BIS Department for Business Innovation & Skills

CONSULTATION ON AUDIT EXEMPTIONS AND CHANGE OF ACCOUNTING FRAMEWORK

6 OCTOBER 2011

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Consultation on audit exemptions and change of accounting framework

This consultation paper concerns two separate proposals: a change in the audit exemptions and a change in the law to allow companies to change their accounting framework. Each proposal has its own draft Impact Assessment, copies of which are annexed to this document.

In March 2011 the Chancellor of the Exchequer and the Secretary of State for Business, Innovation and Skills published *The Plan for Growth*. This is a plan to put the UK on a path to sustainable, long-term economic growth. One of the ambitions in this plan is to make the UK one of the best places in Europe to start, finance and grow a business. In order to achieve this the Government committed itself to remove regulatory burdens and improve corporate governance.

Over time, both the volume of reporting requirements for UK business, and associated costs, have increased, and businesses and investors have stressed that there are ways to be more flexible and targeted in applying rules on reporting, accounting and audit. Tackling these problems should ultimately help to deliver growth through the greater availability of capital at a lower cost and through improved productivity and performance.

In the *Plan for Growth*, amongst other measures, the Government therefore committed to reduce the number of UK SMEs required to undertake an audit; and to substantially reduce the burden of financial accounting for UK businesses, by bringing forward legislation in 2012 to exempt many subsidiaries from the requirement for audit.

This document is seeking views on its proposed implementation of these commitments.

Separately, in Chapter 11 of this document, the Government is also consulting on the proposal to give companies who have chosen to prepare accounts under the IFRS framework more flexibility to change to UK GAAP.

Issued: 6 October 2011 Department for Business, Innovation and Skills

Respond by: 29 December 2011

Enquiries to: Rufus Rottenberg, BIS, Spur 2, 3rd floor, 1 Victoria Street, London SW1H 0ET, telephone 020 7215 0163 email audconsult@bis.gsi.gov.uk

This consultation is relevant to: companies who are currently subject to mandatory audit, academics, investors, credit rating agencies, banks, audit professionals and legal advisers.

1. Executive Summary

1. This consultation on increasing audit exemptions concerns the proposal to give more SMEs and subsidiary companies the ability to make a commercial decision about whether or not to have an audit. It is estimated that removing this EU gold plating will save UK businesses £612m per year. Every company requires robust financial controls and appropriate governance and for many companies audit will be a vital part of this. However it is well established in the UK that the requirement for audit should not be imposed by law on all companies.

2. The Government announced in March 2011 that it would reduce the burdens of financial reporting on business by taking advantage of certain Member State options that it has not previously taken up under the European Directives to reduce the number of UK SMEs required to undertake an audit and to bring forward legislation in 2012 to exempt many subsidiaries from producing audited accounts. The Government is now consulting on how it should take up these options. Because audit requirements in the UK do not allow as much flexibility to companies as currently available under EU requirements, this gold plating creates a market inequality.

3. The policy options considered are:

- Option A: take advantage of **some** of the exemptions available under Articles 51(2) and 57 of the 4th Company Law Directive to reduce mandatory audit and accounting (this is the Government's preferred option);
- Option B: take advantage of **all** of the exemptions available under Articles 51(2) and 57 of the 4th Company Law Directive to reduce mandatory audit and accounting;
- Option C: do nothing.

4. The preferred option reduces the number of UK SMEs required to undertake a statutory audit by aligning mandatory audit thresholds with small company thresholds. At present, EU rules mean that a company must fulfil two out of three criteria (turnover, balance sheet total and number of employees) in order to be classified as "small" (subject to certain exclusions) for accounting purposes[1]. However, to obtain the audit exemption in the UK, a small company must fulfil both the balance sheet and turnover criteria. Under new proposals set out here for consultation, a small company would be able to obtain the audit exemption if it met any two out of the three criteria above. This could release 36,000 small companies from the legal obligation to have an audit. Similar changes will be applied to the audit requirements for Limited Liability Partnerships (LLPs). Additional savings for small companies under this proposed policy are estimated at £206m per year.

5. Under the Government's preferred option it will also introduce legislation in 2012 to exempt a subsidiary company from mandatory statutory audit where the subsidiary fulfils all the conditions set out below (where a subsidiary is dormant, it will be exempt from

1 The thresholds are currently: number of employees: no more than 50; balance sheet total: no more than £3.26 million; turnover: no more than £6.5 million.

not only mandatory audit, but also mandatory filing and mandatory preparation of accounts):

a. the subsidiary's parent company is registered in the EU;

b. the parent has declared that it guarantees the debts of the subsidiary and this declaration must be published by the subsidiary in Companies House ;

c. the subsidiary's shareholders unanimously must have declared each year to dispense with an audit and this declaration must be published by Companies House;

d. the subsidiary must be included in the consolidated accounts drawn up by the parent undertaking; these consolidated accounts and the consolidated annual report must be audited and filed in the company registry;

e. the use of the exemption by the subsidiary must be disclosed in the notes on the consolidated accounts drawn up by the parent;

f. the subsidiary is unquoted;

g. the subsidiary is not in the banking or finance sector.

6. The final two conditions above are ones that the Government proposes to add in addition to those imposed by the Directive in order to reduce the potential risks of not mandating an audit. The changes will also apply to subsidiary Limited Liability Partnerships. The annual net benefit to businesses of the change to the audit exemption for subsidiaries is £406m per year.

7. In the light of the consultation by the Accounting Standards Board on changes to UK GAAP, the Government is also seeking views as to whether to allow companies who currently prepare accounts under IFRS as adopted in the EU more flexibility to change their accounting framework to UK GAAP. This will permit subsidiaries to take advantage of the reduced disclosures under UK GAAP.

8. The options considered are as follows:

- Option A: permit companies to change their accounting framework no more than once every 5 years
- Option B: add a change in the accounting standards to the list of relevant reasons for a permitted change in companies' accounting framework.
- Option C: permit companies to change their accounting framework no more than once every 3 years
- Option D: permit companies to change their accounting framework every year.
- Option E: do nothing/status quo

9. The Government's preferred option is to permit a company to make the change once every 5 years as it will allow companies to take advantage of the cost and burden saving

changes to UK GAAP proposed by the ASB, while retaining increased comparability of accounts over Options C and D and limiting the possible risk of tax arbitrage, particularly in relation to Option D. This would provide an annual net benefit of £2m per year.

10. For both audit exemptions and change of accounting framework, it is proposed that the changes will apply for accounting years ending on or after 1 October 2012.

11. This consultation covers the whole of the UK and will last 12 weeks. It is relevant to companies and LLPs who are currently subject to mandatory audit, business associations, academics, investors, credit rating agencies, banks, audit and accounting professionals and legal advisers.

12. Responses will be published on the BIS website unless respondents explicitly state that they wish all or part of their responses to remain confidential.

