

These notes refer to the Companies (Audit, Investigations and Community Enterprise) Act 2004 (c.27) which received Royal Assent on 28 October 2004

COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) ACT 2004

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 1: Auditors, Accounts, Directors' Liabilities and Investigations

Chapter 2: Accounts and Reports

Auditing of accounts

43. The purpose of *sections 8* and *9* is to strengthen the rights of company auditors, by entitling them to require information and explanations from a wider group of people than previously; and by requiring the directors' report to contain a statement that the directors are not aware of relevant information which has not been disclosed to the company's auditors.

Section 8 - Auditors' rights to information

44. Under previous legislation (section 389A of the Companies Act 1985) a company's auditors were entitled to require from the company's officers such information and explanations as they thought necessary for the performance of their duties as auditors. It was a criminal offence for an officer of the company to provide misleading, false or deceptive information or explanations. However, it was not an offence for them to fail to provide any information or explanation that the auditors required of them.
45. This section is intended to help auditors to carry out their duties by strengthening their right to require information or explanations, with the aim of increasing the reliability of, and confidence in, company accounts.
46. It does this in two ways:
- it entitles the auditor to require information and explanations from a wider group of people. Specifically, it reflects a recommendation in the Company Law Review that those required to provide information and explanations to auditors should include employees (*Modern Company Law for a Competitive Economy*, Final Report July 2001, URN 01/942, paragraph 8.119 first bullet);
 - it makes it a criminal offence to fail to provide information or explanations required by the auditor.
47. *Section 8* substitutes *new sections 389A* and *389B* for the previous section 389A in the Companies Act 1985.
48. In *new section 389A*, *subsections (1)* and *(2)*:
- re-enact the auditor's right to access relevant material; and

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- add to the category of people from whom the auditor may require information. Auditors previously had the right to require "officers" of the company (which includes directors, managers and company secretaries) to provide information and explanations necessary for their work. However, others, in particular employees who are not "managers", may hold relevant information. Those to whom the requirement to provide information applies are set out in *subsection (2)*.
49. *Subsections (3)-(5) in new section 389A* re-enact previous provisions dealing with information and explanations concerning non-GB subsidiaries, extended to include employees and certain others. It is neither desirable nor effective to place a direct responsibility on a non-GB subsidiary and those associated with it to give information and explanations to a UK auditor. The responsibility is therefore placed on the parent company to do what is reasonable to obtain the required information and explanations from the subsidiaries.
50. *New section 389B* sets out criminal offences relating to the provision of information to auditors. *Subsection (1)* re-enacts the previous offence in section 389A(2) of the Companies Act 1985 of providing false or misleading information or explanations to an auditor. The subsection also applies this offence to the new categories of people from whom the auditor may require information under *new section 389A*.
51. There has previously been no criminal sanction where an officer of the company is required to give information but fails to do so altogether. *Subsection (2) of new section 389B* therefore introduces a new criminal offence for such a failure by an officer of the company or by the other persons from whom the auditor is entitled to require information or explanations.
52. *Subsection (3) of new section 389B* provides a person with a defence if he can prove that it was not reasonably practicable to provide the information or explanations required. *Subsection (4)* makes it an offence for a parent company to fail to take all steps reasonably open to it to obtain the information or explanations which the auditor has required it to obtain from its non-GB subsidiary and those associated with it; and the offence applies also to any officer of the company who knowingly and wilfully authorises or permits the failure.

Section 9 - Statement in directors' report as to disclosure of information to auditors

