



**EUROPEAN COMPANY LAW AND
CORPORATE GOVERNANCE**

Implementation of Directive
2006/46/EC on Company
Reporting – Amending the
Accounting Directives

A CONSULTATIVE DOCUMENT

MARCH 2007

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

MARCH 2007

The Department of Trade and Industry is consulting on proposals to implement amendments to the Fourth and Seventh Accounting Directives and to the Bank Accounts and Insurance Accounts Directives in UK Law and invites comments on the issues set out in this consultative document by **1 June 2007**.

You are invited to send comments, together with any supporting evidence on any part of this consultation, preferably by email, to:

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CONTENTS	Page/s
<u>FOREWORD</u>	
By the Minister for Trade, Investment and Foreign Affairs	3
<u>SECTION 1: EXECUTIVE SUMMARY</u>	
Purpose of this consultation	4
About the Directive	4 – 5
Related consultations	5
What happens next	6
How to respond	6
Confidentiality & Data Protection	6 - 7
Help with queries	7
<u>SECTION 2: OVERVIEW AND THE GOVERNMENT'S APPROACH</u>	
Overview of the Directive	8 - 9
Government's Overall Approach to the Directive	9 - 10
<u>SECTION 3: THE KEY MEASURES TO BE IMPLEMENTED</u>	
Small and Medium-sized Company Thresholds	
Thresholds	11 - 14
Other Observations concerning thresholds	14 - 15
Fair Value Accounting	15 - 18
Disclosure Requirements	
Off-balance sheet arrangements	18 - 20
Related Party Transactions	20 - 23
Corporate Governance Statement	23 – 30
Collective Responsibility of Directors	30 - 31
<u>SECTION 4: OTHER ISSUES</u>	
Timetable for implementation	32
Cost Savings and Benefits	32
List of Consultation Questions	33 - 34
<u>Annex A</u>	35 - 36
<u>Annex B</u>	37 - 56
<u>Annex C</u>	57 - 69
<u>Annex D</u>	70

FOREWORD

By the Minister for Trade, Investment and Foreign Affairs

Good corporate reporting is one of the cornerstones of efficient capital markets and the wider economy. It promotes trust and confidence in business, encourages investment and provides the basis for sound commercial decision making. It is important that the accounting and reporting framework operates in a way that supports long-term growth and innovation and ensures stakeholders and others are provided with fair and accurate information.

The potential impact of a loss of investor confidence across Europe and globally is immense. This was made all too real with the significant decline in stock market prices that followed from a number of corporate scandals earlier this decade. Many of us - whether through lost jobs or falls in value in our pension, endowment or other investment products – suffered directly.

It was important there was a concerted response, both from the EU and national Governments, to reduce the risk of similar events in the future. The measure on which we are now consulting, in amending the EU accounting and reporting framework, is a part of that response. It seeks to enhance confidence in the financial statements and annual reports published by European companies. The Directive aims to achieve its objective by making more transparent financial arrangements and requiring companies to give information relevant to good corporate governance.

The provisions in the Directive will not be sufficient to guarantee prevention of another Enron or Parmalat but it is hoped that placing additional targeted disclosure requirements on companies will reduce the likelihood of corporate malpractice. Certain provisions of the Directive are either already in place, or there are similar kinds of requirements, in the UK. These will require little, if any, change to existing practice. However, the requirement for a corporate governance statement, either as part of the directors' report or as a separate statement, is new. It is important that we find the right way to implement this in the UK so that we achieve the aims of the Directive - whilst avoiding disruption in the ongoing dialogue between companies and their investors.

We invite your views on the policy proposals to implement this Directive in the UK. We are determined to ensure that the UK continues to have the very best corporate reporting standards within a regulatory framework which avoids unnecessary burdens. To this end, we have engaged with many of our stakeholders to seek their views on these issues, and as we continue to do so your views would be extremely welcome and would guide us in making the right choices in implementation of this Directive into UK law.



Rt. Hon. Ian McCartney MP

SECTION 1: EXECUTIVE SUMMARY

Purpose of this consultation

1.1 Directive 2006/46/EC (“the Directive”) of the European Parliament and of the Council on Company Reporting was adopted on 14 June 2006. This consultative document seeks your comments on the UK Government’s plans to implement the Directive, including the likely costs and benefits of the implementation proposals as indicated in our draft Regulatory Impact Assessment (RIA) at Annex B. Your views will inform the implementation of the Directive in the UK. 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 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”).

1.2 **The formal consultation period will end on 1 June 2007. The Government will consult on draft regulations in due course**

About the Directive

1.3 The amendments introduced by the Directive are part of the short-term priorities under the 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 by introducing:

- An option for Member States to raise the financial thresholds defining small and medium-sized companies, from which various provisions of the Fourth and Seventh Directives may be disappplied, by 20%.
- An option for Member States to require or permit the valuation of further categories of financial instruments using “Fair Value” accounting in accordance with International Financial Reporting Standards (IFRS).
- A requirement to extend disclosure requirements in respect of off-balance sheet transactions and related party transactions.

- A requirement for publicly traded companies¹ to include a corporate governance statement in their annual reports.
- A requirement to ensure the collective responsibility of board members towards the company for the annual accounts and reports.