2. How to respond

13. The consultation will begin on 6 October and will run for 12 weeks, closing on 29 December 2011.

14. When responding please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents by selecting the appropriate interest group on the consultation response form and, where applicable, how the views of members were assembled.

15. A copy of the Consultation Response form is available electronically at www.bis.gov.uk/assets/biscore/business-law/docs/c/11-1196-consultation-audit-exemptions-and-accounting-framework-form. Responses should be submitted by letter, fax or email **(but preferably using the Consultation Response form by email)** to:

    Name: Rufus Rottenberg
    Audit & Accounting Team
    Department of Business, Innovation and Skills
    Postal address: Spur 2, 3rd Floor, 1 Victoria Street, London SW1H 0ET
    Tel: 020 7215 0163
    Fax: 020 7215 0235
    Email:audconsult@bis.gsi.gov.uk

3. Additional copies

16. You may make copies of this document without seeking permission. Further printed copies of the consultation document can be obtained from:

    BIS Publications Orderline
    ADMAIL 528
    London SW1W 8YT
    Tel: 0845-015 0010
    Fax: 0845-015 0020
    Minicom: 0845-015 0030
    www.bis.gov.uk/publications

17. An electronic version can be found at http://www.bis.gov.uk/assets/biscore/business-law/docs/c/11-1193-consultation-audit-exemptions-and-accounting-framework.

18. Other versions of the document in Braille, other languages or audio-cassette are available on request.

4. Confidentiality & Data Protection

19. Information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want information, including personal data that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

20. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

5. Help with queries

21. Questions about the policy issues raised in the document can be addressed to Rufus Rottenberg at the above address. A copy of the Code of Practice on Consultation is in Annex 3. This describes who to contact if you are not happy about the way in which the consultation is being run.

6. What happens next?

22. Following the close of the consultation period, the Government will publish all of the responses received, unless specifically notified otherwise (see data protection section above for full details).

23. The Government will, within 3 months of the close of the consultation, publish the consultation response. This response will take the form of decisions made in light of the consultation, a summary of the views expressed and reasons given for decisions finally taken. This document will be published on the BIS website with paper copies available on request.

7. Why reform the law on audit exemptions?

We will end the so-called 'gold-plating' of EU rules, so that British businesses are not disadvantaged relative to their European competitors.

The Coalition: our programme for government[2]

24. The Government identified in the March 2011 Plan for Growth[3] that over time, financial reporting and audit requirements and the costs which these impose on UK business have increased, and the Government has identified opportunities to make changes which support growth. Businesses have stressed that UK audit requirements could be applied in a more targeted and flexible manner to reduce compliance costs without significant impacts on disclosure and verification objectives. Options exist as detailed below in the 4th Directive 78/660/EEC to reduce the cost of audit and accounts preparation. Because audit requirements in the UK do not allow as much flexibility to companies as currently available under EU requirements, this gold plating creates a market inequality. In fulfilment of the Coalition programme, the Government has now decided to take advantage of some of these options in order to reduce the burden of regulation on companies.

25. The Government's view is that every company requires robust financial controls and appropriate governance and for many companies audit will be a vital part of this. However, as already recognised in UK and EU law, the benefits of audit vary according to company size. The Government has not found unambiguous evidence that mandatory audit decreases the cost of capital across the whole economy. What the evidence does show is that in situations where a company has an audit voluntarily, (a) it does benefit from a reduction in its cost of capital because of the signalling effect of audit[4], and (b) the bigger the company, the more likely it is to have a voluntary audit[5]. The role of audit need not be exactly the same in all sectors of the economy. For example, given the importance of key financial institutions to the economy the Government sees a clear need for auditors to contribute to prudential supervision.

26. However there do not appear to be systemic risks to reducing mandatory audit requirements for unquoted companies. The UK successfully introduced many of the EU audit exemptions in 1994 for small companies, as permitted by the Directives and there

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[2] May 2010 www.direct.gov.uk/prod_consum_dg/groups/dg.../dg_187876.pdf

[3] http://www.hm-treasury.gov.uk/ukecon_growth_index.htm

[4] Ahmed, Rasmussen, Tse *Audit Quality, Alternative Monitoring Mechanisms and Cost of Capital: An Empirical Analysis*, Texas A&M University August 2008; Melnick A. and Plaut S. (1995) *Disclosure costs, regulation, and the expansion of the private placement market; professional adaptation.* Journal of Accounting, Audit & Finance (Winter) 23-42.

[5] Collis, Jill *Directors' views on accounting and auditing requirements for SMEs* April 2008 http://www.bis.gov.uk/files/file50491.pdf p.55;
Rennie M, Senkow D. Rennie R. & Wong J (2003) *Deregulation of the private corporate audit in Canada: Justification, lobbying and outcomes* Research in Accounting Regulation 16 227-241, referred to in Wallace W. (2004) *The economic role of the audit in free and regulated markets: a look back and a look forward* Research in Accounting Regulation Volume 17, 267-298

have been no ill effects. The current proposal may be regarded as a further step in extending those exemptions.

27. The Netherlands, Germany and Ireland[6] are amongst the jurisdictions that have taken advantage of the EU exemptions for subsidiary accounts with a parent company guarantee.

28. At the same time, the Government recognises the public interest in having an amount of accounting information about active companies on the public register.

29. The impact of the changes proposed by the Government is expected to have a net benefit on business of £606m per annum. Details of the calculations and assumptions are contained in the Impact Assessment, which is attached to this document.

Question 1

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

8. Alignment of audit with accounting exemption for small companies

30. The UK does not currently take advantage of the full extent of the existing small company audit exemptions available under Article 51(2) of the 4th Council Directive (78/660/EC). The Article 11 of that Directive broadly states that a company qualifies as small (subject to certain exclusions) in a year in which it satisfies two or more of the following criteria:

Number of employees: no more than 50
Balance sheet total: no more than £3.26 million
Turnover: no more than £6.5 million

31. If it qualifies as small, a company is able to take advantage of a simplified form and content of the annual accounts that it prepares and files. However, the current UK implementation under s477 of the Companies Act 2006 means that a small company is only able to take advantage of an exemption from statutory annual audit if meets both

[6] The Netherlands takes advantage of the exemption under Article 57 of the Fourth Directive 78/660/EEC under Article 2:403 of the Dutch Civil Code, which permits abbreviated accounts for qualifying subsidiaries. Germany takes advantage of the Article 57 exemption under paragraph 264 paragraph 3 of the German Commercial Code (HGB) exempts qualifying subsidiaries from preparation, auditing and filing of both the annual accounts and the annual report. Ireland takes advantage of the Article 57 exemption under Section 17 of the Companies (Amendment) Act 1986 as substituted by Regulation 45 of the Group Accounts Regulations 1992 (S.I. No. 201 of 1992) and as amended by section 65 of the Company Law Enforcement Act 2001 and Regulation 5(j) of the European Communities (International Financial Reporting Standards and Miscellaneous Amendments) Regulations 2005 (S.I.No. 116 of 2005). This permits qualifying subsidiaries exemption only from filing of accounts.

balance sheet and turnover criteria. The Government has now decided to amend UK law to enable a company to obtain the audit exemption if it meets any two out of the three criteria (number of employees; balance sheet total; and turnover). This will bring the small company audit criteria into line with the small company accounting criteria, and hence simplify the operation of the thresholds. Those companies that are currently excluded from the small company audit exemption under s478 CA06, such as public companies, insurance companies and banking companies will continue to be so excluded. Safeguards in company law to protect minority shareholders will continue to apply: s476 CA06 allows shareholders holding at least 10% of the share capital to require an audit. The Government will also make similar amendments to allow small groups to apply the same rules.

