

THE STATUTORY AUDIT REQUIREMENT FOR SMALLER COMPANIES

Summary of responses to the consultation document (URN99/1115 – October 1999)

Introduction:

1. Currently companies with a turnover of above £350,000 are subject to an annual external statutory audit of their accounts. The Government considers that there is scope for a significant increase in the threshold. The objective of such an increase in the threshold is to remove statutory burdens and costs on smaller businesses where the benefits in the wider public interest are not commensurate.

2. On 4 April 2000 the Secretary of State announced the results of the consultation and his decision to increase the threshold to a level of £1 million this year, followed by a further raise to £4.8 million in the light of the recommendations of the current independent Company Law Review. These proposals are dealt with in greater detail below.

3. This paper summarises the 136 responses to the consultation. The responses themselves (except for those who asked for their comments to remain confidential) may be viewed in the DTI Library and Information Centre, Room LG132, 1 Victoria Street, London SW1H 0ET).

The Consultation Exercise:

4. In June 1999 the Secretary of State for Trade and Industry announced his intention to consult on increasing the threshold below which small companies may choose to dispense with having their annual accounts audited. The consultation document on this was published in October 1999 and the consultation period ended shortly before Christmas that year.

5. The paper itself did not suggest a figure at which the threshold should be set but, rather, noted the Secretary of State's initial view that there was a good case for a significant increase in the threshold, that European law allowed that the threshold could be set at any level up to and including a ceiling set by the 4th EU Directive on Company Law (£4.2 million at the time of the Secretary of State's announcement, since raised to £4.8 million)¹. The consultation document set out the various arguments surrounding raising the threshold and sought comments.

¹ Articles 11 and 27 of the Fourth Council Directive of 25 July 1978 on the annual accounts of certain types of companies, and article 27 of the Seventh Council Directive, as amended most recently by 1999/60/CE of 17 June 1999 and taking advantage of a 10% uplift allowed to take account of currency conversion.

Summary of Responses to the Consultation:

6. There were 136 responses to the consultation document. Of these, 81 came from accounting and audit firms (there were a range of responses from both large and small firms) and 17 from bodies representing accountants (these included the main professional bodies and other organisations, including regional and small practitioner bodies). There were seven responses from companies who have to prepare accounts, eight from companies in the business of providing information or credit ratings on companies and twenty three from others including organisations representing small companies. A graphical breakdown of the responses is at Annex A.

7. The crude numbers show: 22% of respondents favour retaining the status quo; 31% favour £1 million; 10% favour £2M; and, 30% favour £4.8 million. About 75% of those who favour £4.8 million include one or more caveats, either that the change should be in two stages, that the audit requirement should be replaced by a statutory review or professional involvement, or that this should await the next stage of the Company Law Review.

8. There were wide variations in the quality of the responses which ranged from the statement of a simple preference for a threshold figure without argument to detailed and closely argued papers supported by various evidence/surveys etc.

9. There were largely predictable differences according to the type of respondent. The companies who prepare accounts and two bodies of the representing small firms favoured £4.8 million. However, one major trade body representing small firms has argued that were the threshold to be raised above £1 million this would be against the interests of suppliers and customers (also often small businesses). The responses from those in the business of using or providing company accounting information favour retention of the status quo.

10. The responses from accountancy firms, large and small, and from the accountancy bodies are much more mixed, closely reflecting the overall percentages shown above.

11. The response from the accountancy bodies and groups were mixed but the majority of responses preferred a threshold of £1 million. One of these responses included the results of a survey of over 1000 small member firms of which 64% favoured £1 million or below (30% suggesting £1 million itself) and only 15% favouring an increase to £4.8 million.

12. In the responses to the consultation a number of arguments were put forward by respondents in favour of moving to £4.8 million and £1 million respectively. These are summarised below

Arguments put forward for moving to £4.8 million:

13. The following arguments were put forward by those respondents who argued for a move to the maximum level permissible under EU law, £4.8 million:

(a) The question, as stated in the consultation document, is whether audit should be a statutory requirement for smaller companies. The case for moving to a threshold at the maximum permitted by EU law does not therefore depend on any argument that there is little value in audit as such. Indeed the expectation was that a substantial number of companies would continue to recognise the value of the audit - and that those that did not may be judged critically by the market place.

