Grant Thornton

An instinct for growth™

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Dear Mr Conway

UK Implementation of the EU Accounting Directive

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the consultation issued by the Department for Business, Innovation and Skills (BIS) on the UK implementation of the EU Accounting Directive.

Grant Thornton UK LLP is a leading financial and business adviser with offices in 26 locations nationwide and more than 25,000 individual and 15,000 corporate and institutional clients. The Grant Thornton global organisation is one of the world's leading organisations of independent assurance, tax and advisory firms. Grant Thornton member firms operate in over 100 countries.

General comments

Grant Thornton supports the growth agenda and believes that the application of reason combined with instinct will allow dynamic businesses to unlock their potential for growth. We therefore support the Government's overall approach to implementing the EU Accounting Directive prioritising the need for the regulatory framework in the UK to reflect properly the needs of a wide range of users of financial information whilst ensuring that the burden imposed on business, and smaller companies in particular, is both necessary and appropriate. This approach will help to ensure that smaller companies are able to remain competitive and increase comparability with their European counterparts, which in turn will support growth and the contribution to economic prosperity through the creation of employment opportunities. However, at the same time, the UK's financial reporting framework must also continue to provide high quality information for users and third parties such as creditors, shareholders and regulators.

In principle, we agree that where options are available to Member States in the Directive they should be taken up where doing so reduces overall costs to business. When assessing the cost to business, short-term cost savings should be assessed against the additional cost that may be incurred in the longer term. For example, costs savings that may result due to the preparation of simplified accounts may be outweighed by increased finance costs due to future limitations on access to finance. We would therefore question whether there is a need for guidance to help companies make an informed decision as to whether to take advantage of the exemptions available. However, we urge that sufficient thought be given to the impact of taking options, for example, the option for companies to prepare abbreviated accounts for shareholders. We discuss this further below and in our response to Question 15 of the consultation.

The new regulations will have to be adopted in the UK for accounting periods commencing on or after 1 January 2016. However, we also support the possibility of early adoption so as to coincide with the implementation of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* which will apply for accounting periods commencing on or after 1 January 2015.

Definition of Public Interest Entities

In applying the Accounting Directive, Member States are permitted to designate additional companies as Public Interest Entities (PIEs) under Article 2(1)(d) where not specifically listed in Article 2(1)(a)-(c) of the Directive. Our view is that in designating additional entities as PIEs for the purposes of implementing the Accounting Directive, the existing exclusions from the small company regime and audit exemption should be maintained.

Whilst not specifically addressed in the consultation document, one of our key concerns is that the definition of a PIE for the purpose of applying the Accounting Directive (for example determining which companies can take advantage of the small company accounting regime and audit exemption) should be distinct from the definition of PIE for the purpose of applying the European Audit Directive and Regulation.

In both Directives, Member States are permitted to designate additional entities as PIEs. In our view, if the same definition were applied to both Directives, this would lead to an unsatisfactory outcome. For example, if companies such as those with securities listed on the Alternative Investment Market (AIM) and privately held public companies were included in the definition of a PIE within the Accounting Directive, and this definition also applied in implementing the Audit Directive, this would result in these companies being caught by new rules on audit committees, audit tendering and restrictions on the provision of non-audit services. Similarly, if public companies such as those listed on AIM were excluded from the definition of a PIE for the purposes of the Accounting Directive, smaller AIM companies would qualify for the proposed small company accounting regime and for exemption from audit. This would not be in the public interest. More generally, privately-held public limited companies (plcs) would also qualify for these exemptions on size grounds, which we believe would not be in the public interest as plc status is widely regarded by the public in general as indicating substance, status and financial strength.

In our view, subject to any specific legal restrictions that may exist to prevent this, the definition of a PIE for Accounting Directive purposes, and that for the Audit Directive and Regulation should be different, so as to maintain the current exclusions from the small companies regime without imposing undue costs that would otherwise arise from extending the scope of the Audit Regulation.

In order to achieve this, we recommend that, if possible, different terminology be used in the amendments to the Companies Act 2006 to implement the Accounting and Audit Directives respectively such that the term 'public interest entity' is not used in the Act in two different contexts.

True and fair view

We note that whilst the Accounting Directive restricts Member States' ability to require statutory disclosures, a small company is still required to consider if its financial statements provide a true and fair view. Additional notes to the accounts may therefore be necessary to achieve a true and fair view, and the Directive specifically requires such disclosure. However, the additional notes necessary to achieve a true and fair view will vary from company to company and will involve the exercise of judgement by company directors in discharging their legal duty under section 393 Companies Act 2006 not to approve the accounts unless they are satisfied that they show a true and fair view. This may put additional pressure on directors, particularly if they find themselves at risk of legal challenge as to whether they have discharged their duties properly. We discuss this point in more detail in our response to Question 31.

Whilst we do not recommend that extensive new guidance is produced on applying the concept of true and fair in this context, it may be helpful for attention to be drawn to guidance that already exists. For example, we draw attention to the True and Fair document produced by the Financial Reporting Council in 2011. Such guidance could be referred to in accounting standards such as FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, as well as a general statement regarding the applicability of the true and fair requirement to small company accounts.

