

**EXPLANATORY MEMORANDUM TO  
THE COMPANIES ACT 2006 (AMENDMENT) (ACCOUNTS AND REPORTS)  
REGULATIONS 2008**

**2008 No.**

**1.** This explanatory memorandum has been prepared by the Department for Business, Enterprise & Regulatory Reform and is laid before Parliament by Command of Her Majesty.

**2. Description**

2.1 These Regulations implement parts of Directive 2006/46/EC<sup>1</sup> on company reporting, by amending the provisions in Parts 15 and 16 of the Companies Act 2006 (the 2006 Act) which set out the conditions that determine whether a company or group qualifies as small or medium-sized (SMEs); SMEs are entitled to certain accounting and audit exemptions. The Regulations also implement the Directive requirement for disclosure of off-balance sheet arrangements in the notes to the accounts.

2.2 The Regulations reinstate in the 2006 Act certain exemptions relating to the directors' reports of SMEs which are currently contained in the Companies Act 1985 (the 1985 Act) and which were inadvertently omitted from the 2006 Act. They also make a few technical amendments to the accounts provisions of the 2006 Act.

**3. Matters of special interest to the Joint Committee on Statutory Instruments**

3.1 None.

**4. Legislative Background**

4.1 Parts 15 and 16 of the 2006 Act (which replace the provisions in Part 7 of the 1985 Act on accounts and audit, and corresponding Northern Ireland provisions) are to come into force on 6th April 2008 for financial years beginning on or after that date.

4.2 Regulations 3 to 5 in Part 2 of the Regulations implement the Member State option in paragraphs 1 to 4 of article 1 of Directive 2006/46/EC relating to the conditions defining SMEs for accounts and audit purposes. They do so by amending the relevant sections of the 2006 Act. Part 3 of the Regulations implements the first point of article 1.6 and the first point of article 2.1 of the Directive requiring the disclosure in the notes to accounts of off-balance sheet arrangements, by inserting a new section 410A into the 2006 Act. Advantage is taken of the Member State options in the Directive to exempt small companies from the requirement, and to permit medium-sized companies to make more limited disclosure. As a general rule when transposing this EU legislation the

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<sup>1</sup> Directive 2006/46/EC of the European Parliament and the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (OJ L 224 of 16 August 2006, page 1).

Government has followed the wording of the Directive as closely as possible. Transposition Notes for Directive 2006/46/EC are attached at Annex A.

4.3 The remainder of Directive 2006/46/EC will be implemented by the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 and the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (also to be laid before Parliament at the same time as this instrument), and by rules to be made by the Financial Services Authority under Part 6 of the Financial Services and Markets Act 2000 as amended by section 1269 of the 2006 Act (corporate governance rules).

4.4 Regulation 6 reinstates the exemptions currently contained in section 247A(1A) of the 1985 Act, which enable SMEs to take advantage of exemptions relating to the directors' report even though they are members of ineligible groups. These exemptions were inadvertently omitted from the 2006 Act. This has the unintended consequence of widening the numbers of small companies which would have to make full disclosures in their directors' reports (including preparing a business review) and of medium-sized companies required to disclose non-financial performance indicators in the business review. It would also widen the class of small companies that would have to deliver a directors' report to the registrar of companies. As the relevant sections of the 2006 Act and these Regulations will both come into force on the same day and apply to the same financial years, the original omission will therefore have no practical effect.

4.5 Regulations 9 to 13 make a number of technical improvements to Part 15 of the 2006 Act suggested by consultees. In particular, regulation 9 extends the circumstances in which a company which has opted to prepare individual accounts under international accounting standards can opt back to preparing Companies Act accounts.

4.6 As the Regulations make textual amendment to primary legislation they have been vetted by Parliamentary Counsel.

4.7 Explanatory Memorandum OTNYR EM covering the proposal for Directive 2006/46/EC (2002/0112 (COD)) was submitted on 5 December 2002. The Commons European Scrutiny Committee considered it politically important and cleared it. The Lords Select Committee on the EU did not report on it (Progress of Scrutiny 21.12.02, session 02/03).

## **5. Territorial Extent and Application**

5.1 This instrument applies to all of the United Kingdom.

## **6. European Convention on Human Rights**

6.1 The Minister of State for Competitiveness, Stephen Timms, has made the following statement regarding Human Rights:

In my view the provisions of the Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008 are compatible with the Convention rights.

## 7. Policy background

### *Policy*

7.1 The amendments introduced by Directive 2006/46/EC are part of the short-term priorities under the European Commission's EU Company Law and Corporate Governance Action Plan published in May 2003 (endorsed by the Competitiveness Council in September 2003). They seek to enhance confidence in financial statements and annual reports published by European companies.

7.2 The overall objective behind the measures in the Directive was to further enhance confidence in the financial statements and annual reports published by European companies. In this respect, the Commission believed that “shareholders and other stakeholders need reliable, complete and easily accessible information”.<sup>2</sup> The Commission further believed that enhanced and consistent disclosures would facilitate cross-border investments and improve EU-wide comparability of financial statements and reports. The Commission did not believe that these objectives could be sufficiently achieved by Member States since national legislation differs.

7.3 The Government’s approach to both EU and domestic reform is that company law should be seen primarily as facilitative, providing the key vehicle - the limited company - through which enterprise and entrepreneurship may flourish. The Government believes that EU measures should further at least one of the following five objectives:

- enhancing financial stability and market confidence,
- extending investment opportunities across borders,
- removing barriers to the efficient operation of markets, improving access to capital for companies,
- making it easier for companies to set up cross border operations and
- creating trust in our companies and markets that will attract internal investment and those seeking capital from around the world.

7.4 In general terms, consultation with stakeholders to date has confirmed our general view that the provisions in the Directive do meet these objectives in a proportionate way.

7.5 Certain arrangements a company enters into may have a material impact on the company but may not be included in the company’s balance sheet. Such arrangements may expose a company to risks and benefits which are material for an assessment of the financial position of the company and, when the company belongs to a group, the financial position of the group as a whole. It is therefore important for purposes of transparency that companies should disclose any off-balance sheet arrangements and their financial impact where they are material to an assessment of a company’s financial position.

7.6 Small companies are exempted from this requirement and medium-sized companies may limit disclosure regarding off-balance sheet arrangements to information about the nature and business purpose of such arrangements.

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<sup>2</sup> Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts. Explanatory Memorandum p. 2.

7.7 In order to help ensure that the objective of the Directive is achieved in a proportionate fashion and to provide some relief for SMEs, the options to increase the thresholds defining SMEs are being implemented. Existing and proposed thresholds are set out in table 1 below.

**Table 1**

	Existing Thresholds		No change	Proposed Thresholds	
	Turnover (not more than)	Balance sheet total (not more than)		Turnover (not more than)	Balance sheet total (not more than)
Small company	£5.6 million	£2.8 million	50	£6.5 million	£3.26 million
Small Group	£5.6 million net (or £6.72 million gross)	£2.8 million net (or £3.36 million gross)	50	£6.5 million net (or £7.8 million gross)	£3.26 million net (or £3.9 million gross)
Medium-sized company	£22.8 million	£11.4 million	250	£25.9 million	£12.9 million
Medium-sized Group	£22.8 million net (or £27.36 million gross)	£11.4 million net (or £13.68 million gross)	250	£25.9million net (or £31.1million gross)	£ 12.9 million net (or £15.5 million gross)

7.8 The decision to raise the thresholds was introduced outside of the formal five year review process to enable Member States to minimise the burden that the increased disclosure requirements in the Directive may place on SMEs and, indeed, reduce the burdens imposed on such companies more generally by the European accounting directives. The UK Government supports this approach which is in line with its own policies on simplification and reducing burdens on business.

#### *Consultation*

7.9 The Directive was subject to consultation from March to June 2005 when it was still at the proposal stage.<sup>3</sup> Small stakeholder groups were established to consider the proposals in the Directive. The Government response and a summary of responses to the 2005 consultation were published in September 2005.<sup>4</sup> As a result of these consultations a number of changes were made to the Directive including an option to increase the thresholds for SMEs aimed at eliminating or reducing the potential burden that the additional disclosure requirements of the Directive might impose on them.

<sup>3</sup> European Company Law and Corporate Governance. Directive Proposals on Company Reporting, Capital Maintenance and the Transfer of the Registered Office of a Company: A Consultative Document. March 2005. URN 05/544.