32. Currently, in the UK, 1,398,400 (86.3%) of non-dormant companies do not have their individual (i.e. non-group) accounts audited[7]. After this proposed alignment of audit with accounting thresholds the number eligible for the exemption will increase by 36,000, and with an average audit fee for these firms of £9,500 (based on analysis of the FAME database) there is the potential for significant savings in audit costs.

33. Our Impact Assessment, which is annexed to this document, assumes that 60% - 85% of additional small private companies that will now qualify as audit exempt will take up the option of exempting themselves from audit after alignment of the audit exemption with the accounting exemption, and that the assumed audit fee saving is £9,500 per company. This generates annual benefits of £206m - £292m. We have not assumed any saving of management time for small companies taking up the audit exemption, as we assume that accounts are prepared and audited by the same audit firm.

> Question 2
>
> A Do you agree about 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?

34. The proposal by the Government to take up this exemption is a continuance of the historical process in the UK of such exemptions being granted by the EU and implemented in stages over a number of years by the UK. The reason for the gradual UK implementation is to minimise the risks of systemic misstatement in the accounts of audit exempt companies, harming shareholders and third parties. In 1978, the Fourth Directive (78/660/EEC) introduced an audit requirement but gave Member States the option to exempt small companies from it. The Government did not take advantage of this option until 1994 (SI 1994/1935). Then, small companies with a turnover of £90,000 or below were exempted from the requirement to have an independent audit. The turnover criterion was increased to £350,000 in 1997 (SI1997/936), to £1m from 2000 (SI2000/1430), and to the EU maximum of £5.6m (SI2004/16) in 2004. In 2006 the EU raised the net turnover threshold to €8.8m and the UK raised its threshold in line with

[7] Companies House, Statistical Tables on Companies Registration Activities 2009-10, Table F2 in period 2009-10

this to £6.5m in 2008. There have been no serious concerns raised as a result of the introduction of the audit exemptions and external research[8] shows that companies close to the threshold and larger small companies have continued to have their accounts audited.

35. The Government's view is that extending the audit exemption to encompass more companies will not cause significant deterioration of the quality of financial information. This view is supported by informal stakeholder discussions. It is also worth noting that the main creditors of small companies are HMRC and banks. HMRC relies on a system of self assessment but may, in certain circumstances, use its powers to ask for additional explanation and information.

36. In the past some commentators have suggested that lack of an audit would prevent companies from raising finance. However, we do not believe alignment of the criteria for a small company for audit purposes with those for accounting purposes will prevent companies from raising finance, since these companies will remain free to opt for a voluntary audit, should they wish or should this be demanded by the market. There is no reason why the Government should impose the regulatory burden of mandating audits for those companies. In addition it should be noted that the providers of finance are in a position to require a company to provide current financial information before deciding to do business with them.

37. HMRC considers that the audit provides an independent assurance as to the quality of the financial information in the financial statements. However, it does not rely solely on these, but in individual cases and in specific circumstances is able to seek further information beyond the financial statements in order to satisfy itself as to the veracity of the information provided to it. The increased assurance of information to HMRC is therefore not in itself a satisfactory argument for mandatory audit.

Question 3

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?

[8] *Directors' views on accounting and auditing requirements for SMEs*, Dr Jill Collis April 2008 (minor updates at November 2008) Department for Business URN 09/601 http://www.bis.gov.uk/files/file50491.pdf Published 13 March 2009

9. Reduction in the costs of subsidiary company accounts

38. Article 57 of the Fourth Directive 78/660/EC provides Member States with the option to exempt qualifying subsidiaries from the requirement to prepare, audit and publish annual accounts where all of the following conditions are met:

(a) the parent undertaking must be subject to the laws of a Member State;
(b) all shareholders or members of the subsidiary undertaking must have declared their agreement to the exemption from such obligation; this declaration must be made in respect of every financial year;
(c) the parent undertaking must have declared that it guarantees the commitments entered into by the subsidiary undertaking;
(d) the declarations referred to in (b) and (c) must be published by the subsidiary undertaking as laid down by the laws of the Member State in accordance with Article 3 of Directive 68/151/EEC;
(e) the subsidiary undertaking must be included in the consolidated accounts drawn up by the parent undertaking in accordance with Directive 83/349/EEC;
(f) the above exemption must be disclosed in the notes on the consolidated accounts drawn up by the parent undertaking;
(g) the consolidated accounts referred to in (e), the consolidated annual report, and the report by the person responsible for auditing those accounts must be published for the subsidiary undertaking as laid down by the laws of the Member State in accordance with Article 3 of Directive 68/151/EEC.

39. These options have been implemented in whole or in part in Germany, the Netherlands and Ireland for many years. Currently the UK does not take advantage of any of these exemptions for subsidiary companies which has led to a position of gold-plating of audit and accounting regulation. The Government's view, supported by stakeholder discussions, is that the audit of subsidiary accounts adds limited value but imposes significant costs on the companies affected. The average cost of audit for these companies ranges from £8,000 for small companies to £83,000 for large companies. The group report and accounts of the parent company, into which the subsidiary accounts are consolidated, are subject to mandatory audit.

What exemptions are being consulted on?

Non-dormant qualifying subsidiaries

40. In relation to non-dormant qualifying (under Article 57 and additional conditions set out above) subsidiaries, the Government is considering exempting them from mandatory audit of their accounts, but not from mandatory preparation or filing of accounts (the reasons for this are set out in a separate section below). The following options are being consulted on, with (b) as the recommended option:

(a) Do nothing;

(b) Exempt qualifying non-dormant subsidiaries from mandatory audit of their accounts;

(c) Exempt qualifying non-dormant subsidiaries from mandatory preparation of accounts, mandatory filing of accounts and mandatory audit of accounts

Question 4 Do you agree with option B to exempt qualifying non-dormant subsidiaries from mandatory audit of their accounts?

Question 5 Under Option C, what would be the effect of exempting qualifying non-dormant subsidiaries from mandatory preparation of accounts, mandatory filing of accounts and mandatory audit of accounts?

