

Mr D Benjamin  
Company Law & Investigations Directorate  
Department of Trade & Industry  
Bay 4102  
1 Victoria Street  
London SW1H 0ET

8 December 1999

Dear Mr Benjamin

#### **THE STATUTORY AUDIT**

Please find attached SPA's response to your discussion document dated October 1999. SPA welcomes the Government's initiative to reduce this regulatory burden on small corporate businesses, and hopes that our commentary and data obtained from our third survey since 1996 on this topic will assist your deliberations.

Our members work at the coal face of our profession, alongside the very companies the Government seeks to assist. We have a deep understanding of how such companies manage their affairs and whether statutory audit is a benefit or burden to them.

Our principal recommendation is that a limited company with no public interest would be deemed to be small and eligible for audit exemption where turnover threshold were below £4.2m. p.a. - plus either of where

- i. Employees were less than 50 and/or
- ii. Gross assets were less than £2.4m

SPA can find no substantive evidence from its own surveys or analysis of available international data to suggest that this may not be undertaken safely without impairing the public interest, and can suggest no advantage in moving to an intermediate level.

Such an exemption will bring the UK into concordance with our European and other international accounting colleagues, and underlines the seriousness of Government's intent on deregulation of small businesses.

Alongside this exemption we would propose that a professionally qualified accountant be appointed to each limited company at an early stage of its existence, preferably as it commences trading, to ensure necessary compliance is provided.

The savings arising have been assessed as a little under £100m and, whilst this is lower than other forecasts, we do not believe that saving money is the only driver of such change - it is more to do with modern management and provision of valuable services.

SPA would be pleased to discuss any of our findings or comments with you in more detail.

Yours sincerely

Peter J D Mitchell FCA  
Chairman

**THE STATUTORY AUDIT  
REQUIREMENT FOR SMALLER COMPANIES**

**SURVEY AND REPORT**

**DECEMBER 1999**

**Peter J D Mitchell FCA  
Chairman  
Small Practitioners Association  
P O Box 542 Amersham Bucks HP6 5TS**

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# **1. EXECUTIVE SUMMARY**

## **1.1 STATUTORY AUDIT**

1.1.1 In SPA's view the threshold may safely be increased to £4.2m. turnover p.a. as it is widely accepted that the Statutory Audit has no practical or beneficial role to play for the vast majority of small private owner managed companies; if audit were optional those wishing a deeper verification of a small company's accounts for lending or other purpose would use their commercial power to demand it be carried out.

1.1.2 There appears to be no advantage in raising the threshold to an intermediate level which would leave the UK out of step with other international accounting conventions and disadvantage many thousand small UK corporate businesses.

1.1.3 A significant question mark remains over the benefit and methodology of statutory audit as practised towards larger companies and plc's. SPA maintains that statutory audit is in need of radical overhaul and repositioning to be effective in the next millennium.

## **1.2 THE BURDEN OF THE AUDIT**

1.2.1 SPA's surveys consistently portray statutory audit as a costly burden on most small companies, both in terms of actual expense and involvement of unproductive director or management time. For a substantial majority of corporate clients the retained professional accountant continues to work alongside the directors to provide business guidance, accounts preparation, tax management and Companies Acts compliance; these services are valued - the statutory audit is not.

1.2.2 The absolute savings from raising the threshold to £4.2m. have been quantified by SPA as £87.5m - a lower yield than other forecasts - but reflecting the low profitability of statutory audit to smaller practices.

## **1.3 THE POSSIBLE BENEFITS OF AUDIT**

1.3.1 The right for a minority shareholding of over 10% to request an audit should provide reasonable protection for such an interest, and should be retained at any future threshold set. Such a right should be available to a single shareholder or group of small shareholders holding 10% of the issued share capital.

1.3.2 The association of a professionally qualified accountant with the company's accounts is undoubtedly helpful when dealing with banks or the Inland Revenue, but this does not suggest statutory audit is required to bring such an accountant alongside the company's management.

## **1.4 OPTIONS**

### **1.4.1 Alternate Thresholds**

SPA can suggest no substantive reason or evidence why an intermediate threshold should be set, as this would only postpone and prolong the debate which has already reached its conclusion regarding the worth of statutory audit to small companies.

### **1.4.2 Treatment of Groups**

The present exemption available to groups, whose combined accounting values fall within the exemption criteria, appears sensible and consistent with the relationship of exemption to size. It follows that if higher criteria are set for audit exemption then similar exemption should continue to be afforded to groups who fall within these higher criteria set.