<sup>4</sup> European Company Law And Corporate Governance. Directive Proposals on Company Reporting, Capital Maintenance and Transfer of the Registered Office of a Company: Government Response and Summary of Responses. September 2005

7.10 The Government consulted on proposals for implementing Directive 2006/46 on 5 March 2007.<sup>5</sup> The consultation closed on 1 June 2007. Notice of the consultation was sent to a wide range of interested parties and the consultation document was placed on the Department's website. A number of pre-consultation stakeholder discussions were also held to talk through the practicalities of implementing the Directive. The Government response and a summary of responses to the consultation were published in July 2007.<sup>6</sup> The draft Regulations were then made available on the Department's website on 20 July 2007, with comments invited by the end of September.

7.11 The majority of those responding to the consultation supported the government's proposals to implement the Directives' requirements in respect of off-balance sheet arrangements without further elaboration, and that detailed guidance should be provided by the Accounting Standards Board. The majority of respondents also agreed that the thresholds defining SMEs should be raised, confirming that the risks associated with a potential loss of information were outweighed by the benefits arising from reduced burdens for small and medium-sized companies.

### *Guidance*

7.12 The Department is discussing with the Accounting Standards Board the production of guidance on the new disclosure requirements relating to off-balance sheet transactions. Guidance on the new SME thresholds will be published on the Department's website once the Regulations have been made.

## **8. Impact**

8.1 An Impact Assessment on the changes made to implement Directive 2006/46 is attached to this memorandum at Annex B. An Impact Assessment has not been prepared for other aspects of the Regulations because the impact on business is minimal.

8.2 These Regulations have no impact on the public sector.

## **9. Contact**

Julie Ford at the Department for Business, Enterprise & Regulatory Reform, telephone: 020 7215 2162 or e-mail: Julie.Ford@berr.gsi.gov.uk can answer any queries regarding the instrument.

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<sup>5</sup> European Company Law and Corporate Governance. Implementation of Directive 2006/46/EC on Company Reporting – Amending the Accounting Directives: A Consultative Document. March 2007. URN 07/597.

<sup>6</sup> Corporate Governance and Europe. Implementation of Directive 2006/46/EC on Company Reporting – Amending the Accounting Directives: Government Response. July 2007. URN 07/1225/GR.

<b>Department for Business, Enterprise and Regulatory Reform</b>		<b>Final Impact Assessment of : Directive 2006/46/EC on Company Reporting – Amending the Accounting Directives</b>
<b>Stage</b> Final	<b>Version 2</b> 04/12/2007	<b>Related Publications</b> Implementation of Directive 2006/46/EC on Company Reporting - Amending the Accounting Directives - A Consultative Document.

Available to view or download at <http://www.dti.gov.uk/bbf/co-act-2006/made-or-before-parliament/page35232.html>.

**Contact name for enquiries:** Julie Ford

**Telephone number:** 020 7215 2162

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

To give effect in UK law to Directive 2006/46/EC on Company Reporting, amending the 4<sup>th</sup> and 7<sup>th</sup> Accounting Directives, the Bank Accounts Directive and the Insurance Accounts Directive – to improve transparency and so reduce the risk of future corporate scandals such as Parmalat and Enron and the adverse impact on investor confidence.

**What are the policy objectives and the intended effects?**

To further enhance confidence in the financial statements and annual reports published by European companies allowing investors and stakeholders to make comparable

**What policy options have been considered? Please justify any preferred option.**

1. Implement the provisions in the Directive for companies which fall within the scope of the Directive taking up all exemptions other than applying the threshold increases to the audit exemption.
2. Implement the provisions in the Directive for all companies which fall within the scope of the Directive taking up exemptions and apply the threshold increases to the audit exemption.

**When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?** The 4<sup>th</sup> and 7<sup>th</sup> Directives are currently under review as part of EU simplification plans.

**Ministerial Sign-off** For final proposal/implementation stage Assessments:

***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 impacts of the policy, and (b) the benefits justify the costs.***

Signed by the responsible Minister: Stephen Timms

Date: 17<sup>th</sup> December 2007

**Policy Option 2**

**ANNUAL COSTS**

One off (Transition) **£ 0.00** Yrs

**Average Annual Cost**  
(excluding one-off)

**£ 3.3 M**

Description and scale of **key monetised costs** by 'main affected groups'

Additional disclosure costs for large companies in respect of corporate governance statement, related party and off balance sheet transactions assume costs.

**Total Cost (PV)**

**27.44 M**

Other **key non-monetised costs** by 'main affected groups'

**ANNUAL BENEFITS**

One off Yrs   
**£ 0.00**

**Average Annual Benefit**  
(excluding one-off)

**£ 36.73M**

Description and scale of **key monetised benefits** by 'main affected groups'

The thresholds are used to define small and medium-sized companies (SMEs) to determine which SMEs companies may produce and file abbreviated accounts and which small companies are exempted from the requirement to have a statutory audit. It is also estimated that around 2,100 companies may also be eligible for first year capital allowances provided by the tax system.

**Total Benefit (PV)**

**£ 305.47M**

Other **key non-monetised benefits** by 'main affected groups'

Trust in our companies, and markets that will attract internal investment and those seeking capital from around the world.

**Key Assumption/Sensitivities/Risks** Risks associated with the loss of quality financial information for small companies include non compliance with accounting disclosures, inaccuracies in reports, loss of a deterrent/detection for fraud and money laundering activities, and the possible loss of audit provision/expertise.

Price Base Year 2007	Time Period Years 10	<b>Net Benefit Range (NPV)</b> £-£	<b>NET BENEFIT (NPV Best estimate)</b> £ <b>278.03M</b>
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What is the geographic coverage of the policy/option?	UK			
On what date will the policy be implemented?	6 April 2008 for financial years beginning on or after that date			
Which organisation(s) will enforce the policy?	SoS/FRRP/FSA (within existing arrangements)			
What is the total annual cost of enforcement for these organisations?	Minimal			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	No			
What is the value of the proposed offsetting measure per year?	NA			
What is the value of changes in greenhouse gas emissions?	Negligible			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small -	Med £52	Large £106-158
Are any of these organisations exempt?	N/A	Yes	Some	No

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)			<b>Net Impact</b>	<b>£ 9m(Decrease)</b>
Increase of	<input type="text" value="2m"/>	Decrease of		

Key:

**Annual Cost: Constant Prices**

**(Net) Present Value**

# Evidence Base for Summary Sheets

## Directive 2006/46/EC on Company Reporting - Amending the Accounting Directives

### FINAL IMPACT ASSESSMENT

#### STRATEGIC OVERVIEW

- 1.1 The EU Action Plan published in May 2003 contained the Commission's intention to come forward with legislative measures in the area of collective responsibility of board members for annual accounts and reports, financial statement transparency and corporate governance statements. These measures were part of a broader programme of company law reform.
- The full text of the Directive can be found at: [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_224/l\\_22420060816en00010007.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_224/l_22420060816en00010007.pdf)
- 1.2 The Commission was concerned that investors have reduced confidence in the trustworthiness of companies, following recent corporate scandals. They sought to reduce the risk of future corporate scandals in Europe deterring investors by making more transparent financial arrangements and requiring companies to give information relevant to good corporate governance. These measures will not be sufficient to guarantee prevention of another Enron but the Commission hopes that placing additional targeted disclosure requirements on companies will make it more difficult and unlikely that corporate malpractice will be possible.
- 1.3 It is difficult to quantify the risk of poor investor confidence across Europe and also globally. Companies involved in corporate scandals lose significant market value and are often forced to restructure, with consequent job losses. How damaging poor investor confidence can be has been well analysed with respect to the two largest American bankruptcies (Enron and WorldCom in July 2002) stemming from corporate mismanagement. The loss in stock market wealth as a result of these scandals has been estimated at 0.36% of Gross Domestic Product (GDP) – or \$38.2 billion in the first year.<sup>7</sup>
- 1.4 On 16th August 2006 Directive 2006/46/EC (“the Directive”) of the European Parliament and of the Council was published. The Directive amends Council Directives 78/660/EEC on the annual accounts of certain types of companies (“the Fourth Directive”), 83/349/EEC on consolidated accounts (“the Seventh Directive”), 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions (“the Bank Accounts Directive”) and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (“the Insurance Accounts Directive”). The proposal gives effect in UK law to this Directive. Separate rules on the requirement for a corporate governance statement will be made by the Financial Services Authority.