Dormant qualifying subsidiary companies

41. Dormant companies are defined in s1169 Companies Act 2006 as ones in which no significant accounting transactions have taken place in the past year. For qualifying dormant subsidiary companies (that is, that fulfil the requirements of Article 57 and additional requirements set out above) the Government believes that preparation and filing of accounts for the public record provides little additional information given their lack of trading activity. In the UK, small dormant companies are already exempt from mandatory audit if they fulfil the conditions in s480 CA06. The Government proposes not only to extend the audit exemption to medium and large qualifying subsidiary dormant companies, but also to exempt all qualifying dormant subsidiaries from preparation and filing of accounts altogether. There will still be information at Companies House about these dormant companies, as they will still continue to file an Annual Return. The Annual Return discloses, amongst other information, the names of the directors, which appears to be a key reason that their accounts are searched. It is proposed that the Annual Return would also disclose that the company was dormant. The Government does not have the option under Article 57 of the Directive to exempt all dormant companies from preparation and publication of accounts, only qualifying dormant subsidiaries.

42. The Government therefore is consulting on the following, with (c) as the recommended option:

(a) Do nothing

(b) Exempt qualifying dormant subsidiaries (of whatever size) from mandatory audit;

(c) **Exempt qualifying dormant subsidiaries (of whatever size) from mandatory preparation, mandatory filing and mandatory audit of accounts**.

Question 6 Do you agree that the Government should exempt qualifying dormant subsidiaries of whatever size from mandatory preparation, mandatory filing and mandatory audit of accounts? What difference would this make to your business and to the wider economy?

Which subsidiaries will qualify?

43. Qualifying subsidiaries, whether dormant or not, will have to comply with all the conditions set out in Article 57 above, but in order to reduce the potential risks (see paragraph 40) of not mandating audit for subsidiaries which might be systemically important, the Government is proposing to impose additional conditions, in order to qualify for the exemptions:

- the subsidiary must be unquoted (within the meaning of s385 CA06); and
- the subsidiary must not be involved in financial services or insurance.
- Certain other companies under industrial relations legislation are also excluded, in line with the existing exclusions from the audit exemption in UK company law.

44. It should be noted that there is no maximum size limitation in order to qualify, and the Government is not proposing to introduce such a size limitation. The UK Government is considering the following options for consultation with (a) as the recommended option:

(a) a subsidiary will qualify where it fulfils not only the Article 57 conditions but also is unquoted, is not involved in financial services or insurance and does not fall into the category of certain other companies under industrial relations legislation, in line with the existing exclusions from the audit exemption in UK company law.

(b) a subsidiary will qualify where it fulfils the Article 57 requirements only

Question 7

A Do you agree that in addition to the Article 57 exemptions, in order to qualify, a subsidiary company should be unquoted, not involved in financial services or insurance and not fall into the category of certain other companies under industrial relations legislation, in line with the existing exclusions from the audit exemption in UK company law?

B Why? What difference would this make to your business and to the wider economy?

Question 8

What would be the consequences (e.g. to investors, depositors or lenders or to the wider economy) of allowing financial services subsidiaries to take advantage of this exemption?

45. It is proposed that the same rules on exemptions for qualifying subsidiaries will broadly apply to Limited Liability Partnerships and unregistered companies.

Question 9

Do you agree that the same rules on exemptions for qualifying subsidiaries should broadly apply to Limited Liability Partnerships and unregistered companies?

46. The purpose of the audit is to reduce the risk of misstatement of financial statements. The potential risk therefore of reducing the number of companies subject to mandatory audit is an increase in misstatement of financial statements. The Government believes

that the risks are justified by the level of the potential benefits. The risks are discussed in more detail in the annexed Impact Assessment.

47. A qualifying subsidiary or dormant subsidiary of a Limited Liability Partnership will be able to take advantage of the same options.

Benefits of preferred options

Saving the cost of audit

48. We assume that 75% to 100% of the 83,000 qualifying subsidiaries will take up the audit exemption in return for a parent company guarantee. This is based on experience in other European countries which take advantage of the Article 57 exemption. For example in Germany and the Netherlands, the authorities have estimated (although no figures are available) that most eligible companies take up the exemption. In Ireland, over 50% of qualifying subsidiaries receive a parent guarantee in return for exemption from filing accounts. It is assumed that the take-up will be higher than in Ireland because of the potential cost saving in dispensing with an audit. We assume that only 10% to 25% of the audit cost of £8,000 to £83,000 of the subsidiary will be saved because of the additional audit work necessary at group level. This generates annual benefits of £174m to £578m. Please see the impact assessment for further detail on these calculations.

Saving of management time interacting with the auditor

49. For qualifying subsidiaries taking up the exemption we have assumed an annual saving of £9m to £12m of management time in interacting with the auditor (assuming a saving of 5 hours of senior management time).

50. For the 67,000 qualifying dormant subsidiaries we assumed an annual saving per dormant of £280 and therefore a total annual saving of £19m. Please see the impact assessment for further detail.

Question 10 Do you agree with our estimate of the savings of the cost of the audit as detailed in the impact assessment, and in particular the underlying assumptions: A That the average cost of the audit is in the range of £8,000 to £83,000 per subsidiary? B That 75% to 100% of qualifying subsidiaries will take up the exemption? C That 10% to 25% of the audit cost of each qualifying subsidiary will be saved?

Question 11

Do you agree with our estimate of the saving of management time interacting with the auditor and in particular, with our underlying assumptions that for subsidiary companies the saving will be 5 hours of senior management time, which gives rise to £60 to £273 saving per company, depending on size of company?

Question 12

Do you agree with our estimate of the saving of the cost of management time to prepare and file qualifying dormant subsidiary accounts and in particular the underlying assumption of the £280 per dormant subsidiary?

Costs of preferred option

51. The main cost we have assumed is the one-off cost occurring in the first year of qualifying subsidiaries taking legal advice about the guarantee. This is assumed to be £110 per subsidiary, which amounts to £9m, if all 83,000 qualifying subsidiaries took up the exemption. If the Government provided guidance on an acceptable form of the guarantee, companies would not need to take this legal advice and we believe the cost would reduce to zero.

Question 13

Do you agree with our estimate of the cost of taking legal advice of £110 per subsidiary in the first year only, but that if the Government provided guidance on an acceptable form of the guarantee, this cost of legal advice would be zero?

