EXPLANATORY MEMORANDUM TO

THE COMPANIES ACT 1985 (SMALL COMPANIES' ACCOUNTS AND AUDIT) REGULATIONS 2006

2006 No. 2782

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 These regulations amend the provisions on the types of companies that can take advantage of accounting, reporting and auditing exemptions in Part 7 of the Companies Act 1985 (the 1985 Act). They permit certain categories of companies and limited liability partnerships (collectively referred to as companies for ease of reference) regulated under the Financial Services and Markets Act 2000 (FSMA) to take advantage of these exemptions.

3. Matters of special interest to the joint committee on statutory instruments

3.1 None.

4. Legislative background

4.1 All companies are required by the 1985 Act to prepare annual accounts and to have those accounts audited. These requirements originate from EU directives.[1] However, small companies can take advantage of less onerous accounting and reporting requirements. Under section 246 of the 1985 Act they can prepare and file at Companies House less detailed accounts and reports. Small companies do not have to have their accounts audited (sections 249A and 249AA).

4.2 To qualify as small, a company must meet two of the following criteria (set out in section 247 of the 1985 Act):

- its turnover in a financial year is not more than £5.6m,
- its balance sheet total for that year is not more than £2.8m, and
- it has not more than 50 employees.

4.3 Section 249 of the 1985 Act sets out similar criteria for qualifying as a small group. Under section 248 the parent company of a small group does not have to prepare group accounts.

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[1] Fourth Council Directive of 25 July 1978 (78/660/EEC) based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ L222/11 of 14 August 1978. Seventh Council Directive of 13 June 1983 (83/349/EEC) based on Article 54(3)(g) of the Treaty on consolidated accounts, OJ L193/1 of 18 July 1983.

4.4 Under section 249A of the 1985 Act, a company is exempt from the requirement to have its accounts for any financial year audited if it meets all three of the following criteria:

- it qualifies as a small company in relation to that year,
- its turnover in that year is not more than £5.6m, and
- its balance sheet total for that year is not more than £2.8m.

4.5 Certain categories of companies are excluded from taking advantage of the accounting and audit exemptions, despite the fact that they meet the criteria set out above. The exclusions are set out in sections 247A, 248(2), 249AA(3) and 249B of the 1985 Act. Those that relate to financial services are of companies that: carry on an insurance market activity (as defined in section 316(3) of the Financial Services and Markets Act 2000 (FSMA)); have permission under Part 4 of FSMA to carry on a regulated activity; are appointed representatives under section 39 of FSMA and whose scope of activity is limited to activities that are regulated activities. "Regulated activity" is defined by section 262 of the 1985 Act as having the meaning given in section 22 of FSMA with certain specified exemptions[2].

4.7 These regulations amend the 1985 Act so that more small financial services companies are able to take advantage of the exemptions conferred by Part 7 of the 1985 Act.

4.8 Only those that are required to have an audit by European directives (for example banking and insurance companies) or that are subject to specific capital requirements imposed by European directives (for example, investment firms coming under the Investment Services Directive) will remain unable to take advantage of the exemptions.

4.9 It is the Government's intention that amendments corresponding to those made by these regulations be made to the equivalent provisions in the Companies Bill which is currently going through Parliament and which is expected to receive Royal Assent later this year. The amendments are initially being made by regulations under section 257 of the 1985 Act in order to allow the companies affected to benefit earlier than if the amendments were made only in the Bill. The regulations have been vetted by Parliamentary Counsel where they make textual amendments to the 1985 Act.

5. Extent

5.1 These regulations apply to Great Britain.

6. European convention on human rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

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[2] As amended by regulation 17 of the Companies Act 1985 (Investment Companies and Accounting and Audit Amendments) Regulations 2005, S.I. 2005/2280 and by article 26 of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2006, S.I. 2006/2383.

7. Policy background

7.1 The accounting, reporting and audit exemptions for small financial services companies engaged in certain mortgage and insurance mediation-related activities were restored in August 2005[3]. This led to consideration of whether it was appropriate to continue to require other small financial services companies to have their accounts audited.

