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PART A



Part. A.

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PART. A.

Chancellor's (Lawson) Papers:  
Small Company Audits: The Touche  
Ross Submission.

DD's: 25 Years

*[Signature]*

24/1/96

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PART. A.



With  
Compliments

 **Touche Ross**

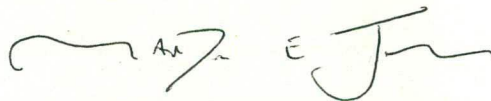
Chartered Accountants

To : Rt Hon Norman Lamont MP

From: Martyn E Jones

We attach a copy of a letter which we have sent  
to Lord Young together with earlier submissions  
referred to in our letter.

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20/1/1988

Touche Ross International



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**Touche Ross**  
Chartered Accountants

Ref: MEJ/sg

Rt Hon Lord Young of Graffham,  
Secretary of State for Industry,  
1/19 Victoria Street,  
London SW1H 0ET

Dear Lord Young,

We write in response to the White Paper on the "DTI - The Department for Enterprise" and following on from our previous submissions on the DTI consultative document "Accounting and Auditing Requirements for Small Firms" and the Enterprise Unit's report on "Burdens on Business". We understand that Mr R Hewes of the Enterprise and Deregulation Unit has been in touch with one of our partners, Mr K Wild, on this matter.

In general we welcome the objectives and policies which the White Paper describes. We welcome also the changes which it proposes and in particular paragraph 2.36 which states that deregulation will be sought through new companies legislation, an objective of which will be to reduce compliance costs to business particularly small firms.

Our proposal is that the companies legislation implementing the Eighth Directive should also be used to enable shareholders of small companies, as defined in the Companies Act, to dispense with the requirement for an annual audit; subsidiary companies which qualify as small should be included in this relaxation. In our view the only problem that needs to be addressed is the protection to be afforded to minority shareholders. Our suggestion is that the decision to dispense with audit should require a special resolution but subject to the right of any ordinary shareholder or any director to require one.

The aims of this submission are to demonstrate that:

- (i) such a change would be in the interests of small companies;
- (ii) the arguments advanced in favour of retaining the statutory requirement for the audit of small companies are unconvincing;
- (iii) our proposal is in line with the enterprise initiative.

CC : PS / C + E.

Aberdeen, Birmingham, Bracknell, Bristol, Cardiff, Chepstow, Crawley, Dartford, Edinburgh, Glasgow, Leeds, Leicester, Liverpool, London, Luttreth, Manchester, Milton Keynes, Newcastle upon Tyne, Newport, Plymouth, Swansea, and Wolverhampton

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Touche Ross International



The basic issue is does the statutory requirement for the audit of small companies represent unnecessary red tape. In our view all good reason for imposing a statutory audit on small companies disappeared when the decision was taken to allow such companies to file only modified accounts with the Registrar of Companies: such modified accounts are the only financial statements which third parties have a right to inspect and it is hard to see what significant decisions can validly be made on the basis of the minimal information that they contain. We suggest that an assurance that the full accounts on which the modified accounts are based have been audited is of no significant value to readers of the modified accounts. Thus the only people who can benefit from the audit of annual accounts are the shareholders themselves. It seems unnecessary and unreasonable to impose on those shareholders a legal requirement to accept and pay for a service if they neither want nor value that service, and no third party benefits from the requirement. However as discussed above we think it is important that fair arrangements are made for the protection of the rights of minority shareholders.

We are of course aware of the arguments that have been advanced in the past in favour of the retention of the statutory audit for small companies, but find these unconvincing. We include as Appendix 1 to this submission a list of the main arguments in favour of retention which we identify together with our comments on them. One of the arguments in favour of retention is that is in the interests of the Inland Revenue: we have commented on this argument separately in Appendix 2. Perhaps the most telling argument against retention is the experience of other countries. Both Australia and Canada abandoned the requirement some years ago. This move has been generally welcomed by businessmen in these countries as the end of a statutory nuisance. We have seen no suggestion that the interests of members of companies or third parties dealing with them have been damaged, but professional accountants have commented that a more positive and constructive relationship with their clients has resulted.

