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19 December 2011

Our ref: MJ/RG/AJC

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Dear Sir

Consultation Paper: Consultation on Audit Exemptions and Change of Accounting Framework

We write in response to the invitation to comment on the above named Consultation Paper issued in October 2011.

We believe that the government's audit exemption proposals represent a sensible balance.

- Removing the anomaly whereby certain small companies could not take audit exemption is a practical step to simplifying the law and creating a level playing field.
- Where a subsidiary's debts are guaranteed by its parent company, and shareholders do not demand a separate audit, it is likely that external stakeholders will only be interested in the financial statements of the group; the decision to obtain assurance over the subsidiary's financial statements should therefore be driven by the directors.

We question some of the key assumptions applied in arriving at your estimate of the total potential savings, particularly around the take-up of the subsidiary audit exemption. However, we believe that allowing companies greater choice is the right thing to do. Companies will be keen to understand the exact nature of the guarantee required to obtain exemption; to this end draft wording for the proposed guarantee should be made available as promptly as possible to enable interested parties to make a fully informed decision.

We support the proposal to allow companies who currently prepare accounts under IFRS as adopted in the EU more flexibility to change their accounting framework to UK GAAP, especially in light of the forthcoming changes to UK GAAP. However, we believe that only allowing such a change every five years (absent any other change of circumstances) is overly restrictive; we do not believe companies would choose to go through the challenges of changing accounting framework regularly. Our preference would be to allow companies a free and unrestricted choice of accounting framework.

In the Appendix to this letter we respond individually to the questions raised in the Consultation Paper.

If you have any questions regarding our response, please contact Martyn Jones, Richard Gillin or Anne Cowley.

Yours faithfully

Deloitte LLP

Deloitte LLP

Appendix: Deloitte's responses to the questions raised in the Consultation Paper

Proposal One: Changes to Audit Exemptions

Q1: What are your views on the overall principle of reducing audit requirements for unlisted companies?

We support the overall aim to increase flexibility through the reduction of statutory audit requirements for unlisted companies. Reducing the requirements imposed by legislation will enable companies to seek assurance to a degree that is suited to their strategic position and needs. In many cases this may still be an audit.

It would be helpful for the government to explain how they have considered the EC proposals to replace the Accounting Directives should be considered when reviewing audit requirements within the UK. Whilst the government will be unable to change the small company thresholds until EU law is changed, it will be helpful to make companies aware of the proposed increased size limits for small companies to (at today's exchange rates) £8.7m turnover and a balance sheet total of £4.35m. This might mean that some smaller subsidiaries might not go to the time and expense of entering into a parent guarantee if they would become audit exempt next year without doing so.

Q2 A: Do you agree about the underlying assumptions in our Impact Assessment that at least 60% of small companies now eligible will take up the audit exemption?

Whilst we anticipate that many eligible small companies will be unlikely to see a need for a continued audit if not required by law, we have no evidence to agree or disagree with the estimate in the Impact Assessment.

We believe that audit will remain a valuable service for many SMEs. A number of our clients aspire to growth and look to an audited track record when seeking investment. Others are required to submit audited accounts to their lenders or to comply with other covenants and, again, we have no evidence as to what assurance, if any, lenders will demand in the future.

Q2 B: Do you agree that the whole of the audit fee will be saved?

No. Many of the businesses falling within the revised thresholds may still require assistance in preparing and filing statutory accounts. The synergies between the procedures required for preparation and audit of SME accounts mean that only a partial saving is likely to be achievable if a small company takes advantage of the exemption.

As one of the primary users of SME accounts, HMRC currently benefits from the improvement in the quality of financial statements which results from the audit process and the deterrent effect of audit on deliberate misstatement of the financial statements. Although the Consultation Paper notes that HMRC has powers to seek further information if required, care should be taken to ensure that this does not become a 'routine' occurrence which could become more time-consuming and costly than being audited.

