Title: **Audit exemptions** Lead department or agency: Department for Business, Innovation & Skills Other departments or agencies:	Impact Assessment (IA)
	IA No: BIS 0301
	Date: 05/09/2011
	Stage: Consultation
	Source of intervention: EU
	Type of measure: Secondary legislation
	Contact for enquiries: Rufus Rottenberg 02072150163 rufus.rottenberg@bis.gsi.gov.uk

Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

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.

What are the policy objectives and the intended effects?

There are three areas where the Government has decided to intervene:(a) alignment of audit with accounting exemptions for small companies; (b) permit companies to reduce the costs of subsidiary company accounts; (c) permit companies to reduce the cost of financial statement preparation and filing for subsidiary dormant companies. The policy objectives are : (a) to implement the Government's commitments in the Plan for Growth, published in March 2011; (b) to be more targeted in applying rules on company reporting, accounting and audit in order to reduce the burden of regulation on companies; (c) to recognise the public interest in having an amount of accounting information about active companies on the public register.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 1: the status quo;
Option 2: taking advantage of some of the exemptions available under Articles 51(2) and 57 of the 4th EU Company Law Directive to reduce mandatory audit and accounting;
Option 3: taking all of the exemptions under Articles 51(2) and 57 of the 4th EU Company Law Directive to reduce mandatory audit and accounting.

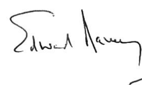
The Government is currently minded to prefer Option 2 because it delivers significant benefits in terms of reduction of cost, whilst keeping an acceptable amount of accounting information on the public register. Option 3 is not favoured because while it would deliver financial benefits over Option 2, it would impose a large non monetised cost in loss of company financial information in the public domain.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** Month/2017
What is the basis for this review? PIR. **If applicable, set sunset clause date:** Month/Year

Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	Yes

SELECT SIGNATORY Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.



Signed by the responsible Minister: Date: 5/9/11

Summary: Analysis and Evidence

Policy Option 1

Description:

Do nothing

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate: £0**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	0		0	**0**

Description and scale of key monetised costs by 'main affected groups'

None

Other key non-monetised costs by 'main affected groups'

None

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		0	**0**
High	0		0	**0**
Best Estimate	£0		£0	**£0**

Description and scale of key monetised benefits by 'main affected groups'

None

Other key non-monetised benefits by 'main affected groups'

Benefit of comfort provided by audit (or in the case of qualifying dormant companies, benefit of comfort provided by filed accounts) to shareholders, credit suppliers, suppliers, investors, and regulatory authorities.

Key assumptions/sensitivities/risks | **Discount rate (%)**

Direct impact on business (Equivalent Annual) £m):			In scope of OIOO?	Measure qualifies as
Costs: 0	**Benefits:** 0	**Net:** 0	Yes	NA

Enforcement, Implementation and Wider Impacts

<table>
<tr><td colspan="3">What is the geographic coverage of the policy/option?</td><td colspan="3">United Kingdom</td></tr>
<tr><td colspan="3">From what date will the policy be implemented?</td><td colspan="3">01/10/2012</td></tr>
<tr><td colspan="3">Which organisation(s) will enforce the policy?</td><td colspan="3">Companies House</td></tr>
<tr><td colspan="3">What is the annual change in enforcement cost (£m)?</td><td colspan="3">0</td></tr>
<tr><td colspan="3">Does enforcement comply with Hampton principles?</td><td colspan="3">Yes</td></tr>
<tr><td colspan="3">Does implementation go beyond minimum EU requirements?</td><td colspan="3">Yes</td></tr>
<tr><td colspan="3">What is the CO_2 equivalent change in greenhouse gas emissions?
(Million tonnes CO_2 equivalent)</td><td colspan="2">Traded:
0</td><td>Non-traded:
0</td></tr>
<tr><td colspan="3">Does the proposal have an impact on competition?</td><td colspan="3">No</td></tr>
<tr><td colspan="3">What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?</td><td colspan="2">Costs:
0</td><td>Benefits:
0</td></tr>
<tr><td>Distribution of annual cost (%) by organisation size
(excl. Transition) (Constant Price)</td><td>Micro
0</td><td>< 20
0</td><td>Small
0</td><td>Medium
0</td><td>Large
0</td></tr>
<tr><td>Are any of these organisations exempt?</td><td>Yes</td><td>Yes</td><td>Yes</td><td>No</td><td>No</td></tr>
</table>

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on…?	Impact	Page ref within IA
Statutory equality duties[1] Statutory Equality Duties Impact Test guidance	No	
Economic impacts		
Competition Competition Assessment Impact Test guidance	No	
Small firms Small Firms Impact Test guidance	No	
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	No	
Sustainable development Sustainable Development Impact Test guidance	No	

[1] Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Summary: Analysis and Evidence

Policy Option 2

Description:

Align audit with accounting exemptions for small companies; exempt subsidiaries from mandatory audit where the subsidiary fulfils the Article 57 and additional criteria; exempt dormant subsidiaries from all accounts preparation and filing requirements.

Price Base Year 2010	PV Base Year 2010	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 3444	**High:** 7717	**Best Estimate: 5213**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	0.05	1	Optional	**0.05**
High	22.5		Optional	**22.5**
Best Estimate	9		0	**9**

Description and scale of key monetised costs by 'main affected groups'

Transitional costs are estimated at £0.05m - £22.5m and will occur in the first year. These are one-off costs borne by (a) Companies House (which operates as a trading fund) of amending its filing software which are estimated to be £50k and (b) one-off legal costs of £0m - £22.5m to those companies who choose to seek advice about the operation of the guarantee.

