Title: Audit Exemptions	Impact Assessment (IA)
IA No: BIS 0301 (supersedes that dated 12 June 2012)	**Date:** 26 March 2014
Lead department or agency:	**Stage:** Final
Department for Business, Innovation & Skills	**Source of intervention:** Domestic
Other departments or agencies:	**Type of measure:** Secondary legislation
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Summary: Intervention and Options

RPC Opinion: GREEN

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£2687.33m	£2687.33m	-£304.26m	Yes	OUT

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

Audit requirements in the UK do not allow as much flexibility to companies as currently available under EU requirements. This gold plating reflects government failure and creates a market inequality by restricting the ability of UK subsidiaries with a UK or EU parent from taking up a possible audit exemption and the associated cost savings.

What are the policy objectives and the intended effects?

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

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

Option 1: align audit with accounting exemptions for small companies; exempt subsidiaries from mandatory audit where they fulfil the Article 57 and additional criteria, and exempt dormant subsidiaries from all accounts preparation and filing requirements;
Option 2: align audit with accounting exemptions for small companies; exempt subsidiaries from mandatory preparation, filing and audit where they fulfil the Article 57 criteria, and exempt dormant subsidiaries from all accounts preparation and filing requirements;
Option 3: the status quo.

The Government's preferred option is Option 1 because it delivers significant benefits in terms of reduction of cost, whilst keeping an acceptable amount of accounting information on the public register. Option 2 is not favoured because while it would deliver financial benefits over Option 1, it would impose a large non monetised cost in loss of company financial information in the public domain.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** Month/**2017**

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** None		**Non-traded:** None

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: Jo Swinson Date: 14 August 2014

Summary: Analysis & Evidence Policy Option 1

Description: Align audit with accounting exemptions for small companies; exempt subsidiaries from mandatory audit where they fulfil the Article 57 and additional criteria, and exempt dormant subsidiaries from all accounts preparation and filing requirements.

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
2010	2010	10	**Low:** 2107.80	**High:** 4740.51	**Best Estimate:** 2687.33

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	60	3.1	**86.7**
High	150	7.7	**216.3**
Best Estimate	105	5.4	**151.5**

Description and scale of key monetised costs by 'main affected groups' Transitional costs for those choosing to take up this option are estimated at between £60m and £150m and will occur in the first year. These are largely one-off legal costs to those companies who choose to seek external advice about the operation of the parent company guarantee in the first year of operation. There is also a small one-off cost borne by Companies House (which operates as a trading fund) of amending its filing software which is estimated to be £50k. Ongoing costs include annual internal legal costs at the group level for 30,000 groups.

Other key non-monetised costs by 'main affected groups' Loss of comfort and possible other benefits provided by audit of accounts of qualifying small companies, of qualifying subsidiaries (or in the case of qualifying dormant companies, loss of comfort provided by preparing and publishing accounts) to shareholders, credit suppliers, suppliers, investors, taxation and regulatory authorities and companies themselves. Costs may also be incurred by a parent company under the guarantee when a creditor makes a claim against the parent.

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	270.0	**2324.1**
High	0	560.8	**4827.2**
Best Estimate	0	329.8	**2838.8**

Description and scale of key monetised benefits by 'main affected groups' Annual benefit to 22,000 to 31,000 qualifying small companies (£168m to 240m - best estimates at lower bound) and 41,500 to 62,250 qualifying subsidiaries (80m to 299m - best estimate £139.4m) in terms of unspent audit fees. Benefit of management time not spent by subsidiary companies on audit (3.3m to 5m – best estimate at lower bound). Benefit of management time no longer spent on preparation and filing of accounts of qualifying dormant companies £19m per annum. Calculations based on FAME data of number of qualifying companies and truncated mean of audit fees by company size and assumptions on take up and savings tested in consultation.

Other key non-monetised benefits by 'main affected groups' Possible reduction in cost of capital for those companies who choose voluntarily to have an audit.

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

Assumptions: take up of small company audit exemption 60-85% based on take up of current exemption and Collis external research; internal management saving of minimal two hours per company following consultation; take up of subsidiary audit exemption 50-75% based in part on experience in other EU countries and stakeholder discussions; a subsidiary company taking advantage of an exemption from mandatory audit would save 10% - 25% of its total annual audit fee, and five hours of senior management time based on stakeholder views. We assume parent company needs 4-10 hours internal legal/consultancy advice in form of guarantees per year and one-off external legal advice to the value of £2k to £5k per group of subsidiaries; accounts preparation cost of each dormant company £280 using PWC admin burden data; and number of companies and subsidiaries is assumed to remain constant over time.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:						In scope of OIOO?	Measure qualifies as
Costs:	17.2	**Benefits:**	321.4	**Net:**	304.3	Yes	OUT

Evidence Base (for summary sheets)

Problem under consideration

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

The Government identified in the March 2011 Plan for Growth[1] that over time, financial reporting and audit requirements and the costs which these impose on UK business have increased, and the Government has identified opportunities to make changes which support growth. Businesses have stressed that UK audit requirements could be applied in a more targeted and flexible manner to reduce compliance costs without significant impacts on disclosure and verification objectives. Options exist as detailed below in the 4th Directive 78/660/EEC to reduce the cost of audit and accounts preparation. In fulfilment of the Coalition programme, the Government has now decided to take advantage of some of these options.

Rationale for intervention

Although the UK has adopted many of the available exemptions in the 4th Directive there remain some elements of gold-plating in relation to both small companies and subsidiaries which reflect historical concerns about the risks posed by these companies not having their accounts audited. By removing this gold-plating we will be addressing an element of government failure which currently imposes unnecessary costs on business.

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

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

(b) reducing the costs to subsidiary companies by allowing those that qualify to be exempt from audit of their annual accounts; and,

(c) reduce the costs to qualifying **dormant** subsidiary companies by allowing those that qualify to be exempt from preparation and filing at Companies House of their annual accounts.

Alignment of audit exemptions with accounting exemption for small companies

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

Number of employees: no more than 50
Balance sheet total: no more than £3.26 million
Turnover: No more than £6.5 million

If it qualifies as small, a company is able to take advantage of a simplified form and content of the annual accounts that it prepares and files. However, under s477 CA06 such a small company is only able to take advantage of an exemption from statutory annual audit if meets both balance sheet **and** turnover criteria. The Government has now decided to amend UK law to enable a company to obtain the audit exemption if it meets **any two** out of the three criteria (number of employees; balance sheet total; and turnover). This will bring the small company audit criteria into line with the small company accounting criteria, and hence simplify the operation of the thresholds. Those companies that are currently excluded from the small company audit exemption under s478 CA06, such as public companies, insurance companies and banking companies will continue to be so excluded. Safeguards in company law to

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

protect minority shareholders will continue to apply: s476 CA06 allows shareholders holding at least 10% of the share capital to require an audit.

The Government will also make similar amendments to allow small groups to apply the same rules.

Currently, in the UK, 1,398,400 (86.3%) of non-dormant companies do not have their individual (i.e. non-group) accounts audited[2]. After this proposed alignment of audit with accounting thresholds the number eligible for the exemption will increase by 36,000, and with an average audit fee for these firms of £7.7k (based on analysis of the FAME database) there is the potential for significant savings in audit costs under both options 1 and 2.

The decision by the Government to take up this exemption is a continuance of the historical process in the UK of such exemptions being granted by the EU and implemented in stages over a number of years by the UK to minimise the risks of systemic misstatement in the accounts of audit exempt companies, harming shareholders and third parties. In 1978, the Fourth Directive (78/660/EEC) introduced an audit requirement but gave Member States the option to exempt small companies from it recognising that there was little value in imposing such a regulation on small companies with few shareholders or creditors who might benefit from this additional assurance. The Government did not take advantage of this option until 1994 (SI 1994/1935). Then, small companies with a turnover of £90,000 or below were exempted from the requirement to have an independent audit. The turnover criterion was increased to £350,000 in 1997 (SI1997/936), to £1m from 2000 (SI2000/1430), and to the EU maximum of £5.6m (SI2004/16) in 2004. In 2006 the EU raised the net turnover threshold to €8.8m and the UK raised its threshold in line with this to £6.5m in 2008. There have been no serious concerns raised as a result of the introduction of the audit exemptions and external research[3] shows that companies close to the threshold and larger small companies have continued to have their accounts audited.

Those companies choosing to continue with a voluntary audit have done so because creditors or shareholders have insisted upon it, in order to maintain consistency with earlier accounts or because they are close to the small company threshold.

The Government's view is that extending the audit exemption to encompass more companies will not cause significant deterioration of the quality of financial information. This view is supported by informal stakeholder discussions and by a public consultation[4]. In any case small companies tend to have very few shareholders and their main creditors are HMRC and banks. HMRC has powers to ask for additional explanations and information, where it feels this is necessary. Banks will also be able to request companies to whom they lend for additional information or verification as a condition of their lending.

In the past some commentators have suggested that lack of an audit would prevent companies from raising finance. However, we do not believe alignment of the criteria for a small company for audit purposes with those for accounting purposes will prevent companies from raising finance, since these companies will remain free to opt for a voluntary audit, should they wish or should this be demanded by the market. There is no reason why the Government should impose the regulatory burden of mandating audits for those companies. In addition it must be noted that the financial information contained in the statutory accounts is not current (private companies normally have 9 months from the year end to file their statutory accounts at Companies House). The providers of finance are in a position to require a company to provide current financial information before deciding to do business with them.