The full text of the Directive can be found at Annex C or from the following link: http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_224/l_22420060816en00010007.pdf

- 1.4 This consultation document identifies the different types of undertaking to which the various Directive provisions apply.
- 1.5 The measures introduced by the Directive are a mixture of provisions that have to be transposed into national legislation on a mandatory basis and a number of optional modifications. They should be implemented by 5 September 2008. They will be implemented in UK company law as part of the package of secondary legislation that will implement the accounting provisions in Part 15 of the Companies Act 2006.

Related consultations

- 1.6 European Directive 2006/43/EC on the Statutory Audit of Annual and Consolidated Accounts must be implemented by 29 June 2008. The Department of Trade and Industry is consulting on the implementation of that Directive in parallel with the consultation on the present Directive amending the accounting Directives, which are relevant to the scope of the Audit Directive. A separate consultation document can be found on the DTI website at

<http://www.dti.gov.uk/consultations/index.html> .

- 1.7 The Department of Trade and Industry is also consulting on the wider implementation of the Companies Act 2006. This consultation document can also be found on the DTI website at:

<http://www.dti.gov.uk/consultations/index.html> .

¹ Companies whose securities are admitted to trading on a regulated market within the meaning of 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>

What happens next?

- 1.8 The Government will issue a summary of responses within three months of the closing date of this consultation. It is intended that the Government response to this consultation be issued at the same time.

How to respond

- 1.9 Comments are welcome on all aspects of the proposal. In particular, we invite your views on the specific issues highlighted in this consultation document. A summary of the consultation questions is set out at pages 33 - 34. In relation to the draft Regulatory Impact Assessment at Annex B, any relevant data or other supporting evidence would be especially useful.
- 1.10 When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of an organisation, please make it clear who the organisation represents and, where applicable, how the views of members were assembled.
- 1.11 Responses should be submitted **by 1 June 2007**, preferably by email, to:

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1 Victoria Street
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SW1H 0ET

Email: 4and7.consultation@dti.gsi.gov.uk
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Fax: 0207 215 0235

Confidentiality & Data Protection

- 1.12 Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want other information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.
- 1.13 In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive

a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

- 1.14 The Department will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Help with queries

- 1.15 Questions about the policy issues raised in the document can be addressed to Julie Ford using the contact details in paragraph 1.10 above.

- 1.16 If you have comments or complaints about the way this consultation has been conducted, these should be sent to:

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- 1.17 A copy of the Code of Practice on Consultations is at Annex D.

- 1.18 You may make copies of this document without seeking permission. Further printed copies of the consultation document can be obtained from:

DTI Publications Order line
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<http://www.dti.gov.uk/publications>

An electronic version can be found at:

<http://www.dti.gov.uk/consultations/index.html>

SECTION 2: AN OVERVIEW AND THE GOVERNMENT'S APPROACH

Overview of the Directive

- 2.1 The overall objective behind the Directive is to “**further enhance confidence in the financial statements and annual reports published by European companies**” (EU Commission). To help ensure that this objective is achieved in a proportionate fashion the Directive also includes options to provide some relief for medium-sized companies, and an option to increase the thresholds defining small and medium-sized companies.
- 2.2 The specific measures in the Directive cover:
- A Member State option to **increase the financial thresholds used to define SMEs** for the purposes of the Fourth and Seventh Directives by 20% (Euros) for all eligible companies;
 - A Member State option to permit or require “**Fair Value**” **accounting** for the valuation and disclosure of a larger category of financial instruments for all companies;
 - Changes to **disclosure requirements for off-balance sheet arrangements** for all companies (with Member State options to except the individual accounts of qualifying small companies and consolidated accounts of qualifying small and medium-sized groups and to reduce the disclosures required in the individual accounts of medium-sized companies);
 - Changes to disclosure requirements for **related party transactions** for companies preparing accounts under national legislation implementing the accounting Directives (with Member State options to except the individual accounts of qualifying small companies and to reduce the disclosures required in the individual accounts of medium-sized companies and to except the consolidated accounts of qualifying small and medium-sized groups);
 - A requirement for Member States to ensure **the collective responsibility of board members** for the annual accounts and reports which applies to all companies;
 - A requirement to produce an **annual corporate governance statement** in the annual (directors’) report or as a separate report. The statement has to refer to the corporate governance code applied by the company and explain whether, and to what extent, the company complies with that code. It will also have to include a description of the main features of the company’s internal control and risk management systems in relation to the financial reporting process (and, in relation to groups, a description of the main features of the group’s internal control and risk management

systems in relation to the process for preparing consolidated accounts) and information on:

- Certain matters related to the company's share and control structures (already required by the Takeovers Directive ²)
- the composition and operation of the board of directors and its committees
- the general meeting and shareholder rights.

This requirement will apply to all companies whose securities are traded on a regulated market in the EU.

Government's Overall Approach to the Directive

- 2.3 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".³ 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 the Member States since national legislation differs.
- 2.4 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
 - Creating trust in our companies and markets that will attract internal investment and those seeking capital from around the world.
- 2.5 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.

² European Directive on Takeover Bids (2004/25/EC).

³ 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.