(b) In principle the issue should be determined by a dispassionate assessment of the costs and benefits. The difficulty is that the benefits in particular are difficult to capture in financial terms and thus there is a large element of judgement involved. Nevertheless it may be argued that the nature and size of many small companies does not justify a mandatory, statutory audit because the benefits for management and third parties do not justify the costs involved.

(c) For many small companies managers and owners are the same people and therefore the audit check on the directors' trusteeship is not needed. Owner managers can decide for their own purposes or to satisfy the needs and interests of others whether to have an audit. There is in any event no requirement on other small businesses, organised for example as a partnership, to have a statutory audit (although such businesses do not enjoy the privilege of limited liability).

(d) In general terms such businesses (individually) have a lesser impact on the economy and are not likely to be a source of major fraud or illegalities. Statutory audit may help to limit abuses in these areas but it is less relevant than for larger companies. However, this argument may not be not entirely convincing as money laundering - to which the Government attaches great importance - may well be focused in smaller companies.

(e) As the size of the company increases, so the balance of advantage changes - their impact on the economy is more substantial. Undetected errors in accounts, deliberate or otherwise, start to have a more material effect on tax revenues and a company failure caused by a lack of financial expertise or professional involvement will have more serious effects - e.g. it can start to have a domino effect on employment etc.

(f) The point at which the balance of advantage shifts in favour of a statutory audit requirement is a matter of judgement but the view is that, by the time a company has a turnover of around £4 million it is certainly likely to be a significant player in local terms.

(g) There are risks in increasing the exemption limits, particularly if the result is that there is no involvement of a qualified accountant in the preparation of the accounts or no form of external assurance at all. It is debatable whether such an option should be a mandatory replacement for the full audit but these options might be explored further before moving to the EU ceiling.

(h) None of this is to deny that third parties make use of audited accounts and place value on them, nor is it to deny that the statutory audit helps to underpin an environment that engenders honesty and integrity in the preparation of accounts and helps with the prevention of fraud and money laundering (a number of respondents commented that a move to £4.8 million would be seen as a "crooks charter"). The difficulty is in deciding what weight to place on the benefits and costs.

Arguments put forward for moving to £1 million:

14. The following arguments were put forward by those respondents who argued for a move to the maximum level permissible under EU law, £4.8 million:

a) Those arguing for a threshold of no more than £1 million for the immediate future tend to share the above analysis in terms of the approach to the issue but to draw much lower the line below which costs exceed benefits. They therefore tend to emphasise the following points.

b) There is a substantial public interest in the accuracy of accounts filed at Companies House. Although the obligations on directors to produce annual accounts which show a true and fair view would be just as before, in practice the quality of accounts on the public record would deteriorate. In particular, there is likely to be an increased failure to account properly for stock and tax liabilities, and "going concern" problems are likely to be masked. Such weaknesses then emerge too late in the day when there is a downturn in the economy. There are undeniable risks in this area, but they are hard to quantify.

c) Accounts and records provide a framework of discipline on which the Inland Revenue rely heavily for accurate tax assessment and collection. The Inland Revenue does not have the capacity to investigate large numbers of companies individually.

d) The deterrent effect of the statutory audit is considerable in relation to fraud and money laundering. It is just those companies for whom the public interest argument for audit is the greatest which will dispense with it. The risk of deliberately misleading accounts will therefore increase as the unscrupulous take advantage of a more lax regime.

e) Audit provides a mechanism for ensuring that growing companies receive proper financial advice. However this cannot, of course, be seen as a justification on its own for audit.)

f) There is a further tranche of arguments which accept that there may be a case for going beyond a £1 million threshold but that there are strong arguments against doing so immediately:

- there is a danger of moving too far too fast. It is sensible to take a (sizeable) step at a time and assess the results before moving further. Once the decision has been taken to raise to the maximum, respondents noted that it might be difficult to subsequently remove the exemption should a raise to £4.8 million cause unforeseen problems;
- it would be a mistake for the audit exemption debate to pre-empt the Company Law Review which is currently looking at proposals for an improved, less burdensome reporting regime for small companies;
- the option of a “lighter touch” replacement, such as an independent professional review, needs to be explored before moving to a higher figure (this is also the conclusion of the Company Law Review);
- as noted in the consultation document, simple comparisons with the position in some other EU countries are not straightforward.