Q2 C: Do you agree that there is no saving of management time for small companies taking up the audit exemption?

Although management will still be required to prepare and file statutory accounts, a time saving could arise from the reduced requirement to prepare and provide information (schedules, copy invoices etc) to the auditors and to make management time available to answer their questions.

Q3: 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, we agree with this proposal. In particular we welcome the alignment of the 'small' definition for both accounting and auditing purposes.

It is not clear from the consultation document whether the government proposes to remove the existing gold-plating of EU law which requires that small subsidiaries of larger groups nevertheless require audit (assuming that they have not met the requirements of the proposed exemption for guaranteed subsidiary companies). Clarity in this area would be helpful.

Q4: Do you agree with option B to exempt qualifying non-dormant subsidiaries from mandatory audit of their accounts?

Yes. In our view the proposed exemption would provide groups with added flexibility and the opportunity to choose an approach to assurance which makes the most commercial sense for their circumstances. However, we have reservations around the expected level of take-up given the restrictions which are proposed, and hence the level of savings achievable. Specific considerations around take-up and the guarantee are discussed below.

The exemption will be relevant to a wide number of groups with substantially differing structures and arrangements and each group will need to assess the risks and benefits given its individual circumstances. In considering the effect of this proposed exemption, companies will need to be aware of the impact this may have on a group audit. ISA 600 is a demanding standard and considerable work on subsidiaries may be needed, even if they are exempt from statutory audit individually.

Q5: 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?

Groups with considerable numbers of subsidiaries could potentially achieve substantial time and cost savings with the ability to obtain an exemption from preparation, filing and audit.

As with exemption from audit, the effect would depend on the situation of the group in question. It will still be necessary for significant subsidiaries to prepare sufficient information for audit at group level, which will not differ significantly from the information required to prepare statutory accounts. Smaller subsidiaries, which may be 'scoped out' for the purposes of group audit testing, could benefit to a greater degree.

It is also necessary to consider the degree to which exemption from preparation and filing of accounts would increase the risk of loss of useful information. Users require access to sufficient information to be able to understand the financial position and performance of the company in which they have an interest. If such accounts are to be exempt from audit in the future, the question arises as to the value of unaudited accounts and the extent to which external (i.e. non-group) stakeholders will be able to rely upon them. Please refer also to Q15 for further comments on this subject.

Q6: 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. The risks associated with dormant companies are low and there are relatively few users of such accounts. The only real benefit obtained by users in accessing dormant accounts is to confirm that they remain dormant. It seems sensible, therefore, to adopt a structure whereby accounts are not filed unless a company is active.

In our view the impact on UK business is unlikely to be significant since the time and expense involved in rolling forward and re-signing a set of dormant accounts is relatively minimal.

Q7 A: Do you agree that in addition to the Article 5 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?

We support the view that subsidiaries with securities admitted to trading on a regulated market should continue to be required to obtain an audit (under Disclosure and Transparency Rule 4.1.7 such entities will require an audit in any case). We are unsure whether the expression 'unquoted company' is intended to be as defined in section 385 of the Act or to have the broader meaning of a company that does not have shares traded on a market. For example, an AIM company is an unquoted company for the purposes of s385.

We agree that financial services and insurance companies, and those others currently excluded from audit exemptions under UK company law, should be required to obtain an audit. The Consultation Paper did not make clear whether the scope of these exclusions are intended to have the same meaning as the current definition of an 'ineligible company' under Section 478 of the Companies Act 2006, and also as to whether the subsidiary exemption will be available to companies which are members of ineligible groups but are not, themselves, ineligible.

Q7 B: Why? What difference would this make to your business and to the wider economy?

There is an increased level of public interest in the types of entity described in Q7A, and the impact of such an entity failing would be substantially greater in respect of the wider economy. Such entities have a wide number of stakeholders and the guarantee may not be sufficient to reduce their exposure to risk to an acceptable level in these cases.