When the possibility of abolishing the statutory requirement for audit of the accounts of small companies has been debated in the past much of the debate has focussed on the nature of any alternative attestation of accounts such as an "accountant's review" that may be required in such cases, and difficulty in defining the requirement has perhaps been one of the factors which has resulted in the possibility not being pursued. Our argument is based on the proposition that it is neither necessary nor reasonable to impose on shareholders a requirement to purchase a service that they do not want, and that argument applies equally to any alternative form of attestation as it does to an audit report. For that reason we believe that the right of shareholders to dispense with an audit requirement should not be conditional on the acceptance of any other form of report or of the involvement of a professional accountant with the financial statements in any way. There should be no question of any form of "limited review" being required in place of a normal statutory audit. As we indicate below, however, we think it is likely that the abolition of a statutory audit requirement will result in directors calling on the services of professional accountants to provide them with some limited assurance regarding their annual financial statements, and it may well be appropriate for the Accountancy bodies to issue guidance for the performance of such work.



If any significant relaxation of the statutory accounting requirements for small companies in accordance with the derogations permitted by the Fourth Directive were contemplated, it would also be necessary for the Accountancy bodies to revise the guidance presently given to members regarding the significance of statements of standard accounting practice. The present position is that only under exceptional circumstances may financial statements which do not comply with statements of standard accounting practice be regarded as showing a true and fair view. This needs to be changed so that, for small companies, the true and fair view requirement will be met even if certain specified statements of standard accounting practice which prescribe basic measurement standards are the only ones that are followed. It would clearly be very unsatisfactory if reliefs provided by statute are not accompanied by significant relaxations of the rules currently requiring compliance with all statements of standard accounting practice.

The abolition of the requirement for an audit report, even if combined with a modification of the statutory accounting requirements to take advantage of the derogations permitted to small companies by the Fourth Directive, would not relieve the directors of any of their responsibilities under the Companies Act, in particular their responsibilities to:

- (a) maintain proper accounting records, and
- (b) prepare annual accounts which give a true and fair view of the company's state of affairs and profit or loss.

The vast majority of boards of directors of small companies will feel it necessary to obtain external assistance in complying with these requirements and it is to be expected that they will usually, but not necessarily, consult practising accountants.

There would however be a significant difference in the relationship between the accountant and his client in such circumstances. Directors would use the services of accountants because they perceived a real value in these services rather than in order to satisfy a statutory requirement. The work done by the accountant would be agreed with the client and would be tailored to his precise needs; it would no longer be necessary to carry out extensive work to verify the correctness of assertions that the directors know to be true. While he would still have an obligation to work to proper professional standards, the practising accountant would be relieved of the obligation of independence which is imposed on the auditor and which is reasserted by the Eighth Directive. He would thus be free to offer a wide range of alternative and additional services to his client. These might include not only routine services in connection with accounting and compliance with legislative requirements, but also wider assistance in the provision of management information, the introduction or improvement of financial and information systems and advice on financial management and on business matters generally. In other words, assistance in many of the key functions identified in chapter 6 of the White Paper describing the enterprise initiative. We might even see a resumption of the practice, which was commonplace before 1948, of practising accountants serving as non-executive directors of small companies.



There are of course special problems for auditors of small companies arising largely from the lack of independent evidence in some areas and the difficulty of achieving reliable internal control with small numbers of staff but these are not relevant to our present argument. Our view is that the accountancy profession is being prevented by the unnecessary cost of audit and the requirements of auditor independence from providing to small companies a much more constructive service which could be of substantial benefit to these companies and to the climate for enterprise. We believe that the case for retaining this constraint only when it is wanted by the members of the company affected is now overwhelming and hope that it will be the subject of early Government action.

We hope you will find our comments helpful. Mr J B Stevenson and Mr M E Jones will be happy to provide you with any amplification or clarification of our views that you may think necessary. We are sending a copy to the Financial Secretary to the Treasury.

Yours sincerely,

*Touche Ross & Co*

TOUCHE ROSS & CO



APPENDIX 1: Comments on the arguments advanced in favour of compulsory audit for small companies

1. The interests of shareholders. It is reasonably argued that shareholders are entitled to some independent assurance that the accounts which are furnished to them are fair. This is the strongest argument in favour of audit and we agree that an ordinary shareholder should be able to insist on audit if he or she so wishes. However there does not seem to be any good reason to impose the requirement on shareholders if they have no wish for it.

It has sometimes also been argued that audit provides shareholders with assurance that their company is being properly managed: this argument is based on a misconception of the function of audit which provides no assurance as to quality of management at all. Shareholders ought to obtain more comfort in this area from being aware that their board relies on a professional accountant for advice on financial matters.

2. The interests of trade creditors. The argument is that traders rely either directly, or indirectly through credit enquiry agencies, on audited financial statements in deciding whether to grant or continue credit. There is little evidence to support this assertion and the evidence provided as to credit-worthiness by accounts filed with the Registrar of Companies is of very little value. The modified accounts for small companies provide only minimal information and the information on file is out of date normally by at least ten months and possibly by as much as twenty two months. We believe that decisions regarding the initial granting of credit are normally based on information obtained from sources other than audited accounts, and that decisions to continue credit are based on the supplier's experience of the customer without any reference to audited accounts.