Other key non-monetised costs by 'main affected groups'

Loss of comfort provided by audit of accounts of qualifying small companies, of qualifying subsidiaries (or in the case of qualifying dormant companies, loss of comfort provided by preparing, publishing and auditing accounts) to shareholders, credit suppliers, suppliers, investors, taxation and regulatory authorities.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low			408	**3467**
High			901	**7717**
Best Estimate	0		612	**5222**

Description and scale of key monetised benefits by 'main affected groups'

Annual benefit to 22,000 qualifying small companies (£206m to £292m) and 83,000 subsidiaries (£174m to £578m) of audit fee not spent. Benefit of management time not spent on audit by subsidiary companies £9m to £12m per annum. Benefit of management time no longer spent on preparation and filing of accounts of qualifying dormant companies £19m per annum. Calculations based on FAME data of number of qualifying companies and average audit fee by company size and assumptions below to be tested in consultation.

Other key non-monetised benefits by 'main affected groups'

Possible reduction in cost of capital for those companies who choose to have an audit in a voluntary audit environment.

Key assumptions/sensitivities/risks | **Discount rate (%)** | 3.5

Assumptions: take up of small company audit exemption 60-85% based on take up of current exemption and Collis external research; internal management saving zero; take up of subsidiary audit exemption 75-100% based in part on experience in other EU countries; a subsidiary company taking advantage of an exemption from mandatory audit would save 10% - 25% of its total annual audit fee, and five hours of senior management time based on stakeholder views. We assume parent company needs 0-10 hours legal advice on form of guarantee and that number of parent company guarantees equals number of subsidiaries; accounts preparation cost of each dormant company £280 using PWC admin burden data; and number of companies and subsidiaries is assumed to remain constant over time.

Direct impact on business (Equivalent Annual) £m):			**In scope of OIOO?**	**Measure qualifies as**
Costs: 0	**Benefits: 606**	**Net:** 606	Yes	OUT

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?	United Kingdom				
From what date will the policy be implemented?	01/10/2012				
Which organisation(s) will enforce the policy?	Companies House				
What is the annual change in enforcement cost (£m)?					
Does enforcement comply with Hampton principles?	Yes				
Does implementation go beyond minimum EU requirements?	Yes				
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)	**Traded:** None	**Non-traded:** None			
Does the proposal have an impact on competition?	No				
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?	**Costs:**	**Benefits:**			
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large**
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

Please note this checklist is not intended to list each and every statutory consideration that departments should take into account when deciding which policy option to follow. It is the responsibility of departments to make sure that their duties are complied with.

Does your policy option/proposal have an impact on…?	Impact	Page ref within IA
Statutory equality duties[1] Statutory Equality Duties Impact Test guidance	No	18
Economic impacts		
Competition Competition Assessment Impact Test guidance	No	18/19
Small firms Small Firms Impact Test guidance	Yes	19/20
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	No	
Sustainable development Sustainable Development Impact Test guidance	No	

[1] Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Summary: Analysis and Evidence

Policy Option 3

Description:

Align audit with accounting exemptions for small companies; exempt subsidiaries from accounts preparation, filing and mandatory audit of accounts where the subsidiary fulfils the Article 57 criteria; exempt dormant subsidiaries from all accounts preparation and filing requirements

Price Base Year 2010	PV Base Year 2010	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 3717	High: 8491	Best Estimate: 5736

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	0.05	1	Optional	**0.05**
High	22.5		Optional	**22.5**
Best Estimate	9		0	**9**

Description and scale of key monetised costs by 'main affected groups'

Transitional costs are estimated at £0.05m - £22.5m and will occur in the first year. These are one-off costs borne by (a) Companies House (which operates as a trading fund) of amending its filing software which are estimated to be £50k and (b) one-off legal costs of £0m - £22.5m to companies seeking advice about the operation of the guarantee.

Other key non-monetised costs by 'main affected groups'

Loss of comfort provided by audit. Loss of information from no longer filing of accounts of 162k qualifying subsidiaries (including around 12,000 large companies and 11,000 financial companies) to investors, borrowers, employees,, credit suppliers, suppliers, , regulatory authorities and other users of Companies House data. In the case of financial companies this might increase the risk of systemic failure.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		445	**3739**
High	Optional		1007	**8491**
Best Estimate	0		683	**5745**

Description and scale of key monetised benefits by 'main affected groups'

As in option 2 above plus benefits of audit exemption for 11,000 non-quoted subsidiary companies in the finance sector of audit fee not spent £28m-£94m per annum and internal management time saved £0.6m-£0.8m per annum. Also additional benefit of management time not spent on filing of accounts £8.5m to £11.4m for qualifying subsidiaries. Calculations based on FAME data of number of qualifying companies, average audit fee by company size, PWC admin burdens data and assumptions below to be tested in consultation.

Other key non-monetised benefits by 'main affected groups'

Possible reduction in cost of capital for those companies who choose to have an audit in a voluntary audit environment.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Assumptions: As in Option 2 plus; assume that savings in relation to exemption from the preparation of accounts for subsidiaries are zero as HMRC would still require near equivalent accounts to be prepared and filed with them; assume take up rate of accounting exemption by all subsidiaries is 75-100% based in part on the experience in other EU countries; and cost of filing accounts is £70 per company (PWC admin burden data).

