

FINAL REGULATORY IMPACT ASSESSMENT ON THE AUDIT EXEMPTION THRESHOLD

1 Proposal

1.1 To increase the audit exemption threshold to the maximum permissible under EU law (turnover not more than £5.6 million; balance sheet total not more than £2.8 million) by **the Companies Act 1985 (Accounts of Small and Medium-Sized Enterprises and Audit Exemption) (Amendment) Regulations 2004**.

2 Purpose and intended effect

(i) Objective

2.1 The increase in the audit exemption threshold level will relieve most¹ small companies and Limited Liability Partnerships (collectively referred to as companies for ease of reference) of the requirement to have their statutory accounts independently audited.

2.2 **Devolution:** Responsibility for company law matters lies with the Secretary of State for Trade and Industry. Company law is a reserved area under the Scottish and Welsh devolution legislation and therefore any resulting changes to companies legislation will also apply in Scotland and Wales. In Northern Ireland, matters arising from the proposal would normally be the responsibility of the Northern Ireland Executive Ministers. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments subject to the direction and control of the Secretary of State for Northern Ireland.

(ii) Background

2.3 In July 2001 the Final Report of the Company Law Review² recommended that the turnover threshold below which small companies are not required to have an audit should be raised from £1 million to the then EU maximum of £4.8 million. This reflected a concern that, for some small companies, the benefits of a statutory audit may not be sufficient to justify the cost.

¹ Section 249B of the Companies Act 1985 sets out those companies for whom exemption from audit is not available. Those not exempt from audit include public companies, registered insurance brokers, persons or representatives authorised under the Financial Services and Markets Act 2000, certain companies defined in the Trade Union and Labour Relations (Consolidation) Act 1992, and companies within a group whose group turnover exceeds the thresholds.

² Modern Company Law for a Competitive Economy, July 2001, URN 01/942.

2.4 The Modernising Company Law White Paper³ announced that the Government would assess the impact of the July 2000 increase in the audit exemption threshold and consult further before making a final decision. In his budget statement on 9 April 2003, the Chancellor said that the Government was minded to increase the threshold, subject to consultation.

(iii) Risk Assessment

2.5 There are concerns that the statutory audit places a burden on small companies. Increasing the audit exemption threshold would exempt more small companies from the statutory audit requirement. However, doing so is not without risk. These risks are discussed at paragraphs 3.6 to 3.12 below.

3 Options

3.1 The three main options are as follows:

Option 1:

3.2 **The threshold at or below which companies can be exempt from the requirements of the statutory audit remains at a turnover level of not more than £1 million and a balance sheet total of not more £1.4 million. The threshold also applies to groups.**

3.3 There are concerns that the statutory audit places a burden on small companies that outweighs the benefits that the audit gives to shareholders and suppliers of credit (both those who provide financial backing, and those who are suppliers of credit in that their goods and/or services are supplied prior to payment being received).

3.4 If the audit threshold was increased to the maximum permissible under EU law, those companies relieved from the statutory audit would be able to decide for themselves whether audited accounts were of benefit to them.

3.5 Currently some 822,000⁴ companies are exempt from the statutory audit requirement. Increasing the audit exemption threshold to the maximum would mean that a further 69,000 companies would no longer be required under the 1985 Act to have their accounts audited.

³ Cm 5553-I, July 2002

⁴ Source: Financial Analysis Made Easy (FAME) 2003. Total number of companies that filed accounts for financial year 2001/2003: 1,115,000

Option 2:

3.6 The threshold at or below which companies can be exempt from the requirements of the statutory audit should be increased to turnover not more than £2 million and a balance sheet total of not more than £2.8 million. The threshold would also be applied to groups where the total turnover of the group does not exceed the new maxima.

3.7 There were a number of respondents who considered that the audit exemption threshold should be increased to a level below the EU maximum. They suggested increases in the turnover of between £1.5m and £3m. This option has all the risks of option 3, although to a lesser extent, and benefits fewer companies. The risks are detailed in full under option 3 at paragraphs 3.10 to 3.12 and are therefore not repeated here.