3. The interests of banks and other providers of loan finance. Banks and similar institutions clearly have a requirement for reliable financial information regarding entities to which they have advanced significant amounts. We understand that it is their practice therefore to place reliance on audited accounts, but we are not aware that they require audited accounts to be produced by partnerships or unincorporated bodies who are not required by statute to have an audit. In our view the practice of lenders in this respect is not of itself good reason to retain a statutory audit requirement. It is not reasonable that companies which do not have recourse to significant borrowing should be forced into having an audit only for the convenience of lenders to other entities. It is open to lenders to negotiate whatever arrangements they think appropriate as a condition of a loan and these could include the production of audited financial statements. Borrowers would then correctly identify the costs involved as part of the cost of borrowing. In practice we believe that in these circumstances banks would be likely to define more closely the nature of the information they require and that this would be different in nature and less in quantity than is contained in annual financial statements. They might well insist on some independent attestation of the information they require.



4. The interests of intending purchasers. It is sometimes suggested that audited accounts are required by intending purchasers of small companies to enable them to place a value on the company. We do not believe that audited accounts can be expected to contain all the information that is necessary to determine the amount that a purchaser might pay for a company and that a competent purchaser will invariably arrange for his own investigation of the company's affairs rather than rely on audited accounts. In any case the convenience of a possible purchaser does not seem an adequate reason for a statutory requirement for the accounts of all companies to be audited. A more difficult position arises in relation to a minority shareholder who wishes to sell his holding to an independent third party: in the absence of audited accounts such a third party may have no basis on which to form an opinion on the value of the shares. This is seldom a problem in practice since the articles of association of such small companies usually include clauses which effectively prohibit the transfer of shares without the consent of the directors in any event. However where it is a relevant consideration it is one to be considered by minority shareholders before agreeing to dispense with the audit requirement.
5. The problem of public offerings of shares. Companies which wish to offer their shares to the public will need to be in a position to provide audited accounts for a significant period (usually five years) prior to the date of the offer. This point would only be significant to companies which are planning to grow over a relatively short period to the point where they could change status to that of plc and offer their shares to the public. Directors of such companies will almost always be sufficiently far-seeing to retain the audit requirement at least over the period of rapid growth. The number of companies affected by these considerations is likely to be very small indeed.
6. The interests of management. Audited accounts provide management with assurance as to the accuracy of the financial information on which they base their decisions and the audit activity contributes useful advice to management. We suggest that these arguments must be rejected. It is no part of the function of audit to provide assurance to management, its purpose is to provide assurance about management, specifically about management's report to shareholders: Furthermore, financial statements prepared six or more months after the end of the financial year are not usually a good basis for management decisions. The extent to which the audit itself can provide advice for management is limited particularly in small companies, but if management consider it helpful they are not prevented from obtaining it. It is our argument that the requirement of audit, by imposing requirements of procedures to be performed and of professional independence, actually operates to prevent the professional accountant from applying his skills in the most cost effective manner for the purpose of giving management the most useful possible service.



7. The prevention of fraud. It has been suggested that the abolition of the statutory audit for small companies would be tantamount to granting a general license to commit fraud. We believe that this argument must be rejected for two reasons. First we believe that the incidence of significant fraud on the part of managers and proprietors of small companies is very small indeed and that it is not efficient to impose an unnecessary cost on the vast majority of companies which are managed honestly in order to curb a few miscreants. Secondly, and more significantly, an audit is not an effective activity for the purpose of preventing or detecting management fraud in small companies. Generally the audit activity is carried out so long after the event that substantial damage has been done before the auditor has an opportunity of discovering it. Further a director of a small company who has all the company records under his control is normally in a position to deceive the auditor simply by omission of transactions from the accounting records and by suppression of all evidence connected with them: the frauds involved are discovered only when they grow to such a size that they can no longer be concealed, and often they are not discovered by the auditor.
8. The price of limited liability. Perhaps the most commonly heard but in our view least rational argument for the retention of a statutory audit requirement is that audit is the price that must be paid for the privilege of limited liability. For the proprietors of most small companies limited liability is a myth since in order to obtain credit they have been forced to provide personal guarantees to their bankers or major creditors. If a price is to be paid for the privilege of limited liability, it should be the cost of running the company in an orderly and proper manner which should of necessity include maintaining proper accounting records and preparing annual accounts which give a true and fair view. There is no possible justification for saying that the price that ought to be paid should be the performance of an unwanted activity.
9. The interests of the Inland Revenue. See Appendix 2.