Direct impact on business (Equivalent Annual) £m):			In scope of OIOO?	Measure qualifies as
Costs: 0	**Benefits:** 666	**Net:** 666	Yes	OUT

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			01/10/2012		
Which organisation(s) will enforce the policy?			Companies House		
What is the annual change in enforcement cost (£m)?					
Does enforcement comply with Hampton principles?			Yes		
Does implementation go beyond minimum EU requirements?			No		
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** None		**Non-traded:** None
Does the proposal have an impact on competition?			No		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			**Costs:**		**Benefits:**
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large**
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Set out in the table below where information on any SITs undertaken as part of the analysis of the policy options can be found in the evidence base. For guidance on how to complete each test, double-click on the link for the guidance provided by the relevant department.

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Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	
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Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	
Human rights Human Rights Impact Test guidance	No	
Justice system Justice Impact Test guidance	No	
Rural proofing Rural Proofing Impact Test guidance	No	
Sustainable development Sustainable Development Impact Test guidance	No	

[1] Public bodies including Whitehall departments are required to consider the impact of their policies and measures on race, disability and gender. It is intended to extend this consideration requirement under the Equality Act 2010 to cover age, sexual orientation, religion or belief and gender reassignment from April 2011 (to Great Britain only). The Toolkit provides advice on statutory equality duties for public authorities with a remit in Northern Ireland.

Evidence Base (for summary sheets) – Notes

Use this space to set out the relevant references, evidence, analysis and detailed narrative from which you have generated your policy options or proposal. Please fill in **References** section.

Assumptions: a subsidiary company taking advantage of an exemption from mandatory audit would save 10% - 20% of the annual audit fee. The cost of preparation of financial statements is 50% of the annual audit fee. A subsidiary company taking advantage of the accounts preparation exemption would save 10%-20% of the accounts preparation costs. These assumptions were tested and approved in June 2011 by the Institute of Chartered Accountants in England & Wales and the Institute of Chartered Accountants in Scotland, who have tested these assumptions with a number of member firms of different sizes.

References

Include the links to relevant legislation and publications, such as public impact assessments of earlier stages (e.g. Consultation, Final, Enactment) and those of the matching IN or OUTs measures.

No.	Legislation or publication
1	http://www.legislation.gov.uk/uksi/2008/393/pdfs/uksiem_20080393_en.pdf - impact assessment for increase in audit and accounting exemption thresholds 2008
2	
3	
4	

+ Add another row

Evidence Base

Ensure that the information in this section provides clear evidence of the information provided in the summary pages of this form (recommended maximum of 30 pages). Complete the **Annual profile of monetised costs and benefits** (transition and recurring) below over the life of the preferred policy (use the spreadsheet attached if the period is longer than 10 years).

The spreadsheet also contains an emission changes table that you will need to fill in if your measure has an impact on greenhouse gas emissions.

Annual profile of monetised costs and benefits* - (£m) constant prices

	Y_0	Y_1	Y_2	Y_3	Y_4	Y_5	Y_6	Y_7	Y_8	Y_9
Transition costs	9.05	0	0	0	0	0	0	0	0	0
Annual recurring cost	0	0	0	0	0	0	0	0	0	0
Total annual costs	9.05	0	0	0	0	0	0	0	0	0
Transition benefits	0	0	0	0	0	0	0	0	0	0
Annual recurring benefits	665	643	621	599	578	557	537	517	499	481
Total annual benefits	665	643	621	599	578	557	537	517	499	481

* For non-monetised benefits please see summary pages and main evidence base section

Evidence Base (for summary sheets)

Problem under consideration

The Coalition Programme commits the Government to cutting red tape by introducing a "one-in, one –out rule" whereby no new regulation is brought in with other regulation being cut by a greater amount. It also commits the Government to end gold-plating of EU rules.

The Government identified in the March 2011 Plan for Growth[1] 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. In fulfilment of the Coalition programme, the Government has now decided to take advantage of some of these options.

Rationale for intervention

There are three areas where the Government has decided to intervene:

(a) alignment of audit with accounting exemptions for small companies; and

(b) permit companies to reduce the costs of subsidiary company accounts;

(c) permit companies to reduce the cost of financial statement preparation and filing for subsidiary dormant companies.

Alignment of audit with accounting exemption for small companies

The UK does not currently utilise the existing small company audit exemptions available under Article 51(2) of the 4th Council Directive (78/660/EC) to the maximum effect. The current UK implementation of Article 11 of the Directive in Part 15 of the Companies Act 2006 (sections 382 (2) and 383(3)), broadly states that a company qualifies as small (subject to certain exclusions) if 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

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, under s477 CA06 such a small company is only able to take advantage of an exemption from statutory annual audit if meets both 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.

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

Currently, in the UK, 1,398,400 (86.3%) of non-dormant companies do not have their individual (i.e. non-group) accounts audited[2]. 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 £9.5k (based on analysis of the FAME database) there is the potential for significant savings in audit costs under both options 2 and 3.

The decision 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 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 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[3] shows that companies close to the threshold and larger small companies have continued to have their accounts audited.

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. In any case small companies tend to have very few shareholders and their main creditors are HMRC and banks. HMRC has powers to ask for additional explanations and information, where it feels this is necessary. Banks will also be able to request companies to whom they lend for additional information or verification as a condition of their lending.

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 and 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 must be noted that the financial information contained in the statutory accounts is not current (private companies normally have 9 months from the year end to file their statutory accounts at Companies House). The providers of finance are in a position to require a company to provide current financial information before deciding to do business with them.

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 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.