HMRC considers that the audit provides an independent assurance as to the quality of the financial information in the financial statements. However, it does not rely solely on these, but is able to seek further information beyond the financial statements in order to satisfy itself as to the veracity of the information provided to it. The increased assurance of information to HMRC is therefore not in itself a sufficient argument for mandatory audit.

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

[3] *Directors' views on accounting and auditing requirements for SMEs*, Dr Jill Collis April 2008 (minor updates at November 2008) Department for Business (URN 09/601) http://webarchive.nationalarchives.gov.uk/20090609003228/http://www.berr.gov.uk/files/file50491.pdf (Published 13 March 2009)

[4] http://www.bis.gov.uk/Consultations/audit-exemptions-and-accounting-framework?cat=closedawaitingresponse URN 11/1193

Reduction in the costs of subsidiary company accounts[5]

Article 57 of the Fourth Directive 78/660/EC provides Member States with the option to exempt qualifying subsidiaries from the requirement to prepare, audit and publish annual accounts where all of the following conditions are met:

- the subsidiary has a parent registered in the EU;
- the parent must have declared that it guarantees the commitments entered into by the subsidiary and this declaration must be filed at Companies House;
- the subsidiary's shareholders unanimously must have declared that they agree to dispense with an audit and this declaration must be made in respect of every financial year and must be filed at Companies House;
- the subsidiary must be included in the consolidated accounts drawn up by the parent undertaking; these consolidated accounts and the consolidated annual report must be audited and filed at Companies House; and
- the exemption must be disclosed in the notes to the consolidated accounts drawn up by the parent undertaking.

Currently the UK does not take advantage of any of these exemptions for subsidiary companies, which has led to a position of gold-plating of audit and accounting regulation. The Government's view, supported by stakeholder discussions and public consultation, is that the audit of subsidiary accounts adds little value but imposes significant costs on the companies affected. (The average cost of audit for these companies ranges from £8k for small companies to £83k for large companies[6]). The group accounts of the parent company, into which the subsidiary accounts are consolidated, are subject to mandatory audit.

For the financial year for which no audit report is produced, in place of the audit report, creditors of the subsidiary in relation to whom liabilities arise in that year will benefit instead from a parent company guarantee. The words of the Directive are that "The parent undertaking must have declared that it guarantees the commitments entered into by the subsidiary undertaking." The Government will, as far, as possible, copy out the text of the Directive with minor modifications to minimise uncertainty and reflect the Government's additional policy requirements. The Government has decided that any parent company guarantee issued will be irrevocable and must be in respect of all debts and liabilities of the subsidiary in respect of the financial year for which an exemption from audit is sought. The guarantee must be renewed annually.

For a dormant subsidiary company (defined in s1169 Companies Act 2006 as one in which no significant have accounting transactions have taken place in the past year) the preparation and filing of accounts for the public record is thought to provide little additional information given the lack of trading activity. The dormant company will still appear on the Register at Companies House and will continue to file an Annual Return. The Annual Return discloses, amongst other information, the names of the directors, which appears to be a key reason that their accounts are searched. It is proposed that the Annual Return would also disclose that the company was dormant.

A twelve week consultation was launched on 6 October 2011 which sought opinions on these proposals. 60 responses to the consultation were received, with the majority of responses received from accounting firms and bodies, but responses were also received from large corporate firms, bodies representing preparers and users of accounts, business information providers, and individuals. A summary of responses to the consultation was published on 2 March 2012[7]. Respondents were broadly supportive of the proposals and welcomed the increased level of flexibility and the reduction in the regulatory burden offered by the proposals. To the extent that concerns were raised, they were primarily raised by accounting firms with regard to the proposed take-up rate of the audit exemption for qualifying non-dormant subsidiaries and the proposed level of savings available for subsidiaries.

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[5] Subsidiary defined as a company or LLP whose parent undertaking owns >50% of voting rights.

[6] Based on analysis of Bureau van Djik FAME database of active UK subsidiaries with a UK or EU ultimate holding company. Audit cost figures quoted are averages (in each case this is the mean, though it has been truncated to exclude significant outliers).

[7] http://www.bis.gov.uk/Consultations/audit-exemptions-and-accounting-framework?cat=closedawaitingresponse URN 12/609

Policy objectives

The policy objectives are:

- to be more targeted in applying rules on company reporting, accounting and audit in order to reduce the burden of regulation on companies;
- to recognise the public interest in having an amount of accounting information about active companies on the public record; and,
- to implement the Government's commitments in the Plan for Growth, published in March 2011.

Description of options considered (including do nothing)

Option 1 (Take up some exemptions under Articles 51(2) and 57 subject to certain additional conditions)

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

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

- Align the audit with the accounting exemption for small companies (same as Option 1).
- Exempt a subsidiary company or dormant subsidiary company **from mandatory audit, mandatory filing of accounts and mandatory preparation of accounts** where the subsidiary fulfils all the conditions set out in Article 57. The exemption from preparation and filing is therefore far wider than under Option 1, where there is (for non-dormant companies) only an exemption from audit. Under Option 2, qualifying subsidiaries would therefore not produce any annual accounts at all. (All dormant companies are already exempt from audit). Unlike Option 1, there are no additional conditions, so companies in the financial sector and quoted subsidiaries would not specifically be excluded from taking up these exemptions. However the Transparency Directive (2004/109/EC) requires all companies whose shares are traded on a regulated market to be audited so in practice quoted subsidiaries would continue to be subject to audit. The regulators responsible for companies regulated under the Financial Services and Markets Act 2000 have informed BIS that, because it is in the public interest that such companies are subject to greater regulation, they would reimpose any preparation, filing and audit requirements that would have been removed if Option 2 had been implemented. Furthermore, as HMRC uses much of the information contained in statutory accounts, subsidiaries would still have to prepare and provide this information to HMRC.
- Same rules will broadly apply to Limited Liability Partnerships ("LLP") and unregistered companies.

Option 3 (Do nothing)

Do nothing

Other options were not considered plausible for the following reasons:

With regard to audit exemptions, Options 1 and 2 are the only options allowed by the EU Directive. All other exemptions have been implemented (see page 4 for further detail).

An option to align only the audit with the accounting exemption and not take up the Article 57 exemption would not be consistent with the desire of the Government to end "gold-plating" of EU rules in this area.

Different combinations of the exemptions (preparation, filing and audit) for each of dormant and non-dormant subsidiaries, with exclusion or non exclusion of finance subsidiaries would add a further eight options and make the impact assessment and consultation document more difficult to understand.

Costs and benefits of each option (including administrative burden)

The figures for estimated benefits have been revised downwards since the earlier consultation version of the impact assessment to exclude some unintentional double counting of subsidiary audit cost savings and to reflect the changes in assumed levels of take up of the audit exemption by subsidiary companies following the consultation. Other adjustments to the figures include the inclusion of internal management time saving by newly eligible small companies and introduction of annual legal costs at the group level for those subsidiaries taking up the audit exemption. These amendments are explained in more detail below and a summary table of the costs and benefits of options 1 and 2 are shown below on page 15.

Option 1 (Take up some exemptions under Articles 51(2) and 57 subject to certain additional conditions)

Benefits

- **Saving the cost of the audit – small companies**

The consultation provided strong support for aligning the audit and accounting thresholds (73% of respondents in favour) though those objecting were concerned about some sizeable entities no longer being subject to audit. The number of additional private small companies that now qualify as audit exempt is 36,314 based on analysis using the FAME database[8] which provides information on the population of all UK registered companies.

Audit fee saving

The assumed audit fee saving in this IA is £7,700 per company. This is based on FAME analysis of the audit fees of these 36,314 qualifying companies. The figure is a truncated mean of those fees. All companies are obliged to file statutory annual accounts at Companies House. These accounts are required by law to include a note specifying the audit fee[9]. The FAME database contains all the information contained in the filing. The amount of £7,700 therefore represents an accurate reflection of the average audit cost for this affected sample of companies. The earlier impact

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

[9] Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI 2008/489 as amended by SI 2011/2189) as any audit fee would have to be specified in a note to the accounts, that disclosure would also be within scope of the auditor's scrutiny and will therefore have been verified.

assessment which considered the 2008 increase in audit thresholds[10] used the same methodology but a cost of £5,000 per company based on the median small company audit fee at the time. The average audit cost used in this IA is higher for the following reasons:

- It uses the mean audit fee, rather than the median fee. The mean audit fee is significantly higher than the median because of the skewed distribution of companies. However, we have chosen to use the mean throughout this IA in calculating the savings to companies because statistically we believe this is the correct approach when multiplying the number of companies by the average saving. We have however used a truncated mean which excludes the most extreme outlying figures in the distribution. In the case of the mean audit fee for those small companies that would now be able to take up the small companies and groups audit exemption for the first time, we have excluded the largest 2.5% of audit fees in the distribution. **Annex 2** considers issues around the most appropriate way to truncate this mean and includes a sensitivity analysis for this truncation.
- Audit fees measured in the 2008 IA were from the FAME database measured at July 2006. These will have come from the accounts for companies with year-end December 2004. The current IA used FAME figures at May 2011, which will have come from accounts for companies with year-end December 2010. Audit fees have risen in six years.
- The audit fees in the 2008 IA were for <u>all</u> small companies showing an audit fee. These therefore included more smaller companies, with correspondingly lower audit fees, than the fees for the additional 36,314 companies, which we know meet either but not both of the turnover and balance sheet criteria.
- Some consultation respondents felt that the proposed audit fee saving was too high because it was difficult for companies to determine what constituted audit costs as distinct from accounting advice more generally. However, as stated above, the data used in the IA is not just an estimate, but is taken from statutory company accounts filed at Companies House, which are obliged to separately identify audit fees from other accounting fees. We accept the point that the total amount paid by companies to their auditor may not fall by the full value of the audit if the auditor is able to offer alternative services instead but this still represents a saving in discretionary spending to the company.

