BIS | Department for Business Innovation & Skills

Consultation on audit exemptions and change of accounting framework

Response form

The Department may, in accordance with the Code of Practice on Access to Government Information, make available, on public request, individual responses.
The closing date for this consultation is 29 December 2011.

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Please state YES in the box from the list of options that best describes you as a respondent. This allows views to be presented by group type.

Preparer: Large business (over 250 staff)	
Preparer: Medium business (50 to 250 staff)	
Preparer: Small business (10 to 49 staff)	
Preparer: Micro business (up to 9 staff)	
Preparer representative body	
Accountants: over 500 UK Partners	Yes
Accountants: 200 – 500 UK Partners	
Accountants: 100 – 199 UK Partners	
Accountants: 50 - 99 UK Partners	
Accountants: under 50 UK Partners	
Accounting bodies	
Legal representative or professional legal bodies	
User representative bodies	
Academics	
Regulators and Government bodies	

Individuals	
Other (please describe)	

Question 1

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

We support the overall principle, as it reduces the regulatory burden on companies. However we believe that there are risks to stakeholders and a potential loss of benefits in extending the audit exemption, in particular:

- Erosion in the quality and reliability of publicly available financial information which is used by various stakeholders, such as HMRC, which could impact on confidence in that information. There could be an increase in fraudulent financial reporting, because an audit acts as a strong deterrent against such fraud.
- A loss of general business advice and the independent challenge provided to companies through the audit process, which helps management in terms of its governance, business processes and controls.

Question 2

A Do you agree with the underlying assumptions in our Impact Assessment that at least 60% of small companies now eligible will take up the audit exemption?
B Do you agree that the whole of the audit fee will be saved?
C Do you agree that there is no saving of management time for small companies taking up the audit exemption?

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

Comments:

A) Many small companies have close involvement of their shareholders in day-to-day management and therefore do not derive the full benefit of an independent audit of their financial statements. However, we believe that there will be a proportion of companies who will continue voluntarily to request an audit because, for example, the shareholders are not involved in the company's management, or audited financial statements are requested by the company's bankers or other third parties, or management themselves want the additional confidence in their company's financial information. Other companies may engage accountants to perform other assurance services (such as that developed by the Institute of Chartered Accountants in England and Wales) which provide a lower level of assurance, and care will be needed to ensure that users understand that the level of assurance provided will be significantly less than that provided by an audit.

B) The whole of the audit fee may not necessarily be saved. Some companies may require accounting advice that is typically provided as part of an audit. Others may still require some assurance on their financial information as noted above.

C) We would expect there to be management time savings, as it is inevitable that an audit conducted in accordance with International Standards on Auditing (UK and Ireland) requires the auditors to make enquiries of management, and this time would be saved. Also, the need to prepare additional analyses for the auditors to support disclosures in the financial statements could be eliminated.

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?

☒ Yes ☐ No ☐ Not sure

Comments:

We believe that management in a number of small companies, and their advisors, are currently confused about the requirements for audit exemption because of the use of different criteria. Therefore we agree with the proposal, as this alignment will result in simplification. However, further thought is required to understand the full impact in terms of the scale of companies that might now be able to take advantage of the exemption.

Question 4

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

☒ Yes ☐ No ☐ Not sure

Comments:

We support this option. However, as noted in our responses to questions 10 b) and 20, we believe the requirement for a parent guarantee may reduce the take-up of this exemption, and the form and substance of the guarantee needs further consideration. The following issues also require further consideration:

- Some very large trading subsidiaries will become eligible for audit exemption. The financial statements of such subsidiaries may be of considerable interest to stakeholders. Therefore consideration should be given to the inclusion of an upper size limit for the exemption.
- A number of UK subsidiaries have ultimate parent companies outside the EU. These subsidiaries frequently have UK intermediate parent companies, but such companies do not currently produce consolidated accounts, and therefore the subsidiaries would not qualify for the exemption. The need to produce consolidated accounts may outweigh the benefits of the audit exemption for these subsidiaries. Also, the UK intermediate parent company may not have the resources to provide a guarantee.