Reasons for rejecting exemption for non-dormant qualifying subsidiaries from preparation and filing of accounts

52. The Government does **not** propose to exempt non-dormant qualifying subsidiaries from either preparation or filing of accounts. The reasons for this are as follows:

    a. No cost of saving of management time for <u>preparation</u> of accounts would in practice be achieved because HMRC uses much of the information provided in statutory accounts. Management would have to prepare and provide HMRC with this information.

    b. The subsidiaries qualifying for exemption from <u>filing</u> accounts would range from large companies to very small and would even include some public companies (though not quoted companies, who are obliged to publish their financial statements under stock market rules). Therefore the potential loss of public information would be significant. When the Company Law Review consulted on

this issue in 2000[9], the loss of information to creditors, employees and other interested parties if qualifying subsidiaries chose not to file accounts was objected to by a large number of respondents[10] including the ACCA, KPMG, Hermes Investment Management, Clifford Chance and the Institute of Credit Management. Their reasons given were: large companies employing thousands would not produce accounts: this would make it impossible for economists and analysts to understand what was happening in the UK economy; company stakeholders, not just creditors, need access to published accounts and these promote competitiveness; information useful for mergers and acquisitions would be hidden and shield both excellent and poor performance; it was claimed that some foreign companies run their UK operations at a loss to undermine the domestic price structure and in the absence of accounts, such behaviour could not be challenged; non-publication of accounts would expose creditors more readily to fraud.

c. Although we have not been able to monetise the value of the information that would have been lost if the Government had taken this exemption we have some information from Companies House on the extent to which company information on the register is accessed. Companies House website has around 500k hits a day and analysis undertaken in 2010 found that accessing annual accounts and checking financial information were amongst the top reasons given by customers accessing free and paid-for information (over a third of requests for paid-for information). Full accounts seem to be particularly highly valued by customers of Companies House, allowing them to make business decisions, undertake credit assessments, due diligence and assess customers/suppliers. In addition, Companies House supplies the contents of the register, including the details of the company accounts, to a number of commercial companies who then package the information to sell on to third parties.

53. Whilst we have not been able to monetise the cost of this loss of information it is clear that it would represent a significant loss to a wide range of stakeholders. (See risks section below for a further discussion of the issues).

Question 14

Have views of stakeholders expressed to the Company Law Review changed since 2000?

Question 15

Do you agree with the Government's conclusions on the likely impacts that would have been involved in exempting non-dormant qualifying subsidiaries from either preparation or filing of accounts and that the costs of such a proposal would likely exceed the benefits?

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[9] [9] "Completing the Structure" A consultation document from the Company Law Review Steering Group – November 2000 URN 00/1335 Paragraphs 10.19 onwards http://www.bis.gov.uk/policies/business-law/company-and-partnership-law/company-law/publications-archive

[10] "Final report" Company Law Review Steering Group – 2001 URN 01/942 para 8.23 onwards

Risks

Risks arising from reducing the number of companies audited

54. The purpose of the statutory audit is, through a report to the shareholders by an independent, qualified auditor, to reduce the risk of misstatement of financial statements. The risk therefore of reducing the number of companies subject to mandatory audit is an increase in misstatement of financial statements. However the Government believes that this risk is manageable because the effects of such misstatement would not pose a systemic risk to the economy: systemically important companies, such as quoted companies and those in banking and insurance, will continue to be subject to mandatory audit. We do not believe that there is a risk that the reduction in mandatory audit will prevent companies from raising finance, since these companies will be able to make a commercial decision to opt for a voluntary audit should they wish, or should this be demanded by the market. If the lack of audit led to material misstatement of profits in companies then this could potentially lead to a tax loss to the Exchequer. As stated above however, regulatory authorities such as HMRC are able to call for more information from taxpayers if they wish.

55. As a result of the Government's current proposals, it is likely that some small audit firms will see a decrease in demand for their audit product. However, such firms would continue to be able to provide business services such as accounts preparation and taxation advice and in addition would be able to provide other business services which they may be currently prevented from doing by their position as auditor by Ethical Standards of the UK Auditing Practices Board. It is therefore unlikely that the Government's proposals, insofar as they affect small auditors will have any significant adverse impact. Please see the impact assessment for further discussion of these issues and the impact of earlier changes in exemptions.

Question 16 Do you agree with the assumption that it is unlikely that the Government's proposals will have a significantly adverse impact on the number of small audit firms?

Risks arising from aligning audit with accounting exemptions

56. We believe that there are limited risks arising from the increased risk of misstatement of accounts or reduction in credibility of accounts which are no longer audited. The UK successfully introduced audit exemptions in 1994 for most small companies, as permitted by the Directive and there is no evidence of ill effects. In the UK, 86% of non-dormant companies do not have their individual (i.e. non-group) accounts audited[11]. After this change the number eligible for the exemption will increase by 36,000. Risks to shareholders are limited because the safeguards in company law under s476 CA06, which allows shareholders holding at least 10% of the share capital to require an audit, will continue to apply.

[11] Companies House, Statistical Tables on Companies Registration Activities 2009-10, Table F2 in period 2009-10

Risks arising from reducing the costs of subsidiary company accounts

57. There is no size limit on the subsidiary whose parent gives a guarantee, so even large subsidiary companies could now be unaudited. However, since all shareholders of the subsidiary have to agree to this, there is no risk of oppression of minority shareholders. The parent company guarantee reduces the risks for creditors of the subsidiary. It will be for the parent company granting the guarantee to determine whether the risks of giving the guarantee outweigh the burden of the mandatory audit. The risk of adverse effects on the economy is reduced by the additional conditions to Article 57 that the Government is proposing (that the subsidiary must not be listed and must not be in the financial sector).

58. There is a risk that the creditors of the parent will be prejudiced when the guarantee is given: no declaration of solvency is being made by the directors of the parent company. However existing unsecured creditors are always in a worse position when their debtor takes on additional liabilities. A note in the parent company's group accounts will have to state that its subsidiary is taking advantage of the audit exemption.

59. Since they are not trading it is not considered that there is any adverse risk in dormant qualifying subsidiaries no longer preparing or publishing accounts. Little public information will be lost from this change.

Question 17

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

Parent Company Guarantee

60. Particular issues arise concerning the nature of the parent company guarantee under Article 57. The Directive states only that "the parent undertaking must have declared that it guarantees the commitments entered into by the subsidiary undertaking." Do the commitments, mean "liabilities" (which would include liability in tort and contingent liabilities) or "debts" (which would include only debts that are owed by the subsidiary as a matter of contract)? Is the guarantee irrevocable in respect of a particular financial year? Is the guarantee in relation to the commitments that exist at the balance sheet date of the financial year for which the audit exemption in claimed, or for all the commitments that exist at the balance sheet date as well as future commitments until a set of audited accounts is deposited? Should there be a date by which the declaration of the guarantee must be filed at Companies House? Should it be from a date before the filing of the subsidiary accounts or the Annual General Meeting, whichever is the earlier? Should there be a delay between the date that the parent company files the declaration at Companies House and the date that it becomes effective? Can a parent company in administration or liquidation grant a guarantee?

61. The nature of the guarantee will be a key determinant as to whether companies are prepared to take up the proposed audit exemption.