53. *Section 9* complements the auditors' rights to information provided by *section 8*. It requires the directors' report to contain a statement that so far as each director is aware, there is no relevant audit information of which the auditors are unaware; and that the director has taken all the steps he should have taken as a director to make himself aware of such information and to establish that the auditors are aware of it.
54. The aim of *section 9* is to ensure that each director will have to think hard about whether there is any information that he knows about or could ascertain which is needed by the auditors in connection with preparing their report. This derives from a recommendation in the Company Law Review (*Modern Company Law for a Competitive Economy*, Final Report July 2001, URN 01/942, paragraph 8.119 second bullet) that directors should be required to volunteer information to the auditors in certain circumstances.
55. *Subsection (2)* establishes the basic requirement for the new statement in the directors' report. It applies to all companies whose accounts have been subject to a statutory audit for that financial year. Under the law as amended by the [Companies Act 1985 \(Accounts of Small and Medium-Sized Enterprises and Audit Exemption\) \(Amendment\) Regulations 2004 \(SI 2004/16\)](#), most small companies with a turnover of £5.6 million or less and a balance sheet total of £2.8 million or less are exempt from the requirement to have their accounts audited.
56. *Subsection (3)* inserts a new section 234ZA into the Companies Act 1985. This sets out the content of the statement. The statement must confirm that each individual

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director is not aware of any relevant audit information of which the auditors are unaware (*new section 234ZA(2)(a)*); and that each individual director has taken steps to ascertain relevant audit information and establish whether the auditors are aware of it (*new section 234ZA(2)(b)*). Taken with *new sections 234ZA(4)* and *(5)*, *new section 234ZA(2)(b)* provides that the steps which the statement confirms have been taken by each director to make himself aware of relevant audit information and to ascertain the auditors' awareness of it are those required by the directors' existing common law duty to exercise due care, skill and diligence. *New section 234ZA(3)* defines "relevant audit information."

57. *New section 234ZA(6)* sets out the offence and sanctions that apply if a false statement is made. (If the statement is not made at all, the existing offence in section 234(5) of the 1985 Act - failure to comply with the provisions of Part 7 of the Act as to the contents of the directors' report - will apply.) The offence applies to each individual director who knew that the statement was false, or was reckless as to whether it was false, and who did not take reasonable steps to prevent the report from being approved. A person found guilty on indictment will be liable to imprisonment for up to two years and/or an unlimited fine, and on summary conviction to up to twelve months' imprisonment and/or a fine up to the statutory maximum (£5,000).

Defective accounts

Summary and background

58. *Sections 10-12* with *sections 14 and 15* deal with the enforcement of accounting requirements. They strengthen the role of the person authorised under section 245C of the Companies Act 1985 to apply to the court to order a company to revise its accounts. The person currently authorised is the FRRP. The statutory role of the Secretary of State or the authorised person has previously been restricted to examining companies' annual accounts and applying to the courts to order their revision as necessary. *Sections 10-12* and *14* and *15* enhance this regime in a number of ways: by (a) providing for a prescribed body (which will be the FRRP) to be appointed to monitor aspects of accounts or reports required under Listing Rules, such as interim financial statements; (b) providing for the authorised person and the prescribed body (the FRRP in both cases) to have a power to obtain information in order to carry out their functions; (c) opening an information gateway from the Inland Revenue to the FRRP.
59. In future the "Review Panel" (a body formed under the constitution of the FRRP) will be authorised under section 245C and also appointed under *section 14* to monitor aspects of accounts or reports required under Listing Rules. It is not envisaged that any other person or body is likely to be authorised or appointed. For that reason these notes refer to the FRRP or the Review Panel of the FRRP throughout, although the legislation itself does not name the FRRP.
60. Strengthening the role of the FRRP was a key recommendation of the Coordinating Group on Audit and Accounting Issues, one of the reviews set up by the Government in response to the financial reporting scandals in the US at companies such as Enron. The Group reported to the Government in January 2003. The changes to the role of the FRRP also need to be seen in the context of overall changes to the Financial Reporting Council Ltd and its associated companies, of which the FRRP is one.

Section 10 - Persons authorised to apply to court in connection with defective accounts

61. *Section 10* makes certain changes to section 245C of the Companies Act 1985 in relation to an order authorising a person to apply to the court to correct defective accounts. The person currently authorised under section 245C is the Financial Reporting Review Panel Ltd. It is expected that the person who will be authorised under *section 10* will be the Review Panel of the FRRP. Unlike the FRRP Ltd, the Review Panel is not an incorporated body but is formed under the constitution of the FRRP. *Section*

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10 provides that where the authorised person is an unincorporated association (as the Review Panel will be), any proceedings brought in connection with the exercise of its functions may be brought in the name of the body corporate whose constitution provides for its establishment. This means, for example, that the Review Panel may bring proceedings in the name of the FRRP Ltd. *Section 10* also makes alterations to the authorisation power under section 245C to allow the Secretary of State, if she considers it appropriate, to prescribe how the authorised person will exercise its functions.

