ICAEW representation

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

ICAEW REP 35/06

CP 06/6 Quarterly Consultation No.8 – Chapter 4: Proposed Extension of Audit Exemption in the Companies Act 1985

Memorandum of comment submitted in June 2006 by the Institute of Chartered Accountants in England and Wales, in response to Chapter 4 of the Financial Services Authority's consultation paper 06/6 'Quarterly Consultation (No. 8)', published in April 2006.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales ('ICAEW') welcomes the opportunity to respond to the FSA on its Consultation Paper 06/6 'Quarterly Consultation (No. 8)'. Our comments relate to the proposed extension of the audit exemption in the Companies Act 1985 set out in Chapter 4 of the document.

2. The ICAEW is the largest accountancy body in Europe, with more than 127,000 members operating in business, public practice and within the investor community. The Institute operates under a Royal Charter, working in the public interest.

MAJOR COMMENTS

Support for cost effective regulation

3. The ICAEW supports the principles of better and more cost effective regulation. Regulatory burdens should only be imposed upon business where they address a regulatory need. Regulatory burdens should be removed or replaced if they do not meet regulatory needs. For many small regulated firms, the main regulatory risks relate to the fair treatment and quality of advice provided to clients and the handling of client assets, rather than in the financial position. For these firms, a financial statements audit, while enhancing the quality of financial information produced by the firm, is a blunt tool for providing of consumer protection against the main risks to customers. For these firms, we do not consider that a financial statements audit is sufficiently well targeted to regulatory risks to justify a different audit exemption treatment as for non-regulated companies. We therefore support the proposals for these firms. However, there are stronger reasons for continuing to require an audit for all firms subject to capital requirements where a sound financial position is considered to be an effective regulatory safeguard. We note that this issue is considered more fully in CP 06/11 *Integrated Regulatory Reporting* and suggest that the audit requirements for firms with capital requirements is considered in conjunction with the outcome of CP 06/11.

4. With any deregulatory measure, there are risks and complexities attached. If the proposals are taken forward, the effectiveness of the measure should be reviewed to ensure that the quality of the regulatory environment has not been adversely affected.

Benefits of audit

5. Audits provide additional credibility to financial information, through a process of independent review by qualified professionals working under rigorous ethical framework and bound by high quality professional standards. Paragraph 4.27 appears to quote out of context the findings of a review the Professional Oversight Board for Accountancy into the quality of small company accounts filings. The results may not be altogether surprising given that most small companies require assistance from external accountants to produce their

accounts, many of whom will also be registered auditors. Furthermore, any review of filed accounts can only be carried out at a superficial level and with a small sample. It can look at matters such as arithmetic accuracy, cross-referencing, and at the disclosed accounting policies and information. Such a review cannot, however, look at whether the information contained in the accounts has been properly extracted from the underlying books and records nor the completeness and validity of information provided.

6. An audit will look at these matters so, while audited and unaudited accounts may appear to be superficially of a similar quality, the audit provides independent comfort on the substance of the information in the accounts. Even in the best managed companies, an audit will often result in adjustments to the accounts. Audited accounts are therefore more robust and reliable than unaudited accounts.

Use of audit reports for regulatory purposes

7. The primary purpose of a statutory audit is to report to the shareholders on whether the financial statements provide a true and fair view of the financial position, performance and cash-flows of a company. Although other stakeholders may take an interest in, and gain comfort from, audited financial statements, they should not seek to place undue reliance upon the work on a report that is not addressed to them or their specific needs. The FSA obtains financial information directly from regulated firms through regulatory returns. It is these regulatory returns, and not the audited financial statements, that the FSA uses as their principle source of financial information.

8. Under the current regime, auditors are not required to report on regulatory returns such as the Retail Mediation Activities Return (RMAR) for many categories of small firm. For these firms, there is therefore no direct link between the audited financial statements and the unaudited RMAR, notwithstanding the statutory duty to report certain information direct to the regulator. This creates an inherent limitation in the effectiveness of a financial statements audit for regulatory purposes. An auditors' report on relevant sections of the regulatory return is therefore a much more effective tool for regulatory purposes than an audit report to the shareholders on the statutory accounts. If the FSA seeks to take comfort from the work of the auditors, auditors should be required to report on relevant sections of regulatory returns. We note that CP 06/11 proposes similar changes in the auditor reporting requirements for certain larger institutions in this area and we will consider this issue further in our response to that paper.

9. A statutory audit primarily provides comfort on the numbers and disclosures in the financial statements. Auditors will consider other matters, such as the internal control systems and compliance with laws and regulations as part of their normal audit work. However, there is a difference between the level of work required for this general review and that for a more focussed report on an aspect of the control or regulatory environment.