Reduction in the costs of subsidiary company accounts[4]

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:

- the subsidiary has a parent registered in the EU;
- the parent must have declared that it guarantees the commitments entered into by the subsidiary and this declaration must be filed at Companies House;
- the subsidiary's shareholders unanimously must have declared that they agree to dispense with an audit and this declaration must be made in respect of every financial year and must be published in Companies House;

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2 Companies House, Statistical Tables on Companies Registration Activities 2009-10, Table F2 in period 2009-10

3 *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

4 Subsidiary defined as a one whose holding company owns >50% of voting rights.

- 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 Companies House; and
- the exemption must be disclosed in the notes to the consolidated accounts drawn up by the parent undertaking

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 little value but imposes significant costs on the companies affected. (The average cost of audit for these companies ranges from £8k for small companies to £83k for large companies[5]). The group report and accounts of the parent company, into which the subsidiary accounts are consolidated, are subject to mandatory audit.

In relation to the guarantee, the Government's policy objective is that for the financial year for which no audit report is produced, creditors of the subsidiary benefit instead from a parent company guarantee in place of the audit. The words of the Directive are that "The parent undertaking must have declared that it guarantees the commitments entered into by the subsidiary undertaking." The Government has therefore a number of choices in relation to what is covered by the guarantee:

to copy out the text, or to clarify whether "the commitments" means only "the debts" or whether it means "all liabilities";

to copy out the text or clarify whether the guarantee is forward looking or is intended only to cover commitments existing at the balance sheet date of the financial year in question; for example, although events might have occurred during the financial year which give rise to litigation, should the guarantee extend to the financial court award against the subsidiary, as this commitment only arises on the date that the penalty/ damages is payable, which is likely to be some time in the future i.e. in another financial year; to provide guidance on the form of the guarantee. These issues will be explored in the consultation document, as they are likely to affect whether the parent is prepared to issue a guarantee and therefore the take-up of the exemption.

For a dormant subsidiary company (defined in s1169 Companies Act 2006 as one in which no significant accounting transactions has taken place in the past year) the preparation and filing of accounts for the public record is thought to provide little additional information given the lack of trading activity. The dormant company will still appear on the Register at Companies House and will 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.

Policy objectives

The policy objectives are:

to implement the Government's commitments in the Plan for Growth, published in March 2011;

to be more targeted in applying rules on company reporting, accounting and audit in order to reduce the burden of regulation on companies;

to recognise the public interest in having an amount of accounting information about active companies on the public register.

[5] Based on analysis of Bureau van Djik FAME database of active UK subsidiaries with a UK or EU ultimate holding company. Figures quoted are truncated mean averages (excluding significant outliers).

Description of options considered (including do nothing)

Option 1 (Do nothing)

Do nothing

Option 2 (Take up some exemptions under Articles 51(2) and 57 subject to certain additional conditions)

- Align the audit with the accounting exemption for small companies.
- Exempt a subsidiary company **from mandatory audit** where the subsidiary fulfils all the conditions set out in Article 57 as well as these additional conditions: the subsidiary must be unquoted (within the meaning of s385 CA06) and must not be in the banking or finance sector. Subsidiaries will continue to prepare and file statutory accounts. Where a subsidiary is **dormant**, it will be exempt from **not only mandatory audit**, **but also mandatory filing and mandatory preparation** of accounts where the dormant company meets all the conditions set out in Article 57 as well as well as these additional conditions: the subsidiary must be unquoted and must not be in the banking or finance sector.
- Same rules will broadly apply to Limited Liability Partnerships ("LLP") and unregistered companies.

Option 3 (Take up all exemptions under Articles 51(2) and 57)

- Align the audit with the accounting exemption for small companies (same as Option 2).
- Exempt a subsidiary company or dormant subsidiary company **from mandatory audit, mandatory filing of accounts and mandatory preparation of accounts** where the subsidiary fulfils all the conditions set out in Article 57. The exemption from preparation and filing is therefore far wider than under Option 2, where there is (for non-dormant companies) only an exemption from audit. Under this Option 3, qualifying companies would therefore not produce any annual accounts at all. (All dormant companies are already exempt from audit). Unlike Option 2, there are no additional conditions, so companies in the financial sector and quoted subsidiaries would not be specifically excluded from taking up these exemptions. However the Transparency Directive (2004/109/EC) requires all companies whose shares are traded on a regulated market to be audited so in practice quoted subsidiaries would continue to be subject to audit.
- Same rules will broadly apply to Limited Liability Partnerships ("LLP") and unregistered companies.

Costs and benefits of each option (including administrative burden)

Option 1 (Do nothing)

Benefits

There would be no additional benefit of this option relative to the current position but:

- Creditors and employees of companies qualifying for the audit exemption under Options 2 or 3 would continue to have the assurance of the accounts having a mandatory audit.
- Dormant subsidiary company accounts would continue to be prepared and filed at Companies House.
- Some small firms of auditors would not risk losing business as a result of f[6]ewer audits being demanded.

