

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	
Accountants: 200 – 500 UK Partners	
Accountants: 100 – 199 UK Partners	
Accountants: 50 - 99 UK Partners	

Accountants: under 50 UK Partners	
Accounting bodies	YES
Legal representative or professional legal bodies	
User representative bodies	
Academics	
Regulators and Government bodies	
Individuals	
Other (please describe)	

Question 1 (para 25)

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

Comments:

We are strongly opposed to drawing a line at the level of listed companies. Large and medium sized unlisted companies are often of significant size and an audit is necessary to meet the needs of users.

Question 2 (para 29)

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**

B **Yes**

C **Yes**

Comments:

Re A – This is adequately supported by research and experience.

Re B – While the words ‘audit fee’ will not appear, the allocation of costs of the professional accountant between services is to some extent approximate. There may be some reallocation of costs recovered as ‘audit fees’ to other forms of billing, for example advice on improving systems of financial control.

Re C – There are undoubtedly some administrative tasks completed by management that relate only to statutory audit but their overall cost is not significant.

Question 3 (para 33)

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

Comments:

This is necessary to bring the small company audit criteria into line with the small company accounting criteria.

Question 4 (para 36)

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

Yes

Comments:

The principal rationale put forward for adopting option B is that it would enable individual group companies (and the group as a whole) to save the financial costs of multiple audits at no detriment to the interests of stakeholders. We can also see that there is a 'competition' element to this matter in that other EU countries have already adopted the option in article 57. We suspect, however, that, should the option be adopted, the claimed financial advantages would not, in practice, be substantial. We say this for two reasons.

Firstly, as the document acknowledges, the savings made by exempting group companies from the current requirement would be counter-balanced by the extra cost and time that would be taken to undertake the audit at the group level. Under EU law and ISAs, the group auditor is responsible for the audit of the whole of the consolidated accounts, and if no work has been carried out at the subsidiary level, the auditor of the group will need to undertake substantially more work than would the case if he were able to use the results of the subsidiary audits. For this reason we would query the assumption made in the document that up to 25% of current group audit costs could be saved. Further, we think it likely that individual audit firms will be so reluctant to undertake group audits in these circumstances that they will advise their clients not to take advantage of the proposed option, or else demand higher fees by way of compensation.

Secondly, however the definition of 'guarantee' is framed, any parent company giving it would thereby take on a potentially significant new risk. Our anecdotal understanding is that parent companies in the UK will not be prepared to take on this risk, and will therefore not be prepared to allow at least their more material subsidiaries to go without an audit. This causes us to question the other assumption made by BIS that between 75% and 100% of qualifying subsidiaries would take up the new option. We are aware that, in the Republic of Ireland, guarantees are frequently given by parent companies. Our understanding is, however, that the most common motivation that parent companies have in choosing to do this is to ensure that their group companies' individual results are not published – in implementing article 57 Ireland has decided not only to exempt group companies from the audit requirement but also the requirement for companies to prepare and publish their accounts. This is in our view not an example the UK should follow.

Accordingly, our feeling at this stage is that the claimed financial advantages would not be likely to materialise in practice. Since, however, adopting option B would only be permissive, and not mandatory on parent companies, we cannot argue against allowing individual companies and groups to make their own commercial decisions about whether or not taking advantage of the option would be in their interests. There are, though, certain public interest factors which, we suggest, have a bearing on whether the option should be introduced: these are discussed in our response to question 17 below.

Question 5 (para 36)

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:

We endorse the reasons set out in para 52 for why it would not be appropriate to exempt active subsidiaries from the existing requirements to prepare and publish accounts. In addition to the points made in para 52, we believe that, as a matter of company law principle, the separate legal existence of individual companies should be reflected in individual requirements for them to account for their actions, and to make these available to the general public. We would add that section 172 of the Companies Act 2006 now stresses that companies are expected to operate in accordance with wider public interest motivations, and in the light of this it should not be sufficient for shareholders alone to make the decision not to prepare or publish a transparent account of their company's position and performance.