3.8 The costs and the number of companies affected by option 2 are shown in summary below:

- a) If all companies with a turnover between £1 million and £2 million (48,000) choose not to have an audit, there would be a loss to the profession of £48 million (based on a cost of £1,000 per audit⁵). (See paragraph 3.12a below).
- b) If 69% of companies in the £1 million to £2 million turnover range take advantage of audit exemption then a further 33,000 companies will exempt themselves from audit with a loss to the profession of £33 million.

Option 3:

3.9 The threshold at or below which companies can be exempt from the requirements of the statutory audit should be increased to the maximum permissible under EU Directives (turnover not more than £5.6 million and a balance sheet total of not more than £2.8 million). The threshold would also be applied to groups where the total turnover of the group does not exceed the new maxima.

3.10 The principal purpose of a statutory audit is to provide a reasonable assurance that a company's financial statements are free from material misstatements and fraud and show a true and fair view of the company's state of affairs. This is first and foremost for the benefit

⁵ Directors Views on Exemption from the Statutory Report, A research report for the DTI, Jill Collis, Oct 2003, URN 03/1342 (The Collis Report). Available online at <http://www.dti.gov.uk/cld/audit.htm>

of shareholders of companies, although suppliers of finance, goods and services also place a reliance on the audit.

3.11 The risks of removing the requirement for small companies to have a statutory audit of their accounts are that:

- a) There is an increased risk that statutory accounts will include errors or not be prepared in accordance with legal requirements as there is no requirement for statutory accounts to be prepared by a professionally qualified accountant. However, company law requires directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company⁶ at the end of the financial year and the profit or loss for that period. In preparing those financial statements, the directors are required to:
- select suitable accounting policies and then apply them consistently;
 - make judgements and estimates that are reasonable and prudent; and
 - state whether applicable accounting standards have been followed.

These requirements are separate from those of the statutory audit. The companies being brought into within the new threshold are likely to have in-house financial expertise and thus the technical capacity to prepare accounts. They are also more likely to have external shareholders and external financiers who may require the companies to have an audit.

- b) Errors in the accounts of companies could lead to a degradation in the quality of information filed at Companies House. Research carried out between 1 March 2003 and 31 May 2003 shows that 986 complaints on accounts were received by Companies House. 93.3% of the complaints were on unaudited accounts. However, looking back to the period when those accounts were filed, the complaints represent less than 0.2% of accounts filed.
- c) Companies may lose the external, independent check on their financial position, which protects the interests of shareholders and suppliers of finance or goods and services against incompetent or fraudulent managers. A survey by the Association of Certified Chartered Accountants (ACCA)⁷ shows that, of the frauds reported in their survey, 45% were discovered by auditors. Conversely, 55% of frauds were not discovered by auditors. Research and responses to

⁶ Section 226 & 227 of the Companies Act 1985, Duty to prepare individual accounts and Duty to prepare group accounts.

⁷ ACCA Members' Survey. Fraud and the Smaller Company: January 2001

the consultation suggest that the majority of companies with a turnover at or below £5.6 million are owner/managed with shareholders who have access to internal financial information. Shareholders who are also owner/managers with such access are less likely to require the reassurance of an external, independent audit. It should be noted that the interests of minority shareholders are protected. Section 249B(2) of the 1985 Act allows shareholders of at least 10% of the share capital to require an audit. Suppliers of credit can look behind the unaudited accounts and request more detailed and up-to-date financial information such as management accounts before making decisions on supply finance or credit terms to companies.

- d) It could lead to increases in the risk of undetected fraud against companies. The statutory audit is not designed to detect fraud but it may do so and, it also acts as a significant deterrent.