### **1.4.3 Asset Test**

Turnover is only one of three criteria used to define a small company, numbers employed and gross assets being the others. Whilst the number employed of 50 seems more than adequate already, it appears logical to move gross asset values up in relation to any higher turnover threshold set. Accordingly, at the preferred level of £4.2m, SPA's preference for the gross asset threshold would be the EU maximum of £2.4m.

## **2. BACKGROUND TO SPA**

- 2.1 SPA is a wholly independent association of small practitioners within the ICAEW, and was formed in early 1996 because of concerns with the perceived effectiveness, or not, of our Institute's support for such members, further because the design of regulations and their implementation was perceived to be based largely on a minority of larger companies or plc's rather than the vast majority of small private corporate businesses.
- 2.2 SPA's membership has grown steadily to over 1,000 small practices numbering some 1,300 partners in total, throughout England and Wales. Our stated policy includes the provision of commentary and proposals to the ICAEW and other authorities influencing our practising environment with a view to its improvement; a forward looking philosophy of review, constructive criticism and development.
- 2.3 SPA has carried out two previous surveys in late 1996 and early 1997 to test support for the DTI's earlier initiative proposing audit exemption below £350,000 turnover p.a., and in our subsequent report 'Statutory Audit - A Service or Disservice?' we found from 662 respondents over 90% support for the proposal that 'Any small non-public interest company, as defined by the Companies Acts, may elect not to be subject to a statutory audit'. Our proposal added 'in place of which (statutory audit) a suitably worded qualified accountant's report would be provided'.
- 2.4 Our 1999 Survey carried out research amongst broadly the same population, and found similar support from 642 respondents - over 67% favoured increasing the exemption level to £4.2m. turnover p.a. but would prefer to see a professionally qualified accountant retained to guide on accounts production compliant with the Companies Acts and Corporation Tax, which preference reflects that currently over 90% of all small companies are using such an accountant to assist them in this way besides carrying out the audit function.

## **3. COMMENTARY**

### **3.1 THE STATUTORY AUDIT**

- 3.1.1 It is now widely accepted that the value of statutory audit to an owner managed company is marginal at best and of no measurable benefit at worst. Loss claims arising

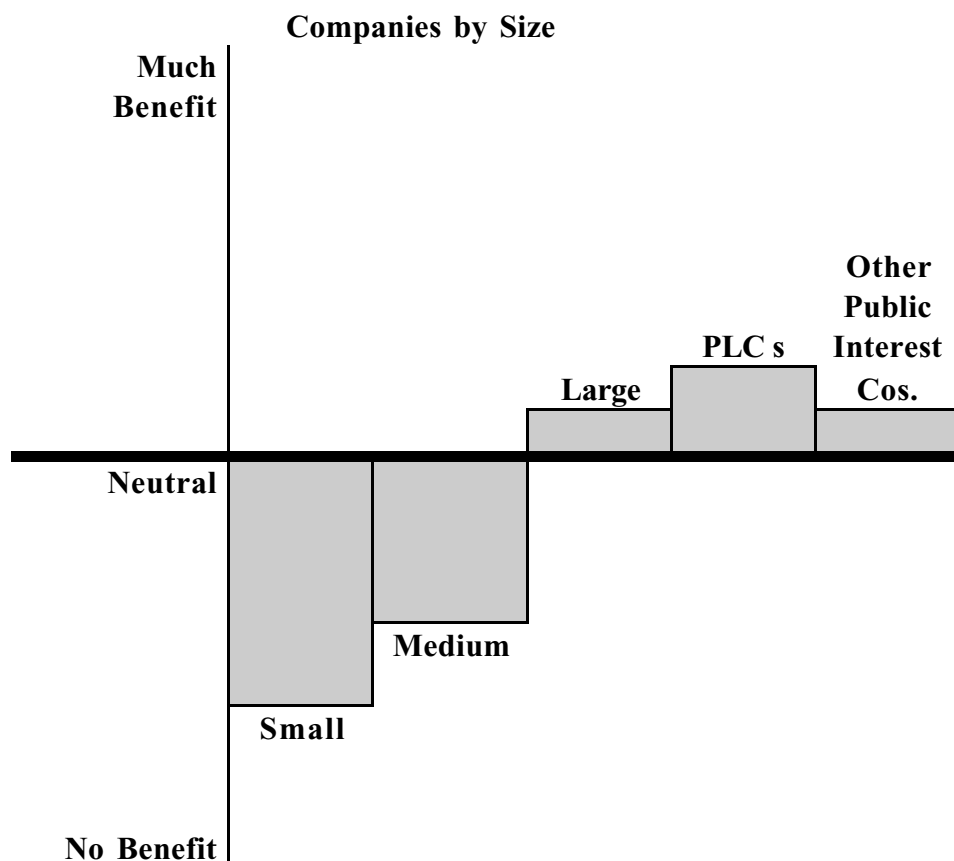
from inadequate audit of small companies are rare as has been confirmed by our Professional Indemnity underwriters.