Need for clarity in drafting the Statutory Instrument

10. For many firms with various permissions it can be difficult to know which category they fall under. The complexities of amending legislation by statutory instrument can exacerbate this. We are aware that a number of firms, for example, were uncertain as to whether they were covered by the earlier extension of the statutory small companies audit exemption intended to apply to newly regulated mortgage and insurance intermediaries due the complexity of the statutory instrument and extent to which it cross-referred to other instruments. If the proposals are to be taken forward, the statutory instrument should be drafted very clearly to enable firms to easily determine whether the exemption is available to them.

RESPONSES TO QUESTIONS

Q3 Do you agree with our proposal that those firms listed in paragraph 4.9 that are only required to appoint an auditor under the CA, by virtue of holding permissions under Part IV of FSMA, should be included in the proposed audit exemption or should the current audit requirement in the CA remain in force?

11. Before extending the audit exemption available to regulated firms, the FSA should carefully consider the risks relating to these firms, and the extent to which it places reliance upon financial information provided by firms to meet its regulatory objectives. The firms listed in paragraph 4.9 can be divided into three broad categories. There are different factors to consider for each category which affect the cost-benefit equation.

12. The first category is those firms whose auditor is currently required to report to the FSA on the regulatory returns. This covers non-ISD Investment Management firms, non-ISD Securities and Futures firms and non-ISD Personal Investment firms with 26 or more advisors. This category also includes firms subject to financial resource requirements. Extending the audit exemption available under the Companies Act to small firms in this category will only be have a deregulatory effect if the requirement for relevant sections of the regulatory returns to be audited is also removed, or at least careful thought is put into the form of reporting required.

13. For this first category, the current regulatory approach suggests that there are significant regulatory risks relating to the financial position of these firms. Removing the requirement for an auditors report on relevant sections of the regulatory return will significantly reduce the reliability and credibility of these returns, unless the audit report is replaced by an alternative measure such as significantly increased direct interaction between the FSA and regulated firms.

14. If the FSA intends to continue utilising financial information for regulatory purposes for this category of firm, we would not support the extension of the audit exemption without careful consideration of the implications for reliability of that information and compliance with regulatory capital requirements. Where capital requirements are considered necessary to provide consumer

protection, there are strong arguments in favour of retaining the audit requirements. If the FSA considers that financial information does not form a key part of their regulatory strategy, it should consider more radical deregulatory measures, such as simplifying regulatory returns such as the RMAR and removal of capital or financial resource requirements.

15. The second category is firms not subject to capital or financial resource requirements, whose auditors are not currently required to report on regulatory returns and where the main regulatory risks relate to client money or the quality of advice given to customers rather than the financial position. Most of the firms listed in paragraph 4.9, except for those with capital requirements, are likely to fall into this category. An audit of the financial statements is a blunt tool for regulating these matters. While an auditor might pick up on some issues as part of their normal audit work, other measures, such as a separate client assets audit report, are more effective and targeted controls over these off-balance sheet risks. For these firms, we support allowing similar rights to audit exemption as non-regulated companies.

16. The third potential category is firms where the financial information and financial position are considered by the FSA to represent significant regulatory risks, but which do not currently have requirements for an audit report on the regulatory returns. Without an audit report on the regulatory return, the current auditing requirements do not provide as effective a tool for regulatory purposes as they might due to the lack of direct linkage between the financial information used by the FSA and the work of the auditor. For this category, the FSA should either provide a similar right to audit exemption as non-regulated companies or require these firms to submit audited regulatory returns, dependant upon the importance it attaches to the financial information based upon risk profiles.

17. Requiring skilled persons' reports on a small sample of firms might provide a signalling effect on common errors and areas of non compliance, but will not provide an effective control over the overall reliability of financial information in the regulatory returns across the sector.

Q4 Do you agree with our proposal that firms that do hold client assets or client money should still be required to appoint an auditor under SUP 3 for the purposes of a client assets audit report?

18. Yes. Control over client assets and client money is a key area of regulatory risk. An auditors report on compliance with client money requirements is an effective and targeted measure which clearly addresses a specific regulatory need. A client money audit is also a distinct piece of work that is clearly separable from a statutory audit and which requires a not insignificant amount of additional audit work. However, the rules must make clear that the responsibility for appointing an auditor for client money purposes lies with the firm. The rules should also be clear on which firms fall into which category and on whether the audit requirements are based upon permissions or the holding of client assets.

19. There is an element of overlap between the statutory audit and a client assets audit, in that the statutory auditor would gain an overall understanding of the

control environment, including those related to client money and may conduct limited testing in this area. Therefore, the cost of conducting a stand-alone client asset audit is likely to be higher than the incremental cost of conducting a client asset audit on top of a statutory audit. This may impact upon the cost-benefit equation, reducing the cost savings involved in extending the statutory audit exemption.