Section 11 - Disclosure of tax information by Inland Revenue to facilitate application for declaration that accounts are defective

62. This section provides for the passage of information from the Inland Revenue (IR) to a person authorised under section 245C of the Companies Act 1985 and makes equivalent provision in Northern Ireland. That person is currently the FRRP. It adds new sections and Articles after section 245C of the Companies Act 1985 and Article 253C of the Companies (Northern Ireland) Order 1986. The new provisions permit the disclosure of information by the IR to a person authorised, under section 245C of the Companies Act 1985 and Article 253C of the 1986 Order, to apply to the court for a declaration that a company's accounts do not comply with the legislation in question. They also provide restrictions on use and further disclosure of the information.
63. *Subsection (1): 245D - Disclosure of information held by Inland Revenue to persons authorised to apply to court.* This subsection adds a *new section 245D* after section 245C of the Companies Act 1985, permitting the Inland Revenue to pass information to the authorised person if the disclosure is made for a permitted purpose. *Subsection (3) of new section 245D* defines what counts as a permitted purpose: to enable the authorised person to discover whether there are grounds for an application to the court, or to determine whether or not to make such an application. *Subsection (2)(b) of new section 245D* provides that personal data may not be disclosed in contravention of the Data Protection Act 1998. Under *subsection (4)* the Inland Revenue Commissioners may delegate the power to authorise disclosure to an officer of the Board of Inland Revenue.
64. *Subsection (1): 245E - Restrictions on use and further disclosure of information disclosed under section 245D.* *Subsection (1)* also adds a *new section 245E* to the Companies Act 1985, which places restrictions on the uses to which disclosed information may be put; and on further disclosure by the authorised person. Under *subsection (1) of new section 245E*, the uses to which the information may be put are to enable the authorised person to discover whether there are grounds for an application to the court, to determine whether or not to make such an application, and in proceedings on any such application.
65. *Subsection (2) of new section 245E* prevents information being disclosed by the authorised person to anyone else, except to the person to whom the information relates, or in connection with court proceedings. *Subsection (3) of new section 245E* makes it a criminal offence to breach the restrictions on use or further disclosure set out in *subsections (1) and (2)*, and should be read in conjunction with the amendments in *paragraph 10(3) of Schedule 2*, to Schedule 24 of the Companies Act 1985. A person guilty of use or further disclosure in contravention of the restrictions is liable on summary conviction to imprisonment for a term not exceeding twelve months or a fine not exceeding £5,000, or both; or, on conviction on indictment, to imprisonment for a term not exceeding two years or a fine, or both.
66. *Subsection (4) of new section 245E* provides a person with a defence if he can prove that he did not know or had no reason to suspect that the information in question had been disclosed under this legislation; or that he took reasonable steps to prevent wrongful use or disclosure.
67. *Subsection (5) of new section 245E* applies to offences under *new section 245E*, sections 723, 733(2) and (3) and section 734 of the Companies Act 1985. Section 732 concerns

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restrictions on the institution of proceedings for offences. Section 733(2) and (3) concern the liability of individuals for corporate defaults. Section 734 makes provision for criminal proceedings against unincorporated bodies.

