that if you asked bankers if they would like additional information about companies, the answer would generally be in the affirmative. For example, in response to the questionnaire survey, several bankers commented that they would like more information on which to base their corporate lending decisions. Therefore, although the results of the questionnaire survey support the idea of external management auditing, would bankers actually use an external management audit report when making their corporate lending decisions? To try to answer this question, a simulated lending decision was developed. The objective of this simulation exercise was to attempt to determine whether or not the addition of an external management audit report would have a significant effect on the corporate overdraft decisions of bankers. Before considering the detailed development of this simulated lending decision, similar research involving the external financial audit report will be examined.

Effects of financial audit reports

In 1973 the American Accounting Association's Committee on Basic Auditing Concepts suggested in relation to the financial audit report:

> 'In most cases today, the intended effect of the auditor's report is not clear and the effects it does produce are not well known. More consideration needs to be given to this area and greater research needs to be performed. Communication is not neutral. It does have an impact and can change behavior.'[1]

Several research studies have tried to examine the effects of different external financial audit reports on various user groups. These research studies can be divided into two broad categories namely share price based analyses and simulation exercises. Share price based studies attempt to investigate the reactions of share prices to different types of audit opinion. For example, Alderman[2] examined the changes in the share prices of 20 American companies with an uncertainty audit qualification (in other words a subject to qualification) between 1968 to 1971 and compared the changes in these 20 shares with the changes in the share prices of 20 other companies which had received clean audit opinions during this period. Alderman concluded:

> 'Uncertainty qualifications had little impact on market-assessed risk.'[3]

In an Australian study Ball, Walker and Whittred[4] selected a final sample of 117 audit qualifications relating to the financial statements of 101 companies during the period 1961 to 1972. Most of these audit qualifications were 'subject to' opinions where the financial statements gave a true and fair view subject to a specific qualification. Ball, Walker and Whittred found:

> 'For the sample as a whole the average difference between the returns on qualified shares and the market is small. The net abnormal return in the effective announcement period is positive and statistically insignificant. However, once the total sample is broken down into somewhat more homogeneous sub-groups different price responses are observable .... Certain types of audit qualifications are associated with changes in shareholders' assessment of the value of securities.'[5]

In a British study Firth[6] had similar findings to those of Ball, Walker and Whittred on 'subject to' audit qualifications. From the 1,500 largest stock exchange companies Firth found that, of their 3,000 financial statements issued in 1974 and 1975, 247 contained an audit qualification. Firth concluded:

> 'The research has found that certain types of qualified audit reports contain significant "information" which investors use in their portfolio decision making. It also emphasizes that investors react differently to the various types of audit qualification.'[7]

However, Bailey[8] has questioned the validity of such share price based studies. For example, in relation to two of studies mentioned above Bailey has argued:

> 'Neither Alderman nor Firth excluded the systematic financial statement differences between the experimental and "control" groups; so any inference about the information content of audit reports is unwarranted.'[9]

Bailey has suggested that information sets with identical financial statements are required and that share price based studies cannot meet this requirement. Furthermore, share price based studies are restricted to one user group namely investors. The second category of research study on the effects of financial audit reports on the decisions of users, namely simulation exercises, can meet this requirement of identical financial statements and can also examine the effects of such reports on various user groups.

When developing this simulated lending decision for bankers using external management audit reports, the results were available from three simulation exercises involving bankers and external financial audit reports namely Estes and Reimer[10], Firth[11] and Libby[12]. After completing my simulation exercise, the results of another study by Houghton[13] became available. Firstly, in 1977 Estes and Reimer[10] attempted to determine whether commercial bank loan and credit officers would be influenced by an 'except for' audit opinion when deciding maximum loan limits for a hypothetical company. Estes and Reimer posted financial statements, footnotes and descriptive information about this hypothetical company to 1,000 bankers with 500 also receiving an unqualified audit report and 500 receiving a qualified audit report. From the group of bankers receiving the unqualified report 120 replies (24% response rate) were received and from the other group 102 replies (20% response rate). Estes and Reimer concluded:

> 'The present study suggests that bank loan officers are not separately affected to a statistically significant degree by an 'except for' opinion on financial statements, when the basis for the exception is otherwise fully disclosed in a footnote.'[14]

Secondly, in 1979 Firth[11] tried to examine what effect, if any, qualified audit reports had on bankers' lending decisions by sending a set of financial statements for a hypothetical company to a sample of British bankers. These financial statements contained a profit and loss account, balance sheet and funds statement for three years. A summary of the notes to the financial statements was also given for the final year. Firth sent these financial statements containing four different types of audit report to 700 bankers. Firth himself admits that these bankers, who were sent four different audit reports, may give biased results. Therefore, Firth divided the 800 remaining bankers in the sample of 1,500 bankers into four groups of 200 each with each group receiving a different - but only one - audit report. The bankers were asked to state the maximum amount of money which they would lend to this company. Firth received 293 replies from the group of 700 bankers (42% response rate) and 351 replies (44% response rate) from the group of 800 bankers. Firth concluded:

'The results showed the bankers attached considerable importance to going concern and asset valuation qualifications and companies suffering these types of audit reports would find their credit ranking considerably impaired. It was also shown that SSAP qualified audit reports, where companies have not followed recommended accounting practice, have little impact on bank lending decisions.'[15]

Thirdly, 36 bank loan officers from four large American commercial banks participated in an experiment conducted by Libby.[12] A senior officer at each bank arranged for their staff to participate with the four banks providing two, ten, ten and fourteen participants respectively. Libby was trying to test the effects of 'subject to' qualifications in the audit report by combining three pieces of information:

1. Two different sets of two-year comparative financial statements.
2. Two management evaluations.
3. Five uncertainty disclosures.

The two management evaluations presented a favourable and an unfavourable report. These evaluations included information on the background and qualifications of the company's management and on the accounting and marketing systems. The uncertainty disclosures were as follows:

1. No disclosure and qualified audit report.
2. Footnote disclosure and unqualified audit report.
3. Footnote disclosure and 'subject to' audit qualification.

The two disclosures containing loss contingencies (legal cases) were then combined with the above second and third uncertainty disclosures to give a total of five uncertainty disclosures.

The two sets of financial statements, the two management evaluations and these five uncertainty disclosures gave a total of 20 loan cases. The bankers were asked whether or not they would grant the loan and, if they would grant the loan, the interest rate premium to be charged on the loan. If they would not grant the loan, the bankers were asked to estimate the interest rate premium which would be required by another bank. Libby used ANOVA (analysis of variance) to analyse the results and found no statistically significant difference between the loan decisions based on qualified and unqualified audit reports provided that the uncertainty was disclosed in a footnote. Libby's conclusion is consistent with the findings of Estes and Reimer.

Fourthly, in 1983 Houghton[13] attempted to examine the impact of an unqualified audit opinion compared to a 'subject to' qualified audit opinion on both the lending decision process and decision outcome of Australian bank staff. The participants in this simulation exercise came from six Western Australian banks with three banks allowing all their lending staff to participate and three banks choosing a sample of their staff to give a total sample of 247 bankers. One-third of the participants (82) received an unqualified audit report, one-third (82 participants) received a qualified audit report and the remaining one-third (83 participants) received no audit report. The bankers were asked to grant the loan or not rather than (as in the Estes and Reimer[10] and Firth[11] studies) to state the maximum loan which they would grant.

Houghton attempted also to examine the bankers' decision process by asking respondents to state the steps involved in arriving at their decision and to give the reasons for their loan decision. However, it is doubtful whether two such questions in a postal survey examine the real decision process of bankers. Initially 156 replies (63% response rate) were received and, after the follow-up procedures, the replies totalled 173 (70% response rate). Houghton concluded:

> 'This study has found that the existence of a qualified audit report does not necessarily have a sufficient impact upon a bank loan decision to alter significantly the decision outcome .... Further, it was found that whilst not necessarily having a significant impact on the decision outcome the presence of an audit report did play a part in the loan decision process of bankers.'[16]

Therefore, of these four studies discussed above, only Firth[11] found that an audit qualification (such as going concern or asset qualifications) made a statistically significant difference to bankers' lending decision outcomes.

Simulated overdraft decision

The Estes and Reimer[10], Firth[11] and Libby[12] studies formed a basis on which to develop a simulated lending decision with external management audit reports instead of external financial audit reports. These three studies used a specific loan decision for a particular project. However, when approaching the three Scottish banks, I raised the possibility of a simulated overdraft decision to finance working capital instead of a simulated term loan decision. The senior bank officials in the three Scottish banks agreed that most of their lending officials at both head office and branch manager level would have more experience of corporate overdraft decisions for working capital purposes than of corporate term loan decisions. The main advantage of the corporate overdraft is that the company pays interest only on the amount of the overdraft used and not on the total overdraft limit; whereas a company pays interest on the full amount of any term loan. A disadvantage of the corporate overdraft is that the bank can recall the overdraft at any time; whereas the term loan is available for a given period of time.

The senior bank officials confirmed that the financial statements, external financial audit report and assessment of the company's management would generally play as important a part (if not a more important part) in the corporate overdraft decision as in the corporate loan decision. Indeed, although in theory the bank can recall the corporate overdraft on demand, in practice almost all such overdrafts are a form of continuing finance. With the potentially long-term nature of many corporate overdrafts, bankers take the initial decision to grant an overdraft facility very seriously. Therefore, a simulated overdraft decision was devised and, for the convenience of the reader, this simulation exercise is included in a pocket on the cover of this thesis so that the following comments can be read together with the final version of this simulation exercise.

Based on the Estes and Reimer[10] and Firth[11] studies, my first proposal was to divide the bankers into two groups. One group would receive the following financial information for an individual company:

(a) Profit and loss account
(b) Balance sheet
(c) Funds statement
(d) Financial audit report

and would be asked to state the maximum overdraft facilities which they would grant to this particular company. The second group of bankers would receive exactly the same information together with an external management audit report and would be asked the same question. It could then be determined whether or not a statistically significant difference existed between the answers of the two groups.

However, from discussions with various bankers in the Bank of Scotland, the Clydesdale Bank and the Royal Bank of Scotland, it became apparent that this proposal would be unrealistic for the bankers for two main reasons. Firstly, and most importantly, bankers are not accustomed to stating the maximum overdraft facility which they would grant. This is too open-ended. Bankers expect their customer to request a specific overdraft limit. By definition a simulated lending decision can never be totally realistic but it was considered important to make this exercise as realistic as possible. Therefore, instead of being an open-ended decision on the overdraft limit, a specific limit was requested by the company and the decision to grant this overdraft facility would be yes, no or don't know. It is interesting that the recent Australian study by Houghton[13] also asked bankers whether or not they would grant the loan rather than the maximum loan which they would grant. Nevertheless this change, from an open-ended decision on the corporate overdraft limit to either granting the overdraft or not, made it more difficult to distinguish differences between the two groups of bankers. The possibility of using several different companies was considered but rejected because, give the second point below, this simulation exercise would have become too lengthy.

Secondly, again to make this simulated overdraft decision more realistic, the bankers suggested that they would require answers to the following questions:

(a) Is this a new or an existing customer?

(b) What are the backgrounds of the directors of the company?

(c) Will any security be offered for this overdraft?

(d) What is the cash flow forecast for the next year?

Answers to these questions were therefore incorporated into this simulated overdraft decision. Points (a), (b) and (c) above were covered in at least one of the four studies discussed above by Estes and Reimer[10], Firth[11], Libby[12] and Houghton[13]. However, none of these four studies included a cash flow forecast. Nevertheless, the senior management officials in the three Scottish banks had no doubt that bankers would always request a cash flow forecast for a minimum period of one year when making such an overdraft decision. Therefore, this simulation exercise included a cash flow forecast for the following year.

With the decision alternatives for the bankers of yes, no or don't know, it was decided to use as an example a company to which bankers would generally grant overdraft facilities although they would consider this company to be reasonably close to the borderline of being refused overdraft facilities. With such a company it would be possible to isolate the effects of the management audit report. The senior management officials in the three banks gave me assistance in designing a simulation exercise with such a company. For example, my first proposal was considered to be too strong a company. Taking account of the comments from these senior bankers and from colleagues at the University of Edinburgh and elsewhere several changes were made to this simulation exercise. After these changes the bankers involved in the development of this simulated lending decision agreed that the data given for AB Limited would make it a good (but not too good) proposition if it was requesting overdraft facilities of £350,000 for working capital purposes.

(a) <u>Objective</u>

Given the revised yes, no or don't know alternatives for the bankers' decisions, it was decided that, instead of having only the following:

1. Information with the financial audit report only;
2. Information with the financial audit report and a management audit report

it might help to detect any differences caused by the addition of a management audit report by having both a 'favourable' management audit report (ie. favourable comments on the management of the company) and an 'adverse' management audit report (ie. adverse comments on the management of the company). As discussed above, each package of information included the same profit and loss account, balance sheet, funds statement, cash flow forecast and financial audit report. This would be the first package of information. The second package of information would also include (in addition to the financial audit report) a favourable management audit report. The third package of information would include (in addition to the financial audit report) an adverse management audit report. For ease of description, the three packages of information sent to the bankers will be described from this point as:

1. Financial audit report only
2. Favourable management audit report
3. Adverse management audit report.

The group of bankers receiving the favourable management audit report could be used to monitor the effect of an additional piece of information (namely a favourable management audit report) on the bankers' overdraft decisions. For this group, if a similar percentage of bankers granted overdraft facilities compared to the group receiving the information with only the financial audit report, it could be argued that the addition of a management audit report <u>by itself</u> did not change the bankers' decisions. However, if a smaller percentage of the group receiving the adverse management audit report granted overdraft facilities compared to the other two groups, then it could be concluded that the adverse management audit report had changed some bankers' decisions. The objective of this exercise, therefore, was to attempt to determine whether or not the addition of an adverse management audit report would have a significant effect on bankers' lending decisions. The null hypotheses to be tested are discussed and the results are analysed in Chapter 8.

It should be emphasised that this simulation exercise is very much a first tentative step in testing the effects of external management audit reports on bankers' lending decisions. For example, different versions of the adverse management audit report could be tested. Furthermore, the reverse could also be tested to determine whether or not a favourable management audit report might change bankers' lending decisions in the case of a company where bankers would generally not grant overdraft facilities. This was the background to the development of this simulated overdraft decision and the final version, which is included in a pocket on the cover of this thesis, will now be considered in more detail.

(b) Sample

A random sample was not taken for this simulated lending decision. With this being the second stage of the project the population of bank managers was divided into those who had received the first stage questionnaire and those who had not (see Table 30).

TABLE 30

Branch managers for simulated lending decision

	Total number of branch managers	Branch managers: Received first stage questionnaire	Branch managers: Did not receive first stage questionnaire
Bank of Scotland	377	150	227
Clydesdale Bank	309	100	209
Royal Bank of Scotland	453	150	303
	1,139	400	739

The six branch managers in the pilot survey for the first stage questionnaire have been excluded from the population of branch managers in Table 30 for the purpose of this sample. The reason for dividing the population of branch managers into those who received the first stage questionnaire and those who did not was in case the branch managers who had received the first stage questionnaire on external management auditing might be biased in their replies to this second stage simulated lending decision. For example, it could be suggested that those branch managers who did receive this first stage questionnaire on external management auditing might place more importance on the management audit report in this simulation exercise than those branch managers who did not receive the first stage questionnaire.

This distinction between branch managers, of having received the first stage questionnaire or not, divided the total population of 1,139 branch managers into 400 (who had received the first stage questionnaire) and 739 branch managers (who had not received the first stage questionnaire). It would have been possible to take two random samples from these two groups of branch managers but this was not done because the first stage questionnaire had shown that a few branch managers (approximately 3% of respondents) had no corporate customers and others (approximately 40% of respondents) had no large limited liability companies as customers. One objective of this simulated lending decision was to make this exercise as realistic as possible and it was considered important that the branch managers selected should have experience of this type of lending decision. Therefore, instead of taking two random samples from these two groups of 400 and 739 branch managers, a senior management official in each of the three banks selected an equal number of branch managers (from their two groups of branch managers who did receive the first stage questionnaire and those who did not) who would have experience of this type of lending decision. The sample selected, therefore, was very much a judgment sample - using the judgment of senior management officials of the three banks - and not a random sample.

In addition to the branch managers being divided into two groups of those who received the first stage questionnaire and those who did not, the total number of branch managers selected from each bank could be divided by three because the branch managers would be divided into three groups for the three different types of information (financial audit report only, favourable and adverse management audit reports). The Clydesdale Bank suggested that the total number of branch managers with the appropriate lending experience out of the 100 branch managers receiving the first stage questionnaire would be only 24. This seemed a low number but after discussion with a senior Clydesdale Bank official, the number of Clydesdale Bank branch managers selected with the appropriate lending experience totalled 48 (being 24 branch managers from those who received the first stage questionnaire and 24 branch managers from those who did not receive this first stage questionnaire). These two groups of 24 branch managers would be each divided into three to receive the three different types of information so that in total we have six groups of eight Clydesdale Bank branch managers.

As with the first stage questionnaire, it was decided to sample the same number of branch managers from both the Bank of Scotland and the Royal Bank of Scotland. A senior management official in the Bank of Scotland considered that 60 branch managers from the 150 branch managers who received the first stage questionnaire would have the appropriate lending experience. Therefore, in total 120 Bank of Scotland branch managers were selected with 60 also being chosen by that senior Bank of Scotland official form those 227 branch managers who did not receive the first stage questionnaire. Similarly, a senior management official in the Royal Bank of Scotland selected 60 branch managers from the group of 150 who did receive the first stage questionnaire and 60 from the 303 branch managers who did not receive the first stage questionnaire. The branches selected for this second stage simulated overdraft decision are given in Appendix I.

As with the first stage questionnaire, all the head office lending officials from the three banks were included in this second stage simulated lending decision because, generally, these head office officials had the greatest experience in making this type of corporate overdraft decision. By chance, the number of head office lending officials for each of the three banks could be divided by three so that an equal number of head office lending officials could receive the three different types of information (financial audit report only, favourable and adverse management audit reports). However, as with the branch managers who had received the first stage questionnaire, it was possible that these head office officials might be biased in their replies to this second stage simulation exercise. This possibility will be examined when the results are analysed in Chapter 8.

Table 31 summarises the number of bankers selected for this second stage simulated overdraft decision.

TABLE 31

Number of bankers surveyed

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
Head office staff	21	15	30	66
Branch managers	120	48	120	288
Total number surveyed	141	63	150	354

In summary, all the above 66 head office staff surveyed would have received both the first stage questionnaire and the second stage simulated overdraft decision; and 144 branch managers (60 from the Bank of Scotland, 24 from the

Clydesdale Bank and 60 from the Royal Bank of Scotland) would be in a similar position. The remaining 144 branch managers would not have received the first stage questionnaire but would receive only the second stage simulated overdraft decision.

(c) Covering letter

With some bankers in this simulated lending decision having received the first stage questionnaire and others not, it was necessary to have two different covering letters (see the simulated overdraft decision in the pocket on the cover of this thesis). However, the core of these two letters was the same namely:

> I have therefore devised a simulated overdraft decision which I should like you to make. This should not involve a great deal of your time and, in order to make this decision, the following are attached to this letter:
>
> 1. A page of assumptions;
> 2. A cash flow forecast for 1983 prepared by AB Limited;
> 3. A profit and loss account, balance sheet and source and application of funds for AB Limited for 1982;
> 4. Audit reports.
>
> I APPRECIATE THAT THIS INFORMATION IS LIMITED BUT PLEASE DO NOT MAKE ANY ASSUMPTIONS OTHER THAN THOSE GIVEN AND PLEASE READ THE ATTACHED SET OF FINANCIAL STATEMENTS AND THE AUDIT REPORTS BEFORE ENTERING ON THE FOLLOWING PAGE WHETHER OR NOT YOU WOULD GRANT AN OVERDRAFT TO THIS COMPANY.

Point 4 above refers to those bankers who received both financial and management audit reports. One third of the bankers only received a financial audit report and point 4 was amended accordingly for this group.

For those branch managers who had not received the first stage questionnaire, each of the three banks agreed to include a covering letter with this simulated lending decision similar to that included with the first stage questionnaire. Again the main reason for this letter from head office was to inform those who received the simulated lending decision that their head office had approved the distribution of this exercise. As discussed in Chapter 5, the advantage of such a covering letter is that it may encourage recipients of this simulation exercise to return it but the disadvantage is the potential bias if recipients perceive this simulation exercise as a directive from head office. As with the covering letter for the first stage questionnaire, therefore, the covering letter for the second stage simulated overdraft decision included two main points:

(1) The bank had given me permission to send out this simulated lending decision to their staff.

(2) The individual bankers were under no obligation to complete this exercise.

An example of the covering letter from the Royal Bank of Scotland is given in Appendix J.

(d) Decision sheet

The decision sheet was kept as simple as possible with the question:

	YES	NO	DON'T KNOW
WOULD YOU GRANT AN OVERDRAFT OF £350,000 TO AB LIMITED?	☐	☐	☐

PLEASE GIVE REASONS FOR YOUR DECISION:

This left respondents with three-quarters of a page for any reasons which they wished to give.

With only two pages (this decision sheet and a personal details sheet) being returned, it was necessary to mark this decision sheet in various ways to ensure that the returned sheets could be identified. With the number of permutations possible, this decision sheet was marked in two ways. Firstly, the following were written on the decision sheet:

H.O. = Head office staff

R = Royal Bank of Scotland

1 = Received data with only a financial audit report

2 = Received data with both a financial audit report and a 'favourable' management audit report

3 = Received data with both a financial audit report and an 'advers' management audit report.

Furthermore, the Bank of Scotland decision sheets were in a large typeface to distinguish these from the Clydesdale decision sheets which were in a small typeface. Therefore, for instance, H.O.R3 would indicate a respondent from the head office of the Royal Bank of Scotland who had received data with both a financial audit report and an 'adverse' management audit report.

Secondly, it was necessary to distinguish from the returned decision sheets whether or not such respondents had received the first stage questionnaire. Therefore, on the decision sheet the following distinction was made:

PLEASE GIVE REASONS FOR YOUR DECISION:

indicated that this individual had received the first stage questionnaire; whereas

PLEASE GIVE REASONS FOR YOUR DECISION:

(ie. no underlining) meant that this respondent had not received the first stage questionnaire.

(e) Background variables

At the foot of the decision sheet respondents were asked to complete also the following page of background details before returning the two pages to me in the enclosed stamped addressed envelope. The personal details requested were exactly the same as those for the first stage questionnaire namely:

Age

Sex

Number of years employed by a bank

Number of years using financial information

Qualifications

Types of banking experience

Small and large limited liability companies as customers.

To use this last background factor of customers would have required the inclusion of a definition of small and large limited liability companies. This had been important for the first stage questionnaire with the random sample but was less appropriate for this second stage with the judgment sample. Furthermore, to include a definition of small and large limited liability companies would have been a distraction from the lending decision. Therefore, no such definitions were included.

This question on small and large limited companies as customers was included so that those who had received the first stage questionnaire would be asked for exactly the same personal details again. However, as a background factor it was of little relevance for this simulated lending decision because all the respondents had already been selected as having experience of this type of lending decision. Similarly, on the basis of the results of the first stage questionnaire, the background variable of sex could have been omitted but was in fact included because it was decided to retain exactly the same background variables for this second stage simulation exercise as for the first stage questionnaire so that recipients of the first stage questionnaire would be asked for exactly the same background variables again.

(f) Assumptions

The first page of the actual lending decision was a page of assumptions. The first four assumptions were to ensure that all the respondents were making their decision on the same basis:

(a) Your bank has money to lend;

(b) Your bank's current base rate is 8% p.a;

(c) You have no upper lending limit;

(d) You are taking this decision on 26 January 1983.

Regarding (d), the cash flow forecast was for 1983 and the financial statements were for the year ended 31 December 1982.

Five further assumptions related specifically to AB Limited and provided information which the bankers in the pilot study had requested. My discussions with senior management officials in the three banks confirmed that the inclusion of the following five assumptions would make this simulated overdraft decision more realistic:

(1) This is an existing customer requesting overdraft facilities for the first time. AB Limited is requesting overdraft facilities for £350,000 for working capital purposes because of the planned growth in its business.

(2) The three directors, who are in their late 40s, have been managing AB Limited for 15 years and hold 90% of the ordinary shares of AB Limited. Their backgrounds are respectively sales, production and finance.

(3) The directors are not prepared to charge any personal assets, but they are willing to grant security for the bank overdraft over the heritable land and buildings of AB Limited. It is estimated that the heritable land and buildings could be sold for approximately £400,000 at 31 December 1982.

(4) AB Limited is a private company which specialises in the manufacture of top quality knitwear.

(5) Any overdraft granted to AB Limited will be at a cost of 2% over your bank's base rate.

The criterion used to select these assumptions was to make this simulated lending decision as realistic as possible.

