



Why Audit Matters to Practitioners

ABOUT ACCA

ACCA is the largest and fastest-growing international accounting body, with over 300,000 students and members in 160 countries. ACCA has an extensive network of over 70 staffed offices and other centres around the world.

DISCLAIMER

This booklet does not aim to be comprehensive or exhaustive in its treatment of the topics covered or to give specific legal or other advice.

No part of this publication may be reproduced, in any format, without the prior written permission of ACCA.

Why Audit Matters to Practitioners

INTRODUCTION

This booklet outlines why audit remains a valuable activity for ACCA practising members and why it is anticipated that many small and medium-sized enterprises (SMEs) will continue to demand this service.

The threshold increase to £5.6m turnover for small companies came into force on 30 January 2004. It will affect financial years ending on or after 30 March 2004.

At the same time the company thresholds have been increased. The increased turnovers are:

	Turnover	Balance sheet total	Number of employees
Small company	£5.6m	£2.8m	50
Medium company	£22.8m	£11.4m	250

ACCA believes that audit exemption represents an opportunity for practitioners, as it will:

- result in an increase in the number of voluntary audits performed. ACCA's view is backed up by October 2003 research conducted for the DTI by Kingston University. This report states that 79% of those companies that are likely to be eligible for exemption

for the first time will continue to have an audit on a voluntary basis;

- demonstrate the value of investment in audit; and
- speed the development of guidance on review-type engagements.

ACCA believes that the increase in the audit threshold will have far-reaching impacts for the business world. These include:

- an increase in fraud. ACCA conducted a survey of 1,250 of its practising firms in 2001 to determine the incidence of fraud they had encountered. The principal cause of fraud was found to be personal gain by management and in 45% of cases it was the external auditor who discovered the fraud;
- risk of financial statements containing undetected errors. It is clearly in the public interest that accounts filed at Companies House should be true and fair. Although the obligations on directors to produce annual accounts which show a true and fair view would not change, in practice the quality of accounts on the public record would be threatened. There may also be an increase in Inland Revenue investigations which will place a burden on SMEs;

Why Audit Matters to Practitioners (continued)

PAGE 4

- risk that the quality of financial statements will suffer by being prepared by unqualified accountants leading to a, potentially undetectable, deterioration in the quality of financial information held on the public record, which is used by credit agencies and for company tax purposes. Companies House reports that 93% of complaints it receives about the credibility of filed accounts concern audit-exempt companies; and
- a reduction in the number of firms holding registered auditor status and the removal of a vital practical element in the training of future generations of accountants. This would in turn lead to a reduction in the availability of audit services to the non-exempt part of the small business community. It would have a similar adverse effect on those companies that wish to have voluntary audits and other small organisations, such as charities and solicitors, that require either audits or the services of a qualified professional auditor.

It is argued that there is an economic benefit to businesses of raising the audit threshold, but ACCA's analysis questions this:

- the projected total cost saving to the UK's SMEs will be £66m for the 66,000 additional companies that will become exempt. However, in terms of the individual company, this measurable saving of on average

£1,000 is likely to be immaterial, given the benefits that audit brings to the credibility of financial reports from a user's perspective;

- the projected saving of £66m will almost certainly not be achieved. First, serious well-run businesses will continue to have an audit. Second, the directors of all potentially exempt companies will still have to produce and file accounts that show a true and fair view. Unless they are all planning to train as accountants, they will continue to need expert outside help, since a company with turnover of £2m is not a simple micro-enterprise; and
- a final reason for casting doubt on the economic case for raising the audit exemption threshold relates to the nature of the relationship between a small company and its auditor. Though there is a separate debate to be had over the ethics of auditor independence, it is worth recording that professional accountants are generally seen as the first port of call for business advice to SMEs. Removing the requirement for small companies to have regular and significant contact with an independent professional will almost certainly deprive some companies of the valuable advice that came as part of the audit process.

Why Audit Matters to Practitioners (continued)

PAGE 5

ACCA believes that the proposals give rise to a potentially damaging conflict between regulatory intentions in respect of money laundering, and deregulatory ambitions in respect of small business.