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<sup>7</sup> See Graham, Carol/ Litan, Robert/ Sukhtankar, Sandip (2002) The bigger they are, the harder they fall: an estimate of the costs of the crisis in corporate governance. Working paper. Economic studies/ Governance studies programme. Brookings Institutions (2002). <http://www.brookings.edu/Views/Papers/Graham/20020722Graham.pdf>



- 1.5 The options in the Directive covering the increase in the thresholds defining small and medium-sized companies do not address a particular risk but are measures aimed at relieving companies of burdens that may be imposed by the increased disclosure requirements it introduces or arising from the accounting Directives more generally. Similarly, the provisions relating to fair value accounting are intended to enable companies to use modern, more transparent accounting practices that are consistent with International Financial Reporting Standards (IFRS).

## **BACKGROUND TO THE DIRECTIVE**

- 2.1 The Directive focuses on the linked objectives of increasing confidence in corporate governance frameworks and improving investor confidence through increased transparency and better information on companies. In the Action Plan the Commission took the view that the creation of a European Corporate Governance Code would not add value to the work being undertaken at national level in individual Member States to develop effective Codes. However, it did not believe that a self-regulatory market approach, based on non-binding recommendations, would be sufficient to ensure that sound corporate governance practices would be adopted. The Government supports this view.
- 2.2 The measures in the Directive contribute to several of the aims the Government believes important, namely:
- increasing financial stability and market confidence
  - extending investment opportunities across the EU
  - improving access to capital by companies across borders.
- 2.3 The requirements of the Directive are broadly consistent with existing UK law and practice and informal stakeholder soundings in response to the proposal indicated that we should support its broad principles. Light-touch common standards for disclosure should contribute to EU market confidence in the wake of the Parmalat scandal, encourage cross-border investment and facilitate cross-border access to capital. Any cost impact on companies appears to be relatively small.

## **RATIONALE**

3.1 **Traditional economics and finance literature on the issue of corporate governance views the firm as an economic profit-maximising entity where managers maximise value for shareholders. Rational (in the economic sense) risk-neutral shareholders (principals) rely on risk-averse managers (agents) to maximise shareholder value. This separation of ownership and control can give rise to a principal-agent problem, which becomes the raison d'être for corporate governance. Principals need to effectively monitor and to some extent control their agents to ensure that managers are acting in the best interests of the company's owners and that the scope for moral hazard<sup>8</sup> is minimised. In doing so principals incur agency costs related to efforts they make by which agents can be monitored and influenced in the interests of owners. Better disclosure helps reduce the agency costs associated with effective monitoring of agents by principals. In addition greater transparency and more information reduces some of the uncertainties and risks faced by investors which in turn results in them requiring lower risk adjusted rates of return thus helping to reduce the cost of capital for firms that provide adequate disclosure.**

3.2 **Managers can increase agency costs by raising barriers to shareholder engagement and activism, which may result in the company being run on behalf of managers and not the owners. The Directive aims**

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<sup>8</sup> Moral hazard – the perverse incentive whereby agents are not held responsible for their actions which encourages them to engage in risky behaviour.

**to lower agency costs so that shareholders can engage more effectively and ensure the companies that they own are more efficient. Better governance can be useful in lowering agency costs and facilitate a lower cost of equity capital. Evidence suggests that companies that improve the strength of shareholders' rights are expected to see a reduction in their equity cost of capital<sup>9</sup>. Shareholder rights can lead to a lower cost of equity capital through increased investor confidence - "capital will not flow unless adequate investor protections are in place."<sup>10</sup>**

- 3.3** There has been little evidence to assess the intuitive link between transparency and the cost of capital although Leuz<sup>11</sup> and Hail<sup>12</sup>'s work in this area of legal institutions and securities regulation does provide some empirical support for this intuitive link. Hail and Leuz find that firms from countries with more extensive disclosure requirements, stronger securities regulation and stricter enforcement mechanisms (as enabled by a high quality legal infrastructure) have significantly lower cost of equity capital than those that do not rate as highly on these parameters. In the Hail and Leuz paper, securities regulation determines the minimum amount of information available to investors. When more information is available, investors are better placed to assess the risks and benefits of their investments and so enable them to make more efficient investment decisions. Consequently, firms that face a lower cost of equity capital are able to consider projects that previously may have been uneconomic. In both cases allocative efficiency gains are encouraged.

## **OBJECTIVE**

- 4.1** The overall objective of the Directive is to "further enhance confidence in the financial statements and annual reports published by European companies" through shareholders and other stakeholders having easy access to reliable and complete information (Commission Proposal's Explanatory Memorandum). The Commission believes that this action will have the effect of building confidence in EU capital markets, as well as facilitating cross-border investments and improving EU-wide comparability.
- 4.2** The measures in the Directive arise in the context of wider EU company law reform as outlined in the EU Company Law and Corporate Governance Action Plan of May 2003<sup>13</sup>. The measures contained in the Directive were identified as short-term priorities in the Action Plan. Corporate scandals, such as Parmalat, have strengthened the Commission's view that such action is necessary.
- 4.3** The Government agrees with this view. The proposed additions to the financial and non-financial information provided by companies together with the clarity of the responsibility of directors will provide common standards on content and reliability of information published across the

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<sup>9</sup> Huang, Henry, Cheng, C.S. Agnes and Collins, Denton, "Shareholder Rights and the Cost of Equity Capital" (February 2006). Available at SSRN: <<http://ssrn.com/abstract=594505>>

<sup>10</sup> Himmelberg, Charles P., Hubbard, R. Glenn and Love, Inessa, "Investor Protection, Ownership, and the Cost of Capital" (April 2004). World Bank Policy Research Working Paper No. 2834. Available at SSRN: <<http://ssrn.com/abstract=303969>>

<sup>11</sup> "The Benefits of Transparency, Christian Leuz, Capital Ideas Journal, July 2006, "Capital Ideas, a publication highlighting research from the University of Chicago Graduate School of Business."

<sup>12</sup> Hail, Luzi and Leuz, Christian, "International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?" (December 2005). ECGI - Law Working Paper No. 15/2003 Available at SSRN: <http://www.ssrn.com/abstract=641981> or DOI: 10.2139/ssrn.641981

<sup>13</sup> Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:NOT>

EU, and are designed to allow investors to make comparable assessment of companies regardless of the Member State in which they are incorporated.

**4.4** In order to achieve its overall objective, the Directive contains 6 revisions to the Fourth and Seventh Directives and the Bank Accounts and Insurance Accounts Directives, 5 of which require, or contain a Member State option to permit, changes to UK company law:

- (a) Raising the financial thresholds used to define small and medium-sized companies for accounting, reporting and audit purposes.

**A Member State option applicable to:** all companies and groups that meet the criteria.

- (b) Extended use of Fair Value Accounting.

**A Member State option applicable to:** all companies that are required or choose to adopt fair value accounting for financial instruments and associated disclosures.

- (c) Enhancing transparency about related party transactions.

**A requirement applicable to:** All companies, other than those preparing accounts under IFRS. Member States have the option to exempt small companies and non-public medium-sized companies from this requirement .

- (d) Enhancing transparency about off-balance sheet arrangements, including Special Purpose Entities.

**A requirement applicable to:** All companies. Member States have the option to exempt small companies from this requirement and to require less disclosure from medium-sized companies.

- (e) Introducing an annual corporate governance statement.

**A requirement applicable to:** Publicly traded Companies<sup>14</sup>

- (f) Ensuring the collective responsibility of board members for the annual accounts and reports. This is the position already under UK law, so no change is necessary (other than change to encompass the corporate governance statement where it is separate from the annual (directors') report).

**A requirement applicable to:** All companies.

**4.5 The changes required by the Directive will apply to the UK, and will amend companies legislation. They are also likely to lead to changes in UK accounting standards. Rules implementing 4.4(e) above will be made by the Financial Services Authority.**

**4.6** The accounting requirements for other entities such as partnerships all of whose members having unlimited liability are limited companies, certain banking undertakings and certain insurance undertakings are based on those for companies in the Schedules to the 1985 Act. It is proposed that regulations will apply these requirements to such non-company entities in the same sort of way, also for financial years starting on or after 6th April 2008.

