

**FINAL REGULATORY IMPACT ASSESSMENT
ON
THE THRESHOLDS DEFINING SMALL AND MEDIUM-SIZED COMPANIES**

1 Proposal

1.1 To increase the thresholds defining small and medium-sized companies to the maximum possible under EU law. This will be implemented by **The Companies Act 1985 (Accounts of Small and Medium-Sized Enterprises and Audit Exemption) (Amendment) Regulations 2004**.

2 Purpose and intended effect

(i) Objective

Small Company Threshold

2.1 The increase in the small company threshold will mean that more companies and Limited Liability Partnerships (collectively referred to as companies for ease of reference) will be able to take advantage of the less onerous accounting requirements available to small companies. The increase will also allow more small enterprises to benefit from the first year capital allowances available on Information and Communication Technology and Plant and Machinery.

Medium-sized Company Threshold

2.2 The increase in the threshold defining a medium-sized company will mean that more companies can be exempted from the new reporting requirements in the Modernisation Directive¹ when this is implemented in British law. It will also allow medium-sized enterprises to benefit from the first year capital allowance on plant and machinery.

2.3 **Devolution:** Responsibility for company law matters lies with the Secretary of State for Trade and Industry. Company law is a reserved area under the Scottish and Welsh devolution legislation and therefore any resulting changes to companies legislation will also apply in Scotland and Wales. In Northern Ireland, matters arising from the proposal would normally be the responsibility of the Northern Ireland Executive. 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.

¹ The Directive to modernise the 4th and 7th directives on the annual and consolidated accounts of companies (Directives 78/660/EEC and 83/349/EEC respectively) and the Directive on the annual and consolidated accounts of banks and other financial institutions, and insurance undertakings (Directives 86/635/EEC and 91/674/EEC respectively).

(ii) **Background**

2.4 Section 247 of the 1985 Act currently defines small and medium-sized companies as ones that meet 2 or more of the following requirements in their first financial year, or in the case of a subsequent year, in that year and the preceding year:

	Turnover (not more than)	Balance sheet total (not more than)	Number of employees (not more than)
Small company	£2.8 million	£1.4 million	50
Medium company	£11.2 million	£5.6 million	250

2.5 When a company meets the qualifying conditions of a small company it is able to take advantage of the less onerous accounting requirements that are set out in the 1985 Act². Small and medium-sized companies are also able to prepare and file less detailed accounts at Companies House. The accounting requirements for small and medium-sized companies are currently under review.

2.6 Articles 11 and 27 of the Fourth Directive set out the thresholds for small and medium-sized companies respectively (expressed as turnover, balance sheet total and number of employees). Article 53(2) of the Fourth Directive provides that every five years the Council of Ministers, acting on a proposal from the European Commission shall examine and, if need be, revise the amounts expressed in euros in the Directive, in the light of economic and monetary trends in the European Community. The thresholds have been reviewed and on 13 May 2003 the Council of Ministers adopted a Directive³ increasing the thresholds by 16.8%. The Directive came into force on 15 May 2003. The increases, expressed in euros, are shown in the table below.

2.7 Under Article 12(2) of the Fourth Directive Member States may also increase the thresholds specified in the Directive by a maximum of 10%. This was originally to take account of conversion from ecus into national currencies. It remains an option for all Member States, in order to maintain the principal of equal treatment. The pounds sterling figure⁴ provided in the table below takes account of the 10% increase.

² Section 246 of the 1985 Act

³ Council Directive amending Directive 78/660/EEC concerning amounts expressed in euro.

⁴ The exchange rate used is that published in the Official Journal of the EU on 15 May 2003 (£1 = 0.7118 euros)

	Turnover (not more than)	Balance sheet total (not more than)	Number of employees (not more than)
Small company	€7.3 million	€3.65 million	50
£ sterling with 10% increase	£5.6 million	£2.8 million	
Medium company	€29.2 million	€14.6 million	250
£ sterling with 10% increase	£22.8 million	£11.4 million	

2.8 The Modernising Company Law White Paper accepted the recommendation of the Company Law Review⁵ that the small company definition be increased to the maximum then allowed under EU law. On 9 April 2003 the Chancellor reaffirmed that the Government would be increasing the small company definition to the maximum permissible under EU Law. The Chancellor also announced the Government's intention to increase the medium-sized company threshold to the maximum possible under EU law.