62. Government has adopted Guiding Principles for EU legislation that it will use when introducing European measures into UK law. These are designed to end so-called "gold-

plating" so that British businesses are not put at a disadvantage relative to their European competitors[12].Government policy therefore is to "always use copy out for transposition where it is available, except where doing so would adversely affect UK interests e.g. by putting UK businesses at a competitive disadvantage compared with their European Counterparts. If departments do not use copy out, they will need to explain to the Reducing Regulation Committee the reasons for their choice."

63. For this reason Government proposes option (a):

(a) **the guarantee will be irrevocable and in respect of all debts in respect of that financial year. Until an audited set of accounts for the subsidiary is filed it will also be in respect of future debts incurred by the subsidiary**;

(b) the guarantee will be irrevocable and will be in respect of the debts of the subsidiary in respect of that financial year.

Question 18 Do you agree that the guarantee should be irrevocable and in respect of all debts in respect of that financial year? Until an audited set of accounts for the subsidiary is filed it will also be in respect of future debts incurred by the subsidiary.

64. The Government does not want to gold plate the Directive by making the parent company guarantee more than the debts of the subsidiary that subsisted at the balance sheet date, because to guarantee the liabilities of the subsidiary would be more onerous on the parent company and make it less likely that it would issue the guarantee. Government therefore proposes option (a).

(a) the guarantee will cover debts of the subsidiary and not the wider definition of "liabilities"

(b) the guarantee will cover liabilities of the subsidiary

Question 19 Do you agree that the guarantee should cover the "debts" of the subsidiary and not extend to its "liabilities"?

65. In order to reduce the burden on companies, the Government proposes to issue guidance on an acceptable form of such a guarantee.

66. The requirements for publicity of the guarantee are set out in Article 57 and the Government does not propose exceeding these, as to do so would be gold plating. The guarantee itself will not be filed. Article 57 requires that it is the subsidiary that must file at Companies House the declaration that the parent company has made the guarantee (we anticipate that this declaration will be part of the subsidiary's annual return). The subsidiary must also file at Companies House the annual declaration by its shareholders that they have agreed to the audit exemption (or preparation and filing exemption, in

[12] http://www.bis.gov.uk/policies/better-regulation/policy/european-legislation/goldplating

relation to qualifying subsidiary companies). It is anticipated that this will be part of the subsidiary's annual return. To this end, the Government will need to amend the Annual Return Regulations in order to give Companies House the power to require the information on the Annual Return.

67. There will be no requirement to file the guarantee at Companies House. There will be no requirement for a declaration of solvency before the parent grants the guarantee, even though to do so would add a greater measure of creditor protection as this would be gold plating.

Question 20

A Do you agree with the proposals for the Guarantee?

B Do you think the form of the proposed guarantee will encourage its take-up in line with our assumptions above (75-90%)? If not, why not?

C Do you have alternative proposals that would not gold plate the Directive, provide adequate protection for those to whom the subsidiary owes a debt, but do not make it unlikely that the parent would issue such a guarantee?

68. The Government is satisfied that guarantees will be enforceable. Where an elective parent is formed under the laws of another EU Member State, under the provisions of the European Convention on Jurisdiction and Enforcement of Judgements in Civil and Commercial Matters, an English or Scottish court has jurisdiction to hear a claim by a creditor of a British elective subsidiary against a parent incorporated elsewhere in the EU which has given a guarantee. If a creditor obtains a judgement in his favour in an English or Scottish court under the terms of the guarantee, then under the Convention, a court elsewhere in the EU should recognise that judgment.

Penalties

69. In line with the commitment not to gold plate, no new penalties are proposed. Companies claiming the auditing or filing exemption will continue to be subject to the provisions of the Companies Act 2006 s451 (whereby it is a criminal offence not to follow the filing requirements of s441), s452 (court direction), and s453 (civil penalty).

Question 21

Do you agree that no new penalties should be proposed in conjunction with the introduction of these proposals?

Charities

70. These proposals will not affect the audit thresholds for charities, since these were last changed comparatively recently in 2008.

10. Amendment of restriction for companies moving from IFRS to UK GAAP

Background

71. UK company law provides the legal framework within which the 2.5 million entities[13] established as companies must operate and many of the accounting requirements are contained in Part 15 of the Companies Act 2006. Generally Accepted Accounting Principles in the UK (UK GAAP) broadly comprise The Companies Act 2006 (CA06) and UK accounting standards developed or adopted by the UK Accounting Standards Board (ASB) over many years. International Financial Reporting Standards (IFRS) are international accounting standards issued by the International Accounting Standards Board (IASB)[14]. According to Part 15 of the Companies Act 2006, accounts produced using UK GAAP are called "Companies Act accounts", and those produced using "IFRS as adopted in the EU" (for the purpose of this consultation document abbreviated to "IFRS") are called "IAS accounts."

72. Under the IAS Regulation (EC 1606/2002), since financial years beginning on or after 1 January 2005, all listed companies in the EU must prepare their consolidated financial statements as IAS accounts (that is, under IFRS). Following a public consultation in 2002[15], the Government decided that unlisted UK companies would be permitted to choose whether to switch to IFRS or continue to prepare their accounts in accordance with UK GAAP. Thus in the UK most companies have a free choice as to whether they prepare their individual financial statements under UK GAAP or under IFRS . Around 7,300[16] UK companies use IFRS, 50,000 UK companies use full UK GAAP[17] and the remaining 1,959,000 use the Financial Reporting Standards for Smaller Entities (FRSSE)[18].

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[13] http://www.companieshouse.gov.uk/about/busRegArchive/businessRegisterStatisticsMay2011.pdf
14 Accounting standards inherited by the IASB from its predecessor body are called International Accounting Standards (IAS). Completely new standards issued by the IASB are called International Financial Reporting Standards (IFRS).
[15] International Accounting Standards , 30 August 2002, URN 02/1158, Department for Trade and Industry.
[16] Source: FAME database at 22 June 2011
[17] Choosing your GAAP Planning for the proposed removal of UK GAAP, Deloitte LLP 2009 http://www.iasplus.com/uk/0908ukgaap.pdf
[18] FRSSE sets out accounting requirements and disclosures for smaller entities under UK GAAP, as modified and simplified from other accounting standards contained in "full" UK GAAP. Source of number of companies in UK: Companies Register Activities 2009-10, Companies House, Table F2 http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2009_2010.pdf

73. UK companies whose securities are not listed[19] may prepare their consolidated financial statements under EU-adopted IFRS or under UK GAAP. However, the Government, after consultation[20] in 2004 implemented some restrictions and conditions:

    a. once a company has prepared its financial statements under EU-adopted IFRS, it cannot revert to UK GAAP in a later financial year unless there is "a relevant change in circumstances". A relevant change in circumstances occurs if the company becomes a subsidiary of an undertaking that is not preparing its individual financial statements under EU-adopted IFRS; if the company ceases to be a subsidiary undertaking; or if the company (or its parent) ceases to have its securities admitted to trading on a regulated market in an EEA state. (CA06 s395(3)(4).

    b. a parent company may elect to prepare its individual financial statements under UK GAAP even if it elects to use EU-adopted IFRS in its consolidated financial statements.

    c. where the parent company prepares group accounts, companies in the same group must adopt the same accounting framework (either IFRS or UK GAAP) as each other, unless there are "good reasons" not to do so (CA06 s407). That is, the parent must ensure that all UK companies in the group use either IFRS or UK GAAP. There is an exception to this requirement: where a parent adopts IFRS in both its consolidated financial statements and its individual financial statements, it will not be required to ensure that all its subsidiaries use IFRS too. BIS has issued guidance notes on these rules, including an explanation of when there might be "good reasons"[21].