APPENDIX 2: Comments on the argument that compulsory audit for small companies is in the interests of the Inland Revenue

The argument is that the Inland Revenue rely on statutory audit and in particular on whether the audit report on a small business's accounts is qualified or unqualified. In refuting this argument we make the following points:-

1. There is evidence that the Revenue do not in fact rely on statutory audit to any significant extent.
  - (a) In their evidence to the Keith committee [see Vol I Chapter 3 para 3.2.11] the Revenue acknowledged that many of the investigations which have revealed the largest discrepancies between the profits returned and the true profit have concerned accounts with an unqualified report, and that the requirements of a statutory audit do not necessarily direct attention to the same features as those covered in a tax investigation.
  - (b) It is apparent that many tax investigations are started on the basis of information which is neither sought by, nor available to, the auditor, e.g. evidence of an inappropriate life-style, omissions from personal tax returns, information from informants.
  - (c) Accounts of small businesses submitted to the Revenue are usually accompanied by one of the following reports from an accountant:-
    - (i) a "prepared but not audited" report where the enterprise (eg. a sole trader or partnership) is not subject to statutory audit;
    - (ii) a qualified audit report, usually on the basis of reliance on management representations and the absence of internal control;
    - (iii) an unqualified audit report.

We issue all these reports according to the circumstances (though we try to avoid (ii)), and we cannot detect any pattern whereby the depth of investigation and enquiry by the Revenue varies according to the report issued.
2. The Revenue should not place particular reliance on an audit report because an audit examination is not specifically directed at the matters that are of prime concern to them. The auditor's work is directed towards forming an opinion as to whether the accounts show a true and fair view within the recognised framework of acceptable accounting practice: it is not an investigation designed to detect fraud and is indeed relatively unlikely to do so. In practice evidence shows that relatively few frauds are detected as a result



of audit. Equally the auditor is not primarily concerned that the accounts should meet the Revenue's rules for the computation of profit for tax purposes. The following specific points are worth noting:-

- (a) an auditor's primary concern is that accounts do not overstate the position, whereas the Revenue's concern is that they should not understate:
  - (b) an auditor has only very "broad brush" tools with which to obtain evidence of omission or understatement, particularly in the case of the small company where there is a lack of internal control; if the owner-manager is suppressing income then the auditor is very unlikely to detect this unless it is done to a very significant extent - so significant that the Revenue would be put on enquiry in any event:
  - (c) while there is a much greater chance that the auditor will detect material over-statement of expenditure, this is not in practice the way in which much tax evasion is committed; it is much more common to find tax evasion attempted by the inclusion of improper expenditure (e.g. personal expenses of the owner-manager) or by misclassification of expenditure; again these are matters which may or may not come to the attention of the auditor but he is under no duty to search for them:
  - (d) although an auditor has a duty to report if proper accounting records are not being maintained by the company, in practice he does not do so unless the position is so bad that from the information available to him he is unable to create the records that are necessary to make good any deficiencies of the client.
3. The reality is that the Revenue is justified in taking assurance from the fact that an accountant has been involved with the small business in preparing the accounts or in submitting tax computations to them, to virtually the same extent as if he had signed a formal audit opinion. In particular in either case the accountant will normally:-
- (a) review the accounts including significant accounting ratios with particular regard to indications that income may have been materially understated and enquire into any anomalies:
  - (b) review the accounting records with a view to detecting any significant misclassifications of expenditure, or major items of improper expenditure, and (if he is submitting tax computations) significant disallowable items:
  - (c) be satisfied that the accounting records are at least good enough for it to be possible to prepare from them financial statements that appear to be reasonably reliable.