2.9 On 6 May 2003 the Council of Ministers adopted a Directive to modernise the Fourth and Seventh Directives on the annual and consolidated accounts of companies (Directives 78/660/EEC and 83/349/EEC respectively) and the Directives on the annual and consolidated accounts of banks and other financial institutions and insurance undertakings (Directives 86/635/EEC and 91/674/EEC respectively ("the Modernisation Directive").

2.10 The Modernisation Directive includes a Member State option to exempt medium-sized companies from the requirement to include non-financial information in their annual report (the Fourth Directive allows Member States to exempt small companies from the requirement to prepare an annual report entirely). The Government considers that the reporting of non-financial information could be unduly burdensome on medium-sized companies, many of which may be family businesses or subsidiaries.

(iii) Risk Assessment

2.11 The proposal to increase the thresholds defining small and medium-sized companies is not addressing a particular risk but is a deregulatory measure that will relieve those businesses of a burden.

3 Options

3.1 The Government has identified the following options:

Option 1a:

3.2 The threshold that defines small companies remains at a turnover level of no more than £2.8 million, balance sheet total of £1.4 million and no more than 50 employees.

⁵ Modern Company Law For a Competitive Economy, July 2001, URN 01/942

3.3 Following extensive consultation as part of the independent Company Law Review, the Government announced in the Modernising Company Law White Paper in July 2002, its intention to increase the small company threshold to the maximum permissible under EU Law.

3.4 If the threshold defining small companies remains the same additional companies will not be able to take advantage of the less onerous accounting requirements available to small companies. Additional businesses will also not benefit from the first year capital allowances on information and communication technology (currently available until 31 March 2004) and plant and machinery.

Option 1b:

3.5 The thresholds defining small companies should be increased to the maximum possible under EU law:

Turnover no more than £5.6 million;

Balance Sheet total no more than £2.8 million; and

No more than 50 employees.

The thresholds increase will also be applied to group accounts where the turnover for the group does not exceed the new maxima.

3.6 The risks identified in the increase of the small company threshold are that an additional 31,000 companies will fall under the definition of small company, allowing them to file abbreviated accounts. Abbreviated accounts contain less detailed information. (98,500⁶ companies filed abbreviated accounts in the financial year 2002-2003. However, this has reduced from a high of 444,800 companies in financial year 2000 – 2001.) Small companies are currently required to prepare “full” accounts for shareholders but are able to produce a second, additional set of “abbreviated accounts” for filing on the public register. Respondents commented that there is a risk that more small companies will take advantage of the opportunity to file abbreviated accounts resulting in less information being available to the public. This may add confusion to the financial information available to investors and creditors and could hamper comparability.

3.7 This risk is for a limited period only. The Modernising Company Law White Paper confirmed the Government’s intention to abolish abbreviated accounts as part of the wider reforms of Company Law.

3.8 Option 2a:

The threshold that defines medium-sized companies remains at a turnover level of no more than £11.2 million, balance sheet total of £5.6 million and no more than 250 employees.

⁶ Companies in 2002-2003, DTI, July 2003

3.9 If the threshold defining medium-sized companies is not increased, when the Modernisation Directive is implemented into GB law more companies will be subject to new requirements to report on non-financial indicators relevant to the particular business. Additional businesses will also not benefit from the first year capital allowance on their spending on plant and machinery.

Option 2b:

The thresholds defining medium-sized companies should be increased to the maximum possible under EU law:

Turnover no more than £22.8 million;

Balance Sheet total no more than £11.4 million; and

No more than 250 employees.

The thresholds increase will also be applied to group accounts where the turnover for the group does not exceed the new maxima.