Q5 Do you agree with our proposals to enable firms that are able to benefit from the audit exemption under the CA to submit unaudited financial reports to the FSA?

20. This question is constructed the wrong way around. As noted above, requiring firms eligible for statutory audit exemption to submit audited financial reports would remove any cost savings for those firms. The FSA should first decide the firms for which it requires the financial information in regulatory returns to be audited; those firms should be ineligible for audit exemption under the CA. All other firms should have the same CA exemption available to them as other companies. The FSA should then consider separately if they wish other, more targeted, work from auditors, such as client money audit reports.

Q6 Do you agree with our proposal that firms that qualify for the small company audit exemption should be allowed to include unaudited reserves and unverified interim profits within their capital resources calculation and, where relevant, calculate their annual expenditure with reference to unaudited financial statements?

21. Requiring an audit of capital requirements on a firm qualifying from the small company audit exemption would completely undermine the benefits of extending the CA audit exemption to those firms. As with question 5, the FSA should consider whether they require capital resource calculations to include audited data before considering whether to extend the audit exemption to those categories of firm. The FSA should not extend the audit exemption to any firms that will still to be required to use audited numbers in their capital resource calculations. On the other hand, if after considering all of the implications, the FSA decides to extend the CA audit exemption to firms, it should not then *de facto* reintroduce that requirement through the back door by retaining the requirement for capital resource requirements to be audited.

22. An audit adds reliability and credibility to the capital resource requirement calculation. Allowing capital resource requirements to be unaudited, or to include unaudited financial information, would significantly weaken their effectiveness as regulatory tools. The FSA should carefully consider the implications upon the quality of capital resources before removing the audit requirement. If capital requirements are considered to provide effective consumer protection, removing the audit requirements might significantly undermine that effectiveness. If capital resource requirements are not considered to provide effective consumer protection, the appropriateness of the capital requirements should be reconsidered.

23. We are more sympathetic towards allowing interim calculations to be unaudited and including unaudited interim profits, provided that the annual calculation is audited.

Q7 We invite firms' views on the cost estimates and allocation outlined above.

24. The benefits of the reduced audit costs may be somewhat overstated. Many small firms currently require assistance from their auditors the preparation of their accounts and completion of the RMAR. They are likely to continue to require this additional assistance from external accountants. The cost of providing this as a standalone service is likely to be higher than the incremental cost of providing this in addition to an audit, given the potential for cross-savings.

25. Experience to date among accountants assisting in the completion of small firm RMARs suggest that the RMAR takes significantly more time to complete than the regulatory reports it replaced. If the FSA considers that reducing the reliability and robustness of the financial information it receives will not adversely affect the effectiveness of its regulation, it should also consider reducing the volume and complexity of financial information it requires firms to provide, which would potentially provide even greater cost savings for the industry.

26. The cost estimates of the proposal to require a sample of skilled persons' reports may need some further thought. If the skilled persons' report takes the form of a full financial statements audit, a one-off audit is likely to cost more than the annual cost of an annual audit since the auditor in subsequent years is likely to benefit from a learning curve on the client's business and may only need to update certain prior year documentation, rather than starting from a blank sheet of paper. In addition, for a one-off audit, the auditor will need to carry out some testing on the unaudited prior-year comparative figures and may be faced by a less robust book-keeping system. All of this is likely to increase the costs of the one-off audit.

27. We note the suggestion that scope of the report might be more limited than a full financial statements audit. While in principle we would support a more targeted approach, our experience in developing guidance for auditors on conducting skilled persons reports suggested that the scoping notice for non-standard reports requires considerable thought to ensure that the terms of the assignment are clearly set out and the auditor has a suitable framework in which to conduct their work. For small firm audits, the cost of producing a clearly defined audit framework might outweigh the cost savings of having a more limited scope of audit. In addition, many small audit firms are not well experienced in conducting non-audit assurance assignments and might need more detailed guidance in setting the terms for non-standard engagements.

28. One final point is that extending the audit exemption to regulated firms will potentially have a knock-on effect on the availability of auditors to conduct these skilled persons' report audits. Auditing an FSA regulated business requires specialist skills and industry knowledge. Extending the audit

exemption may take small firms of auditors out of this market. Those auditors may not feel that they have sufficient industry knowledge to accept a one-off audit assignment on an FSA regulated when they have no other clients in the sector. Larger firms of auditors may not be willing to accept very small audit clients as being uneconomical. As a result, this might restrict the choice of auditors available for these assignments or increase the costs involved.

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