

RAISING THE THRESHOLDS

**SUBMISSION TO
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RAISING THE THRESHOLDS

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RAISING THE THRESHOLDS

1. EXECUTIVE SUMMARY

1.1. Benefits Obtained from Raising the Audit Threshold to £1 million

1.1.1. Our research and analysis has determined that the increase to £1 million has been well received by small practitioners and their small corporate clients, with almost no evidence of detriment to third party users of those accounts. It appears that savings in annual accountancy charges approaching £70 million may have been achieved. The proposal to increase the threshold further was also welcomed.

1.2. Adopting the European Audit Threshold of £5.6 million (the EAT)

1.2.1. The EAT is set higher than the anticipated level in 1999 of £4.2 million, nevertheless, given the successful outcome of raising the audit threshold to £1 million, SPA suggest there are few persuasive commercial, professional or statutory arguments why the EAT should not be introduced, which would provide estimated opportunity cost savings of approaching £100 million per annum in professional charges together with valuable freed up management time.

1.2.2. As the impact of the EAT will largely affect small practitioners and their corporate clients SPA urges Government to give due weight to their views, which undoubtedly contrast with those expressed by others possibly with vested interests in maintaining the status quo.

1.3. Benefits of Appointing a Professionally Qualified Accountant (PQA)

- 1.3.1. PQAs act as the custodians of the financial morals of the business community, and SPA suggests that the appointment of a PQA to any small limited company, besides deterring crime, will help ensure compliance with accounting standards, company and taxation law.
- 1.3.2. The quality of accounts prepared by a PQA does not vary whether audited or not, and evidence of a PQA's involvement provides comfort to readers, especially financiers and the Inland Revenue. We suggest that such an appointment should be mandatory before a company commences to trade and should form part of Companies House accessible information.

1.4. Impact of Audit Thresholds on Money Laundering and Proceeds of Crime

- 1.4.1. Government's intentions towards harmonising UK audit thresholds with our European colleagues should not be obscured by the fact that criminal activity will remain whatever level is introduced; corporate criminals in small companies are unlikely to appoint PQAs as accountants or auditors, and their activities may not be discovered for lengthy periods — if at all.
- 1.4.2. SPA suggests the ease with which a limited company may be formed and commence trading should be reviewed, with more positive vetting introduced to prevent potential crime.

1.5. Impact on the Registered Auditor Population

- 1.5.1. Raising the audit threshold to the EAT would cause more practitioners to give up their audit registration for economic reasons. However SPA suggests that a number of Registered Auditors then remaining would develop this sector of their practice to offer audit support to other practitioner colleagues retaining only a few audit clients.

1.6. Treatment of Groups

- 1.6.1. Should the EAT be introduced then SPA agree similar exemptions should continue to be afforded to groups of companies falling within the increased threshold.

1.7. The Thresholds Defining Medium Sized Companies

- 1.7.1. We support the government's intention to increase the threshold defining medium sized companies to the maximum permissible under EU law. We are unaware of any costs or savings that might arise from the raising of this threshold.

2. BACKGROUND TO SPA

- 2.1.** SPA is a wholly independent society of small practitioners holding a qualification issued by a recognised professional accountancy institute. It was formed in early 1996 because of concerns with the perceived effectiveness, or not, of the ICAEW's support for such members. SPA's Constitution and Rules was amended in 2002 to admit practitioners from ICAI, ICAS, ACCA and CIMA. Currently there are in excess of 1,500 member practices.
- 2.2.** The Society's stated policy is to promote and improve the relationship between members and their Institutes by providing constructive criticism together with practical proposals for improvements. Further to provide commentary and proposals to other authorities influencing our practising environment.
- 2.3.** SPA's members work at the coal face of our profession, alongside the very many thousands of the small companies the Government seeks to assist. Our members have many years' experience and a deep understanding of how such companies manage their affairs and whether statutory audit is a benefit or burden to them.
- 2.4.** SPA has previously made submissions on small limited company activities to the DTI on Audit Exemption levels, to the Accountancy Standards Board on Financial Reporting Standards for Small Entities (FRSSE), to the DTI on Modern Company Law Developing the Framework, and most recently the Society provided a commentary to the DTI on the benefits obtained from raising the audit threshold to £1 million.
- 2.5.** In respect of small private owner/managed limited companies where no material public interest arises, our view is that statutory audit should not be mandatory as, in the vast majority of instances, there is no distinction between directors and shareholders on which audit is focused, hence little or no benefit to be obtained: raising audit thresholds allows such companies to choose whether audit is commercially beneficial to them.