We would also support the inclusion in accounting standards of a disclosure principle for small companies, drawing attention to the need to show a true and fair view. This could be achieved by the accounting standards applicable to small companies stating that, when considering whether disclosures provided are sufficient to give a true and fair view, regard should be had to the disclosure requirements of standards applicable to larger entities where relevant, but without requiring compliance with those standards.

Abbreviated accounts prepared for shareholders

We note the proposal to take up the option to permit companies to prepare abbreviated accounts for shareholders. We understand that the intention behind permitting this option is to simplify accounts and thus further reduce the burden on small companies.

Our principal concern with this proposal is whether the level of detail given in the abbreviated accounts prepared for shareholders will be sufficient to achieve a true and fair view, which remains a requirement for such accounts, including the potential need for additional disclosure not set out in the Directive. We discuss this point in more detail in our response to Question 15.

In our view, the cost savings to small companies of preparing abbreviated accounts for their shareholders will be minimal at best and quite possibly nil but there will be disbenefits in terms of loss of information for shareholders and any other users of a small company's accounts.

However, were the UK to take up the option to permit companies to prepare abbreviated accounts for shareholders, we would recommend that a company's ability to take up this option should be subject to minority objection rights similar to those currently set out in Part 16 of the Companies Act 2006 in relation to the small companies audit exemption so that shareholders effectively have a choice as to whether or not abbreviated accounts are prepared in place of full small company accounts.

Timeframe for increase in audit exemption threshold

We agree that the thresholds for the small companies audit exemption should remain unchanged for the time being. The impact of changing the threshold should be considered more widely through further consultation and the potential advantages and disadvantages (both quantitative and qualitative) of raising the threshold considered in more detail, taking into account the interests of a wide range of users and interested parties. We recommend that such a consultation should be open for a minimum of 12 weeks to ensure adequate time is allowed for responses to be given full consideration by all interested parties.

However, more clarity is needed on the proposed implementation of this particular aspect of the Accounting Directive. We therefore recommend that when the results of the EU Accounting Directive consultation are published, an outline of the steps that the Government intends to take to consult more widely on this issue and the expected timeframe for raising the audit threshold be set out.

Our detailed comments on the specific questions set out in the consultation are included in the response form which is enclosed with this letter. We have set out in Appendix 1 further detailed comments on matters we recommend that BIS consider that were not addressed by the consultation questions. If you have any questions regarding this response, please contact Mary Starr (phone: 020 7728 2063; email: mary.m.starr@uk.gt.com or Robert Carroll (phone: 020 7728 2210; email: robert.w.carroll@uk.gt.com).

Yours sincerely

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Further issues identified

In this appendix, we draw attention to issues that we have identified in our review of the Accounting Directive and the current UK legislation that are not addressed specifically in the consultation document.

Merger accounting

Article 25 of the Directive permits a 'merger accounting' approach to consolidation in some circumstances. This Article is headed up "Business combinations within a group" and Recital 29 refers to "intra-group transfers of participating interests, so-called common control transactions". However, the text of Article 25 itself refers to "undertakings…ultimately controlled by the same party both before and after the business combination".

There appears to be some inconsistency here as there are references to "group" which normally means a parent and its subsidiaries, but a reference to "party" which suggests that common control may be by the same individual or group of shareholders.

In our view, it is important in implementing this provision in UK law that the wording of the legislation does not unduly restrict the scope for applying merger accounting. In particular, we note that FRS 102 permits merger accounting to be used for group reconstructions which are combinations between two entities that have the same shareholders and for the common situation where a newly incorporated company is added to the top of an existing group. Neither of these situations is an intra-group transfer of participating interests but both situations cover undertakings ultimately controlled by the same party both before and after the business combination. We believe that the law should continue to permit the use of merger accounting in such situations as, in our view, its use is consistent with achieving a true and fair view.

Financial instruments

Paragraph 36 of Schedule 1 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) is difficult to follow. This paragraph will need to change in any event as the 5 September 2006 date is not in the new Directive. In addition, we recommend that the drafting of this paragraph, and its equivalent in the small companies regulations, be reviewed and clarified if possible.

Our reading of Article 8 of the Accounting Directive is that paragraph 7 sets out an overriding rule that financial instruments may be included at fair value only where that fair value can be measured reliably. Everything else that is permitted by Article 8 is subject to this condition. Paragraph 6 permits any financial instrument to be included at fair value where this is permitted by EU-adopted IFRS provided that the disclosures required by such standards are given. However, our reading is that disclosures required by EU-adopted IFRSs are required only where paragraph 6 applies. In addition to paragraph 6, paragraphs 1(a), 3 and 4 taken together permit financial instruments, including derivatives, to be included at fair value subject to specified exclusions, without requiring the disclosures set out in EU-adopted IFRS to be provided. We believe that paragraph 36 of Schedule 1 to SI 2008/410 would be clearer if it were set out in this order.