7.2 There are some 4,690 small financial services companies that are required to have their accounts audited purely by domestic legislation, where the audit requirement is not based on an EU directive. The FSA has calculated that the audit requirement costs these companies between £10.1m and £15.8m annually in total.[4] It also potentially puts them at a competitive disadvantage to sole traders and partnerships, who can trade in the same market but are not subject to the 1985 Act requirement to prepare and have audited statutory accounts, and so do not have to bear this extra cost burden.

7.3 A requirement to have accounts audited does provide certain benefits in terms of consumer protection, market confidence and reduction of financial crime. However, the Government is satisfied that there are other measures in place to provide these safeguards. Most small authorised companies are subject to the FSA's Retail Mediation Activities Return (a half-yearly return that includes financial data and information on the conduct of the business). The FSA are not relaxing their quantitative capital resources requirements (the amount of capital the company is required to hold) imposed on these companies, nor the requirement imposed on certain companies to hold professional indemnity insurance. Any company that holds client money will still be required to have a client money audit. Under section 166 of FSMA, the FSA have powers to require a company to appoint a skilled person to report to the FSA on matters related to the firm; this may happen if the FSA believes there is a risk of regulatory failure, or on a random sample basis. Under section 249B(2) of the 1985 Act, company members holding 10% of shares are entitled to require an audit if they so choose. The delay between the coming into force date of the regulations and the effective date is to give members the opportunity to require an audit for current financial years. The Government does not consider that any additional protection provide by the statutory audit requirement in the 1985 Act justifies the cost burden on companies.

7.4 As a result of qualifying as a small company and being eligible for the audit exemption, the affected companies will also be eligible for certain other accounting and reporting simplifications. The cost saving from this is likely to be relatively small.

7.5 The change is not legally or politically important.

Commencement date

7.6 The regulations come into force on 8 November 2006, and the accounting and auditing exemptions they confer will be available for financial years ending on or after

[3] The Companies Act 1985 (Investment Companies and Accounting and Audit Amendments) Regulations 2005, SI 2005/2280.
[4] Consultation Paper 06/6, Financial Services Authority Quarterly Consultation (No. 8), 7 April 2006.

31 December 2006. The timing of the consultation by the FSA and the complexities of defining in the regulations the companies affected meant that it was not possible to meet the 1 October 2006 common commencement date. It is considered to be more beneficial for business to bring the measure into effect on 8 November 2006 than to wait for the 6 April 2007 common commencement date. If the regulations came into force then, the vast majority of the companies affected would be unable to benefit in their current financial years and would have to incur an extra year's costs.

Consultation

7.7 The FSA published a consultation document on 7 April 2006 that included this proposal.[5] Twenty-two responses were received on this proposal, from representative organisations, audit firms and companies involved in financial services. Three-quarters of those strongly supported the proposal. Those who disagreed with aspects of the proposal raised concerns about consumer protection issues. However, they did not disagree that the burden imposed by the audit was disproportionate to the risk or that small companies were not being treated on an equal footing to partnerships and sole traders. The Government is confident that the net level of consumer protection will not be compromised, in view of the other measures in place to provide consumer protection. Media interest in the proposal was limited (about half a dozen short articles, supportive or neutral in tone).

Guidance

7.8 Guidance has been published on the DTI website to accompany the regulations. The recommended 3 month gap has not been left between the guidance being published and the regulations coming into force. However, this should not cause problems for companies: there is a gap of nearly 2 months between the coming into force and the effective dates of the regulations; and the regulations do not require companies to do anything, but merely provide them with an option not to do something.

7.9 The guidance will also be available through the FSA website, an FSA newsletter to financial advisors and information to the trade press, and Companies House. The relevant trade body will be informed and asked to pass the information on to its members.