3. COMMENTARIES

3.1. Benefits Obtained from Raising the Audit Threshold to £1 million

- 3.1.1. SPA s 2002 survey established that savings in professional fees have been obtained by corporate clients amounting to approximately 10% of total annual accountancy charges, whilst the impact of fewer audits has not been reflected in lower incomes in the large majority of small practices.
- 3.1.2. SPA s estimate in 1999 of potential savings was £87.5 million based on an average saving of £350 across a DTI identified population of 250,000 companies able to take advantage of the higher threshold. As the population of companies between £1 million and the EAT is statedly 66,000 it appears around 200,000 companies may have saved approaching £70 million per annum.
- 3.1.3. No evidence has been found within SPA s membership of a corporate client dismissing the PQA where audit is not now performed; the package of accountancy services, namely accounts production, Companies House returns, taxation, payroll and other services provided by the PQA remain highly valued.
- 3.1.4. Extremely little evidence has been found of detriment to third party users of these unaudited accounts, with only the very occasional audit sought by financiers, major suppliers or minority shareholders
- 3.1.5. There is no evidence amongst our members that the quality of unaudited accounts produced has fallen by any discernable amount. Related professional indemnity claims reported by SPA s PII brokers were extremely low in the last two calendar years, less than 0.2% of all client accounts prepared both corporate and unincorporated, indicating a very high level of client and third party acceptance.

3.2. Adopting the European Audit Threshold of £5.6M

- 3.2.1. It is evident from our European colleagues that the presence of the EAT has been successfully managed without weakening the public interest. There are lessons for the UK to learn from this European experience.
- 3.2.2. A very large majority of respondents to SPA s 1999 and 2002 surveys welcomed the possibility of thresholds being raised to the EAT which was seen as beneficial to both their practices and their corporate clients. They do not anticipate any significant loss in income resulting from fewer audits and expect to utilise freed up time more profitably.
- 3.2.3. It is understood 66,000 companies fall between the £1.1M threshold and the EAT, many of whom will be capable of providing their own draft annual accounts, and SPA estimates that opportunity cost savings of an estimated £100 million per annum in professional fees is available to this population should the EAT be introduced.
- 3.2.4. This estimated saving has been found by identifying the likely minimum audit charge of £1,500 per annum for a mid-point company with turnover of £3°million across the population of 66,000 companies.
- 3.2.5. It should be noted that by definition a PQA is already appointed to these 66,000 companies to whom they are probably providing a range of other services, in particular final accounts preparation and corporation tax guidance using specific and sophisticated software.
- 3.2.6. It is thus unlikely that where audit was not undertaken in this population the relationship with the PQA would be terminated. It follows that SPA does not expect the quality of the accounts within this population to suffer if audit were not undertaken.

3.3. Benefits of Appointing a Professionally Qualified Accountant

- 3.3.1 SPA suggests the appointment of a PQA to each company should be mandatory before it can commence trading. In the commentary at 3.4 we suggested how such an appointment might help prevent criminal activity, and we suggest below how this might assist essential compliance.
- 3.3.2 The appointment of a PQA by the directors of a small private limited company, to ensure compliance with preparing and filing annual accounts to exacting standards - financial, legal and taxation, would seem an appropriate price to pay for the limited liability and trading facility provided.
- 3.3.3 Besides their ethical standards and knowledge of Financial Standards, Company and Taxation law, the PQAs can provide the benefit of their wide business experience to guide and advise the company in its infancy and as it develops
- 3.3.4 Even where no audit is performed a PQA will generally attach a statement to the company's accounts, which will be prepared to the same high standard as those audited, and this presence gives comfort to third party readers of those accounts, in particular financiers and the Inland Revenue.
- 3.3.5 SPA remains concerned that confusion exists within the general public mind as to who can act as an accountant, with a section of the business community choosing the apparently cheaper option of an unqualified or unregulated accountant that, in our members' experience, may lead to unexpected problems and costs later on. It has been noted that Companies House does not appear to review the financial correctness of small company accounts filed, and SPA can cite instances of materially incorrect accounts prepared by unregulated accountants appearing on file.
- 3.3.6 In respect of limited companies SPA suggests the public interest is not being best served by this option and that it should be addressed:

- All new companies should be obliged to appoint a PQA
- Existing companies without a PQA should be obliged to appoint one within two years
- Details of the reporting accountant should be recorded as standing data at Companies House and form part of the Annual Return.