(g) Financial information

It was difficult to decide on the best size of company for this exercise but, after discussions with senior management officials in the three banks, a reasonable proposal seemed to be a private company with a turnover of about

£5 million. As discussed above, a cash flow forecast was included in the financial information given for AB Limited. The 1983 cash flow forecast began from the closing bank figure in the balance sheet at 31 December 1982 and the rest of the forecast was based on the 1982 figures adjusted for the projected growth in AB Limited. According to this cash flow forecast AB Limited would require a bank overdraft from April 1983 with a maximum projected overdraft of £304,000 in July falling to £54,000 by December 1983.

The profit and loss account and balance sheet of AB Limited were originally based on a particular company but changes were made in finalising the financial statements used in the simulation exercise included in the pocket on the cover of this thesis. The turnover of AB Limited increased by approximately 18% between 1981 and 1982 and this increase in turnover was chosen deliberately for this simulation exercise because AB Limited was an expanding company and was planning for further growth in 1983. In both 1981 and 1982 the gross profit percentage of AB Limited remained the same at approximately 37% and similarly in both 1981 and 1982 the net profit before tax was approximately 27% of net assets employed. Again both these ratios were chosen deliberately to show that, although AB Limited was increasing its sales, it was maintaining its profitability. The tax charge changed marginally from £129,000 in 1981 to £121,000 in 1982 and the total dividends remained the same in both years at £168,000. After tax and dividends, the annual retained profit was only £4,000 in 1981 and £32,000 in 1982.

The current ratio of AB Limited was slightly under 1.5:1 for both 1981 and 1982 and the quick ratio was 0.8:1 for both years. Two important features of the current assets for this simulation exercise were, firstly, that debtors had increased from £806,000 at 31st December 1981 to £929,000 at 31st December 1982 (mainly because of the increase in sales rather than because of poor credit control) and, secondly, the cash and bank total had fallen from £124,000 at 31st December 1981 to £34,000 at 31st December 1982. These two points about the increase in debtors and the decrease in the bank were important for this simulated lending decision because the overdraft was required by AB Limited during 1983 to finance an increase in the working capital because of the planned growth in the business of AB Limited.

The funds statements for 1981 and 1982 emphasised this increase in working capital in both years and the reduction in cash and bank (£127,000 in 1981 and £90,000 during 1982). Furthermore, AB Limited has been undertaking a capital investment programme without any borrowing and has spent £151,000 on capital expenditure in 1981, £111,000 in 1982 and has projected capital expenditure of £100,000 in 1983. The final details of the financial information for AB Limited benefited from the comments of academic colleagues both at the University of Edinburgh and elsewhere, senior management officials in the three banks and bankers in the pilot study.

(h) Audit reports

The financial audit report was of the standard form recommended in the British Auditing Standards and Guidelines[17]. This audit report was signed by XY, Chartered Accountants, on 24 January 1983. This date was chosen because the bankers were taking their decision on 26 January 1983 and they required the financial audit report for the purposes of this simulated overdraft decision. Twenty-four days after the year-end is a short, but not unreasonably short, period in which to complete the audit work for 1982.

The drafting of the favourable and adverse management audit reports proved to be more difficult than the drafting of the financial audit report. In drafting the management audit reports, the two criteria of conciseness and realism were chosen for the following reasons. Firstly, the management audit reports were to be kept reasonably short. The bankers might pay attention to the management audit reports simply because they had not seen such reports before, but it would have defeated the purpose of this exercise if the management audit reports had been so long that they appeared to be out of place in relation to the rest of the material. No other single item in this simulation exercise exceeded one page and, therefore, the management audit reports were restricted to one page. Secondly, the management audit reports were to be as realistic as possible. The management audit reports included only examples in which I had been involved personally. This obviously restricted the choice of items to be included in the management audit reports but this restriction meant that these reports could be regarded as being relatively realistic. The examples were drawn from my two years' experience as an internal operational auditor although, to preserve confidentiality, the examples selected had in fact been included in different audit reports and the figures included in the management audit reports were scaled appropriately to the size of AB Limited.

The management audit report was headed:

AB Limited
MANAGEMENT AUDITORS' REPORT
for the year ended 31 December 1982

and was signed by MN, management auditors, to show that they were different from the financial auditors, XY. However, both the management and financial audit reports were dated 24 January 1983.

The favourable management audit report began:

> 'The following summarised report indicates that a generally satisfactory situation existed within AB Limited.'

In contrast the adverse management audit report began:

> 'A number of areas were found where potential cost savings and improvements in operational and financial controls could be implemented as summarised below.'

In both reports, following the findings of the first stage questionnaire, comments were included on the corporate objectives, organisational structure, management information system and on the performance of the finance, purchasing, production and selling functions. By its very nature the adverse management audit report was longer than the favourable management audit report but both reports were restricted to one page. Both the favourable and adverse management audit reports together with the rest of this simulated overdraft decision are included in the pocket on the cover of this thesis. The results of this simulation exercise are discussed in the following chapter.

CHAPTER 8

RESULTS OF SIMULATED OVERDRAFT DECISION

Response rates

The simulated overdraft decision was posted during 1983 to the 354 participants in the survey with 118 participants receiving each of the three different types of information namely the financial audit report only, the favourable management audit report and the adverse management audit report. As discussed in Chapter 6 on the first stage questionnaire survey, in my initial approach to the three banks it had been agreed that no follow-up letters would be sent. Again, therefore, no follow-up letters were sent for this second stage simulation exercise. The number of responses and the response rates for each bank for this simulated overdraft decision are given in Table 32.

TABLE 32

	Number of respondents and response rates			
	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
Number of head office respondents	11	7	12	30
Number of branch manager respondents	72*	35	69	176*
Total number of respondents	83*	42	81	206*
% response from head office staff	52%	47%	40%	45%
% response from branch managers	60%	73%	58%	61%
% total response	59%	67%	54%	58%

*1 decision sheet was blank with a covering letter

Although it is slightly lower than the response rate of 63% for the first stage questionnaire survey, the overall response rate of 58% (205 respondents from 354 surveyed) for this second stage simulated overdraft decision is reasonable relative to the response rates of the surveys discussed in Chapter 7 (which involved a decision by respondents) such as Estes and Reimer[1] with a 22% response rate, Firth[2] with a 43% response rate and Houghton[3] with a 63% response rate before follow-up and 70% after follow-up. The overall response rate for each of the three banks in Table 32 varied from 54% for the Royal Bank of Scotland to 67% for the Clydesdale Bank. As with the first stage questionnaire, the percentage response from head office staff was lower than that from branch managers for all three banks, although when examining the percentage in Table 32 the relatively small absolute number of head office staff must be remembered.

Of the 210 bankers surveyed who had received the first stage questionnaire, 110 replied to this simulated overdraft decision giving a response rate of 52%; whereas of the 144 bankers surveyed who did not receive the first stage questionnaire, 95 replied to this simulated overdraft decision giving a response rate of 66%. Confining this comparison to branch managers only, the response rate from those who had received the first stage questionnaire was 56% against the above 66% response rate. Therefore, as expected, the overall response rate of 58% for this simulated overdraft decision appears to have been affected by the fact that it was the second stage in this research project.

However, 125 respondents (61% of all respondents) demonstrated an interest in this second stage simulated overdraft decision by requesting a copy of the results (see Appendix K for a copy of the results of this simulation exercise sent to such respondents). This compared with 103 respondents (35% of all respondents) requesting a copy of the results for the first stage questionnaire. Therefore, if the number of requests for a copy of the results can be used as a measure of interest, greater interest was shown by respondents in this simulated overdraft decision than in the questionnaire survey. Furthermore, every respondent in this lending decision exercise gave some reasons for their decision. Indeed, many respondents gave very detailed reasons (including some calculations) for their final decision.

In Table 32, of the 205 usable replies, 30 (15%) were from head office staff and 175 (85%) from branch managers. Table 33 shows how these 205 respondents from the 354 bankers surveyed were divided between the various groups receiving the three different types of information. For each bank the same number of branch managers received the three different types of information - for example, of the 120 Bank of Scotland branch managers surveyed:

40 received the financial audit report only
40 received the favourable management audit report
40 received the adverse management audit report.

Similarly, for each bank the same number of head office staff received the three different types of information - for example of the 21 Bank of Scotland head office staff surveyed:

7 received the financial audit report only
7 received the favourable management audit report
7 received the adverse management audit report.

This emphasises the relatively small sample sizes involved and in Table 33, therefore, the number of respondents (not percentages) by bank and by type of information are given.

TABLE 33

Number of respondents by type of information

	Total number surveyed	Number of respondents: Total	Branch returns	H.O. returns
Bank of Scotland[1]				
1. Financial audit report only	47	25	22	3
2. Favourable management audit report	47	27	23	4
3. Adverse management audit report	47	30	26	4
	141	82	71	11
Clydesdale Bank[2]				
1. Financial audit report only	21	15	13	2
2. Favourable management audit report	21	14	10	4
3. Adverse management audit report	21	13	12	1
	63	42	35	7
Royal Bank of Scotland[3]				
1. Financial audit report only	50	23	19	4
2. Favourable management audit report	50	31	26	5
3. Adverse management audit report	50	27	24	3
	150	81	69	12
All 3 Banks[4]				
1. Financial audit report only	118	63	54	9
2. Favourable management audit report	118	72	59	13
3. Adverse management audit report	118	70	62	8
	354	205	175	30

Notes:

(1) 40 branch managers and 7 head office staff surveyed for each type of information.

(2) 16 branch managers and 5 head office staff surveyed.

(3) 40 branch managers and 10 head office staff surveyed.

(4) 96 branch managers and 22 head office staff surveyed.

The overall response rates for the three types of information are similar with 53% (63 respondents from 118 surveyed) for the financial audit report only, 61% (72 respondents from 118 surveyed) for the favourable management audit report and 59% (70 respondents from 118 surveyed) for the adverse management audit report. If the individual banks are considered the differences are greater with the lowest percentage response rate being 46% (23 respondents out of 50 surveyed) for the Royal Bank of Scotland for the financial audit report only and the highest percentage response rate being 71% (15 respondents out of 21 surveyed) for the Clydesdale Bank for the financial audit report only. Again the relatively small absolute numbers involved must be remembered when considering these percentages. Table 33 was given in absolute numbers and not in percentages to show that, for each of the three banks, the number of respondents can be regarded as being reasonly similar for the three types of information with:

25, 27 and 30 respondents for the Bank of Scotland;
15, 14 and 13 respondents for the Clydesdale Bank;
and 23, 31 and 27 respondents for the Royal Bank of Scotland.

As the decision sheets were received, the date of receipt was noted on them. Later these dates were grouped into weeks to indicate the week of receipt. 47% of the replies were received in week 1, 25% in week 2, 13% in week 3, 8% in week 4 and only 7% in week 5 or later. The decision sheets were grouped by bank and by the type of information received to give nine groups and, within each of these groups, the decision sheets were arranged by date of receipt and on this basis the questionnaire were numbered as shown in Table 34.

TABLE 34

Numbering of decision sheets

Number	Bank	Type of information
001 - 025	Bank	- financial audit report only
026 - 052	of	- favourable management audit report
053 - 082	Scotland	- adverse management audit report
083 - 097		- financial audit report only
098 - 111	Clydesdale	- favourable management audit report
112 - 124	Bank	- adverse management audit report
125 - 147	Royal Bank	- financial audit report only
148 - 178	of	- favourable management audit report
179 - 205	Scotland	- adverse management audit report

The decision sheets were then key-punched and checked. A manual check was also made between the decision sheets and the computer print-out to ensure that the final computer file was as accurate as possible for the statistical analysis to be carred out on it. As with the first stage questionnaire, S.P.S.S. was used to analyse the data. The following analysis excludes missing answers (in other words the answers given total 100%) and shows the number of respondents for each question. Therefore, with 205 respondents having returned usable decision sheets, the number of 'missing answers' can be calculated from any of the following tables.

Background variables

As discussed above, one reason for asking respondents for background details was to determine the characteristics of a 'typical' respondent. The following sections summarise the results for each of the background variables in this second stage simulation exercise.

1. Age

As can be seen from Table 35, 45% of respondents were in the 40 to 49 age range with 63% under 50 and 37% 50 and older.

TABLE 35

Age of respondents

	n* = 205 %
Under 30	1
30 - 39	17
40 - 49	45
50 - 59	37
	100

*In all the Tables n indicates the number of respondents answering that particular question out of a possible maximum of 205 respondents.

2. Sex

Of the 202 respondents answering this question all were male.

3. Number of years employed by a bank

Table 36 shows that 87% of respondents had been employed by a bank for at least 20 years with 44% being employed by a bank for under 30 years and 56% for 30 years and more.

TABLE 36

	Number of years employed by a bank
	n = 204 %
Under 5	-
5 - 9	1
10 - 19	12
20 - 29	31
30 and over	56
	100

4. Number of years using financial information

Although 87% of respondents had been employed by a bank for at least 20 years, Table 37 shows that only 30% of respondents had been using financial information for at least 20 years. However, 80% of respondents had been using financial information for at least 10 years.

TABLE 37

	Number of years using financial information
	n = 205 %
Under 5	4
5 - 9	16
10 - 19	50
20 - 29	24
30 and over	6
	100

5. Qualifications

This question was not answered by 42 respondents which could mean, of course, that they had no paper qualifications. However, of those answering, 92% gave their only qualification as being an Associate of the Institute of Bankers.

TABLE 38

	Qualifications n = 163 %
A.I.B.	92
A.I.B. + other qualification	5
Fellow of the Institute of Bankers	3
	100

6. Banking experience

Table 39 gives the number of respondents answering this question who had the various types of banking experience.

TABLE 39

	Respondents with banking experience n
Personal	202
Commercial	200
Industrial	159
Agricultural	154
Fishing	56

7 and 8. Customers

All respondents had limited liability companies as customers. As mentioned previously, the distinction between small and large companies was not made specifically in this second stage simulated overdraft decision.

Summary of background variables

In summary, a 'typical' respondent to this simulated lending decision was over 40 years old, male, employed by a bank for at least 20 years, a user of financial information for at least 10 years, an Associate of the Institute of Bankers and experienced in the commercial and industrial banking fields with limited liability companies as customers. This 'typical' respondent is the same as that for the first stage questionnaire. However, comparing in detail the background variable of the respondents to both stages of this research, certain very minor differences can be seen. For example, 33% of questionnaire respondents against 37% of overdraft decision respondents were at least 50 years old. Similarly, only 49% of questionnaire respondents but 56% of overdraft decision respondents had been employed by a bank for at least 30 years; and 72% of questionnaire respondents against 80% of overdraft decision respondents had been using financial information for at least 10 years. These three minor differences reflect the fact that on average the overdraft decision respondents were slightly older and more experienced than the questionnaire respondents. This was to be expected with the judgment sampling for this second stage simulated overdraft decision based on the criterion of having experience of this type of decision compared with the random sampling of the branch managers for the first stage questionnaire.

Non-response bias

The similarity of the background variables for both the questionnaire and the overdraft decision respondents confirms the previous comments that the characteristics of the 'typical' respondent were to be expected given the population of head office staff and branch managers in the three banks. As with the first stage questionnaire, a second test for non-response bias was conducted by comparing the early and late respondents to this simulation exercise on the assumption that late respondents are similar to non-respondents. The 97 respondents whose decision sheets were received in the first week were compared with the 57 respondents whose decision sheets were received in the third week and later. The results are given in Table 40.

TABLE 40

Comparison of early and late respondents

	Respondents in first week		Respondents in third week and later	
	n = 97	%	n = 57	%
Information received				
Financial audit report only		35		25
Favourable management audit report		36		40
Adverse management audit report		29		35
		100		100

	Respondents in first week		Respondents in third week and later	
	n = 97	%	n = 57	%
Bank				
Bank of Scotland		40		32
Clydesdale Bank		16		26
Royal Bank of Scotland		44		42
		100		100
Category of respondents				
Head office		16		19
Branch		84		81
		100		100
Received first stage				
Yes		50		67
No		50		33
		100		100
Anwer to overdraft decision				
Yes		71		60
No		22		30
Don't know		7		10
		100		100

Background variables

	Respondents in first week	Respondents in third week and later
Age		
Under 30	1	2
30 - 39	17	17
40 - 49	46	42
50 - 59	36	37
60 and over	-	2
	100	100

	Respondents in first week		Respondents in third week and later	
	n = 97	%	n = 57	%
Sex				
Male		99		96
No answer		1		4
		100		100
Number of years employed by a bank				
Under 5		-		-
5 - 9		1		2
10 - 19		12		14
20 - 29		27		33
30 and over		60		49
No answer		-		2
		100		100
Number of years using financial information				
Under 5		3		3
5 - 9		14		18
10 - 19		51		47
20 - 29		26		23
30 and over		6		9
		100		100
Qualifications				
A.I.B.		74		72
A.I.B. + other qualification		4		5
F.I.B.		3		4
None given		19		19
		100		100

	Respondents in first week		Respondents in third week and later	
	n = 97	%	n = 57	%
Banking experience				
Personal		100		98
Commercial		99		95
Industrial		83		81
Agricultural		78		68
Fishing		27		35
Other		12		14
Limited liability companies as customers				
Yes		100		100
No		-		-
		100		100

Table 40 illustrates that the early (first week) and late (third week and later) respondents have very similar backgrounds in terms of age, sex, number of years employed by a bank, number of years using financial information, qualifications and limited liability companies as customers. The implication is that non-respondents would have similar backgrounds to respondents. The evidence implies that the respondents are reasonably representative of this total judgment sample in terms of background variables.

However, some differences are apparent in the non-background variables of the early and late respondents. Of the early respondents 35% received the financial audit report only as compared with 25% of the late respondents. In other words, respondents who received the financial audit report only were more likely to be early respondents; whereas, respondents who received one of the two management audit reports were more likely to be late respondents. Given the fact that bankers would not have seen such management audit reports before, this difference is not unexpected.

A second difference between early and late respondents was that only 16% of the early respondents were from the Clydesdale Bank against 26% of the late respondents; and in contrast 40% of the early respondents were from the Bank of Scotland against 32% of the late respondents. A third difference was that only 50% of the early respondents had received the first stage questionnaire against 67% of the late respondents. In other words respondents who had received the first stage questionnaire tended to be late respondents to this simulated overdraft decision compared to those who had not received this first stage questionnaire. This difference was expected in that those who received the first stage questionnaire would not have expected this second stage simulation exercise and their first reaction might have been not to make this simulated overdraft decision but, after reconsidering, they might have become late respondents. The final difference was that 71% of early respondents replied yes to this overdraft decision against 60% of late respondents. However, this is meaningless without considering the type of information received.

In addition to comparing the early and late respondents on the basis of background variables, therefore, an attempt was made to examine any differences in their overdraft decisions. The three null hypotheses to be tested relate to the three types of information and for conciseness they will be described as H_o10a, H_o10b and H_o10c:

H_o10 Bankers' overdraft decisions

(a) on the basis of the financial audit report only

(b) on the basis of the favourable management audit report

(c) on the basis of the adverse management audit report

are not significantly related to early or late respondents.

In the above hypothesis (and in later hypotheses) 'decisions' refer to the decision outcomes in other words to the yes, no and don't know answers of bankers, rather than to the actual decision process to reach the final decision outcome.

Using S.P.S.S. the cross-tabulations were calculated for the overdraft decisions by week (first week and third weeks and later) by information (the three different types of audit report) with the no and don't know answers being combined for two reasons. Firstly, the main reason is that the decision is to grant the overdraft (yes answers) or not (no and don't know answers). Secondly, we have the relatively small numbers involved. The rules of thumb for the chi-square test recommended by Yeomans[4], and used also in the analysis of the results of the first stage questionnaire, are that:

(1) The expected frequency for any cell should not be below one;

(2) No more than 20% of all cells should have an expected frequency below five.

The results are shown in Table 41.

TABLE 41

Cross-tabulations of overdraft decisions* by early and late respondents controlling for information

	n	χ^2	df	p
Financial audit report only	48	0.08	1	0.77
Favourable management audit report	58	0.00	1	1.00
Adverse management audit report	48	1.66	1	0.20

*No and don't know decision are combined

(Note: n = number of respondents for that particular cross-tabulation

χ^2 = chi-square or corrected chi-square where necessary

df = degrees of freedom
p = significance)

As in the analysis of the results of the questionnaire survey in Chapter 6, the guidelines of Schuman and Presser[5] will be used in the analysis of this simulation exercise with a probability of less than .10 being regarded as 'borderline' in terms of statistical significance and a probability of less than .05 being regarded as 'significant'. Table 41 shoes that none of the chi-squares were significant at the 5% level. We have no reasons therefore to reject H_o10a, H_o10b and H_o10c at the 5% level of significance. In this simulation exercise, bankers' overdraft decisions do not appear to be significantly related to early or late respondents.

Detailed results of simulated overdraft decision

In the first stage questionnaire survey, bankers answered that they would use management audit reports on limited liability companies. Would the addition of the management audit reports make any significant difference to their overdraft decisions in this simulation exercise? Before analysing the overall results to try to answer this question, various subsets of the respondents will be considered to attempt to identify any significant differences. The results from this simulation exercise will be analysed by:

(a) Bank to determine whether or not the bankers' overdraft decisions are significantly related to a particular bank;

(b) By head office staff and branch managers to determine whether or not the bankers' overdraft decisions are significantly related to head office or branch manager respondents;

(c) Recipients and non-recipients of the first stage questionnaire to determine whether or not the bankers' overdraft decisions are significantly related to recipients or non-recipients of the first stage questionnaire;

(d) Various background variables to determine whether or not the bankers' overdraft decisions are significantly related to such background variables as age, number of years employed by a bank, number of years using financial information and qualifications.

(a) Results by bank

If we examine the results by bank, the Clydesdale Bank appears to be slightly different from the Bank of Scotland and the Royal Bank of Scotland but this may be because of the relatively small number of Clydesdale Bank respondents namely 42. The results by bank are given in Table 42 in percentages for ease of comparison.

TABLE 42

Overdraft decisions by bank

	n	Yes %	No %	Don't know %
Clydesdale Bank				
Financial audit report only	15	53	27	20
Favourable management audit report	14	86	14	-
Adverse management audit report	13	77	15	8
	42			

	n	Yes %	No %	Don't know %
Bank of Scotland				
Financial audit report only	25	76	8	16
Favourable management audit report	27	63	26	11
Adverse management audit report	30	47	47	6
	82			
Royal Bank of Scotland				
Financial audit report only	23	74	22	4
Favourable management audit report	31	74	26	-
Adverse management audit report	27	52	37	11
	81			

As can be seen from Table 42 only 53% of the Clydesdale Bank respondents would lend on the basis of the financial audit report only (although a further 20% answered don't know) against 76% and 74% for the Bank of Scotland and the Royal Bank of Scotland respectively. Furthermore, 77% of the Clydesdale Bank respondents would lend on the basis of the adverse management audit report against 47% for the Bank of Scotland and 52% for the Royal Bank of Scotland. However, are these apparent differences statistically significant? The three null hypotheses to be tested are as follows H_o11a, H_o11b and H_o11c:

H_o11 Bankers' overdraft decisions

(a) on the basis of the financial audit report only

(b) on the basis of the favourable management audit report

(c) on the basis of the adverse management audit report

are not significantly related to a particular bank.

The cross-tabulations were calculated for the overdraft decisions by bank (using the actual number of replies and not the percentages shown in Table 42) for the three sets of information and, for the reasons given in relation to H_o10 above, the no and don't know answers were combined. The resulting chi-squares are shown in Table 43.

TABLE 43

Cross-tabulations of overdraft decisions* by all three banks controlling for information

	n	χ^2	df	p
Financial audit report only	63	2.57	2	0.28
Favourable management audit report	72	2.48	2	0.29
Adverse management audit report	70	3.45	2	0.18
	205			

(*No and don't know decisions are combined)

The chi-squares in Table 43 are not significant at the 5% level. Given this possibility of the Clydesdale Bank being different from the Bank of Scotland and the Royal Bank of Scotland, further analysis was carried out and the details are included in Appendix L. However, the conclusion of this further analysis is that at the 5% significance level, or indeed even at the 10% significance level, there is no reason to reject the null hypotheses H_o11a, H_o11b and H_o11c. The overdraft decisions of the Clydesdale bankers are not statistically significantly different from those of the Bank of Scotland and of the Royal Bank of Scotland.

(b) Results by head office staff and branch managers

Again we have the problem of small numbers with only 30 head office respondents. If we examine the results in Table 44 (in percentages for comparison) we have no apparent major differences between head office and branch manager respondents.