Q8: 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?

Many FSA regulated entities are required to obtain an audit as a result of other EC Financial Services Directives, or because the FSA requires audited financial information as a regulatory tool in considering capital requirements or solvency. Any proposal to change exemptions in this area should be consulted on by BIS together with the FRC and FSA.

Q9: Do you agree that the same rules on exemptions for qualifying subsidiaries should broadly apply to Limited Liability Partnerships and unregistered companies?

Yes.

Q10: 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:

Q10 A: That the average cost of the audit is in the range of £8,000 to £83,000 per subsidiary?

The range of the stated 'average cost' is broad and is therefore quite meaningless in attempting to calculate a total saving; the subsidiaries within the scope of the exemption will vary dramatically in size and complexity and it is therefore not possible to arrive at a meaningful 'average' cost of audit. This will depend on the subsidiary and on the group's circumstances.

For instance, a small straightforward subsidiary audit could be significantly cheaper than £8,000, whereas a large, complex subsidiary audit could cost tens of thousands of pounds. In considering taking the exemption, though, a parent company may be more willing to guarantee the debts of the small subsidiary than the larger subsidiary from a risk perspective and considering that the larger subsidiary is likely to be covered in detail as part of the group audit in any case.

Q10 B: That 75% to 100% of qualifying subsidiaries will take up the exemption?

This appears to be a high estimate which is not based on sufficient evidence. The consultation paper refers to experience in other European countries which take advantage of the exemption, but then notes that this is based on the estimates of the authorities in those countries only.

The nature of the proposed guarantee is discussed in more detail below, but we envisage that each group will need to assess whether it is willing (and able) to make such a guarantee before taking the exemption. The level of audit work required at group level as a result of taking the exemption will also need to be understood through discussion with the group auditor.

Other external issues will also need to be considered, including availability of finance to subsidiaries exempt from audit, any potential impact on local/national credibility and whether competitor entities choose to take the exemption or not. Where a group has established an entity in a particular country with a view to providing customers and suppliers with the comfort of dealing with a 'home' company, for example, that group will need to consider how a guarantee could impact on relations with those customers and suppliers. However, we welcome the flexibility that the option in the law gives to directors as it will allow them to consider whether the exemption is appropriate in their circumstances.

Q10 C: That 10% to 25% of the audit cost of each qualifying subsidiary will be saved?

As noted above, this will vary depending on the situation of each subsidiary and of the group as a whole and it is therefore difficult to estimate or provide an average expected saving.

Q11: 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 per company, depending on size of company?

Given the diversity of the entities which will be affected by this exemption it is difficult to give a meaningful indication of average time savings.

In our experience, some groups with large numbers of similar subsidiaries which are centrally administered already spend fewer than 5 hours of senior management time on each subsidiary and will therefore see a smaller time saving. A group with diverse accounting systems and business processes could make a greater saving.

Where a subsidiary is significant to the group as a whole, it can still expect a substantial degree of interaction with the auditor at the time of the group audit and the savings achieved in such cases would be expected to be negligible.

Q12: 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 £280 per dormant subsidiary?

The level of work required to prepare dormant accounts is minimal and cost savings are therefore likely to be limited and will relate almost entirely to time spent in preparing and signing the accounts. Such time will primarily be spent in ensuring that required updates to disclosures have been made and that the accounts are presented in the correct format. The cost is unlikely to increase proportionally with the number of dormant subsidiaries within a group and the average saving is therefore likely to be lower than that proposed, depending on the number of dormant entities within a group.

Q13: 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?

No. We anticipate the cost would be substantially higher. Additionally, legal costs are unlikely to be entirely incremental on the number of subsidiaries. Instead we would expect that a group will take legal advice on its overall position, and the cost of that legal advice will vary dependent on the group's structure, countries of operation and existing intragroup relationships.