68. *Subsection (2) 253D - Disclosure of information held by Inland Revenue to persons authorised to apply to court; and 253E - Restrictions on use and further disclosure of information disclosed under Article 253D. Subsection (2) inserts, after Article 253C of the Companies (Northern Ireland) Order 1986, two new Articles 253D and 253E whose purpose and effect, in respect of their application in Northern Ireland, are equivalent to that of new sections 245D and 245E discussed above, in respect of Great Britain.*

Section 12 - Power of person authorised to require documents, information and explanations; and Schedule 1 - New Schedule 7B to the Companies Act 1985

69. The FRRP (as the person authorised under section 245C of the Companies Act 1985) previously had no power to require a company to provide it with the information it needed to carry out its functions. Hitherto, it relied on the voluntary co-operation of the company in question to provide explanations and documents which were not publicly available.
70. The view of the Government and the FRRP was that with the FRRP moving to a more proactive approach, in which the FRRP would be considering more cases, such co-operation could not be relied on in every instance. Moreover, the Committee of European Securities Regulators has set out a number of key enforcement principles, including that any competent enforcement authority should have adequate powers. *Section 12* therefore provides the FRRP with a statutory power to obtain relevant material.
71. *Subsection (1)* inserts a *new section 245F* into the Companies Act 1985. *Subsections (1) to (3)* of this new section provide the FRRP with a statutory power to require a company and its officers, employees and auditors to provide documents and information. The effect of *subsection (1)* is that the FRRP may use its power to obtain information, explanations and documents only when it considers that there is a question as to whether the accounts or reports comply with the relevant requirements relating to that report or those accounts. It will not be able to exercise the powers as part of a random sampling or sector-wide review of accounts where there is no reason to believe there is any particular problem with the accounts of the company in question.
72. The person against whom the power is used must produce any document that the FRRP may reasonably require in relation to such accounts or reports or provide any relevant information that the FRRP may reasonably require. *Subsection (8)* ensures that a "document" can refer to information stored on computer as well as hard copies.
73. Where a person refuses to provide information or documents to the FRRP, the FRRP may apply to the court for an order. The court may make an order requiring disclosure. Failure to comply with such an order would be contempt of court.
74. *Restrictions on further disclosure of information obtained under section 245F.*
A *new section 245G* is also inserted into the Companies Act 1985, ensuring that information obtained by the FRRP under the new powers will be subject to restrictions on onward disclosure. Information may not be disclosed by the FRRP without the consent of the individual or business in question, except for the purposes of carrying out its functions, or unless it is disclosed to specified persons or for specified purposes set out in a *new Schedule 7B* of the Act which is inserted by *Schedule 1*.
75. *New Schedule 7B* sets out the disclosures of information obtained by the authorised person under *new section 245F* which are permitted under *new section 245G*. It lists the specified persons to whom disclosures are permitted and the specified descriptions of disclosures which are permitted. It also sets out the circumstances in which a disclosure to an overseas regulatory authority is permitted. Under *subsection (4)* of

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new section 245G, the Secretary of State has the power to amend the Schedule. Under *subsection (5)* the Schedule can only be amended to specify persons exercising functions of a public nature or to specify descriptions of disclosure, where the purpose for which the disclosure is permitted is likely to assist in the exercise of a function of a public nature.

76. *Subsection (7)* of *new section 245G* makes it an offence to disclose information in contravention of the new section. A person guilty of such an offence is liable on conviction on indictment to two years' imprisonment or a fine or both; and on summary conviction to twelve months' imprisonment or a fine. *Subsection (8)* provides a person with a defence if he can prove that he did not know or had no reason to suspect that the information in question had been disclosed under this legislation; or that he took reasonable steps to prevent wrongful use or disclosure.