It may also facilitate the use of companies for illegal purposes such as money laundering. However, the Money Laundering Regulations 2003, when in force, will cover all persons providing accountancy services by way of business. This will bring all accountants, bookkeepers and tax advisors (not just auditors) into the regime regardless of whether they are professionally qualified. However, employees of a company providing these services to their employer are not covered by the Money Laundering Regulations. But even the number of companies able to take advantage of the higher threshold (and not all will) is small compared to the number that have already dispensed with an audit. The Government does not consider that increasing the threshold will have a substantial impact upon the anti-money laundering regime in the UK.

- e) Lenders may charge more for finance if accounts are not audited, to reflect greater perceived risk. The DTI's survey of the members of the Institute of Credit Management (ICM)⁸ shows that exemption from audit is likely to affect a company's credit rating. However, some respondents stated that it is not necessarily the statement by auditors that lenders rely on but the fact that the accounts have been prepared by an outside accountant. Other respondents have commented that annual accounts are out of date by the time they are published and lenders require other more up-to-date accounts and forecasts. Ultimately it will fall to the company to make the choice to dispense with the audit and possibly incur higher credit fees.
- f) It removes the assurance for other suppliers of credit, goods and services (who may themselves be small companies). However, it should be noted that no respondents to the consultation said they relied on company accounts in making their decision to supply goods

⁸ Raising the Thresholds consultation document, DTI, July 2003, URN 03/961

or that raising the threshold would alter that decision. Suppliers of goods and services are able to take an informed decision, by looking at the credit rating of the company they intend to supply.

3.12 There are further risks which are discussed below:

- a) The audit profession's revenue may be reduced by the loss of audit fees. In 2001 there were around 11,300 entities holding registered auditor status. If all companies with a turnover between £1 million and £5.6 million (69,000) choose not to have an audit, there would be a loss to the profession of £69 million (based on a cost of £1,000 per audit).

If 69% of companies in the £1 million to £5.6 million turnover range take advantage of audit exemption then a further 47,000 companies will exempt themselves from audit with a loss to the profession of £47 million.

The SPA Report (see paragraph 6.3 below) found that small practices generally provide a package of services to corporate clients for a single annual fee. Respondents reported that annual fees had been reduced on average by 10% where the audit had been dispensed with following the last increase in the audit fee.

ICAEW research⁹ shows that following the last increase 55% of members in practice lost client audit work. 70% of those members offset these losses by new work with 41% finding new non-audit work from the same clients. 20% of members in practice reported that new work only offset some of the loss. Costs savings to auditors have also been identified (see paragraph 4.6 below).

- b) There is also a risk that a two-tier accounting structure may develop within the accounting profession. This is discussed at paragraphs 7.2 to 7.6 below.
- c) Some respondents raised concerns that an increase in the audit threshold may bring a loss of revenue to the Exchequer. The Inland Revenue have no evidence to show that increasing the threshold will reduce tax receipts.
- d) Some respondents have suggested that removing more companies from the requirement to have a statutory audit will increase the costs of audit on those who retain the statutory audit as there will be a smaller market. Respondents have suggested that the cost of audit is already held artificially low by not passing the full cost through to

⁹ Available on the internet at <http://www.icaew.co.uk>

clients and the quality of the audit has been affected by the cost cutting. If the market does shrink and some firms react by specialising in audit, business would benefit from this more specialised audit service. It would be difficult to say that any increase in fees was tied solely to the increase in the threshold, rather than to a combination of market factors.

4 **Benefits**

Option 1:

4.1 The benefits of retaining the current audit exemption threshold are that:

- It provides an independent check on the reliability and accuracy of company accounts, for management, shareholders and others.
- It provides assurance for suppliers of credit, goods and services (who may themselves be small companies) and may prevent the degradation of information available to users of accounts from Companies House.
- It may deter or detect some fraud against companies.
- It may prevent companies from incurring a higher cost for credit.

Option 2:

4.1 This option has all the benefits of option 3, although for fewer companies. The benefits are detailed in full under option 3 at paragraphs 4.2 to 4.6 and are therefore not repeated here.