<u>Further investigation into auditee fee saving for those now likely to take up exemption</u>

To continue to investigate this issue we have undertaken an analysis of the sectors in which companies operate that would be eligible to take up the exemption for the first time. We have considered whether audit fees vary systemically according to the size of the client company. Further data explored in Annex 2 on the truncation of the fee distribution suggests that fees do not correlate well with asset size and there is significant variation within asset bands.

Annex 3 on characteristics of companies newly able to take up the exemption suggests a disproportionate number of companies in the property sector will be able to take up the exemption for the first time, perhaps because the assets they hold have up to now prevented them for taking up the small companies audit exemption. A sensitivity analysis for the effect of truncation of the distribution of companies by asset size on the mean audit fee is included in Annex 3. This approach was found to

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

be less effective than truncation of the distribution by audit fee, as discussed in Annex 2.

The above is as much as we have been able to establish about the characteristics of those companies likely to take up the small companies audit exemption as a result of the change. However, we have also investigated the characteristics of those small companies that are eligible for the existing audit exemption, but have not taken it up. **Annex 4** discusses this and includes a chart showing the distribution of companies by asset size previously taking up or not taking up the audit exemption.

The evidence does not suggest that those likely to take up the exemption are predominantly at the lower end of the audit cost distribution. Although we cannot conclude with certainty that all the companies that will be newly audit exempt will behave in exactly the same way, there is nothing in the analysis we have done to suggest that the take up amongst this group of slightly larger, but still small, companies will differ systemically from those small companies eligible for the existing exemption.

<u>Level of take-up</u>

If all eligible companies were to take up the exemption the annual cost saving would be £279.6 million (36,314 x £7,700). However, in line with earlier analysis of administrative burden savings we anticipate that some of this cost would be “business as usual” in that some companies choose to have their accounts audited regardless of their eligibility for exemption under company law. Some reasons why a company may opt for a voluntary audit are: they may not be aware that they have a choice; some suppliers, banks or lenders may require audited accounts; they are close to the threshold; they wish to apply for certain grants which oblige them have an audit; they are considering selling the business; for a trade sale.

The demand for audit amongst these smaller companies is therefore largely driven by external requirements rather than any benefits that might accrue directly to the company or indeed price. This is different to larger companies where the assurance and control provided by the audit might provide significant value to the company and its shareholder or creditors. The benefits of mandatory audit are therefore assumed to be limited for most of the small companies affected by this deregulation because the managers are much more likely to be the shareholders of the business, they will certainly have fewer shareholders and are less likely than larger companies to have requirements imposed on them by creditors or suppliers. This is supported by the evidence from the audit exemption already implemented where 86%, the vast majority, of companies have chosen to take up the exemption.

Evidence[11] from earlier consultations on implementing the audit exemption for small companies and stakeholder discussions all support the assumption that there is very limited value to audit amongst most of the affected companies. Furthermore most only voluntarily choose an audit when this is imposed on them by third parties[12]. Stakeholders[13] have also suggested that a large proportion of the current cost of the audit for these small companies covers the compliance costs of the auditor (necessary to retain the auditor’s own audit registration) rather than any added value service.

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[11] "Raising the thresholds" Society of Professional Accountants, October 2003

[12] Collis (2008) found that those who continued with a voluntary audit did so because banks or lender required an audit (44% agreed) or shareholders required an audit (33% agreed). The other major factor affecting the decision to have an audit was a desire for consistency with previous years' accounts (45% agreed). Whilst these results are not statistically robust they do give an indication of the major factors influencing the decision for a voluntary audit amongst smaller companies

[13] "The Business Journey - the arguments for and against having an audit" Michael Warner and Co, Chartered Accountants; Society of Professional Accountants as above.

Our simplifying assumption is therefore that there is a discontinuity in the willingness to pay for audit services in the population of affected companies with some willing to pay the full cost and the majority willing to pay zero. For the majority of companies the existing audit requirement represented a deadweight cost with very little or no benefit to the company – because it was not required by creditors or shareholders and provided no additional value over and above the services already provided by the external accountant. In practice, there may have been some residual benefit to companies and their creditors, shareholders and suppliers from mandatory audit which we have not accounted for. We do not believe it is feasible or proportionate to try to estimate such a benefit (see below for further discussion on proportionality). These therefore remain non-monetised costs. For the reasons set out above we do not believe that these benefits are significant for most companies.

That minority of companies which does choose to take up an audit voluntarily is assumed therefore to differ in some way from the first group of companies above in that there is some external requirement on them to have an audit, they are close to the threshold for small companies, or may be considering a trade sale. We assume no benefit to these companies from removing the audit requirement.

Upper and lower bounds and best estimate for level of take-up

From the figures given above around 85% of companies currently eligible have so far chosen to take up the existing small company audit exemption, although the Collis study which considered slightly larger small firms found the level of take-up to be lower at around 60%. Using these estimates of the upper and lower bounds of likely take up suggest assumed annual benefits are:

(£279.6m x 60% = **£167.8m**) **to** (£279.6m x 85% = **£237.7m**).

Given that this extension of the audit exemption will be covering the larger small companies, and wanting to be conservative, we have used the lower bound as the best estimate of likely costs savings. Some respondents to the consultation such as a large accounting body commented that the take-up rate could be higher than 60% in practice, and so these savings may be underestimated. 59% of respondents did agree with the estimated 60% take-up rate as best estimate, with only 6% disagreeing, and 35% unsure.

Best estimate = **£167.8m**

- **Saving the cost of the audit – subsidiaries**

There was a mixed consultation response to the proposals to exempt qualifying subsidiaries from audit requirements, with accounting firms in particular being more sceptical of likely take-up and some respondents unsure of the outcome. There was however strong support from a number of very large companies who responded to the consultation.

Number of eligible subsidiaries

Of the population of 230k subsidiary companies with a UK or other EU parent, around 67k are already audit exempt because they are dormant and 69k are audit exempt because they are small companies within a small group (as defined by the Companies Act 2006). The number of additional subsidiary companies with a UK or other EU parent that would now qualify for an audit exemption as a result of these proposals is calculated at 83k based on analysis of the FAME database. This breaks down into the size bands set out in the following table. Using the FAME database it is then possible to identify the average audit fee for subsidiaries in that size band in order to calculate an estimate for the total audit fees paid by subsidiaries. This gives the maximum potential total fees that could be saved:

Table 1: Calculation of maximum potential savings in audit fees to subsidiaries who take up audit exemption

Size of subsidiary	Numbers of subsidiaries eligible to take up exemption	Average audit fee for subsidiaries of this size	Total estimated audit fees
Small	56,000	£8,000	£448m
Medium	16,000	£14,500	£232m
Large	11,000	£83,000	£913m
TOTAL	83,000		£1,593m

All of the above figures are rounded to the nearest thousand apart from the average audit fee for medium sized subsidiaries. This figure for the maximum total potential saving of £1593 million can then be used as the basis for calculating an estimated actual saving given limitations on the proportion of the subsidiary audit fee that is actually saved and on the level of take up by subsidiaries.,

Proportion of subsidiary audit fee saved by the group

Discussions with stakeholders suggest that it is unlikely that all of this cost would be saved as a result of the audit exemption given the additional audit costs that would be incurred at the group level. Subsidiaries will continue to be included in the group audit, and thus some audit work will still be required at the subsidiary level.

The calculations below recognise that there would continue to be significant audit costs at the group level. Informal discussions with stakeholders suggested this saving could be in the range of 10-25%, and having consulted on the likely scale of savings, we believe this to be a valid estimate. Only 11% of respondents expressly disagreed with this estimate and 43% agreed, with agreeing respondents including all large corporate firms. We have therefore calculated benefits based on savings of 10% to 25% of the mean audit fee, with a best estimate of 17.5% to reflect the uncertainty amongst stakeholders about the likely level of savings.

Level of take up

We believe that most eligible subsidiaries will wish to take up the exemption given that there is little or no advantage to them to continue to have their individual accounts audited where no statutory requirement exists. Experience in some other European countries where the article 57 exemptions have existed for much longer suggests that there is significant appetite for the use of the parent guarantee.[14] However, this may to some extent depend on the details of the form and application of the parent guarantee and the individual circumstances of the subsidiary and parent companies.