An alternative approach may be to replace the current paragraph 36 with two paragraphs: one setting out the permission to carry financial instruments at fair value where permitted by EU-adopted IFRS provided disclosures required by such standards are given, and the other setting out instruments that may be carried at fair value without recourse to EU-adopted IFRS or providing the disclosures required by such standards.

Limited liability partnerships

Currently, the law relating to accounts of limited liability partnerships (LLPs) is based closely on equivalent provisions for companies, but is in the form of stand-alone regulations. We strongly support the current approach and the way in which the LLP accounting regulations are set out. We believe that this approach should be maintained when the new Accounting Directive is implemented for companies and strongly recommend that BIS consults on this issue at the earliest opportunity as we believe it is important that the changes are implemented for LLPs from the same mandatory date as for companies.

Profits in the profit and loss account

In our response to consultation Question 27 regarding equity accounting in individual accounts, we commented on the reference in current UK legislation to profits realised at the balance sheet date. We set out below our more general comments on this issue.

We observe that paragraph 13(a) of Schedule 1 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) states that "only profits realised at the balance sheet date are to be included in the profit and loss account." There is an identical requirement in the regulations for small company accounts.

However, the wording of Article 6 paragraph 1(c)(i) of the Directive, from which the above requirement is taken, which is itself unchanged from the previous Directive, refers to "profits made" rather than "profits realised". We also note that the fair value accounting rules in SI 2008/410, override paragraph 13(a) of Schedule 1 and that the introduction of FRS 102 will mean that more unrealised profits will be included in companies' profit and loss accounts, such as on remeasurement of investment property under the fair value accounting rules. Consequently, it may not be apparent to the reader of the accounts whether all profits included in the profit and loss account for the year are realised.

We are unclear as to whether "made" in the Directive is intended to have the same meaning in law as "realised". If "realised" is in law more restrictive than "made", then we believe that the use of the word "realised" in the regulations is unnecessary gold-plating of EU law and has become outmoded in that accounting practice has moved on significantly since the words were introduced into UK legislation in the early 1980s. Therefore, we believe that, in implementing the new Directive, the phrase "profits realised" should be changed to the Directive words "profits made". This would in no way affect the profits available for distribution, which will continue to be determined in accordance with Part 23 Companies Act 2006 as, in essence, accumulated realised profits less accumulated realised losses, with additional restrictions for public companies.

In our view, distributions should be determined by reference to a solvency test rather than one based solely on realised profits in the accounts, but we note that with regard to public limited companies, European law would not permit such a move. We also acknowledge that primary legislation would be required to move to a solvency regime for private companies.

Ineligibility for small company exemptions

The current wording of section 384 of the Companies Act 2006 (CA 2006) regarding ineligible companies and groups is "The small companies regime does not apply to a company that is, or was at any time within the financial year to which the accounts relate..." The inclusion of "is, or" distinguishes s384 from the similar provisions regarding ineligibility of companies for medium-sized exemptions (s467 CA 2006) and from the small audit exemption (ss478-9 CA 2006) as neither of those sections includes the "is". Rather they refer only to the status at any time during the financial year. On a strict reading, the inclusion of "is, or" in s384 means that, if a company becomes ineligible after its year end but before it files its accounts, it loses entitlement to the small company filing and accounts preparation exemptions for the year just ended, but retains the audit exemption. However, this seems to be a counter-intuitive position and is at odds with how the small companies audit exemption works, due to inconsistency in the wording of the legislation. We therefore encourage BIS to review the wording of s384 CA 2006 and delete the "is, or" for consistency with the similar provisions in Part 16 CA 2006.

Accounting reference periods and accounting reference dates

We observe that sections 391 and 392 of the Companies Act 2006 are the source of considerable confusion regarding the minimum length of an accounting reference period, in particular where that period is a company's first. We also note that section 391 appears to contain text that is now largely redundant. Our recent experience is that there is a real cost to companies as a result of this issue due to a perceived need to obtain professional advice, which would be reduced or eliminated if the law were unambiguous. We therefore propose that the opportunity be taken to rationalise these requirements.

We propose that subsection 391(5) "A company's first accounting reference period is the period of more than six months, but not more than 18 months, beginning with the date of its incorporation and ending with its accounting reference date" be repealed as this is redundant given that any companies incorporated since the late 1990s will have had their first accounting reference period set automatically by section 391(4) or its predecessor under the Companies Act 1985 as amended. Those companies will have been able to alter this period under section 392 with the only restriction being the maximum limit of 18 months, as section 391(7) states that section 391 is subject to section 392, ie the latter takes priority and sets no minimum length for an altered accounting reference period. We note that this view is consistent with guidance given by Companies House.

We also propose that subsections 391(2) and (3) be repealed as they appear to be redundant.

Charitable companies

We note that at present charitable companies are required to comply with both charity and company law. We believe that it would be helpful if regulatory and accounting requirements as they apply to charitable companies were contained in one set of legislation.