TABLE 44

Overdraft decisions by head office staff and branch managers

	n	Yes %	No %	Don't know %
Head office respondents				
Financial audit report only	9	78	22	-
Favourable management audit report	13	85	15	-
Adverse management audit report	8	63	25	12
	30			
Branch manager respondents				
Financial audit report only	54	68	17	15
Favourable management audit report	59	70	25	5
Adverse management audit report	62	53	39	8
	175			

The three null hypotheses to be tested are H_o12a, H_o12b and H_o12c as follows:

H_o12 Bankers' overdraft decisions

(a) on the basis of the financial audit report only

(b) on the basis of the favourable management audit report

(c) on the basis of the adverse management audit report

are not significantly related to head office or branch manager respondents.

The cross-tabulations for the overdraft decisions by head office staff and branch managers by information are given in Table 45.

TABLE 45

Cross-tabulations of overdraft decisions* by head office staff and branch managers controlling for information

	n	χ^2	df	p
Financial audit report only	63	0.03	1	0.87
Favourable management audit report	72	0.58	1	0.45
Adverse management audit report	70	0.01	1	0.91
	205			

(*No and don't know decisions are combined)

Even with the grouping of the no and don't know overdraft decisions together, the cross-tabulations in Table 45 suffer from the problem of one of the four valid cells having an expected cell frequency less than five. However, accepting this problem, there is no reason to reject the null hypotheses H_o12a, H_o12b and H_o12c at the 5% level of significance (or even at the 10% significance level).

(c) Results by recipients and non-recipients of questionnaire

Of the 205 respondents to this simulated overdraft decision, 110 (including 30 head office respondents) had also received the first stage questionnaire. Would the fact that some respondents had received this questionnaire affect their overdraft decision? Table 46 shows the results.

TABLE 46

Overdraft decisions by recipients and non-recipients of questionnaire

	n	Yes %	No %	Don't Know %
Respondents (head office staff and branch managers) who had received questionnaire				
Financial audit report only	29	72	14	14
Favourable management audit report	42	71	24	5
Adverse management audit report	39	64	26	10
	110*			
Respondents (ie. branch managers only) who had not received questionnaire				
Financial audit report only	34	68	20	12
Favourable management audit report	30	74	23	3
Adverse management audit report	31	42	52	6
	95			
Respondents (ie. branch managers only) who had received questionnaire				
Financial audit report only	20	70	10	20
Favourable management audit report	29	65	28	7
Adverse management audit report	31	64	26	10
	80*			

(*Difference between 110 and 80 respondents is the 30 head office staff)

These results from Table 46 show that 64% of respondents who had received the first stage questionnaire (both including and excluding head office respondents) were willing to lend given the adverse management audit report against 42% for respondents who had not received this questionnaire. It can be suggested that respondents who had received the questionnaire were aware of the emphasis on management auditing in this research and therefore when they received this simulated overdraft decision including an adverse management audit report, they may have tended to counteract the influence of such a management audit report.

However, is this difference between recipients and non-recipients of the questionnaire statistically significant? The null hypotheses to be tested are as follows H_o13a, H_o13b and H_o13c:

> H_o13 Bankers' overdraft decisions
>
> (a) on the basis of the financial audit report only
>
> (b) on the basis of the favourable management audit report
>
> (c) on the basis of the adverse management audit report
>
> are not significantly related to recipients or non-recipients of the first stage questionnaire.

The cross-tabulations of overdraft decisions by recipients and non-recipients of the questionnaire by information were calculated with the no and don't know overdraft decisions combined. The resulting chi-squares are shown in Table 47.

TABLE 47

Cross-tabulations of overdraft decisions* by recipients and non-recipients of questionnaire controlling for information

	$\underline{n}$	$\underline{\chi^2}$	$\underline{df}$	$\underline{p}$
Financial audit report only	63	0.02	1	0.89
Favourable management audit report	72	0.00	1	1.00
Adverse management audit report	70	2.58	1	0.11
	205			

(*No and don't know decisions are combined)

We have no reason to reject H_o13a and H_o13b at the 5% level of significance. The cross-tabulations of overdraft decisions by recipients and non-recipients of the questionnaire by information were calculated for the branch managers only (ie. excluding the head office staff) with the no and don't know overdraft decisions combined. The resulting chi-squares are shown in Table 48.

TABLE 48

Cross-tabulations for branch managers only of overdraft decisions* by recipients and non-recipients of questionnaire controlling for information

	$\underline{n}$	$\underline{\chi^2}$	$\underline{df}$	$\underline{p}$
Financial audit report only	54	0.00	1	1.00
Favourable management audit report	59	0.14	1	0.71
Adverse management audit report	62	2.33	1	0.13
	175			

(*No and don't know decisions are combined)

Again we have no reason to reject H_o13a, H_o13b and H_o13c at the 5% significance level. In conclusion, even at the 10% significance level there is no reason to reject the null hypotheses H_o13a, H_o13b and H_o13c.

(d) Results by background variables

Three of the background variables could be ignored:

(1) Sex because all respondents were male.

(2) Experience because the sample had been selected by the top management of the three banks on the basis of staff having the relevant experience for this type of overdraft decision.

(3) Limited liability companies as customers because all respondents had such customers.

As discussed in Chapter 7, the above three background variables were included in this second stage simulation exercise so that recipients of the first stage questionnaire would be asked for exactly the same background variables as for the first stage questionnaire. On the basis of the analysis of background variables at the beginning of this chapter, age, number of years employed by a bank, number of years using financial information and qualifications were tested with regard to the following twelve null hypotheses which are described for convenience as H_o14 [ie. $H_o14a(1)$, $H_o14a(2)$, $H_o14a(3)$, $H_o14a(4)$, $H_o14b(1)$ ..... $H_o14c(4)$]:

H_o14 Bankers' overdraft decisions

(a) on the basis of the financial audit report only

(b) on the basis of the favourable management audit report

(c) on the basis of the adverse management audit report

are not significantly related to

(1) age (under 50 years old or 50 years and over)

(2) number of years employed by a bank (under 30 years or 30 years and more)

(3) number of years using financial information (under 10 years or 10 years and more)

(4) qualifications (stating a paper qualification or not).

In relation to H_o14 the cross-tabulations were calculated for the overdraft decisions (with the no and don't know answers combined) by:

(1) age
(2) number of years employed by a bank
(3) number of years using financial information
(4) qualifications

controlling for information in each case. The resulting chi-squares are given in Table 49.

TABLE 49

Cross-tabulations of overdraft decisions* by background variables controlling for information

	n	χ^2	df	p
Age (<50 or ≥50 years)				
Financial audit report only	63	0.06	1	0.80
Favourable management audit report	72	1.42	1	0.23
Adverse management audit report	70	0.03	1	0.87
	205			

	n	χ^2	df	p
Years employed by bank (<30 or ≥30 years)				
Financial audit report only	63	0.29	1	0.59
Favourable management audit report	72	0.88	1	0.35
Adverse management audit report	69	0.06	1	0.81
	204			
Years using financial information (<10 or ≥10 years)				
Financial audit report only	63	0.28	1	0.59
Favourable management audit report	72	0.02	1	0.89
Adverse management audit report	70	0.00	1	0.95
	205			
Qualifications (Given or not)				
Financial audit report only	63	0.35	1	0.55
Favourable management audit report	72	0.00	1	1.00
Adverse management audit report	70	0.90	1	0.34
	205			

(*No and don't know decisions are combined)

Even with the grouping of the no and don't know overdraft decisions together, some of the cross-tabulations in Table 49 suffer from the problem of one of the four valid cells having an expected cell frequency less than five. However, accepting this problem, Table 49 shows that all twelve chi-squares calculated were not significant at the 5% level (or even at the 10% level) and therefore we have no reason to reject any of the twelve hypotheses in H_o14.

Overall results for all three banks

The results of this simulated overdraft decision have now been examined by various subsets of the respondents namely by:

(a) The three banks

(b) Head office staff and branch managers

(c) Recipients and non-recipients of the first stage questionnaire

(d) Background variables.

At the 10% level of significance not one of the null hypotheses relating to the above would be rejected. It is therefore reasonable to examine the overall results of this simulated overdraft decision which are given in Table 50.

TABLE 50

Overdraft decisions by type of information

	n	Yes %	No %	Don't know %
Financial audit report only	63	70	17	13
Favourable management audit report	72	72	24	4
Adverse management audit report	70	54	37	9
	205			

Although given exactly the same information, bankers did make different overdraft decisions. For example, on the basis of the financial audit report only, 70% granted the overdraft and 30% did not. Table 42 above also showed that, even within the same bank, bankers did make different overdraft decisions although given exactly the same information. The reasons for such differences would be an interesting area of research but the objective of this particular exercise was to examine whether or not different audit reports would have a significant effect on bankers' corporate overdraft decisions. Little difference exists between the overdraft decisions with the financial audit report only and the addition of the favourable management audit report. On the basis of the financial audit report only, 30% of respondents answered no or don't know to this overdraft decision compared to 28% on the basis of the favourable management audit report. These two results imply that an additional piece of information by itself (ie. a favourable management audit report) has not greatly affected the responding bankers' overdraft decisions.

However, the main conclusion from Table 50 is that the adverse management audit report has affected the bankers' decisions. Instead of at least 70% of the responding bankers lending to this company given the financial audit report only or the favourable management audit report, only 54% of responding bankers would lend to this same company given the adverse management audit report. The adverse management audit report appears to make a difference to the overdraft decision of the bankers in this simulation exercise.

The next question is how statistically significant are these results. The null hypothesis to be tested for the overall results was:

> H_o15 There are no significant differences between bankers' overdraft decisions on the basis of
>
> (a) the financial audit report only
>
> (b) the favourable management audit report
>
> (c) the adverse management audit report.

Without combining the no and don't know overdraft decisions, the cross-tabulation of the overdraft decisions by information gives a chi-square of 10.18 with four degrees of freedom and with a significance of 0.04. The null hypothesis $H_0 15$ must therefore be rejected at the 5% level of significance. The computer package of MINITAB can be used to examine the composition of this chi-square of 10.18 and the results are given in Table 51.

TABLE 51

Composition of chi-square of overdraft decisions by information

Information	Overdraft decision: Yes	No	Don't know	Total
Financial audit report only	0.19	1.89	1.47	3.55
Favourable management audit report	0.52	0.20	1.48	2.20
Adverse management audit report	1.31	3.10	0.02	4.43
				10.18

Table 51 shows that 3.10 of the chi-square of 10.18 can be attributed to the cell of the adverse management audit report with the decision to refuse the overdraft for AB Limited where the expected frequency was 18 and the actual number of answers was 26.

If the no and don't know overdraft decisions are combined, the cross-tabulation of the overdraft decisions by information gives a chi-square of 5.85 with two degrees of freedom and with a significance of 0.05. MINITAB can again be used to examine the composition of this chi-square of 5.85 and the results are given in Table 52.

TABLE 52

Composition of chi-square of overdraft decisions by information with no and don't know decisions combined

Information	Overdraft decision		
	Yes	No and Don't Know	Total
Financial audit report only	0.19	0.37	0.56
Favourable management audit report	0.52	0.98	1.50
Adverse management audit report	1.31	2.48	3.79
			5.85

Table 52 shows that 2.48 of the chi-square of 5.85 can be attributed to the cell of the adverse management audit report with no and don't know decisions where the expected frequency was 24 and the actual number of answers was 32. This overall result implies that there is evidence that the overdraft decisions of bankers are related to the three different types of information and we can now examine this overall result in more detail.

From the frequencies in Table 50 it appears that the addition of the favourable management audit report by itself has not greatly affected the bankers' decisions. The null hypothesis to be tested is:

H_o16 There are no significant differences between bankers' overdraft decisions on the basis of

(a) the financial audit report only

(b) the favourable management audit report.

Similarly, from Table 50 it appears that the addition of the adverse management audit report has affected the bankers' overdraft decisions. The null hypothesis to be tested is:

> H_o17 There are no significant differences between bankers' overdraft decisions on the basis of
>
> (a) the financial audit report only
>
> (b) the adverse management audit report.

Without combining the no and don't know overdraft decisions, the cross-tabulations of:

(1) The financial audit report only by the favourable management audit report

and (2) The financial audit report only by the adverse management audit report

are given in Table 53.

TABLE 53

Cross-tabulations of overdraft decisions by information

	n	χ^2	df	p
Financial audit report only by favourable management audit report	135	3.64	2	0.16
Financial audit report only by adverse management audit report	133	6.46	2	0.04

At the 5% level of significance (and indeed also at the 10% level of significance), therefore, we have no reason to reject H_o16 but we would reject H_o17. The adverse management audit report appears to have 'changed' the corporate overdraft decision of a statistically significant number of bankers.

The same cross-tabulations of:

(1) The financial audit report only by the favourable management audit report

and (2) The financial audit report only by
the adverse management audit report

are shown in Table 54 with the no and don't know decisions combined.

TABLE 54

Cross-tabulations of overdraft decisions by information with the no and don't know decisions combined

	n	χ^2	df	p
Financial audit report only by favourable management audit report	135	0.01	1	0.91
Financial audit report only by adverse management audit report	133	2.77	1	0.10

At the 5% level of significance therefore, we would reject both H_o16 and H_o17 but at the 10% level of significance we have no reason to reject H_o16 but we would reject H_o17. Considering both Tables 53 and 54, at the 10% level of significance we have no reason to reject H_o16 but we would reject H_o17. The overall conclusion of Tables 50 to 54 is that the overdraft decisions of bankers are not significantly related in this simulation exercise to the addition of a favourable management audit report but are related to the addition of an adverse management audit report (see also Appendix M).

Reasons for overdraft decisions

In addition to asking the bankers to make this overdraft decision, the decision sheet also asked the bankers for the reasons for their decision. All 205 respondents gave at least one reason for their particular lending decision and most gave several reasons. An attempt has been made to classify such reasons into general categories although a degree of interpretation is involved. A number of actual quotations from the reasons given which relate to the management audit reports are given in Appendix N. Table 55 summarises the reasons given by respondents for each of the three decisions on the basis of the financial audit report only. Some respondents gave several reasons for their decision.

TABLE 55

Reasons for overdraft decisions with financial audit report only

	Number of respondents			
	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
	(n=19)	(n=8)	(n=17)	(n=44)
Yes				
Adequate shareholders' interest relative to overdraft	13	5	5	23
Reasonable profitability	6	2	9	17
Experienced directors	4	5	6	15
Adequate security	8	4	3	15
Satisfactory liquidity	4	2	-	6
No	(n=2)	(n=4)	(n=5)	(n=11)
Dividends too high	2	3	3	8
Inadequate security	2	1	3	6
Margins under pressure	-	1	3	4
Don't know	(n=4)	(n=3)	(n=1)	(n=8)
Dividends too high	3	2	1	6
Inadequate security	3	2	1	6

The reasons listed in Table 55 give an indication of how bankers in this survey assessed AB Limited when given the information with the financial audit report only. The most frequently cited reason for granting the overdraft was the adequate shareholders' interest relative to the overdraft. The bankers giving this reason apparently considered it important that the owners of the company had a reasonable investment in the company relative to the size of overdraft requested. In other words the bankers wished to avoid the situation where the shareholders themselves accept little risk and finance the company with a bank overdraft with the result that the shareholders benefit if the company prospers but the bank - rather than the shareholders - suffers if the company goes into liquidation. In addition to examining the adequacy of the shareholders' interest in AB Limited relative to the overdraft requested, 15 or more bankers out of the 44 granting the overdraft also considered the level of profitability, the experience of the directors and the adequacy of the security offered.

Despite the reasons given in Table 55 for granting the overdraft facility on the basis of the information with the financial audit report only, two reservations were also expressed by several respondents although these reservations did not change their decision to reply yes. Firstly, 22 respondents (from the 44 replying yes) would like a floating charge as security because of the problem of selling industrial buildings in the event of a liquidation. Secondly, 18 of these 44 respondents commented on the high dividends paid (mainly to the directors themselves) and suggested that future dividends should be reduced. These two reservations of inadequate security and dividends being too high were also the two main reasons given by bankers refusing to grant overdraft facilities or answering don't know on the basis of the information with the financial audit report only. Table 55 highlights the fact that in the overdraft decision we are concerned with bankers' judgments and individual bankers will view items differently such as the adequacy of the security for the overdraft.

The second type of information included the favourable management audit report and Table 56 shows the reasons given for each of the three decisions.

TABLE 56

Reasons for overdraft decisions with favourable management audit report

	Number of respondents			
	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
	(n=17)	(n=12)	(n=23)	(n=52)
Yes				
Adequate shareholders' interest relative to overdraft	7	7	19	33
Experienced directors	6	6	4	16
Reasonable profitability	4	3	3	10
Adequate security	8	-	2	10
No	(n=7)	(n=2)	(n=8)	(n=17)
Management audit report weaknesses are not minor	4	1	8	13
Dividends too high	2	1	7	10
Inadequate security	4	1	2	7
Margins under pressure	1	1	1	3
Don't know	(n=3)	(n=0)	(n=0)	(n=3)
Inadequate security	3	-	-	3
Dividends too high	2	-	-	2

As with the financial audit report only, the four main reasons given for granting the overdraft facility on the basis of the favourable management audit report are adequate shareholders' interest relative to the overdraft requested, experienced directors, reasonable profitability and adequate security. Similarly, of the 52 respondents who would grant overdraft facilities on the basis of the information with the favourable management audit report, a number expressed the two reservations of the need for a floating charge (19 respondents) and the question of the high dividends (15 respondents). Furthermore, of these 52 respondents replying yes, 37 emphasised the need to correct the weaknesses mentioned in the management audit report.

It is interesting that some bankers have interpreted 'a minor weakness' in the favourable management audit report as being more than minor. Indeed it is the most common reason expressed (by 13 out of 17 respondents) for refusing the overdraft facility. This finding has important implications for the drafting of management audit reports. My perception of minor weaknesses was obviously different from that of some bankers and the clarification of communication between sender and receiver would have to be investigated further. After the management audit report weaknesses, the two other main reasons for refusing to grant the overdraft facility on the basis of the favourable management audit report are again dividends being too high and inadequate security.

The third type of information included the adverse management audit report and Table 57 summarises the reasons given for each of the three answers.

TABLE 57

Reasons for overdraft decisions with adverse management audit report

	Number of respondents			
	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
	(n=14)	(n=10)	(n=14)	(n=38)
Yes				
Adequate shareholders' interest relative to overdraft	3	5	9	17
Adequate security	4	4	5	13
Reasonable profitability	3	5	3	11
Experienced directors	1	2	1	4

	Number of respondents			
	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
	(n=14)	(n=2)	(n=10)	(n=26)
No				
Management audit report weaknesses	14	2	10	26
Dividends too high	4	2	4	10
Inadequate security	5	1	1	7
Margins under pressure	1	1	3	5
Don't know	(n=2)	(n=1)	(n=3)	(n=6)
Management audit report weaknesses	2	1	3	6
Dividends too high	-	1	2	3
Inadequate security	2	-	1	3

Table 57 shows that, as with the financial audit report only and also with the favourable management audit report, the most frequently cited reason for granting the overdraft on the basis of the information with the adverse management audit report was the 'gearing effect' - in other words adequate shareholders' interest in the company relative to the size of overdraft requested. Taking the three types of information together (financial audit report only, favourable and adverse management audit reports) 73 respondents out of the 134 respondents granting the overdraft gave this reason of adequate shareholders' interest relative to the size of overdraft compared with 38 respondents citing reasonable profitability, 38 respondents citing adequate security and 35 respondents citing the experience of the directors.

Concentrating on Table 57, of the 38 respondents who would grant overdraft facilities on the basis of the information with the adverse management audit report, 19 respondents desired a floating charge and 11 respondents mentioned the high level of dividends. However, all 38 respondents stated that, although they would grant this overdraft facility, the weaknesses outlined in the management audit report would be investigated. To be more specific, 14 of the 38 respondents who would grant overdraft facilities to AB Limited made it a condition of their lending that the weaknesses mentioned in the management audit report should be corrected. Furthermore, all of the remaining 24 respondents granting overdraft facilities stated that the contents of this management audit report would be discussed with the directors of AB Limited.

Of those 26 bankers refusing to grant overdraft facilities, all 26 mentioned the weaknesses outlined in the management audit report as being one reason for their decision. Similarly, all 6 of the bankers answering don't know also gave these weaknesses as being one of the reasons for their decision. In summary the adverse management audit report appears to have had an effect not only in influencing the decision outcome of those bankers refusing the overdraft facility but also in causing those bankers who would still grant this overdraft facility to take an extra precaution such as adding a condition to the overdraft or discussing the management audit report with the directors of the company.

Conclusion on adverse management audit report

When examining the results of this simulation exercise it should be remembered that only one[6] of the four[7] studies cited in Chapter 7 found that an external financial audit qualification made a statistically significant difference to bankers' lending decisions. The main conclusion from this simulated overdraft decision is that there are statistically significant differences between bankers' overdraft decisions on the basis of the financial audit report only and decisions with the addition of the adverse management audit report. However, when considering this conclusion it should be remembered that even with this relatively strong adverse management audit report, 54% of respondents would still grant the overdraft on the basis of the information with the adverse management audit report.

Nevertheless, the effects of the adverse management audit report can also be seen in the reasons given by bankers for their overdraft decisions. For example, all 32 bankers who did not grant the overdraft on the basis of the adverse management audit report gave the weaknesses outlined in this report as being one reason for their decision. Furthermore, all 38 respondents who did grant the overdraft on the basis of the adverse management audit report replied that the weaknesses outlined in this report would be investigated further. The responding bankers stated in the first stage questionnaire that they would use external management audit reports and they have shown in this simulation exercise that the addition of an external management audit report can have a significant effect on their overdraft decisions.

CHAPTER 9

SUMMARY AND CONCLUSIONS

Summary

(a) Definition, roots and reasons

An external management audit was defined as an independent examination of an organisation resulting in a statement to external users on the performance of the management function. However, this thesis has concentrated on one particular type of organisation namely the limited liability company and three separate roots of external management auditing were identified namely external financial auditing, internal operational auditing and management consultancy. Nevertheless, although external management auditing has links with these three activities, it is also different from each of these three activities.

For example, external financial auditors concentrate on the honesty of management's stewardship and ignore the efficiency of that stewardship in which external management auditors are interested. The internal operational auditors are internal auditors who conduct the audit FOR the company's management and audit certain parts of the company at the request of top management; whereas the external management auditors conduct an audit OF top management, report to external user groups and decide for themselves the parts of the company on which to concentrate. Similarly, the management consultants, although external to the company, report their findings internally to the management and again very often concentrate on a particular problem identified by the management of the company. External management auditing has links with, but also important differences from external financial auditing, internal operational auditing and management consultancy.

The reasons for conducting external management audits were considered particularly in relation to the idea of the accountability of corporate management in society and the interests of various potential user groups. This growing emphasis on the accountability of corporate managements, not only to shareholders but also to society as a whole, could be an important source of pressure for corporate external management auditing. Furthermore, many user groups (such as bankers, creditors, financial analysts, trade unions and governmental agencies) may be interested in the economy, efficiency and effectiveness of the managerial performance of companies. For example, empirical surveys have shown that financial analysts and investors rank the quality of corporate management very highly in any list of important factors affecting their decisions. In particular the increase in the percentage of shares held by institutional investors could be another possible source of pressure for corporate external management auditing.

(b) Examples and empirical evidence

Many proposals have been made for external management audits both in the Great Britain and North America and, although these proposals begin generally from the viewpoint of shareholders, they illustrate the variety of possible forms of external management auditing. These proposals range from the audit of corporate and financial factors to public relations to product development to asset management to the total management information system. However, external management auditing is not merely a proposal but also a reality. Actual examples of external management audits can be found particularly in North America and especially in the public sector. One common theme in this variety of proposed and actual examples of external management audits both in the public and private sectors is the assessment of the efficiency and effectiveness of management. One of the most interesting actual examples of statutory external management auditing in the private sector is the Indian cost audit.

In the fields of both internal operational auditing and external management auditing there is a lack of British empirical evidence. Nevertheless, it seems that probably, even in Great Britain, operational auditing is now approximately 50% of all internal auditing. Corporate managements appear to find internal operational audits useful. In the American surveys on external management auditing the general conclusion is that users perceive a greater need for external management audits than do accountants. Given this lack of British empirical evidence in the field of external management auditing, it was decided to survey one potential user group.

(c) Questionnaire survey

Bankers were chosen as this user group because empirical surveys have shown that bankers claim to read the external financial audit report more carefully than financial analysts, institutional shareholders and private shareholders. Furthermore, bankers also try to assess corporate managements. The primary objective of this questionnaire survey was to attempt to determine whether or not bankers in the Bank of Scotland, the Clydesdale Bank and the Royal Bank of Scotland would express any demand for external management audit reports on companies. The proposed external management audit report was defined for bankers, in comparison with the external financial audit report, as 'a report containing an independent opinion on the performance of the management of a limited liability company, prepared by a professionally qualified team and included with the financial statements of your limited liability customer companies'.