Directors' reports

Section 13 - Power to specify bodies who may issue reporting standards

77. *Section 13* amends section 257 of the Companies Act 1985 which confers power on the Secretary of State to amend the accounting and audit provisions in Part 7 of the Act. It is primarily intended as a paving device to allow a specified body to issue a standard in relation to a new report, the operating and financial review, which it is proposed to require of directors in due course by regulations under section 257.
78. *New subsection (4A)(a)* inserted by *section 13* into section 257 gives the Secretary of State the power to specify a body to issue standards relating to reports which the directors are required to prepare under Part 7 of the Companies Act 1985. Directors are currently required to prepare a directors' report and, for the directors of a quoted company, the directors' remuneration report. This provision allows standards to be drawn up for these reports, and reports such as the operating and financial review, which are not covered by the "accounting standards" issued by bodies prescribed under section 256 of the Companies Act 1985. Such reporting standards would not have the "true and fair" authority of accounting standards. In order to confer statutory authority, *new subsection (4A)(b)* confers power on the Secretary of State to provide in regulations that compliance with the reporting standards will be presumed, unless the contrary is proved in civil or criminal proceedings for breach of the Act's requirements, to be compliance with the Act's requirements in respect of the report to which it relates.
79. Regulations under section 257 introducing the new requirement for an operating and financial review will be subject to affirmative resolution. *New subsection (4B)* inserted into section 257 stipulates that the order to be made by the Secretary of State specifying the body or bodies authorised to issue the new reporting standards will be subject to negative resolution.

Supervision of accounts and reports

Section 14 – Supervision of periodic accounts and reports of issuers of listed securities

80. *Section 14* provides the Secretary of State with the power to appoint a body (intended to be the Review Panel of the FRRP) to monitor compliance by issuers of listed securities, or certain classes of these issuers, with accounting requirements of the Listing Rules.
81. These rules are made and enforced by the Financial Services Authority (FSA). Under section 74(1) of the Financial Services and Markets Act 2000 (FiSMA), the FSA is required to maintain an official list. Under sections 74(4) and 96 of that Act, the FSA may make Listing Rules governing the admission of securities to the official list and specifying the requirements on companies and other entities which list securities.

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82. The section will allow the Government to create a role for the Review Panel in checking the financial information contained in some of the documents which are required to be produced periodically under Listing Rules: namely, the half yearly (interim) report and the annual report. Currently, the FRRP checks the annual reports of Companies Act companies only (it performs a similar function under Northern Ireland companies legislation). The section thus allows the Secretary of State to extend the scope of the FRRP's activities in two directions:
- she may appoint the Review Panel to look at interim reports and any other periodic reports required by Listing Rules, in addition to annual reports;
 - she may appoint the Review Panel to look at annual and interim reports of entities which are on the official list but are not Companies Act companies; this covers entities whose securities are listed in the UK but which are not UK companies, such as some UK building societies, as well as overseas companies and other entities. By virtue of *subsection (5)*, the body may be appointed in respect of certain classes of issuer only, and in respect of certain types of reports and accounts. For example, the power could be used to extend the Review Panel's remit to cover the accounts of overseas companies which have a primary listing in the UK, and the accounts of UK issuers which are not companies but which issue equities or domestic debt.
83. The section also allows the FSA to refer individual cases which may not fall within the Review Panel's remit (for example issuers of specialist debt) to the Review Panel for it to review. The FSA would conduct their own assessments and refer cases to the Review Panel only where they identified a risk in respect of the reports and accounts.
84. The section is drafted to allow maximum flexibility in these regards: negotiations in Europe (for example in the Committee of European Securities Regulators, and on the Transparency Directive) and internationally (on international accounting standards) may have an impact on the precise remit which will be set out in the order.
85. The Review Panel's function under this section will be to check that the accounting information contained in the accounts and reports complies with the accounting requirements of the Listing Rules, and to inform the FSA of any conclusions it reaches. The FSA will then decide what further action should be taken, and has a range of sanctions available to it under FiSMA 2000.
86. This will be in addition to the FRRP's existing activities in respect of annual accounts under section 245C of the Companies Act 1985, where the enforcement route is through an application to the court for an order requiring revised accounts.

Section 15 - Application of provisions inserted by sections 11 and 12 to bodies appointed under section 14

87. *Section 15* applies the provisions relating to the disclosure of information by the Inland Revenue in *section 11* to the body appointed under *section 14*. It also applies the provisions concerning the power to obtain documents and information and the restrictions on use of the information so obtained in *section 12* to the body appointed under *section 14*. The effect is that the Review Panel will have the same power, and the same access to IR information, in respect of its activity under *section 14* (checking interim reports and reporting to the FSA) as it will when exercising its remit under section 245C of the Companies Act 1985 (checking annual reports of Companies Act companies).