Other arguments put forward

1. There were also a range of responses which, rather than arguing for a particular turnover threshold below which the exemption from audit should become available, argued that the simple analysis of turnover was an inappropriate measure for whether a company’s accounts should be audited. They suggested that a more radical approach should be taken. These included, for instance the scrapping of audit for all companies classified as small but accompanied by a requirement that a “qualified accountant” should be used to prepare the accounts. Others argued that a different form of threshold should be used to signify audit exempt status. For instance, a company might only be allow an exemption from audit where all its shareholders were also directors in the company. In this case, they argued, all the shareholders would have an intimate knowledge of the company’s finance and the external assurance of a statutory audit was unnecessary.

2. Whilst such opinions were noted they were not, however, taken into account determination of the new audit threshold. They would have represented a more fundamental change to the accounting and audit regime applied to small companies. As such their consideration was more appropriate to the Company Law Review. The Review document published in March 2000 considers such matters in further detail. Information on the proposals of the Company Law Review can be obtained from the Company Law Review team on 020 7215-0431 or on the Review web-site, <http://www.dti.gov.uk/cld/modcolaw.htm>.

Recommendations arising from the consultation

3. There was no clear consensus arising for a single option with approximately one third of respondents favouring either a move to £1 million or £4.8 turnover. However, it was clear from the responses that over 70% of respondents favoured an increase to at least £1 million turnover. The Government was also aware that it could not simply consider the raising of the audit threshold in isolation from other initiatives currently under way in the area of company law. It was necessary, also, to take account of the proposals on the accounts and audit of small companies arising from the Company Law Review.

4. The Government proposes that, in the light of the responses to the consultation, the threshold should be increased to a level of £1 million as soon as possible. This can be done under regulation making powers. The Government's intention is to lay regulations before Parliament as soon as possible which will deal with the raising of the audit threshold along with changes to the regime for dormant companies which have resulted from a separate consultation. Subject to the regulations being approved by Parliament the intention is that the regulations should apply to financial periods ending after 31 July 2000.

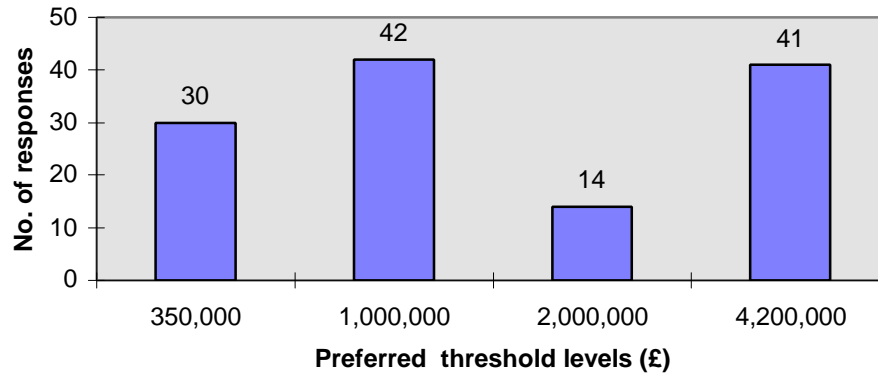
5. In the light of the Company Law Review's proposals on reporting and audit for small companies the Government envisages that the threshold should be raised to the maximum allowed under EU law (currently £4.8 million) but with perhaps some other, less burdensome form of assurance for those companies between £1 million and £4.8 million.

6. The Government considers that this course will produce the maximum, immediate deregulatory benefit for small companies without damaging the interests of the investors in those companies, their customers and their creditors. In the longer term the option to raise the threshold further (with the possibility of some less burdensome form of assurance) will be examined. This course is compatible with the emerging conclusions of the Company Law Review relating to the reporting and audit of small companies.