## **ASSESSMENT OF RISK**

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<sup>14</sup> Publicly traded companies are companies whose securities are traded on regulated markets as defined by article 4(1) (14) of Directive 2004/39 EC. A list of regulated markets is situated on the website of the Financial Services Authority at <http://fsahandbook.info/FSA/html/handbook/SUP/17/Annex5>

- 5.1 There are risks associated with the increase in thresholds as they are used to determine the eligibility of small and medium-sized companies to take up reduced reporting and audit requirements. These risks include the loss of quality financial information, non compliance with accounting disclosures, inaccuracies in reports, loss of a deterrent/detection for fraud and money laundering activities, and the possible loss of audit provision/expertise. However, companies eligible to take up reduced reporting requirements will still be required to submit accounts to the registrar of companies. Those companies eligible to be exempt from the requirement to have their accounts audited can have their accounts audited if they consider it beneficial to do so, and under section 476 of the Companies Act 2006 shareholders will still have the right to require an audit.
- 5.2 Existing and revised thresholds are set out in appendix A of this IA. The population of companies, small, medium-sized and large that are affected by the changes in the Directive is shown at appendix B.

## HOW THE PROPOSALS WILL WORK, THEIR COSTS AND BENEFITS

- 6.1 Where the requirements are mandatory there will be costs and benefits should they differ from what UK companies do at present. The relative impact is likely to vary depending on the size of the company. For a company to exercise any or all of the options it will need to undertake its own subjective cost/benefit analysis. Given the diversity and size of the population affected, it will be difficult to provide typical costs and benefits let alone aggregate the data.
- 6.2 A one off cost has been incurred by BERR in developing and disseminating the policy estimated at £100,000<sup>15</sup>, whichever option is pursued.
- 6.3 **Raising the Thresholds defining Small and Medium Companies**

**Impact:** An increase in the thresholds used to define small and medium-sized companies. When a company meets the qualifying conditions of a small or medium-sized company (see appendix A), it is able to take advantage of the less onerous accounting and reporting requirements that are set out in the Companies Act. As a result of the proposed increase in thresholds 1,600 large companies will become medium-sized and 3,100 medium-sized companies will become small.

**Costs:** The Government considers there to be a reduction in compliance costs for companies that will be redefined as small or medium-sized using the new thresholds. There may be some loss of information to users of accounts as abbreviated accounts provide less detailed information than would be available in full accounts. If thresholds are used to determine eligibility for an exemption from the requirement to have an audit there will be some loss of independent assurance. However companies may provide more detailed information or have their accounts audited in response to requests if they consider it beneficial to do so.

**Benefits:** It is estimated that a further 3,100 medium-sized companies and 1,600 large companies will be eligible to prepare and file less detailed accounts at Companies House<sup>16</sup>. If the reduced reporting requirements would lead to a saving of only 6 hours of accountancy time per year, using an hourly rate of £26.00<sup>17</sup> the

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<sup>15</sup> Based on DTI ready reckoner and an estimate of staff time and overheads, spent on implementing the Directive.

<sup>16</sup> These figures refer to private companies only – public companies would not be eligible.

<sup>17</sup> Based on the 2006 Annual Survey of Hours and Earnings (ASHE) Analysis by Occupation (4 digit SOC) the average hourly rate for an accountant is £20 per hour. 30% has been added to the hourly rate for non-wage costs and overheads giving an overall hourly rate of £26.

savings per company would be in the region of £156 per annum. This results in a reduced burden for all 4,700 qualifying companies amounting to a total saving of up to £730k per annum. Those companies that continue with their current accounting and reporting arrangements will be doing so because of the commercial value to their enterprises and not as a result of legislative requirements.

### **Audit Exemption**

If the thresholds used to define small companies are used to determine eligibility for exemption from the requirement to have a statutory audit, it is estimated that 1,100 medium-sized companies and approximately 6,100 small companies would become eligible to take up the option not to have their accounts audited. The median audit fee for small companies is £5,000 per year. If all eligible companies were to take up the exemption total estimated savings would be in the region of £36.0 million per annum.

### **First Year Tax Allowances**

It is also estimated that around 2,100 companies may also be eligible for first year capital allowances provided by the tax system.

## **6.4 Fair Value Accounting:**

**Impact:** Companies will have the option to adopt extended use of fair value accounting when valuing certain liabilities and associated disclosures. The financial instruments concerned will be shown in companies' balance sheets at fair value (current market value), rather than at historical cost (purchase price) as traditionally used. Changes in fair value will then usually be included in companies' profit and loss accounts.

**Cost:** Certain liabilities are already subject to valuation using fair value. The adoption of extended use of fair value accounting is an optional alternative to existing valuation methods and should not lead to additional disclosure or costs. Indeed, only enterprises which benefit from the opportunity might be expected to utilise it.

**Benefit:** Enables companies to use modern, more transparent accounting practices that are consistent with International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (specifically IAS 39) and adopted under the EU International Accounting Standards Regulation. This measure should provide companies with additional flexibility in preparing their accounts.

## **6.5 Off-balance sheet transactions**

**Impact:** Certain arrangements a company enters into may have a material impact on the company but may not be included in the company's balance sheet. Consequently, there is a public policy desire on the part of the Commission to improve implementation of the "true and fair view" across Europe. IFRS and the accounting Directives provide for some disclosure of off balance sheet arrangements as implemented in national law. We estimate that 50% of all large and medium-sized companies (48k) will be required to apply the extended reporting requirements (though medium-sized companies will be subject to a reduced reporting requirement).

Disclosure should be improved by imposing a specific disclosure requirement in the notes for material off-balance sheet arrangements.

**Costs:** Arrangements of the type that would need to be disclosed, and whose disclosure is not required under existing generally accepted accounting practice, are not expected to be in common use by most companies. In the cases where additional disclosures are required to be given, the cost of providing such disclosure are expected to be modest. Based on the assumption that 50% of all large and medium-sized companies (48k) would be required to apply the extended reporting requirements, and this would involve an additional 2 hours of

an accountant's time, the costs, based on an hourly rate of £26 per hour, could lead to costs of up to around £2.5M per annum.

**Benefits:** Enhanced disclosure of off balance sheet arrangements will improve transparency and facilitate a better understanding of companies' financial position and results. It is assumed that overall this will contribute to investor confidence in the market being strengthened.

Qualifying small companies will be able to be exempted from this requirement in relation to their individual accounts. Qualifying small groups are exempt from the obligation to prepare group accounts.

*Note: UK FRS already contains disclosure requirements related to items that may be covered by the off-balance sheet arrangements provision in the Directive. The current UK position already involves the disclosure of the economic substance of transactions under FRS 5 on 'Reporting the substance of transactions' for all companies reporting under UK FRS, although the FRS 5 requirements differ in certain respects from the Directive's requirements. The Accounting Standards Board is therefore also reviewing possible changes to FRS 5. It is not, however, envisaged that implementation of this Directive will add significantly to the burden imposed. It is anticipated therefore that the additional costs may not be as high as set out above.*

## 6.6 Related Party Transactions (RPTs)

**Impact:** Related parties of a company include parties which the company controls, parties that have control, joint control or significant influence over the company, parties subject to common control with the company, key managers of the company and their immediate family, and the company's associates and joint ventures. We estimate that 50% of all large companies will be required to apply the extended reporting requirements.

Qualifying small and medium-sized companies will be able to be exempted from this requirement in relation to their individual accounts. Qualifying small groups are exempt from the obligation to prepare group accounts.

In accordance with the ASB's strategy of progressively converging UK standards with IFRS, it is expected that in due course Financial Reporting Standard (FRS 8) covering Related Party Disclosures will be replaced with a standard based on IAS 24. This would eliminate any differences in definition of related party between existing UK practice and the requirements of the Directive.

**Costs:** The new requirements are not expected to have a significant impact beyond existing UK practice in most circumstances. Where the proposal does require additional disclosure, the information should be readily available from the accounting records. The proposal is most likely to have an impact on companies that are part of a group, in situations where such companies enter into material transactions with other group members on non-arm's length terms. We do not have any reliable data on the prevalence of such transactions. Minor additional costs will be incurred by some companies in compiling and presenting the information and in its audit. If we assume 50% of large companies (13k), excluding public companies already using IFRS, are required to apply extended reporting requirements, the costs using hourly rate for an accountant of £26, providing additional 2 hours work could result in additional costs for companies in the region of £700k.

