AccountancyAge

Auditors prepare for life under increased exemption thresholds

by Richard Crump 26 Nov 2013

AUDITORS are preparing for the prospect that more than 99% of UK businesses will soon no longer be required to have an audit.

If, as expected, the proportion of audit exempt companies is increased next year, many firms risk losing a significant chunk of audit business, raising the prospect that they would be better-served ditching the service line altogether.

As part of changes to the EU's Accounting Directive, voted through European Parliament earlier this year, member states have the option to significantly increase the size of businesses that will no longer require audited financial statements for those with a turnover below €12m (£10.3m) and a balance sheet below €6m.

Last year, BIS aligned mandatory audit thresholds with the range of businesses that can be defined as small, and thus exempt from an audit, under EU rules. Companies are exempt from requiring an audit if they meet two out of three qualifying criteria - a balance sheet of less than £3.26m, turnover below £6.5m and fewer than 50 employees. However, a new paragraph introduced into the EU's Accounting Directive earlier this year could effectively double the size of company able to obtain an exemption.

EU member states have until 2015 to implement the directive, and BIS is expected to consult on any changes next year. But with the government's continued enthusiasm for deregulation, firms appear resigned to an increase in thresholds as all but inevitable.

Dire consequences

For some medium-sized firms, particularly those with a large number of regional offices, the consequences could be dire. "For some firms it will be a disaster," says Lynton Stock, head of audit and one of the founding partners at Shelley Stock Hutter, who adds that raising thresholds further would be a "retrograde step".

According to Paul Woosey, audit partner at Carter Backer Winter, the danger is that so many firms will drop out of the service line altogether that the profession will become "polarised between those that offer audit and those that don't."

Indeed, making a buck out of audit is already difficult enough for smaller constituents of the *Accountancy Age* Top 50+50. Audit fees among the constituents excluding the top six firms fell by 4% to £664.4m from £690.8m; evidence of the tough pricing environment firms have been wrestling with over the past three years.

With exemption thresholds only ever increasing since a £350,000 turnover limit was introduced in 1993, and rising to £5.6m in 2004 and £6.5m in 2008, firms have been dropping out of the market at a startling rate. According to the FRC's latest Key Facts and Trends report, the number of registered audit firms has dropped from 8,099 in 2008 to 7,239 in 2012. Meanwhile, the number of applications for registered audit status from 495 in 2010 to 420 in 2012.

"People are dropping out of audit," explains Woosey. "Will the mid-tier be doing audit work in five years' time? You have to look at where future profits are going to come from. "The market is being driven to a point where you can't do the work for the fees people expect to pay."

Firms that rely on a handful of audit clients shared among only a few partners may find it uneconomical to offer the service. "There could come a point where that could be true. The cost of audit regulation and training will make it uneconomical," says Malcolm Bacchus, an ICAEW council member.

As such, the quality of work at the lower end of the market could be degraded as firms will struggle to recruit or retain the best talent.

"Good staff will want to work at a regulated auditor where they will be exposed to complex transactions," explains Stock. However, firms able to stay in the game will benefit from the reduced competition.

"We've got some pretty big clients. We will still be in the ball game as the bar is raised," says Stock. "We should be able to attract some pretty good graduate staff."

Quality concerns

Not everyone is sounding the alarm just yet. Many firms remain optimistic that no longer requiring an audit is very different from no longer needing one. The adverse consequences of ditching audited financial statements could outweigh the cost of continuing with an annual audit.

"Taking away the obligation opens up questions about the veracity and integrity of financial statements. Taking away a statutory obligation doesn't take away the need," says Tom McMorrow, partner at Baker Tilly. "Clients still get comfort from the audit process."

For instance, users of financial statements such as customers, suppliers and credit agencies all react poorly to change are unlikely to react favourably when a business moves from an audit to unaudited regime.

This could lead to a reduced credit rating for the business or suppliers finding it harder to insure your debt - which could have a significant impact on the trading capabilities of the business.

The quality of financial statements are also likely to take a knock. Speaking at an ICAEW event in the City in October, Bacchus, said accounts could "look worse than they are now" if the thresholds are hiked.

"There's a whole tranche of businesses I worry about," Bacchus said, adding that the BIS would need to monitor the quality of unaudited accounts filed at Companies House as any deterioration would happen over a long period.

Limited assurance

Fiona Hotston Moore, partner at Reeves, worries too that the profession is not "taking seriously enough" the risk that the "temptation will be for companies to take opportunity to reduce their cost" by dumping their audit regardless of the potential consequences.

Nevertheless, there are cheaper alternatives to offering a full audit. Audit exemption has created a market for services that add credibility to the financial statements of audit exempt companies, including voluntary audit, a compilation engagement and an assurance review engagement.

Earlier this year, the ICAEW started to trumpet the merits of providing an assurance review engagement and produced a technical release providing guidance on the conduct of assurance reviews.

"An assurance review increases credibility of accounts...improves business confidence...and helps practices that feel under threat from unqualified accountants," explained Michelle Fisher, partner at Sobell Rhodes, as the October ICAEW event.

For an accountant conducting a review engagement instead of an audit, audit registration and compliance with audit regulations is not required solely as a result of carrying out the reviews although the work falls within the ambit of practice assurance standards. Additionally, substantive testing and testing of controls are not mandated as part of the review service.

The technical release goes on to highlight circumstances in which clients may find an assurance review useful; such as businesses with outsourced bookkeeping, subsidiaries needing some assurance for their parent company or instances when investors or lenders don't have access to additional financial records.

However, there is a mixed view on the value of limited assurance. For every advocate, there are those who think it is a waste of time. Indeed, the service was originally launched in 2006 "with a whimper rather than a bang".

"Take up has been relatively small. It hasn't been over-promoted, and attempts at doing it before haven't been entirely right," says Bacchus, while Stock says he has found clients want to have "all or nothing" when it comes to audit.