8. Impact

8.1 A Regulatory Impact Assessment is attached at Annex A.

8.2 There is no impact on the public sector as this Statutory Instrument only applies to companies.

9. Contact

Valerie Carpenter at the Department of Trade & Industry (telephone: 020 7215 0225 or email valerie.carpenter@dti.gsi.gov.uk).

[5] Consultation Paper 06/6, Financial Services Authority Quarterly Consultation (No. 8), 7 April 2006.

FINAL REGULATORY IMPACT ASSESSMENT

The Companies Act 1985 (Small Companies' Accounts and Audit) Regulations 2006

1. Title of Measure

1.1 The Companies Act 1985 (Small Companies' Accounts and Audit) Regulations 2006.

2. Purpose and Intended Effect

Objective

2.1 To reduce the cost of reporting for certain small financial services companies while maintaining an appropriate degree of protection for consumers, maintaining market confidence and continuing to reduce financial crime. The measure would give some 4,690 small financial services companies and limited liability partnerships (collectively referred to as companies for ease of reference) the option of not having their accounts audited, and of taking advantage of certain accounting and reporting exemptions. Most other small companies already have these options.

2.2 The measure comes into force on 8 November 2006, and the option will be available for financial years ending on or after 31 December 2006. The timing of the consultation by the Financial Services Authority (FSA) and the complexities of defining in the regulations the companies affected meant that it was not possible to meet the 1 October 2006 common commencement date. It is considered to be more beneficial for business to bring the measure into effect on 8 November 2006 than to wait for the 6 April 2007 common commencement date. If the measure came into force then, the vast majority of companies affected would be unable to benefit in their current financial years and would have to incur an extra year's costs.

2.3 The objective is linked to the Government's better regulation objective of reducing burdens on business in general, and on small businesses in particular.

Geographical scope

2.4 Company law matters relating to Scotland are reserved to the UK Parliament under the Scotland Act 1998. Those relating to Wales have not been transferred to the National Assembly for Wales under the Government of Wales Act 1998. Therefore any changes to company legislation will also apply in Scotland and Wales. Company law in Northern Ireland is currently a transferred matter under the Northern Ireland Act 1998. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland

Departments, subject to the direction and control of the Secretary of State for Northern Ireland.

Background

2.5 All companies are required by the Companies Act 1985 (the 1985 Act) to prepare annual accounts and to have those accounts audited. These requirements originate from EU directives.[6] However, small companies can take advantage of less onerous accounting and reporting requirements. Under section 246 of the 1985 Act they can prepare and file at Companies House less detailed accounts and reports. Small companies do not have to have their accounts audited (sections 249A and 249AA).

2.6 To qualify as small, a company must meet two of the following criteria (set out in section 247 of the 1985 Act):

- its turnover in a financial year is not more than £5.6m,
- its balance sheet total for that year is not more than £2.8m, and
- it has not more than 50 employees.

2.7 Under section 249A of the 1985 Act, a company is exempt from the requirement to have its accounts for any financial year audited if it meets all three of the following criteria:

- it qualifies as a small company in relation to that year,
- its turnover in that year is not more than £5.6m, and
- its balance sheet total for that year is not more than £2.8m.

2.8 Certain categories of companies are excluded from taking advantage of the accounting and audit exemptions, despite the fact that they meet the criteria set out above. The exclusions are set out in sections 247A, 248(2), 249AA(3) and 249B of the 1985 Act. Those that relate to financial services are of companies that: carry on an insurance market activity (as defined in section 316(3) of the Financial Services and Markets Act 2000 (FSMA)); have permission under Part 4 of FSMA to carry on a regulated activity; are appointed representatives under section 39 of FSMA and whose scope of activity is limited to activities that are regulated activities. "Regulated activity" is defined by section 262 of the 1985 Act as having the meaning given in section 22 of FSMA with certain specified exemptions[7]. Therefore, financial services companies that would otherwise qualify as small and

[6] Fourth Council Directive of 25 July 1978 (78/660/EEC) based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ L222/11 of 14 August 1978. Seventh Council Directive of 13 June 1983 (83/349/EEC) based on Article 54(3)(g) of the Treaty on consolidated accounts, OJ L193/1 of 18 July 1983.