- 2.6 In the Government's view the changes introduced by the Directive will have a beneficial impact on corporate reporting. The Government is supportive of the measures introduced by the Directive and believes that it should contribute to EU market confidence in the wake of recent financial scandals, encourage cross-border investment and facilitate cross-border access to capital.
- 2.7 In implementing the Directive it will be important to get the balance right - ensuring proper disclosures are made, whilst not imposing disproportionate burdens on business.
- 2.8 A more detailed description of each of these provisions and initial thoughts on implementation are provided in the next section. The background to the Directive is set out at Annex A to this consultation.

Position of other entities

- 2.9 The accounting requirements for other entities such as limited liability partnerships, banking undertakings and 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, although not necessarily in the same time frame.

SECTION 3: THE KEY MEASURES TO BE IMPLEMENTED

SMALL AND MEDIUM-SIZED COMPANY THRESHOLDS

THE DIRECTIVE

- 3.1 Articles 1.1, 1.2 and 1.3 give Member States the option to increase the financial thresholds used to define small and medium-sized companies and groups for the purposes of the Fourth and Seventh Directives by 20% (Euros).

IMPLEMENTATION PROPOSAL:

- 3.2 The Government proposes to take advantage of the option to raise the thresholds defining small and medium-sized companies. If it does so, the DTI will use the power in section 468 of the Companies Act 2006 to amend the thresholds defining small and medium-sized companies and groups.**

BACKGROUND

- 3.3 Article 53(2) of the Fourth Directive (78/660/EC) 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 decision to raise the thresholds in the present Directive 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 small and medium-sized companies and, indeed, reduce the burdens imposed on such companies more generally by the accounting Directives.
- 3.4 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). In the UK, the thresholds used to define small and medium-sized companies are based on the maxima permitted by the Directives.
- 3.5 Sections 382, 383, 465 and 466 of the Companies Act 2006 define small and medium-sized companies and groups as, generally, those that meet 2 or more of the criteria set out in the table below in their first financial year, or in the case of a subsequent year, in that year and the preceding year. The table also sets out the revised thresholds that the UK would be able to apply were it to take full advantage of the 20% increase in the thresholds permitted by the Directive.

Thresholds used to define Small and Medium-Sized Companies

	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)

(Please note that the raise in the UK thresholds does not represent 20% in sterling figures. This is because the relevant threshold figures in the Directive are expressed in Euros. In transposing these figures into domestic currency, the exchange rate in the Official Journal at the date the Directive enters into force (5 September 2006) must be applied. Additionally, under Article 12(2) of the Fourth Directive, Member States may also increase the thresholds specified in the Directive by a maximum of 10%. The pounds sterling figure⁴ provided for the proposed thresholds in the table above takes account both of the applicable exchange rate and the 10% increase).

- 3.6 Most companies defined as small are currently permitted to produce an abbreviated profit and loss account and balance sheet for members, and to file only an abbreviated balance sheet with the registrar of companies. They are also exempt from a number of disclosures and many are exempt from the requirement to have a statutory audit. These exemptions will continue under the Companies Act 2006. Medium-sized companies also have the option to file less detailed accounts at Companies House and are exempt from some disclosure requirements. Under the Companies Act 2006 parents of medium-sized groups will no longer be exempt from preparing group accounts. This implements a recommendation of the Company Law Review against

⁴ The exchange rate used is that published in the Official Journal of the EU on 5 September 2006 (£1 = 0.67475euros).

the background of greatly increased SME thresholds for financial years starting on or after 1 April 2004.

3.7 The decision as to whether or not to take advantage of the increased thresholds is essentially a question of weighing the possible risks of reducing reporting requirements (for instance, those arising from more limited information being made publicly available) against the potential benefits (greater flexibility and lower costs for companies). As part of this consultation exercise on implementation of Directive 2006/46, the DTI held a workshop in early October 2006 to consider the implications of raising the financial thresholds defining small and medium-sized companies in the UK. A mix of delegates representing accounting institutions, the small business community and regulators attended the workshop. Responses to the idea of raising the thresholds and their application in respect of financial reporting were varied. Emerging themes included:

- The need to balance needs of users of accounts and the regulatory burdens on business
- Recognition that users of the accounts of small business are likely to be small businesses themselves
- Users' need for reliable and accurate information
- A desire for the accounting profession to provide alternative accounting services focussed on the need of small business rather than simply the fulfilment of statutory requirements
- The need to educate users – the accounts may provide useful information but readers may not know how to interpret it
- The need to recognise that thresholds are used for purposes other than company law.

Many of the issues raised related to the need for reliable and accurate information which is also transparent and easily understood by companies and the users of accounts.

3.8 On balance, the Government proposes to take advantage of this option to increase the thresholds. It is estimated that this would lead to 3,100 medium-sized companies becoming small, and 1,600 large companies becoming medium-sized⁵. These small companies would be eligible to take advantage of the less onerous reporting requirements available to small and medium-sized companies. It is also estimated that 1,100 medium-sized companies and 6,100 small companies would become eligible to take advantage of the audit exemption.

⁵ Source: Financial Analysis Made Easy (FAME) July 2006 – also see appendix B of the Regulatory Impact Assessment (RIA).

- 3.9 Small and medium-sized companies may also be able to take advantage of the first year allowance (FYA) for investments on plant and machinery provided by the tax system⁶.