This questionnaire was sent to a sample of 466 bankers in the three Scottish joint-stock banks out of a population of 1,205 with a resulting 63% response rate without any follow-up letters. A typical respondent was over 40 years old, male, employed by a bank for at least 20 years, a user of financial information for at least

10 years, an Associate of the Institute of Bankers and experienced in the commercial and industrial banking fields with limited liability companies as customers. No evidence was found to suggest that the respondents were not reasonably representative of the total sample.

In this survey the bankers' answers were not generally significantly related to:

(a) a particular bank;

(b) head office or branch respondents;

(c) the background variables of sex, number of years employed by a bank, number of years using financial information, agricultural banking experience, commercial banking experience, fishing banking experience, personal banking experience, other banking experience and having small and large limited liability companies as customers.

The two most important background variables for this survey in terms of the number of null hypotheses rejected at the 5% level of significance were qualifications (having paper qualifications or not) and industrial banking experience (having such experience or not). Furthermore, in this survey bankers' answers to the questions for small companies were significantly related to the answers for large companies. The distinction made in the questionnaire between small and large companies can generally be ignored.

The main findings of this questionnaire survey can be summarised as follows:

(1) Bankers claim to read and use the external financial audit report. For example, 80% of respondents found the external financial audit report useful in helping them to make their lending decisions about companies.

(2) Bankers do try to assess corporate managements.

(3) When assessing corporate managements, bankers use a range of financial and non-financial information such as annual financial statements, practical experience of management, personal knowledge of management and external financial audit reports.

(4) Less than 10% of respondents consider that they always have sufficient information to assess corporate managements.

(5) Over 85% of respondents agree that they would find the external management audit report useful in their corporate lending decisions.

(6) Over 90% of respondents would always or sometimes use the external management audit report as part of the information on which to assess corporate management.

(7) Bankers consider that the company should pay for the cost of the external management audit.

(8) Bankers consider that the external management audit report should include assessments both of the general management function and of the individual business functions. For example, over 80% of respondents wish assessments of the following reported in an external management audit report:

    (a) efficiency and effectiveness of management in the achievement of company objectives;

(b) budgetary control system;

(c) company objectives;

(d) performance of the management of the finance, accounting, marketing and production functions.

(9) Bankers consider that the external financial and external management audit reports would be equally useful in helping them to make their corporate lending decisions.

The results of this questionnaire survey indicate support for both the external financial and external management audit reports from the responding bankers. Despite the fact that bankers have had experience of using external financial audit reports but not external management audit reports, as much support existed for the external management audit as for the external financial audit. The results of this questionnaire survey provide evidence that bankers would be interested in external management audit reports on limited liability companies. Bankers did express a demand for external management audit reports.

(d) Simulated overdraft decision

The findings of this questionnaire survey implied that it would be worthwhile to continue with the second stage of this project which was a simulation exercise. The objective of this simulation exercise was to determine whether or not the addition of an external management audit report would have a statistically significant effect on the corporate overdraft decision outcomes of bankers. The general conclusion from research into external financial auditing is that audit qualifications have not made a statistically significant difference to bankers' lending decision outcomes. Would the same apply to external management audit reports?

A simulated overdraft decision was devised with the assistance of several bankers who agreed that the data given for the company would make it a good (but not too good) proposition if it was requesting an overdraft of £350,000 for working capital purposes. To make this simulation exercise as realistic as possible, all the bankers received the following information about AB Limited:

(a) nine assumptions;
(b) cash flow forecast for one year;
(c) profit and loss accounts for two years;
(d) balance sheets for two years;
(e) funds statements for two years;
(f) external financial audit report.

A sample of 354 bankers, with experience of this type of corporate overdraft decision, were selected to receive this simulation exercise and were divided into three groups of 118 each with one group receiving only the above information for the company. A second group received the above information plus a 'favourable' management audit report (with favourable comments on the management of the company) and a third group received the above information plus an 'adverse' management audit report (with adverse comments on the management of the company). The bankers receiving the favourable management audit report could act as a control group. For this group of bankers, if a similar percentage of bankers granted overdraft facilities compared to the group receiving the data with only the financial audit report, it could be argued that the addition of a management audit report by itself did not affect the bankers' decisions. However, if a smaller percentage of the group receiving the adverse management audit report granted overdraft facilities compared to the other two groups, then it could be concluded that the adverse management audit report had affected the bankers' decisions.

The response rate for this simulated overdraft decision was 58% and the typical respondent was very similar to the typical respondent in the first stage questionnaire survey. With a response rate of less than 100%, the potential problem of non-response bias always exists but no evidence was found to suggest that the respondents were not reasonably representative of the total sample. In this simulation exercise bankers' overdraft decisions were not significantly related to:

(a) a particular bank;

(b) head office or branch respondents;

(c) recipients or non-recipients of the first stage questionnaire;

(d) background variables of age, number of years employed by a bank, number of years using financial information and qualifications.

The overall results of this simulated overdraft decision were as follows:

<u>Overdraft decisions by type of information</u>

	Yes	No	Don't Know
	%	%	%
Financial audit report only	70	17	13
Favourable management audit report	72	24	4
Adverse management audit report	54	37	9

Even when given exactly the same information, bankers did make different overdraft decisions. For example, on the basis of the information with the financial audit report only, 70% of respondents granted the overdraft and 30% did not. However, little difference existed between the overdraft decisions with the financial audit report only and the overdraft decisions with the addition of the favourable external management audit report. On the basis of the financial audit report only, 30% of respondents answered no or don't know to this overdraft decision compared to 28% on the basis of the favourable external management audit report. Indeed at the 10% level of significance there were no significant differences between bankers' overdraft decisions on the basis of the information with the financial audit report only and the information with the addition of the favourable external management audit report. It appears that an additional piece of information, namely the favourable external management audit report, has not by itself greatly affected the responding bankers' decisions outcomes.

In contrast, the main conclusion is that, at the 10% level of significance, the addition of an adverse external management audit report did have a statistically significant effect on bankers' corporate overdraft decision outcomes. Instead of at least 70% of the responding bankers lending to this company given the information with the financial audit report only or with the addition of the favourable external management audit report, only 54% of responding bankers would lend to this same company given the adverse external management audit report. Furthermore, <u>all</u> the bankers who granted the overdraft on the basis of the information with the adverse external management audit report stated specifically that the weaknesses outlined in the external management audit report would be investigated further with the management of the company. <u>All</u> the bankers who did not grant the overdraft on the basis of the information with the adverse external management audit report specifically mentioned the weaknesses summarised in the external management audit report as being one reason for their decision not to grant the overdraft. The results of both the questionnaire survey and the simulated overdraft decision imply that bankers would be interested in receiving, and would use, external management audit reports on their customer companies.

Limitations of research and further research

Although the conclusion of this research project is that bankers would be interested in and would use external management audit reports, the limitations of this research project must be remembered. Firstly, this research project has concentrated on only one user group namely bankers and indeed on only one subset of bankers namely those employed by the three Scottish joint-stock banks. Secondly, with response rates of under 100% the possibility always exists of non-response bias. In relation to the second stage simulation exercise the following limitations also apply. Thirdly, this simulation exercise concentrated on one particular type of decision namely the granting of bank overdraft facilities to a company. Fourthly, this simulation exercise used a specific example of a favourable and an adverse external management audit report on a company to which bankers would generally grant overdraft facilities. Fifthly, this simulation exercise used relatively small sample sizes.

Sixthly, despite the aim of making this simulation exercise as realistic as possible, it could never be totally realistic. For example, items such as the interest rate and the security were given in this simulation exercise, whereas in reality these two items would be a matter of negotiation. Similarly, the responding bankers obviously could not interview the directors of the company requesting the overdraft. Seventhly, respondents may make a different decision in a simulation exercise from their decision in a real-life situation.

Some of the limitations of this research project and some of its results suggest further interesting areas of research. For example, the questionnaire survey and the simulation exercise (both suitably adapted) could be replicated with other user groups such as creditors (probably the most similar user group to bankers), financial analysts and shareholders. It would also be important to discover how managers view such external management audits. It will also be necessary to replicate the simulation exercise with bankers using different examples of external management audit reports both favourable and adverse. For example, using a company to which bankers would generally refuse over-draft facilities, would a favourable external management audit report have a significant effect on bankers' decisions to grant an overdraft?

The results of this simulated overdraft decision showed that even when given exactly the same information, a reasonable number of bankers would make different decisions. The decision process and the various factors influencing bankers' overdraft decisions would be interesting areas for further research. The reactions of some respondents to the 'favourable' external management audit report revealed that bankers may perceive 'minor weaknesses' to be major rather than minor. The classification of such weaknesses requires further research. The problems suggested by some respondents of actually conducting external management audits could be another fruitful area of research. These problems would include the scope of external management audits, the qualifications and experience required to become an external management auditor, the development of performance indicators and standards used by external management auditors and the question of whether or not external management audits would stifle the initiative of corporate managements. Like much accounting and auditing research, this research project has raised as many questions as it has answered.

Conclusions

In recent years the role of external financial auditing has been emphasised in relation to society as a whole.

For example, in 1980 Pound and Courtis argued:

> 'If the audit profession wishes to maintain a role in society, the quality of its output must be improved. To improve the readership of the audit opinion it must contain more of what the users of financial statements want. This is an area requiring further research.'[1]

The results of this research project suggest that bankers want not only an improved external financial audit report but also the proposed external management audit report. Also on this theme of auditing in society Flint has suggested:

> 'Society has to resolve this issue of how to stimulate evolution and dynamism in this important social process of auditing, the practice of which is certainly in danger of becoming, if it has not already become, excessively introverted when its true social role and function require quite the opposite.'[2]

External management auditing has part of its roots in external financial auditing and external financial auditors could be one group supporting the development and evolution of external management auditing. Indeed, in an 1984 issue of the journal of the Institute of Chartered Accountants in England and Wales, Accountancy, Glynn[3] has proposed that value for money audits (a form of external management audit) should be conducted in the private sector.

However, external management auditing is still in the relatively early stages of its development but, even at this stage, its inter-disciplinary nature is clear and accountants and auditors cannot develop external management auditing on their own. Furthermore, support from external financial auditors (or from other potential producers of external management audit reports such as management accountants and management consultants) can be compared to 'supply push'. This is why it is important to collect evidence about any 'demand pull' which exists. In my opinion, priority in the area of external management auditing research should be given to projects to discover what various user groups think about external management audit reports. This research project with bankers is only one small part of the jigsaw which will take several years to complete.

Nevertheless, this part of the jigsaw reveals support for external management audit reports from bankers. At present bankers use a range of financial and non-financial information in trying to assess corporate managements but bankers wish more information and they consider that external management audit reports would be used, together with the existing available information, in making their corporate lending decisions. The detailed content of external management audit reports requires further research. However, as a starting point, bankers wish external management audit reports to include assessments both of the general management function (for example the efficiency and effectiveness of management in achieving the company's objectives) and of the individual business functions (for example finance, accounting, marketing and production). External management audit reports will certainly be longer than the existing, standardised external financial audit report. The results of this research project suggest that it is not a question of replacing the external financial audit with the external management audit but, instead, of having both an external financial audit and an external management audit. The results of the questionnaire survey show that bankers would use both the existing external financial audit report and the proposed external management audit report.

Therefore, the main conclusions of this research project are twofold. Firstly, bankers in the questionnaire survey expressed a demand for external management audit reports. Secondly, the simulation exercise showed that bankers would use the external management audit report as part of the information on which they would base their corporate overdraft decisions. If other potential user groups express the same interest as bankers in external management audit reports, the case for some form of external management audit in the private sector would be very strong indeed.

NOTES

Chapter 1

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6. J.G. San Miguel, J.K. Shank and V. Govindarajan, Extending the Audit Function: A Survey and Framework for Analysis, Harvard Business School Working Paper 76-39, Boston, 1976, p.10.

7. R.B. Denis, A Critical Study of Operations Auditing, PhD, University of Connecticut, 1972, Questionnaire Summary p.3.

8. P. Macchiaverna, op cit, p.40.

9. J. Santocki, (1976), op cit, p.66.

10. R.B. Denis, op cit, pp. 3-4.

11. J. Santocki, (1976), op cit, pp. 65-66.

12. P. Macchiaverna, op cit, p.39.

13. The Institute of Internal Auditors, An Evaluation of Selected Current Internal Auditing Terms, I.I.A., Florida, 1975, pp. 30-31.

14. C.T. Norgaard, 'The Professional Accountant's View of Operational Auditing', The Journal of Accountancy, December 1969, pp. 45-48.

15. F.J. Imke, 'The Future of the Attest Function', The Journal of Accountancy, April 1967, pp. 51-58.

16. Ibid., p.55.

17. S.A. Moscove, A Survey of Security Analysts' and Certified Public Accountants' Opinions on a Management Audit Attest Function, PhD, Oklahoma State University, 1971.

18. Ibid., p.137.

19. C.H. Smith, R.A. Lanier and M.E. Taylor, The Need for the Scope of the Audit of Management: A Survey of Attitudes, The Accounting Review, April 1972, pp. 270-283.

20. Ibid., p.273.

21. G.G. Miller, A Critical Analysis and Appraisal of the Theory and Techniques of the Management Audit, PhD, University of Austin in Texas, 1959.

22. Ibid., p.66.

23. C.H. Smith et al, op cit, p.273.

24. C.H. Smith et al, op cit, p.275.

25. S.A. Moscove, op cit, p.62.

26. S.A. Moscove, op cit, p.110.

27. Details of the number surveyed and the response rate for each survey cited in Chapter 4 are as follows:

	Number Surveyed	Relies Number	Relies % of Total Surveyed
Macchiaverna	Not given	284	Not given
1975 Institute of Internal Auditors	800	343	43%
1979 Institute of Internal Auditors	1,100	497	45%
San Miguel, Shank and Govindarajan	200	169	85%
Denis	500	316	63%
Santocki	1,172	252	22%
Norgaard	Not given in article		
Imke	100	47	47%
Smith, Lanier and Taylor			
- C.P.A.s	108	19	18%
- Controllers	115	34	30%
- C.F.A.s	157	34	22%
- Mutual Fund Managers	103	18	17%
Miller	475	147	31%
Moscove			
- C.P.A.s	252	149	59%
- Security Analysts	252	142	56%

Chapter 5

1. Details of the number surveyed and the response rate for each survey cited in Chapter 5 are given in note 38.

2. M.J. Epstein, The Usefulness of Annual Reports to Corporate Shareholders, California State University, Bureau of Business and Economic Research, Los Angeles, 1975.

3. T.A. Lee and D.P. Tweedie, 'Accounting Information: An Investigation of Private Shareholder Usage', Accounting and Business Research, Autumn 1975, pp. 280-291.

4. V.C. Brenner, 'Are Annual Reports Being Read?', The National Public Accountant, November 1971, pp. 16-21.

5. Ibid., p.20.

6. P.E. Fess and R.E. Ziegler, 'Readership of the Audit Report', The CPA Journal, June 1977, pp. 5-6.

7. Ibid., p.6.

8. T.A. Lee and D.P. Tweedie, The Private Shareholder and The Corporate Report, Research Committee of The Institute of Chartered Accountants in England and Wales, London, 1977.

9. T.A. Lee and D.P. Tweedie, The Institutional Investor and Financial Information, Research Committee of The Institute of Chartered Accountants in England and Wales, London, 1981.

10. T.A. Lee and D.P. Tweedie (1977), op.cit., p.54.

11. T.A. Lee and D.P. Tweedie (1981), op.cit., p.78.

12. R. Estes, The Auditor's Report and Investor Behavior, Lexington Books, Massachusetts, 1982, p.17.

13. R. Libby, 'Bankers' and Auditors' Perceptions of the Message Communicated by the Audit Report', Journal of Accounting Research, Spring 1979, pp. 99-122.

14. Ibid., p.118.

15. K.J. Cohen, T.C. Gilmore and F.A. Singer, 'Bank Procedures for Analyzing Business Loan Applications', in Analytical Methods in Banking edited by K.J. Cohen and F.S. Hammer, Richard D. Irwin, Homewood, 1966.

16. Ibid., pp. 230-231.

17. Ibid., p.231

18. D.A. Egginton, *Accounting for the Banker*, Longman, London, 1982.

19. Ibid., p.181.

20. Ibid., p.181.

21. *Companies Act 1981*, Her Majesty's Stationery Office, London, 1981, Sections 8(1) and 8(2).

22. This proposal is discussed in Sir B.R. Williams, 'More Power to the Shareholder', *Journal of Business Finance*, Autumn 1969, pp. 55-61.

23. The following books were found to be particularly helpful in advising on the design of this questionnaire:

    (a) E.R. Babbie, *Survey Research Methods*, Wadsworth, Belmont, 1973.

    (b) K.D. Bailey, *Methods of Social Research*, Macmillan, New York, 1978.

    (c) W.A. Belson, *The Design and Understanding of Survey Questions*, Gower, Aldershot, 1981.

    (d) C.J. Drew, *Introduction to Designing Research and Evaluation*, C.V. Mosby, Saint Louis, 1976.

    (e) A.N. Oppenheim, *Questionnaire Design and Attitude Measurement*, Heinemann, London, 1966.

    (f) H. Schuman and S. Presser, *Questions and Answers in Attitude Surveys*, Academic Press, New York, 1981.

24. W.A. Belson, op.cit., p.389.

25. K.D. Bailey, op.cit., p.57.

26. I am particularly grateful for the comments on this questionnaire from Professor Tom Lee and Jan Santocki.

27. K.D. Bailey, op.cit., p.61.

28. H. Schuman and S. Presser, op.cit., p.12.

29. A.J. Winters, 'Banker Perceptions of Unaudited Financial Statements', *The CPA Journal*, August 1975, pp. 29-33.

30. V.C. Brenner, op.cit.

31. R. Estes and M. Reimer, 'A Study of the Effect of Qualified Auditors' Opinions and Bankers' Lending Decisions', <u>Accounting and Business Research,</u> Autumn 1977, pp. 250-260.

32. R. Libby, 'The Impact of Uncertainty Reporting on the Loan Decision', <u>Journal of Accounting Research</u>, Supplement 1979, pp. 35-57.

33. T.A. Lee and D.P. Tweedie (1975), op.cit.

34. R. Estes (1982), op.cit.

35. R. Libby (Supplement 1979), op.cit., p.45.

36. T.A. Lee and D.P. Tweedie (1975), op.cit., p.289.

37. R. Estes (1982), op.cit., pp. 48-49.

38. Details of the number surveyed and the response rate for each survey cited in Chapter 5 are as follows:

	Number Surveyed	Relies: Number	Relies: % of Total Surveyed
Epstein			
- shareholders	N.A.	432	N.A.
Lee and Tweedie (1975)			
- private shareholders	1,594	374	24%
Brenner			
- bankers	1,000	340	34%
- financial analysts	1,000	417	42%
- shareholders	2,000	484	24%
Fess and Ziegler			
- bankers	400	214	54%
- financial analysts	298	118	40%
- shareholders	1,851	188	10%
Lee and Tweedie (1977)			
- private shareholders	2,002	301[1]	16%
Lee and Tweedie (1981)			
- insurance companies	32	29	91%
- pension funds	67	18	27%[3]
- investment and unit trusts	65	18	28%[3]
- merchant banks	32	14	44%[3]
- stockbroking firms	281	61	22%
		140[2]	

	Number Surveyed	Relies: Number	Relies: % of Total Surveyed
Libby (1979)			
- audit partners	30	30	100%
- bankers	28	28	100%
Winters			
- bankers	1,200	566	47%
Estes and Reimer (1977)			
- bankers	1,000	222	22%
Libby (Supplement 1979)			
- bankers	34	34	100%
Estes (1982)			
- institutional investors	1,500	224	15%
- security analysts	1,500	179	12%
- shareholders	3,500	405	12%
- students	551	551	100%

Notes:

1. 339 respondents accepted but only 301 were used.
2. From these 140 organisations, 231 interviews were undertaken.
3. These percentages are the acceptance rates related to requests for cooperation. The acceptance rates related to maximum possible acceptances were 45% for pension funds, 30% for investment and unit trusts and 47% for merchant banks.

Chapter 6

1. E.R. Babbie, Survey Research Methods, Wadsworth, Belmont, 1973, p.165.

2. J. Santocki, Report on Management Audit Survey, I.C.M.A. and City of Birmingham Polytechnic, Birmingham, 1983, p.3.

3. A.N. Oppenheim, Questionnaire Design and Attitude Measurement, Heinemann, London, 1966, p.34.

4. H. Schuman and S. Presser, Questions and Answers in Attitude Surveys, Academic Press, New York, 1981, p.15.

5. K.A. Yeomans, Statistics for the Social Scientist: 2 Applied Statistics, Penguin, 1968, p.285.

6. Of the population of 582 the following were excluded:

No answers	39
Answering 'uncertain'	108
	147

7. A minor inconsistency on the ranking scale was defined as a case where, for example, the answer to question 3 or 4 was 'strongly agree that the financial audit report is useful' and the answer to question 10 or 11 was 'agree' that the management audit report would be useful' and then the answer to question 16 was that 'the management audit and financial audit reports would be equally useful'. In other words if we do not differentiate between the 'strongly agree' and 'agree' answers there is no inconsistency.

8. A major inconsistency on the ranking scale was defined as a case where, for example, either

   (a) the answer to question 3 or 4 was 'disagree that the financial audit report is useful' and the answer to question 10 or 11 was 'agree' that the management audit report would be useful' and then the answer to question 16 was that 'the management audit and financial audit reports would be equally useful?

   or (b) the answer to question 3 or 4 was 'agree that the financial audit report is useful' and the answer to question 10 or 11 was 'strongly agree that the management audit report would be useful' and then the answer to question 16 was that 'the management audit report would be less useful than the financial audit report'.

9. Table 13 omits three significant cross-tabulation related to questions asking whether a management audit should be voluntary or required by the professional accounting bodies or required by law because, as discussed in Chapter 6, many respondents gave more than one answer to this question and the results became almost meaningless.

10. K.G. Stanga and M.G. Tiller, 'Needs of Loan Officers for Accounting Information from Large versus Small Companies, Accounting and Business Research, Winter 1983, p.69.

11. P.E. Fess and R.E. Ziegler, 'Readership of the Audit Report', The CPA Journal, June 1977, pp. 5-6.

12. V.C. Brenner, 'Are Annual Reports Being Read?', The National Public Accountant, November 1971, p.20.

13. Further details of this problem (of respondents with no large companies as customers) in relation to question two are given in Appendix E note 32.

Chapter 7

1. Committee on Basic Auditing Concepts, A Statement of Basic Auditing Concepts, American Accounting Association, Sarasota, 1973, p.52.

2. C.W. Alderman, 'The Role of Uncertainty Qualifications: Evidence to Support the Tentative Conclusions of the Cohen Commission', Journal of Accountancy, November 1977, pp. 97-100.

3. Ibid., p.99.

4. R. Ball, R.G. Walker and G.P. Whittred, 'Audit Qualifications and Share Prices', Abacus, June 1979, pp. 23-34.

5. Ibid., pp. 32-33.

6. M. Firth, 'Qualified Audit Reports: Their Impact on Investment Decisions', The Accounting Review, July 1978, pp. 642-650.

7. Ibid., p.649.

8. W.T. Bailey, 'An Appraisal of Research Designs Used to Investigate the Information Content of Audit Reports', Accounting Review, January 1982, pp. 141-146.

9. Ibid., p.144.

10. R. Estes and M. Reimer, 'A Study of the Effect of Qualified Auditors' Opinions on Bankers' Lending Decisions', Accounting and Business Research, Autumn 1977, pp. 250-260.

11. M. Firth, 'Qualified Audit Reports and Bank Lending Decisions', Journal of Bank Research, Winter 1979, pp. 237-241.

12. R. Libby, 'The Impact of Uncertainty Reporting on the Loan Decision', Journal of Accounting Research, Supplement 1979, pp. 35-57.

13. K.A. Houghton, 'Audit Reports: Their Impact on the Loan Decision Process and Outcome: An Experiment', Accounting and Business Research, Winter 1983, pp. 15-20.

14. R. Estes and M. Reimer, op.cit., p.255.

15. M. Firth, op.cit., p.240.

16. K.A. Houghton, op.cit., p.19.

17. Institute of Chartered Accountants of Scotland, Auditing Standards and Guidelines, I.C.A.S., Edinburgh, 1980, p.18.

Chapter 8

1. R. Estes and M. Reimer, 'A Study of the Effect of Qualified Auditors' Opinions on Bankers' Lending Decisions', Accounting and Business Research, Autumn 1977, pp. 250-260.

2. M. Firth, 'Qualified Audit Reports and Bank Lending Decisions', Journal of Bank Research, Winter 1979, pp. 237-241.

3. K.A. Houghton, 'Audit Reports: Their Impact on the Loan Decision Process and Outcome: An Experiment', Accounting and Business Research, Winter 1983, pp. 15-20.

