



**THE ADVERSE IMPACT OF PROPOSED ETHICAL STANDARDS**

**SUBMISSION TO**

**AUDITING PRACTICES BOARD**

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**BY**

**THE SOCIETY OF PROFESSIONAL ACCOUNTANTS**

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## **BACKGROUND TO THE SOCIETY OF PROFESSIONAL ACCOUNTANTS**

The Society of Professional Accountants is an independent grouping of professionally qualified accountants in 1500 smaller practices throughout the British Isles.

The Society was established in 1996 to provide support services to its members and to act as a forum for opinion and response to those affecting the practising environment.

At 31 March 2004 some 63% of member practices were registered to carry out audit work.

Submissions and representations have been made to the DTI, Company Law Reform Group Accounting Standards Board, Financial Services Authority and the Institute of Chartered Accountants in England and Wales.

Further information on the Society made be found at [www.spa.org.uk](http://www.spa.org.uk)

# THE ADVERSE IMPACT OF PROPOSED ETHICAL STANDARDS

## EXECUTIVE SUMMARY

- i. SPA is disappointed and concerned that the proposed Auditing Ethical Standards to be implemented on or after 15 December 2004 by the Auditing Practices Board appear insensitive to the needs and realities of many thousand small and medium sized entities.
- ii. The proposed regulations may make much practical good sense if applied to plcs or large companies, but their gold plating will probably work against the efficient and economic provision of either audit or ancillary accountancy services to private non-public interest companies of all sizes.
- iii. It appears that little consultation may have taken place with those most affected by these proposals — medium sized limited company audit clients and their representative business bodies such as the IOD, CBI and FSB. These bodies should be consulted on the validity or desirability of proposals before they are confirmed.
- iv. This additional burden on business in terms of undoubted increased professional charges has not been estimated or justified.
- v. The proposed regulations will also hasten the withdrawal of accountancy practitioners from providing audit services, limiting future choice of Auditors and leading to higher audit charges.

- vi. For many SME clients the proposals require them to deal with two independent accountancy firms instead of one, which will incur further management time without any identified economic benefits arising.
  
- vii. SPA urges the APB to heed these real concerns as it fears that, if no sensible exemptions are provided to medium sized concerns before these regulations are introduced, a real disservice will have been done to both the business community and the accountancy profession

### **In the Public Interest — or Not?**

The DTI recognises that the vast majority of UK s business and other entities by number are small, and widely consults in these areas to determine the economic impact of proposed changes, for example, the recent bottom up approach to Company Law modernisation and audit thresholds; the APB has taken the opposite stance with its top down approach to Audit Ethics that impacts on all audits, and which does not adequately reflect the very differing needs of public and private entities.

For entities of any size where there is no public interest SPA would hope to see optional exemption from full auditing standards by providing the equivalent of an audit FRSSE (as is available for accounting standards). However, Audit Ethics exemptions proposed are limited, conditional and temporary, unhelpful in planning terms for both the accountancy profession and their audit clients.

Whilst a generally acceptable definition of public interest is awaited, SPA suggests that the absence of public interest may be confirmed where 90% or more stakeholders and managers in an organisation are the same groups or individuals. This may be said to be true of all owner-managed limited companies having less than 50 employees, residents associations and other

non-profit making member organisations where the requirement for audit is often historically sought through their constitution or rules rather than statute.

### **Impact on Registered Auditor Population**

SPA recently canvassed its 1500 member practices on the probability of their maintaining audit registration given the raising of EU audit thresholds, and learned that up to 40% of those currently registered for audit may not seek re-registration after 31 December 2004; the probability of such a mass departure looks more certain given the tone of APB proposals on Audit Ethics.

The need for registered auditors may be further diminished, as it will make good economic sense for some of the non-public interest organisations identified earlier to go through the procedural pain of changing their constitutions and rules, to delete audit in favour of an examination of their financial statement by a professionally qualified accountant, who could report to the stakeholders in similar and adequate vein as is presently provided to unincorporated clients.

It may be anticipated that the perceived new threats identified in the Audit Ethics to objectivity, requiring the proposed artificial separation of audit from other accountancy services to SME clients, will result in further practitioners opting out of already unprofitable audit work but, for such clients to replace just their audit requirement through another wholly disassociated auditor may double or even triple audit costs.

### **Proposed Identification of Perceived Threats to Auditors Performance**

The proposals appear to offer complication of procedure and an artificial separation of audit from other accountancy services which will not add efficiency to the audit process, but will add

costs to SME clients, whilst providing no identifiable benefit. Relief for small entities is restricted to those requiring audit within the general audit threshold, i.e. having turnover or assets of less than £5.6m and £2.8m respectively. For SME clients with no public interests such separation appears unjustified and uneconomic and, in our estimate, over 25,000 SME clients will be disadvantaged.

Audit Ethics proposals relate extensively to the elimination of hypothetical audit performance risk, but appear light on actually protecting against the next Enron from happening; statutory audit has not stopped crooked management in the past and there is no substantive reason provided to suppose it may halt fraud to the future.

APB proposals dwell on hypothetical self threats , conflicts of interest and perceived lack of independence of action which in our view for SME clients are imaginary, or where present are of no consequence and, if applied, are tantamount to a restraint of an auditor s trade; in the real world SME clients have no need for such artificial restraint, or whether 5% or 10% of a practice income is from the fees they pay and, where the appointed accountancy firm prepares the audit and deals with tax matters, will be incensed by the need to appoint and deal with a further firm of professionally qualified accountants plus pay undoubtedly more for this separate audit process.

In summary, for SME clients such restrictions appear meaningless and self-defeating in terms of management efficiency and economic supply of service, they do no more than add bureaucratic process and cost to clients without compensatory benefit; they will certainly not improve either the quality of the audit or the opportunity to detect or deter fraud.

It is relevant to suggest that perceived threats to independence, objectivity and economic dependence be discussed widely by the APB with affected entities to see whether audit clients agree that such hypothetical weaknesses in the audit approach are of concern to them or not.

### **Proposed Audit Report Qualifications**

Many smaller practices have a low or much reduced number of audit clients remaining. If one audit client exceeds the new stipulated percentage of a practices total audit income they will be obliged to disclose this to the client and take steps to eliminate the risk. It is probable that a number of practices will to the future fail this arbitrary test. Nothing has changed so far as the client is concerned, but an added level of bureaucracy — a hot file review by a suitably qualified independent auditor (to the engaged firm) is to be completed before the audit report can be signed off — and this will add cost and time pressure. Surely, even if this were a sensible approach, it would be better to evaluate the reality of and potential maximum damage to a client in such circumstances before artificially causing further non-beneficial work to be undertaken.

SPA believes that the audit report should reflect only statements on the company s performance, and should not be extended as proposed to include ambiguous threats to the auditor s performance of his duties. The inclusion of any such proposed qualification arising from perceived weaknesses in the auditor s approach may reflect back on the client, and will add confusion rather than clarity to the third party reader.

The proposed exemptions available to auditors of small entities for three years appears a temporary compromise that may be subject to change after that period; entities need certainty rather than uncertainty, and surely it would be better to allow all those entities that satisfy the

non public interest criteria to opt whether they wish to avail themselves of the proposed audit exemptions.