3.1.2 Providing wider exemption would have the effect of making audit optional to the vast majority of active small companies, and would undoubtedly free up valuable resources without endangering the public at large, or limiting other interested parties such as banks or financiers who would still be able to demand an audit to satisfy lending criteria.

3.1.3 Undoubtedly statutory audit has an important role to play in larger companies or plc's; it acts as a badge of respectability and assurance to the outside world that the accounts are trustworthy and consistent and, whilst fraud may not always be detected, audit will act as a significant deterrent.

3.1.4 However, SPA remains deeply concerned with the results of its own analysis in 1996, obtained against the background of widely publicised major corporate failures, that suggested statutory audit is not valued much in its present form by even larger companies or plc's; nothing has happened to statutory audit since 1996 to change this view.

**Audit and Reporting Process - Perceived Benefits  
(818 Respondents to 1996 Survey)**



- 3.1.5 The current method of applying statutory audit is perceived to be outmoded and out of step with modern management needs; it has a uniquely British history and a style that has changed little in the last hundred years; it is not generally found in Europe and is applied only to major or public concerns in other countries where the concept of a business entity with public ownership has been developed.
- 3.1.6 Statutory audit is therefore seen to be in need of considerable review in the UK; amongst other issues considering whether statutory audit should form part of corporate governance within the responsibility of the Supervisory Board as recommended by Cadbury.
- 3.1.7 To be effective, audit must be carried out in real time as events happen, not as an historical raking over of ashes long gone cold. As such, it needs to be implemented on a continuous basis and within a system of internal control.
- 3.1.8 SPA would prefer to see a strengthening of the Cadbury recommendation for corporate governance to include the appointment of the statutory auditor by the Supervisory Board - rather than the Executive Board to which statutory auditors also currently report. This latter situation surely is compromising and unacceptable in terms of real independence.

## **3.2 THE BURDEN OF THE AUDIT**

- 3.2.1 The SPA's 1999 survey sought evidence of average savings available to corporate clients arising from a threshold of £4.2m. - the preferred level of respondents - and has assessed this to be £350 of total annual charges which, for many corporate clients are not necessarily separated into the component parts, and frequently form part of an all-in annual charge.
- 3.3.2 The repeated message from respondents was that annual savings would be low given that audit was an 'add on' obligatory - and hence often unwelcome - service where the full costs of providing this heavily regulated and regimented activity could not be recovered.
- 3.2.3 Many respondents indicated that the time made available should thresholds be increased would be utilised in providing better and more valued services to corporate clients.
- 3.2.4 Similarly, and whilst SPA did not attempt to quantify the saving, company managers welcome the possibility of doing better things with their time rather than addressing seemingly unnecessary queries from auditors and providing audit evidence.

## **3.3 THE POSSIBLE BENEFITS OF AUDIT**

### **3.3.1 Benefits to Shareholders**

3.3.1.1 A stated concern exists for the protection of minority shareholders, and suggests audit may provide comfort and some implicit safeguard. However, to the knowledge of SPA's members, there has been no reported instance or evidence of detrimental treatment of such a shareholder; that such protection is made available to guard minority shareholders in isolated circumstances is laudable and should be retained.

### **3.3.2 Benefits for the Company's Directors and Management**

3.3.2.1 SPA has difficulty with the MORI findings quoted, as it appears there may be a misunderstanding between preparation of informative accounts compliant with the Companies Acts, and the statutory audit process of verification leading to a clean or qualified audit report.

3.3.2.2 What information provided by the audit has been found to be essential or very useful? Audit papers and analyses are not normally made available to the client and, beyond the audit report, there would generally only be a management letter to the client outlining material procedural weaknesses or failings. SPA's experience is that few such letters are written to small corporate clients, and our view is that it is the accounts and their interpretation that small corporate clients find useful - business analysis and guidance - not the audit process or its findings.

### **3.3.3 Benefits for the Main Lenders such as Banks**

3.3.3.1 There would seem no reason to suggest that audit need be statutory to enable bankers or the credit companies to obtain essential or reliable information for lending purposes.

3.3.3.2 Audit information is by definition many months old, and can form only part of the picture to lenders; lenders are generally more interested in current information, order books, profit forecasts and projected cash flows.