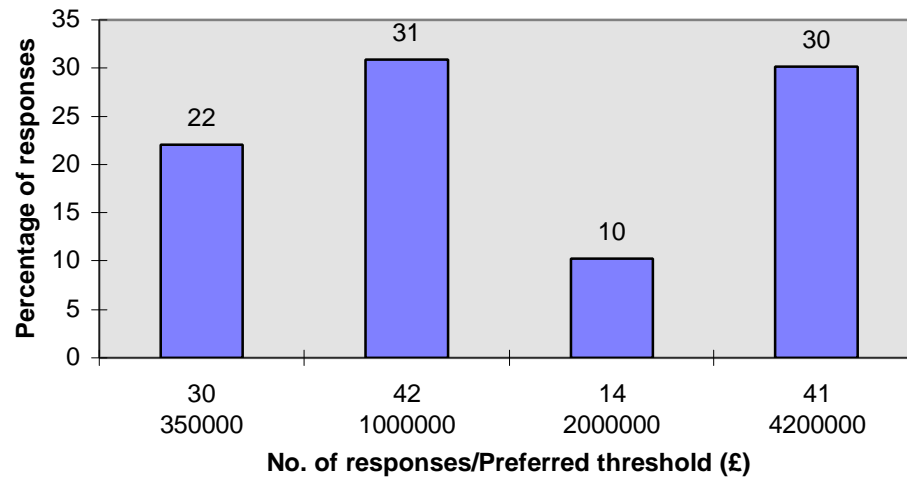
April 2000

Graphical breakdown of responses to audit consultation

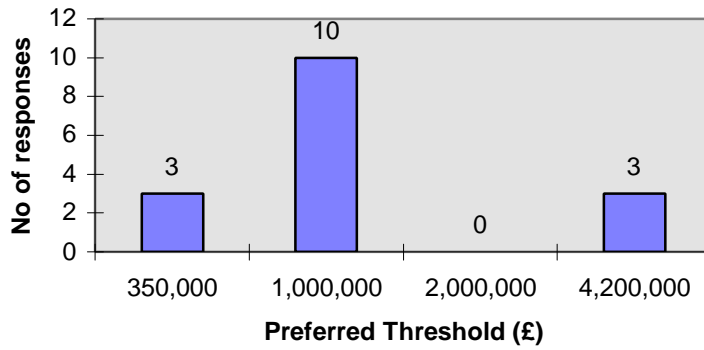
Overall responses to the 1999 Audit Exemption Consultation Exercise



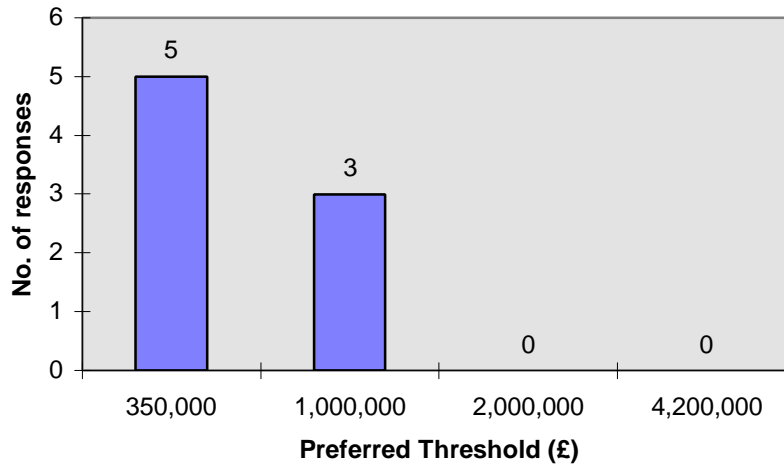
Responses to 1999 Audit Exemption Consultation Exercise (Percentages)