ASB proposed changes

74. In October 2010 the ASB issued for consultation "The Future of Financial Reporting in the UK and Republic of Ireland.[22] Amongst other measures, this proposes that subsidiaries who currently file IFRS accounts should be able to switch to filing accounts under a new version of UK GAAP and make savings from reduced disclosures that the ASB is introducing. The parent company, if listed on the Main Market or on AIM would continue to file its group accounts with normal disclosures of the group's activities under IFRS. Of those companies filing IFRS accounts, the vast majority are subsidiary companies and/or holding companies – these may be listed (AIM/main market), public or private companies of any size.

75. As described above, company law provides that a company or group which prepares IAS accounts may not move to preparing Companies Act accounts unless there is "a

[19] In this context, listed companies means any companies that have securities traded on a regulated market of any EU member state. Regulated markets in the UK are the following: London Stock Exchange; London Metal Exchange; ICE Futures Europe; SWX Europe Ltd; LIFFE; EDX and PLUS-listed Market.
[20] "Modernisation of accounting directive/IAS infrastructure" March 2004, URN 04/733 Department for Trade and Industry and HM Treasury
[21] http://www.bis.gov.uk/files/file46791.pdf
[22] http://www.frc.org.uk/asb/technical/projects/project0072.html

relevant change in circumstance". The ASB has therefore asked[23] the Government to consult on amending the Act so that the definition of a relevant change in circumstance includes the implementation of the ASB's proposals. Once the changes proposed by the ASB are introduced, unless the law is amended, companies currently choosing to report under IFRS will be restricted from taking advantage of the reduced costs available for qualifying subsidiary companies under the reduced disclosure regime available under the ASB's proposals.

76. Responses to the ASB's consultation have now been published[24], and the reduced disclosures for subsidiaries are supported by responses from a wide variety of stakeholders.

77. The Government is minded to significantly deregulate the process of moving from IFRS to UK GAAP by allowing companies, not only to change from IFRS to UK GAAP if there is a "change of circumstances", but also for any other reason. A change "for any other reason" will be restricted by how often they may make such a change.

Rationale for intervention

78. Before the IFRS regime was introduced, the reason given in 2004[25] by the Government for restricting companies' ability to move from IFRS to UK GAAP was to prevent companies from "misrepresenting their position by switching regimes depending on which shows their performance in a better light". The reasons for intervening now are that:

- the Government is committed to reducing the burden of unnecessary regulation;
- the use of IFRS in the UK is well established; and
- the new framework proposed by the ASB for UK Financial Reporting Standards will be based on IFRS. This significantly reduces scope for companies misrepresenting their position by switching between accounting regimes depending on which shows their performance in a better light. In this context, therefore the Government now considers that law in this area is unduly restrictive.

Proposals

79. The Government is therefore considering the following options, with a current preference for (a) on the grounds that it provides benefits to companies and the business environment at a low risk:

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[23] Appendices to "The Future of Financial Reporting in the UK and Republic of Ireland" , ASB (October 2010) paragraph A1.15 http://www.frc.org.uk/images/uploaded/documents/Part%203%20Web%20Optimized.pdf
[24] http://www.frc.org.uk/asb/technical/projects/responses_fred_UK_IRE.cfm
[25] "Modernisation of accounting directive/IAS infrastructure" March 2004, URN 04/733 Department for Trade and Industry and HM Treasury

(a) allow companies that prepare their accounts under IFRS to move to UK GAAP for any other reason than a relevant change in circumstances, no more frequently than once every 5 years;

(b) add a change in accounting standards to the list of relevant change in circumstances under which companies can switch from IFRS to UK GAAP;

(c) allow companies that prepare their accounts under IFRS to move to UK GAAP for any other reason than a relevant change in circumstances no more frequently than once every 3 years;

(d) allow companies that prepare their accounts under IFRS to move to UK GAAP without restrictions;

(e) do nothing.

80. Options A and C differ only in the frequency with which companies would be able to move to UK GAAP. Option D deregulates entirely. Option B is the ASB's original proposal and simply adds to the existing relevant circumstances in which a company may make the change a change in the accounting standards such as that proposed by the ASB. As discussed below in the sections on benefits, costs and risks, there are different levels of flexibility and risks attached to each option. Option A is currently preferred, because it will provide significantly more flexibility for companies and groups than both the current position and the ASB proposal (Option B). Option A will allow companies to take advantage of the cost and burden saving changes to UK GAAP proposed by the ASB, as well as allowing future flexibility, while retaining increased comparability of accounts over Options C and D and limiting the possible risk of tax arbitrage particularly in relation to Option D.

Question 22

Do you agree that the Government should impose restrictions on companies' ability to move from IFRS to UK GAAP?

Question 23

How frequently should a company be able to move from IFRS to UK GAAP, unless there is a relevant change in circumstances? Every year, every 3 years, every 5 years, or never?

Benefits

81. Of the 7,300 UK companies preparing their accounts under IFRS, around 1,700 are group accounts of listed companies, which would be obliged to continue to produce accounts under IFRS[26]. This leaves 5,600 companies who would be free to change to UK GAAP, of which around 5,500 are subsidiaries who would benefit most from

[26] Source: FAME database 6 July 2011

switching to UK GAAP. We have estimated that 90% (4,950) of those companies would take up this option, in order to take advantage of the reduced disclosures proposed by the ASB. These figures exclude dormant companies.

82. It is estimated by BIS that this will save 1 hour of senior management time and 2 days of middle management time per year in accounts preparation. This amounts to an annual saving per company of £569, and therefore a total annual saving for the 4,125 companies taking up the option of £2.34m to £2.81m. The details of the benefits and costs are contained in the Impact Assessment annexed to this document.

Question 24

A Do you agree with the Government's estimate that 90% of eligible subsidiary companies will take up the option?

B Do you agree that the saving for each company will be £569?

There are additional benefits of companies being able to move regularly between IFRS and UK GAAP:

83. Companies may have perfectly valid business reasons – not necessarily foreseeable at the time of the initial election for wishing to revert to UK GAAP. For example, a subsidiary which elects to apply IFRS to prevent measurement differences with other group companies would be unable to return to UK GAAP when those differences had been eliminated and would therefore be unable at that time to take advantage of any disclosure exemptions retained in UK GAAP.