[7] As amended by regulation 17 of the Companies Act 1985 (Investment Companies and Accounting and Audit Amendments) Regulations 2005, S.I. 2005/2280 and by article 26 of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2006, S.I. 2006/2383.

able to take advantage of the audit exemption cannot do so if they carry on any of these activities.

2.9 Certain categories of companies that are regulated under FSMA also fall within one of the Single Market Directives. These companies are required to appoint an auditor either because they are subject to an audit requirement imposed by a European Directive (for example those involved in banking and insurance activities), or because they are subject to specific capital requirements imposed by a European Directive (for example, investment firms coming under the Investment Services Directive) which require Member States to monitor on an ongoing basis their level of capital. In these cases where the audit requirement is based on a European Directive, it would not be possible to remove the requirements in domestic legislation without an amendment to the relevant directives. However, in other cases the requirement is purely domestic.

Rationale for Government intervention

2.10 Policy on accounting and audit requirements for companies rests with the Department of Trade and Industry (DTI). Policy on financial services rests with the Financial Services Authority (FSA) and HM Treasury. Regulations made in August 2005 to restore the accounting, reporting and audit exemptions to certain small financial services companies[8] led to consideration of whether it was appropriate to continue to require other small financial services companies to have their accounts audited. The FSA carried out a study and then a public consultation in April 2006 on extending the audit exemption to other small financial services firms. As a result, the Government has concluded that the exemptions should be extended to a wider group of companies.

2.11 To implement this, the 1985 Act must be amended to remove the prohibition on these companies from taking advantage of the exemptions. It is the Government's intention that the amendments will also be carried through into the Companies Bill which is currently going through Parliament and which is expected to receive Royal Assent before the end of 2006. The amendments are initially being made by regulations under section 257 of the 1985 Act in order to allow the companies affected to benefit earlier than if the amendments were made only in the Companies Bill.

3. Consultation

Within Government

3.1 Those involved with this proposal within Government were the DTI (responsible for accounting and audit requirements for companies) and HM Treasury and the FSA (responsible for financial services).

[8] The Companies Act 1985 (Investment Companies and Accounting and Audit Amendments) Regulations 2005, S.I. 2005/2280.

Public consultation

3.2 The FSA published a consultation document on 7 April 2006 that included this proposal.[9] They also issued a press notice specifically on this proposal, and informed the Association of Independent Financial Advisers (AIFA) and the accountancy bodies, who then informed their members.

3.3 Twenty-two responses were received on this proposal, from representative organisations, audit firms and companies involved in financial services. Three-quarters of those strongly supported the proposal. Those who disagreed with aspects of the proposal raised concerns about consumer protection issues. However, they did not disagree that the burden imposed by the audit was disproportionate to the risk or that small companies were not being treated on an equal footing to partnerships and sole traders. The Government is confident that the net level of consumer protection will not be compromised, in view of the other measures they have in place to provide consumer protection.

4. Options

4.1 The requirement for companies to prepare and have accounts audited originates in EU legislation. The Government has already taken advantage of the option to exempt most small companies from the audit requirement and certain other accounting and reporting requirements. Certain categories of financial services companies that would otherwise qualify for the exemptions are required by other EU legislation to have their accounts audited. There is no immediate scope for those EU requirements to be changed. Therefore, there is only one option that would meet the objective – to remove the audit requirement in the 1985 Act for those small financial services companies that are not required by EU legislation to have an audit. The other option is to do nothing.

Option 1 – Allow small financial services companies to take advantage of the exemptions where the audit requirement is domestic only and is not contained in an EU directive

Benefits

4.2 Small financial services companies that are affected by this measure can benefit from a saving in audit costs. In the April consultation document, the FSA estimates that the total number of companies affected is 4,690. The cost of a statutory audit for these companies is estimated to be between £2,150 and £3,370 per annum. This gives a total potential cost saving of between £10.1m and £15.8m per annum. Taking a central estimate of £2,760 per company, this gives an average cost saving of £12.9m per annum.