Questions relating to the option to increase thresholds defining small and medium sized companies

- Q.1 Are there any risks associated with an increase in the thresholds used to define small and medium-sized companies?**
- Q.2 If so, in your view, are the risks of increasing the small and medium-sized company thresholds outweighed by the benefits?**

Other observations concerning the reporting obligations for small and medium-sized companies

- 3.10 It is important to set the issue of the thresholds defining small and medium-sized companies, and reporting burdens more generally on such companies, in a wider context. Both at the EU level and within the UK, there have been recent and thoroughgoing reviews of the appropriateness of legislative burdens placed upon business.
- 3.11 The European Commission has proposed a strategy to measure administrative costs and reduce administrative burdens, which includes the adoption of a joint target for reducing such burdens by 25%⁷. Annual accounts and company law have been identified as priority areas in the strategy.
- 3.12 In the context of accounting and audit, there were discussions at the Accounting Regulatory Committee meeting on 24 November 2006 on the possible scope for simplifying the Fourth and Seventh Directives⁸. This included:
- a.) possible further raising of the thresholds defining small and medium-sized companies;
 - b.) extending available exemptions under the Directives;
 - c.) amending or removing options;
 - d.) simplifying accounting requirements; and
 - e.) reducing the number of disclosure requirements.

⁶ Further details of the scheme are available from the HM Revenue & Customs website at: http://www.hmrc.gov.uk/capital_allowances/investmentschemes.htm#a

⁷ EU Commission Press Release (IP/06/1562) dated 14 November 2006, available on Commission website: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/1562&format=HTML&aged=0&language=EN&guiLanguage=en>

⁸ Further information concerning the Accounting Regulatory Committee and details of its meetings is contained on the website of the EU Commission: http://ec.europa.eu/internal_market/accounting/committees_en.htm

3.13 Similarly, in the UK, the DTI's Simplification Plan was published on 11 December 2006 setting out how and where specific savings in administrative burdens could be delivered to business⁹.

Q.3 What are your views on current and proposed reporting provisions (thresholds, exemptions, disclosure requirements, etc.) for small and medium-sized companies – do they merit further review?

“FAIR VALUE“ ACCOUNTING

THE DIRECTIVE

3.14 Article 1.5 of the Directive provides Member States with the option to permit or require fair valuation of a larger category of financial instruments than is permitted at present, together with associated disclosure requirements.

IMPLEMENTATION PROPOSAL

3.15 The option to adopt “Fair Value” accounting for a wider range of financial instruments is considered to be simpler for business. The Government proposes to permit, but not require, all companies preparing accounts under the Companies Act using UK Financial Reporting Standards (FRS) to use fair value in accordance with IAS 39 in both their individual and consolidated accounts. It believes this flexible, permissive approach is most appropriate for businesses at this time. The Government does not propose to elaborate on the Directive provision in the regulations to be made under Part 15 of the Companies Act 2006 specifying the form and content of accounts.

3.16 The Accounting Standards Board (ASB) will consider what, if any, action needs to be taken in respect of UK accounting standards.

BACKGROUND

3.17 Fair Value Accounting enables companies to use accounting practices that are consistent with IFRS¹⁰ issued by the International Accounting Standards Board (mainly IAS 39 on “Financial Instruments: Recognition and Measurement”, but also IAS 40 on “Investment Property” and IAS 41 on “Agriculture”). The Directive (article 1.5) will provide companies which prepare their accounts under the Companies Act 2006 and UK Financial Reporting Standards (see paragraphs 3.20 and 3.21 below)

⁹ Further details concerning the DTI's 2006 Simplification Plan are available on the website of the DTI: http://www.dti.gov.uk/bbf/better-regulation/2006_Simplification_Plan/page35599.html

¹⁰ In this consultation document the abbreviation IFRS is used to denote both International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS), except where the reference is to a specific numbered standard.

with additional flexibility in preparing their accounts by enabling greater use of fair value accounting.

- 3.18 IAS 39 defines “fair value” as the “amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”.
- 3.19 A “financial instrument” is defined by IAS 39 as “any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise” and includes cash, receivables, payables, equity and debt securities as well as financial derivatives such as futures, options and swaps. At present a limited range of financial instruments may be accounted for at fair value.
- 3.20 In the UK, FRS’s issued by the ASB apply to all UK companies and building societies preparing accounts under UK legislation and FRS; they are also used by a variety of other entities. FRS 26 on “Financial Instruments: measurement” is based on IAS 39. At present, companies applying FRS 26 are still subject to the provisions of the Companies Act 1985 which restrict the use of fair value measurement for liabilities.
- 3.21 The Accounting Schedules to Part 7 of the Companies Act 1985, i.e.
- Schedule 4 Part II Section D (for companies and groups other than banking or insurance companies and groups)
 - Schedule 8 Part II Section D (for small companies)
 - Schedule 9 Part I paragraphs 44A to 44F (for banking companies and groups) and
 - Schedule 9A Part I Section B (for insurance companies and groups)

have since 2004 permitted companies preparing accounts under the Companies Act using UK FRS to include some financial instruments in their balance sheets at fair value. Other types of financial instruments, particularly certain financial liabilities, are at present excluded from fair valuation. The exclusions are as follows:

- All financial liabilities except those held as part of a trading portfolio and those which are derivatives;
- Financial instruments (other than derivatives) held to maturity;
- Loans and receivables originated by the company and not held for trading purposes;
- Interests in subsidiary undertakings, associated undertakings and joint ventures;
- Equity instruments issued by the company;
- Contracts for contingent consideration in a business combination;
- Financial instruments where the fair value cannot be determined reliably; and

- Some other financial instruments with special characteristics such that they are accounted for differently under FRS.
- 3.19 These Schedules to the Companies Act 1985 implement the Fair Value Directive (Directive 2001/65/EC) which amended the accounting Directives to enable Member States to permit or require valuation of financial instruments at fair values and to require additional appropriate disclosures for financial instruments. The 1985 Act Schedules will be replaced by regulations to be made under Part 15 of the 2006 Act.
- 3.20 The IAS Regulation (1606/2002/EC) requires the use of IFRS for the consolidated accounts of publicly traded companies (and allows Member States to permit or require their use in other cases). Regulations 1725/2003/EC and 2086/2004/EC made under the IAS Regulation initially adopted the existing IFRS with some specific exceptions ('carve-outs') in relation to IAS 32 on Financial Instruments: disclosure and presentation, IAS 39 on Financial Instruments: recognition and measurement, and some related interpretations. These carve-outs (which primarily affected financial institutions such as banks and insurers) related to two issues:
- the fair valuation of a company's own liabilities and
 - the accounting treatment of portfolio hedging.
- 3.21 The International Accounting Standards Board (IASB) amended the fair value option in IAS 39 to restrict the ability of entities to fair value financial liabilities (and assets) to those financial instruments that meet specific conditions, i.e.
- where the information provided will be more relevant, because, either
 - a.) fair valuation will reduce recognition or measurement inconsistencies, or
 - b.) the relevant financial assets or liabilities are managed or evaluated on a fair value basis.

As a result of these changes by the IASB, which have now been adopted under the IAS Regulation, the Directive under article 1.5 amends the Fourth Directive to enable Member States to "permit or require valuation of financial instruments, together with the associated disclosure requirements", in accordance with IFRS as adopted. This amendment flows through to the other accounting Directives (i.e. the Seventh, Bank Accounts and Insurance Accounts Directives. It will

- enable companies preparing Companies Act accounts using UK FRS to value a slightly wider range of financial liabilities at fair value in accordance with IAS 39, and

- make it easier for such companies to comply with both EU endorsed IFRS and full IFRS simultaneously.
- 3.22 The Government believes that by permitting companies to follow accounting best practice the proposal will make their balance sheets more transparent at the balance sheet date and that this will create greater confidence for investors.

Questions relating to the use of “Fair Value” Accounting

- Q.4 Do you agree with the Government’s proposals to take up the option to extend the application of “Fair Value” accounting?**

DISCLOSURE REQUIREMENTS

- 3.23 Provisions in the Directive impose disclosure requirements in the notes to the accounts regarding off-balance sheet arrangements and related party transactions, with the objective of improving transparency in relation to such items.

A: OFF-BALANCE SHEET ARRANGEMENTS, INCLUDING SPECIAL PURPOSE ENTITIES

THE DIRECTIVE

- 3.24 Article 1.6 of the Directive amends Article 43 of the Fourth Directive by adding a requirement for disclosure of off-balance sheet arrangements. This will apply to all companies incorporated in an EU Member State whether they are preparing their annual accounts in accordance with national legislation implementing the accounting Directives (the Fourth, Seventh, Bank Accounts and Insurance Accounts Directives) or in accordance with EU adopted IFRS (under Regulation 1606/2002).

IMPLEMENTATION PROPOSAL

- 3.25 The requirement to disclose “off-balance sheet arrangements” (and the meaning of that term) becomes a matter of EU law as a result of the Directive’s provisions. The Companies Act 2006 will be amended to introduce the Directive’s disclosure requirements concerning off-balance sheet arrangements for all companies, whether preparing accounts using EU adopted IFRS, or preparing Companies Act accounts. It is proposed to implement the Directive’s requirement without further elaboration. DTI Guidance will draw attention to Recital (9) to the Directive.**
- 3.26 **Small companies and groups will be exempt from this requirement.**

- 3.27 It is proposed to utilise the Member State option to allow medium-sized companies to limit disclosure to information about the nature and business purpose of the arrangements.**
- 3.28 The ASB will consider what action needs to be taken in respect of UK accounting standards.**

