

Mr J Grewe
Director, Company Law (Reporting & Audit)
Department of Trade & Industry
1 Victoria Street
London SW17 0ET

5 June 2002

Dear Mr Grewe

Co-ordinating Group on Audit and Accounting Issues

Thank you for your letter of 23 May inviting this Association's comments on the above matters, which we are pleased to provide in the attached short report.

For your information the Association now represents over 1300 smaller practices within the ICAEW, many of whose partners trained with or worked with the Big 5 accounting firms on plc audits prior to setting up in practice for themselves.

It should be noted that to meet the preferred deadline of 7 June did not permit as wide a consultation process as we would have wished.

Reference may also be made to SPA's earlier report where commentary was provided on the plc audit 'The Statutory Audit Requirement for Smaller Companies' Section 3i, issued in December 1999, a copy of which is enclosed for your information.

Please let me know if SPA can be of any further assistance in this matter.

Yours sincerely

Peter J D Mitchell
Chairman



...Strength in numbers

REGULATION OF AUDIT AND ACCOUNTING IN THE UK

A RESPONSE TO

DEPARTMENT OF TRADE AND INDUSTRY

BY

SMALL PRACTITIONERS ASSOCIATION

JUNE 2002

Peter J D Mitchell FCA
Chairman
Small Practitioners Association

EXECUTIVE SUMMARY

1. Corporate Governance

- i An independent Supervisory Board should be a prerequisite for a Stock Exchange quote
- ii Best Corporate Governance practices should be established for all plcs

2. External Auditors and Independence

- i Separation of audit from other client services appears essential
- ii Emphasis required on robust internal audit
- iii Rotation of auditors seems ineffective

3. Accounting Standards

- i Prudence, consistency and going concern principles remain adequate

4. Effectiveness of Audit Staff

- i External audit staff may lack effectiveness
- ii Internal audit staff should be experienced and act with confidence

1. Corporate Governance – The buck must stop here

- i Protection of shareholders and creditors is paramount, with prevention of fraud rather than its ‘cure’ after the event the objective; unless this can be achieved through the process of Corporate Governance, no amount of external examination or regulation can prevent further occurrences of the Enron / Maxwell nature.
- ii It is SPA’s belief that Corporate Governance ‘Best Practice’ already exists within several of the FT Top 200 companies, and that their methods and experiences should be used to benchmark minimum standards demanded of all quoted plcs.
- iii Good Corporate Governance should start with a Supervisory Board of non-executive directors, and should exhibit, amongst others, the following criteria:
 - a) total independence of the Operating Board
 - b) responsibility for Internal Audit and a robust system of continuous Internal Control
 - c) responsibility for appointing external Statutory Auditors, and to whom Statutory Auditors should report on all audit issues found
 - d) responsibility for determining the salary packages of the Operating Board
 - e) representation on the Board of Trustees of any managed company pension fund
- iv All new entrants to a listing should first be required to demonstrate agreed Corporate Governance criteria drawn from 1(ii) above, with an obligation on existing quoted companies to report any shortcomings against such criteria. The DTI should enforce introduction to these latter companies within, say, two years, and provide direct supervision in identified ‘weak’ cases.

2. Independence of External Auditors to Plcs

- i SPA holds that no firm of external auditors can claim they are wholly independent if they are both appointed or removed by and report to an executive officer of the Operating Board; independence will be strengthened by the proposal in (1 iii c) whereby such a responsibility would be undertaken by the Supervisory Board
- ii Independence is weakened where the external audit firm also provides other accounting services to the company and, until such activity is disallowed, all fees paid to accountancy firms should be disclosed in the Company Accounts, split between audit and non-audit charges
- iii Independence is clearly compromised where external auditors are appointed to carry out internal audit work
- iv In SPA's view independence would be strengthened by a division of roles, with statutory audit carried out by one accountancy firm, and any further client services provided by other firms – including internal audit where subcontracted by the Company
- v The proposal that audit firms be rotated is not thought practical; understanding of the client company will have to re-learned on each occasion and the re-establishment of personal contact will lead to inefficiency. Unless other factors stated in (1) above change there is no reason why rotation alone should improve the audit process or independence.
- vi SPA holds that external statutory audit is largely an archaic and obsolete function having its origins in the needs of merchant traders sailing the globe in long by-gone years. It is notable that no similar process evolved elsewhere in the developed world, such activity appears to be peculiarly British, and has not prevented an ongoing series of spectacular

financial scandals harming thousands of individuals. Having said that, internal control and internal audit does have a real and vital role to play in the proper management of public interest organisations and plcs, and in our view their reputation and presence should be both promoted and strengthened.

- vii At the same time SPA remains of the view that audit is of little or no benefit for almost all owner-managed private limited companies, and that any changes in either audit regulation or accounting standards arising from the present review should not apply to this sector of the business community; here the limited ‘exemption’ from plc standards is offered by the FRSSE and audit thresholds, and which reliefs should be continued; the adoption of the European threshold for audit need not be delayed.

3. Accounting Standards

- i The three fundamental statements of directors’ responsibilities in the Directors’ Report are clear and unambiguous, speaking to prudence, consistency and going concern bases of preparing the accounts; given the existence of a Supervisory Board and External Auditors, who may not provide other services to the client company, such statements provide an adequate ongoing basis for future plc accounts.
- ii It follows that ‘Aggressive Earnings Management’ or off Balance Sheet transactions do not have a place in the preparation of acceptable accounts, and such practices should be outlawed by the DTI.
- iii Absolute responsibility for the protection of a company’s shareholders and prevention of fraud rests between the Operating and Supervisory Boards; at best External Auditors find committed fraud, but at worst their efforts prove futile, and cast shadows on the profession as a whole.

4. Audit Staff and their Effectiveness

- i A criticism may be made of plc auditors that their audit staff often comprise recently recruited and rapidly rotated graduates, and that audit work is carried out in a somewhat mechanical way

Can such personnel, with little or no experience or understanding of a plc's accounting processes, act effectively or efficiently as audit staff? Ticking boxes on an audit programme is a poor substitute for hands-on experience.

- ii As SPA has indicated in 2(iv) above it is held that the emphasis on audit should be Internal and in 'real time' rather than External and generally months after the event; every effort should be made to prevent major fraud occurring

- iii Internal audit staff should, besides appropriate professional qualification, have a close understanding of the company's financial activities and, given that they report to a Supervisory Board, should be able to act with confidence; the maintenance of a robust system of internal control is paramount to the early detection and minimisation of fraud.