We initially assumed a take-up rate in the range of 75-100%, however following consultation on the likely scale of the take-up and in order to reflect concerns expressed over the willingness of companies to avail themselves of this exemption, we have decided to reduce the assumed take-up rate. Respondents who disagreed largely felt that the costs and risks associated with the provision of such a guarantee may outweigh the benefits in terms of the loss of the limited liability status of a

[14] In Ireland over 50% of subsidiaries file section 17 accounts which take advantage of the accounts filing exemption. Relevant data from other European countries is unavailable.

subsidiary availing of the exemption, the need for legal advice, and the marginal level of savings. Such concerns, however, were primarily raised by accounting firms and accounting representative bodies. All large corporate firms responding to the consultation expressed strong support for this proposal and further discussions with stakeholders have indicated that considerable savings might be achieved through subsidiaries availing themselves of the exemption from audit. A large corporate suggested that savings would be significant where subsidiaries already had a US GAAP audit, and in the case that such subsidiaries were neither regulated nor had employees, almost the whole UK statutory audit fee for each of these subsidiaries could be saved.

We have therefore revised our estimate of the take up rate to a range of 50-75%, though wanting to be conservative and consistently with the approach for the small companies audit exemption discussed above, our best estimate will be 50%.

Estimated range of potential savings via take up of subsidiaries audit exemption

Using the figure for the maximum potential saving from the subsidiaries audit exemption calculated in Table 1 and discounting this for the estimated partial savings and levels of take up above, we can calculate the following totals for the estimated annual benefits from the exemption. Discounting is calculated as follows:

(Total potential saving = £1,593 million) x % Take-up rate x % of audit costs saved

Table2: Potential Savings to Subsidiaries who take up audit exemption (£m)

Take-up Rate	% of audit cost saved		
	10%	17.5%*	25%
50%*	£79.6 million	£139.4 million	£199 million
75%	£119.5 million	£209.0 million	£298.6 million

The range of estimated benefits is therefore **£79.6m to £298.6m** in terms of annual audit cost savings.

Using our best estimates for the saving in the audit fee as a result of the exemption and for the take-up rate (both marked * in the table) , our best estimate for the overall saving resulting from the exemption is **£139.4 million**.

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

Small Companies

On the basis of responses to the consultation (64% of respondents disagreed with the view that there would be no management time savings including 80% of accounting respondents), we believe that internal management time savings can be made by small companies qualifying for the audit exemption. However, we estimate the level of these savings will be low. This is because in the case of most small companies the accounts will be prepared and audited by the same firm (77% according to Collis 2008). We have therefore assumed a management time saving of two hours per qualifying company. Using ASHE[15] data for hourly costs of corporate managers we calculate the annual savings for internal management time to be £11, giving a total of £22 for each small company. As 36,314 companies will be newly eligible to take up the small companies exemption, if we assume a 60% to 85% take

[15] http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-238620 Table 2.5a - Annual pay - gross 2010 (in Table 2 – Occupation). The lower decile wage rate has been used for calculating small company cost savings, the upper quartile wage rate for large and public companies and the median for medium sized companies. All have been uprated by 16% to reflect overhead costs.

up rate, this gives us the following range for the number of companies that would save management time if they took up the exemption:

(36,314 x 60% = **21,788**) **to** (36,314 x 85% = **30,867**) **companies**

This results in the following estimated cost saving:

(21,788 x £22 = **£480,000**) **to** (30,867 x £22 = **£680,000**)

As with the audit costs savings if we have assume a best estimate for the likely take up of the exemption is at the lower end of the 60% to 85% range, this gives a best estimate for the total saving in management time of **£480,000**.

Subsidiary Companies

For subsidiary companies that choose to take up the audit exemption there will still need to be an audit at the group level of the consolidated accounts which will entail some degree of internal management time to explain the internal controls of the business and answer the auditor's questions. This point has been emphasised by consultation respondents and supports the assumption below that savings in management time will be modest compared to the total time devoted to audit.

Therefore, on the basis of stakeholder discussions confirmed through the consultation process we have assumed that only five hours of senior management time will be saved per company. Using the same ASHE data for hourly costs of corporate managers as we did for the small companies exemption, this suggests a saving of £55 for a small company; £113 for a medium sized company and of £163 for a public or large company.

Table 3: Calculation of maximum potential savings in management time for subsidiaries who take up audit exemption

Size of subsidiary	Numbers of subsidiaries eligible to take up exemption	Estimated saving resulting from reduction in internal management time	Total potential saving
Small	56,000	£55	£3.1 million
Medium	16,000	£113	£1.8 million
Large	11,000	£163	£1.8 million
TOTAL	83,000		£6.7 million

Assuming a 50-75% take up rate then gives a total annual cost saving of:

(£6.7m x 50% = **£3.3m**) **to** (£6.7m x 75% = **£5.0m**)

A best estimate take-up of 50% therefore suggests an estimated saving of £3.3m

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

The number of dormant subsidiaries who would qualify for the exemption to prepare and file their accounts is 67k based on analysis of the FAME database.

We have assumed a 100% take up rate in relation to this exemption. This is for three reasons:

First, dormant companies are defined as those that haven't had an accounting transaction during the previous year. A company might remain dormant for a period of time during which it continues to exist only to hold assets. Dormant companies are already entitled to audit exemption in most cases, which they already take up in very large numbers.

Secondly, as a dormant company hasn't conducted any transactions, it can't really have any active creditors, or have any developing liabilities, which significantly reduces the probability that it might enter insolvency proceedings. This would usually be the point at which the limited liability of the company would have an effect ie on the creditors. For the new accounting exemption any creditors would be protected in any case by the parent company guarantees, so this very low insolvency risk is carried by the parent. As it is so low there is very little disincentive for the parent to put in place the guarantee that would allow the subsidiary to take up the exemption.

Thirdly, although the cost saving for a subsidiary taking up the exemption is small it is significant given its overall accounting situation.

On this basis, we think a 100% take up rate for those companies entitled to the exemption is reasonable.

We have used the PWC administrative burdens calculator[16] to estimate the likely saving from no longer having to prepare and file dormant company accounts (uprated in line with inflation to 2011 prices). The calculator was really a database of unit costs of administrative compliance covering all of the regulatory requirements that were in place at that time. As the data was assembled before the commencement of the Companies Act 2006, the references are to the equivalent requirements in the Companies Act 1985. The requirements would have been the requirement to prepare accounts under section 226, and 226A of the Companies Act 1985. In the admin burdens calculator this is identified specifically for dormant companies because the calculator puts together all the filing requirements for each type of company.

The total unit cost is £240.54, which when uprated from 2006 prices to 2011 prices is £280. We think this figure is reasonable. When it was quoted in BIS's consultation impact assessment we asked a specific question about its validity in the consultation document. This received a mixed response with a balance of opinion between those who thought the figure too high and those who thought it too low.

These figures give an overall annual saving for dormant subsidiaries of £280 x 67k = **£18.8m**.

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

Choosing to have an audit in voluntary audit environments has a clear effect in reducing the cost of capital for individual companies[17] because it provides a signal to outsiders that the company is confident enough in the figures in the accounts to allow them to be audited and is prepared to spend money on the audit. In voluntary audit environments[18], the bigger the company the more likely it is to have a voluntary audit[19]. In mandatory audit environments, some of this signalling effect is lost,

[16] The PWC Administrative Burdens Measurement calculator is no longer publically available however the Administrative Burdens Measurement Exercise Technical Summary is available at http://webarchive.nationalarchives.gov.uk/20070603164510/http://www.dti.gov.uk/files/file35995.pdf

[17] [17] Ahmed, Rasmussen, Tse *Audit Quality, Alternative Monitoring Mechanisms and Cost of Capital: An Empirical Analysis*, Texas A&M University August 2008; Melnick A. and Plaut S. (1995) *Disclosure costs, regulation, and the expansion of the private placement market; professional adaptation.* Journal of Accounting, Audit & Finance (Winter) 23-42.

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

[19] *Directors' views on accounting and auditing requirements for SMEs*, Dr Jill Collis April 2008 (minor updates at November 2008) Department for Business (URN 09/601)

because all comparable firms have to have an audit. However, this benefit is unquantifiable given the number of factors impacting on the cost of capital, and is considered an indirect benefit as affected companies will be free to choose to undertake an audit.

Total annual benefits of this option are therefore in the range of:

£167.8m + £79.6m + £0.5m + £3.3m + £18.8m = **£269.9m per annum to**

£237.7m + 298.6m + £0.7m + 5.0m + 18.8m = **£560.8m per annum**

… with a best estimate of:

£167.8m + £139.4m + £0.5m + £3.3m + £18.8m = **£329.8m per annum.**

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http://webarchive.nationalarchives.gov.uk/20090609003228/http://www.berr.gov.uk/files/file50491.pdf (Published 13 March 2009) (p.55)

Costs

- **Costs to a parent company under the guarantee when a creditor makes a claim against the parent** if that creditor's claim against the assets of the subsidiary had not been satisfied. This is more than a transfer of costs between the subsidiary and the parent because without the guarantee, the subsidiary would have been able to have relied on its limited liability status, and the unsatisfied creditors would not have been able to pursue the parent. The shareholders of the parent company will therefore bear the loss in this case through a possible reduction in value of their shareholding. We expect this cost to be negligible for most companies and where this is not the case the parent company is unlikely to offer the guarantee. Also any unanticipated cost to the parent company is likely to be offset by equivalent benefits to the creditors of the subsidiary.