Legal advice may also be required beyond the first year of exemption. As the situation and composition of a group changes, it could reasonably be expected that further legal advice would be required as to the interaction of the guarantee with new or further financing or regulatory requirements, or in respect of restructuring and takeover plans. There is also a question around the enforceability and legality of a guarantee issued by a non-UK parent company in respect of UK subsidiaries. Directors of such subsidiaries may seek further legal advice as to whether to rely on such a guarantee.

Without having sight of the format of the proposed guarantee it is difficult to comment on the second part of this question. We agree that if the government provided sufficient guidance on the acceptable form of the guarantee, companies would not need to seek legal advice as to whether the guarantee met the conditions for audit exemption. However, the parent company may still wish to take advice as to the extent of their exposure to the guarantee and directors take advice on their personal liability.

Q14: Have views of stakeholders expressed to the Company Law Review changed since 2000?

No. In our opinion the views of stakeholders have not changed since 2000.

Q15: 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?

We are of the view that exemption from preparation and filing of accounts would save substantial management time. However we agree that exemption could lead to loss of useful information, as mentioned within Q5 above.

The Consultation Paper comments that no time saving would be achieved on exemption from preparation since the same information would be required to be prepared for use by HMRC anyway. In our opinion, this is not a relevant consideration since (a) the information provided to HMRC within the tax computation differs significantly from that provided in statutory accounts, (b) it is not a given that HMRC would demand all of the information contained within a set of statutory accounts if those accounts were not required by company law and (c) some information will be required in any case for consolidation purposes.

Therefore the more relevant question is whether exemption from actual preparation of the statutory format and approval thereof would generate a significant saving. We have addressed this point in Q5 above.

Loss of information presents a more pertinent concern in our view. While users would be able to access the group's consolidated accounts at Companies House, they may face challenges in interpreting those accounts satisfactorily (whether due to translation issues, different measurement bases or other differences). It is likely that they would therefore continue to benefit from accessing the subsidiary statutory accounts – which must still have been prepared by the directors to show a true and fair view.

Q16: 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. We agree that it is unlikely that these proposals will have a significant adverse impact on the number of small audit firms.

In the case of the extension of the exemption for small companies, the number of companies which will fall into the exemption as extended is relatively low and would not be expected to have a substantial impact on fee revenues. In addition, the removal of the audit exemption may enable firms to offer value-added non-audit services which they would previously have been unable to provide as the company's auditor because of reasons of independence and objectivity.

It is probable that the exemptions for qualifying subsidiaries will have a less significant impact on smaller audit firms since in many cases companies with larger group structures will be audited by larger audit firms.

Q17: Do you agree with the Government's assessment of the risks of the proposal?

Yes. The proposed increase to the thresholds for small companies will not give rise to a substantially increased risk of misstatement of accounts or reduction in credibility. Rather, it offers small entities a greater choice as to the level of assurance that they would prefer. The extension to the thresholds is not so significant that it would be expected to have a sizeable impact. Likewise we do not consider that the proposed exemptions for dormant subsidiaries would significantly increase risk.

We believe that the risks arising from exemption of qualifying subsidiaries from audit are more noteworthy because of the potential size of the entities qualifying for the exemption, as well as their importance within a group. There is the potential that significant, complex trading subsidiaries could no longer require an audit.

We consider that the risks arising can be largely mitigated by two factors. Firstly, it is important that any material subsidiary (from a group perspective) is subject to sufficient audit procedures at group level so as to obtain reasonable assurance over the consolidated accounts. This will result in a need for additional audit work at group level, but the work may be more targeted towards the group risk areas and use a group approach to materiality.

Secondly, the fact that the parent company must guarantee the debts of any exempt subsidiary provides creditors with a degree of reassurance. However, in order for the guarantee to be valuable to users, they must be able to understand and assess the full extent of the guarantee and the parent's ability to meet it, and sufficient information must be available to them in a timely manner so as to enable that assessment to take place – as discussed in Q15 above and Q20A below.