Costs

- None

[6] Collis (2008) p43

Option 2 (Take up some exemptions under Articles 51(2) and 57 subject to certain additional conditions)

Benefits

- **Saving the cost of the audit**

Small Companies

The number of additional private small companies that now qualify as audit exempt is 36,314 based on analysis using the FAME database[7]. The assumed audit fee saving is £9,500 per company based on FAME analysis of the truncated mean audit fee of qualifying companies. The earlier impact assessment which considered the 2008 increase in audit thresholds[8] used a cost of £5k per company based on the median small company audit fee at the time[9]. If all eligible companies were to take up the exemption the annual cost saving would be £344 million (36,314 * 9,500). However, in line with earlier analysis of administrative burden savings we anticipate that some of this cost would be "business as usual" in that some companies choose to have their accounts audited regardless of their eligibility for exemption under company law. From the figures given above around 85% of companies currently eligible have so far taken up the existing small company audit exemption, although the Collis study which considered slightly larger small firms found the level of take-up to be lower at around 60%. Using these estimates as the upper and lower bounds of likely take up suggest assumed annual benefits are £206m – £292m (£344m*0.085 - £344m*0.6). Given that this extension of the audit exemption is likely to cover the larger small companies we have used the lower bound as the best estimate of likely costs savings but will consult on this assumption.

Subsidiaries

Of the population of 230k subsidiary companies with an EU or UK parent around 67k are already audit exempt because they are dormant and 69k are audit exempt because they are small companies within a small group (as defined by the Companies Act 2006). The number of additional subsidiary companies with a UK or EU parent that would now qualify for an audit exemption as a result of these proposals is calculated at 83k based on analysis of the FAME database. The mean audit fee for these companies ranges from £8k for small to £83k for large companies; however discussions with stakeholders suggest that it is unlikely that all of this cost would be saved as a result of the audit exemption given the additional audit costs that would be incurred at the group level. We will be consulting on the likely scale of the savings, but informal discussions with stakeholders suggest this could be in the range of 10-25%. We have therefore calculated benefits based on savings of 10%, 17% and 25% of the mean audit fee. We believe that all eligible subsidiaries will take up the exemption given that there is little or no advantage to them to continue to have their individual accounts audited where no statutory requirement exists. Experience in some other European countries where the article 57 exemptions have existed for much longer suggests that there is significant appetite for the use of the parent guarantee.[10] However, this may to some extent depend on the details of the form and application of the parent guarantee and the individual circumstances of the subsidiary and parent companies. We have therefore assumed a take-up rate in the range of 75-100% and will be consulting on the likely scale of the take-up. This generates total annual benefits in the range £174m to £578 million.

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[7] FAME – Financial Analysis Made Easy – Database of company information www.bvd.co.uk

[8] http://www.legislation.gov.uk/uksi/2008/393/pdfs/uksiem_20080393_en.pdf

[9] From the FAME analysis the mean audit fee for companies is higher than the median because of the skewed distribution of companies. However, we have chosen to use the mean throughout this IA in calculating the savings to companies because statistically we believe this is the correct approach when multiplying the number of companies by the average saving. We have however used truncated means that exclude the most extreme outlying figures in the distribution.

[10] In Ireland over 50% of subsidiaries file section 17 accounts which take advantage of the accounts filing exemption.

Table1: Potential Savings to Subsidiaries who take up audit exemption (£m)

Take-up Rate	% of audit cost saved		
	10%	17%	25%
75%	174	295	434
100%	231	393	578

- **Saving costs of management time interacting with the auditor**:

Small Companies

For small companies we have assumed that there will only be minimal internal management time saved by those qualifying for the audit exemption. This is because in the case of most small companies the accounts will be prepared and audited by the same firm (77% according to Collis 2008). We have therefore assumed the cost savings to be zero in the calculation of overall benefits.

Subsidiary Companies

For subsidiary companies that choose to take up the audit exemption there will still need to be an audit at the group level of the consolidated accounts which will entail some degree of internal management time to explain the internal controls of the business and answer the auditor's questions.

Therefore, on the basis of stakeholder discussions we have assumed that only five hours of senior management time will be saved per company. Using ASHE[11] data for hourly costs of corporate managers we calculate the annual savings for internal management time to range from £60 for small companies to £273 for public and large companies. This gives a total annual cost saving of £9m - £12m (again assuming a 75%-100% take up rate). Again we will test the scale of these likely savings as part of the consultation process.

- **Saving costs of management time to prepare and file qualifying dormant subsidiary accounts**

The number of dormant subsidiaries who would qualify for the exemption to prepare and file their accounts is 67k based on analysis of the FAME database. We have used the PWC administrative burdens data[12] to estimate the likely saving from no longer having to prepare and file dormant company accounts (uprated in line with inflation to 2011 prices). This gives an annual saving per dormant subsidiary of £280 and therefore an overall annual saving of £18.8m (£280*67k).

- **Possibly reduced cost of capital for those opting for an audit**

Choosing to have an audit in voluntary audit environments has a clear effect in reducing cost of capital for individual companies[13], because it provides a signal to outsiders that the company is confident enough in the figures in the accounts to allow them to be audited and is prepared to spend money on the audit. In voluntary audit environments[14], the bigger the company the more likely it is to have a voluntary audit[15]. In mandatory audit environments, some of this signalling effect is lost, because all comparable firms have to have an audit. This benefit is though unquantifiable given the number of factors impacting on the cost of capital.

Total annual benefits of this option are therefore in the range £408 to £901m per annum.

Costs

- **Costs to a parent company under the guarantee when a creditor makes a claim against the parent** if that creditor's claim against the assets of the subsidiary had not been satisfied. This is more

[11] http://www.statistics.gov.uk/downloads/theme_labour/ashe-2010/2010-occupation.pdf. The lower decile wage rate has been used for calculating small company cost savings, the upper decile wage rate for large/public companies and the average for medium sized companies. All have been uprated by 24% to reflect overhead costs.

[12] https://www.abcalculator.berr.gov.uk/login_register.php

[13] [13] 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.