3.10 The risk identified in increasing the threshold defining medium-sized companies are that 16,000⁷ additional companies falling under the new definition would be eligible to file abbreviated accounts at Companies House reducing the amount of information on the public register however, they would still have to prepare full accounts for shareholders.

3.11 Although there is little difference between the content of the abbreviated accounts⁸ for medium-sized companies and the full accounts available to shareholders, this may add confusion to the financial information available to investors and creditors and could hamper comparability. Currently some 9,500⁹ medium-sized companies file abbreviated accounts. This risk is for a limited period only as the Modernising Company Law White Paper confirmed the Governments intention to abolish “abbreviated accounts” as part of the wider reforms of Company Law.

4 Benefits

Option 1a:

4.1 There are no benefits to companies in keeping the small company thresholds at its present level.

Option 1b

4.2 The current thresholds are significantly below the maxima permitted by EU Legislation. Most EU Member States have already adopted the previous maxima. The increase will allow an additional 31,000 companies to take advantage of the less onerous accounting requirements available to small companies. It will also allow these additional companies to take advantage of

⁷ Financial Analysis Made Easy (FAME) 2003

⁸ Items listed in the profit and loss account formats in Part I of Schedule 4 are combined as one item under the heading “gross profit or loss” and particulars of turnover are not included.

⁹ Companies in 2002-2003, DTI, July 2003

the 100% first year capital allowance on Information and Communication Technology available to small companies (currently available to until 31 March 2004). They will also still be eligible for the 40% first year capital allowance on Plant and Machinery. (See paragraph 4.5 below).

Option 2a:

4.3 There are no benefits to companies in keeping the medium-sized company thresholds at their present level.

Option2b:

4.4 When the provisions in the Modernisation Directive are implemented into GB law, the Government proposes to take advantage of the Member State option to exempt medium-sized companies from the requirements to include non financial information in their annual report (small companies are already exempt from most requirements in relation to annual reports). If the threshold defining medium-sized companies is increased to the EU maximum, it would relieve an additional 16,000 companies from new reporting requirements.

4.5 In addition, more SME's will benefit from the 40 per cent first year capital allowance on their spending on plant and machinery. The benefit to business from the allowances is in the period during which the investment is made as they allow a greater proportion of the cost of an investment to qualify for tax relief compared to the generally available rate of capital allowances for plant and machinery. They bring forward the tax relief on capital spending and can provide a helpful cash boost.

4.6 The increase in the qualification thresholds for both small and medium-sized companies will provide a cash flow benefit totalling £395 for both small and medium-sized enterprises over the next three years.

Business Sectors Affected

4.7 An increase in the thresholds defining small and medium-sized companies would affect all companies that meet the criteria set by the new definition in all business sectors.

Issues of Equity and Fairness

4.8 The Government considers that the proposal to increase the small and medium-sized company thresholds will not bring disproportionate benefits or have disproportionate effects on particular groups.

5 Costs

(i) Compliance costs

Option 1a:

5.1 The Government considers there to be no compliance costs for companies should the definition of small companies remain unchanged.

Option 1b:

5.2 The Government considers there to be no compliance costs for companies that will be redefined as small companies by the proposal.

Option 2a:

5.3 Medium-sized companies can be exempted from new reporting requirements placed on large companies by the Modernisation Directive. If the threshold is not increased, it will not be possible to exempt the further 16,000 companies falling under the new threshold. The cost of complying with this reporting requirement is difficult to isolate. If it is estimated to be £500 a company (in management time), the cost to companies would be £8 million in total.

Option 2b:

5.4 The Government considers there to be no compliance costs for companies that will be redefined as medium-sized companies by the proposal.

(ii) Other costs

5.5 The Government considers that there are no other costs imposed on sectors other than business.

(iii) Costs for a typical business

5.6 The Government considers that the proposal to increase the small and medium-sized company thresholds has no significant costs for business.

5 Consultation with small business: The Small Firm's Impact Test

5.1 The Government has consulted with small business throughout the process of the Company Law Review. The response from small business was that they were in favour, with no impact on existing small companies.