4. The foregoing comments are mainly concerned with the Inland Revenue and the assessment and collection of corporation tax. The position with regard to the Customs and Excise and the collection of VAT is similar. Typically auditors do not regard it as any part of their duty to police compliance with statutory regulations whether of VAT or otherwise except where that duty is imposed by statute. If they become aware of significant compliance failures, they should consider their possible effect on the financial statements, but they do not search for them. In regard to VAT they will usually satisfy themselves that returns are being made regularly, that payments made agree with amounts shown as due by the accounting records, and that the liability, if any, outstanding can be identified with inputs and outputs for a specific period. They may also enquire when the last VAT inspection took place and rely on that inspection as their principal source of evidence that the VAT position is in order. Thus the only assurance which the VAT authorities can draw from the involvement of an accountant with the business (whether as auditor or as preparer of accounts) is that the accounting records are at least such that it is possible to use them to prepare reasonably credible accounts.
5. It is important to emphasise that no accountant no matter in what capacity he acts, can reasonably be expected to accept responsibility for the dishonest client, particularly a small client, who deliberately sets out to deceive him. For the reasons set out in 1(b) above the Revenue is in a much better position to detect such deception than the accountant. At the same time no accountant should allow himself to be associated with accounts in any way if he suspects that they may be seriously misstated.
6. The thrust of this Appendix is that the assurance which the tax authorities can reasonably take from the audit of accounts of small companies is no different from the assurance they get from the fact that a professional accountant is involved in preparing the accounts and/or tax computations. We hope however that they will not be taken as arguing the case for a statutory requirement for some lesser form of involvement of professional accountants in the accounts of small companies than is implied by a full audit. In practice we believe that if the audit requirement for small companies were abolished the number of companies who would then cease to use the services of professional accountants altogether would be very small indeed. It would be a great pity if any possible marginal reduction in the assurance available to the Inland Revenue in relation to this small number were allowed to stand in the way of a reform which would provide the accounting profession with the opportunity to sell to the small business community precisely the services it requires. This opportunity would be of great advantage to the business community and to the profession alike; it would largely be lost if there was a continuing statutory requirement for a professional accountant to have a role (even though less than audit) in the accounts of all companies.



CONFIDENTIAL



FROM: MISS M P WALLACE

DATE: 29 January 1988

PS/FINANCIAL SECRETARY

cc Sir P Middleton  
Sir A Wilson  
Mr Cropper  
Mr Tyrie

**AUDIT REQUIRMENT FOR SMALL FIRMS: LETTER FROM TOUCHE ROSS**

The Chancellor has seen a copy of Touche Ross' letter to Lord Young. He would be grateful for a note on appendix 2, (comments on argument that compulsory audit for small companies is in the Revenue's interests) which he finds persuasive. I should be grateful if you could arrange for this to be provided.

mpw.

MOIRA WALLACE





*paperspse*

H.M. CUSTOM AND EXCISE  
VAT CONTROL DIVISION A  
ALEXANDER HOUSE, 21 VICTORIA AVENUE  
SOUTHEND-ON-SEA, X, SS99 1AA.  
TELEPHONE: SOUTHEND-ON-SEA (0702) 36 7088

**FROM:** D F W FRYETT

**DATE:** 4 February 1988

Financial Secretary

cc PS/Chancellor ✓  
PS/Chief Secretary  
PS/Paymaster General  
PS/Economic Secretary  
Sir P Middleton  
Sir A Wilson  
Mr Monck  
Mr Scholar  
Mr Burgner  
Mr Culpin  
Mrs Lomax  
Mr Tyrie  
PS/IR

**SMALL COMPANY AUDIT: TOUCHE ROSS SUBMISSION**

1. You asked Mr Beighton for comments on the Touche Ross submission on this subject and, in particular, on the points raised in Appendix 2. Although the submission was primarily addressed to the Inland Revenue, Customs and Excise also have a clear interest in maintaining the audit requirement insofar as our VAT control requirements are concerned.

2. The thrust of the submission from Touche Ross is designed to show that the Revenue Departments do not place any reliance on the statutory audit, nor should they. The reality, however is more complex. Annual accounts which are subject to audit are a deterrent to fraud and provide us with a level of reassurance that an independent check has been made on the materiality of the business activities. They help us to assess the overall credibility of the VAT returns in relation to the business activity of the trader. Instructions to our officers also point out that audited accounts are clearly of more value than unaudited accounts and are heavily relied upon when we find traders records are deficient or missing.

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Internal distribution

CPS  
Mr Knox

Mr Finlinson  
Mr Trevett

Mr Holloway  
Mr Chisholm ✓

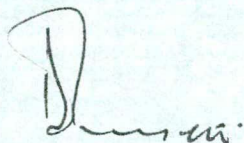


3. Visits by our officers are not full audits and Touche Ross are wrong to assume in paragraph 4 of the Appendix 2 that a VAT visit provides a "clean bill of health" for all the traders activities. In the same vein we do not assume that audited accounts are necessarily correct or complete across all of the traders activities but they do provide a higher plane of compliance; even if it is only minimum standards. Reliable records and standards are an important aid to our control programme since our visits to small companies are relatively infrequent (up to 8 years between visits) and of short duration.