Question 6 (para 38)

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

Comments:

Yes, provided additionally that the directors make the necessary decision that the company has been technically dormant and that each case is disclosed in the group accounts.

Question 7 (para 40)

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**

B Comments:

It is appropriate to recognise the higher user expectations in relation to certain types of company as proposed.

Question 8 (para 40)

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:

The effectiveness of financial services regulation and supervision may be significantly damaged if reports by auditors are not possible (because no auditor is appointed). User confidence in UK financial services has to be maintained in order for the sector to contribute fully to the economy.

Question 9 (para 41)

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

Yes

Comments:

Question 10 (para 46)

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	<input type="checkbox"/> Yes	<input type="checkbox"/> No	<input type="checkbox"/> Not sure
B	<input type="checkbox"/> Yes	<input type="checkbox"/> No	<input type="checkbox"/> Not sure
C	<input type="checkbox"/> Yes	<input type="checkbox"/> No	<input type="checkbox"/> Not sure

Comments:

We have addressed this issue in our response to Q4. We suspect that BIS may have overestimated the likely cost savings of introducing the option and the likelihood that the option would be used in practice.

Question 11 (para 46)

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?

Not sure

Comments:

We expect the quantum of saving, if any, to vary widely. The assessment does not, however, assess the benefit to senior management of interaction with an auditor capable of providing information and insights relevant to increasing business efficiency and effectiveness.

Question 12 (para 46)

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?

Not sure

Comments:

While we have no reason to doubt the reliability of the PWC admin burden data, the actual saving in any particular instance could be expected to vary considerably.

Question 13 (para 47)

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

Comments:

We suspect that the estimate of £110 for initial legal advice on the framing of a guarantee is likely to prove an underestimate. Going forward, official guidance would be helpful but would not eliminate the need to seek specific advice. What would help to reduce company costs to a minimum would be for the Government to produce a standardised format for the guarantee.

Question 14 (para 49)

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

No

Comments:

Question 15 (para 49)

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

Comments:

Question 16 (para 51)

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?

No

Comments:

The document acknowledges that small audit firms would be likely to see a decrease in the demand for their audit services, although it claims that they could compensate for this by providing other services. Small and medium sized practitioners (SMPs) have indeed proved to be resilient in terms of adapting to successive changes in the audit rules. One ramification that BIS does not acknowledge, however, is that the continuing reduction of statutory audit work will mean smaller firms doing less and less audit work, and this in turn will lead to fewer and fewer audit firms in the SMP sector. We believe that this would not be a healthy development for the availability of audit and similar services at this level, including in the charity sector where audit is still mandated at relatively low income thresholds. If only larger firms were in a position to offer audit services to SMEs and small charities, that could have the undesirable effect of increasing costs to client entities.

Question 17 (para 55)

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

No

Comments:

Para 58 acknowledges that the parent company guarantee will offer no comfort to unsecured creditors should the parent prove unable to honour it. We believe that this, together with the reduction in the level of credibility of the exempt subsidiary's published accounts, will expose such creditors to an increased level of risk, which they may not be in a position to mitigate.

There are additional risks which need to be considered.

Firstly, if an audit is only to be undertaken at the group level, the threshold of materiality can be expected to rise in respect of the information being audited. Accordingly, mis-statements, whether caused by fraud or error, which would be expected to be detected at the individual company level may not fall to be detected and disclosed at the group level. Given the reported significant increase in the incidence of fraud (KPMG Fraud Barometer 2011) during the current economic downturn, and given the UK's recent initiative to live up to its obligations under international anti-bribery agreements, BIS must accept that the proposal would increase the possibility of mis-statements not being detected and reported under auditing standards.