4.2 The costs and the number of companies affected by option 2 are shown in summary below:

- a) There would a cost saving to companies of some £33 million (33,000 X £1,000 (cost of audit)) to businesses (although it is likely that the larger the company the less inclined it would be to take advantage of the threshold).
- b) There will also be cost savings to companies in staff and management time. Respondents to the consultation have stated that these cost savings will be around £1,000 per company. This would result in a further saving to companies of a further £33 million per annum.

Option 3:

4.2 Increasing the audit exemption threshold will empower directors enabling them to make decisions about the effect dispensing with the

audit would have on their company rather than having regulation imposed upon them. This option gives directors of small companies the opportunity to decide whether they want to subject their statutory accounts to an independent audit or whether any resulting cost savings can be put to better use within the business. The Collis Report (see paragraph 6.1 below) shows that directors are more likely to have a voluntary audit if:

- The company has a larger turnover.
- The audit improves the quality of the financial information.
- The audit has a positive effect on the company's credit rating score.
- The company is not wholly family owned.
- The company has shareholders without access to internal financial information.
- The directors normally give a copy of the statutory accounts to the bank and other providers of finance.
- Loss of business to auditors will not occur.

4.3 There are costs savings to a company in choosing not to audit their accounts. In the financial year 2001/2002, 69% of companies (569,730¹⁰) who could take advantage of the audit exemption threshold chose not to have their accounts audited. If the threshold is increased to £5.6 million a further 69,000¹¹ companies will no longer be required to have their accounts audited. If the same percentage of companies took advantage of the new threshold there would a cost saving of some £47 million (47,000 X £1,000 (cost of audit)) to businesses (although it is likely that the larger the company the less inclined it would be to take advantage of the threshold).

4.4 There will also be cost savings to companies in staff and management time. Respondents to the consultation have stated that these cost savings will be around £1,000 per company. This would result in a further saving to companies of £47 million per annum.

4.5 Respondents to the consultation have identified that there will also be cost savings to auditors who no longer have to audit, in not being liable for audit registration fees. This may be in the region of £2,000 per firm per annum. This would result in cost savings of some £22.6 million per annum which would offset the loss in audit fee income. There will also be savings on time spent on administration and training.

¹⁰ FAME

¹¹ FAME

Reports and responses to the consultation show that accounting firms work closely with their clients. Both could benefit from the accounting firm being able to devote more time to providing its customers with more focussed and specialised services (such as valuations, internal audit, taxation, IT and financial information technology systems). The fees for these services would offset any loss resulting from audit fees. Respondents have stated that they will also gain as they have been unable to pass on the full cost of audit to their clients, and have absorbed some of that cost themselves.

Business Sectors Affected

4.6 An increase in the audit exemption threshold level to the maximum permissible would allow all small companies (with some exceptions) with a turnover at or below £5.6 million to take advantage of the exemption from audit. The increase would also affect audit firms. This affect is discussed at paragraphs 7.2 to 7.6 below.

Issues of Equity and Fairness

4.7 The Government considers that the proposal to increase the audit exemption threshold will not bring disproportionate benefits or have disproportionate effects on particular groups other than business.

5 Costs

(i) Compliance costs

Option 1:

5.1 The requirement to have statutory accounts independently audited places a cost burden on business. The cost of an audit varies depending on the size and complexity of the business. The initial findings of the Collis Report found that £1,000 was a typical fee for auditing accounts (see paragraph 6.1 below). Responses to the consultation have stated that audit fees range between £500 and £9,000 depending on the size and complexity of the company. Therefore cost savings may be higher.

5.2 There are in the region of 48,000 companies in the £1 million to £2 million turnover range and a further 21,000 companies in the £2 million to £5.6 million turnover range. If the audit threshold is retained at its current level of £1 million the cost to companies in terms of lost benefit would be £69 million (or greater) (69,000 X £1,000 (cost of audit)).