**Benefits:** Enhanced disclosure of transactions that have not been carried out under normal conditions will improve transparency and facilitate a better understanding of companies' financial position and results. It is assumed that this will contribute to investor confidence in the market being strengthened.

*Note: Under both IFRS and UK FRS there is already considerable disclosure concerning related parties and related party transactions, especially in the notes to the accounts. It is not envisaged that implementation of this Directive will add significantly to the burden imposed. It is not, therefore, anticipated that the costs will be as high as set out above.*

## 6.7 Corporate Governance Statement

**Impact:** The Directive will require all publicly traded EU-companies to provide a specific "Corporate Governance Statement" in their annual report. This will require a reference to the corporate governance code the company is required to apply or which it decides to apply and application of the "comply or explain" principle. This requirement will apply to all companies traded on a regulated market – an estimated 1,300<sup>18</sup> listed companies in the UK will be caught by this requirement.

**Costs:** Much of the corporate governance information required by the Directive is currently required of listed companies in the UK. As the scope of the requirement cannot be limited to listed companies, other publicly traded companies (i.e. other UK companies traded on regulated markets elsewhere in the EU) will also need to comply. For listed companies there are, therefore, unlikely to be additional costs in terms of collecting the required information. Depending on how a company structures its reports currently, there might be some additional costs in terms of replicating information or moving it from elsewhere. The estimated cost of providing the statement, based on an additional 2 hours of accountant's time at £26 per hour for 1,300, is £68k per annum

**Benefits:** An annual corporate governance statement, together with the establishment of a "comply or explain" rule in relation to national corporate governance codes will improve EU standards of corporate governance. Common standards here will also contribute to giving confidence to investors to invest across borders, and make it easier for companies to access capital across borders; investors might be deterred from providing capital by differing or unknown standards. A statement that sets out clearly shareholder rights should help to enable shareholders to participate more fully in the company's affairs.

## OPTIONS

### Option 1

**7.1 Implement the provisions in the Directive for companies which fall within the scope of the Directive taking up all exemptions (other than applying the increased thresholds to audit exemption):** The mandatory elements of the Directive cover the increased disclosure requirements relating to off balance sheet and related party transactions, the annual corporate governance statement and the collective responsibility of directors. This approach would meet the objectives of the Directive in terms of reducing the risk of future corporate scandals in Europe deterring investors by making more transparent financial arrangements and requiring companies to give information relevant to good corporate governance.

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<sup>18</sup> Number of companies on main UK listed markets – Main Market Fact sheet December 2006 Market Summary <http://www.londonstockexchange.com/en-gb/pricesnews/statistics/factsheets/>

**7.2** The exemptions attached to the mandatory elements of the Directive exempt small companies from all but the requirement in respect of the collective responsibility of directors. The Government proposes to take advantage of options relating to small companies so this will not result in further burdens to them. The Government also proposes to take advantage of the options to exempt or limit disclosure for medium-sized companies in respect of off-balance sheet arrangements and related party transactions.

**7.3** There may be some small administrative costs for some large and medium-sized companies in respect of the increased disclosure requirements in respect of

- Increased disclosure of related party transactions – possible costs up to £2.50M;
- Increased disclosure of off-balance sheet arrangements- possible costs up to £700k;
- Compilation of the Corporate governance statement – possible costs up to £68k;

There may also be potential savings in respect of:

- Threshold increases – reduced disclosure requirements leading to possible savings of up to £730k;

No additional costs are associated with the measure in respect of the collective responsibility of directors.

**Total costs £2.5M**

## **Option 2**

**7.5 Implement the provisions in the Directive for all Companies which fall within the scope of the Directive but take up all exemptions and apply the threshold increases to the audit exemption:** In addition to the mandatory requirements above, this option will enable companies to take advantage of the options to increase the thresholds defining small and medium-sized companies and the use of fair value accounting.

**7.6** The mandatory costs in respect of related party and off-balance sheet transactions and the corporate governance statement would still be incurred, however; this approach would lead to an increase in the number of medium-sized (1,600) and small (3,100) companies. The additional medium-sized and small companies will be able to take advantage of the exemptions in respect of the disclosure requirements in the Directive. They would also be able to take advantage of existing exemptions in respect of reporting requirements. An additional 1,100 medium-sized and 6,100 small companies would become eligible to take up the audit exemption. Estimated costs and savings would accrue as follows:

- Increased disclosure of related party transactions – possible costs up to £700k;
- Increased disclosure of off-balance sheet arrangements- possible costs up to £2.50M;
- Compilation of the Corporate governance statement – possible costs up to £68k;



- Threshold increases – reduced disclosure requirements leading to possible savings of up to £730k;
- Threshold increase – reduced audit requirements leading to possible of savings of up to £36.0M.

### **Total Savings £33.4M**

- 7.7** It is also estimated that 2,100 companies may also be eligible for first year capital tax allowances provided by the tax system.
- 7.8** Equally, companies will have the option to adopt fair value accounting – a more modern, transparent accounting practice in line with IFRS.

### **WHO WILL BE AFFECTED?**

- 8.1** Publicly traded companies will have to comply with all aspects of the new proposals. All other companies that are not qualifying small companies will have to comply with the enhanced financial information requirements. Small companies are already subject to law as regards the collective responsibility of directors.
- 8.2** Therefore, the effect of the proposal is that any extra burden to companies is based upon a sliding scale. Publicly traded companies will need to conform to all of the new requirements.
- 8.3** All business sectors will be affected by the proposal.
- 8.4** The accounting profession may lose some business in relation to the provision of audit services for small companies – this is noted under the competition assessment below.

### **ISSUES OF EQUITY AND FAIRNESS**

- 9.1** The Government considers that the measures introduced by the Directive will not bring disproportionate benefits or have disproportionate effects on particular groups.

### **CONSULTATION WITH SMALL BUSINESS: THE SMALL FIRMS' IMPACT TEST**

- 10.1** None of the corporate governance statement and disclosure requirements will apply to qualifying small companies or groups. Therefore, there is unlikely to be a significant impact on small business.
- 10.2** The accounting directive requirements may have an unintended consequence on small businesses which are intending to go for an initial public offering. It is unlikely, however, that this will be a significant deterrent factor, as the benefits of a public offering will outweigh the costs.
- 10.3** Small companies will be exempted from disclosing any off balance sheet arrangements and related party transactions.
- 10.4** Therefore the sole certain impact on small business will be the collective responsibility requirement by directors to the company, which is already required by UK law.
- 10.5** The 3,300 additional small companies will be eligible to take advantage of reduced reporting requirements, 6,100 will become eligible to take up the audit exemption. These small companies would be eligible to take advantage of the less onerous accounting and audit requirements available to small companies. Some newly defined small and medium companies may also be able to take advantage of the first

## COMPETITION ASSESSMENT

**11.1 The competition filter has been applied. It has been concluded that the Directive has a potential impact on all UK companies and all market sectors. It is considered that the Directive will not give rise to disproportionate costs of entry or administrative costs for either small or large business. The Directive is not anticipated to restrict innovation in sectors characterised by rapid technological change and would not impair freedom to provide services.**

**11.2 One particular business sector identified as being affected by this change is the auditing profession. In 2003, there were 10,888 entities holding registered auditor status.**

**11.3** Information produced by the Professional Oversight Board in March 2006<sup>20</sup>, noted an 11.5% fall in the number of registered audit firms as a result of the substantial increase in thresholds defining small and medium-sized companies and eligibility for audit exemption in 2003. However the drop was not as large as anticipated. Accountancy firms providing audit services are able to provide other business services to their clients which they may currently be prevented from doing by their position as auditor.

**11.4** A recent Keynote Market Report on Accountancy forecast continued strong growth in income from accountancy and related services in 2006 and 2007 and growth at a slower but robust rate thereafter.<sup>21</sup> The estimated population of companies eligible to take up the exemption in 2003 was 69,000. It is not anticipated that the impact of the current increase will be as significant as the number of companies involved (7,200) is much smaller.

## ENFORCEMENT AND SANCTIONS

**12.1** The bodies which are currently responsible for monitoring and enforcing sanctions related to the different requirements of the proposal are as follows:

- **Disclosure in the accounts and reports and Collective Responsibility**

For criminal sanctions: BERR

Enforcement by way of revision of defective accounts: BERR and the Financial Reporting Review Panel

Civil liability: the courts

- **Corporate Governance statement**

The Financial Services Authority / UK Listing Authority, BERR or FRRP

**12.2** We believe that these arrangements are adequate to ensure enforcement of, and compliance with, the Directive's provisions.

