Fraud Advisory Panel

Response to the BIS consultation paper

Consultation on Audit Exemptions and Change of Accounting Framework

December 2011

Fraud Advisory Panel
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INTRODUCTION

1. The Fraud Advisory Panel (the 'Panel') is a registered charity and membership organisation which acts as an independent voice and leader of the counter fraud community in the United Kingdom.

2. Established in 1998, the Panel works to encourage a truly multi-disciplinary perspective on fraud. It has approximately 300 corporate and individual members, drawn from the public, private and third sectors and across a variety of professions.

3. The Panel's role is to raise awareness of the immense human, social and economic damage caused by fraud and financial crime and to help individuals and organisations to develop effective strategies to prevent it.

4. This response has been prepared on behalf of the Fraud Advisory Panel by its Board of Trustee Directors which includes representatives from the business community, law enforcement, and the legal and accountancy professions.

THE CONSULTATION PROCESS AND QUESTIONS

5. The Panel welcomes the opportunity to respond to the Consultation on Audit Exemptions and Change of Accounting Framework, issued by the Department for Business Innovation and Skills (BIS) in October 2011. The Panel has no significant views on the proposals in relation to the exemption of qualifying subsidiaries from mandatory audit, nor the proposals on changes of accounting framework, but is concerned that BIS may not have given sufficient consideration to the adverse effects on fraud risk that may result from implementation of the proposals for small companies and the impact that this might have on them, their trading partners, employees, the local economic environment and the public purse.

6. For that reason the Panel has limited its comments to those aspects of the consultation which deal with the proposed alignment of the audit and accounting exemption for small companies. The Panel has completed the response form in relation to those questions directly relevant to this matter, which are questions 1 to 3, 17 and the consultation process. These responses are included in Appendix 1 of this response. However, the format of the consultation does not lend itself well to expressing the depth of the Panel's concerns, which are enlarged upon below.

SMALL COMPANY FRAUD AND ITS IMPACT

7. Paragraph 26 of the Consultation asserts that there have been no ill effects of the introduction of audit exemptions in 1994, though over the period since then we believe that corporate as well as non-corporate fraud has risen remorselessly. Though authoritative evidence is difficult to find, we do not consider it appropriate to assume that small company fraud has not also risen, and that at least some of this is due to a rise in the audit exemption limit.

8. Paragraphs 25 and 26 also comment on the absence of systemic risk and the lack of unambiguous evidence of an increase in overall cost of capital as a result of reducing mandatory audit requirements. Even if one accepts that a "lack of unambiguous evidence" is sufficient to assume that the overall cost of capital in small unaudited businesses is not raised as a result of increased fraud risk, this analysis does not take account of the impact of harms caused to third party victims of fraud (including the public purse). And a lack of "systemic risk" on an economy-wide basis does not obviate the cost of such fraud to the communities in which they exist, their employees or other local businesses. Over the country as a whole, this is likely to be significant.

9. The National Fraud Authority's Annual Fraud Indicator for 2011 estimates that the total annual losses due to fraud in the UK at £38.4 billion. Of this, more than £779 million represents fraud losses to small and medium sized businesses outside the financial services. In addition, small businesses may be the perpetrators of frauds. For example, small businesses will contribute to losses caused by tax fraud (£15 billion) and losses caused to central and local government by procurement fraud (£2.4 billion) and grant fraud (£515 million). They will also contribute to the losses of banks, through misuse of unauthorised overdrafts, as well as more explicitly fraudulent behavior.

10. The National Fraud Authority's figures do not include the harm caused by fraudulent trading. Small businesses may well be particularly prone to a tendency to carry on trading while insolvent, whether on an intentionally fraudulent basis, as a result of willful blindness, or in error. The difference between these is not always easy to determine, but in each of them the impact on trading partners, employees and others becomes more damaging as debts continue to be incurred which cannot be paid, and a rescue of the company more difficult to achieve.

11. Even if only a small proportion of these losses could have been saved by the continuation of the audit of small businesses, this would radically alter the assumptions on which the proposals have been drawn up.

CONTRIBUTION OF AUDITORS AND QUALIFIED ACCOUNTANTS

12. Paragraph 33 assumes that there will be no savings of management time, as small business accounts are prepared and audited by the same audit firm. Paragraph 55 assumes that there will be no loss of small audit firms. We believe that these are not valid assumptions to make. Small company management are not necessarily aware of the extent of fraud risk, the need for strong financial controls, nor how they can best be achieved in a small company environment. Pressures for savings in time and money may contribute to an inappropriate judgement by small company proprietors that they do not need to consult a professional accountant for any purpose, thus leading to a reduction in the quality of financial statements and other financial information, as well as a reduction in anti-fraud controls and general business and financial advice. Since statutory audit is the only service reserved to professional accountants, this is not a trivial possibility.

13. In addition to unanticipated dangers to small businesses, of reduced access to professional accountants, there are also increased dangers to third parties. Small companies may consult accountants, book-keepers or business advisers which are not members of a professional body, or otherwise be under any system of over-sight of their competence, objectivity or other ethical standards. Or they may consult no outside adviser at all, but depend on their own resources. A professional accountant's relationship with their small business clients typically includes advice on compliance with taxation and other regulatory requirements as well as the advantages overall of appropriate behavior, and a consequent good reputation, in the continuation and growth of a business. If this contribution to the legal and ethical conduct of small businesses is lost, it is very likely that a deterioration of behavior will result, with consequent losses to not only third party users of a small company's financial information, but also to other business contacts and employees.