Option 2:

5.3 There are 21,000 companies in the £2 million to £5.6 million turnover range. If the threshold is set at £2 million the cost to

companies in terms of lost benefit would be £21 million (or greater) (21,000 X £1,000 (cost of audit)).

Option 3:

5.4 Increasing the audit threshold to the maximum permissible under EU law will not impose compliance costs on business.

(ii) **Other costs**

5.5 The Government considers that the option to increase the audit exemption threshold to the maximum permissible under EU law will not impose costs on sectors other than business.

5.6 The increase in the audit exemption threshold will not affect charitable companies.

5.7 There will be a cost to the audit sector in loss of audit fees (see paragraphs 3.12 a and b above).

6 Consultation with small business: The Small Firm's Impact Test

6.1 Jill Collis, a senior lecturer at Kingston University was commissioned by the DTI to gather views on issues relating to audit exemption from the directors of companies that fall within the EU threshold defining small companies. The study is based on a survey of 790 independent private limited companies that fall within the EU definition of small in their 2002 accounts. The final Report ("the Collis Report") was published in November 2003.

6.2 The findings of the Collis Report show that whilst directors of small companies can see benefits in retaining the audit and having an independent check on their accounts, they support the proposal to increase the audit exemption threshold. The Collis Report provides information on the likely take-up of the audit exemption threshold by companies and shows that 42% of companies predict that they would still continue to have their accounts audited.

6.3 In June 2003 the Society of Professional Accountants (SPA) (formerly know as the Small Practitioners Association) submitted to the DTI a report entitled "The Beneficial Impact of Raising Audit Thresholds from £350,000 to £1,000,000" ("the SPA Report"). The SPA Report is available on the internet at www.spa.org.uk.

6.4 The SPA Report shows that the last increase in the audit exemption threshold was welcomed by small professional accounting practices. Their corporate clients benefited from lower fees, few

instances of problems by third party users of accounts were experienced and a further increase to the EU maximum was supported.

7 Competition Assessment

7.1 The proposal has the potential to affect all small private companies in all markets. It is not anticipated that the proposal will: affect some of those businesses more than others; affect market structure; change the number or size of those businesses; lead to higher set-up costs for those businesses; or lead to higher on-going costs, than at present.

7.2 One particular business sector identified as being affected by this change is the auditing profession. The cost to the audit profession has been discussed in paragraphs 3.12 a and b above.

7.3 If a large number of companies took advantage of the removal of the requirement to have an audit, it is possible that some registered auditors may review the need for their registration. There are currently some 11,300 entities holding registered auditor status. If there was a significant decrease in that number, it is possible that a two-tier structure of professional accountants could develop, with firms polarised between those who work with the accounts of small companies and do not audit, and those who work with medium and large companies and do have the expertise to audit.

7.4 Some respondents to the consultation raised this as a concern, suggesting that a two-tier structure would increase the cost of the audit for those smaller companies who required an audit of their accounts. It would be difficult to isolate the impact of this change from the impact of other factors on any increase in audit fees.

7.5 However, the view was also put that audit work is specialised and should not be carried out by general practitioners. A two-tier accounting profession should therefore be allowed to develop with firms being able to decide whether they want to specialise in audit or outsource the audit of their clients to other firms. This would allow firms to concentrate on providing other business services to their clients which they are currently prevented from doing by their position as auditor. The Association of Accounting Technicians (AAT) noted that there is already a two-tier structure of professional accountants: those that work with small companies that do not require an audit and those who work those companies, small, medium and large that do require an audit.

7.6 The Collis Report shows that 85% of small companies (using the EU definition in force at that time) normally use an external accountant

to prepare their statutory accounts¹². In a large proportion of cases the external accountant also provides tax services (65%), additional detailed annual accounts (36%) and/or advice in connection with the annual results (33%).