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<sup>19</sup> Further details of the scheme are available from the HM Revenue & Customs website at: [http://www.hmrc.gov.uk/capital\\_allowances/investmentschemes.htm#a](http://www.hmrc.gov.uk/capital_allowances/investmentschemes.htm#a)

<sup>20</sup> Key Facts and Trends in the Accountancy Profession March 2006. <http://www.frc.org.uk/images/uploaded/documents/Key%20Facts%20and%20Trends%20March%202006.dist.pdf>

<sup>21</sup> **Key Note Market Report 2006 Accountancy** Tenth Edition September 2006 Edited by Dominic Fenn. ISBN 1-84729-018-3

## CONSULTATION

### 13.1 Within government

BERR has discussed the proposed implementing provisions with Small Business Service, HM Treasury and HMRC.

### 13.2 Regulators and Public Bodies

BERR has consulted the Financial Services Authority and the Financial Reporting Council including the Professional Oversight Board, the Auditing Practices Board, the Financial Reporting Review Panel and the Accounting Standards Board.

### 13.3 Public consultation

Prior to the proposal, BERR consulted informally with a range of stakeholders during the Commission's pre-proposal web-based consultation (April to June 2004). The proposals were the subject of a formal consultation and the views of key stakeholders reflected in the Directive in terms of:

- Greater clarity in the definition of off-balance sheet transactions
- Consistency in related party transactions requirements and those of IFRS
- Recognition of different corporate governance reporting structures in member states
- An option to produce the corporate governance statement as part of the annual report or as a separate document.

13.4 BERR established a small working group of stakeholders to advise on negotiating objectives and to offer an expert view throughout Council negotiations.

**13.5 A formal public consultation exercise on the proposed Directive was undertaken in March 2005. The Government response and summary of responses was published in September 2005.**

**13.6 BERR held a workshop to discuss implementation of the Directive aimed at representatives of the small business community to discuss the implications of an increase in the thresholds used to define small and medium-sized companies and their application to reporting requirements. Delegates attended from the Institute of Chartered Accountants in England and Wales (ICAEW), Association of Chartered Certified Accountants (ACCA), Association of Accounting Technicians (AAT), Institute of Directors (IoD), Forum of Private Business (FPB), Federation of Small Business (FSB), Financial Reporting Council/CASE, Financial Reporting Council/ Professional Oversight Board. A brief summary is set out in the consultation document.**

## SUMMARY AND RECOMMENDATIONS

14.1 The table below shows a summary of the estimated costs and benefits of the proposals:

**Table of Options**

Option	Cost per annum	Benefit per annum
1. Implement the provisions in the Directive for companies which fall within the scope of	<b>Disclosure of off- balance sheet transactions</b> admin costs for up to 50% of 96k	Enhanced confidence in the financial statements and annual reports published by European

Option	Cost per annum	Benefit per annum
<p>the Directive taking up all exemptions (other than applying the increased thresholds to audit exemption)</p>	<p>large and medium-sized companies (48k) companies required to apply the extended reporting requirement. <b>Costs £2.50M.</b></p> <p><b>Disclosure of related party transactions</b> admin costs for up to 50% of 26k large companies (13k) companies required to apply the extended reporting requirement. <b>Costs £700k.</b></p> <p><b>Corporate Governance Statement</b> admin costs of presenting information in one place for up to 1,300 listed companies. Although information is already collected additional costs may be incurred to present it in one place. <b>Costs £68k.</b></p> <p><b>Collective responsibility of Directors</b> – no additional cost for companies as provisions in the Directive are already met.</p> <p><b>Total Costs £3.3M less savings of £730k = £2.5M.</b></p>	<p>companies through shareholders and other stakeholders having easy access to reliable and complete information leading to increased confidence in the EU capital markets and reduced malpractice, and facilitation of cross-border investments and improved EU-wide comparability</p> <p><b>Raising thresholds</b> - no compliance costs for companies but potential reduction in admin costs for those companies eligible to take up the option. <b>Savings £730k</b></p>
<p><b>2. Implement the provisions for all companies which fall within the scope of the Directive - take up the option to increase thresholds and apply to audit exemption for small companies</b></p>	<p><b>Disclosure of off- balance sheet transactions</b> admin costs for up to 50% of 96k large and medium-sized companies (48k) companies required to apply the extended reporting requirement. <b>Costs £2.50M.</b></p> <p><b>Disclosure of related party transactions</b> admin costs for up to 50% of 26k large companies (13k) companies required to apply the extended reporting requirement. <b>Costs £700k.</b></p> <p><b>Corporate Governance Statement</b> admin costs of presenting information in one place for up to 1,300 listed companies. Although information is already collected additional costs may be incurred to present it in one place. <b>Costs £68k.</b></p> <p><b>Collective responsibility of Directors</b> – no additional cost for companies as provisions in the Directive are already met.</p> <p><b>Fair Value Accounting</b> – this option will increase companies' flexibility to use current market</p>	<p>Enhanced confidence in the financial statements and annual reports published by European companies through shareholders and other stakeholders having easy access to reliable and complete information leading to increased confidence in the EU capital markets and reduced malpractice, and facilitation of cross-border investments and improved EU-wide comparability.</p>

Option	Cost per annum	Benefit per annum
	<p>values to evaluate certain liabilities.</p> <p><b>Total costs: £3.3M.</b></p>	<p><b>Fair Value Accounting</b> – the flexibility to use fair value estimates in line with more flexible and transparent reporting in line with International Accounting Standards.</p> <p><b>Raising thresholds</b> - no compliance costs for companies but potential reduction in admin costs for those companies eligible to take up the option. <b>Savings £730k</b></p> <p>Use of increased thresholds to determine eligibility for audit exemption and release up to 7,200 firms from the legal requirement to have accounts audited each year. Median audit fees £5,000 per annum. <b>Savings of £36 million per annum.</b></p> <p><b>Savings (£36.0M + £730) less costs £3.3M = £33.4M.</b></p>

**14.2 The Government recommends option 2 as the cost of improved transparency in the case of larger companies will be offset by reductions in the burdens for small companies. This approach will allow advantage to be taken of the increased transparency that improved disclosure requirements and the corporate governance statement will bring which together with clarity of directors' responsibility will help increase investor confidence. This option also provides companies with the flexibility to use fair value accounting or current market values to evaluate the value of financial instruments. The changes to thresholds will create 3,100 small companies and 1,600 medium-sized companies eligible to prepare and file less detailed accounts at Companies House. It is estimated that 1,100 previously medium-sized companies and 6,100 small companies would become eligible to take up the option not to have accounts audited.**

**14.3** BERR is committed to working closely with UK stakeholders during the consultation process to ensure the effective implementation of the provisions in the Directive to ensure that each element of the proposal brings economic benefits that justify legislation.

**14.4** BERR will endeavour to ensure that the final implementation proposal offers business options for flexibility that keep extra bureaucracy to an absolute minimum.

## Thresholds used to define Small and Medium-Sized Companies

	Existing Thresholds		Number of employees (not more than)	Proposed Thresholds	
	Turnover (not more than)	Balance sheet total (not more than)		Turnover (not more than)	Balance sheet total (not more than)
Small company	£5.6 million	£2.8 million	50	£6.5 million	£3.26 million
Small Group	£5.6 million net (or £6.72 million gross)	£2.8 million net (or £3.36 million gross)	50	£6.5 million net (or £7.8 million gross)	£3.26 million net (or £3.9 million gross)
Medium-sized company	£22.8 million	£11.4 million	250	£25.9 million	£12.9 million
Medium-sized Group	£22.8 million net (or £27.36 million gross)	£11.4 million net (or £13.68 million gross)	250	£25.9 million net (or £31.1 million gross)	£ 12.9 million net (or £15.5 million gross)

### Definition of Small and Medium-Sized Companies

To be eligible to be defined as small or medium-sized companies must meet 2 of the 3 criteria in respect of turnover, balance sheet total (assets) and employee numbers for 2 consecutive years.

### Exemption from Audit

To be exempt from audit requirement a company must be small (meet 2 of the 3 criteria), and then meet the criteria in respect the balance sheet total (assets) and turnover for 2 consecutive years.