- **Legal advice to parent to issue a guarantee for qualifying subsidiary -** The need for parent companies to take legal advice will depend on the details of the final regulations including the definition of the guarantee. We will primarily be using copy out to avoid gold plating of the Directive; however some amendments and additions will be made in order to protect both users and the UK economy. Further detailed discussions with stakeholders during the consultation and subsequently has led us to assume that there might be a one-off cost of external legal and tax advice at a cost in the range of £2k to £5k per group holding company when the guarantee is first developed and valued, and a requirement for ongoing annual internal legal/tax advice for parent companies to assure themselves that the guarantee remains appropriate and is valued correctly in the accounts. Analysis of the FAME database suggests that there are around 30,000 parent companies associated with the subsidiaries who would be eligible for the audit exemption under these proposals. This would suggest one-off costs of:

  30,000 x (£2k to £5k) = £60m to £150m in the first year of external legal and tax advice.

  Using ASHE data for hourly professional legal services[20] we have calculated ongoing costs of £102 to £256 per group for annual internal legal advice. This assumes, following consultation, a range of 4-10 hours of legal and tax advice. This gives a range for these ongoing internal costs across all eligible subsidiaries of 30,000 x (£102 to £256) = £3.1m to £7.7m per year if legal advice is sought.

  In all cases the best estimate is considered to be at the mid-point.

- **Loss of information on qualifying dormant companies whose accounts are no longer prepared and filed.** However, given the lack of trading activity by these companies we do not consider that this would be a significant loss of public information.

- **A cost of misstatement of subsidiaries' financial position** is not a cost, as unsatisfied debts will be guaranteed by the parent.

- **Loss of the benefit an audit can give** to help management manage and control the subsidiary should be noted, though it is not easily quantifiable.

- **Transitional costs to Companies House of adjusting their systems**

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[20] ASHE professional legal services hourly wage rate including 16% uplift for overhead costs (£22 x 1.16 = 25.6). 4 hours of legal advice therefore costs (4 x £25.6 = £102) and 10 hours costs (10 x £25.6 = £256).

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

- **Increase in tax compliance costs -** HMRC may increase its number of enquiries of those companies not conducting audits. However it is not currently able to estimate the increase in the number of such enquiries. Where such enquiries are launched HMRC estimates that this could increase tax compliance costs for those companies by 10% to 20%. However HMRC is currently unable to estimate the current level of those tax compliance costs.
- **Loss of income to accounting firms no longer undertaking audits**

  Although there will be a loss of income to accountancy firms no longer undertaking audits of qualifying small companies and subsidiaries we do not propose to include this as a cost to business given that the economy-wide impact is likely to be marginal as the accountants affected will instead shift their resource to the next most profitable activity and indeed may make good some of their income loss by providing companies with other more value added activities (see pages 20-22 below for a further discussion of these wider impacts) Furthermore, this represents a relatively small incremental change in the regime with an additional 120k companies eligible for audit exemption compared to the existing 1.4 million already exempt. (See further discussion of these issues on page 16).

Total monetised costs of Option 1 are therefore:

£3.1m to £7.7m per annum with a best estimate of £5.4m per annum

Plus transitional costs to business in the first year of £60m to £150m with a best estimate of £105m.

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

Benefits

- **Saving the cost of the audit for small companies that now qualify as audit exempt and for qualifying subsidiaries**

  With regard to the cost of audit for small companies, the savings available are the same as those estimated under Option 1. It is extremely unlikely that additional audit savings could be achieved under Option 2. The regulators responsible for companies regulated under the Financial Services and Markets Act 2000 have informed BIS that, because it is in the public interest that these entities are subject to greater regulation, they would reimpose any preparation, filing and audit requirements that would have been removed if Option 2 had been implemented.
- **Saving costs of management time interacting with the auditor**

  With regard to small companies, the savings available are the same as those estimated under Option 1. For the reasons outlined directly above, it is also extremely unlikely that any additional savings of the cost of management time interacting with the auditor could be achieved under Option 2.
- **Saving costs of management time to prepare and file qualifying subsidiary accounts**

  The saving in costs of management time to prepare and file qualifying dormant subsidiary accounts is as for option 1.

The number of non-dormant subsidiaries qualifying for the exemption from the preparation and filing of accounts is 152,000 (this includes those 83k who would newly qualify for the subsidiaries audit exemption in option 1 plus the 69k small subsidiaries that are already audit exempt because they are small companies - we are not including the finance subsidiaries excluded from Option 1). We have assumed the cost saving from no longer having to file subsidiary company accounts to be £70 per filing (based on PWC admin burdens data for a similar requirement). Assuming again a 50% to 75% take-up of the subsidiary exemption with a best estimate of 50%, this gives an annual cost saving of:

152,000 x £70 x (50% to 75%) = **£5.3m to £8.0m per annum**

…with a best estimate for the saving of **£5.3m**.

However, we have assumed that there will be no saving from the preparation of subsidiary company accounts. This is because the UK's tax legislation taxes companies on their individual accounts rather than their consolidated accounts, using as a starting point of the tax calculation the profits calculated in accordance with generally accepted accounting practice[21]. HMRC also uses much of the information provided in the statutory accounts. The subsidiary would therefore have to prepare and provide to HMRC this information. This would remove the cost saving of management time for preparation of accounts identified above.

This must be added to the £18.8m saving for dormant subsidiaries calculated under option 1, giving a range of:

£24.1m to 26.8m… with a best estimate for the of £24.1

- **Possibly reduced cost of capital for those opting for an audit (same as Option 1).**

Total annual benefits of option 2 are therefore in the range of:

£167.8m + £79.6m + £0.5m + £3.3m + £24.1m = **£275.3m per annum to**

£237.7m + £298.6m + £0.7m + £5.0m + £26.8m = **£568.8m per annum**

… with a best estimate of:

£167.8m + £139.4m + £0.5m + £3.3m + £24.1m = **£335.1m per annum.**

Costs

- The subsidiaries qualifying for exemption from filing accounts will range from large companies to very small and could even include some public companies (though not quoted companies, who are obliged to publish their financial statements under stock market rules). Therefore the potential loss of public information would be significant. When the Company Law Review consulted on this issue in 2000[22], the loss of information to creditors, employees and other interested parties if qualifying subsidiaries chose not to file accounts was objected to by a large number of respondents[23] including the ACCA, KPMG, Hermes Investment Management, Clifford Chance and the Institute of Credit Management. Their reasons given were: large companies employing thousands would not produce accounts: this would make it impossible for economists and analysts to understand what was

[21] See for example s46 Corporation Tax Act 2009

[22] "Completing the Structure" A consultation document from the Company Law Review Steering Group – November 2000 URN 00/1335 Paragraphs 10.19 onwards http://www.bis.gov.uk/policies/business-law/company-and-partnership-law/company-law/publications-archive

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

happening in the UK economy; company stakeholders, not just creditors, need access to published accounts and these promote competitiveness; information useful for mergers and acquisitions would be hidden and shield both excellent and poor performance; it was claimed that some foreign companies run their UK operations at a loss to undermine the domestic price structure and in the absence of accounts, such behaviour could not be challenged; non-publication of accounts would expose creditors more readily to fraud.

Although we have not been able to monetise the value of the information that would be lost under option 2 we have some information from Companies House on the extent to which company information on the register is accessed. Companies House website has around 500k hits a day and analysis undertaken in 2010 found that accessing annual accounts and checking financial information were amongst the top reasons given by customers accessing free and paid-for information (over a third of requests for paid-for information). Full accounts seem to be particularly highly valued by customers allowing them to make business decisions, undertake credit assessments, due diligence and assess customers/suppliers. In addition, Companies House supplies the contents of the register, including the details of the company accounts, to a number of commercial companies who then package the information to sell on to third parties (such as Bureau van Djik who supply BIS with access to the FAME database).

Whilst we have not been able to monetise the cost of this loss of information it is clear that it would represent a significant loss to a wide range of stakeholders. (See risks section below for a further discussion of the issues related to the loss of information and associated systemic risks, particularly with respect to financial services companies).

- Costs to a parent company under the guarantee when a creditor makes a claim against the parent if that creditor's claim against the assets of the subsidiary had not been satisfied (same as Option 1).
- Legal advice to parent to issue a guarantee for qualifying subsidiary. We have assumed that the number of affected groups is the same under both options 1 and 2 on the basis that the majority of the 11,000 additional financial subsidiaries are likely to operate within groups that include non-financial subsidiaries.
- Transitional costs to Companies House of adjusting their system. Companies House estimate this will be £50k (same as option 1)
- Some possible increase in tax compliance costs as a result of loss of audit (same as Option 1)

Therefore total costs are £3.1m to £7.7m (best estimate of £5.4m).

Option 3 (Do nothing)

Benefits

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

- Creditors and employees of companies qualifying for the audit exemption under Options 2 or 3 would continue to have the assurance of the accounts having a mandatory audit.
- Dormant subsidiary company accounts would continue to be prepared and filed at Companies House.

- Some small firms of auditors would not risk losing business as a result of fewer[24] audits being demanded.