4. A reduction in auditing standards will undoubtedly lead to a reduction in the number and size of underdeclarations discovered and in the overall effectiveness of our control programme. Our control of traders is currently enhanced by the co-operation of accountants and the Consultative Committee of Accounting Bodies (CCAB) issued guidance to their constituent members in August 1982 concerning the correction of errors in VAT payable or repayable, in excess of £1,000. Control officers also use the auditors record of errors and omissions, commonly corrected through a Journal, to ensure that the appropriate adjustments have been made to the VAT account.

5. We do not share Touche Ross' optimism that only a small number of companies would cease to use the services of professional accountants if the audit requirement was abolished. Our experience suggests that many small companies would be motivated more by cost than the reduced level of accountability and would be keen to engage the cheapest alternative bookkeeping/accounting services on the market.

6. Finally, Touche Ross consider that the Revenue (and presumably Customs) should not place particular reliance on the audit report because it is not specifically directed at the matters of prime concern to them. In our view this fact could be considered to give added weight to the value and independence of the audit report. It provides a useful cross check of a company's activities and we regard it as a valuable tool in the verification of VAT returns.



D F W FRYETT





INLAND REVENUE  
CENTRAL DIVISION  
SOMERSET HOUSE

FROM : L J H BEIGHTON  
DATE : 4 February 1988

FINANCIAL SECRETARY

**SMALL COMPANY AUDIT : TOUCHE ROSS SUBMISSION**

In his note attached Mr Shaw is commenting on the Touche Ross submission as requested in Mr Heywood's minute of 25 January.

Perhaps I could take this opportunity to make two comments on Sir Tony Wilson's brief for your meeting on 9 February with Mr Maude and Mr Cope. I entirely agree of course with his suggestion in the line to take that you should repeat the points

---

cc PS/Chancellor  
PS/Chief Secretary  
PS/Paymaster General  
PS/Economic Secretary  
Sir Peter Middleton  
Mr Anson  
Mr Monck  
Mr Scholar  
Mr Culpin  
Mrs Lomax  
Mr Mason  
Mr Ilett  
Mr MacAuslan  
Mr Inglis  
Mr Wynn Owen  
Mr Flanagan  
Mr Call  
Mr Cropper  
Mr Tyrie  
Mr Fryett (C&E)  
PS/C&E

Mr Battishill  
Mr Isaac  
Mr Painter  
Mr Rogers  
Mr Pollard  
Mr Deacon  
Mr Campbell  
Mr G Miller  
Mr D Shaw  
Mr K Shaw  
PS/IR



made by the Chancellor in his letter to Lord Young of 18 December. It follows from them that your suggestion that the mandatory audit be relaxed for companies with an annual turnover of £100,000 (with a power to increase) should be conditional on the mandatory review by an independent professional accountant in place of the audit. The exact figure of turnover may need to be negotiated but, whatever it is, the two - relaxation of the audit and the introduction of the mandatory review - should go hand in hand. (It is not clear to me whether the implication in Sir Tony's brief that they can be separated is an intentional departure from the Chancellor's line.)

Second, if the further point of accounting disclosures comes up at the meeting we would be ready to take part in any discussions with the DTI. But you might stress the substantial extent of the reductions which have already been agreed, with implications for the prospects from going over the same ground all over again; the need to tie in any changes with the Pay & File legislation; and the fact that officials here are very heavily engaged in preparations for the Budget and Finance Bill which would have to take precedence.

LJB

L J H BEIGHTON





## Inland Revenue

Policy Division  
Somerset House

FROM: D L SHAW

DATE: 4 FEBRUARY 1988

MR BEIGHTON

FINANCIAL SECRETARY

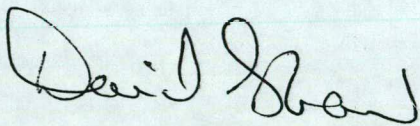
### SMALL COMPANY AUDIT: TOUCHE ROSS SUBMISSION

1. You have asked for comments on the submission from Touche Ross to Lord Young of 20 January, particularly Appendix 2, in advance of your meeting with Mr Maude and Mr Cope on 9 February.
2. The Touche Ross submission cannot be taken as representative. The Department of Trade and Industry did carry out an extensive public consultation on the abolition of the small company audit at the end of 1985. They sent out more than 2000 copies of the consultative paper and received more than 200 replies. These were more or less evenly divided, though most of those who favoured abolition either wished to do so only in relation to shareholder-managed companies or to couple abolition with new rules governing the preparation of accounts. The Touche Ross view that the audit should be abolished for all small companies including subsidiaries was shared by only a small minority.
3. Nor can their letter be regarded as indicative of a groundswell of opinion. It was apparently prompted by an approach from the Enterprise and Deregulation Unit who had seen their earlier submission in favour of abolition in response to the Department of Trade and Industry consultative paper.