BACKGROUND

- 3.29 Off-balance-sheet 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. The overall aim of the Directive is that companies should disclose any off-balance sheet arrangements and their financial impact if they are material to an assessment of a company's financial position (see Recital 8).
- 3.30 Small companies can be exempted from this requirement in relation to their individual accounts (Article 44.1 of the Fourth Directive).
- 3.31 There is also a Member State option in Article 1.6 of the Directive to provide that medium-sized companies (qualifying under Article 27 of the Fourth Directive) may limit disclosure regarding off-balance sheet arrangements to information about the nature and business purpose of such arrangements.
- 3.32 Article 2.1 of the Directive amends Article 34 of the Seventh Directive to enact equivalent obligations to disclose off-balance sheet arrangements in-group accounts. The amendments flow through to the Bank Accounts and Insurance Accounts Directives by virtue of articles 3 and 4 of the Directive.
- 3.33 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. However, FRS 5's requirements differ in certain respects from the Directive's requirements. The Accounting Standards Board is therefore also reviewing possible changes to FRS 5.
- 3.34 Off-balance sheet arrangements are not defined in the Directive. However, the concept is expanded upon by recital (9), which states that such arrangements can include:
- “any transactions or agreements which companies may have with entities, even unincorporated ones, that are not included in the balance sheet. Such off-balance-sheet arrangements may be associated with the creation or use of one or more Special Purpose Entities (SPEs) and offshore activities designed to address, inter alia, economic, legal, tax or accounting objectives. Examples of such off-balance-sheet arrangements include risk and benefit-sharing arrangements or

obligations arising from a contract such as debt factoring, combined sale and repurchase agreements, consignment stock arrangements, take or pay arrangements, securitisation arranged through separate companies and unincorporated entities, pledged assets, operating leasing arrangements, outsourcing and the like. Appropriate disclosure of the material risks and benefits of such arrangements that are not included in the balance sheet should be set out in the notes to the accounts or the consolidated accounts”.

- 3.35 Currently, SPEs are consolidated into group financial statements when the substance of the relationship between an entity and an SPE indicates that the SPE is controlled by that entity, either in accordance with IFRS or, in the UK, in accordance with the relevant provisions of the Companies Act and FRS 2 on “Reporting the substance of transactions”. These provisions cover all companies other than small companies.
- 3.36 Although Part 7 of the Companies Act 1985 and its related Schedules (which are to be re-enacted in regulations under Part 15 of the 2006 Act) already includes requirements to disclose certain matters that might be within the scope of the proposal, such as information on related undertakings, derivative financial instruments, guarantees and financial commitments, the proposed disclosures go wider than existing legislation. As discussed above, accounting standards also set out detailed requirements on the recognition and de-recognition of financial instruments and the consolidation (or otherwise) of SPEs. In a UK context, the Directive’s provisions may therefore be considered to require disclosure of other material arrangements that are not required to be disclosed through these more specific measures.
- 3.37 The Government believes that, in principle, transparency in financial statements of off-balance sheet arrangements should contribute to further integrating capital markets, improving access to capital and increasing cross-border investment.

Questions relating to off-balance sheet arrangements

Q.5 What are your views on the proposals for implementing disclosure requirements in respect of off-balance sheet arrangements?

B: RELATED PARTY TRANSACTIONS

THE DIRECTIVE

- 3.38** Article 1.6 of the Directive inserts a new paragraph (7b) into the Fourth Directive requiring disclosure in the notes to the accounts of transactions entered into by the company with related parties if they are material and have not been concluded under normal market conditions. This will apply to companies preparing Companies Act accounts and

using UK FRS, but not those preparing their accounts in accordance with EU adopted IFRS which are already subject to IAS 24 on “Related Party Transactions”. There is corresponding provision for group accounts in article 2.1 of the Directive, and these provisions flow through into the Bank Accounts and Insurance Accounts Directives (see articles 3 and 4). The disclosure will need to include the amount of the transaction, the nature of the related party relationship and other information about the transaction necessary for an understanding of the financial position of the company.

IMPLEMENTATION PROPOSAL

3.39 The requirement to disclose related party transactions becomes a matter of EU law as a result of the Directive’s provisions. Regulations under Part 15 of the Companies Act 2006 will introduce the Directive’s disclosure requirements on related party transactions for companies preparing Companies Act accounts and using UK FRS.

3.40 As regards the Member State options, it is proposed as follows:-

- a.) option to exempt small companies – it is proposed to take advantage of this option;**
- b.) option to exempt medium-sized companies (which are not public companies) from the obligation to disclose related party transactions – consultees’ views on the UK approach to this option are sought;**
- c.) option in respect of medium-sized companies, which are public companies, to restrict the disclosure obligation as regards related party transactions in certain respects – consultees’ views on the UK approach to this option are sought;**
- d.) option to exempt transactions entered into between two or more members of a group provided that subsidiaries which are party to the transaction are wholly owned by such a member - it is proposed to take advantage of this option.**

The ASB will consider what action needs to be taken in respect of UK accounting standards.

BACKGROUND

3.41 The Government believes, in principle, that information in the financial statements on related party transactions will contribute to integrated capital markets, improved access to capital and increased cross-border investment.