Costs

- None

[24] *Directors' views on accounting and auditing requirements for SMEs*, Dr Jill Collis April 2008 (minor updates at November 2008) Department for Business (URN 09/601) http://webarchive.nationalarchives.gov.uk/20090609003228/http://www.berr.gov.uk/files/file50491.pdf (Published 13 March 2009) (p.43)

Table 4: Annual Costs and Benefits summary of Options 1 and 2

	Option 1 **£m per annum (best)**	**Option 2** **£m per annum (best)**
Reduced audit costs (small companies)	167.8 to 237.7 (167.8)	167.8 to 237.7 (167.8)
Reduced audit costs (subsidiary companies)	79.6 to 298.6 (139.4)	79.6 to 298.6 (139.4)
Reduced management costs (small companies)	0.5 to 0.7 (0.5)	0.5 to 0.7 (0.5)
Reduced management costs (subsidiary companies)	3.3 to 5.0 (3.3)	3.3 to 5.0 (3.3)
Reduced costs of preparing and filing company accounts	18.8 (18.8)	24.1 to 26.8 (24.1)
Total Benefits:	270.0 to 560.8 (329.8)	275.3 to 568.8 (335.1)
Annual costs of holding company taking internal legal advice	3.1 to 7.7 (5.4)	3.1 to 7.7 (5.4)
Net Benefits:	266.9 to 553.1 (324.4)	272.2 to 561.1 (329.7)

Risks and assumptions

The key assumptions in terms of likely take-up rates, potential cost savings, etc are set out in the analysis above and in the summary sheet for option 1. However, throughout the analysis there is a simplifying assumption that the number of companies qualifying for the audit and accounting exemptions in options 1 and 2 will remain constant. In practice the company population has grown over the last 10 years, particularly during the early part of the last decade but rather more slowly since 2006/07. Many of these new companies will however be small companies qualifying for the audit exemption under the existing regulations and to that extent this analysis may underestimate potential savings. The likely variation in the number of parent and subsidiary companies over time is unknown but it is unlikely to change substantially over the next ten years. We have had to make a simplifying assumption about the likely demand for audit for small companies in the absence of the regulatory requirement. This may mean that the benefits are slightly overstated as discussed in the costs and benefits section above. However, given the conservative estimate on the likely take up on the small company exemption and other non-monetised benefits we do not believe the impact assessment overstates the benefits of the policy which is clearly net beneficial.

Risks arising from the reduction of the number of companies audited

The purpose of the statutory audit is, through a report to the shareholders by an independent, qualified auditor, to reduce the risk of misstatement of financial statements. The potential risk therefore of reducing the number of companies subject to mandatory audit is an increase in misstatement of financial statements. However the Government believes that this risk is manageable because the effects of such misstatement would not pose a systemic risk to the economy: systemically important companies, such as quoted companies and those in banking and insurance, will continue to be subject to mandatory audit; We do not believe that there is a risk that the reduction in mandatory audit will prevent companies from raising finance, since these companies will be able to make a commercial decision to opt for a voluntary audit should they wish, or should this be demanded by the market. If the lack of audit led to material misstatement of profits in companies then this could potentially lead to a tax loss to the Exchequer. As stated above however, regulatory authorities such as HMRC are able to call for more information from taxpayers if they wish.

Risks arising from aligning audit with accounting exemptions

We believe that there are limited risks arising from the increased risk of misstatement of accounts or reduction in credibility of accounts which are no longer audited. The UK successfully introduced audit exemptions in 1994 for most small companies, as permitted by the Directive and there is no evidence of ill effects. In the UK, 1.4m (87%) of non-dormant companies do not have their individual (i.e. non-group) accounts audited[25] because they fall beneath the size criteria. After this change the number eligible for the exemption will increase by 36,000. Risks to shareholders are limited because the safeguards in company law under s476 CA06, which allows shareholders holding at least 10% of the share capital to require an audit, will continue to apply.

Risks arising from reducing the costs of subsidiary company accounts

There is no size limit on the subsidiary whose parent gives a guarantee, so large companies could now remain unaudited. However, since all shareholders of the subsidiary have to agree to this, there is no risk of oppression of minority shareholders. The parent company guarantee reduces the risks for creditors of the subsidiary. It will be for the parent company granting the guarantee to determine whether the risks of giving the guarantee outweigh the burden of the mandatory audit. The risk of adverse effects on the economy is reduced by the additional conditions in Option 1 that the subsidiary must not be listed and must not be in the financial sector. After this change, if all companies take up the exemption the % of subsidiary companies no longer having audits would represent 95% of the population. There is a risk that the creditors of the parent will be prejudiced when the guarantee is given: no declaration of solvency is being made by the directors of the parent company. However existing unsecured creditors are always in a worse position when their debtor takes on additional liabilities. The parent company will have to file the declaration of the guarantee on the public register (Companies House) so that creditors and shareholders are aware of the potential liability.

Since they are not trading it is not considered that there is any adverse risk in dormant qualifying subsidiaries no longer preparing or publishing accounts. Little public information will be lost from this change, since the accounts from the year(s) before a company became dormant will still be accessible on the public register.

[25] Companies House, Statistical Tables on Companies Registration Activities 2010-11, Table F2 in period 2010-11

Particular risks of Option 2 (Take up all exemptions)

Particular risks exist in relation to Option 2, since under this option all the exemptions (from preparation, audit and reporting) would be made available to all qualifying subsidiaries. The availability of accounts promotes competitiveness: the loss of transparency by removing from the public record, even in the case of large companies, the financial information that the accounts provide would be significant to those who use accounts of companies such as creditors, investment analysts, credit analysts, Trade Unions and employees. As set out above, this loss of information was objected to by a large number of stakeholders in response to the consultation in the Company Law Review of 2000. Information useful for mergers and acquisitions would be hidden and shield both excellent and poor performance.

Analysis from Companies House suggests that checking financial information is one of the key reasons given by customers accessing company information and of those paying to access the Companies House register over a third of enquiries were for company annual accounts. The majority of information accessed by customers in relation to both audited and non-audited accounts was rated as useful or very useful. This suggests that public information in relation to company accounts continues to be valued and its removal would represent a significant cost to the UK economy.

Option 2 would also permit qualifying companies in the financial sector to take up the audit exemption – this might have systemic risks. As a matter of public policy it is desirable that those companies regulated under the Financial Services and Markets Act 2000, are subject to the additional oversight that an audit provides. The regulators responsible for this sector have informed BIS that, because of the need for transparency in this sector for the benefit of consumers, it is in the public interest that these entities are subject to greater regulation. The regulators would find it necessary to re-impose any preparation, filing and audit requirements that would have been removed if Option 2 had been implemented. Consensus was achieved among respondents to the consultation (70% of respondents agreeing) that the additional qualifying conditions, imposed under Option 1, are required for the benefit of public interest and transparency. A significant number of respondents felt that allowing financial services subsidiaries to take advantage of the audit exemption would result in a threat to user confidence, an increase in the risk of fraud and error, and a decline in the quality and reliability of financial information.

Rationale and evidence that justify the level of analysis used in the IA (proportionality approach)

The impact assessment makes use of existing evidence on the level of take up of audit exemption by similar but smaller companies, research considering the reasons why companies might adopt a voluntary audit and reported evidence on levels of audit costs. Assumptions around levels of take up and likely savings have been estimated on the basis of stakeholder discussions and consultation feedback. We have not found any evidence to suggest that companies forced to have an audit under the current regulatory regime would lose any benefits which should be netted off the assumed gross savings. It is not considered proportionate or feasible to try to estimate such benefits given that this would require primary research and would rely on companies attempting to place a value on their willingness to pay for audit services, which is unlikely to produce statistically robust results.

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

Under the “One In, One Out” rule, whereby a measure that has a net cost to business must have a measure or measures of equivalent cost removed in order to be implemented, the net benefit present value of implementing Option 1 is £2,687.33m over the ten year period. As very nearly all the costs and benefits accrue to business (with the exception of the one-off costs to Companies House) the Equivalent Annual Net Cost to Business is -£304.3m. This represents a saving to business and is therefore an Out.

Wider impacts

The reduction of unnecessary burdens of reporting, accounting and audit is one element in the process aimed at putting the UK on a path to sustainable, long-term economic growth, by making the UK one of the best places in Europe to start, finance and grow a business. Tackling these problems should ultimately help to deliver growth through the greater availability of capital at a lower cost and through improved productivity and performance. These proposals will affect both audit firms, and the wider audit and accounting profession; however, we do not believe this impact will be overly significant. Further discussion of the potential impact of the proposals on the number of small audit firms can be found on pages 21 and 22.

Summary and preferred option with description of implementation plan

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

Specific Impact Tests

Statutory equality duties

The proposed changes are not expected to have any impact.

Economic impacts

Competition effects

Dynamics of the audit market

The structure of the audit market can be analysed by number of principals[26] in each audit firm as follows:

Table 5: Breakdown of numbers of UK audit firms according to numbers of principals at those firms

Number of principals in firm	1	2-6	7-10	11-50	50+
Number of firms	3917	3189	212	119	20

(source POB Key Facts, data at 31 December 2010)

The number of registered audit firms continues gradually to decline. (Source: Professional Oversight Board (POB) "Key Facts and Trends in the Accountancy Profession" June 2011[27] http://www.frc.org.uk/pob/publications/. The overall number of audit firms registered as at 31 December 2010 (7,457) is 22% lower than the number as at 31 December 2005 (9,548). The POB considers that this decrease can largely be explained by the increase in the mandatory audit threshold from 2004 which has resulted in a lower number of entities requiring an audit. There has been a 9% decrease in the number of sole practitioners between 2009 and 2010, and between 2005 and 2010 the number of sole practitioners has reduced by 33%, from 5,837 to 3,917.