4. K.A. Yeomans, Statistics for the Social Scientist: 2 Applied Statistics, Penguin, 1968, p.285.

5. H. Schuman and S. Presser, Questions and Answers in Attitude Surveys, Academic Press, New York, 1981, p.15.

6. M. Firth, op.cit.

7. (a) R. Estes and M. Reimer, op.cit.
   (b) M. Firth, op.cit.
   (c) R. Libby, 'The Impact of Uncertainty Reporting on the Loan Decision', Journal of Accounting Research, Supplement 1979, pp. 35-57.
   (d) K.A. Houghton, op.cit.

Chapter 9

1. G.D. Pound and J.K. Courtis, 'The Auditor's Liability: A Myth?', Accounting and Business Research, Summer 1980, p.305.

2. D. Flint, 'Social and Ethical Issues in Auditing', Auditing Research: Issues and Opportunities edited by M. Bromwich, A.G. Hopwood and J. Shaw, Pitman and Deloitte Haskins & Sells, London, 1982, p.94.

3. J. Glynn, 'VFM Audits for Private Sector?', Accountancy, May 1984, pp. 140-141.

APPENDIX A

Covering letters from the three banks
for first-stage questionnaire

The following covering letters from the Bank of Scotland, the Clydesdale Bank and the Royal Bank of Scotland are discussed in Chapter 5 including the disadvantage of the possible bias arising from such letters. The actual letters did not meet the margin requirements of this thesis and, therefore, the letters have been retyped. The original letters were, of course, on the headed paper of each bank and were signed by the appropriate official.

BANK OF SCOTLAND

Staff Training Centre
58 St Albans Road
EDINBURGH EH9 2LS

21st January 1983

Dear Sir

We have been asked by the Department of Accounting and Business Method at Edinburgh University to co-operate with research being undertaken into the question of whether or not a management audit would be worthwhile from the viewpoint of users of accounts.

The Bank is keen to be of assistance and has agreed to the distribution of a brief questionnaire to a number of Branch Managers and Head Office Lending Officials. The letter which accompanies the questionnaire is self explanatory and while we would wish to stress that you are under no obligation to participate if you do not wish to do so, we hope that you will feel able to be of assistance.

Any views expressed should reflect your personal opinion rather than what you may see as the likely Bank view, and you may be assured that your confidence will be respected.

We thank you in anticipation of your co-operation.

Yours sincerely,

W.S. Anderson,
Course Manager.

CLYDESDALE BANK PLC

P O Box
30 St Vincent Place
GLASGOW G1 2HL

9th February 1983

Dear Sir

We have been asked by Mr John Innes, a lecturer in the Department of Accounting and Business Method at Edinburgh University if we would be willing to assist him in connection with a project he is undertaking on the auditing of Management performance in Companies from the viewpoint of those who use such accounts, e.g. Bankers, Accountants etc.

We feel there would be value to the Bank in taking part in this project and a few of our Managers and Lending Officials have already been involved in a pilot exercise. We have now received the material and while you are under no obligation to participate we hope you will be willing to assist.

I would emphasise that you are being asked to give a personal view and not a 'Bank' view and you will see from the accompanying letter that you will not be identified in any way unless you wish a copy of the survey.

With thanks in anticipation of your co-operation.

Yours sincerely

W.C. Harvey
Deputy General Manager
(Administration)

Head Office
P O Box 31
42 St Andrew Square
Edinburgh EH2 2YE

12 April 1983

THE ROYAL BANK
OF SCOTLAND LIMITED

Dear Sir

We have been approached by Mr John Innes, a Lecturer in the Department of Accounting and Business Method at Edinburgh University to assist him in connection with a project he is undertaking on the auditing of Management performance in Companies from the viewpoint of those people who use Companies' Audited Accounts.

We have studied Mr Innes's project and feel there is genuine merit in what he is doing. We, therefore, are happy for our Managers and other lending Officials to become involved and while you are under no obligation to participate, we hope you will be willing to assist.

You will observe that you are being asked for a personal view and also that you will not be identified in any way unless you wish a copy of the final report.

Thank you in anticipation of your co-operation.

Yours sincerely

Norman J Lang
Assistant General Manager
Branch Department

APPENDIX B

Random sample of branch managers

The three different random samples of branch managers were taken manually using Table 21.7.1 on page 267 of the book by T.W. McRae, 'Statistical Sampling for Audit and Control' published by Wiley in 1974. Each bank provided a complete list of branches (together with the addresses and managers) and these branches were numbered to give the population for each bank.

1. Bank of Scotland

A random sample of 150 (without duplicates) was taken from a population of 377. The sample started in column 9, line 756 using the last three digits and moving vertically down a column. The branches selected were as follows:

001	Bridge of Don, Aberdeen
04	George Street, Aberdeen
05	Kittybrewster, Aberdeen
06	Market Street, Aberdeen
07	Mile End, Aberdeen
09	Queen's Cross, Aberdeen
11	Tullos, Aberdeen
16	West End, Aberdeen
17	Aberfeldy
18	Aberlour
20	Stirling Street, Airdrie
34	High Street, Ayr
35	Killoch Place, Ayr
38	Ballater
40	Bathgate
41	Kessington, Bearsden
48	Birmingham Region
51	Blairgowrie
53	Bo'ness
55	Bowmore
56	Brechin
57	Bridge of Allan
58	Bridge of Weir
63	Broxburn
68	Carluke
69	Carnoustie
71	Clarkston
75	Coupar Angus
77	Crieff
81	Cumnock
82	Cupar

85	Dalkeith
89	Denny
90	Dingwall
93	Drumnadrochit
96	Queensberry Square, Dumfries
97	Dunbar
101	Murraygate, Dundee
103	Panmure Street, Dundee
107	82 High Street, Dunfermline
109	Dunoon
110	Duns
115	Barnton, Edinburgh
117	Brunswick Place, Edinburgh
120	Comely Bank, Edinburgh
123	Head Office, Edinburgh
125	Drumsheugh, Edinburgh
126	Fairmilehead, Edinburgh
127	Frederick Street, Edinburgh
130	George Street, Edinburgh
138	Lothian Road, Edinburgh
141	Morningside, Edinburgh
144	New Town, Edinburgh
145	North Morningside, Edinburgh
148	Polwarth, Edinburgh
149	Portobello, Edinburgh
152	St. Andrew Square, Edinburgh
158	Tollcross, Edinburgh
160	Waterloo Place, Edinburgh
161	West End, Edinburgh
168	Vicar Street, Falkirk
170	Forfar
172	Fort Augustus
173	Fortrose
175	Fraserburgh
177	Galashiels
180	Gatehouse
184	Glasgow Chief Office
185	Anniesland, Glasgow
188	Bothwell Street, Glasgow
191	Byres Road, Glasgow
193	Cathcart, Glasgow
196	Drumchapel, Glasgow
205	Hyndland, Glasgow
207	Jordanhill, Glasgow
210	Kinning Park, Glasgow
212	Laurieston, Glasgow
213	Linthouse, Glasgow
214	Merrylee, Glasgow
223	Queen Street, Glasgow
224	Johnstone
226	Sandyford, Glasgow
229	Shawlands, Glasgow
231	Stockwell, Glasgow
232	Strathbungo, Glasgow

Bank of Scotland (continued)

234	Victoria Road, Glasgow
236	West George Street, Glasgow
239	Gorebridge
241	Grangemouth
244	West Blackhall Street, Greenock
245	Gullane
246	Haddington
249	Hawick
252	Hillington
253	Huntly
254	Innerleithen
258	Union Street, Inverness
259	Inverurie
261	Jedburgh
262	Glasgow Cross
264	Kelso
267	Bank Street, Kilmarnock
269	Portland Street, Kilmarnock
270	Kinghorn
272	Kinross
276	Kirkcudbright
278	Kirkwall
279	Kirriemuir
280	Kyle
282	Lanark
289	Leven
291	Linwood
293	Loanhead
294	Lochcarron
296	Lochgilphead
297	Lochmaddy
299	London Chief Office
301	Oxford Street, London
302	Piccadilly Circus, London
303	Lossiemouth
307	Maybole
312	Moffat
313	Montrose
314	Motherwell
316	Nairn
319	Newton Mearns
320	Newtonmore
321	Newton Stewart
327	St. Mirren, Paisley
328	South, Paisley
329	Wellmeadow Street, Paisley
332	George Street, Perth
333	High Street, Perth
336	Peterhead
337	Pitlochry
339	Port Glasgow
343	Renfrew
345	Rutherglen
349	Sanquhar

Bank of Scotland (continued)

350	Selkirk
353	Stewarton
354	2 King Street, Stirling
356	University, Stirling
358	Stonehouse
359	Stornoway
361	Strathaven
363	Tain
372	West Linton
373	Wick
376	Wooler

2. Clydesdale Bank

A random sample of 100 (without duplicates) was taken from a population of 309. The sample started in column 1, line 751 using the last three digits and moving vertically down a column. The branches selected were as follows:

011	Mile End
18	Tullos
28	Arbroath
29	Ardrossan
34	Burns Statue Square
38	Banchory
42	Beith
44	Bishopbriggs
49	Brechin
54	Buckie
56	Burnbank
58	Campbeltown
63	Clarkston
65	Radnor Park
66	Coatbridge
73	Kildrum
78	Dalry
79	Darvel
80	Denny
81	Dingwall
87	Buccleuch Street
91	Downfield
93	West End
95	Dunlop
96	Dunoon
97	Dyce
100	Princes Street
103	Charlotte Square
104	Corstorphine
111	Newington
113	Princes Street
114	Tollcross

Clydesdale Bank (continued)

119	Falkirk
122	Forfar
123	Forres
124	Fort William
131	Glasgow, Head Office
132	Aikenhead Road
133	Anderston
134	Anniesland
135	Bothwell Street
136	Calton and Bridgeton
137	Cambridge Street
138	Cardonald
140	Cathcart
141	Dalmarnock Road
144	Gibson Street
150	India Street
151	Ingram Street
153	Maryhill Road
155	Moore Place
157	Parkhead
158	Partick
162	St Enoch Square
166	Sauchiehall Street
167	Scotland Street
168	Shawlands
170	Springburn
171	Tollcross
182	Cathcart Square
185	Hamilton
186	Almada Street
187	Hawick
192	Inverbervie
194	Inverkeithing
196	Queensgate
200	Centre
203	Kelso
204	Kemnay
206	Kilmacolm
211	Kincardine-on-Forth
214	Kirkcaldy
216	Kirkwall
217	Lanark
221	Leith
223	Leven
228	30 Lombard Street, London Chief Office
232	Longside
233	Lossiemouth
235	Macduff
237	Mid Calder
243	Muirkirk
248	Newmains
250	Newport-on-Tay
256	Oldmeldrum
258	High Street
263	St John Street

Clydesdale Bank (continued)

264	Peterhead
270	Prestwick Airport
272	Rhynie
281	South Queensferry
283	Stevenston
290	Stranraer
292	Strichen
294	Tarbert
295	Tarland
298	Thurso
299	Tillicoultry
304	West Kilbride
305	Whitburn

3. Royal Bank of Scotland

A random sample of 150 (without duplicates) was taken from a population of 453. The sample started in column 1, line 801 using the last three digits and moving vertically down a column. The branches selected were as follows:

001	Armadale
04	George Place, Bathgate
06	Castlegate, Berwick-Upon-Tweed
10	Broxburn
11	Chirnside
13	63 High Street, Dalkeith
20	Castle Street, Edinburgh
23	Colinton, Edinburgh
27	Davidson's Mains, Edinburgh
33	Leven Street, Edinburgh
34	Lothian Road, Edinburgh
35	Murrayfield, Edinburgh
37	St Andrew Square, Edinburgh
39	Shandon Crescent, Edinburgh
41	Stockbridge, Edinburgh
50	Almondvale, Livingston
53	Bridge Street, Musselburgh
56	Newtongrange
57	North Berwick
62	Uphall
63	West Calder
65	Annan
71	Blackford, Edinburgh
75	Craigentinny, Edinburgh
82	Granton, Edinburgh
89	North Leith, Edinburgh
90	Mayfield, Edinburgh
91	Newhaven, Edinburgh
93	Nicolson Street, Edinburgh
96	Portobello, Central, Edinburgh

Royal Bank of Scotland (continued)

97	Portobello, East, Edinburgh
100	St James Centre, Edinburgh
101	Salisbury, Edinburgh
103	University, Edinburgh
104	Warrender Park, Edinburgh
109	Tower, Hawick
113	Langholm
117	New Cumnock
118	Newton Stewart
120	Peebles
123	Stow
126	Barrhead
127	Bishopbriggs
130	Dalmuir
139	Bridgeton, Glasgow
145	Cathcart, Glasgow
148	Charing Cross West, Glasgow
149	Crosshill, Glasgow
150	Dalmarnock Road, Glasgow
155	394 Dumbarton Road, Glasgow
157	Fruit Market, Glasgow
161	Gordon Street Office, Glasgow
165	1558 Great Western Road, Glasgow
168	Hyndland, Glasgow
172	Mount Florida, Glasgow
177	Renfield Street, Glasgow
178	Riddrie, Glasgow
180	272 Stonelaw Road, Rutherglen
183	36 St Enoch Square, Glasgow
184	St Rollox, Glasgow
185	140 St Vincent Street, Glasgow
189	Stobcross, Glasgow
191	West George Street, Glasgow
196	Netherlee
198	Broomlands, Paisley
201	The Cross, Paisley
202	Well Street, Paisley
205	Bond Street, London
206	Kingsway, London
207	Knightsbridge, London
210	Piccadilly Circus, London
212	Victoria, London
213	Western, London
214	Bridge of Don, Aberdeen
218	Queen's Cross, Aberdeen
220	Southern, Aberdeen
223	Alyth
224	Brothock Bridge, Arbroath
226	Banchory
229	Carnoustie
234	High Street, Dundee
236	Kingsway Circus, Dundee
238	Murraygate, Dundee
239	Overgate, Dundee

Royal Bank of Scotland (continued)

241	Reform Street, Dundee
242	Stobswell, Dundee
246	Kirriemuir
249	Monifeith
252	Bridgend, Perth
253	High Street, Perth
254	Methven Street, Perth
255	South Street, Perth
259	Portlethen
261	Westhill
262	Alford
264	Banff
265	Beauly
267	Castlebay
270	Dingwall
277	Grantown-on-Spey
278	Huntly
281	Academy Street, Inverness
283	West End, Inverness
287	Kirkwall
291	Lochinver
293	Lybster
295	Maud
301	Peterhead
307	Thurso
311	Wick
312	Aberdour
316	Anstruther
322	Buckhaven
337	Denny
339	Dumbarton
340	Dunblane
348	Glenrothes
357	Kelty
363	116 Cowgate, Kirkintilloch
366	Leslie
369	Lundin Links
373	Milnathort
376	South Street, St Andrews
377	Stenhousemuir
379	Murray Place, Stirling
383	Bank Street, Airdrie
387	Beresford Terrace, Ayr
390	58 High Street, Biggar
391	104 High Street, Biggar
393	Brodick
394	Carluke
397	Cleland
398	Main Street, Coatbridge
399	Whifflet, Coatbridge
400	Cumnock
408	Westwood, East Kilbride
409	Forth
410	Girvan
415	50 Cadzow Street, Hamilton

Royal Bank of Scotland (continued)

418	Irvine
421	John Finnie Street, Kilmarnock
423	Riccarton, Kilmarnock
430	Lochwinnoch
431	Mauchline
432	Maybole
435	Newarthill
442	Dykehead, Shotts
446	Stonehouse
449	Tighnabruaich
451	West Kilbride

APPENDIX C

COPY OF RESULTS FOR RESPONDENTS

Questionnaire Survey

The primary objective of this questionnaire survey was to determine what Scottish bankers think about management auditing. Bankers were selected as the group to be surveyed because at present they use financial statements in their lending decisions and are therefore familiar with the financial audit report. The three Scottish joint stock banks (the Bank of Scotland, the Clydesdale and the Royal Bank of Scotland) were approached and all agreed to participate in this research project. All three banks supplied a full list of branch managers and a random sample was taken for each bank. Table 1 summarises the number of bankers surveyed.

TABLE 1

	Number of bankers surveyed			
	Total	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland
Head office staff surveyed	66	21	15	30
Branch managers surveyed	400	150	100	150
Total number surveyed	466	171	115	180

The questionnaire with my covering letter and with the letter from the bank was posted during 1983 to all 466 participants in this survey. At the request of the banks, because this was to be a two stage project with a simulated lending decision exercise after this questionnaire, a follow-up letter was not sent for this questionnaire. The number of responses and the percentage response rates are given in Table 2.

TABLE 2

	Number of respondents and response rates			
	Total	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland
Number of head office respondents	37	13	10	14
Number of branch manager respondents	258*	95	71	92
Total number of respondents	295*	108	81	106
% total response	63%	63%	70%	59%

*4 responses were blank with a coveringletter.

Given the response rate of recent postal surveys in Great Britain (such as Santocki with 10.3%), the nature of the topic being researched and the fact of no follow-up letter, an overall response rate of 63% was extremely encouraging. Furthermore, from the number of detailed comments on the returned questionnaires it was apparent that many respondents had spent a considerable amount of time on completing the questionnaire. One hundred and three respondents (35% of all respondents) also indicated a continuing interest in this project by requesting a copy of the results of the survey.

Summary of background factors

In summary a 'typical' respondent to this questionnaire was between 40 and 49 years old, male, employed by a bank for at least 20 years, a user of financial information for between 10 and 19 years, an Associate of the Institute of Bankers and experienced in either the commerical or industrial banking fields with limited liability companies as customers.

Conclusions

The main findings of this survey are:

1. Given previous research findings on the use of the financial audit report, the support for it from the responding bankers in this survey was surprising. For example, 93% of respondents claim to always read the financial audit report, approximately 80% replied that they have used the financial audit report as part of the data on which they have based their lending decisions to both small and large companies and 80% also find the audit report useful in helping them to make their lending decisions about both small and large limited liability companies.

2. Despite this support for the existing financial audit report, over 50% of respondents still consider that it could contain more information for both small and large companies.

3. 89% of respondents always assess the management when making lending decisions about small companies but only 69% do this for large companies.

4. Over 50% of respondents always use the annual financial statements, practical experience of management, personal knowledge of management and financial audit report when assessing the managements of both small and large companies.

5. Less than 10% of respondents consider that they always have sufficient information to assess the managements of either small or large companies.

6. Over 95% of respondents would always or sometimes use the management audit report as part of the information on which they would assess the management of both small and large companies. Furthermore, over 85% of respondents agree that they would find a management audit report useful in relation to their lending decisions about small and large companies.

7. Comparing the answers to questions from the two parts of the questionnaire, over 75% of respondents consider that both the financial and management audit reports would be useful in relation to their lending decisions about both small and large companies.

8. Less than 70% of respondents support the management audit being required by the banks; whereas approximately 90% of respondents consider that it should be paid for by the company and, again in contrast, approximately 50% of the respondents favour an annual management audit.

9. Over 80% of respondents wish assessments of the following reported in a management audit report:

(a) efficiency and effectiveness of management in achievement of company objectives;

(b) budgetary control system;

(c) company objectives;

(d) performance of the management of the finance, accounting, marketing and production functions.

10. The respondents consider that the management and financial audit reports would be <u>equally</u> useful in helping them to make their lending decisions about companies.

The results of this questionnaire survey indicate support for both the financial and management audit reports from the responding bankers. The answers indicate that it is certainly <u>not</u> a question of replacing the financial audit with a management audit. However, despite the fact that bankers have experience of using financial audit reports but not management audit reports, as much support exists for the management audit as for the financial audit. The findings of this survey therefore suggested that it would be worthwhile to continue with the second stage of this project which was a simulated lending decision exercise to try to determine whether or not the addition of a management audit report might affect bankers' lending decisions.

APPENDIX D

77 individual and 38 comparative questions

As discussed in Chapter 6, excluding the background variables, 77 individual questions and 38 comparative questions (for small and large companies) can be identified in the first stage questionnaire. In the following list, the first number is for the individual question and the second number in brackets denotes the comparative question.

1.(-) Do you read the financial audit report on the financial statements of your customer companies?

2.(1) Have you used the financial audit report as part of the data on which you have based any of your lending decisions to SMALL limited liability companies?

3.(1) Have you used the financial audit report as part of the data on which you have based any of your lending decisions to LARGE limited liability companies?

4.(2) In general, you find the financial audit report useful in helping you to make your lending decisions about SMALL limited liability companies.

5.(2) In general, you find the financial audit report useful in helping you to make your lending decisions about LARGE limited liability companies.

6.(3) Do you consider that the financial audit report could contain more information for SMALL limited liability companies?

7.(3) Do you consider that the financial audit report could contain more information for LARGE limited liability companies?

8.(4) Do you assess management when making your lending decisions about SMALL limited liability companies?

9.(4) Do you assess management when making your lending decisions about LARGE limited liability companies?

10.(5) For SMALL limited liability companies do you use the annual financial statements in assessing management?

11.(5) For LARGE limited liability companies do you use the annual financial statements in assessing management?

12.(6) For SMALL limited liability companies do you use the financial audit report in assessing management?

13.(6) For LARGE limited liability companies do you use the financial audit report in assessing management?

14.(7) For SMALL limited liability companies do you use the qualifications of management in assessing management?

15.(7) For LARGE limited liability companies do you use the qualifications of management in assessing management?

16.(8) For SMALL limited liability companies do you use the practical experience of management in assessing management?

17.(8) For LARGE limited liability companies do you use the practical experience of management in assessing management?

18.(9) For SMALL limited liability companies do you use your own personal knowledge of management in assessing management?

19.(9) For LARGE limited liability companies do you use your own personal knowledge of management in assessing management?

20.(10) For SMALL limited liability companies do you use any other information in assessing management?

21.(10) For LARGE limited liability companies do you use any other information in assessing management?

22.(11) Do you consider that sufficient information is available to you at present to make an adequate assessment of management for SMALL limited liability companies?

23.(11) Do you consider that sufficient information is available to you at present to make an adequate assessment of management for LARGE limited liability companies?

24.(12) Would you use a management audit report as part of the information on which you would assess the management of SMALL limited liability companies?

25.(12) Would you use a management audit report as part of the information on which you would assess the management of LARGE limited liability companies?

26.(13) You would find a management audit report useful in relation to your lending decisions about SMALL limited liability companies.

27.(13) You would find a management audit report useful in relation to your lending decisions about LARGE limited liability companies.

28.(14) Do you consider that a management audit should be voluntary for SMALL limited liability companies?

29.(14) Do you consider that a management audit should be voluntary for LARGE limited liability companies?

30.(15) Do you consider that a management audit should be required by the professional accounting bodies for SMALL limited liability companies?

31.(15) Do you consider that a management audit should be required by the professional accounting bodies for LARGE limited liability companies?

32.(16) Do you consider that a management audit should be required by law for SMALL limited liability companies?

33.(16) Do you consider that a management audit should be required by law for LARGE limited liability companies?

34.(17) Do you consider that a management audit should be required by the banks for SMALL limited liability companies?

35.(17) Do you consider that a management audit should be required by the banks for LARGE limited liability companies?

36.(18) Do you consider that a management audit should be paid for by the company for SMALL limited liability companies?

37.(18) Do you consider that a management audit should be paid for by the company for LARGE limited liability companies?

38.(19) Do you consider that a management audit should be paid for by the government for SMALL limited liability companies?

39.(19) Do you consider that a management audit should be paid for by the government for LARGE limited liability companies?

40.(20) Do you consider that a management audit should be paid for by the users (eg. bankers) for SMALL limited liability companies?

41.(20) Do you consider that a management audit should be paid for by the users (eg. bankers) for LARGE limited liability companies?

42.(21) For SMALL limited liability companies how often do you think that a management audit should be conducted?

43.(21) For LARGE limited liability companies how often do you think that a management audit should be conducted?

44.(22) For SMALL limited liability companies would you like an assessment of company objectives specifically reported upon in a management audit report?

45.(22) For LARGE limited liability companies would you like an assessment of company objectives specifically reported upon in a management audit report?

46.(23) For SMALL limited liability companies would you like an assessment of the efficiency and effectiveness of management in achievement of company objectives specifically reported upon in a management audit report?

47.(23) For LARGE limited liability companies would you like an assessment of the efficiency and effectiveness of management in achievement of company objectives specifically reported upon in a management audit report?

48.(24) For SMALL limited liability companies would you like an assessment of the organisational structure specifically reported upon in a management audit report?

49.(24) For LARGE limited liability companies would you like an assessment of the organisational structure specifically reported upon in a management audit report?

50.(25) For SMALL limited liability companies would you like an assessment of the budgetary control system specifically reported upon in a management audit report?

51.(25) For LARGE limited liability companies would you like an assessment of the budgetary control system specifically reported upon in a management audit report?

52.(26) For SMALL limited liability companies would you like an assessment of the management information system specifically reported upon in a management audit report?

53.(26) For LARGE limited liability companies would you like an assessment of the management information system specifically reported upon in a management audit report?