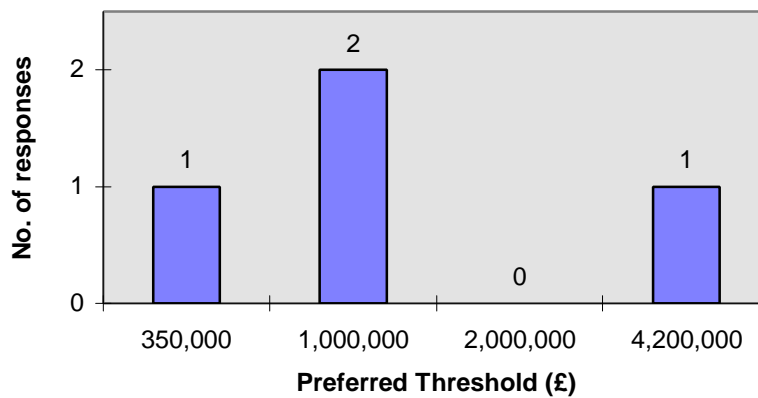
Responses from the Accountancy Bodies



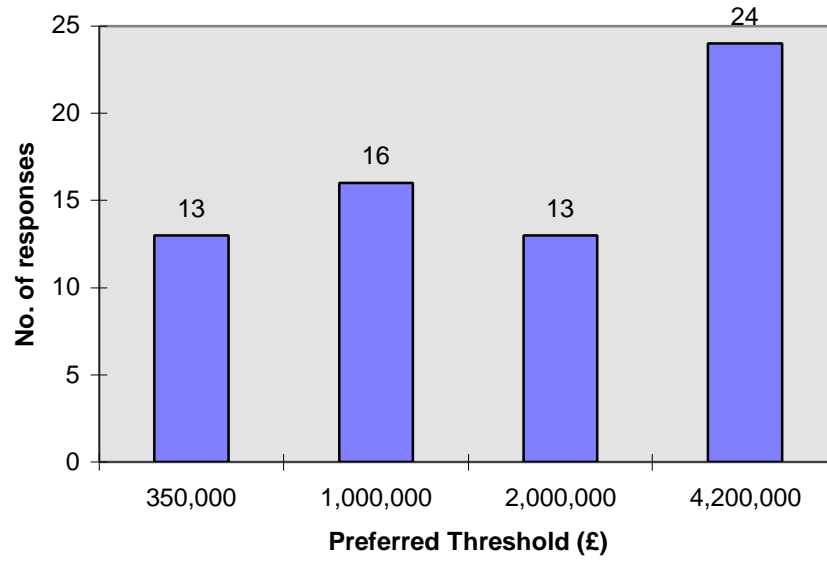
Credit Agencies/Finance Providers



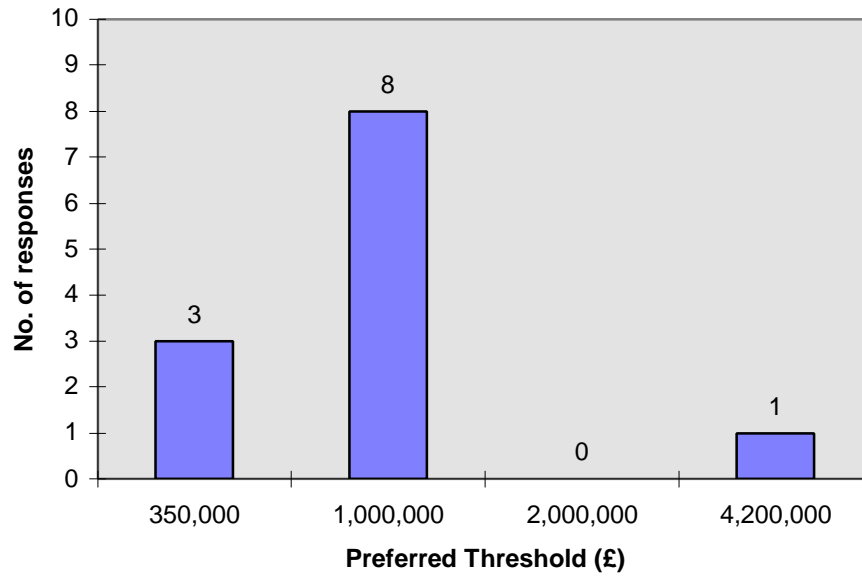
Responses from Professional Bodies/Trade Associations



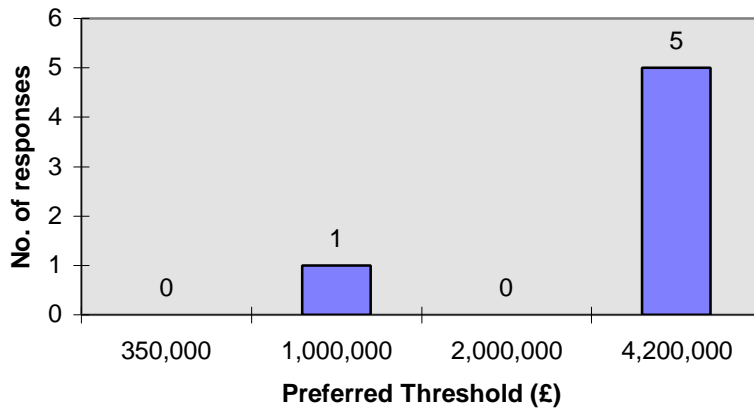
Responses: small practitioners



Large practitioners



Company responses



Other respondents