The proportion of annual accounts filed at Companies House that are audit exempt has increased from 61.9% in 2004/05 to 71% in 2010/11. The reduction in the number of entities having an audit has meant that some firms have found that there is no longer a good business case for retaining their audit registration, merged with other firms or passed on this work to larger firms where there are greater economies of scale in relation to matters such as quality assurance and Continuing Professional Development.

The Collis Report[28] found that in 2006, 32% of her sample of small companies had chosen a voluntary audit for the benefits it brings to a company, and a further 7% had done so because they were close to the threshold.

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

OFT competition filter

The Office of Fair Trading Competition filter has been applied

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

It is likely to reduce the number of auditors in the market, if the demand for audit is reduced, although the data above demonstrates that it is reasonable to assume that some companies will continue to opt for a voluntary audit. If a large proportion of

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[26] Principals are Partners or Members of an LLP

[27] http://www.frc.org.uk/images/uploaded/documents/Final%20KFAT%20Report%20June%202011.pdf

[28] *Directors' views on accounting and auditing requirements for SMEs*, Dr Jill Collis April 2008 (minor updates at November 2008) Department for Business (URN 09/601) http://webarchive.nationalarchives.gov.uk/20090609003228/http://www.berr.gov.uk/files/file50491.pdf (Published 13 March 2009) (p.39)

eligible companies took advantage of the removal of the requirement to have an audit, it is possible that some registered auditors may review the need for their registration.

It will not limit the ability of auditors to compete.

It will not reduce auditors' incentives to compete vigorously.

Small firms impact test

As noted above in the Competition section, as a result of the Government's current proposals, some small audit firms may cease registration as a statutory auditor as demand decreases for their audit product. However, despite no longer being a registered statutory auditor as a result of the Government's proposals, such firms would continue to be able to provide other business services. These could include such as accounts preparation and taxation advice and in addition other business services which they may be currently be prevented from providing because of their position as auditor by the Ethical Standards of the UK Auditing Practices Board. It is therefore unlikely that the Government's proposals, insofar as they affect small auditors, will have any significant adverse impact.

The Collis Report (page 31) used data from a postal survey to show that 83% of SMEs used an external accountant to prepare their 2006 accounts for shareholders, filing and tax authorities. NB. This part of Collis' work did not deal with audit. The full range of non-audit services received was as follows:

Table 6: Breakdown of non-audit services received by small and medium sized companies from their auditors with percentages of companies receiving these

Service	% of small companies	% of medium companies
Preparing statutory accounts for shareholders and Companies House	77	88
Preparing accounts for tax authorities	56	66
Advice on accounting/auditing regulations	49	71
General advice on running a company	22	16
Bookkeeping or preparing periodic management accounts	17	10
Additional detailed annual accounts for management's use	16	19
Management advice in connection with the annual results	15	25
Preparing accounts for the bank/lenders	10	15
Advice on raising finance	4	7
Preparing accounts for major suppliers or customers	1	4

Page 42 of the Collis report examined the effect of the external accountant's total fees on companies who had stopped having their accounts audited since the higher exemption thresholds in 2003 were introduced. Companies were asked what effect this had on the total fees they paid to an external accountant. These findings must be treated with caution. They are not statistically significant (only 161 responses were received to this area of the survey, and they relied on a director's response to a postal questionnaire). Just over half the companies taking up the exemption (54%) claimed that they had not experienced lower total accountancy fees and in 2% of cases, fees had risen due to other services being supplied. A likely explanation for the 54% who claimed no change in total accountancy fees and the low reduction in fees where there was a decrease, is that the audit services carried out before the company took up the audit exemption were replaced by additional business advice services provided by the external accountant after the company took up the audit exemption. The data collected is set out below:

Table 7: Change in accountancy fees experienced by companies taking up the small companies audit exemption

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

Environmental impacts

The proposed changes are not expected to have any impact.

Social impacts

The proposed changes are not expected to have any impact.

Sustainable development

The proposed changes are not expected to have any impact.

Annex 1: Post Implementation Review (PIR) Plan

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

Basis of the review: [The basis of the review could be statutory (forming part of the legislation), i.e. a sunset clause or a duty to review , or there could be a political commitment to review (PIR)]; Given the uncertainty over the level of take up by the affected smaller companies and subsidiaries we will monitor the Companies House figures for companies filing audit exempt accounts annually. We will also review the operation of the audit exemption 5 years after the proposed changes come into force. However the EU is scheduled to review the 4th Directive in the short term, which may result in their changing the audit exemption thresholds.
Review objective: [Is it intended as a proportionate check that regulation is operating as expected to tackle the problem of concern?; or as a wider exploration of the policy approach taken?; or as a link from policy objective to outcome?] The object of the review is not to discourage audit, but simply to move the decision for qualifying companies as to whether to have an audit from Government to companies. The review would consider the number of additional companies taking up the audit exemption and the impacts of this change, including any ill effects on companies, auditors and their creditors/customers.
Review approach and rationale: [e.g. describe here the review approach (in-depth evaluation, scope review of monitoring data, scan of stakeholder views, etc.) and the rationale that made choosing such an approach] We will develop the methods that are most appropriate to the evaluation. This is likely to be a quantitative examination of the take up of the option.
Baseline: [The current (baseline) position against which the change introduced by the legislation can be measured] 2009-10 number of audit exempt companies 1,398,400 (representing 70.3% of all company accounts filed).Source: Company Register Activities 2009-10 Table F2 http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2009_2010.pdf
Success criteria: [Criteria showing achievement of the policy objectives as set out in the final impact assessment; criteria for modifying or replacing the policy if it does not achieve its objectives] Awareness by companies and their advisers of the availability of the exemption.
Monitoring information arrangements: [Provide further details of the planned/existing arrangements in place that will allow a systematic collection systematic collection of monitoring information for future policy review] Data collected by Companies House on number of companies claiming audit exemption.
Reasons for not planning a review: [If there is no plan to do a PIR please provide reasons here]

Annex 2: Small companies audit exemption – appropriate truncation of distribution of audit fees

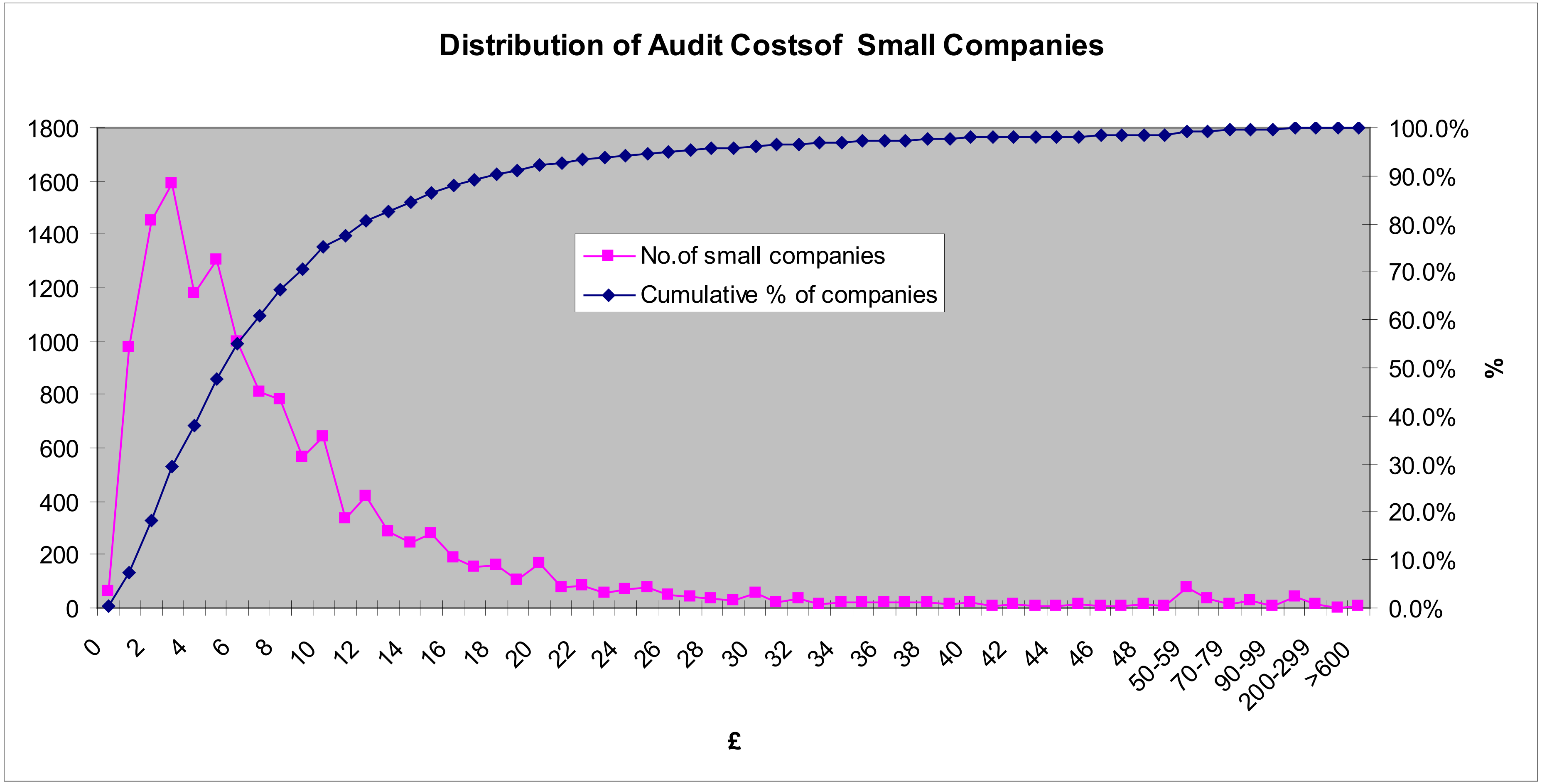
The table below represents a sensitivity analysis for the mean audit fee of those small companies that would be audit exempt for the first time following the amendment. It considers the distribution of the population of companies by audit fee and considers the effect on the mean of truncating the distribution to differing degrees.