Q18: 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, we agree with these proposals, although we would express concern that the irrevocable nature of the guarantee could be off-putting and could limit take-up.

We acknowledge that these requirements place a significant burden on the parent but consider them necessary to provide satisfactory comfort to creditors of the audit-exempt company.

Q19: Do you agree that the guarantee should cover the 'debts' of the subsidiary and not extend to its 'liabilities'?

In our view this proposal requires further consideration. We agree that it may be helpful to provide a clear definition of what is to be guaranteed and to offer a commercially viable position for groups considering the guarantee (although we question whether such clarification is permissible without gold-plating the Directive).

However, we express concern as to whether these advantages exceed the consequent restriction in assurance for those dealing with guaranteed subsidiaries. The restriction potentially leaves those not party to a contractual arrangement with the company lacking assurance.

For instance, a party bringing a claim against an audit-exempt subsidiary for environmental damage would not be protected by the guarantee. In our view this disadvantage seems to outweigh the suggested benefit of increased take-up (and whether or not restriction of the definition will encourage take-up remains to be seen, as arguably the irrevocable nature of the guarantee is the more significant challenge for groups to overcome).

The consultation paper draws a distinction between 'debts' and 'contingent liabilities' but we would comment that contingent liabilities can also constitute debts owed as a matter of contract; it would seem inappropriate to exclude such items from the definition.

Q20 A: Do you agree with the proposals for the Guarantee?

We agree that subsidiaries should be required to file the annual declaration by its shareholders that they have agreed to the relevant exemption, and that this should be part of the annual return.

Although Article 57 does not require that the parent company publicises the guarantee outside of its group accounts, it could be considered beneficial to do so, for instance by requiring the parent to file a copy of the guarantee with Companies House. It could also be included as part of the annual return, as proposed for subsidiaries.

This would avoid a lack of information arising from, for instance, timing differences between the signing of group accounts and arrangement of the guarantee. This is particularly relevant in the first year in which the guarantee is introduced. It would also help users accessing Companies House records to assess the full extent of the guarantee which the parent has given.

Please see also our responses to Q13, Q18 and Q19 above for further comment.

Q20 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?

It is difficult to comment on the form of the proposed guarantee without having the opportunity to review the proposed guidance. However our initial view is that take-up is unlikely to be as significant as assumed. The principal reasons for this are as follows:

- Groups which have been structured so as to spread risk around the group entities will be unlikely to choose to centralise risk to the extent required by the guarantee; and

- the benefits of the exemption through reduced audit costs may not exceed the costs to the group in terms of increased risks and the need for legal advice. This is particularly so given that accounts still have to be prepared and filed

Q20 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?

We have no alternative proposals to make in respect of this Consultation Paper. The guarantee provides companies with a choice, which in our view is the most important aspect of the proposals.

Q21: Do you agree that no new penalties should be proposed in conjunction with the introduction of these proposals?

Yes, we agree that no new penalties should be proposed in conjunction with the proposals.

Proposal Two: Change of accounting framework

Q22: Do you agree that the Government should impose restrictions on companies' ability to move from IFRS to UK GAAP?

No, we do not agree that restrictions should be imposed on companies' ability to move from IFRS to UK GAAP.

With significant changes to UK GAAP on the horizon, it is conceivable that a number of companies may wish to transition back from IFRS, especially if this enables them to take advantage of reduced disclosure for subsidiary companies. As a minimum, therefore, this should be permissible under company law.

However, we do not agree that restrictions should necessarily be imposed on the ability to move from IFRS to UK GAAP. In our view, it is unlikely that companies would want to switch accounting frameworks frequently due to the time, cost and complexity of so doing. Even were they to 'flip' from one to the other, the disclosure requirements are such that the impact of the change would be clearly demonstrated.

Q23: How frequently should a company be able to move from IFRS to UK GAAP, unless there is a relevant change in circumstances? Every year, every 3 years, every 5 years or never?