Audit exemption is often said to benefit the unscrupulous at the expense of the law-abiding. Nowhere is this more likely to be true than in the area of money laundering. The option will be available to dispense with the auditor, hire a compliant internal bookkeeper and file regular accounts. Taking firms with a combined turnover of £132bn out of the audit net will make it easier to use ostensibly legitimate small corporate vehicles for criminal purposes.

HOW AN AUDIT BENEFITS A SME

For SMEs to flourish it is necessary that they:

- apply the basic financial disciplines necessary to address cash flow and credit management;
- have access to finance;
- are able to cope with the tax system, employment and other legislation; and
- recognise the need for succession planning as the business grows.

The audit ensures that the systems supporting these functions are reliable and credible. An ACCA practitioner is well-placed to ensure that a much higher proportion of new SMEs survive, prosper and contribute to overall economic growth. Part of auditors' routine work involves the assessment of accounting and internal control systems. It is common for auditors to report to directors on structural and operational weaknesses in systems and to make recommendations for their improvement. This advice can be invaluable where directors are inexperienced in such matters and particularly in emerging areas such as e-commerce. Auditors have unique insights into best practice and benchmarking across a range of industries. The audit can also bring to light going concern issues at an early stage.

It is also likely that the Inland Revenue will increase the number of investigations it conducts because of the rise in the audit exemption threshold. It may be wise therefore for clients to continue to have their accounts audited and for these to be sent in with their tax returns.

WHY A SME MIGHT NEED TO RETAIN THE AUDIT

There is likely to be some pressure from banks, other lenders and creditors for companies to retain the audit. There are also an increasing number of reports required by a variety of regulators.

Why Audit Matters to Practitioners (continued)

PAGE 6

There are many entities that, despite the fact that they are audit exempt, still require a variety of reports that must be prepared by registered auditors:

- under the terms of their constitutions, for example under Articles of Association. (Constitutions can, of course, be changed but practitioners should examine any constitutional requirements before making any recommendations to clients);
- because they are regulated entities;
- because they are bound to banking covenants; and
- because they were formed under various provisions of certain Companies Acts.

REPORTS REQUIRED BY REGULATORS

Entities in this category include non-company organisations which may or may not require an audit, but which do require registered auditors' reports for a variety of purposes. Regulators often require reports from auditors, such as the Law Society's requirement for a report on client monies under the Solicitors' Accounts Rules. The following is a non-exhaustive list of regulated entities that are currently required to obtain reports signed by registered auditors, regardless of the size of the entity. (In some cases this requirement is under review in the light of audit exemption):

- building societies;
- insurance companies;
- other organisations regulated under the financial services legislation;
- pension schemes;
- industrial and provident societies and friendly societies;
- solicitors;
- chartered surveyors and estate agents;
- charities;
- registered social landlords and landlords under the Landlords and Tenants Act; and
- travel agents.

Other organisations currently requiring reports from registered auditors include:

- the Audit Bureau of Circulation;
- the Civil Aviation Authority;
- the Periodical Publishers Association; and
- the English Partnerships Investment Fund.

Why Audit Matters to Practitioners (continued)

PAGE 7

Reports by registered auditors are also commonly required for UK and European grant certificates.

There are certain types of entities which will still require an audit, regardless of size, under Section 249b of the Companies Act 1985:

- a public company;
- a person who had permission under part four of the Financial Services and Markets Act 2000 to carry on a regulated activity;
- an entity carrying on an insurance market activity;
- an entity enrolled in the list maintained by the Insurance Brokers Registration Council under Section 4 of the Insurance Brokers (Registration) Act 1977;
- an appointed representative, within the meaning of Section 39 of the Financial Services and Markets Act 2000;
- a special registered body as defined in Section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 or an employers' association as defined in Section 122 of that Act; or
- a parent company or subsidiary undertaking.

BANKING COVENANTS

Many entities are bound to banking covenants that require auditors' reports on their financial statements and/or other financial information.

It remains to be seen whether the banks and regulators will continue to require audits or whether they will accept other forms of assurance instead. It is probably safe to assume, for the time being at least, that if audits have been required in the past, they will continue to be required in the future, regardless of audit exemption.

COMPANIES ACTS 1985 AND 1989

The Companies Act 1985 has a number of provisions requiring reports or statements by auditors even where the entity is audit exempt. These include:

- Section 156 auditors' report in relation to financial assistance for the purchase of own shares;
- Section 173 report required where a permissible capital payment is made; and
- Section 43 auditors' statement on the re-registration of private companies as public companies.