84. The London Stock Exchange[27] is the operator of the UK's largest public equity markets, the Main Market and AIM (the Alternative Investment Market). An appropriate accounting framework for companies that join its market enable investor confidence to be maintained and allows companies to raise capital at a reasonable cost over the long term, and preserves the flexible regime which has contributed to the attractiveness of London as a major global financial centre. The Main Market is an EU Regulated Market and therefore companies on the Main Market already have to comply with IAS, under the IAS Regulation, i.e. to prepare IFRS accounts. Currently the AIM rules for companies require that companies incorporated in an EEA country must prepare their financial statement in accordance with IFRS[28].

85. There are two reasons why the amendment in the law sought by ASB will assist AIM:

(a) if a company delists from AIM, under the current law, it would not be able to move to UK GAAP, since it is not covered by s395(4)(b) (which allows moving to UK GAAP if a company ceases to be admitted to trading on a regulated market) as AIM is not a regulated market;

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[27] Source of information letter 288 from London Stock Exchange in response to ASB consultation on the Future of Financial Reporting: http://www.frc.org.uk/asb/technical/projects/responses_fred_UK_IRE.cfm

[28] If a company is a single entity and does not produce consolidated financial statements it may choose UK GAAP (<2% of AIM companies still use UK GAAP

(b) The London Stock Exchange believes that the AIM IFRS requirement might be relaxed at some point in the future to help SMEs access a wider range of funding sources. If this occurred it would be likely for many existing AIM companies to wish to move to UK GAAP, which the current law precludes, but the proposed change would permit. This would potentially benefit 934[29] companies who are UK registered and are quoted on AIM. However this is not yet a proposal from the Stock Exchange and is therefore too remote to be quantified.

Costs

86. Additional one-off costs of implementation of each company moving from IFRS to UK GAAP[30] in the year of movement are estimated at £390 (including £250 additional audit cost and four hours of internal staff time). When multiplied by the 4,125 to 4,950 companies estimated to make the change the one-off cost amounts to £1.6m to £1.9m.

Question 25

Do you agree that the one-off cost per company will be £390?

87. The ASB believes that[31] the disclosure exemptions for companies proposed will not impede the quality of financial reporting. This was agreed by almost all respondents to the ASB's consultation. The costs of lack of comparability over time when companies change accounting frameworks are minimised by transitional arrangements in the accounting standards.

Risks

88. There is a risk that giving a company power to change from IFRS to UK GAAP every 3 or 5 years might result in companies being able to misrepresent their position by switching between accounting regimes depending on which shows their performance in a better light. The cost of misrepresentation will in the long term result in a reduction in shareholder value. However (a) the new accounting framework proposed by the ASB for UK Financial Reporting Standards will be based, not on "old UK GAAP" but on IFRS. Thus, since the accounting differences between the two are now less significant, the risk of arbitrage between the two sets of financial statements is mitigated; (b) whether accounts are prepared under IFRS or UK GAAP, s393 Companies Act 2006 still requires that the directors of a company must not approve the accounts of a company unless that they are satisfied that they give a true and fair view of the company's results and financial position (c) there are transitional rules in accounting standards which means that the risk of lack of comparability of accounts between periods when the company changes between accounting framework is minimised.

[29] http://www.londonstockexchange.com/statistics/historic/aim/may-2011.pdf
[30] The Future of Financial Reporting , Volume 1, ASB assumption p158
[31] ASB "The Future of Financial Reporting" Part 1, p39 October 2010

89. It is assumed that companies will only exercise the option to change from IFRS to UK GAAP if the benefits for them outweigh the costs and that this will not happen very frequently, indeed the analysis above assumes that companies will only move once (from IFRS to UK GAAP).

90. There may be scope for tax arbitrage, but these will be addressed by application of the powers of the tax authorities, rather than by keeping restrictions in company law. HMRC does not from a general point of principle, have an issue with companies switching back to UK GAAP, although they recognise there is uncertainty over the extent to which companies may switch for tax arbitrage reasons once the rules are relaxed.

Question 26

Do the proposed changes in any way increase the risk of financial irregularities? If so, what would you estimate the potential impact to be on investors?

Question 27

What is the risk that investors will be misled or confused by a company switching between accounting frameworks?

Question 28

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

11. Timing for both proposals

91. Because of the need to ensure a thorough consultation process, the earliest common commencement date that the changes to the audit exemptions and to the law allowing companies to change their accounting framework could be brought into force is 1 October 2012. The Government is considering the following options for consultation with (a) as the recommended option, as this would enable companies to be take advantage of the flexibilities of these proposals earlier.

(a) The proposals should apply to entities for financial years ending on or after 1 October 2012.

(b) The proposals should apply to entities for financial year beginning on or after 1 October 2012.

Question 29

Do you agree that the proposals should apply to entities for financial years ending on or after 1 October 2012?

Annex 1: Impact Assessment of Consultation on Audit Exemptions

This can be found on **www.bis.gov.uk/assets/biscore/11-1194-audit-exemptions-impact-assessment**

Annex 2: Impact Assessment of Consultation on Amendment of restriction for companies moving from IFRS to UK GAAP

This can be found on **www.bis.gov.uk/assets/biscore/11-1195-amendment-restrictions-for-companies-impact-assessment**

Annex 3: List of consultees

Accounting Standards Board
Association of British Insurers
Association of Chartered Certified Accountants (ACCA)
Association of Authorised Public Accountants (AAPA)
BDO
British Chambers of Commerce
British Information Providers Association
Confederation of British Industry
Deloitte
Ernst and Young
Federation of Small Business
Financial Reporting Review Panel
Financial Services Authority
Grant Thornton
Institute of Chartered Accountants for England and Wales (ICAEW)
Institute of Chartered Accountants of Ireland (ICAI)
Institute of Chartered Accountants of Scotland (ICAS)
Institute of Chartered Secretaries and Administrators (ICSA)
Institute of Directors
Investment Management Association
KPMG
Law Society
Law Society of Northern Ireland
Law Society of Scotland
Local Government Group

National Association of Pension Funds
Northern Ireland Chamber of Commerce and Industry
Northern Ireland Executive
Price Waterhouse Coopers
Professional Oversight Board of the Financial Reporting Council
Scottish Government
UK Shareholders' Association
Welsh Assembly Government

Annex 4: The Consultation Code of Practice Criteria

1. Formal consultation should take place at a stage when there is scope to influence policy outcome.

2. Consultation should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.

3. Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.

4. Consultation exercise should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.

5. Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.

6. Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.

7. Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

Comments or complaints

If you wish to comment on the conduct of this consultation or make a complaint about the way this consultation has been conducted, please write to:

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