4.3 Some may of course choose to continue to have their accounts audited if they believe that the benefits of doing so will outweigh any disadvantages. Similarly, those that take advantage of the exemption are only likely to do so if they anticipate that the net benefits of doing so will outweigh the net benefits of having their accounts audited. It is a challenge to estimate how many companies will take up the option. However, based on figures included in a recent report by

[9] Consultation Paper 06/6, Financial Services Authority Quarterly Consultation (No. 8), 7 April 2006.

the Professional Oversight Board for Accountancy[10], it is estimated that 20% of small companies that could take advantage of the audit exemption choose to have their accounts audited. This data was based on the whole population of small companies (just over 1 million); it may be that those in a regulated market would be less likely to choose not to have their accounts audited, on the basis that the regulator may require the information at some point. However, if 20% of these 4,690 companies choose to continue to have their accounts audited, the total cost saving would be reduced by 20% to between £8.08m and £12.64m per annum, with an average cost saving of £10.32m per annum.

4.4 As a result of qualifying as a small company and now being eligible for the audit exemption, the affected companies will also be eligible for certain other accounting simplifications, further reducing the administrative burden on them. They are no longer required to provide as much information in their annual accounts, they can omit certain information from their directors' report, they do not have to file their directors' report at Companies House and they can file abbreviated accounts at Companies House (ie omitting the profit and loss account and filing an abbreviated balance sheet).

4.5 Since April 2005, all companies other than small companies have been required to include an extended fair review of the business in their directors' report.[11] The RIA on the regulations that introduced that requirement[12] estimated the cost of this for medium sized companies to be an average of £1000 per company per annum. As the fair review should be proportionate to the size of the business, it is reasonable to estimate a cost of £500 in management time per small company per annum, giving a benefit for these companies of an additional £2.35m per annum.

4.6 The cost saving from the other simplifications is likely to be relatively small. Small companies must still produce a directors' report and send it to their members. If they choose to file abbreviated accounts, they must still produce a full set of accounts for their members. And it may be that the cost of revising their accounting and computer systems to produce simplified small company accounts would partly negate annual cost savings from having to collect less information, at least in the first year.

4.7 Therefore, the DTI has calculated that the total quantified potential cost saving is between £2,650 and £3,870 per company per annum, with an average cost saving of £3,260. This gives a total potential cost saving of between £12.45m and £18.15m per annum, with an average cost saving of £15.25m. For a company with a turnover of £2.8m (in the middle of the exemption range of £0m - £5.6m), the average saving represents just over 1% of annual turnover.

4.8 It is likely that the money saved in audit fees and accounting and reporting costs will be redirected elsewhere. It may flow through to lower prices for

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[10] Financial Reporting Council - Professional Oversight Board for Accountancy. Review of how accountants support the needs of small and medium-sized companies and their stakeholders. March 2006.

[11] The Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005, S.I. 2005/1011.

[12] Final Regulatory Impact Assessment on the Operating and Financial Review and Directors' Report Regulations (SI 2005/1011), published December 2005.

consumers, or the directors may spend the money on things that they feel will be more beneficial for the business. However, it is impossible to generalise about how the money might be spent or about the long term impact of the cost saving.

4.9 There is also a potential competition benefit. The small companies affected are likely to be competing directly with small sole traders and partnerships, who are not subject to the 1985 Act requirement to prepare and have audited statutory accounts, and so do not have to bear this extra cost burden. The cost saving should allow the companies to compete on a more equal footing with those of their competitors that do not have to have their accounts audited.

Costs

4.10 There may be some costs to consumers as a result of this measure. There is an argument that statutory audit acts as an aid to consumer protection because an independent third party verifies that the figures are accurate and affords control over the possibility of inadequate financial resources. In the absence of a statutory audit, it is possible that the quality of financial information could diminish and firms could breach their regulatory requirements or become insolvent. In such cases, there may be inadequate resources available to deal with claims against the firm (for example to satisfy a claim for mis-selling where the company's insurance does not cover the full extent of the liability). As a result, costs to consumers might arise in the form of losses from mis-sold products or opportunity costs associated with the time spent obtaining redress.