It is also important to note the provisions of Section 41 of the Companies Act 1989 in relation to "holding out".

Why Audit Matters to Practitioners (continued)

PAGE 8

This section makes it an offence for anyone to describe themselves as, or hold themselves out to be, or to be reasonably understood as to indicate that they are, registered auditors, when that is not in fact the case. If firms do intend to continue providing audit services to their exempt clients, and their clients wish to file the audit report with their accounts, maintaining registered auditor status is essential.

FAMILY COMPANIES

In many small family companies there may be several members of a controlling family in key positions. There can often be strong sibling rivalry and conflicts of interest which can lead to poor management and control. The audit has proved to be a very valuable service to such companies. The auditor is viewed as an independent person who can look at the business objectively and help manage the tensions between the various interested parties.

Potentially more disputes will arise in those small family companies that choose to opt out of audit; especially where they engage their finance directors/chief financial officers to deal directly with Her Majesty's Inspector of Taxes/Companies House.

MARKETING

The provision of audit services can be a potent marketing tool.

- Meeting client needs – if a practitioner is not able to offer audits and a client grows to exceed the audit threshold, the client may change adviser to one who can offer those services.
- Retaining employees – recruiting staff may prove difficult, with strong candidates looking for the opportunity to gain audit experience. At least two years of practical training must be completed after the individual's admission to membership of ACCA and 30% of the training must be in audit work. Potentially training will only be available from large firms. By providing non-statutory audits, firms will be retaining skills which otherwise would be lost.
- Growth – by retaining the provision of audit services, practices will be able to obtain larger clients and thus larger fee income.

SUPPORTING ACCA PRACTITIONERS

In order to support members in promoting the virtues of the audit and thereby to support them in generating new revenue development opportunities ACCA UK proposes to:

Why Audit Matters to Practitioners (continued)

PAGE 9

- continue to promote, through the media and other channels, the benefits of independent external audit to members, to companies and to the users of financial statements;
- seek to develop strong relationships with organisations responsible for mandating auditing requirements in non-statutory areas (eg those representing solicitors, travel agents and charities);
- conduct research within the small business community to ascertain what percentage of potentially exempt companies are likely to remain within a voluntary audit regime;
- conduct research with our practising members to ascertain the implications of the threshold increase on their activities and business strategies;
- monitor the effect of the threshold increase in terms of complaints regarding filed accounts, the demand for additional accounting services and the incidence of fraud;
- seek the views of insolvency practitioners on the likely impact of the reform on the solvency of small companies;

- seek the views of small company directors on the impact of the reform on their responsibilities and liabilities as directors;
- publish a guide to the responsibilities of company directors (which will among other things stress the legal as well as operational importance of establishing appropriate financial controls);
- seek to counter the threat that ACCA practitioners may face from unqualified accountants by promoting the all-round skills and competencies of our members and the quality of the monitoring framework which provides oversight of their activities;
- continue to encourage Approved Training Practices (ATPs) to train ACCA students and, in addition, continue to develop support strategies for ATPs; and
- conduct research with practising members to identify and promote innovative fee-earning activities.

ACCA UK has anticipated and planned for the increase in the audit threshold. The following strategies will assist ATPs in the UK to manage the subsequent reduction in audit work while continuing to exploit the opportunities available to them:

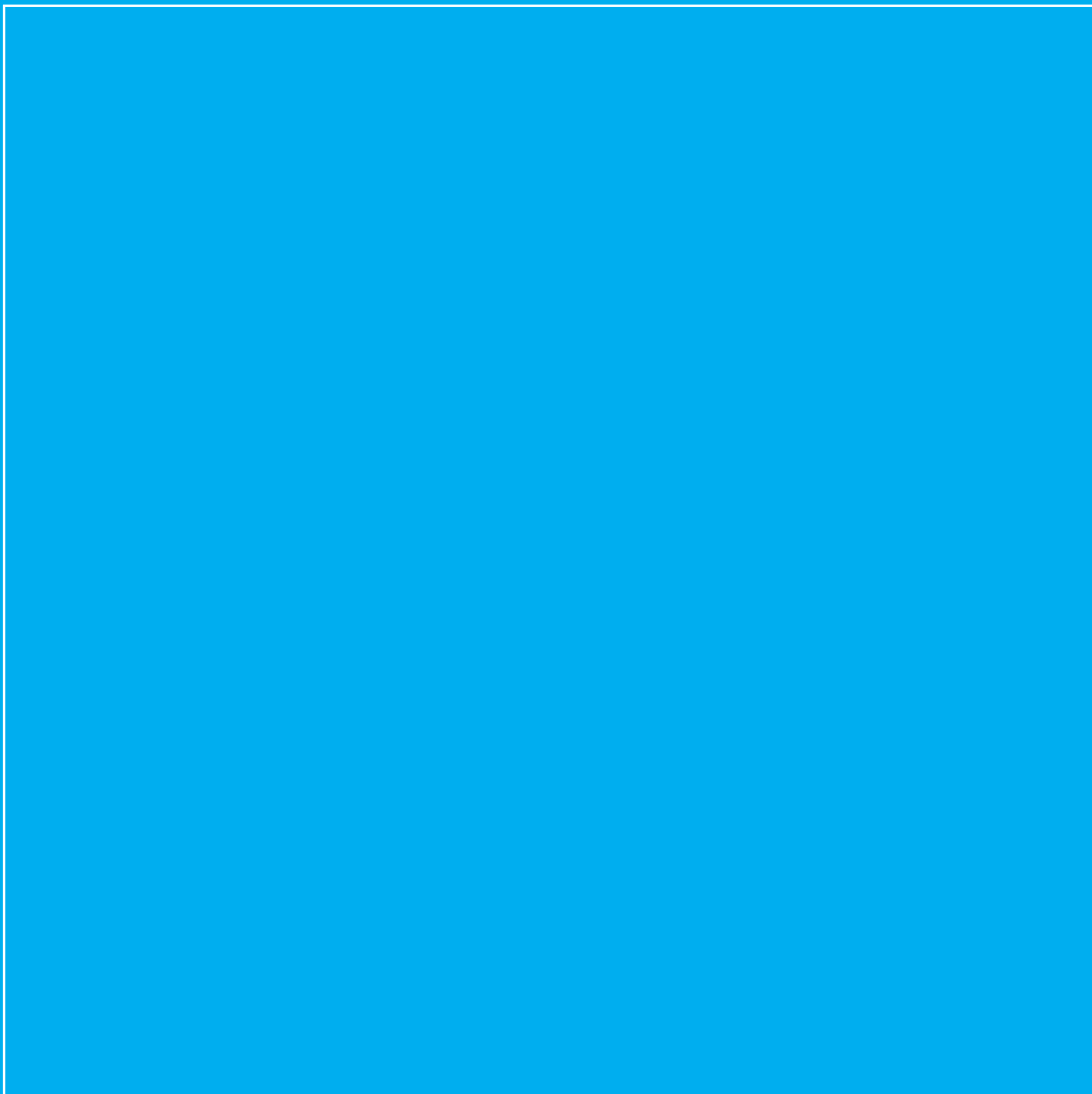
Why Audit Matters to Practitioners (continued)

PAGE 10

- ACCA's Professional Examination Scheme now examines higher level audit skills as a specialist option paper;
- ACCA's new practical training requirements provide an effective assessment of workplace competence. The membership competencies reflect the diverse role of the modern finance professional and recognise recent developments in professional practice;
- ACCA UK takes a supportive approach to ATPs which have low numbers of audit clients. Some firms have entered into arrangements with other ATPs in order to provide audit work experience to their ACCA students and members. ACCA UK can facilitate and support the development of such "audit consortia"; and
- ACCA UK is continuing to promote the value of the audit through training monitoring visits.

CONCLUSION

ACCA believes that SMEs will benefit from continuing to have an external audit. An audit can play a vital role in evaluating accounting and internal control systems and provides practitioners with the opportunity to provide a more rounded business advisory service to clients, growing their business in the process.



ACCA UK

29 Lincoln's Inn Fields London WC2A 3EE United Kingdom

tel: +44 (0)20 7396 7000 fax: +44 (0)20 7396 7070 www.accaglobal.com

The Association of Chartered Certified Accountants