- 3.42 The provisions in the Directive are similar to IAS 24. For example the measure invokes the IAS 24 definition of 'related party'. 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.
- 3.43 For both individual and group accounts, information about individual transactions may be aggregated according to their nature, except where separate information is necessary for an understanding of the effects of the related party transactions on the financial position of the company or the undertakings included in the consolidation taken as a whole.
- 3.44 Under UK accounting standards, information on related party transactions has to be presented in accordance with FRS 8 on 'Related party disclosures'. The requirements are similar for companies reporting under the Financial Reporting Standard for Smaller Entities (FRSSE). Both FRS 8 and FRSSE already permit a similar approach to aggregation to that permitted in the Directive.
- 3.45 So far as group accounts are concerned, intra-group transactions are exempt from disclosure (see Article 2.1 of the Directive, adding new point (7b) to Article 34 of the Seventh Directive).
- 3.46 There are four Member State options in respect of the related party transaction disclosure requirement in the financial statements of individual entities. Member States may: -
- a.) exempt small companies (which are not public companies) from the obligation to disclose related party transactions under the Directive;
 - b.) exempt medium-sized companies (which are not public companies) from the obligation to disclose related party transactions under the Directive;
 - c.) in respect of medium-sized companies which are public companies, restrict the disclosure obligation as regards related party transactions to transactions entered into directly between (i.) the company and its major shareholders, and (ii) the company and members of the administrative, management and supervisory bodies (the board);
 - d.) exempt transactions entered into between two or more members of a group provided that subsidiaries which are party to the transaction are wholly owned by such a member.
- 3.47 For companies that are not groups, UK GAAP, as contained in FRS 8 and FRSSE, does not permit exemptions from disclosure. However,

under FRS 8, transactions with other members within a group of companies need not be disclosed in the parent company's individual and consolidated accounts and subsidiaries' individual accounts where 90% of the voting rights are controlled within a group. The Directive's disclosure requirements in this respect are, therefore, more stringent than those contained in FRS8, and are closer to those contained in IAS 24.

Questions relating to related party transactions

Q.6 Do you have any comments concerning the proposed approach to implementing the requirements in respect of related party transactions? In particular do you think the UK should take advantage of the following options,

option b - to exempt medium-sized companies (which are not public companies) from the obligation to disclose related party transactions;

option c - in respect of medium-sized companies, which are public companies, to restrict the disclosure obligation as regards related party transactions in certain respects.

CORPORATE GOVERNANCE STATEMENT

THE DIRECTIVE

3.48 Article 1.7 of the Directive, which inserts a new Article 46a in the Fourth Directive, applies to companies incorporated in an EU Member State whose securities are traded on a regulated market in the EU. The Government understands this provision as requiring UK law to impose the obligations on UK companies wherever traded within the EU but not, for example, on other EU companies traded in the UK.

3.49 Such companies will have to include, in a separate section of their annual (directors') reports or as a separate statement published with or referred to in the annual report, a new corporate governance statement, referring to:

a. The corporate governance code that applies to the company, and/or the corporate governance code, which the company may have voluntarily decided to apply, and/or information about the corporate governance practices applied beyond the requirements under national law;

b. The extent to which the company departs from such a code and the reasons for doing so;

- c. The main features of the company's internal control and risk management systems in relation to the financial reporting process (and, in relation to groups, a description of the main features of the group's internal control and risk management systems in relation to the process for preparing consolidated accounts);
- d. Certain matters related to the company's share and control structures (already required by the Takeovers Directive);
- e. Unless otherwise provided for in national laws or regulations, the operation of shareholders' meetings and their key powers and a description of shareholders' rights and how they can be exercised;
- f. The composition and operation of the board and its committees

IMPLEMENTATION PROPOSAL

3.50 The Government has yet to decide on:-

- a.) **which option is the most appropriate for implementing the corporate governance statement (i.e. whether as part of the Companies Act regime, through rules made by the Financial Services Authority (FSA) or as self-standing rules made by the Secretary of State); and**
- b.) **on the location of the statement (in the director's report or as a separate document).**

Views are, therefore, invited on both these issues.

BACKGROUND

3.51 Much of the corporate governance information required by the Directive is currently required of companies with shares listed (i.e. admitted to the official list maintained by the FSA in accordance with section 74 of the Financial Services and Markets Act 2000) in the UK. However, the requirement that the information be collated and set out in a discrete "corporate governance statement" is new. The Combined Code¹¹ on Corporate Governance sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders. The Combined Code requirements are not extended by the Listing Rules to companies with securities admitted to trading, but not listed, in the UK.

¹¹ A copy of the Combined Code is available from the FRC Website at: <http://www.frc.org.uk/corporate/combinedcode.cfm>

- 3.52 All companies incorporated in the UK and with listed shares are required under the Listing Rules (LR 9.8.6) to report on how they have applied the Combined Code in their annual report and accounts¹². The FSA is responsible for ensuring that such statements are made. The Combined Code is kept under review by the Financial Reporting Council. UK registered companies with shares traded on an EU regulated market, but not within the UK, are currently subject to any applicable corporate governance rules that apply in respect of that regulated market and not the Combined Code.
- 3.53 The current position, as regards the types of matters contained in the corporate governance statement obligation imposed by the Directive, in relation to companies registered and with shares listed in the UK is set out below:

Directive requirements	Current UK Position
<p>a. and b The corporate governance code that applies to the company including an explanation as to what extent the company complies with the code (or an explanation where it does not)</p>	<p>Listing Rule (LR) 9.8.6 requires in the annual report and accounts:</p> <p>(5) a statement of how the listed company has applied the principles of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied.</p> <p>6) a statement as to whether the listed company has:</p> <p>(a) complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code; or</p> <p>(b) not complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code and if so, setting out:</p> <p>(i) those provisions, if any, it has not complied with;</p> <p>(ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and</p> <p>(iii) the company's reasons for</p>

¹² A copy of the relevant listing rules are available from the FSA website at: <http://fsahandbook.info/FSA/html/handbook/LR/9/8>