- There needs to be greater clarity regarding those subsidiaries which will not qualify for the exemption – see the response to question 7 below.

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?

Comments:
Option C would lead to a significant loss of information currently in the public domain and therefore available to creditors, investors, HMRC, employees, and other interested parties. Therefore, although there will be benefits to companies through savings in management time in relation to preparation and review of the accounts and in dealing with the auditors, we do not believe this option would be in the public interest.

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?

☒ Yes ☐ No ☐ Not sure

Comments:
Given the absence of trading activity of dormant companies, there is little use made of their accounts. Most dormant subsidiaries are small and therefore would not need to prepare financial information for the purposes of the consolidated accounts of their parent companies. This is likely to be viewed by companies as helpful de-regulation.

We audit relatively few dormant companies, and therefore we do not expect the effect on our business to be significant.

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?

A ☒ Yes ☐ No ☐ Not sure

B Comments:

We agree that there should be some exclusions from the audit exemption in order, where necessary, to protect wider public interests even if the existence of a parent company guarantee ultimately provides a degree of protection. However there needs to be a clear rationale for exclusions. For example, where companies hold public money on deposit, the public interest may be protected by the existence of a properly-constructed parent company guarantee rather than requiring audits of the companies' financial statements.

We support the need for the subsidiary to be unquoted. Investors in quoted companies have a right to expect that financial information of companies they invest in is reliable as they may use that information for decision-making, and an independent audit is a strong safeguard of the reliability of the information.

We are unclear as to the precise scope of companies envisaged to be included as within "financial services or insurance", and believe that a clearer definition needs to be provided. Similarly there needs to be clarity regarding "certain other companies under industrial relations legislation."

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?

Comments:
Our response to this question is covered in question 7 above.

Question 9

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

☒ Yes ☐ No ☐ Not sure

Comments:
We are not aware of any reasons why they should be treated differently.

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?

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

C ☐ Yes ☐ No ☒ Not sure

Comments:

A) We agree that there will be many companies which will fit into this range of audit fees. However some large subsidiaries will have audit fees that substantially exceed £83,000, and some small companies' audit fees will be much lower than £8,000.

B) We do not believe that the % of subsidiaries taking up the exemption will be as high as 75%, because:
   a. there is a significant uncertainty as to whether parent companies will want to provide a guarantee over the debts of the subsidiary.
   b. audit work will still be required for larger subsidiaries for the purpose of the audit of the consolidated accounts, and the audit saving may not therefore be considered significant by the parent company.
   c. management of the parent company and/or the subsidiary may still want the assurance that an external audit provides over the financial statements.

C) This depends on factors such as the size of the subsidiary in relation to the size of the group as a whole and the way in which the statutory accounts are produced. For example, a large subsidiary may require substantial audit work to support the audit of the consolidated accounts, and the incremental work for the statutory accounts may be limited. Also, where a parent company has many similar subsidiaries and strong processes for producing statutory accounts the additional costs could be limited. Conversely, if the subsidiary is out of scope for the audit of the consolidated accounts, the saving will be much greater than 10-25%. It is therefore not possible to generalise regarding the cost saving.

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?

☐ Yes ☐ No ☒ Not sure

Comments:

Management time/cost of interacting with the auditors is dependent on many factors, such as the materiality of the subsidiary within the group, risks affecting the group accounts, the complexity of audit and accounting issues, the quality of the financial statements produced by the company and senior managers' pay rates. Therefore it is difficult to assess the potential saving.

Based on our experience, senior management involvement in the statutory accounts is often limited, as most of the work is performed by more junior

finance team members. Therefore we would not expect the saving of senior management time to be significant, because the incremental time that they spend over and above interaction with auditors for the group audit is limited.

Also, we believe that senior management may spend more time reviewing the financial information if the assurance from an external audit is no longer available.

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?

☐ Yes ☐ No ☒ Not sure

Comments:

In line with our response to the previous question, it is difficult to estimate the amount of management time saving. However, because dormant subsidiary accounts will not generally change from year to year, we believe that management time spent preparing the accounts is minimal, and therefore the saving will be small.

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?