8 Enforcement and Sanctions

8.1 The proposal to increase the threshold below which small companies are not required to have their statutory accounts audited removes a burden on business. No further enforcement is required other than that which already exists for enforcing the standards for small company accounts.

9 Monitoring and Review

9.1 The thresholds defining small companies (and therefore the audit threshold) in the EU are reviewed every five years. When the EU thresholds change, it is proposed that the audit exemption threshold in Great Britain would also be reviewed.

10 Consultation

(i) Within Government

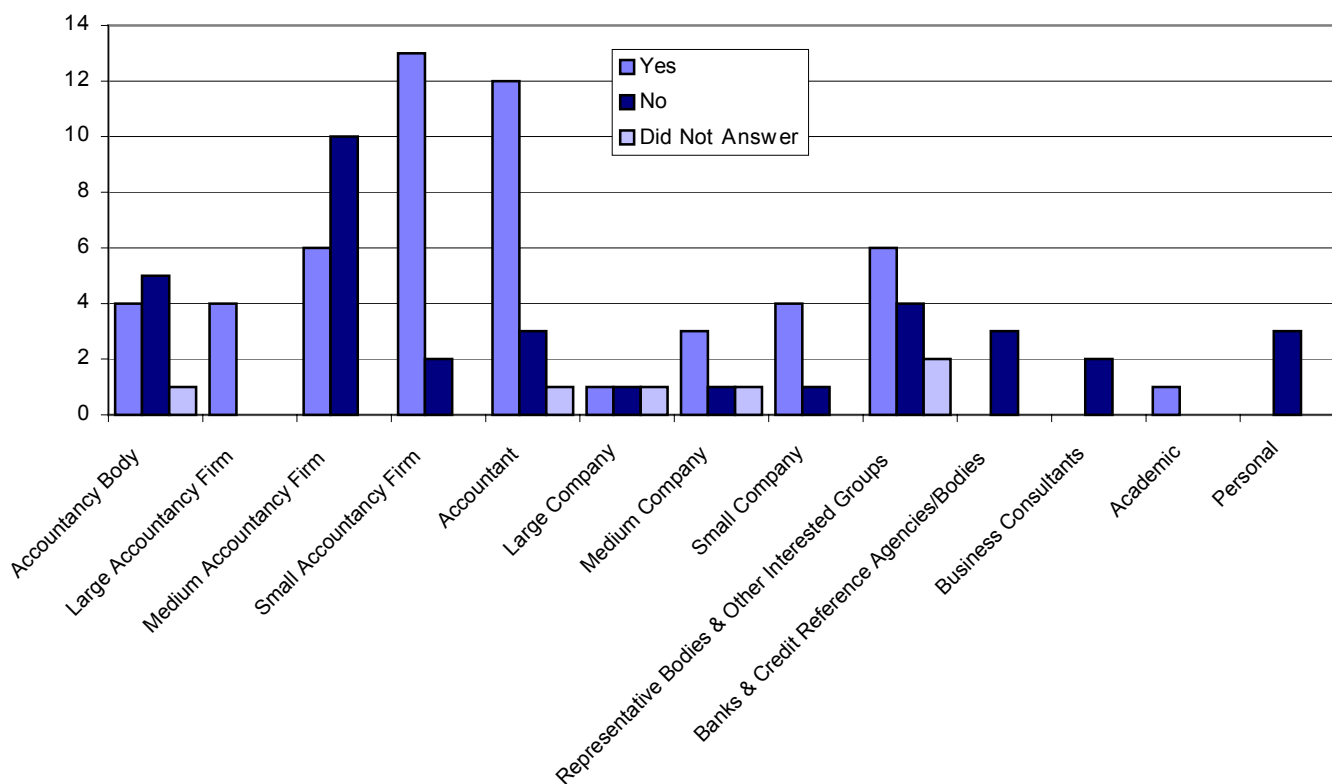
10.1 The DTI has consulted with the Small Business Service, Companies House, HM Treasury and the Inland Revenue.