14. Significantly damaging criminal or otherwise unethical behavior may be particularly likely in a business with few employees, but relatively high turnover or assets, and where there is no regular contact with suitably ethical outside advisors. The temptations

may be higher in such circumstances, and the ameliorating effects of discussions between people of different backgrounds and behavioral characteristics less available.

OTHER FACTORS

15. In the current economic climate, all public services are being rigidly controlled, including the budgets of law enforcement agencies. The Panel has been heartened in recent years by an increase in government and law enforcement attention to the need to control fraud. However, much of this has been driven by the increase of fraud in areas other than corporate fraud, including an increase in frauds related to organised crime and terrorism. In this environment, we would be pleased but surprised if small businesses received more support from the police in helping to prevent fraud, or were subject to a reduced incidence of it due to a successful campaign of detection, investigation and prosecution. This emphasises a need for continued assistance for small businesses in avoiding becoming the victims of their own internal frauds, or the frauds of others. We would suggest that small companies should be encouraged to consult a professional accountant.

16. We recognise that the cost of statutory audit is considerable, and the rise in the number and rigor of standards relating to its conduct tend to make this an evolutionary trend. We support the development of very high standards for the audit of economically significant businesses, but agree that these may be too high for many small companies. This does not mean that no external assurance would be worthwhile for them. Much cheaper alternative assurance products are available, more appropriate to the needs of small companies and their stakeholders, that would nevertheless provide significant assurance levels. Further, if this assurance were required to be provided by a professional accountant, the disadvantages outlined in paragraphs 12 to 14 above would be avoided.

CONCLUSION

17. The Panel concludes that it would be inappropriate to further reduce the number of small companies that are required to undergo a statutory audit, at least until:

- There has been a further consideration of the impact of increased fraud risks on small companies themselves, and third party stakeholders, including not just investors but also other users of financial information, employees and trading partners.

- Consideration has been given to the introduction of other mandatory assurance requirements on small companies, which are less inappropriately demanding than a full statutory audit.

Appendix 1

Consultation on audit exemptions and change of accounting framework

Response form

Name: Fraud Advisory Panel

Organisation (if applicable): As above

Address: Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ (www.fraudadvisorypanel.org).

Preparer: Large business (over 250 staff)	
Preparer: Medium business (50 to 250 staff)	
Preparer: Small business (10 to 49 staff)	
Preparer: Micro business (up to 9 staff)	
Preparer representative body	
Accountants: over 500 UK Partners	
Accountants: 200 – 500 UK Partners	
Accountants: 100 – 199 UK Partners	
Accountants: 50 - 99 UK Partners	
Accountants: under 50 UK Partners	
Accounting bodies	
Legal representative or professional legal bodies	
User representative bodies	
Academics	
Regulators and Government bodies	
Individuals	
Other (please describe) – Charity, aiming to reduce the harm caused by fraud and financial crime	Yes

Question 1 (para 25)

What are your views on the overall principle of reducing audit requirements for unlisted companies?

Comments:

It would be inappropriate to further reduce the number of small companies that are required to undergo a statutory audit, at least until:

- There has been a further consideration of the impact of increased fraud risks on small companies themselves, and third party stakeholders, including not just investors but also other users of financial information, employees and trading partners.

- Consideration has been given to the introduction of other mandatory assurance requirements on small companies, which are less inappropriately demanding than a full statutory audit.

Question 2 (para 29)

A Do you agree with the underlying assumptions in our Impact Assessment that at least 60% of small companies now eligible will take up the audit exemption?

B Do you agree that the whole of the audit fee will be saved?

C Do you agree that there is no saving of management time for small companies taking up the audit exemption?

A	☐ Yes	☐ No	☒ Not sure
B	☐ Yes	☐ No	☒ Not sure
C	☐ Yes	☐ No	☒ Not sure

Comments:

The Panel has no views on the three questions posed, but does disagree with the underlying assumptions of the Impact Assessment. We think that it under-assesses the impact on business, Government, and the UK population as a whole, of the weakening of audit requirements, in that it fails to take appropriate account of the likely increase in misleading financial statements, and other adverse side-effects of the loss of the consequent need for businesses to regularly consult a professional accountant.

Question 3 (para 33)

Do you agree that the audit and accounting exemption for small companies should be aligned and a small company should be able to obtain the audit exemption if it meets two out of the three criteria?

☐ Yes ☒ No ☐ Not sure

Comments:

Some types of fraud are particularly likely to be facilitated by a company with a small number of employees, whether or not they have a larger turnover, larger net assets, or both. Fewer internal checks and balances, and a more dangerously non-compliant corporate culture, is more likely to be promoted with a small number of individuals actively involved in the affairs of the company. For this reason, we think that all three criteria should be met, before a company is exempted from audit. Specifically, we do not think that a company should be exempt, on grounds that include a small number of employees.

Question 17 (para 55)

Do you agree with the Government's assessment of the risks of the proposal?

☐ Yes ☒ No ☐ Not sure

Comments:

We do not think that the proposals take sufficient account of the increased fraud risk that would result from a reduced need for a strong relationship between smaller companies and their professional accountant.

Do you have any other comments that might aid the consultation process as a whole?

The Panel would have welcomed more consultation of bodies representing the victims of fraud, including the National Fraud Authority, HMRC and the Chartered Institute of Public Finance and Accountancy.

Please acknowledge this reply ☒

The Panel would welcome contact from time to time either for relevant research or consultation documents.

☒ Yes ☐ No