☐ Yes ☒ No ☐ Not sure

Comments:

We do not believe that the estimated figure reflects the appropriate cost. It will depend on the number of the subsidiaries within the group - if there is only one subsidiary, we would expect that the cost will be higher than £110 because of the care needed in considering the issues relating to such a guarantee and in setting up the guarantee. If there are many subsidiaries, then the overall cost could be spread across those subsidiaries, so clearly the cost per subsidiary will reduce.

We do not agree with the assumption that the cost of legal advice will be zero if the government provides guidance on an acceptable form of the guarantee. We believe that companies will still want to obtain their own legal advice, and many companies will not have the necessary in-house legal expertise.

Question 14

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

☐ Yes ☒ No ☐ Not sure

Comments:

There is no significant change in our view since the view we expressed at the time of the Company Law Review. We continue to agree with the proposal, but recognise that there are some practical issues which need to be addressed.

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?

☒ Yes ☐ No ☐ Not sure

Comments:

We agree with the points listed in paragraph 52 of the proposal.

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?

☐ Yes ☒ No ☐ Not sure

Comments:

We believe that there is likely to be an impact on the number of small firms who retain their audit registration permitting them to perform statutory audits, because the size of the audit market will contract and the regulatory costs associated with audit registration make it uneconomic for a firm performing only a small number of audits. There may, therefore, be increased concentration in the audit market among small audit firms.

However, the overall number of small firms of accountants may not be significantly affected if these firms have opportunities to redeploy audit staff on other work such as the provision of bookkeeping and accountancy advice.

Question 17

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

☒ Yes ☐ No ☐ Not sure

Comments:

We agree with the points listed in paragraphs 57 to 59 of the proposal. However, whilst paragraph 58 acknowledges the risks for creditors of the parent, there is no mention of the risks in the event that the parent company guarantee is ineffective (because, for example, the parent company does not have the financial resources to support the guarantee). The role of the parent company auditor, where the parent provides the guarantee, needs to be considered.

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

☒ Yes ☐ No ☐ Not sure

Comments:

We agree with this proposal.

Question 19

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

☒ Yes ☐ No ☐ Not sure

Comments:

We agree with this proposal, as extending the guarantee to 'liabilities' would mean an extra burden to parent companies which may reduce the take-up of the audit exemption. However, there needs to be transparency about what would not be covered by the guarantee, for example whether it would cover off balance sheet items such as a company's pension scheme liabilities, or amounts payable to preference shareholders.

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?

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

Comments:

A) We agree with the proposal. However, BIS should ensure that the full legal and practical implications associated with the implementation of a requirement for the provision of a guarantee are considered. We note, for example, that paragraph 67 explains that there will be no requirement for the parent company directors to provide a declaration of solvency before the parent company provides the guarantee.

It is necessary to consider carefully the form and substance of the guarantee to establish that it will be successful in enabling subsidiary companies to take advantage of the audit exemption whilst providing adequate protection to third parties. There will be a need to achieve a balance between a guarantee which can be set up without undue cost and complexity, whilst still providing the necessary legal protection.

A) No. Our initial discussions with management of a number of our audit clients have suggested that the take-up could be significantly less. Those clients indicated that they will be unwilling to provide the necessary parent company guarantee. Although such companies have consistently provided financial support to their subsidiaries if necessary, they may not be prepared to set up a legal commitment to do so. Also, providing a guarantee will require parent companies preparing financial statements in accordance with IFRS (or applying FRS 26 under UK GAAP) to reflect the fair value of that guarantee in their own financial statements, potentially affecting distributable reserves and the parent company's ability to pay dividends.

B) No, we do not have any alternative proposals.

Question 21

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

☒ Yes ☐ No ☐ Not sure

Comments:

We believe that existing penalties for non-compliance with Companies Act requirements are sufficient. However, there is a need to ensure that there are adequate procedures in place to monitor compliance by companies with the requirements.