[14] Pittman, J. and Fortin, S. *Auditor choice and the cost of debt capital for newly public firms*, Journal of Accounting and Economics, Vol 37, Issue 1, February 2004, pp. 113-136

[15] Collis, Jill *Directors' views on accounting and auditing requirements for SMEs* April 2008 http://www.bis.gov.uk/files/file50491.pdf p.55

than a transfer of costs between the subsidiary and the parent because without the guarantee, the subsidiary would have been able to have relied on its limited liability status, and the unsatisfied creditors would not have been able to pursue the parent. The shareholders of the parent company will therefore bear the loss in this case through a reduction in value of their shareholding.

- **Legal advice to parent to issue a guarantee for qualifying subsidiary**

The need for parent companies to take legal advice will depend on the details of the final regulations including the definition of the guarantee and whether or not the UK opts for a simple copy out of the EU regulations or adopts the Irish approach of providing guidance on how an acceptable guarantee might look. If we follow the latter route we do not expect there would be any need for legal advice whilst if the company needs to agree the wording of its own guarantee we have assumed a range of 4-10 hours of professional legal advice. Using ASHE data for hourly professional legal services[16] we have calculated costs of £110 to £273 per subsidiary giving a range for total costs across all eligible subsidiaries of £0m if no legal advice is required and £9m - £22.5m if legal advice is sought. These will be one-off costs.

- **Loss of information on qualifying dormant companies whose accounts are no longer prepared and filed.** However, given the lack of trading activity by these companies we do not consider that this would be a significant loss of public information.
- **A cost of misstatement of subsidiaries' financial position is** not a cost, as unsatisfied debts will be guaranteed by the parent.
- **Loss of the benefit an audit** can give to help management manage and control the subsidiary should be noted, though it is not easily quantifiable.
- **Transitional costs to Companies House of adjusting their systems**

Companies House estimate this will be £50,000 to update their systems to accommodate the changes being proposed.

- **Increase in tax compliance costs**

HMRC may increase its number of enquiries of those companies not conducting audits. However it is not currently able to estimate the increase in the number of such enquiries. Where such enquiries are launched HMRC estimates that this could increase tax compliance costs for those companies by 10% to 20%. However HMRC is currently unable to estimate the current level of those tax compliance costs.

- **Loss of income to accounting firms no longer undertaking audits**

Although there will be a loss of income to accountancy firms no longer undertaking audits of qualifying small companies and subsidiaries we do not propose to include this as a cost to business given that the economy-wide impact is likely to be marginal as the accountants affected will instead shift their resource to the next most profitable activity and indeed may make good some of their income loss by providing companies with other more value added activities (see pages 20-22 below for a further discussion of these wider impacts)

Total monetised costs of Option 2 are therefore £0.05m to £22.5m per annum of transitional costs.

Option 3 (Take up all exemptions under Articles 51(2) and 57)

Benefits

- Saving the cost of the audit for small companies that now qualify as audit exempt and qualifying subsidiaries (These are largely the same as Option 2 but include 11,000 finance subsidiaries excluded from the exemption in option 2 with an annual benefit of £28-94m[17]). Total annual benefits of audit savings under option 3 are therefore calculated as £202 to £672 million.
- Saving costs of management time interacting with the auditor (these are largely the same as Option 2 but includes 11,000 finance subsidiaries excluded from the exemption in option 2 with an annual

[16] ASHE professional legal services hourly wage rate including 24% uplift for overhead costs (£22*1.24=27.28). 4 hours of legal advice therefore equals £110 (4*£27.28) and 10 hours equals £273 (10*£27.28).

[17] As in calculations above for option 2 we have assumed audit fee savings of 10%, 17% and 25% and likely take-up of the exemption of 75%-100%. Savings presented here are an aggregation of those for small, medium and large finance companies. Average audit fees are truncated mean figures by size of company.

benefit of £0.6-£0.8m per annum. Total annual benefits of management time savings under option 3 are therefore calculated as £10m to £13 million (including those from option 2 above).

- **Saving costs of management time to prepare and file qualifying subsidiary accounts**

The number of subsidiaries qualifying for the exemption from the preparation and filing of accounts is 163k (this includes those 83k who would newly qualify for the audit exemption in option 2 plus the 69k small companies already audit exempt and 11k finance subsidiaries excluded from option 2). We have assumed the cost saving from no longer having to file subsidiary company accounts to be £70 per filing (based on PWC admin burdens data for a similar requirement). This gives an annual **cost saving of £8.5 to £11.4m per annum** (assuming again a 75% to 100% take-up of the subsidiary exemption). However, we have assumed that there will be no saving from the preparation of subsidiary company accounts. This is because the UK's tax legislation taxes companies on their individual accounts rather than their consolidated accounts, using as a starting point of the tax calculation the profits calculated in accordance with generally accepted accounting practice[18]. HMRC also uses much of the information provided in the statutory accounts. The subsidiary would therefore have to prepare and provide to HMRC this information. This would remove the cost saving of management time for preparation of accounts identified above.

- Possibly reduced cost of capital for those opting for an audit (same as Option 2).

Total annual benefits of option 3 are therefore £445million to £1008 million.

Costs

- The subsidiaries qualifying for exemption from filing accounts will range from large companies to very small and could 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[19], 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[20] 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.

  Although we have not been able to monetise the value of the information that would be lost under option 3 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 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 (such as Bureau van Djik who supply BIS with access to the FAME database).

  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).