3.4. Impact on Money Laundering and Proceeds of Crime

3.4.1. The setting of audit thresholds will not restrict criminally minded individuals, given that within a day a company can be formed, within a few days a corporate bank account opened, no applications to register for VAT or PAYE need be sought, no PQA need be appointed, and for up to two years trading within an apparently dormant company can take place invisibly at any level until Companies House acts to strike it off for failure to file accounts or annual returns. Such criminal activity may never be discovered by the authorities.

3.4.2. It appears to SPA that it is too easy to obtain and trade through a limited company, and that there should be a reasonable price to pay for the facility and protection provided. To assist prevention of crime Companies House processes might be strengthened, possibly by:

- Maintaining an accessible register of banned directors at Companies House
- Requiring that a PQA be appointed before a Trading Licence is issued
- Requiring the PQA to confirm in writing each year a willingness to act
- Issuing annual Trading Licences and charging for them
- Requiring a current Trading Licence to open and keep open any corporate bank account
- Adding the following data to the Company's standing data at Companies House:
 - The Principal trading address where different from the Registered Office
 - PQA details

- Trading Licence details
- VAT and Corporation Tax registration details

similar requirements could be devised for unincorporated businesses

- 3.4.3 Given that no threshold will act as a barrier to criminality the principal objectives of introducing a higher threshold should not be overlooked, which are to widen the option for audit without weakening public interest, and to put U.K practitioners together with their corporate clients on an even footing with their European colleagues, whilst providing the economic benefits available. Hence, and although raising the threshold may appear to contradict the impending implementation of Money Laundering and Proceeds of Crime Acts, SPA believes the relationship is illusory and should not deter Government s intentions on audit.

3.5. Impact on Registered Auditor Population

- 3.5.1. When measuring the impact of the £1 million threshold it was found there was a reduction of some 20% within the population of small practitioners registering as auditors, and it is estimated from the initial findings of SPA s September 2003 survey that a similar reduction would take place should the EAT be introduced.
- 3.5.2. It is also noted that within those practitioners who would give up their audit registration for economic reasons, several would still retain a few clients requiring a Registered Auditor s report, and where they would look for help from other small practices who have indicated they would develop their audit services to provide such support.
- 3.5.3. A significant number of other small clients require a Registered Auditor s report on their accounts, such as not-for-profit organisations and housing associations, where SPA has suggested that through a rule change many would accept that a report from a PQA was really what they needed.

3.5.4. In summary should the EAT be introduced it appears that the provision of audit services from within a reduced population of Registered Auditors can be managed economically.

4. METHODOLOGY

4.1. Member Research

SPA has carried out surveys to test support for the DTI's initiative in raising audit thresholds in 1996, 1997, 1999, 2002 and Autumn 2003 (where a report will be issued early in 2004) and has drawn on the findings of this work.

Surveys have been variously carried out amongst SPA's 1,500 member practices and also amongst a wider population of 8,500 ICAEW smaller practices. No significant difference in attitude or response has been detected between the two groups, and copies of the reports may be found on SPA's website at www.spa.org.uk as under:

Sept. 1996	Survey and Report - Audit and Reporting Practices
Dec. 1999	The Statutory Audit Requirement for Small Companies
June 2002	Regulation of Audit and Accounting in the UK
Jan. 2003	The Beneficial Impact of Raising Audit Thresholds
Sept. 2003	Survey - An Alternate route to Small Practice Support

4.2. Commentary

Commentary was provided by individual respondents, together with discussion amongst the Society's Steering Committee and Regional Representatives under the Chairman's guidance.