(ii) Public Consultation

10.2 In July 2003, the Government published a consultation document on the proposal to increase the audit exemption threshold. The consultation document was sent to approximately 870 businesses, professional bodies, representative organisations and individuals and was available on the internet. The consultation closed on 3 October 2003.

10.3 The chart below shows a breakdown of responses for and against the proposal by business sector:

¹² The Collis Report, paragraphs 4.12 to 4.18, Financial Reporting and Accountancy.



10.4 The comments and concerns raised by respondents together with costs and savings identified by respondents have been taken into account when preparing this Regulatory Impact Assessment. A summary of responses to the consultation has been published and is available on the DTI's website at <http://www.dti.gsi.gov.uk/cld/audit.htm>. No changes have been made to the proposal following the consultation.

11 Summary and Recommendation

11.1 The table below shows a summary of the costs and benefits of the proposal:

Option	Total cost per annum	Total benefit per annum
1. No change	<ul style="list-style-type: none"> • Cost of audit fees to companies -£69 million (or greater)(69,000 X £1,000 (cost of audit fee)). • Cost of time spent by management and staff of companies on the audit - £69 million • Cost to auditors in audit fees, 	<ul style="list-style-type: none"> • Benefit to shareholders, credit suppliers, suppliers, investors, and regulatory authorities from the comfort of the audit – Unquantifiable. • Loss of business to auditors will not occur.

Option	Total cost per annum	Total benefit per annum
	administration and training - £22.6 million	
<p>2. Increase the audit exemption threshold to: turnover not more than £2 million; balance sheet total £2.8 million</p>	<ul style="list-style-type: none"> • Cost to auditors in audit fees, administration and training - £33 million • Possible increase in costs of borrowing for companies – unquantified • Possible increasing incidence of errors in the accounts of companies filed at Companies House – unquantifiable • A two-tier structure in the accounting profession which would affect the training and development of staff and others wishing to enter the profession. 	<ul style="list-style-type: none"> • Benefit to companies of £33 million or greater. • Cost of time spent by management and staff on the audit - £33 million. • A two-tier structure may develop within the accounting profession which would allow accounting firms to specialise and provide services appropriate to their clients business needs • Higher quality audit

Option	Total cost per annum	Total benefit per annum
<p>3. Increase the audit threshold to the maximum permissible under EU law: turnover not more than £5.6 million; balance sheet total not more than £2.8 million</p>	<ul style="list-style-type: none"> • Cost to audit profession - £47 million • Possible increase in costs of borrowing for companies – unquantified • Possible increasing incidence of errors in the accounts of companies filed at Companies House – unquantifiable • A two-tier structure may develop in the accounting profession which would affect the training and development of staff and others wishing to enter the profession • Increase in cost of audit - unquantified 	<ul style="list-style-type: none"> • Benefit to companies of saving in audit fees - £47 million or greater. • Cost of time spent by management and staff of companies on the audit - £47 million • A two-tier structure may develop within the accounting profession which would allow accounting firms to specialise and provide services appropriate to their clients business needs • Higher quality audit

11.2 The Government recommends option 3. An increase in the audit threshold to the EU maximum will benefit some 69,000 companies with a potential cost saving of £94 million or more to those companies.

- Companies will be able to decide for themselves whether they want an audit of their statutory accounts or whether the money saved from not paying an audit fee is best used elsewhere to the company's advantage.
- It will be for companies to decide whether they wish to take the risk that not auditing their accounts will result in an increase in their costs of borrowing.
- Shareholders will still be able to require the company to audit their accounts if they consider that necessary.
- Suppliers of credit can look behind the audited accounts of the company and can request more detailed financial information, as can regulatory authorities such as the Inland Revenue.
- Suppliers of goods and services can take an informed decision according to the credit rating of the company they intend to supply.

I have read the Regulatory Impact Assessment and am satisfied that the benefits justify the costs.

..... Date:

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