54.(27) For SMALL limited liability companies would you like an assessment of any other item specifically reported upon in a management audit report?

55.(27) For LARGE limited liability companies would you like an assessment of any other item specifically reported upon in a management audit report?

56.(28) For SMALL limited liability companies would you like an assessment of the performance of the management of the finance function specifically reported upon in a management audit report?

57.(28) For LARGE limited liability companies would you like an assessment of the performance of the management of the finance function specifically reported upon in a management audit report?

58.(29) For SMALL limited liability companies would you like an assessment of the performance of the management of the purchasing function specifically reported upon in a management audit report?

59.(29) For LARGE limited liability companies would you like an assessment of the performance of the management of the purchasing function specifically reported upon in a management audit report?

60.(30) For SMALL limited liability companies would you like an assessment of the performance of the management of the production function specifically reported upon in a management audit report?

61.(30) For LARGE limited liability companies would you like an assessment of the performance of the management of the production function specifically reported upon in a management audit report?

62.(31) For SMALL limited liability companies would you like an assessment of the performance of the management of the marketing function specifically reported upon in a management audit report?

63.(31) For LARGE limited liability companies would you like an assessment of the performance of the management of the marketing function specifically reported upon in a management audit report?

64.(32) For SMALL limited liability companies would you like an assessment of the performance of the management of the personnel function specifically reported upon in a management audit report?

65.(32) For LARGE limited liability companies would you like an assessment of the performance of the management of the personnel function specifically reported upon in a management audit report?

66.(33) For SMALL limited liability companies would you like an assessment of the performance of the management of the training function specifically reported upon in a management audit report?

67.(33) For LARGE limited liability companies would you like an assessment of the performance of the management of the training function specifically reported upon in a management audit report?

68.(34) For SMALL limited liability companies would you like an assessment of the performance of the management of the accounting function specifically reported upon in a management audit report?

69.(34) For LARGE limited liability companies would you like an assessment of the performance of the management of the accounting function specifically reported upon in a management audit report?

70.(35) For SMALL limited liability companies would you like an assessment of the performance of the management of the computing function specifically reported upon in a management audit report?

71.(35) For LARGE limited liability companies would you like an assessment of the performance of the management of the computing function specifically reported upon in a management audit report?

72.(36) For SMALL limited liability companies would you like an assessment of the performance of the management of the research and development function specifically reported upon in a management audit report?

73.(36) For LARGE limited liability companies would you like an assessment of the performance of the management of the research and development function specifically reported upon in a management audit report?

74.(37) For SMALL limited liability companies would you like an assessment of the performance of the management of any other function specifically reported upon in a management audit report?

75.(37) For LARGE limited liability companies would you like an assessment of the performance of the management of any other function specifically reported upon in a management audit report?

76.(38) Do you consider that the management audit report would be more useful than the financial audit report in helping you to make your lending decisions about SMALL limited liability companies?

77.(38) Do you consider that the management audit report would be more useful than the financial audit report in helping you to make your lending decisions about LARGE limited liability companies?

APPENDIX E

Answers to questionnaire by background variables

As discussed in Chapter 6, a test was carried out to check whether any answers to the questionnaire might be related to background variables. The following are those of the 924 cross-tabulations (between the answers to the questionnaire and the individual background variables listed in Chapter 6) with chi-squares significant at the 5% level and meeting the two chi-square rules of thumb of Yeomans.[5]

Cross-tabulations of 'row' by age (< 50 or ≥ 50 years) significant at 5% level

Row	n	χ^2	df	p
1. Use qualifications of management in assessing management for small companies	278	7.02	2	.03
2. Consider that sufficient information is available to bankers at present to make an adequate assessment of management for small companies	278	6.45	2	.04
3. Would like assessment of performance of management of accounting function specifically reported in a management audit report for small companies	261	8.82	2	.01
4. Would like assessment of performance of management of computing function specifically reported in a management audit report for small companies	241	7.99	2	.02
5. Would like assessment of performance of management of research and development function specifically reported in a management audit report for small companies	249	12.78	2	.00

(Note: As in the tables in the main text χ^2 is corrected χ^2 where necessary)

Notes on background variable of age (< 50 or ≥ 50 years):

1. 48% of respondents 50 years old and over compared to only 33% of those under 50 use the qualifications of management in assessing the management of small companies.

2. 14% of respondents 50 years old and over compared to 5% of those under 50 consider that sufficient information is always available to bankers at present to make an adequate assessment of the management of small companies.

3. 78% of respondents 50 years old and over compared to 90% of those under 50 would like an assessment of the performance of the management of the accounting function in a management audit report for small companies.

4. 25% of respondents 50 years old and over compared to 43% of those under 50 would like an assessment of the performance of the management of the computing function in a management audit report for small companies.

5. 41% of respondents 50 years old and over compared to 65% of those under 50 would like an assessment of the performance of the management of the research and development function in a management audit report for small companies.

Cross-tabulations of 'row' by number of years employed by a bank (< 30 or ≥ 30 years) significant at 5% level

Row	n	χ^2	df	p
6. Consider that sufficient information is available to bankers at present to make an adequate assessment of management for small companies	277	11.15	2	.00

Notes on background variable of number of years employed by a bank (< 30 or ≥ 30 years):

6. 13% of respondents employed by a bank for 30 or more years compared to 4% of those employed by a bank for under 30 years consider that sufficient information is always available to bankers at present to make an adequate assessment of management of small companies.

Cross-tabulations of 'row' by number of years using financial information (< 10 or $\geq$ 10 years) significant at 5% level

Row	n	χ^2	df	p
7. Have used the financial audit report as part of the data on which based a lending decision for large companies	224	4.27	1	.04
8. Consider that the financial audit report could contain more information for small companies	272	6.83	2	.03
9. Use own personal knowledge of management in assessing management for large companies	206	6.99	2	.03
10. Consider that sufficient information is available to bankers at present to make an adequate assessment of management for small companies	277	7.72	2	.02

Notes on background variable of number of years using financial information (< 10 or $\geq$ 10 years):

7. 86% of respondents using financial information for 10 or more years compared to 70% of those using financial information for under 10 years have used the financial audit report as part of the data on which they have based a lending decision for large companies.

8. 74% of respondents using financial information for 10 or more years compared to 56% of those using financial information for under 10 years consider that the financial audit report could contain more information for small companies.

9. 71% of respondents using financial information for 10 or more years compared to 52% of those using financial information for under 10 years use their own personal knowledge of management in assessing the management of large companies.

10. 2% of respondents using financial information for 10 or more years compared to 14% of those using financial information for under 10 years consider that sufficient information is <u>never</u> available to bankers at present to make an adequate assessment of management for small companies.

Cross-tabulations of 'row' by qualifications (paper qualification or none given) significant at 5% level

Row	n	χ^2	df	p
11. Consider that financial audit report could contain more information				
(a) for small companies	286	11.68	2	.00
(b) for large companies	241	7.85	2	.02
12. Use qualifications of management in assessing management for large companies	219	7.60	2	.02
13. Would like assessment of company objectives specifically reported in a management audit report				
(a) for small companies	264	14.30	2	.00
(b) for large companies	230	11.17	2	.00
14. Would like assessment of organisational structure specifically reported in a management audit report				
(a) for small companies	257	6.33	2	.04
(b) for large companies	226	8.01	2	.02
15. Would like assessment of performance of management of purchasing function specifically reported in a management audit report for large companies	222	16.51	2	.00
16. Would like assessment of performance of management of production function specifically reported in a management audit report for large companies	231	13.45	2	.00

Cross-tabulations of 'row' by qualifications (paper qualification or none given) significant at 5% level

Row	n	χ^2	df	p
17. Would like assessment of performance of management of accounting function specifically reported in a management audit report for small companies	273	6.05	2	.05
18. Would like assessment of performance of management of computing function specifically reported in a management audit report for small companies	253	6.94	2	.03
19. Would like assessment of performance of management of research and development function specifically reported in a management audit report				
(a) for small companies	260	6.97	2	.03
(b) for large companies	230	13.51	2	.00

Notes on background variable of qualifications (paper qualification or none given):

11.(a) 7% of respondents with qualifications compared to 21% of those without qualifications did not know whether or not the financial audit report could contain more information for small companies.

(b) 16% of respondents with qualifications compared to 31% of those without qualifications did not know whether or not the financial audit report could contain more information for large companies.

12. 69% of respondents with qualifications compared to 51% of those without qualifications sometimes use the qualifications of management in assessing the management of large companies. However, if we combine the 'always' and 'sometimes' answers, 94% of respondents with qualifications compared to 88% of those without

12. (continued)

qualifications either <u>always</u> or <u>sometimes</u> use the qualifications of management in assessing the management of large companies. By combining these two answers, the difference between respondents with qualifications and those without qualifications becomes less important.

13.(a) 88% of respondents with qualifications compared to 77% of those without qualifications would like an assessment of company objectives specifically reported upon in a management audit report for small companies.

(b) Similarly, 91% of respondents with qualifications compared to 79% of those without qualifications would like an assessment of company objectives in a management audit report for small companies.

14.(a) 64% of respondents with qualifications compared to 53% of those without qualifications would like an assessment of organisational structure specifically reported upon in a management audit report for small companies.

(b) Similarly, 76% of respondents with qualifications compared to 61% of those without qualifications would like an assessment of organisational structure in a management audit report for large companies.

15. 79% of respondents with qualifications compared to 57% of those without qualifications would like an assessment of the performance of the management of the purchasing function specifically reported upon in a management audit report for large companies.

16. 90% of respondents with qualifications compared to 72% of those without qualifications would like an assessment of the performance of the management of the production function specifically reported upon in a management audit report for large companies.

17. 87% of respondents with qualifications compared to 84% of those without qualifications would like an assessment of the performance of the management of the accounting function specifically reported upon in a management audit

17. (continued)

report for small companies. These percentages are very similar and indeed the main reason for this cross-tabulation giving a chi-square significant at the 5% level is the fact that 2% of respondents with qualifications compared to 8% of those without qualifications answered 'don't know' to this question.

18. 42% of respondents with qualifications compared to 27% of those without qualifications would like an assessment of the performance of the management of the computing function specifically reported upon in a management audit report for small companies.

19.(a) 62% of respondents with qualifications compared to 46% of those without qualifications would like an assessment of the performance of the management of the research and development function specifically reported upon in a management audit report for small companies.

(b) Similarly, 80% of respondents with qualifications compared to 61% of those without qualifications would like an assessment of the performance of the management of the research and development function in a management audit report for large companies.

Cross-tabulations of 'row' by banking experience significant at 5% level

Row	n	χ^2	df	p
Agricultural (Yes or not stated)				
20. Find financial audit report useful in helping bankers to make lending decisions about small companies	291	8.28	3	.04
21. Would you like assessment of company objectives specifically reported in a management audit report for large companies	230	9.75	2	.01

Cross-tabulations of 'row' by banking experience significant at 5% level

Row	n	χ^2	df	p
Commercial (Yes or not stated)				
22. Consider that the financial audit report could contain more information				
(a) for small companies	286	9.15	2	.01
(b) for large companies	241	11.47	2	.00
Fishing (Yes or not stated)				
23. Consider that sufficient information is available to bankers at present to make an adequate assessment of management for large companies.	233	8.71	2	.01
Industrial (Yes or not stated)				
24. Used financial audit report as part of data on which based lending decisions to				
(a) small companies	290	9.03	1	.00
(b) large companies	236	11.96	1	.00
25. Find financial audit report useful in helping bankers to make lending decisions about small companies	291	10.03	3	.02
26. Consider that the financial audit report could contain more information				
(a) for small companies	286	18.34	2	.00
(b) for large companies	241	33.69	2	.00
27. Assess management when making lending decisions about large companies	236	15.61	2	.00
28. Use qualifications of management in assessing management for large companies	219	8.20	2	.02

Cross-tabulations of 'row' by banking experience significant at 5% level

Row	n	χ^2	df	p
Industrial (continued)				
29. Use practical experience of management in assessing management for large companies	218	6.72	2	.03
30. Would like assessment of company objectives specifically reported in a management audit report for large companies	230	6.09	2	.05
31. Would like assessment of performance of accounting function specifically reported in a management audit report for small companies	273	6.90	2	.03

Notes on background variable of industrial banking experience (yes or not stated):

20. 83% of respondents with agricultural banking experience compared to 76% of those without such experience either strongly agree or agree that they find the financial audit report useful in helping them to make lending decisions about small companies.

21. 90% of respondents with agricultural banking experience compared to 79% of those without such experience would like an assessment of company objectives specifically reported upon in a management audit report for large companies.

22.(a) 62% of respondents with commercial banking experience compared to 41% of those without such experience consider that the financial audit report could contain more information for small companies.

22. (continued)

(b) Similarly, 54% of respondents with commercial banking experience compared to 26% of those without such experience consider that the financial audit report could contain more information for large companies.

23. 26% of respondents with fishing banking experience compared to 12% of those without such experience consider that sufficient information is <u>never</u> available to them at present to make an adequate assessment of management for large companies.

24.(a) 89% of respondents with industrial banking experience compared to 75% of those without such experience have used the financial audit report as part of the data on which they have based their lending decisions to small companies.

(b) Similarly, 81% of respondents with industrial banking experience compared to 58% of those without such experience have used the financial audit report as part of the data on which they have based their lending decisions to large companies.

25. 85% of respondents with industrial banking experience compared to 74% of those without such experience either <u>strongly agree</u> or <u>agree</u> that they find the financial audit report useful in helping them to make their lending decisions about small companies.

26.(a) 64% of respondents with industrial banking experience compared to 50% of those without such experience consider that the financial audit report could contain more information for small companies.

(b) Similarly, 59% of respondents with industrial banking experience compared to 33% of those without such experience consider that the financial audit report could contain more information for large companies.

27. 73% of respondents with industrial banking experience compared to 58% of those without such experience <u>always</u> assess management when making lending decisions about large companies.

28. 32% of respondents with industrial banking experience compared to 24% of those without such experience always use the qualifications of management in assessing the management of large companies.

29. 98% of respondents with industrial banking experience compared to 89% of those without such experience either always or sometimes use the practical experience of management in assessing the management of large companies.

30. 90% of respondents with industrial banking experience compared to 78% of those without such experience would like an assessment of company objectives specifically reported upon in a management audit report for large companies.

31. 11% of respondents with industrial banking experience compared to 6% of those without such experience would not like an assessment of the accounting function specifically reported upon in a management audit report for small companies.

Cross-tabulations of 'row' by large companies as customers (yes or no) significant at 5% level

Row	n	χ^2	df	p
32. Have used the financial audit report as part of the data on which based a lending decision for large companies	236	11.93	1	.00
33. Consider that the financial audit report could contain more information for large companies	241	24.62	2	.00
34. Consider that sufficient information is available to bankers at present to make an adequate assessment of management for large companies	233	8.25	2	.02

Notes on background variable of large companies as customers (yes or no):

32. 81% of respondents with large companies as customers compared to 59% of those without large companies as customers have used the financial audit report as part of the data on which they have based lending decisions to large companies. This result has two possible interpretations. A first interpretation is that the 45 respondents with no large companies as customers - and who claimed to have used the financial audit report of large companies in their lending decisions - may have given the same answer for large companies as for small companies. A second interpretation is that some or even all of these 45 respondents may have had large companies as customers in the past (for example at another branch) and may indeed have used the financial audit report of large companies in their lending decisions.

33. 12% of respondents with large companies as customers compared to 38% of those without large companies as customers do not know whether the financial audit report could contain more information for large companies.

34. 85% of respondents with large companies as customers compared to 72% of those without large companies as customers consider that sufficient information is <u>sometimes</u> available to bankers at present to make an adequate assessment of management for large companies.

APPENDIX F

Answers to questionnaire by bank

This Appendix gives the answers to each of the questions in the first stage questionnaire by each of the three banks and also for the three banks in total. The number of respondents with usable replies totalled 291 with 104 from the Bank of Scotland, 81 from the Clydesdalè Bank and 106 from the Royal Bank of Scotland. However, the number of respondents to each question are given in this Appendix.

1. Do you read the financial audit report on the financial statements of your customer companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
ALWAYS	96	87	93	93
SOMETIMES	4	12	7	7
NEVER	-	1	-	-

2(a) Have you used the financial audit report as part of the data on which you have based any of your lending decisions:

to SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(103)	(81)	(106)	(290)
	%	%	%	%
YES	90	79	83	85
NO	10	21	17	15

2(b) Have you used the financial audit report as part of the data on which you have based any of your lending decisions:

to LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(84)	(67)	(85)	(236)
	%	%	%	%
YES	81	69	72	74
NO	19	31	28	26

3. In general, you find the financial audit report useful in helping you to make your lending decisions about SMALL limited liability companies.

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
STRONGLY AGREE	18	12	14	15
AGREE	68	61	67	66
UNCERTAIN	8	16	11	11
DISAGREE	6	11	8	8
STRONGLY DISAGREE	-	-	-	-

4. In general, you find the financial audit report useful in helping you to make your lending decisions about LARGE limited liability companies.

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(86)	(67)	(85)	(238)
	%	%	%	%
STRONGLY AGREE	26	13	20	20
AGREE	58	52	59	57
UNCERTAIN	10	23	11	14
DISAGREE	6	12	10	9
STRONGLY DISAGREE	-	-	-	-

5(a) Do you consider that the financial audit report could contain more information:

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(100)	(80)	(106)	(286)
	%	%	%	%
YES	51	63	64	59
NO	39	25	23	29
DON'T KNOW	10	12	13	12

5(b) Do you consider that the financial audit report could contain more information

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(84)	(69)	(88)	(241)
	%	%	%	%
YES	42	52	58	51
NO	40	22	22	28
DON'T KNOW	18	26	20	21

6(a) Do you assess management when making your lending decisions about:

SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
ALWAYS	87	91	90	89
SOMETIMES	13	9	10	11
NEVER	-	-	-	-

6(b) Do you assess management when making your lending decisions about:

LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(85)	(66)	(85)	(236)
	%	%	%	%
ALWAYS	61	80	67	69
SOMETIMES	34	18	29	28
NEVER	5	2	4	3

7(a) Do you use any of the following information in assessing management:

ANNUAL FINANCIAL STATEMENTS

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(79)	(106)	(289)
	%	%	%	%
ALWAYS	80	66	79	76
SOMETIMES	17	32	18	21
NEVER	3	2	3	3

7(a) Do you use any of the following information in assessing management:

ANNUAL FINANCIAL STATEMENTS

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(76)	(60)	(83)	(219)
	%	%	%	%
ALWAYS	78	72	82	77
SOMETIMES	18	25	14	19
NEVER	4	3	4	4

7(b) Do you use any of the following information in assessing management:

FINANCIAL AUDIT REPORT

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(79)	(105)	(288)
	%	%	%	%
ALWAYS	71	39	66	61
SOMETIMES	26	51	30	34
NEVER	3	10	4	5

7(b) Do you use any of the following information in assessing management:

FINANCIAL AUDIT REPORT

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(76)	(60)	(82)	(218)
	%	%	%	%
ALWAYS	70	45	67	62
SOMETIMES	25	48	27	32
NEVER	5	7	6	6

7(c) Do you use any of the following information in assessing management:

QUALIFICATIONS OF MANAGEMENT

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(105)	(290)
	%	%	%	%
ALWAYS	26	52	38	38
SOMETIMES	67	46	58	58
NEVER	7	2	4	4

7(c) Do you use any of the following information in assessing management:

QUALIFICATIONS OF MANAGEMENT

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(76)	(61)	(82)	(219)
	%	%	%	%
ALWAYS	25	38	28	30
SOMETIMES	68	57	61	62
NEVER	7	5	11	8

7(d) Do you use any of the following information in assessing management:

PRACTICAL EXPERIENCE OF MANAGEMENT

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(104)	(289)
	%	%	%	%
ALWAYS	66	80	78	75
SOMETIMES	34	20	18	24
NEVER	-	-	4	1

7(d) Do you use any of the following information in assessing management:

PRACTICAL EXPERIENCE OF MANAGEMENT

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(76)	(61)	(81)	(218)
	%	%	%	%
ALWAYS	57	67	54	59
SOMETIMES	41	30	38	37
NEVER	2	3	8	4

7(e) Do you use any of the following information in assessing management:

YOUR OWN PERSONAL KNOWLEDGE OF MANAGEMENT

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(80)	(103)	(287)
	%	%	%	%
ALWAYS	74	80	75	76
SOMETIMES	25	20	24	23
NEVER	1	-	1	1

7(e) Do you use any of the following information in assessing management:

YOUR OWN PERSONAL KNOWLEDGE OF MANAGEMENT

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(76)	(60)	(80)	(216)
	%	%	%	%
ALWAYS	54	70	48	56
SOMETIMES	42	30	47	41
NEVER	4	-	5	3

7(f) Do you use any of the following information in assessing management:

ANY OTHER INFORMATION

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(38)	(23)	(40)	(101)
	%	%	%	%
ALWAYS	37	35	40	37
SOMETIMES	50	48	40	46
NEVER	13	17	20	17

7(f) Do you use any of the following information in assessing management:

ANY OTHER INFORMATION

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(28)	(16)	(28)	(72)
	%	%	%	%
ALWAYS	29	25	46	35
SOMETIMES	57	56	18	42
NEVER	14	19	36	23

8(a) Do you consider that sufficient information is available to you at present to make an adequate assessment of management for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
ALWAYS	11	6	8	9
SOMETIMES	79	84	75	79
NEVER	10	10	17	12

8(b) Do you consider that sufficient information is available to you at present to make an adequate assessment of management for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(85)	(63)	(85)	(233)
	%	%	%	%
ALWAYS	7	5	2	5
SOMETIMES	81	82	79	81
NEVER	12	13	19	14

9(a) Would you use a management audit report as part of the information on which you would assess the management of

SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(103)	(81)	(105)	(289)
	%	%	%	%
ALWAYS	58	58	72	63
SOMETIMES	40	41	28	36
NEVER	2	1	-	1

9(b) Would you use a management audit report as part of the information on which you would assess the management of

LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(89)	(72)	(90)	(251)
	%	%	%	%
ALWAYS	56	60	69	62
SOMETIMES	43	37	30	37
NEVER	1	3	1	1

10. You would find a management audit report useful in relation to your lending decisions about SMALL limited liability companies

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(103)	(81)	(105)	(289)
	%	%	%	%
STRONGLY AGREE	16	21	23	20
AGREE	71	69	64	68
UNCERTAIN	12	10	12	11
DISAGREE	1	-	1	1
STRONGLY DISAGREE	-	-	-	

11. You would find a management audit report useful in relation to your lending decisions about LARGE limited liability companies

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(90)	(72)	(92)	(254)
	%	%	%	%
STRONGLY AGREE	16	22	22	20
AGREE	68	67	65	66
UNCERTAIN	15	10	12	13
DISAGREE	1	1	1	1
STRONGLY DISAGREE	-	-	-	-

12(a) Do you consider that a management audit should be

VOLUNTARY

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(89)	(67)	(79)	(235)
	%	%	%	%
YES	65	46	48	54
NO	29	40	47	38
DON'T KNOW	6	14	5	8

12(a) Do you consider that a management audit should be

VOLUNTARY

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(68)	(58)	(63)	(189)
	%	%	%	%
YES	51	34	29	39
NO	46	52	65	54
DON'T KNOW	3	14	6	7

12(a) Do you consider that a management audit should be REQUIRED BY THE PROFESSIONAL ACCOUNTING BODIES for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(76)	(63)	(77)	(216)
	%	%	%	%
YES	43	60	57	53
NO	45	22	30	33
DON'T KNOW	12	18	13	14

12(a) Do you consider that a management audit should be

REQUIRED BY THE PROFESSIONAL ACCOUNTING BODIES

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(66)	(57)	(65)	(188)
	%	%	%	%
YES	49	60	75	61
NO	42	17	17	26
DON'T KNOW	9	23	8	13

12(a) Do you consider that a management audit should be

REQUIRED BY LAW

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(84)	(71)	(86)	(241)
	%	%	%	%
YES	33	39	52	42
NO	54	45	42	47
DON'T KNOW	13	16	6	11

12(a) Do you consider that a management audit should be

REQUIRED BY LAW

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(76)	(66)	(80)	(222)
	%	%	%	%
YES	50	55	70	59
NO	42	27	23	30
DON'T KNOW	8	18	7	11

12(a) Do you consider that a management audit should be

REQUIRED BY THE BANKS

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(81)	(67)	(78)	(226)
	%	%	%	%
YES	53	73	67	64
NO	38	21	28	30
DON'T KNOW	9	6	5	6

12(a) Do you consider that a management audit should be

REQUIRED BY THE BANKS

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(66)	(59)	(64)	(189)
	%	%	%	%
YES	56	78	75	69
NO	35	15	20	24
DON'T KNOW	9	7	5	7

12(b) Do you consider that a management audit should be

PAID FOR BY THE COMPANY

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(95)	(80)	(98)	(273)
	%	%	%	%
YES	87	84	89	87
NO	8	10	9	9
DON'T KNOW	5	6	2	4