4. Appendix 1 rehearses some of the arguments considered in the Department of Trade and Industry consultation. Opinion was divided on each, with no overwhelming view in favour of abolition. But the argument at paragraph 7 that the statutory audit is no defence against fraud was directly refuted by the Government in Lord Young's 1986 White Paper "Building Businesses..... Not Barriers" which said "the Government are determined to clamp down on fraud and have decided that removal of this first defence against fraud would be inappropriate". Nothing has happened since which would alter this view.

5. Appendix 2 attempts to argue that abolition would not affect the Inland Revenue, nor presumably the Exchequer. It misrepresents our position and is based on incorrect evidence. I attach a paper discussing the detailed arguments put.

A handwritten signature in dark ink, appearing to read "David Shaw". The signature is fluid and cursive, with the first name "David" and last name "Shaw" clearly distinguishable.

D L SHAW



## COMMENTS ON APPENDIX 2

1. The writer advances 3 arguments to dismiss the importance of the statutory audit to the Inland Revenue.

### Paragraph 1: Selection of cases for investigation

2. The writer says that there is evidence that we do not rely on statutory audit to any significant extent. He says

- a. that some audited accounts are wrong;
- b. that some investigations start from information that an auditor would not consider; and
- c. that, in his experience, the pattern of investigations by the Revenue is the same for audited accounts as for unaudited accounts.

3. His first two grounds, a. and b., do not tell the whole story. We do not suggest that the audit guarantees the accuracy of the accounts, only that audited accounts are in general more reliable - but some will still be wrong, some spectacularly so.

4. His third ground, c., is not correct. We used to investigate three times as high a proportion of unaudited accounts as we did of audited accounts. We think that this ratio is about right. It has dropped a little because of pressure on resources, but unaudited accounts are still twice as likely to be selected for investigation as audited accounts.

### Paragraph 2: Reliability

5. The writer suggests that the Revenue should not place particular reliance on the audit report because



the audit examination is not specifically directed at matters that are of prime concern to them. He justifies this conclusion by stating that audit rarely detects fraud and has little concern with the tax computation. This is true so far as it goes but it overlooks the importance of the accounts themselves. The tax computation is only as good as the underlying accounts. The added reliability that audit brings to accounts does result in added reliability and improved accuracy in the tax computation.

6. The audit helps to ensure that adequate financial controls are in place and the auditor must satisfy himself that the accounts show a true and fair view and are in accordance with recognised accounting standards. All of these aspects of the audit contribute to the reliability and accuracy of the accounts and the tax computation.

7. Other regular, third party users of company accounts, banks, investors and credit agencies, share the belief that audited accounts are more reliable.

### Paragraph 3: Involvement of a practising accountant

8. The writer says that the Revenue can take assurance from the fact that an accountant has been involved in preparing the accounts to virtually the same extent as if he had signed an audit certificate.

9. Certainly there is considerable value in the association of an accountant, provided that he is independent of the business. But to stop there would be of limited value. The accounts of the vast majority of unincorporated businesses are prepared by a practising accountant but are not audited. If the involvement of a practising accountant were sufficient,



we would find no difference in reliability between audited and unaudited accounts and would investigate the same proportion of each. However, as we have explained above, this is far from the case.

#### Others points

10. Customs and Excise may wish to comment on paragraph 4. The line of argument in paragraph 5 is unclear. The writer appears to be suggesting that the Revenue can draw comfort from the refusal of a professional accountant to associate himself with accounts he knows to be seriously misstated. But this provides little reassurance if the company's instructions prevent his making adequate checks.

11. The writer acknowledges in paragraph 6, that the logic of his argument points to the statutory involvement of a professional accountant. He suggests that this should not be done as accountants will in most cases continue to be involved. This begs the question of the degree to which the accountant is involved and the extent to which he exercises his professional skills in checking the accounts. The statutory audit does ensure a minimum standard of check through the independence of the auditor and the requirement that he satisfy himself that the accounts show a true and fair view and have been prepared in accordance with recognised accounting standards. The added reliability that the audit gives would be lost if these minimum standards were removed.

#### Conclusion

12. The writer's arguments are somewhat misinformed. He misunderstands our position and our concerns and is not familiar with some of the evidence. The audit does add to the reliability of the accounts and in



consequence to the reliability of the tax computations. To remove the audit without putting sufficient and equivalent controls in its place would have serious consequences for the Revenue and put the Exchequer significantly at risk.