Table 8: Sensitivity analysis for mean audit fee of population of small companies newly able to take up audit exemption (removing largest by audit fee)

	Mean audit fee
All companies eligible to take up small companies audit exemption following amendment	£9.9K
Exclude top 2.5% of audit fees (all above £37K)	£7.7K
Exclude top 5% of audit fees (all above £25K)	£7.1K
Exclude top 10% of audit fees (all above £17K)	£6.3K

The cut-off points were chosen by looking at the chart below which shows the distribution of companies newly exempt by audit fee (shown in £'000s along the bottom axis). Whilst the distribution is heavily skewed to the left there is a fairly fat "tail" to the right suggesting that this data is not spurious or completely atypical. This has been confirmed by further discussions with accountants in the field.

However, it could be argued that the very highest audit fees currently included are not realistic for this group of companies suggesting a truncation above a certain point. The sensitivity analysis shown above suggests that even if only 2.5% of observations are excluded we would lose all audits above £37k. This is a much more significant impact on the mean audit fee than is the case if the distribution is truncated by asset size (see Annex 3)


Distribution of Audit Costsof Small Companies
No.of small companies
Cumulative % of companies
1800
1600
1400
1200
1000
800
600
400
200
0
100.0%
90.0%
80.0%
70.0%
60.0%
50.0%
40.0%
30.0%
20.0%
10.0%
0.0%
%
0
2
4
6
8
10
12
14
16
18
20
22
24
26
28
30
32
34
36
38
40
42
44
46
48
50-59
70-79
90-99
200-299
>600
£

Annex 3: Small companies audit exemption – sectoral analysis and possible link with asset size

FAME analysis reveals that the 36,314 small companies that would, as a result of these proposals, be eligible for the audit exemption come from the following sectors:

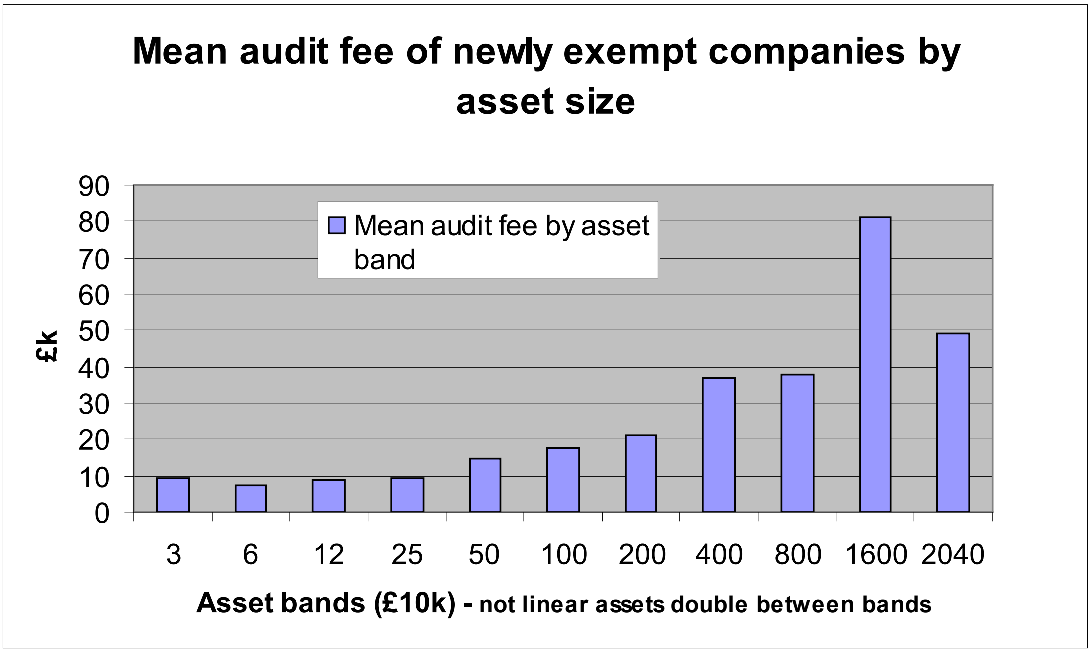
Table 9: Sectoral breakdown of small companies newly able to take up audit exemption

Sector	Count
Agriculture	232
Manufacturing	2,565
Mining	459
Construction	2,286
Motor trades	434
Wholesale	1,491
Retail	556
Hotels and catering	891
Transport	994
Post & Telecoms	195
Property	24,311
Education	50
Health	252
Public admin and other services	1,598
Total	**36,314**

We have also looked at the relationship between audit fee and assets for the newly exempted companies. This shows that, while there is some relationship between asset size and average audit fee(with larger companies having higher audit fee) it is not strong (with very significant variation within each asset band).

A higher audit cost may derive from the more extensive audit work that is required for larger companies on their transactions. However, such a such a cost could also be incurred by a company with low turnover or assets but whose transactions or disclosures were complex, resulting in higher risk of misstatement and a more extensive audit of transactions, systems and controls.

This has been confirmed by the Institute of Chartered Accountants (ICAEW). There will also be other variables including a change in the external financial circumstances of a company.



Finally, we did undertake a sensitivity analysis, not dissimilar to that undertaken for the purpose of Annex 2, to establish the extent to which truncation of the distribution of audit fees by assets would affect the mean audit fee:

Table 10: Sensitivity analysis for mean audit fee of population of small companies newly able to take up audit exemption (removing largest by asset size)

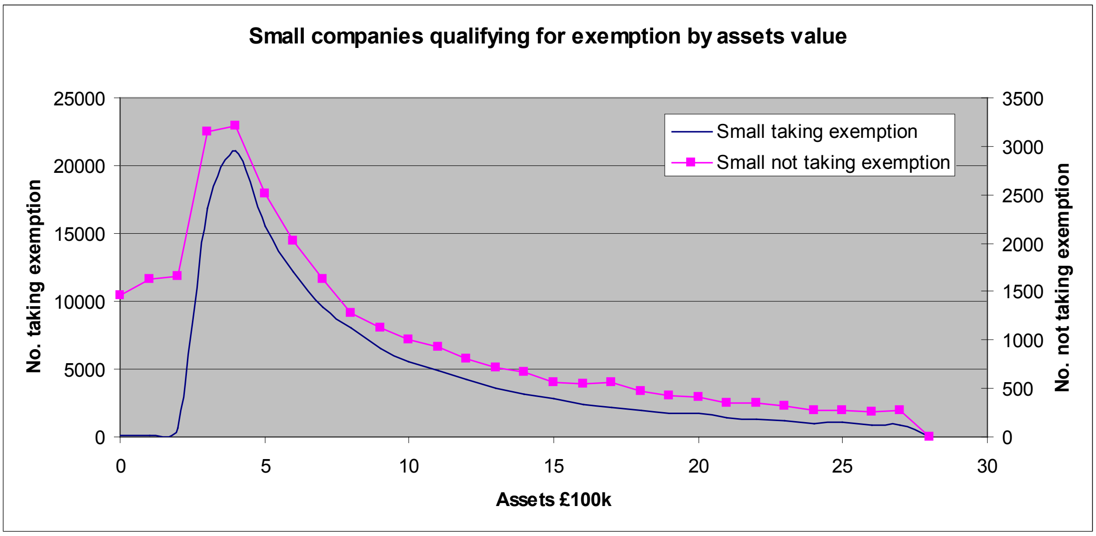
	Mean audit fee
All companies eligible to take up small companies audit exemption following amendment	£9.9K
Exclude top 5% of companies by assets	£9K
Exclude top 10% of companies by assets	£8.7K
Exclude top 15% of companies by assets	£8.4K

Comparing this table with the similar one in Annex 2 suggests that a truncation of the type considered above would not have been as effective a means of removing audit fees from the distribution that are too high to suggest that taking up the exemption is likely or that it would generate the saving anticipated.

Annex 4: Small companies audit exemption – previous take-up and non-take-up of the audit exemption

We have investigated the characteristics of those small companies and micro- companies that are eligible for the existing audit exemption but have not taken it up.

Take up rates for the current small company audit exemption are over 85% of those eligible, suggesting that there are benefits to a very wide range of companies. The chart below shows similar distributions by size of assets for small companies taking up the audit exemption and those that, while qualifying for audit the exemption, chose not to use it.



URN: BIS/14/1059