12(b) Do you consider that a management audit should be

PAID FOR BY THE COMPANY

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(83)	(70)	(83)	(236)
	%	%	%	%
YES	89	87	95	91
NO	7	6	4	5
DON'T KNOW	4	7	1	4

12(b) Do you consider that a management audit should be

PAID FOR BY THE GOVERNMENT

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(71)	(55)	(69)	(195)
	%	%	%	%
YES	10	11	15	12
NO	84	84	84	84
DON'T KNOW	6	5	1	4

12(b) Do you consider that a management audit should be

PAID FOR BY THE GOVERNMENT

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(56)	(50)	(59)	(165)
	%	%	%	%
YES	13	8	13	12
NO	82	80	85	82
DON'T KNOW	5	12	2	6

12(b) Do you consider that a management audit should be

PAID FOR BY THE USERS (eg BANKERS)

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(75)	(56)	(69)	(200)
	%	%	%	%
YES	9	2	6	6
NO	83	95	90	89
DON'T KNOW	8	3	4	5

12(b) Do you consider that a management audit should be

PAID FOR BY THE USERS (eg BANKERS)

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(61)	(50)	(58)	(169)
	%	%	%	%
YES	10	4	9	8
NO	82	90	88	86
DON'T KNOW	8	6	3	6

13. For SMALL limited liability companies how often do you think that a management audit should be conducted?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(102)	(80)	(104)	(286)
	%	%	%	%
NOT AT ALL	3	2	2	2
ANNUALLY	34	49	52	45
EVERY 2 YEARS	30	31	26	29
AD HOC	24	6	12	15
OTHER	6	8	8	7
DON'T KNOW	3	4	-	2

14. For LARGE limited liability companies how often do you think that a management audit should be conducted?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(96)	(74)	(89)	(259)
	%	%	%	%
NOT AT ALL	4	1	-	2
ANNUALLY	49	60	61	56
EVERY 2 YEARS	20	23	26	23
AD HOC	18	5	3	9
OTHER	5	3	8	5
DON'T KNOW	4	8	2	5

15. Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of COMPANY OBJECTIVES

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(91)	(74)	(99)	(264)
	%	%	%	%
YES	84	81	87	84
NO	11	8	11	10
DON'T KNOW	5	11	2	6

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of COMPANY OBJECTIVES

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(78)	(68)	(84)	(230)
	%	%	%	%
YES	87	84	88	86
NO	9	6	8	8
DON'T KNOW	4	10	4	6

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of EFFICIENCY AND EFFECTIVENESS OF MANAGEMENT IN ACHIEVEMENT OF COMPANY OBJECTIVES

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(98)	(76)	(104)	(278)
	%	%	%	%
YES	87	94	92	90
NO	6	1	6	5
DON'T KNOW	7	5	2	5

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of EFFICIENCY AND EFFECTIVENESS OF MANAGEMENT IN ACHIEVEMENT OF COMPANY OBJECTIVES

FOR LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(82)	(69)	(84)	(235)
	%	%	%	%
YES	92	94	95	94
NO	2	6	1	1
DON'T KNOW	6	-	4	5

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of ORGANISATIONAL STRUCTURE

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(90)	(72)	(95)	(257)
	%	%	%	%
YES	67	58	55	60
NO	21	24	28	24
DON'T KNOW	12	18	17	16

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of ORGANISATIONAL STRUCTURE

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(77)	(66)	(83)	(226)
	%	%	%	%
YES	80	68	64	71
NO	8	12	19	13
DON'T KNOW	12	20	17	16

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of BUDGETARY CONTROL SYSTEM

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(99)	(79)	(103)	(281)
	%	%	%	%
YES	90	89	85	88
NO	5	6	12	8
DON'T KNOW	5	5	3	4

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of BUDGETARY CONTROL SYSTEM

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(82)	(72)	(85)	(239)
	%	%	%	%
YES	92	85	91	89
NO	2	7	6	5
DON'T KNOW	6	8	3	6

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of MANAGEMENT INFORMATION SYSTEM

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(93)	(74)	(99)	(266)
	%	%	%	%
YES	76	65	63	68
NO	14	18	22	18
DON'T KNOW	10	17	15	14

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of MANAGEMENT INFORMATION SYSTEM

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(78)	(68)	(84)	(230)
	%	%	%	%
YES	83	72	75	77
NO	7	13	13	11
DON'T KNOW	10	15	12	12

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of OTHER

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(14)	(9)	(21)	(44)
	%	%	%	%
YES	36	-	28	25
NO	14	11	29	20
DON'T KNOW	50	89	43	55

15(a) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of OTHER

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(16)	(9)	(18)	(43)
	%	%	%	%
YES	50	11	28	33
NO	12	11	33	21
DON'T KNOW	38	78	39	46

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of FINANCE function

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(100)	(79)	(104)	(283)
	%	%	%	%
YES	94	98	93	95
NO	4	1	4	3
DON'T KNOW	2	1	3	2

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of FINANCE function

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(85)	(69)	(86)	(240)
	%	%	%	%
YES	93	97	96	95
NO	3	-	2	2
DON'T KNOW	4	3	2	3

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of PURCHASING function

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(89)	(73)	(98)	(260)
	%	%	%	%
YES	69	62	67	66
NO	20	20	20	20
DON'T KNOW	11	18	13	14

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of PURCHASING function

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(77)	(64)	(81)	(222)
	%	%	%	%
YES	74	61	78	72
NO	14	19	11	14
DON'T KNOW	12	20	11	14

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of PRODUCTION function

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(95)	(75)	(100)	(270)
	%	%	%	%
YES	84	76	81	81
NO	11	11	12	11
DON'T KNOW	5	13	7	8

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of PRODUCTION function

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(82)	(66)	(83)	(231)
	%	%	%	%
YES	86	77	87	84
NO	7	8	7	7
DON'T KNOW	7	15	6	9

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of MARKETING function

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(96)	(76)	(100)	(272)
	%	%	%	%
YES	87	78	91	86
NO	8	12	6	8
DON'T KNOW	5	10	3	6

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of MARKETING function

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(82)	(68)	(83)	(233)
	%	%	%	%
YES	88	77	94	87
NO	6	10	4	6
DON'T KNOW	6	13	2	7

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of PERSONNEL function for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(88)	(75)	(94)	(257)
	%	%	%	%
YES	36	44	39	40
NO	41	45	48	45
DON'T KNOW	23	11	13	15

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of PERSONNEL function for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(76)	(67)	(82)	(225)
	%	%	%	%
YES	46	48	51	49
NO	37	39	34	36
DON'T KNOW	17	13	15	15

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of management of TRAINING function

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(89)	(74)	(94)	(257)
	%	%	%	%
YES	34	32	35	34
NO	47	52	50	49
DON'T KNOW	19	16	15	17

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of TRAINING function

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(77)	(66)	(82)	(225)
	%	%	%	%
YES	49	39	44	44
NO	35	41	40	39
DON'T KNOW	16	20	16	17

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of ACCOUNTING function

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(96)	(76)	(101)	(273)
	%	%	%	%
YES	80	93	86	86
NO	13	3	12	10
DON'T KNOW	7	4	2	4

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of ACCOUNTING function

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(80)	(68)	(85)	(233)
	%	%	%	%
YES	81	94	88	88
NO	10	2	10	7
DON'T KNOW	9	4	2	5

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of COMPUTING function

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(87)	(72)	(94)	(253)
	%	%	%	%
YES	34	36	38	36
NO	37	42	36	38
DON'T KNOW	29	22	26	26

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of COMPUTING function

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(75)	(62)	(82)	(219)
	%	%	%	%
YES	50	50	55	52
NO	29	32	24	28
DON'T KNOW	21	18	21	20

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of RESEARCH AND DEVELOPMENT function

for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(93)	(72)	(95)	(260)
	%	%	%	%
YES	56	56	57	56
NO	24	26	27	26
DON'T KNOW	20	18	16	18

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of RESEARCH AND DEVELOPMENT function

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(82)	(66)	(82)	(230)
	%	%	%	%
YES	73	71	76	73
NO	9	14	11	11
DON'T KNOW	18	15	13	16

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report assessment of performance of OTHER functions for SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(13)	(9)	(17)	(39)
	%	%	%	%
YES	-	22	12	10
NO	31	11	41	31
DON'T KNOW	69	67	47	59

15(b) Which, if any, of the following areas would you like specifically reported upon in a management audit report

assessment of performance of OTHER functions

for LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(12)	(8)	(16)	(36)
	%	%	%	%
YES	8	37	19	19
NO	33	-	44	31
DON'T KNOW	59	63	37	50

16(a) Do you consider that the management audit report would be more useful than the financial audit report in helping you to make your lending decisions about:

SMALL limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(102)	(80)	(105)	(287)
	%	%	%	%
YES	19	31	23	24
LESS USEFUL	27	21	24	24
EQUALLY USEFUL	48	44	50	48
DON'T KNOW	6	4	3	4

16(b) Do you consider that the management audit report would be more useful than the financial audit report in helping you to make your lending decisions about:

LARGE limited liability companies?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(88)	(72)	(92)	(252)
	%	%	%	%
YES	16	33	21	23
LESS USEFUL	29	20	24	24
EQUALLY USEFUL	49	43	49	47
DON'T KNOW	6	4	6	6

Personal details:

AGE

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(99)	(76)	(103)	(278)
	%	%	%	%
UNDER 30	-	-	1	-
30 - 39	19	15	16	17
40 - 49	52	59	41	50
50 - 59	27	26	42	32
60 AND OVER	2	-	-	1

Personal details:

SEX

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(96)	(73)	(100)	(269)
	%	%	%	%
MALE	100	100	99	100
FEMALE	-	-	1	-

Personal details:

NUMBER OF YEARS EMPLOYED BY A BANK

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(99)	(76)	(102)	(277)
	%	%	%	%
UNDER 5	-	-	-	-
5 - 9	-	-	1	1
10 - 19	9	5	12	9
20 - 29	43	53	31	41
30 AND OVER	48	42	56	49

Personal details:

NUMBER OF YEARS USING FINANCIAL INFORMATION

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(99)	(75)	(103)	(277)
	%	%	%	%
UNDER 5	3	5	4	4
5 - 9	14	33	26	24
10 - 19	54	46	53	51
20 - 29	23	15	14	17
30 AND OVER	6	1	3	4

Personal details:

QUALIFICATIONS

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(75)	(44)	(70)	(189)
	%	%	%	%
A.I.B.	91	93	93	92
A.I.B. + OTHER	8	2	6	6
F.I.B.	1	5	1	2

Personal details:

Banking experience - AGRICULTURAL

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
YES	66	69	73	69
NO	34	31	27	31

Personal details:

Banking experience - COMMERCIAL

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
YES	91	86	87	88
NO	9	14	13	12

Personal details:

Banking experience - FISHING

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
YES	19	17	27	22
NO	81	83	73	78

Personal details:

Banking experience - INDUSTRIAL

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
YES	61	68	67	65
NO	39	32	33	35

Personal details:

Banking experience - PERSONAL

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
YES	94	93	96	95
NO	6	7	4	5

Personal details:

Banking experience - OTHER

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(104)	(81)	(106)	(291)
	%	%	%	%
YES	9	9	8	9
NO	91	91	92	91

Personal details:

SMALL limited liability companies as customers?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(95)	(78)	(103)	(276)
	%	%	%	%
YES	99	97	94	97
NO	1	3	6	3

Personal details:

LARGE limited liability companies as customers?

	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland	Total
(Number of respondents to this question)	(95)	(75)	(103)	(273)
	%	%	%	%
YES	72	56	52	60
NO	28	44	48	40

APPENDIX G

Reasons given in reply to question 16

The following are some of the reasons given in answer to the question:

> Do you consider that the management audit report would be more useful than the financial audit report in helping you to make your lending decisions about small and large companies?

(a) Management audit report MORE useful than financial audit report

'Would give a deeper insight into the capabilities of management.'

'A great many lending proposals are very dependent on the individuals concerned with management.'

'The audited accounts reflect the company's position at a given date, and this allows a degree of window-dressing. An assessment of management, on the other hand, would represent a review of the performance of those in charge of the company's fortunes over a period of time.'

'Principally because the financial audit report deals with the past and we as bankers should want to know what future the company has under the present management structure.'

'Because of the greater detail which would be available.'

'Benefit of outside and independent views of professional appraisers.'

'There should always be value in an independent assessment - if no more, it at least provides food for thought.'

'Anything that gives a more complete picture must be useful as one can only look forward with an intelligent guess based on all the facts available from the past and present.'

(b) Management audit report LESS useful than financial audit report

'Few auditors have the expertise or practical background to express opinions on the management of large companies.'

'I believe that the financial situation of the company must be the primary consideration, as this will to a degree reflect the ability of management.'

'In a small company the management is usually well known to their bankers.'

'It would have its place in the overall picture. It would never replace the financial audit.'

'I would consider the report only to be a useful addition to the traditional financial audit.'

'The financial audit report would, I consider, continue to be essential and whereas the management audit report may be less useful, I see it as being a welcome addition in providing more information which would enable a company's overall performance to be better assessed.'

'I find it difficult to envisage enough people with the background, expertise and time to be available to properly carry out management audits.'

'Some businesses succeed in spite of management rather than because of it.'

'Management personnel may change and as a result invalidate recent reports. Financial reports in themselves effectively pass judgment on management.'

'As a banker finance comes first with other information as a useful adjunct.'

(c) Management audit report EQUALLY as useful as financial audit report

'A management audit report would along with an up-to-date financial audit be most useful in providing a complete background for decision making.'

'I feel the two would be complementary.'

'The one should complement the other - not replace it.'

'In borderline cases a decision could be more easily reached if it was known who, and what type of people, were at the management level.'

'The management audit report would be equally useful in helping to make lending decisions because it would give information not available in the annual financial statements.'

'Management audit and financial audit combined would make a more useful tool than only one.'

'Management audit reports would give hitherto unavailable insight into aspects of companies which are not covered by statutory financial audits.'

'Viewed together they would give a better insight into the company and could be utilised to supplement personal knowledge and opinions and the published financial position.'

APPENDIX H

Comments given in reply to question 17

The following are some of the comments given in answer to the question:

> Please use the space below for any additional comments which you may wish to make on management auditing.

'Banks are sometimes accused of adopting harsh attitudes from a narrow base. A view from a different angle must add to our perception.'

'Spare industry and commerce from any future legislation. There is already far too much.'

'The idea of a management audit appeals to me strongly.'

'I am not convinced that it will not simply increase costs for little real benefit.'

'I have strong reservations regarding the necessity for or usefulness of a management audit. The quality of management can be assessed to some extent by track record and published data. Accounting data is prepared in accordance with standards broadly accepted by both the accounting profession and their clients. I think it would be very difficult to devise widely accepted standards for a management audit. It would be expensive and in my view would require to be so subjective that at the end of the day it would probably only serve to create uncertainty.'

'I foresee considerable problems in employing suitable auditors to carry out management audits which prove acceptable to the majority of financial accounts' users. This apart, any information which leads to a more comprehensive view of the management of a company must be welcome.'

'If management is to be more professional and competent in an increasingly competitive environment, then it should welcome a management audit report on the lines envisaged as a necessary constructive criticism of objectives and how these are being achieved.'

'This all hinges on the cost of the exercise.'

'The management audit report is only as good as those writing it.'

'A management audit report could give additional information which might help to indicate weaknesses and strengths of businesses and result in taking steps to resolve management problems before they turn into financial problems.'

'Excellent idea but much would depend on the adequacy of the auditor in giving assessment.'

'It would provide independent confirmation or otherwise of personal feelings about a company.'

'It could be of considerable benefit.'

'Provided that the proposed audit is presented in a well devised manner and is not too detailed, it should be possible to make an accurate and meaningful assessment.'

'I feel that the introduction of a management audit would be of little benefit to potential lenders in the vast majority of cases.'

'Management auditing is in principle a good idea and would provide some useful information but such a report should not become too involved and lengthy.'

APPENDIX I

Judgment sample of branch managers

The following branches were selected by top management officials of the three banks as all having managers with experience of this type of lending decision. The numbers indicate the information received by the branch manager:

1 = Financial audit report only
2 = 'Favourable' management audit report
3 = 'Adverse' management audit report

The branches are listed in the order given by the three banks.

1. Bank of Scotland

(a) Branches with managers who had received the first stage questionnaire:

1	Bridge of Don, Aberdeen
2	George Street, Aberdeen
3	Kittybrewster, Aberdeen
1	Market Street, Aberdeen
2	Mile End, Aberdeen
3	Queen's Cross, Aberdeen
1	West End, Aberdeen
2	Stirling Street, Airdrie
3	Killoch Place, Ayr
1	Bathgate
2	Birmingham Region
3	Bo'ness
1	Broxburn
2	Clarkston
3	Cupar
1	Dalkeith
2	Denny
3	Queensberry Square, Dumfries
1	Dunbar
2	Murraygate, Dundee
3	Panmure Street, Dundee
1	82 High Street, Dunfermline
2	Brunswick Place, Edinburgh
3	Head Office, Edinburgh
1	Drumsheugh, Edinburgh
2	Frederick Street, Edinburgh
3	George Street, Edinburgh
1	Morningside, Edinburgh
2	New Town, Edinburgh
3	North Morningside, Edinburgh
1	Polwarth, Edinburgh

Bank of Scotland (continued)

2 St Andrew Square, Edinburgh
3 Tollcross, Edinburgh
1 Waterloo Place, Edinburgh
2 West End, Edinburgh
3 Vicar Street, Falkirk
1 Forfar
2 Galashiels
3 Anniesland, Glasgow
1 Bothwell Street, Glasgow
2 Hyndland, Glasgow
3 Merrylee, Glasgow
1 Queen Street, Glasgow
2 West George Street, Glasgow
3 Grangemouth
1 Jedburgh
2 Bank Street, Kilmarnock
3 Kirkwall
1 Loanhead
2 London Chief Office
3 Oxford Street, London
1 Piccadilly Circus, London
2 Motherwell
3 George Street, Perth
1 Port Glasgow
2 Renfrew
3 2 King Street, Stirling
1 Wooler
2 High Street, Ayr
3 Glasgow Chief Office

(b) Branches with managers who did not receive the first stage questionnaire:

1 Castle Street, Aberdeen
2 Torry, Aberdeen
3 40 Union Street, Aberdeen
1 201 Union Street, Aberdeen
2 207 Union Street, Aberdeen
3 Alexandria
1 Annan
2 Arbroath
3 Sandgate, Ayr
1 Barrhead
2 Roman Road, Bearsden
3 Berwick-upon-Tweed
1 Bristol
2 Clydebank
3 Cumbernauld
1 Dumbarton
2 South Tay Street, Dundee
3 East Port, Dunfermline
1 East Kilbride
2 Chambers Street, Edinburgh

Bank of Scotland (continued)

3 Corstorphine, Edinburgh
1 Corstorphine West, Edinburgh
2 George IV Bridge, Edinburgh
3 Minto Street, Edinburgh
1 Palmerston Place, Edinburgh
2 Princes Street, Edinburgh
3 Queen Street, Edinburgh
1 Shandwick Place, Edinburgh
2 Sighthill, Edinburgh
3 Elgin
1 Forres
2 Fort William
3 Girvan
1 Bath Street, Glasgow
2 Cardonald, Glasgow
3 Charing Cross, Glasgow
1 George Square, Glasgow
2 Gordon Street, Glasgow
3 Hutchesontown, Glasgow
1 Ibrox, Glasgow
2 Sauchiehall Street, Glasgow
3 Waterloo Street, Glasgow
1 Glenrothes
2 Cathcart Street, Greenock
3 Cadzow Street, Hamilton
1 New Cross, Hamilton
2 High Street, Inverness
3 Irvine
1 114 High Street, Kirkcaldy
2 Kirkintilloch
3 Lerwick
1 Livingston
2 Haymarket, London
3 Manchester
1 The Cross, Paisley
2 St John Street, Perth
3 St Andrews
1 54 King Street, Stirling
2 The Cross, Uddingston
3 Carlisle

2. Clydesdale Bank

(a) Branches with managers who had received the first stage questionnaire:

1 Mile End
2 Tullos
3 Arbroath
1 Burns Statue Square
2 Burnbank
3 Coatbridge

Clydesdale Bank (continued)

1	Buccleuch Street
2	Dyce
3	Princes Street
1	Falkirk
2	Anderston
3	Bothwell Street
1	India Street
2	Moore Place
3	Parkhead
1	Partick
2	St Enoch Square
3	Sauchiehall Street
1	Scotland Street
2	Cathcart Square
3	Hamilton
1	Queensgate
2	Centre
3	Kirkcaldy

(b) Branches with managers who did <u>not</u> receive the first stage questionnaire:

1	81 High Street
2	Bridge of Don
3	Great Western Road
1	Harbour
2	Market
3	Queen's Cross
1	King Street
2	Rosemount
3	St Nicholas
1	Airdrie
2	Albert Square
3	West End
1	Buchanan Street
2	St Vincent Street
3	Elgin
1	Glenrothes
2	Gallowgate
3	Laurieston
1	St Rollox
2	Shettleston
3	The Foregate
1	Perth
2	South Methven Street
3	Wishaw

3. Royal Bank of Scotland

(a) Branches with managers who had received the first stage questionnaire:

1	Armadale
2	George Place, Bathgate
3	Castlegate, Berwick-upon-Tweed
1	Broxburn
2	63 High Street, Dalkeith
3	Castle Street, Edinburgh
1	St Andrew Square, Edinburgh
2	Almondvale, Livingston
3	Bridge Street, Musselburgh
1	Annan
2	Granton, Edinburgh
3	North Leith, Edinburgh
1	Nicolson Street, Edinburgh
2	Tower, Hawick
3	Langholm
1	Newton Stewart
2	Bridgeton, Glasgow
3	Fruit Market, Glasgow
1	Renfield Street, Glasgow
2	36 St Enoch Square, Glasgow
3	140 St Vincent Street, Glasgow
1	Stobcross, Glasgow
2	West George Street, Glasgow
3	Bond Street, London
1	Knightsbridge, London
2	Piccadilly Circus, London
3	Victoria, London
1	Western, London
2	Queen's Cross, Aberdeen
3	Southern, Aberdeen
1	Brothock Bridge, Arbroath
2	Carnoustie
3	High Street, Dundee
1	Reform Street, Dundee
2	High Street, Perth
3	South Street, Perth
1	Banff
2	Dingwall
3	Grantown-on-Spey
1	Kirkwall
2	Peterhead
3	Thurso
1	Wick
2	Aberdour
3	Anstruther
1	Dumbarton
2	Dunblane
3	116 Cowgate, Kirkintilloch
1	Stenhousemuir
2	Murray Place, Stirling
3	Bank Street, Airdrie

Royal Bank of Scotland (continued)

1 58 High Street, Biggar
2 Carluke
3 Main Street, Coatbridge
1 50 Cadzow Street, Hamilton
2 Irvine
3 John Finnie Street, Kilmarnock
1 Dykehead, Shotts
2 Stonehouse
3 West Kilbride

(b) Branches with managers who did not receive the first stage questionnaire:

1 Ayton
2 Earlston
3 Corstorphine West, Edinburgh
1 Gorgie, Edinburgh
2 West End, Edinburgh
3 Haddington
1 Tranent
2 Whitburn
3 Carlisle
1 Whitesands, Dumfries
2 Cannonmills, Edinburgh
3 Princes Street Mound, Edinburgh
1 Galashiels
2 Kelso
3 Lockerbie
1 Melrose
2 Stranraer
3 Clydebank
1 Argyle Street, Glasgow
2 Bath Street, Glasgow
3 Buchanan Street, Glasgow
1 Cambuslang, Glasgow
2 Central, Glasgow
3 Charing Cross, Glasgow
1 Goven Central, Glasgow
2 22 St Enoch Square, Glasgow
3 Johnstone
1 Renfrew
2 Lombard Street, London
3 Mayfair, London
1 Central, Aberdeen
2 Harbour, Aberdeen
3 St Nicholas, Aberdeen
1 Brechin
2 Coupar Angus
3 Kirriemuir
1 Montrose
2 Stonehaven
3 Fraserburgh
1 Keith

Royal Bank of Scotland (continued)

2	Lerwick
3	Argyll Square, Oban
1	Stornoway
2	Tain
3	Alloa
1	Campbeltown
2	North, Cowdenbeath
3	Town Centre, Cumbernauld
1	Crossgate, Cupar
2	Central, Dunfermline
3	High Street, Falkirk
1	Central, Kirkcaldy
2	High Street, Markinch
3	Pitt Terrace, Stirling
1	Sandgate, Ayr
2	Princes Square, East Kilbride
3	West Blackhall Street, Greenock
1	The Cross, Kilmarnock
2	Lanark
3	Main Street, Wishaw

APPENDIX J

Covering letter for second-stage
simulated overdraft decision

Head Office
P O Box 31
42 St Andrew Square
Edinburgh EH2 2YE

1 June 1983

THE ROYAL BANK
OF SCOTLAND LIMITED

Dear Sir

We have been approached by Mr John Innes, a Lecturer in the Department of Accounting and Business Method at Edinburgh University to assist him in connection with a project he is undertaking on the auditing of Management performance in Companies from the viewpoint of those people who use Companies' Audited Accounts.