3.3.3.3 Lending to small corporate clients is rarely unsecured, and frequently a charge is taken on the business assets together with a personal guarantee of the directors.

3.3.3.4 It may be worthwhile reflecting on the criteria sought by bankers for lending to unincorporated business where no audited accounts are available; no significant restrictions on lending to sole traders or partnerships is evident to SPA members, where again security will be taken over available assets together with a personal guarantee.

### **3.3.4 OTHER POSSIBLE BENEFITS OF THE AUDIT**

3.3.4.1 In respect of credit management, general creditors, credit agencies, and major trade creditors the same argument may be put forward as for bank lending; in the absence of statutory audited accounts there appears to be no evidence of restriction in similar credit available to unincorporated businesses. It is of note that it is not infrequently found by SPA members that a personal guarantee is sought by a major supplier whether the business is a company subject to audit or not.

3.3.4.2 In SPA's view, and whilst it is impossible to guard against the bad apple - be it client or accountant, the qualities provided by a professionally qualified accountant, namely:

- integrity and consistency
- knowledge of Accounting Standards, Company and Corporation Taxes Acts,
- continuous professional education
- professional indemnity insurance,

together with the presence of that accountant's name on the published accounts, provide comfort with and belief in the accounts themselves.

3.3.4.3 The services offered by professionally qualified accountants are provided in a consistent and reliable manner to both corporate and unincorporated clients - and whether audited or not.

3.3.4.4 Whilst the percentage may reduce, as accounts preparation software becomes more widely available outside the accounting profession, the information obtained by SPA is that over 90% of small corporate clients currently use their retained professionally qualified accountant to prepare the annual accounts and deal with Corporation Tax and Company Acts requirements.

3.3.4.5 SPA would not suggest that a case be made for the retention of statutory audit as the mean for the provision of the beneficial services outlined above; far better that the professional qualified accountant be appointed to each limited company at an early stage in its existence.

### **3.3.5 OPTIONS**

#### **3.3.5.1 Alternative Thresholds**

SPA has considered the support provided from its survey respondents for thresholds other than £4.2m., alongside the available data on international accounting conventions, and has considered that there is no case for an intermediate threshold.

If it is intended to lift the regulatory level then SPA's survey suggests that at £4.2m. the vast majority of small companies, should they so wish, will be able to benefit by opting out of statutory audit.

To introduce intermediate thresholds would send the wrong signal - it would be seen as a half-hearted compromise rather than a bold executive decision; in SPA's opinion there is little evident risk to the public interest in raising the threshold to the £4.2m. level where the UK would match European and international accounting conventions.

#### **3.3.5.2 Treatment of Groups**

AND

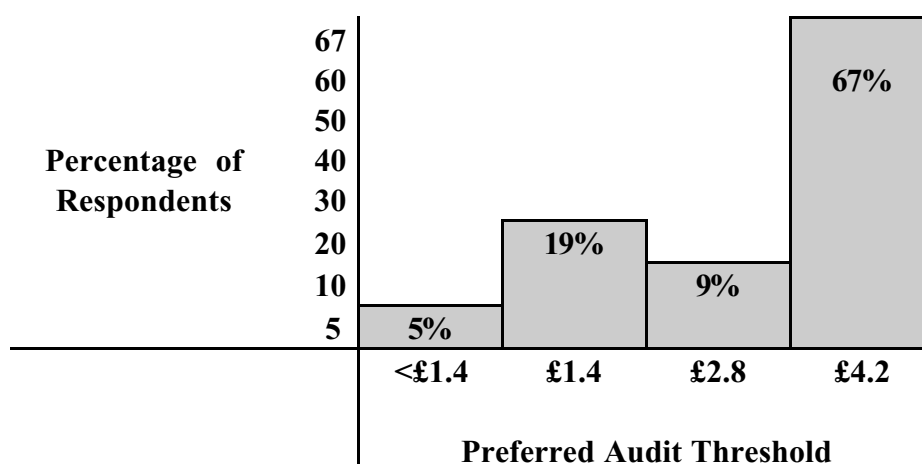
#### **3.3.5.3 Asset Test**

No further commentary is offered on these topics beyond that provided in the Executive Summary.

## 4. SPA SURVEY OCTOBER 1999

### 4.1 TABLE OF FINDINGS FROM 1999 SURVEY

#### 4.1.1 Preferred Audit Exemption Threshold



The number of respondents favouring the highest threshold together with those opting for the £2.8m suggest that at least 76% of small practitioners would prefer to see the turnover threshold set well above £1m.