### Group Accounts

“Net” figures reflect the set-offs and adjustments require by Schedule 4A of the Companies Act 1985 or in the case of IAS accounts in accordance with international accounting standards.

“Gross” figures excludes those set-offs and adjustments (+20%)

Analysis of companies by size is complicated (see Footnote 1 to Table) and most databases available for this task rely to some degree on estimation of data items not present in the company accounts. However, BERR's estimates, based on the FAME database as at July 2006, are as (figures may not add exactly as they have been rounded to the nearest hundred).

**Table 1: BREAKDOWN OF SIZE CATEGORIES BY TYPE OF COMPANY<sup>22</sup>**

	Private	Public <sup>23</sup>	Other <sup>24</sup>	TOTAL
<b>A. Existing Thresholds</b>				
Large	25700	26700	3000	55400
Medium-sized	35400	4500	4300	44100
Small	1407700	6500	97200	1511400
<b>B. Proposed Thresholds</b>				
Large	24100	26300	2900	53300
Medium-sized	33900	4600	4000	42500
Small	1410800	6900	97600	1515300
<b>C. Changes in Population</b>				
Large to medium-sized	1600	400	100	2100
Medium-sized to Small	3100	300	400	3800
<b>D. Changes in eligibility for audit exemption<sup>25</sup></b>				
Medium-sized to small audit exempt	<b>1100</b>	<b>100</b>	<b>200</b>	<b>1400</b>
Small to audit exempt	<b>6100</b>	<b>200</b>	<b>600</b>	<b>6900</b>

**Median Audit Fees for all small companies showing an audit fee: £5,000**

<sup>22</sup> The analysis takes account of one major complication, that Group members should be classified using the characteristics of their Ultimate Holding Company (UHC), not their own. However, this has only been done here when the UHC can be readily identified using FAME. In addition, the higher size criteria for Groups providing unconsolidated accounts have not been allowed for. These factors would have some impact on the figures but it is not thought that the general picture would be much affected.

<sup>23</sup> "Public" - Public Quoted, Public Quoted Investment Trust, Public A.I.M., Public Not Quoted, Public Quoted OFEX

<sup>24</sup> "Other" – Unlimited; Guarantee; Limited Partnership; Royal Charter; European Economic Interest Grouping; Foreign Companies; Industrial/Provident; Limited Liability Partnerships; Not Companies Act and "Other other".

<sup>25</sup> To be eligible for an audit exemption a company must be small, and meet criteria in respect of turnover and balance sheet total.

# Specific Impact Tests - Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

**Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.**

Type of testing undertaken	Results in Evidence Base? (Y/N)	Results annexed? (Y/N)
Competition Assessment	Y	N
Small Firms Impact Test	Y	N
Legal Aid	N/A	N/A
Sustainable Development	N/A	N/A
Carbon Assessment	N/A	N/A
Other Environment	N/A	N/A
Health	N/A	N/A
Race Equality	N/A	N/A
Disability Equality	N/A	N/A
Gender Equality	N/A	N/A
Human Rights	N/A	N/A
Rural Proofing	N/A	N/A



**TRANSPOSITION NOTE**

**IMPLEMENTATION OF DIRECTIVE 2006/46/EC**

OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 14th June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings

**The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008**

**No. 2008/**

**The Large and Medium-sized Companies and Groups (Accounts and Directors' Report) Regulations 2008**

**No. 2008/**

**The Companies Act 2006 (Amendment) (Accounts and Reports) Regulations**

**No. 2008/**

## Transposition Notes

DIRECTIVE 2006/46/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 14th June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies (“the 4<sup>th</sup> Directive”), 83/349/EEC on consolidated accounts (“the 7<sup>th</sup> Directive”), 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions (“the Bank Accounts Directive”) and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (“the Insurance Accounts Directive”)

This table has been prepared by the Department for Business, Enterprise and Regulatory Reform. It sets out the objective of each article of the Directive, and how it is to be implemented in the United Kingdom. The Secretary of State and the Financial Services Authority are responsible for implementation.

European Union accounting requirements are based primarily on the 4<sup>th</sup>, 7<sup>th</sup>, Bank Accounts and Insurance Accounts Directives. From 6th April 2008 UK implementation of those Directives will be in Parts 15 and 16 of the Companies Act 2006 (“the 2006 Act”), and regulations to be made under Part 15. The transposition of Directive 2006/46, which amends the accounting Directives and which must be transposed no later than 5th September 2008, therefore takes the form of amendments to the 2006 Act, and provisions of the regulations to be made under Part 15.

The regulations implementing the Directive do not go beyond what is necessary to implement the Directive, including making consequential changes to domestic legislation to ensure its coherence in the area to which they apply.

Article of Directive 2006/46/EC	Objective of Article	Implementation	Responsibility
1.1	<p>Amends <b>the Member State Option</b> in article 11 of the 4<sup>th</sup> Directive (applied to groups by article 6 of the 7<sup>th</sup> Directive) to increase the thresholds used to define small companies and groups for the purpose of certain accounting, reporting and audit exemptions.</p> <p>To qualify as small, a company or group is required to meet 2 of the 3 criteria in respect of balance sheet total, net turnover or employee numbers.</p>	<p>The criteria defining small companies in the UK are set out in sections 382 (3) and 477(2) of the 2006 Act.</p> <p>The criteria defining small groups are set out in sections 383 (4) and 479(2) of the 2006 Act.</p>	Secretary of State
	<p>The maximum financial thresholds are raised from EUR 3,650,000 to 4,400,000 in the case of balance sheet totals and EUR 7,300,000 to 8,800,000 in the case of net turnover – the average number of employees remains the same (50).</p>	<p>The financial thresholds for small companies and groups are amended in line with the Directive by regulations 3 and 5 in Part 2 of the Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008.</p>	
1.2	<p>Amends the 4<sup>th</sup> Directive to provide for the financial thresholds used to define small companies in the 4<sup>th</sup> Directive to be increased by any Directive, and not just by a Directive implementing the formal 5 yearly review process previously provided for in article 53(2) of the 4<sup>th</sup> Directive.</p>	<p>No action necessary.</p>	

Article of Directive 2006/46/EC	Objective of Article	Implementation	Responsibility
1.3	<p>Amends the <b>Member State Option</b> in article 27 of the 4<sup>th</sup> Directive (applied to groups by article 6 of the 7<sup>th</sup> Directive) to increase the financial thresholds used to define medium-sized companies and groups.</p> <p>To qualify as medium-sized, a company or group is required to meet 2 of the 3 criteria in respect of balance sheet total, net turnover or employee numbers.</p> <p>The maximum financial thresholds are raised from a balance sheet total of EUR 14,600,000 to 17,500,000 and net turnover EUR 29,200,000 to 35,000,000 - the average number of employees remains the same (250).</p>	<p>The criteria defining medium-sized companies are set out in section 465 (3) of the 2006 Act.</p> <p>The criteria defining medium-sized groups are set out in section 466 (4) of the 2006 Act.</p> <p>The financial thresholds are amended by regulation 4 in Part 2 of the Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008.</p>	Secretary of State
1.4	<p>Amends the 4<sup>th</sup> Directive to provide for the financial thresholds used to define medium-sized companies in the 4<sup>th</sup> Directive to be increased by any Directive, and not just by a Directive implementing the formal 5 yearly review process previously provided for in article 53(2) of the 4<sup>th</sup> Directive.</p>	No action necessary.	
1.5	<p>Amends article 42a of the 4<sup>th</sup> Directive as inserted by Directive 2001/65/EC (O.J.L283/328 of 27<sup>th</sup> October 2001) (often referred to as the Fair Value Directive). This contains a <b>Member State Option</b> to permit or require valuation of financial instruments and associated disclosure requirements which are provided for in international accounting Standards adopted in accordance with Regulation (EC) No. 1606/2002 of the European Parliament and Council up until 5 September 2006.</p>	<p>Small Companies and Groups (Accounts and Directors' Report) Regulations 2008, Schedule 1 paragraph 36 (4) gives small companies the option of fair valuing financial instruments in accordance with Article 1.5 of the Directive.</p> <p>Equivalent option given to large and medium-sized companies by the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008- Schedule 1 paragraph 36 (4) (non-banking or insurance companies), Schedule 2 paragraph 44 (4) (banking companies), and Schedule 3 paragraph 30 (4) (insurance companies).</p>	Secretary of State