We have studied Mr Innes's project and feel there is genuine merit in what he is doing. We, therefore, are happy for our Managers and other lending Officials to become involved and while you are under no obligation to participate, we hope you will be willing to assist.

You will observe that you will not be identified in any way unless you wish a copy of the final report.

Thank you in anticipation of your co-operation.

Yours sincerely

Norman J Lang
Assistant General Manager
Branch Department

APPENDIX K

COPY OF RESULTS FOR RESPONDENTS

Development of Simulated Overdraft Decision

The results of the questionnaire survey showed support from the responding bankers for the proposed external management audit report. This is strong evidence in favour of the external management audit. I therefore decided to attempt to determine whether or not the addition of an external management audit report might affect the lending decisions of bankers. A simulated overdraft decision was devised with the help of several bankers who agreed that the data given for AB Limited would make it a good (but not too good) proposition if it was requesting overdraft facilities of £350,000 for working capital purposes. The profit and loss account, balance sheet, funds statement, clean (ie normal) financial audit report and the various assumptions relating to AB Limited can be obtained from me if you do not have a copy already.

The bankers selected to receive this exercise were divided into 3 groups with one group receiving only the above information for AB Limited. However, a second group received the above information plus a 'favourable' management audit report and a third group received the above information plus an 'adverse' management audit report. Copies of these favourable and adverse management audit reports are attached.

The bankers receiving the favourable management audit report could act as a control group. For this group of bankers, if a similar percentage of bankers granted overdraft facilities compared to the group receiving the data with only the financial audit report, it could be argued that the addition of a management audit report by itself did not affect the bankers' decisions. However, if a smaller percentage of the group receiving the adverse management audit report granted overdraft facilities compared to the other two groups, then it could be concluded that the adverse management audit report had affected the bankers' decisions. The objective was to attempt to determine whether or not an adverse management audit report might affect bankers' lending decisions.

Results of Simulated Overdraft Decision

The simulated overdraft decision was posted during 1983 to the 354 participants in the survey with 118 participants receiving each of the three different types of information. The number of responses and the percentage response rates are given in Table 1.

TABLE 1

Number of respondents and response rates

	Total	Bank of Scotland	Clydesdale Bank	Royal Bank of Scotland
Number of head office respondents	30	11	7	12
Number of branch manager respondents	176*	72*	35	69
Total number of respondents	206*	83*	42	81
% response from head office staff	45%	52%	47%	40%
% response from branch managers	61%	60%	73%	58%
% total response	58%	59%	67%	54%

*1 decision sheet was blank with a covering letter.

The overall results of this simulated overdraft decision are given in Table 2.

TABLE 2

Overdraft decisions by type of information

	Number of respondents	Yes	No	Don't know
		%	%	%
Financial audit report only	63	70	17	13
Favourable management audit report	72	72	24	4
Adverse management audit report	70	54	37	9
	205			

As expected, although given exactly the same information bankers did make different overdraft decisions. For example, on the basis of the financial audit report only, 70% granted the overdraft and 30% did not. Even within the same bank, bankers did make different overdraft decisions although given exactly the same information. The reasons for such differences would be an interesting area of research but the objective of this particular exercise was to examine whether or not different audit reports might affect bankers' overdraft decisions. Little difference exists between the overdraft decisions with the financial audit report only and the addition of the favourable management audit report. On the basis of the financial audit report only, 30% of respondents answered no or don't know to this overdraft decision compared to 28% on the basis of the favourable management audit report. Given the fact that this simulated overdraft decision was devised in such a way that it was expected that most bankers would lend to this particular company, these two results imply that an additional piece of information by itself (ie a management audit report) has not greatly affected the responding bankers' decisions.

However, the main conclusion from Table 2 is that the adverse management audit report has affected the bankers' decisions. Instead of at least 70% of the responding bankers lending to this company given the financial audit report only or the favourable management audit report, only 54% of responding bankers would lend to this same company given the adverse management audit report. The adverse management audit report appears to make a difference to the lending decision of the bankers in this simulation exercise.

Reasons for Overdraft Decisions

In addition to asking the bankers to make this overdraft decision, the decision sheet also asked the bankers for the reasons for their decision. All 205 respondents gave at least one reason for their particular lending decision and most gave several reasons. An attempt has been made to classify such reasons into general categories although a degree of interpretation is involved.

As with the financial audit report only, the four main reasons given for granting the overdraft facility on the basis of the favourable management audit report are adequate shareholders' interest relative to the overdraft requested, experienced directors, reasonable profitability and adequate security. Of the 52 respondents who would grant overdraft facilities on the basis of the information with the favourable management audit report, a number expressed the two reservations of the need for a floating charge (19 respondents) and the question of the high dividends (15 respondents). Furthermore, of these 52 respondents replying, 37 emphasised the need to correct the weaknesses mentioned in the management audit report.

It is interesting that some bankers have interpreted 'a minor weakness' in the favourable management audit report as being more than minor. Indeed it is the most common reason expressed (by 13 out of 17 respondents) for not granting the overdraft facility on the basis of the favourable management audit report.

Of the 38 respondents who would grant overdraft facilities on the basis of the information with the adverse management audit report, 19 respondents desired a floating charge and 11 respondents mentioned the high level of dividends. However, all 38 respondents stated that, although they would grant the overdraft facility, the weaknesses outlined in the management audit report would be investigated. To be more specific, 14 of the 38 respondents who would grant overdraft facilities to AB Limited made it a condition of their lending that the weaknesses mentioned in the management audit report should be corrected. Furthermore, all of the remaining 24 respondents granting overdraft facilities stated that the contents of this management audit report would be discussed with the directors of AB Limited.

Of those 26 bankers refusing to grant overdraft facilities on the basis of the information with the adverse management audit report, all 26 mentioned the weaknesses outlined in the management audit report as being one reason for their decision. Similarly, all 6 of the bankers answering don't know also gave these weaknesses as being one of the reasons for their decision. In summary, the adverse management audit report appears to have an effect not only in influencing the decision outcome of those bankers refusing the overdraft facility but also in causing those bankers who would still grant this overdraft facility to take an extra precaution such as adding a condition to the overdraft or discussing the management audit report with the directors of the company.

AB Limited

MANAGEMENT AUDITORS' REPORT

for the year ended 31 December 1982

The following summarised report indicates that a generally satisfactory situation existed with AB Limited:

1. The corporate objectives of AB Limited are clearly stated and are being achieved efficiently and effectively by management.

2. The organisational structure of the company is satisfactory.

3. The general management information system provides adequate information on which management can base decisions.

4. The following minor weaknesses in the performance of the individual business functions were discovered:

   (a) Finance - Customers' cheques are sometimes held for one week before being banked.

   (b) Purchasing - Very few written competitive bids are obtained by the Purchasing Department.

   (c) Production - Time sheets, which are used as the basis for the bonus scheme, are not approved by the foremen.

   (d) Selling - Control over the issue of credit notes is inadequate.

MN
Management Auditors

24 January 1983

AB Limited

MANAGEMENT AUDITORS' REPORT
for the year ended 31 December 1982

A number of areas were found where potential cost savings and improvements in operational and financial controls could be implemented as summarised below:

1. The corporate objectives of AB Limited are not clearly stated and as a result disagreement exists within management on the most important objectives.

2. The organisational structure of the company requires review and amendment. For example, the lack of coordination between the Sales and Production Departments is detrimental to the proper running of the business.

3. No budgetary control system operates within the company and the general management information system is inadequate. For instance, with no slow-moving stock report, management cannot take corrective action on slow-moving finished goods.

4. The following major weaknesses in the performance of the individual business functions were discovered:

(a) Finance - Control over cheque payments is inadequate:

1) some invoices have been paid twice;

2) blank cheques have been signed;

3) with no independent review of the monthly bank reconciliation, errors have remained undetected.

(b) Purchasing - Central Purchasing and Plant Purchasing independently negotiate raw material contracts (in total worth over £1 million p.a.) with the same suppliers at different unit costs.

(c) Production - Use of an alternative raw material would produce important cost savings (approximately £100,000 p.a.) and would eliminate an existing supply problem.

(d) Selling - The credit terms given to customers, which are decided by the salesmen, are twice as generous as those offered by AB's competitors.

MN
Management Auditors
24 January 1983

APPENDIX L

Overdraft decisions -
Clydesdale Bank respondents

With the possibility, discussed in Chapter 6, of the overdraft decisions of the respondents from the Clydesdale Bank being different from the decisions of the respondents from the Bank of Scotland and the Royal Bank of Scotland, further analysis was carried out in relation to the following null hypotheses H_o11a, H_o11b and H_o11c:

H_o11 Bankers' overdraft decisions

(a) On the basis of the financial audit report only

(b) On the basis of the favourable management audit report

(c) On the basis of the adverse management audit report

are not significantly related to a particular bank.

Firstly, cross-tabulations were calculated for the overdraft decisions by bank (with the Bank of Scotland and the Royal Bank of Scotland combined) for the three sets of information with the no and don't know decisions combined. The resulting chi-squares are given in Table A.

TABLE A

Cross-tabulations of overdraft decisions*
by bank† controlling for information

	n	χ^2	df	p
Financial audit report only	63	1.62	1	0.20
Favourable management audit report	72	0.85	1	0.36
Adverse management audit report	70	2.27	1	0.31
	205			

(*No and don't know decisions are combined)

(†Bank of Scotland and Royal Bank of Scotland respondents are combined)

The above chi-squares are not significant even at the 10% level.

Secondly, cross-tabulations were also calculated for the overdraft decisions by bank for the three sets of information for each bank against the other with again the no and don't know overdraft decisions combined. The resulting chi-squares are shown in Table B.

TABLE B

Cross-tabulations of overdraft decisions*
by two banks controlling for information

	n	χ^2	df	p
Clydesdale Bank and Bank of Scotland				
Financial audit report only	40	1.28	1	0.26
Favourable management audit report	41	1.34	1	0.25
Adverse management audit report	43	2.25	1	0.13

	n	χ^2	df	p
Clydesdale Bank and Royal Bank of Scotland				
Financial audit report only	38	0.92	1	0.34
Favourable management audit report	45	0.22	1	0.64
Adverse management audit report	40	1.37	1	0.24
Bank of Scotland and Royal Bank of Scotland				
Financial audit report only	48	0.00	1	1.00
Favourable management audit report	58	0.41	1	0.52
Adverse management audit report	57	0.16	1	0.90

(*Answers no and don't know are combined)

None of the above chi-squares is significant even at the 10% level. The conclusion is that at the 10% significance level there is no reason to reject the null hypotheses H_o11a, H_o11b and H_o11c. The overdraft decisions of the respondents from the Clydesdale Bank are not statistically significantly different from the decisions of the respondents from the Bank of Scotland and the Royal Bank of Scotland.

APPENDIX M

Overdraft decisions - Bank of Scotland and Royal Bank of Scotland respondents

As discussed in Chapter 8, the results of the simulated overdraft decisions of the Clydesdale Bank respondents were different (although not statistically significantly different) from the decisions of the Bank of Scotland and the Royal Bank of Scotland respondents. Therefore, it was considered worthwhile to examine the null hypotheses of H_o15, H_o16 and H_o17 in relation to the decisions from the respondents from the Bank of Scotland and the Royal Bank of Scotland only.

The null hypothesis to be tested for the overall results (excluding the Clydesdale Bank respondents) is:

H_o15 There are no significant differences between bankers' overdraft decisions on the basis of

(a) The financial audit report only

(b) The favourable management audit report

(c) The adverse management audit report.

With the no and don't know overdraft decisions combined, the cross-tabulation of overdraft decisions by information for the 163 respondents gives a chi-square of 8.59 with two degrees of freedom with a significance of 0.01. The null hypothesis of H_o15 in relation to the respondents from the Bank of Scotland and the Royal Bank of Scotland must therefore be rejected at the 5% level of significance.

The null hypotheses to be tested for H_o16 and H_o17 (excluding the Clydesdale Bank respondents) are:

H_o16 There are no significant differences between bankers' overdraft decisions on the basis of

(a) The financial audit report only

(b) The favourable management audit report

H_o17 There are no significant differences between bankers' overdraft decisions on the basis of

(a) The financial audit report only

(b) The adverse management audit report.

Regarding H_o16 and H_o17 for the Bank of Scotland and the Royal Bank of Scotland, the no and don't know overdraft decisions were again combined and the cross-tabulations of the financial audit report only by the favourable management audit report and also by the adverse management audit report are given in Table A.

TABLE A

Cross-tabulations of overdraft decisions* by information for Bank of Scotland and Royal Bank of Scotland

	n	χ^2	df	p
Financial audit report only by favourable management audit report	106	0.22	1	0.64
Financial audit report only by adverse management audit report	105	6.29	1	0.01

(*No and don't know decisions are combined)

At the 5% level of significance, therefore, for the Bank of Scotland and the Royal Bank of Scotland we have no reason to reject H_o16 but we would reject H_o17. This compares with the results for all three banks (including the respondents from the Clydesdale Bank) discussed in

Chapter 8 that at the <u>10%</u> level of significance we have no reason to reject H_o16 but we would reject H_o17. If we exclude the respondents from the Clydesdale Bank we are more confident of our conclusion, but the overall conclusions of rejecting H_o15, not rejecting H_o16 and rejecting H_o17 remain the same whether the analysis excludes or includes the respondents from the Clydesdale Bank.

APPENDIX N

Quotations from reasons for overdraft decisions

The following are a selection of direct quotations from the respondents' reasons for their overdraft decisions relating to the management audit reports.

1. Favourable management audit report

(a) Reasons for YES decision

(i) Bank of Scotland respondents:

'The advance is granted on the understanding that the various points raised in (4) of the Management Auditors' Report will receive attention.'

'Would ensure that steps had been taken to ensure all matters raised under point 4 in the Management Auditors' Report had been dealt with in a satisfactory manner.'

'The minor weaknesses mentioned in the Management Auditors' Report should be rectified forthwith.'

'Some pressure would be exerted to have guarantees from the Directors in view of the Auditors' note 4.'

'The reservations contained in the Management Auditors' Report are more than offset by the company's track record.'

'Management Auditors' Report highlights only minor weaknesses which would be easily remedied.'

'We would of course insist on their controls being tightened up.'

'The Auditors' Report paragraph 4 should be drawn to the attention of the Directors and their assurances obtained that the weaknesses will be thoroughly investigated and remedial action taken.'

'Would insist that the four minor weaknesses listed were remedied immediately.'

'The minor weaknesses mentioned in the management auditors' report could turn into major weaknesses if not rectified.'

'The rather lax internal controls disclosed in the Management Auditors' Report would suggest further enquiry.'

(ii) Clydesdale Bank respondents:

'I would like to see them give attention to clause 4 brought out in the Management Auditors' Report. Indeed I would very much welcome seeing this as a standard procedure in audit reports.'

'Report indicates a well-managed company.'

'The failure to pay in to the bank customers' cheques when received is a symptom of poor financial control.'

'All of these measures would assist in tightening up the company's financial control.'

'The points mentioned in the Auditors' Report should be discussed in more depth.'

'I would wish confirmation that the items 4 and 5 in the management audit report had already received management attention.'

'We would point out the advantages of correcting the weaknesses disclosed in the Auditors' Report and endeavour to ensure that action was taken.'

'Regarding the minor weaknesses in the individual business functions we would hope that we would have built up a sufficiently close relationship with the Directors to enable us to discuss with them their proposals for improvements.'

'The minor weaknesses in paragraph 4 of the Management Auditors' Report can be easily rectified.'

'It would be expected that the Directors would heed the Auditors' criticisms.'

'The various items mentioned at clause 4 on page g of the Auditors' Report are considered to be relevant.'

(iii) Royal Bank of Scotland respondents:

'Directors told to tighten up on various items of financial control (see management audit report 4a, b, c and d).

'In confirming agreement, would suggest to the company that the weaknesses highlighted by the Auditors were tightened up.'

'Provided greater control was exercised over the obvious areas of weakness in finance and production management, the overdraft can be agreed.'

'The content of the Management Auditors' Report would also be discussed with the Directors, particularly item 4, with a view to more frequent lodgements being made to the Bank. The purchasing, production and selling weaknesses would be covered also to ascertain what action the Directors are taking in these areas to improve the company's performance further.'

'We would be insisting that the weaknesses are not minor from a financial point of view and we would expect the Directors to tighten up on all the points made immediately.'

'We would want steps taken to rectify the adverse features highlighted in paragraph 4 of the Management Auditors' Report.

'The "minor" weaknesses in the performance of the individual business functions disclosed in the Management Auditors' Report rather surprised me and these shortcomings would seem to indicate a general slackness in control in the areas involved. .... The information contained in the Management Auditors' Report is certainly very interesting and would be of great value to bank managers in reviewing lending positions.'

'The Directors should heed the advice given in the Management Auditors' Report.'

(b) Reasons for NO decision

(i) Bank of Scotland respondents

'Points 4(a),(b),(c) and (d) would require full discussion. This area is not viewed as minor and may in fact be the cause of the facilities now sought. Positive steps will be required to correct these.'

'We would be looking for a tightening up of the financial control.'

'Points raised under 4 "minor weaknesses" are not minor in our opinion.'

'Management Auditors' Report - consider minor weaknesses to be more than minor.'

'We would reconsider the situation if attention was given to the points raised in the Management Auditors' Report.'

(ii) Clydesdale Bank respondents

'The failure to pay into the Bank customers' cheques when received is a serious weakness'.

'If immediate steps are taken to sort out the weaknesses noted in the Management Auditors' Report then benefits should quickly become apparent.'

(iii) Royal Bank of Scotland respondents:

'Customer should lodge cheques on a more regular basis than once per week.'

'Consider requirements excessive in light of cash flow and terms of management auditors' report. Feel discussion necessary with Directors on tightening up of the administration and cash flow management.'

'As a temporary measure we might help out with facilities in 1983, but only if the Directors agreed to put their own house in order.'

'There is evidence of lack of control per Management Auditors' Report which we would not consider minor.'

'It cannot be said that the items under number 4 in the Management Auditors' Report are of a minor nature in view of the Directors' backgrounds.'

'We would not agree that the weaknesses pointed out in the Management Auditors' Report are minor.'

(c) Reasons for DON'T KNOW decision

Bank of Scotland respondent:

'The auditors comments regarding purchasing and production would indicate a tightening up in the monitoring of costs is needed.'

2. Adverse management audit report

(a) Reasons for YES decision

(i) Bank of Scotland respondents:

'The various points raised in the Management Auditors' Report are disquieting and obviously also require attention as a matter of urgency.'

'Conditional upon implementation of Management Auditors' recommendations.'

'The problems pinpointed by Auditors can be resolved and if so should lead to higher level of profit.'

'Condition attaching to approval:
All the points raised in the Management Auditors' Report to receive urgent attention with appropriate action.'

'Assurances should also be received that the areas highlighted in the Management Auditors' Report would be fully discussed and suggestions implemented.'

'The Management Auditors' Report could not be ignored completely - particularly as it appears to be making very constructive and beneficial recommendations.'

'We would counsel the Directors that it was in their best interest to take cognisance of the Management Auditors' Report and when a review of the borrowing takes place in a year's time, it would be expected that most of the recommendations would have been implemented.'

'I would also wish to discuss the Management Auditors' Report with the Directors and to have their assurances that the recommendations would be brought into operation immediately.'

'Agreement conditional upon receiving undertaking from Directors that recommendations of Management Auditors will be implemented.'

(ii) <u>Clydesdale respondents</u>:

'I would also discuss the management of the business, in particular the finance side.'

'At the lending interview the highlighted points would be discussed in depth and I would require to be satisfied that remedial policies and action would be adopted.'

'Implementing the proposals would be a condition of granting the overdraft facility.'

'Assurances would be sought from the Directors that they would take action to improve the operational and financial controls criticised in the Management Auditors' Report.'

'The Management Auditors' Report was of great interest and various steps would require to be implemented with stronger control. Assurances from the Directors to this end are required.'

'Would obviously wish to have certain assurances from the Directors, before we lend, that they will take immediate steps to put their house in order.'

'The points brought out in the Management Auditors' Report are all very valid but due to the strength of the company we would probably advise rather than insist that these areas be looked at very closely by the management.'

'Whilst agreeing the facility, I would wish disucssions concerning assurances from the Directors that the weaknesses shown in the Management Auditors' Report will be attended to.'

'It is a condition of the Bank's support that strict control is exercised over:
1) Payments to creditors
2) Purchasing policy to be reviewed
3) Implementation of alternative raw material
4) Collection of debtors.'

'We would wish to see all their finance/purchasing/ production/selling systems tightened up.'

(iii) <u>Royal Bank of Scotland respondents</u>:

'The Management Auditors' Report highlights a number of areas of concern, and these would be ventilated fully during the discussions, when assurances would be sought from the Directors that the various points raised would have their attention.'

'Management Auditors' points should be brought to the Directors' attention and their assurance obtained that these will be attended to.'

'However, I am disturbed by the unbusinesslike attitude of the Directors.'

'It would be suggested to the Directors that they take immediate action to implement the recommendations contained in the Management Auditors' Report.'

'Company appears to be successful despite management weaknesses. I was interested in major weakness areas particularly under production.'

'There would be certain conditions attached to my agreeing to the borrowing, these conditions taking into account the details given in the Management Auditors' Report.'

'The Bank to be assured that the Auditors' recommendations are to be implemented effectively.'

'It would be a condition of the overdraft being granted that the matters referred to by the Auditor were corrected.'

(b) Reasons for NO decision

(i) Bank of Scotland respondents:

'At this stage a firm stand should be taken after reading the Management Auditors' Report.'

'Would give further consideration when evidence submitted that the items listed in the Auditors' Report had been rectified. Otherwise the business has the inherent seeds of trouble.'

'Deficiences brought out in Management Auditors' Report are serious and suitable evidence of putting them in order would be required before further consideration by the Bank.'

'I do consider the company worthy of support if the suggestions outlined in the Management Auditors' Report are implemented with the Directors' backing and subject to close control.'

'From the Management Auditors' Report it is obvious that considerable savings could be effected by the Directors.'

'I would be seeking assurances from the Directors that the criticisms contained in the Management Auditors' Report were being remedied.'

'I would not make a decision regarding the provision of overdraft facilities until I had been satisfied that the Directors had taken action to rectify the weaknesses in the company's performance which were detailed in the Management Auditors' Report.'

'The Management Auditors' Report highlights the weaknesses of the company's position.'

'Looking to the critical remarks made in the Management Audit Report regarding the internal organisation of the company, I consider it would be folly to encourage the Directors to continue their policies by granting overdraft facilties to the extent requested.'

(ii) Clydesdale Bank respondents:

'We would wish to see some acceptance by the Directors of the criticisms contained in the Management Auditors' Report and action taken to remedy them.'

'The Management Auditors' Report points to many areas where costs could be reduced to improve profits and negative cash flow.'

(iii) Royal Bank of Scotland respondents:

'The Directors require to put their own house in order to sort out their differing attitudes as to what is best for the company. The company is not well managed on the Management Auditors' Report.'

'Apparent poor management record as revealed in the management auditors' report.'

'The Directors would be well advised to consider the cost savings outlined in the Auditors' Report and the tightening of credit terms.'

'We would require assurances that corrective action had been taken where necessary to rectify weaknesses as highlighted by the Management Auditors' Report.'

'The Management Auditors' Report leads us to decide against granting this loan until matters have been rectified.'

'This general weakness in the management is supported by the remarks in the Management Auditors' Report.'

'I would be prepared to reconsider the application on receiving satisfactory assurances that, as a matter of urgency, steps would be taken to remedy the deficiencies highlighted in the Management Auditors' Report.'

'The Management Auditors' Report highlights many important internal company problems.'

'It would appear that changes should be made in accordance with the Management Auditors' Report.'

(c) Reasons for DON'T KNOW decision

(i) Bank of Scotland respondents:

'The management audit raises questions regarding the efficiency of management which would require to be investigated before a positive decision could be made.'

'The Management Auditors' Report places the proposals very much in doubt and we would wish certain assurances that the weaknesses brought to light therein had been rectified before we could confidently agree to the facility requested.'

(ii) Clydesdale Bank respondent:

'The most helpful thing we can do is to assist the Directors to put their house in order.'

(iii) <u>Royal Bank of Scotland respondent</u>:

'A lender would require to know if the Comprehensive Management Auditors' Report is to be implemented and if so, to assess its possible effects on the borrowing requirement.'

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