4.11 The level of potential cost is difficult to quantify, as it would depend on how effective the statutory audit is in providing protection and the frequency and extent of any problems that may occur. The FSA's other safeguards against regulatory failure by financial services companies should reduce the frequency and extent of any problems as compared to a scenario where there were no other safeguards in place. It may be therefore that the potential cost to consumers is negligible.

4.12 There will be a cost to audit firms in the form of a reduction in revenue as a result of the loss of audit fees, of between £2,150 and £3,370 per audit (an average of £2,760). This gives a total potential loss of between £10.1m and £15.8m per annum (an average of £12.9m). However, this cost will be reduced or negated where companies choose to use the saving in audit fees to buy other services from the audit firm. If 80% of companies took advantage of the option not to have their accounts audited, auditors would lose between £8.08m and £12.64m per annum (an average of £10.32m).

4.13 There will be a cost to the FSA, as they may devote more time and effort to monitoring companies through their other safeguards. The FSA expects to select about 50 firms each year to be subject to a review and report by a skilled person. In the April consultation document, the FSA estimates the additional costs to be £400,000 per annum in FSA staff time to plan and oversee.

4.14 As the measure does not require companies to do anything, all of these costs are policy costs.

Risks

4.15 A requirement to have accounts audited does provide certain benefits in terms of consumer protection, market confidence and reduction of financial crime. However, the FSA consider that they have other measures in place to provide these safeguards. Most small authorised companies are subject to the FSA's Retail Mediation Activities Return (a half-yearly return that includes financial data and information on the conduct of the business). The FSA are not relaxing their quantitative capital resources requirements (the amount of capital the company is required to hold) imposed on these companies, nor the requirement imposed on certain companies to hold professional indemnity insurance. Any company that holds client money will still be required to have a client money audit. And under section 166 of FSMA, the FSA have powers to require a company to appoint a skilled person to report to the FSA on matters related to the firm; this may happen if the FSA believes there is a risk of regulatory failure, or on a random sample basis. Therefore, it is not considered that any additional protection provided by the statutory audit requirement in the 1985 Act justifies the cost burden on companies.

4.16 Removing the audit requirement could remove safeguards for the shareholders of these companies; the audit may reassure them that the financial affairs of the company are in order. However, the majority of small companies are owner-managed and the statutory audit may be seen as an unnecessary burden where there are no outside shareholders. And where there are external shareholders, there are arrangements in place for their protection. Under section 249B(2) of the 1985 Act, company members holding 10% of shares are entitled to require an audit if they so choose. The delay between the coming into force date of the regulations and the effective date is to give members the opportunity to require an audit for current financial years.

4.17 The measure could remove a safeguard for providers of finance, suppliers and customers who may take reassurance from an independent check on the reliability and accuracy of the accounts. However, providers of finance and key suppliers and customers are likely to be in a position to request additional or more recent financial information or audited accounts if they feel it is necessary. Others will still be able to make use of credit scoring by credit reference agencies in deciding whether to do business with a company.

4.18 For a company that takes advantage of the audit exemption, it is possible that the lack of audited accounts could result in increased borrowing costs, lenders being reluctant to lend or others being reluctant to do business. The likelihood of this happening would depend on the particular circumstances of the company. It is a factor the companies will need to consider when weighing up the costs and benefits of the audit exemption.