11/2919

FROM: SIR ANTHONY WILSON

DATE: 5 February 1988

FINANCIAL SECRETARY

cc Principal Private Secretary  
PS/Chief Secretary  
PS/Paymaster General  
PS/Economic Secretary  
Sir P Middleton  
Mr Monck  
Mr Scholar  
Mr Burgner  
Mr Culpin  
Mrs Lomax  
Mr Bradley  
Mr Inglis  
Mr Call  
Mr Cropper  
Mr Tyrie  
Mr Beighton - IR  
PS/IR  
PS/C&E

12/2

A good note

SMALL COMPANY AUDIT: TOUCHE ROSS SUBMISSION

You asked for comments on appendix 2 of the Touche Ross letter in preparation for your meeting with Mr Maude and Mr Cope on 9 February. Customs and Excise have already provided this and Inland Revenue will do so today. I would just like to add some comments on the content of the main Touche Ross letter.

2. Touche Ross say that in their view the only problem that needs to be addressed (in relation to dropping the audit requirement for small companies), is the protection to be afforded to minority shareholders. This overlooks the interest which other business partners, such as Inland Revenue, the banks and the credit agencies, have in the availability of reliable accounts. The remark is useful in focussing on the relationship between cost and user need, but it would be uneconomic for a series of users, other than the shareholders, each to have to pay the cost of special exercises to satisfy their individual needs; it would be cheaper, as it is now, for one overall examination on behalf of the company and its shareholders to satisfy the needs of all users.



3. In the first paragraph of page 3 of their letter, Touche Ross rightly say that, currently, financial statements which do not comply with statements of standard accounting practice, can only be regarded as showing a true and fair view under exceptional circumstances. The application of accounting standards to the accounts of small companies was debated again briefly by the Accounting Standards Committee last week, and it was decided that what is true and fair for a large company is also true and fair for a smaller one. In general, therefore, accounting standards will continue to be applicable to all companies in order that their accounts should show a true and fair view, but any relaxations which prove possible will be identified in the pre-amble to individual standards. As all companies, whatever their size, will continue to have a statutory requirement to file accounts which show a true and fair view, irrespective of whether they are audited, it is reasonable that the general principles contained in the SSAP will apply to all accounts.

4. I agree with Touche Ross when they say that the vast majority of boards of directors of small companies will feel it necessary to obtain external assistance in order to make sure that they maintain proper accounting records and produce accounts which show a true and fair view. All we are seeking in our approach is that the professional accountants involved say openly what they have done in order to prepare the accounts. This will, of course, meet the point to a large extent that the work done by the professional accountant could in future be agreed with the client and tailored much better towards his precise needs.

5. Where I particularly take issue with Touche Ross is over their view that a practising accountant would in future be relieved of the obligation of independence, which is imposed currently on the auditor and which is reasserted by the 8th Directive, thus making him free to offer a wide range of alternative and additional services to his client. Of course, the auditor can already offer a wide range of alternative and additional services to his client, and nothing will change



in this respect if he does accountancy work rather than a statutory audit for a small or large company in the future. I am suspicious of the idea that practising accountants with a professional service relationship with a company should be able to serve as non-executive directors of the same company in the future. I may be conservative in this area, but I suspect that such a move would severely damage the valued independent status of the professional accountant.

6. I would feel better disposed towards Touche Ross' arguments if I felt that they had wider experience within the firm of auditing the accounts of the kind of small companies we are talking about and if their development plans for the firm appeared to be less directed towards non-professional services, as distinct from statutory audit obligations.

7. Incidentally, it should be remembered that the vast majority of incorrect accounts are wrong by reason of error rather than fraud. Since management does not attempt to conceal error, the independence and expertise brought to bear by the independent accountant is likely to have a much higher success rate in identifying and correcting error than fraud.

  
A WILSON



*mpw*

FROM: MOIRA WALLACE

DATE: 8 February 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary  
PS/Paymaster General  
PS/Economic Secretary  
Sir P Middleton  
Sir A Wilson  
Mr Monck  
Mr Scholar  
Mr Burgner  
Mr Culpin  
Mrs Lomax  
Mr Bradley  
Mr Inglis  
Mr Cropper  
Mr Tyrie  
Mr Call  
Mr Beighton - IR  
Mr Shaw - IR  
PS/IR

PS/C&amp;E

**SMALL COMPANY AUDIT: TOUCHE ROSS SUBMISSION**

The Chancellor has seen Mr Fryett's minute of 4 February, Mr Beighton's of the same date, and Sir A Wilson's note of 5 February, which he read with interest.

*mpw.*

MOIRA WALLACE