#### 4.1.2 Number of Active Limited Company Clients Covered by the Survey - 20,500

The close relationship between small professionally qualified accountants in practice and the large population of small corporate clients is reflected in the survey's findings.

#### 4.1.3 Other Services Provided to Corporate Clients

	% of Respondents
Preparation of Accounts	91%
Corporation Tax matters	93%
Companies House matters	92%

The continuing association and involvement of a professionally qualified accountant with all aspects of the accounts of a corporate client remains at a very high level, and is seen to provide a valued service adding quality and reliability to the company's accounts

#### **4.1.4 Where Audit is the Only Service Provided to Corporate Clients - 5%**

Only a very few small practitioners use their audit registration to provide 'audit only' services to corporate clients. This is generally provided by way of sub-contract service to another small practitioner who does not hold the audit registration but has corporate clients requiring audit.

#### **4.1.5 Client Companies Able to Obtain Exemption from Audit - % of Population**

<b>Present Level</b>	<b>Proposed Level</b>
<b>£350K</b>	<b>£4.2m</b>
65%	92%

The £4.2m threshold, if adopted, suggests that the vast majority of the population of small companies will be able to opt out of statutory audit. This suggests there will be a continuing decline in the number of professionally qualified accountants required to take out Audit Registration.

#### **4.1.6 Indicated Savings in Total Accountants Charges - Audit Plus Other Services**

Average Percentage	10%
Average Value	£350

The indicated savings to corporate clients, should the threshold of £4.2m be adopted, varied widely from nil to 90% given the nature of the audit work undertaken - see 4.1.3 and 4.1.5 above and our comment at 3.2.1 earlier.

#### **4.1.7 Indicated National Saving**

- i. The DTI's statistics on population of limited companies by size gives the potential increase in those able to opt out of audit as 250,000 at the £4.2m threshold. Given SPA's findings at 4.1.6 the indicated national saving would then appear to be:

250,000 @ £350 giving £87.5m

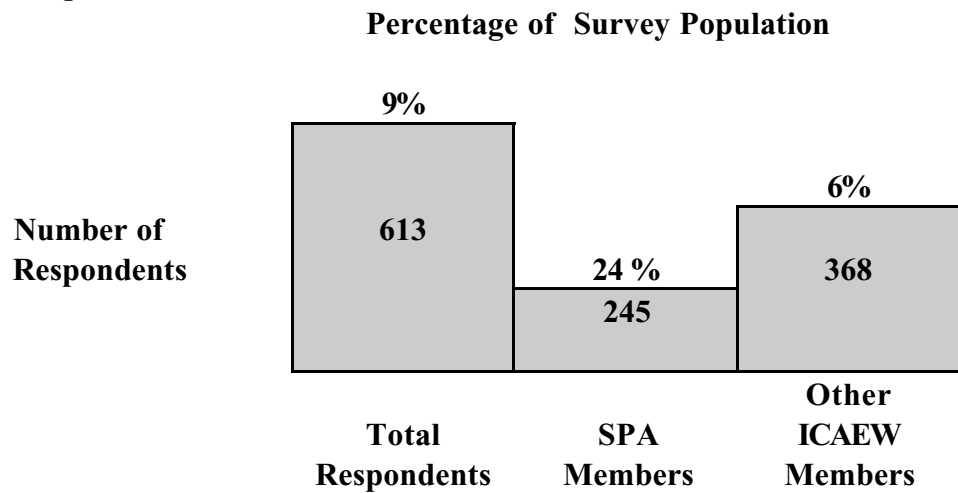
- ii. No estimate has been attempted of the savings arising from freed up management time.

## 4.2 METHODOLOGY

### 4.2.1 Survey Population

The survey was conducted during October 1999 within SPA's current membership of just over 1000 practices of up to 3 partners, together with a further 6000 ICAEW members who were also in practice in firms of similar size.

### 4.2.2 Survey Responses Received



The level of response mirrored that received to the surveys in 1996 and 1997, and analysis of their responses has been carried out by the Association's staff. Copies of the individual responses may be inspected at the Association's offices.

### 4.2.3 Commentary

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

### 4.2.4 Evaluation of Potential Savings

Telephone interviews were carried out by Association staff with just over 50 respondents to establish the monetary value of the percentage savings indicated in their total charges to corporate clients.

### 4.2.5 SPA Steering Committee Background

Members have gained a broad financial experience from working both within practices, large and small, and through appointment to senior commercial positions. The Chairman, Peter Mitchell FCA, has additionally held the position of group internal auditor in a major Plc.