Question 22

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

☐ Yes ☒ No ☐ Not sure

Comments:

There are no current restrictions on a UK GAAP company that wishes to move to IFRS beyond the requirements in Companies Act (CA) 06 s407 that require consistency of financial reporting framework and we consider that there should be no more onerous restrictions for an IFRS company that wishes to move to UK GAAP. As the consultation points out, the new framework proposed by the ASB significantly reduces the scope for misrepresentation by switching (in either direction) between IFRS and UK GAAP. We understand that the ASB's proposals on amending UK GAAP will result in entities complying with UK GAAP as referred to in s395 by using any one of the following accounting methods:

a) FRSSE (small companies)
b) FRSME
c) IFRS with reduced disclosures (for subsidiaries)

The current proposals by BIS do not appear to consider companies moving between a, b, and c above.

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 ☐ Once every 3 years ☐ Once every 5 years ☐ Never
☐ Not sure

Comments:

As per our answer to Question 22 the restriction on consistency of accounting framework set out in CA06 s407 should be enough of a restriction that a time bar is unnecessary.

However, as a practical matter as the restriction only applies when a company moves from IFRS to UK GAAP and not in any move from UK GAAP to IFRS we believe that the option to allow change once every 5 years, while being an arbitrary period of time, will still permit up to 3 changes in accounting framework within a 5 year period which should be more than enough flexibility for the average company.

The need for a change so frequently would be, in practice, unusual and would only arise in the following example: A company had moved from UK GAAP to IFRS as permitted in CA06 sect 395 in (say) 2006. The company then reverts to UK GAAP in 2012 as permitted under this proposal as it has not previously moved from IFRS to UK GAAP. Again the company changes back to IFRS in 2013 (sect 395). The proposed restriction now becomes applicable should the company move back to UK GAAP within 5 years of 2012 i.e. on this fourth move. Given the cost implications in moving accounting frameworks we do not believe companies will move back and forth as illustrated.

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?

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

Comments:

A) Until the revised proposals for UK GAAP accounting are made available by the ASB it will be difficult to estimate the level of uptake of this option. Companies will need time to consider the options and identify the benefits of remaining within IFRS or switching back to UK GAAP. If, as proposed, the ASB introduces an IFRS reduced disclosure framework for subsidiaries our clients have indicated their strong support for applying this to their subsidiaries and the 90% estimate may be achievable.

B) In line with responses to previous questions, it is difficult to estimate the cost of management time saving.

Question 25

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

☐ Yes ☐ No ☒ Not sure

☐ Yes ☐ No ☒ Not sure

Comments:

As per our responses to previous questions the costs in moving from IFRS to UK GAAP depend on the complexity of the accounting issues in each company. For subsidiaries choosing to apply the reduced disclosure framework proposed by the ASB, the number of disclosures will indeed decrease, saving some cost although numerical information will still need to be prepared for use in the group consolidation.

Additional audit costs are likely to be incurred by those subsidiaries not able to or not electing to avail of any audit exemption as an auditor will wish to test any transition between accounting framework and any related change in layout and disclosures within financial statements. We estimate this additional time and cost to be higher than that estimated by BIS.

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?

☐ Yes ☒ No ☐ Not sure

Comments:

As the new ASB accounting regime will be based on an IFRS framework we do not believe there are many opportunities for companies to manipulate their performance by changing accounting framework.

Question 27

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

☐ High risk ☒ Low risk ☐ Not sure

Comments:

As accounting standards require additional disclosures such as reconciliations when IFRS is adopted for the 1st time we would expect the accounting standard setters would respond to any potential risk by requiring additional disclosure.

Question 28

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

☒ Yes ☐ No ☐ Not sure

Comments:

We agree with the Government's assessment of the risks.

Question 29

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

☒ Yes ☐ No ☐ Not sure

Comments:
The ASB has stated that it will allow early adoption of the new UK GAAP which is due to be published in mid-2012 so the proposed timing of October 2012 is consistent with this.

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

Please use this space for any general comments that you may have, comments on the layout of this consultation would also be welcomed.

Thank you for taking the time to let us have your views. We do not intend to acknowledge receipt of individual responses unless you tick the box below.
Please acknowledge this reply ☐

At BIS we carry out our research on many different topics and consultations. As your views are valuable to us, could we contact you again from time to time either for research or to send through consultation documents?
☒ Yes ☐ No

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