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[18] See for example s46 Corporation Tax Act 2009

[19] [19] "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

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

- Costs to a parent company under the guarantee when a creditor makes a claim against the parent if that creditor's claim against the assets of the subsidiary had not been satisfied. (same as Option 2)
- Legal advice to parent to issue a guarantee for qualifying subsidiary (same as Option 2)
- Transitional costs to Companies House of adjusting their system. Companies House estimate this will be £50k (same as option 2)
- Some possible increase in tax compliance costs as a result of loss of audit (same as Option 2)

Table 2: Benefits summary of Options 2 and 3

	Option 2 **£m per annum**	**Option 3** **£m per annum**
Reduced audit costs (small companies)	206 – 292	206 – 292
Reduced audit costs (subsidiary companies)	174 – 578	202 – 672
Reduced management costs (small companies)	0	0
Reduced management costs (subsidiary companies)	9 – 12	10 – 13
Reduced costs of preparing and filing company accounts	19	27.5 – 30.4
Total savings:	408 - 902	445 - 1008

Risks and assumptions

The key assumptions in terms of likely take-up rates, potential cost savings, etc are set out in the analysis above and in the summary sheets for options 2 and 3. However, throughout the analysis there is a simplifying assumption that the number of companies qualifying for the audit and accounting exemptions in options 2 and 3 will remain constant. In practice the company population has grown over the last 10 years, particularly during the early part of the last decade but rather more slowly since 2006/07. Many of these new companies will however be small companies qualifying for the audit exemption under the existing regulations. The likely variation in the number of parent and subsidiary companies over time is unknown but it is unlikely to change substantially over the next ten years.

Risks arising from the reduction of the number of companies audited

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 potential 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 mitigated because: (a) the effects of such misstatement would not pose a systemic risk because systemically important companies, such as quoted companies and those in banking and insurance, will continue to be subject to mandatory audit; (b) there are significant jurisdictions outside the UK where no unquoted company is obliged to have an audit and no significant issues have occurred as a result of this. 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.

Risks arising from aligning audit with accounting exemptions

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[21]. 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.

Risks arising from reducing the costs of subsidiary company accounts

There is no size limit on the subsidiary whose parent gives a guarantee, so large companies could now remain 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 in Option 2, that the subsidiary must not be listed and must not be in the financial sector. After this change, if all companies take up the exemption the % of subsidiary companies no longer having audits would represent 95% of the population.

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. The parent company will have to file the guarantee on the public register (Companies House) so that creditors and shareholders are aware of the potential liability. Those unsecured creditors of the qualifying subsidiary company that exist at the balance sheet date are intended to be the beneficiaries of the parent company guarantee.

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.

Because it is Government policy to copy out EU legislation there is the risk that there will be increased recourse to the courts and costs of legal advice to companies because:

- no statutory parent company guarantee has been drafted in the Regulations;
- there is lack of clarity about what liabilities are guaranteed by the parent:
- no solvency requirement or additional requirements have been imposed on the parent granting a guarantee;
- the Government does not currently intend to impose additional rules setting out the operation of this exemption, such as when there is a sale or change in ownership, or where there is a lapse or rescission of the guarantee.

Particular risks of Option 3 (Take up all exemptions)

Particular risks exist in relation to Option 3, since under this option all the exemptions (from preparation, audit and reporting) would be made available to all qualifying subsidiaries. The availability of accounts promotes competitiveness: the loss of transparency by removing from the public record, even in the case of large companies, the financial information that the accounts provide would be significant to those who use accounts of companies such as creditors, investment analysts, credit analysts, Trade Unions and employees. As set out above, this loss of information was objected to by a large number of stakeholders in response to the consultation in the Company Law Review of 2000. Information useful for mergers and acquisitions would be hidden and shield both excellent and poor performance.

Analysis from Companies House suggests that checking financial information is one of the key reasons given by customers accessing company information and of those paying to access the Companies House register over a third of enquiries were for company annual accounts. The majority of information accessed by customers in relation to both audited and non-audited accounts was rated as useful or very

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

useful. This suggests that public information in relation to company accounts continues to be valued and its removal would represent a significant cost to the UK economy.

Option 3 would also permit qualifying companies in the financial sector to take up the audit exemption – this might have systemic risks. As a matter of public policy it is desirable that those companies involved in banking and insurance are subject to the additional oversight that an audit provides.

Direct costs and benefits to business calculations (following OIOO methodology)

Under the "One In, One Out" rule, whereby a measure that has a net cost to business must have a measure or measures of equivalent cost removed in order to be implemented, the net benefit of implementing Option 2 is £5200m over the ten year period. This represents a saving to business and is therefore a One Out.

Wider impacts

The reduction of unnecessary burdens of reporting, accounting and audit is one element in the process aimed at putting the UK on a path to sustainable, long-term economic growth, by making the UK one of the best place in Europe to start, finance and grow a business. 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.

Summary and preferred option with description of implementation plan

The Government prefers option 2 as it delivers significant benefits at an acceptable risk. Although the net benefits of option 3 are likely to exceed those of option 2, the government considers that Option 3 is too risky as it has the potential to significantly reduce the amount of information in the public domain and runs against principles of transparency in company law. It is intended to publish draft regulations implementing Option 2 in September 2011. It is also intended to apply the provisions to LLPs and unregistered companies. It is intended that regulations will come into force on 1 October 2012.

Specific Impact Tests

Statutory equality duties

The proposed changes are not expected to have any impact.