Secondly, and leading on from the above point, the UK operates a strong anti-money laundering regime to uncover and prosecute cases of financial crime. Auditors, and external accountants generally, form a major element of the UK's system of gate-keepers under the Proceeds of Crime Act, and make up the second-largest group of submitters of suspicious activity reports. Were auditors not to be appointed to the 83,000 companies covered by the proposed reform – this figure would include public companies and large private companies – this could result in the loss of a potentially significant flow of information to SOCA.

Any reduction in audit costs which might materialise as the result of the adoption of the proposed option must therefore be balanced against the likely reduction in the capacity of audit to uncover fraud and error and to report instances of financial crime.

Question 18 (para 59)

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

Comments:

We would agree with the adoption of a restricted definition of 'commitments', one which does not expose the parent to liabilities in the wider sense. However, it will be necessary to define the term 'debts' or 'contractual liabilities' carefully. The definition should cover the fact that 'debts' are sometimes not straightforward. A good example is end-of-lease complications which result in associated financial obligations for the former lease-holder. A clear picture of what liabilities are and are not covered will be necessary if parents are to be prepared to give the guarantee which will make the reform workable.

Question 19 (para 60)

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

Yes

Comments:

We agree with the argument put forward in paragraph 64.

Question 20 (para 63)

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**

B **Yes**

C **No**

Comments:

Question 21 (para 65)

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

Yes

Comments:

Question 22 (para 76)

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

No

Comments:

No. We would support option (d) given adequate disclosure.

We agree with the arguments put forward in paragraph 88 which point to companies switching as not raising significant risks of misrepresentation by their financial statements, namely that

- the two systems of accounting will be closer in future when the IFRS for SMEs becomes the basis for UK GAAP
- provisions in UK GAAP that are currently in place, and will be there in future, generally require restatements of comparative figures on changes of accounting policy.

The reasons for changes in accounting policy are required to be stated. Frequent significant changes in policy should act as a clear signal for any users to be wary of the quality of the financial information provided, despite the general restatement requirements.

We also agree with the reasons for allowing companies to change, set out in paragraphs 83 to 85 in the consultation document.

We do not see significant evidence of the likely abuse of an allowance to switch between IFRS and UK GAAP.

Therefore we do not see any reason why in this case the EU regulation should be gold-plated by the UK law.

Question 23 (para 76)

How frequently should a company be able to move from IFRS to UK GAAP, unless there is a relevant change in circumstances?

Every year

Comments:

The benefits of allowing changes are not ones that will occur within a predictable time scale and so restrictions of every 3 years or every 5 years are likely to have undesirably restrictive consequences in some cases.

Question 24 (para 78)

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 **Not sure**

B **Not sure**

Comments:

We have no data to confirm or refute the estimates.

Question 25 (para 82)

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

Not sure

Comments:

We have no data to confirm or refute the estimate.

Question 26 (para 86)

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

Comments:

There is a theoretical risk that concealment of financial irregularities could be facilitated but we do not attempt to estimate the potential impact on investors.

Question 27 (para 27)

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

Not sure

Comments:

The questions refers to 'misled', which implies intent to mislead, and to 'confused,' which is merely a matter of user comprehension in circumstances of change. There are many variables in relation to both these aspects of the question but overall we suggest that there is little risk relating to deliberate manipulation but a high risk that overall, investors will become confused as to how a change between accounting frameworks ought to influence their financial decisions.

Question 28 (para 86)

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

Yes

Comments:

In general, but see responses to other questions.

Question 29 (para 87)

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

Yes

Comments:

The key reason for deciding on a date is that it allows synchronisation of the changes. Desire that companies be given the benefit of a deregulation as soon as possible seems to drive the suggestion that the proposals should apply for financial years ending on or after 1 October 2012. There remains a need for adequate time to be allowed for assimilation of the changes into an annual reporting cycle and it may be beneficial to have transitional measures protecting those who are 'late adopters'.

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 ☐ **(not necessary)**

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

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