4.19 Audit firms may lose revenue as a result of the loss of audit fees. If 80% of companies took advantage of the option not to have their accounts audited, auditors would lose an average of £10.32m in audit fees per annum. However, audit firms provide other services, and some companies may choose to spend the saving on other services provided by the audit firm. Recent press comments by the Society of Professional Accountants indicate that they viewed the 2004 rise in the

audit exemption threshold[13] as an opportunity to provide other services to their ex-audit clients that were more profitable to the firm and more meaningful to the client.[14]

4.20 The measure could diminish transparency. The companies affected will not have to include as much information in their annual accounts, they will not have to file a Directors' Report at Companies House and they can file abbreviated rather than full accounts, which do not include a profit and loss account. In general, transparency is beneficial for consumers and the market as a whole. However, in this case the benefits of greater transparency are not considered to outweigh the costs to the companies affected. These are small companies and they represent about 2.5% of the total number of companies. Their competitors may be sole traders and partnerships who are not subject to the same disclosure requirements. Providers of finance and key suppliers and customers are likely to be in a position to request additional financial information if they feel it is necessary. And third parties can be reassured by the fact that the companies are regulated by the FSA.

Option 2 – Do nothing

4.21 Doing nothing would bring no benefits and impose no additional costs.

4.22 It would not reduce the cost of reporting for 4,690 small financial services companies, as they would still be required to have their accounts audited and could not take advantage of accounting and reporting exemptions. Directors will have to continue to commit money to audit fees when they might feel that it would be better used elsewhere to the advantage of the business. Higher costs may also put small financial services companies at a competitive disadvantage with sole traders and partnerships, who can trade in the same market but are not subject to the 1985 Act requirement to prepare and have audited statutory accounts, and so do not have to bear this extra cost burden.

5. Sectors and groups affected

5.1 The FSA estimates that 4,690 companies engaged in the following activities can benefit from the measure:

- investment management (but not that coming under the Investment Services Directive) – for example unregulated collective investment scheme managers and investment advisers that do not hold client money;

- personal investment (but not that coming under the Investment Services Directive) – for example an independent financial adviser that does not hold client assets;

- securities and futures (but not that coming under the Investment Services Directive) – for example a corporate advisory firm or an energy/oil market trader;

[13] Effected by the Companies Act 1985 (Accounts of Small and Medium-Sized Enterprises and Audit Exemption) (Amendment) Regulations 2004, S.I. 2004/16.
[14] Comments reported in Accountancy Age on 15 June 2006. Available at www.spa.org.uk.

- mortgage lending;
- mortgage administration;
- service companies (companies that usually only carry on regulated activities for firms within the group to which they belong; for example, taking out insurance for activities carried out by other companies in the group); and
- authorised professional firms (but not those coming under the Investment Services Directive) – for example solicitors or accountants that have permission under Part 4 of FSMA to give financial advice to clients.

If a company is also involved in activities where there is an EU requirement to have an audit, it cannot take advantage of the exemptions.

5.2 The measure may also affect registered auditors in that their fees may be reduced if companies dispense with the audit and do not buy additional services from the auditors. There are around 9,777 firms permitted to carry out an audit[15].

5.3 There may also be an impact on the FSA, as they may devote more time and effort to monitoring companies through their other safeguards. They estimate this cost to be £400,000 per annum in additional FSA staff time to plan and oversee.

6. Small Firms Impact Test

6.1 Prior to consulting publicly, the FSA discussed the proposal with the AIFA, who represent the majority of independent financial advisers, including small companies. The analysis of the impact of the changes in the FSA's April consultation document reflects their views of the impact on small companies. The consultation was targeted at small businesses through the AIFA. Respondents included the Federation of Small Businesses.

6.2 The measure will not have a significant or disproportionate impact on small companies. The companies affected will not be required to do anything. The measure provides certain categories of small financial services companies with the option of not having their accounts audited and of taking advantage of certain accounting and reporting requirements. If a company chooses to take advantage of the options, it is estimated that the cost saving will be on average £3,260 per annum (just over 1% of turnover for a company with a turnover of £2.8m, in the middle of the audit exemption range). Therefore, only Stage 1 of the Small Firms Impact Test has been completed.