Economic impacts

Competition effects

Dynamics of the audit market

The structure of the audit market can be analysed by number of principals[22] in each audit firm as follows (source POB Key Facts, data at 31 December 2009)

Number of principals in firm	1	2-6	7-10	11-50	50+
Number of firms	4,285	3,211	207	119	21

[22] Principals are Partners or Members of an LLP

The number of registered audit firms continues gradually to decline. (Source: Professional Oversight Board (POB) "Key Facts and Trends in the Accountancy Profession" June 2010 http://www.frc.org.uk/pob/publications/pub2301.html) The overall number of audit firms registered in 2009 (7,843) is 21.2% lower than the number in 2004 (9,950). The POB considers that this decrease can largely be explained by the increase in the mandatory audit threshold from 2004 which has resulted in a lower number of entities requiring an audit. There has been an 8% decrease in the number of sole practitioners between 2008 and 2009, and between 2004 and 2009 the number of sole practitioners has reduced by 28%.

The proportion of annual accounts filed at Companies House that are audit exempt has increased from 61.9% in 2004/05 to 70.3% in 2009/10. It should also be noted that the number of annual accounts subject to audit and filed at Companies House between 2004/05 and 2008/09 has remained relatively constant at 143,000. The reduction in the number of entities having an audit has meant that some firms have found that there is no longer a good business case for retaining their audit registration, merged with other firms or passed on this work to larger firms where there are greater economies of scale in relation to matters such as quality assurance and Continuing Professional Development. However the rate of decline continues to slow, and the number of registered audit firms fell by 3.2% in 2009 compared with 4.7% in 2008.

The Collis Report[23] found that in 2006, 32% of her sample of small companies had chosen a voluntary audit for the benefits it brings to a company, and a further 7% had done so because they were close to the threshold.

These data enable the Government to predict that most companies eligible to take up the audit exemption will not do so and will opt for voluntary audits, but it is likely that the number of sole practitioners will continue to reduce. Despite this reduction there will still be a sufficient number of auditors operating in the small audit market for the market to continue to be competitive.

OFT competition filter

The Office of Fair Trading Competition filter has been applied

The measure will not directly limit the number or range of auditors.

It is likely to reduce the number of auditors in the market, if the demand for audit is reduced, although the data above demonstrates that it is reasonable to assume that some companies will continue to opt for a voluntary audit. If a large proportion of eligible companies took advantage of the removal of the requirement to have an audit, it is possible that some registered auditors may review the need for their registration.

It will not limit the ability of auditors to compete.

It will not reduce auditors' incentives to compete vigorously.

Small firms impact test

As noted above in the Competition section, as a result of the Government's current proposals, some small audit firms may cease registration as a statutory auditor as demand decreases for their audit product. However, despite no longer being a registered statutory auditor a result of the Government's proposals, 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.

The Collis Report (page 31) shows that 83% of SMEs used an external accountant to prepare their 2006 accounts for shareholders, filing and tax authorities. The full range of services received was as follows:

Service	**% of small companies**	**% of medium companies**
Preparing statutory accounts for shareholders and Companies House	77	88

[23] *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 page 39

Preparing accounts for tax authorities	56	66
Advice on accounting/auditing regulations	49	71
General advice on running a company	22	16
Bookkeeping or preparing periodic management accounts	17	10
Additional detailed annual accounts for management's use	16	19
Management advice in connection with the annual results	15	25
Preparing accounts for the bank/lenders	10	15
Advice on raising finance	4	7
Preparing accounts for major suppliers or customers	1	4

Page 42 of the Collis report examined the effect of the accountancy fees on those who had stopped having their accounts audited since the higher exemption thresholds in 2003 were introduced were asked what effect this had on the total accountancy fees they paid to an external accountant. Just over half the companies taking up the exemption (54%) had not experienced lower total accountancy fees and in 2% of cases, fees had risen due to other services being supplied. The data was collected in the following categories:

Change in total accountancy fees	**% of companies**
No change	54
Decreased by:	
Up to £1,000	22
£1,001-£5,000	16
£5,001-£10,000	3
£10,001-£15,000	3
Increased	2
TOTAL	**100**

Environmental impacts

The proposed changes are not expected to have any impact.

Social impacts

The proposed changes are not expected to have any impact.

Sustainable development

The proposed changes are not expected to have any impact.

Annexes

Annex 1 should be used to set out the Post Implementation Review Plan as detailed below. Further annexes may be added where the Specific Impact Tests yield information relevant to an overall understanding of policy options.

Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. If the policy is subject to a sunset clause, the review should be carried out sufficiently early that any renewal or amendment to legislation can be enacted before the expiry date. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

Basis of the review: We will review the operation of the audit exemption 5 years after the proposed changes come into force. However the EU is scheduled to review the 4th Directive in the short term, which may result in their changing the audit exemption thresholds.
Review objective: The object of the review is not to discourage audit, but simply to make move the decision for qualifying companies as to whether to audit from Government to companies. The review the number of companies taking up the audit exemption Whether there have been any ill effects from the audit exemption.
Review approach and rationale: We will develp the methods that are most appropriate to the valuation. This is likely to be a quantitative examination of the take up of the option.
Baseline: 2009-10 number of audit exempt companies 1,398,400 (representing 70.3% of all company accounts filed).Source: Company Register Activities 2009-10 Table F2 http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2009_2010.pdf
Success criteria: Awareness by companies and their advisers of the availability of the exemption.
Monitoring information arrangements:] Data collected by Companies House on number of companies claiming audit exemption.
Reasons for not planning a review:

URN 11/1194