Article of Directive 2006/46/EC	Objective of Article	Implementation	Responsibility
1.6	<p>Amends article 43 of the 4<sup>th</sup> Directive to require additional disclosure in the notes to accounts.</p> <p>New article 43(7a) imposes a <b>requirement</b> to include information about financial arrangements that do not appear on the balance sheet and the financial impact of those arrangements, where the risks or benefits arising are material, and in so far as the information is necessary to assess the financial position of the company.</p>	<p>Part 3 of the Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008 which inserts section 410A into the Companies Act 2006.</p>	Secretary of State
	<p>Member State option to exempt small companies from the disclosure requirement.</p> <p>Member State option to limit the disclosure required of medium-sized companies to information about the nature and business purposes of the arrangements.</p>	<p>Options in respect of small and medium-sized companies exercised in new section 410A(1) and (4) respectively.</p>	
	<p>New article 43(7b) imposes a <b>requirement</b> to disclose transactions entered into with related parties as defined in international accounting standards adopted in accordance with EC Regulation 1606/2002. Information may be aggregated unless separate information is necessary for understanding the impact of transactions on the company.</p> <p>Member State option to exempt small companies from the disclosure requirement.</p> <p>Member State option to exempt medium-sized companies which are not public companies from the disclosure requirement.</p>	<p>Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 - Schedule 1 paragraph 72 (non-banking or insurance companies), Schedule 2 paragraph 92 (banking companies), and Schedule 3 paragraph 90 (insurance companies).</p> <p>Option exercised. No requirement for small companies to make the disclosure.</p> <p>Option exercised in regulation 4(2)(b) of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008</p>	

Article of Directive 2006/46/EC	Objective of Article	Implementation	Responsibility
1.7	<p>Inserts a new article 46a into the 4<sup>th</sup> Directive. This imposes a <b>requirement</b> for companies whose securities are traded on a regulated market to produce a corporate governance statement either as a separate part of their annual (directors') report, or as a separate statement. The statement must cover-</p> <ul style="list-style-type: none"> <li>a. The corporate governance code applying to the company.</li> <li>b. Departures from the code and an explanation of the reasons for doing so.</li> <li>c. A description of main features of the company's internal control and risk management systems in relation to the financial reporting process.</li> <li>d. Certain matters related to the company's shares and control structures already required by Directive 2004/25/EC (the Takeovers Directive)</li> <li>e. The operation of the shareholder meeting and key powers and description of shareholders rights and how they are exercised unless information is already fully provided for in national laws or regulations</li> <li>f. The composition and operation of the board of directors and its committees.</li> </ul>	<p>Rules to be made by the Financial Services Authority under Part 6 of the Financial and Market Services Act 2000 as amended by section 1269 of the 2006 Act (corporate governance rules).</p>	<p>Financial Services Authority</p>

Article of Directive 2006/46/EC	Objective of Article	Implementation	Responsibility
	<p>Article 46a.2 contains a <b>Member State Option</b> to permit information to be set out in a separate report published with the annual report by means of a reference in the annual report to where such document is publicly available on the company's website.</p> <p>In the event of a separate report the corporate governance statement may contain a reference to the annual report where information is required at point d above.</p> <p>There is a requirement for a statutory auditor to express an opinion concerning the consistency with information in the annual report and accounts for the same financial year in the case of points c and d. For remaining information the statutory auditor shall check that the corporate governance statement has been produced.</p>	<p>Option to be implemented in the FSA rules referred to above.</p> <p>Section 496 of the 2006 Act (auditor's report on directors' report) to be amended by regulations under section 2(2) of the European Communities Act 1972 once the FSA rules have been made.</p>	<p>Financial Services Authority</p> <p>Secretary of State</p>
	<p>Includes a <b>Member State Option</b> to permit companies issuing securities other than shares, admitted to trading on a regulated market, to be exempt from provisions a, b, e and f.</p>	<p>Option to be implemented in the FSA rules referred to above.</p>	<p>Financial Services Authority</p>
<p><b>1.8</b></p>	<p>A new Section 10A is inserted into the 4<sup>th</sup> Directive. New Article 50b imposes a <b>requirement for</b> Member States to ensure that the directors have collective responsibility for drawing up and publishing accounts and reports, and the corporate governance statement when provided separately.</p>	<p>Part 15 (Accounts and Reports) of the 2006 covers specific responsibilities in respect of accounts and reports:</p> <p>Chapter 4 – collective duty to prepare accounts (sections 394, 399); approval and signing</p>	<p>Secretary of State</p>

Article of Directive 2006/46/EC	Objective of Article	Implementation	Responsibility
		<p>of accounts (section 414) and criminal penalties for failure to comply (section 414(4) and (5)).</p> <p>Chapter 5 – collective duty to prepare directors’ report (section 415); approval and signing of directors’ report (section 419) and criminal penalties for failure to comply (section 415(4) and (5), section 419(3) and (4)).</p>	
	<p>New article 50c imposes a <b>requirement on</b> Member States to ensure that their laws, regulation and administrative provisions on liability apply to the administration, management and supervisory bodies of a company for a breach of the duty referred to above at least towards the company.</p>	<p>Chapter 10 – duty to file accounts and reports with registrar of companies, with criminal and civil penalties for non-compliance (sections 451 to 453).</p> <p>Chapter 11 – provisions for civil enforcement of accounting and reporting requirements, which may result in a court order against the directors (section 456).</p> <p>The provisions listed above in Part 15 of the 2006 Act which relate to the directors’ report to be amended by regulations under section 2(2) of the European Communities Act 1972 once the FSA rules have been made to include reference to any separate corporate governance statement.</p>	<p>Secretary of State</p>
<p><b>1.9</b></p>	<p><b>Requires</b> that Member States exclude companies trading on a regulated market from the exemptions permitted for small and medium-sized companies.</p>	<p>Sections 384, 467 and 478 of the 2006 Act.</p>	<p>Secretary of State</p>
<p><b>1.10</b></p>	<p><b>Requires</b> that Member States lay down rules on penalties applicable to infringements of national provisions adopted pursuant to the Directive.</p>	<p>See the notes against article 1.8 above.</p>	<p>Secretary of State</p>

Article of Directive 2006/46/EC	Objective of Article	Implementation	Responsibility
2	Applies provisions set out in Article 1 of the Directive to the 7 <sup>th</sup> Directive on consolidated accounts.	<p>Section 410A(5) to be inserted by regulation 8 of the Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008.</p> <p>Provisions on individual accounts in the regulations to be made under Part 15 of the 2006 Act are applied to consolidated accounts by- regulation 8 of, and Schedule 6 to, the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008; and</p> <p>Regulation 9 of, and Schedule 6 to, the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.</p> <p>New article 36(2)(f) of the 7<sup>th</sup> Directive to be implemented by FSA rules (see entry for Article 1.7 above).</p>	Secretary of State
3	Applies the provisions in Article 1 of the Directive to the Bank Accounts Directive covering the annual and consolidated accounts of banks and other financial institutions.	See the notes against Articles 1 and 2 above. For those banking undertakings not governed by the 2006 Act, implementation will be by means of the Bank Accounts Directive (Miscellaneous Banks) Regulations 2008 to be made in early Spring 2008 to come into force on 6th April 2008.	Secretary of State and Financial Services Authority



<b>Article of Directive 2006/46/EC</b>	<b>Objective of Article</b>	<b>Implementation</b>	<b>Responsibility</b>
4	Applies the provisions in Article 1 of the Directive to the Insurance Accounts Directive covering the annual reports and accounts of insurance undertakings.	See the notes against Articles 1 and 2 above. For those insurance undertakings not governed by the 2006 Act, implementation will be by means of the Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 2008 to be made in early Spring 2008 to come into force on 6th April 2008.	Secretary of State and Financial Services Authority
5	Requires that the relevant provisions of the Directive be transposed no later than 5 September 2008. Details of transposition shall be communicated to the Commission.	Parts 15 and 16 of the 2006 Act, and the regulations referred to above in this Table, will come into force on 6th April 2008, and will apply to financial years beginning on or after that date. The FSA rules will have the same date of application. Details of transposition measures will be communicated to the EU Commission by administrative process.	Secretary of State and Financial Services Authority
6	Provides that the Directive comes into force on 5 September 2006.	No action necessary.	
7	Addresses the Directive to the Member States.	No action necessary.	