



A P B ETHICAL STANDARDS
DRAFT ETHICAL STANDARD
EXEMPTIONS AVAILABLE FOR SMALL ENTITIES

SUBMISSION TO
THE AUDITING PRACTICES BOARD

NOVEMBER 2004

BY
THE SOCIETY OF PROFESSIONAL ACCOUNTANTS

Peter J D Mitchell FCA FCCA Chairman

EXEMPTIONS AVAILABLE FOR SMALL ENTITIES

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DRAFT ETHICAL STANDARD
EXEMPTIONS AVAILABLE FOR SMALL ENTITIES

1. EXECUTIVE SUMMARY

- i. The principle of Audit may be said to be the provision of an independent report to the stakeholders or investors in an entity on the stewardship of their investment by their appointed directors or managers

- ii. By definition a professionally qualified accountant, with a practising certificate and registered for Audit, is a responsible individual and can provide such a report.

- iii. Audit of an entity that is defined as small or where it is owner-managed may be said to have no public interest; it might be added that in all such instances audit was voluntary and not regulatory.

- iv. SPA s belief is that public interest, or the lack of public interest, should be the defining condition or test to be applied when providing exemption from the full rigours of plc, large or public interest entity audits.

- v. It appears that the Auditing Practices Board, by proposing tests or conditions to be applied to the audit practice when determining the availability of such exemptions, may misapply the basic principles of audit in (i) above. By doing so, the APB would create an additional and unnecessary burden for many SMEs , which would significantly increase cost and time expended by both auditors and the audit client to no purpose or economic benefit.

- vi. In SPA s view, for non-public interest entities of whatever size, it should be the audit client who determines or decides whether it may take advantage of any exemption afforded, with the entity agreeing with its auditors the basis on which the audit is to be performed.

- vii. Adopting such public interest criteria to determine availability of audit exemption would provide a sustainable standard going forward, eliminating the need to review proposals after 3 years and reappraising entity size criteria.

AUDIT ETHICAL STANDARDS

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2. Response to Specific Questions Posed by APB

- Q.1** *Is the proposed level of applicability of the standard for Small Entities set at an appropriate level.?*
- i** SPA maintains that setting the exemption level to coincide with the present defining tests for a small entity per the Companies Act 1985 appears to adopt the wrong criteria, as it ignores the more concerning issue of public interest, or the lack of public interest, in entities exceeding the tests mentioned.
- ii** In SPA s earlier submission we recommended that the level of public interest be the criteria permitting exemption to be adopted, otherwise it will impose an added cost plus management time on medium sized entities to no benefit.
- iii** Our suggested test for public interest would be that more than 10% of an entity s issued share capital were held other than by the managers/directors.
- iv** Such an approach would accord with existing criteria for an external shareholder to call for an audit, and also meet the government s commitment to avoid or reduce red tape for SMEs.

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- Q.2.** *Is the level of applicability to Small Audit Firms for the provisions on economic dependence set at an appropriate level?*
- i** SPA maintains that reference to arbitrary economic dependency tests is spurious, and should have no place in determining the applicability of exemptions which, as in our response to Q.1. above, should be set by reference to the test for public interest in any sized entity.
- ii** The adoption of such economic tests would add costs to the audit process without tangible benefit to both practices and their clients, and potentially increase the existing momentum for practitioners to give up their audit registration, which will further limit the choice of auditors for clients to the future.
- iii** SPA maintains that reference to the number of responsible individuals should not be used as a criterion for providing proposed exemption for small or non public interest entities of any size. The public interest test proposed by SPA should be used instead.
- iv** For SMEs, or non public interest entities, the proposed separation of audit from other services would create huge annoyance and disruption to valued arrangements. Were such entities forced to appoint a second and separate professional accountant to provide services other than audit, such entities would undoubtedly suffer management inefficiency and increased costs without evident benefit.

Such separation of roles appears artificial and unnecessary, where in SPA s view the test should be that for public interest as defined in 1 (iii) above.

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Q.3. *Should the auditors report disclose circumstances where the audit firm has taken advantage of ES-EASE?*

i SPA does believe that the where advantage of exemption is taken, the audit report should include the following additional statement:

In undertaking the audit of XYZ Ltd we have taken advantage of the Auditing Practices Board Exemptions for Small or non public interest Entities

ii SPA does not believe that availability of exemption should be determined by the nature or economic circumstances of the audit practice, and suggests any such proposed identification within the audit report would be arbitrary and wholly unnecessary.

iii Inclusion in the audit report of such circumstances would also suggest a less than best performance of the audit, hence detracting from the perceived value of the certificate in the eyes of any third party reader.

APPENDIX

THE ADVERSE IMPACT OF THE PROPOSED ETHICAL STANDARDS

SUBMISSION SEPTEMBER 2004



The Adverse Impact of Proposed Ethical Standards

SUBMISSION TO

AUDITING PRACTICES BOARD

SEPTEMBER 2004

BY

The Society of Professional Accountants

Peter J D Mitchell FCA FCCA Chairman

The Adverse Impact of Proposed Ethical Standards

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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

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.