7. Competition Assessment

7.1 The market affected by this measure is the financial services market.

7.2 This is a broad term for a number of diverse markets, many of which are dominated by a small number of large firms offering a wide range of services

[15] Professional Oversight Board for Accountancy. Key Facts and Trends in the Accountancy Profession. March 2006.

usually on a UK wide basis. The FSA regulates some 23,500 firms in the financial services market. This measure has the potential to affect some 4,690 small companies. It is likely that these companies operate in a diverse array of markets and compete against a variety of providers, and that there is no disproportionate affect on any single market. Given that the measure is a deregulatory option rather than a requirement, it would not be cost effective to undertake a detailed analysis of every market in which the companies affected operate.

7.3 The impact of the measure on the market is likely to be small but positive. The measure does not impose any costs, but will provide the opportunity for cost savings on an annual basis by small companies in the market. The cost savings are relatively small and affect only a relatively small number of companies, so the impact on the market as a whole would be small.

7.4 However, any cost saving has the potential to increase competition by making it easier for small companies to compete and reducing market entry costs. In this case, the small companies affected are likely to be competing more directly with small sole traders and partnerships rather than with large companies. As sole traders and partnerships are not required to produce audited accounts, the measure should help to promote competition between different types of firm within the market.

8. Enforcement, Sanctions and Monitoring

8.1 The measure does not impose any requirement. Therefore, no changes to the existing regime of enforcement, sanctions and monitoring compliance are needed.

9. Implementation and Delivery Plan

9.1 The measure does not impose any requirement. Therefore, implementation and delivery is only relevant in terms of communication with stakeholders. It needs to be communicated to interested parties (and in particular the companies affected) that more small financial services now have the option not to have their accounts audited, and it needs to be clear what categories of companies are affected.

9.2 Guidance on the measure will be available through the DTI website, the FSA website, an FSA newsletter to financial advisors and information to the trade press, and Companies House. The AIFA and other relevant trade bodies will be informed and asked to pass the information on to their members.

10. Post-implementation Review

10.1 Awareness of the change and the level of take up of the exemptions will be reviewed after 3 financial years following the effective date of the regulations by DTI distributing a short questionnaire to financial services companies through the AIFA. The aim of this will be to identify the level of awareness of the change, establish how many companies have chosen to take advantage of which exemptions and (assuming the take up is less than 100%) indicate why some companies have not taken advantage of the exemptions.

11. Summary and Recommendation

11.1 The Government recommends Option 1. It supports the Government's better regulation objective of reducing burdens on business. It will provide a potential benefit to small financial services companies in the form of cost savings of between £12.45m and £18.15m per annum. It also has the potential to promote competition in the market, which will benefit consumers.

11.2 While there will be a cost to audit firms in the form of lost audit fees of between £10.1m and £15.8m per annum, firms have the potential to recover some of this cost by selling additional services to their customers.

11.3 Option 2 has no costs and no benefits.

Summary costs and benefits table

Option	Cost	Benefit
Option 1 – Allow small financial services companies to take advantage of the exemptions where the audit requirement is domestic only and is not contained in an EU directive	Possible costs to consumers in the form of losses from mis-sold products or opportunity costs associated with the time spent dealing with the process of collecting redress. Cost unquantifiable but likely to be negligible. Reduction in fees for audit firms of between £10.1m and £15.8m per annum (or if 80% of companies choose to take advantage of the audit exemption option, between £8.08m and £12.64m). Increased regulatory costs for the FSA of £400,000 per annum.	For the 4,690 small financial services companies affected, there is a potential cost saving of between £2,650 and £3,870 per annum, giving a total potential cost saving of between £12.45m and £18.15m per annum, with a average cost saving of £15.25m. If 80% of companies choose to take advantage of the main option provided by the measure (not to have their accounts audited), the total cost saving per annum would be between £10.43m and £14.99m, with a average cost saving of £12.67m.
Option 2 – Do nothing	No additional costs.	None.

12. Declaration and Publication

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed: **Jim Fitzpatrick**

Date: **16TH October 2006**

Jim Fitzpatrick, Parliamentary Under-Secretary of State for Employment Relations, Department of Trade and Industry

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