Bodies concerned with accounting standards etc

Section 16 - Grants to bodies concerned with accounting standards etc

88. Section 256(3) of the Companies Act 1985 allowed the Secretary of State to make grants to bodies concerned with the making and enforcing of accounting standards. The

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Secretary of State has paid grants under this section in respect of the work of the FRC and its companion bodies, the ASB and the FRRP.

89. Following the FRC's assumption of the functions of the Accountancy Foundation, its annual running costs will be broadly shared by Government, business and the professional accountancy bodies (with the exception of the costs of disciplinary cases, which will continue to fall to the professional accountancy bodies; and the costs of an independent audit inspection unit which will be borne by audit firms).
90. *Section 16* replaces section 256(3) of the Companies Act 1985 to allow the Government to contribute to the funding of any of the activities of a body which carries out the activities specified in *subsection (2)*. It is expected that the FRC will be the body to whom a grant will be made. *Subsection (4)* makes clear that a grant can be paid to a body in respect of activities carried out by its subsidiary, or any body established under the constitution of its subsidiary (such as a Board or a Panel).

Section 17 - Levy to pay expenses of bodies concerned with accounting standards etc

91. *Section 17* gives the Secretary of State the power to make regulations imposing a levy for meeting the costs of any body to whom the Secretary of State has paid or is proposing to pay a grant under *section 16*. The aim of the power is to ensure that the body to whom a grant is made under *section 16* – expected to be the FRC – will have security of funding; and it is anticipated that a levy would only be imposed if the currently voluntary funding arrangement was no longer viable.
92. In determining the appropriate rate of the levy, the Secretary of State must take account of the level of the Government grant paid, or expected to be paid, under *section 16(subsection (5))*. An amount payable by a person as a result of the levy will constitute a debt owed by that person to the FRC and be recoverable by the FRC as a debt (*subsection (6)*).
93. It is anticipated that should a levy be necessary, it would be imposed on:
 - listed companies; and
 - the members of the Consultative Committee of Accountancy Bodies (ICAEW, ICAS, ACCA, ICAI, the Chartered Institute of Management Accountants, and the Chartered Institute of Public Finance and Accountancy).

These bodies already contribute to the funding of the FRC under the voluntary funding arrangement.

94. The first regulations made in respect of the levy power - and any further regulations which change the persons or bodies by whom the levy is payable - will be subject to the affirmative resolution procedure of both Houses of Parliament (*subsections (10)* and *(11)*). Any other subsequent regulations will be subject to the negative resolution procedure (*subsection (12)*).

Section 18 – Exemption from liability

95. *Section 18* exempts a body receiving a grant under *section 16*, its subsidiary bodies and their members, officers and staff from liability in damages for things done or not done for the purposes of, or in connection with, the activities listed in *section 16* (which is in effect a list of the FRC's regulatory functions). It supersedes two previous exemptions: that enjoyed by a body authorised to apply to the courts in respect of defective accounts (the FRRP) under s245C(6) of the Companies Act 1985; and that available to a body to which the Secretary of State delegates her functions under Part 2 of the Companies Act

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1989 (expected to be the Professional Oversight Board for Accountancy of the FRC) under s48(3) of that Act. These two exemptions are therefore repealed.

96. *Subsection (1)* provides that an exemption from liability in damages applies when a grant has been paid to a body under *section 16*, and that it applies to acts or omissions occurring during the period of 12 months following the payment.
97. *Subsection (3)* provides for a body funded under *section 16*, its subsidiaries and their members, officers and staff to be exempt from liability in damages for things that they do or omit to do during the 12 month period since the grant was paid, for the purposes of, or in connection with, any of the activities listed in *section 16(2)*. The exemption would not apply to any non-regulatory activities conducted by the regulator (for example, providing vocational training on a commercial basis or compiling a database of Non-Executive Directors).
98. *Subsection (4)* sets out the circumstances when the exemption will not apply – that is to say, where the act or omission was in bad faith or where it was unlawful under section 6(1) of the Human Rights Act 1998.