5.2 The Government considers that any change in the threshold defining medium-sized companies will have no impact on small companies.

6 Competition Assessment

6.1 It is not anticipated that the proposal will: affect some of those businesses more than others; affect market structure; change the number or size of those businesses; lead to higher set-up costs for those businesses; or lead to higher on-going costs, than at present.

7 Enforcement and Sanctions

7.1 No further enforcement is required other than that which already exists for enforcing the standards for small and medium-sized company accounts.

8 **Monitoring and Review**

8.1 The thresholds defining small and medium-sized companies in the EU are reviewed every five years. When the EU thresholds change, it is proposed that the thresholds in Great Britain would also be reviewed at that time.

9 **Consultation**

(i) **Within Government**

10.1 The DTI has consulted with the Small Business Service, Companies House, HM Treasury and the Inland Revenue.

(ii) **Public Consultation**

10.2 Following extensive consultation by the independent Company Law Review the Final Report recommended increasing the small company threshold to the EU maximum. In July 2002, the Government published the Modernising Company Law White Paper which proposed the increase to the small company threshold. The responses from the public supported the increase.

10.3 In July 2003, the Government published a consultation document on the proposed increase in the medium-sized company threshold. The consultation was sent to approximately 870 businesses, professional bodies, representative organisations and individuals. The consultation closed on 3 October 2003.

10.4 There were 36 responses to the proposal. 29 respondents were in favour, 4 were opposed and 3 did not express an opinion. Respondents commented that although few medium-sized companies were likely to take the opportunity to file abbreviated accounts, they should be abolished. The Government announced its intention to do so as part of the wider reform of company law. 2 respondents argued that medium-sized companies should not be allowed exemption from the disclosure requirements of the Modernisation Directive. This matter will be consulted on as part of the consultation on implementation of the Modernisation Directive. No further concerns were raised by respondents.

11 **Summary and Recommendation**

11.1 The table below shows a summary of the costs and benefits of the proposal:

Option	Total cost per annum	Total benefit per annum
1a. No change to the small company	• Cost to 31,000 further companies in being	• None.

threshold.	able to take advantage of the less onerous requirements available to small companies. Not quantified	
1b. The small company threshold be increased to the maximum permissible under EU Law.	<ul style="list-style-type: none"> • None. 	<ul style="list-style-type: none"> • Benefits to 31,000 further companies in being able to take advantage of the less onerous requirements available to small companies. – Not quantified. • Benefits to small enterprises from the 100% first year capital spending on Information and Communication Technology and to small and medium-sized enterprises for the 40% first year capital allowance on their spending on plant and machinery – £395 million
2a. No change to the medium-sized company threshold.	<ul style="list-style-type: none"> • Costs to companies in being subject to the reporting requirements of large companies that are proposed in the Modernisation Directive - £8 million. 	<ul style="list-style-type: none"> • None.
2b. The medium-sized company thresholds be increased to the maximum permissible under EU law	<ul style="list-style-type: none"> • None. 	<ul style="list-style-type: none"> • See total benefits to SME's of the capital allowances at option 1 above. • Benefit to companies in not being subject to the reporting requirements of large companies that are proposed in the Modernisation Directive - £8 million.

11.2 The Government recommends options 1b and 2b. An increase in the thresholds defining small and medium-sized companies will reduce burdens on the 31,000 new small companies and 16,000 new medium-sized companies that meet the new criteria. The medium-sized companies will be able to take advantage of the proposed Member State option in the Modernisation Directive to exempt them from the burden of reporting on non-financial issues. An increase in the threshold defining small companies will allow small enterprises to take advantage of the 100% capital allowance on Information and Communication Technology and the 40% first year capital allowance on their spending on plant machinery. An increase in the threshold defining medium-sized companies will allow medium-sized enterprises to take advantage of the 40% first year capital allowance on their spending on plant machinery.

I have read the Regulatory Impact Assessment and am satisfied that the benefits justify the costs.

..... Date:

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