As discussed in Q22 above, we believe that companies should have a free choice in accounting framework every year and that the costs involved will deter frequent 'flipping' between GAAPs purely to present a particular picture. We suggest that the list of relevant circumstances given within s403 of the 2006 Act be replaced by a simple requirement that a company may change the accounting framework under which it reports (unless required to prepare IFRS financial statements by Article 34 of EC Regulation 1606/2002) if the directors consider there to be good reasons for doing so, and to require disclosure in the accounts explaining those reasons.

Placing a time restriction on the transition is not ideal as this does not take into consideration the potential impacts of changes to the position of the company within that time. If a time restriction is imposed, we suggest that the list of relevant circumstances should be retained and extended to include a company or its parent ceasing to be admitted to trading on the AIM market, as some companies trade on AIM for less than five years and would therefore be unduly restricted by the proposals.

Q24: Do you agree with the Government's estimate that 90% of eligible subsidiary companies will take up the option? Do you agree that the saving for each company will be £569?

Yes, we consider it likely that subsidiary companies will take the opportunity to benefit from reduced disclosures under the current proposals for the future of UK GAAP, in order to maximise the savings available from this and the above proposal. However, it is difficult to commit to a response on this point as the final ASB proposals have not yet been made available, and it is likely that the form of these proposals will be critical in the decision to revert to UK GAAP from IFRS. The same issue applies in assessing the savings achievable.

Beyond this specific opportunity we would anticipate it unlikely that companies will switch accounting standards on a frequent basis as stated above, unless they have compelling reasons to do so.

Q25: Do you agree that the one-off cost per company will be £390?

The cost of switching is likely to come primarily from increased management and auditor time. Regardless of whether the audit exemption is taken, professional advice is likely to be sought in taking and implementing the decision to change framework. We would anticipate that this will be in excess of £390 each time a company changes accounting framework, although this will depend on the extent of the disclosures required.

As with the legal costs proposed in Q13, it is unlikely that the one-off cost will increase directly on a per company basis.

Q26: 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?

No, we do not believe that the proposed changes increase the risk of financial irregularities. Sufficient disclosure is required under each GAAP to explain the impact of such changes.

Q27: What is the risk that investors will be misled or confused by a company switching between accounting frameworks?

As mentioned above, in our view both UK GAAP as it stands currently and IFRS contain sufficient disclosure requirements to ensure continuity and clarity. The FRSME (Exposure Draft – October 2010) also includes specific guidance on first-time adoption. Therefore we do not envisage a significant risk that investors will be misled or confused.

Q28: Do you agree with the Government's assessment of the risks of this proposal?

As discussed above, we do not consider it probable that companies will choose to switch between accounting regimes in order to present their performance in a better light. This is not because we believe that the future UK Financial Reporting Standards will represent greater convergence with IFRS (this may be the case to some extent but we are unable to comment on this until the final ASB proposals are available) but rather because of the costs and required disclosures involved in switching – cf. Paragraph 89 of the consultation paper.

Tax arbitrage is dealt with separately by the tax authorities and it is unlikely that changes in accounting framework will significantly impact on tax payable by companies, certainly not in the long term.

Timing for both proposals

Q29: Do you agree that the proposals should apply to entities for financial years ending on or after 1 October 2012?

We agree that this timing is appropriate in respect of the proposals regarding changes to accounting framework.

We agree also that this date is suitable in respect of the changes proposed for small company thresholds; the companies affected should now begin to consider their options and assess whether they would still prefer the additional assurance provided by an external audit.

With regards to the exemption for subsidiaries, it is essential that the government makes available the proposed wording of the guarantee in sufficient time to enable companies to take proper steps to assess whether it is a possible option for them. The extent of any flexibility in the guarantee will also need to be clarified – do companies have to use the prescribed wording or can they adopt their own amendments? Until this information is made available, those affected by this proposal cannot make a clear decision on their next actions.