Directive requirements	Current UK Position
	non-compliance.
<p>c. The main features of the company’s internal control and risk management systems in relation to the financial reporting process (and, in relation to groups, a description of the main features of the group’s internal control and risk management systems in relation to the process for preparing consolidated accounts)</p>	<p>There is no specific provision relating to disclosure of the main features of the company’s internal control and risk management systems in relation to the financial reporting process (or, for groups, the process for preparing consolidated accounts).</p> <p>However the Combined Code does require that “boards should, at least annually, conduct a review of the group’s system of internal controls and report to shareholders that they have done so” and that “The review should cover all material controls, including financial... management systems”. The Turnbull Guidance provides further guidance as to what information should be disclosed.</p>
<p>d. Certain matters related to the company’s share and control structures (already required by the Takeovers Directive)</p>	<p>Required (under Part 7 of the Companies Act 1985) to be included in the directors’ report since 20 May 2006 as a consequence of implementation of the Takeovers Directive.</p>
<p>e. Unless the information is already fully provided for in national laws or regulations, the operation of shareholders’ meetings and a description of how shareholder rights can be exercised</p>	<p>Shareholder participation in company meetings and the conduct of those meetings in listed companies is governed by a mixture of statutory provision, companies’ articles and common law provisions (and the Listing Rules and Combined Code).</p> <p>The relevant provisions of both the Companies Act 1985 and the Companies Northern Ireland Order 1986 will be replaced with the provisions of Part 13 of the Companies Act 2006. Also relevant are new provisions on the exercise of shareholders’ rights (including the exercise of such rights by “indirect investors”), which are included at Part 9 of the 2006 Act.</p>

Directive requirements	Current UK Position
	The Government has not identified any need to legislate to require further disclosure as regards this requirement. Comments are invited.
<p>f. The composition and operation of the board and its committees</p>	<p>Under the Combined Code, listed companies are required to include in their annual report:</p> <ul style="list-style-type: none"> • a statement on the operation of the board (section A.1.1); • the identity of the chairman, the deputy chairman (where there is one), the chief executive, the senior independent director and the chairmen and members of the nomination, audit and remuneration committees, and give details of attendance by individual directors at board meetings (section A.1.2); and • a description of the work of the nomination, remuneration and audit committees (sections A.4.6, B.1.4 and C.3.3 respectively). <p>A requirement to include a disclosure in line with the Directive's requirements would need to be included in the implementing provisions.</p>

3.54 The Government believes that proportionate EU action on corporate governance disclosure can benefit UK business by enhancing market confidence. It may also remove a current disincentive to cross-border investment created by differing levels and types of corporate governance disclosure in various Member States. Potential investors will receive equivalent basic information regardless of the State of incorporation of the company in which they are investing. Similarly, companies may find it easier to raise capital in other EU markets if there are shared minimum standards on corporate governance disclosure.

3.55 Member States have the option to exempt companies which have only issued securities, other than shares, admitted to trading on a regulated market from the measures in the Directive covering compliance or

explanation of non compliance with a code (a and b), the operation of shareholder meetings and shareholder rights (e), and the composition and operation of the board (f), unless such companies have issued shares which are traded in a multilateral trading facility. The requirement upon companies with listed shares to report in their annual report on how they have applied the Combined Code does not extend to companies with only listed debt securities. It is not considered that the same information considerations apply in respect of “debt-listed” companies, which usually attract sophisticated or specialised investors, as to those companies with traded shares. The Government, therefore, is proposing to take advantage of this option to minimise disclosure burdens on companies which do not have shares traded on a regulated market. Even if advantage is taken of the option to only require the more limited disclosures under (c) and (d) above in respect of “debt-listed” companies, the extension of these new disclosure provisions will, nevertheless, represent an extension of the present reporting regime.

Options for implementation of Corporate Governance Requirements

3.56 In implementing the corporate governance statement requirement, it will be necessary to ensure legally enforceable rules are in place (“best practice” or “guidance” recommendations would not give legally binding effect to the Directive’s provisions). The relevant provisions will need to extend to UK companies wherever their securities are traded on a regulated market within the EU. Three possible options have been identified for implementing the corporate governance requirements in the Directive:

- i. Prescribe the reporting requirements as part of the Companies Act regime. This would be consistent with the mechanisms by which the other reporting and disclosure requirements of the accounting Directives are implemented. Enforcement would be undertaken by the Financial Reporting Review Panel who can apply to the courts to request that revised accounts and reports are prepared. As with other mandatory reporting requirements, failure to include such a requirement, or making a false statement, would also be an offence. However, the provisions only apply to companies traded on a regulated market and, as described above, much of the substance of the disclosure requirements relates to matters traditionally the subject of the Combined Code within the UK.
- ii. For the Financial Services Authority (FSA) to prescribe the new requirements. As under the current approach, the requirements would then be enforced by the FSA. This would, however, be a departure from its current role monitoring compliance only with disclosure requirements in relation to the Combined Code as the new requirements in (c) to (f) would not be subject to ‘comply or explain’. Present FSA sanctions include an unlimited fine and the

added possibility of delisting companies that fail to comply with the listing rules. These sanctions do not extend to companies incorporated, but not listed, within the UK and, in respect of such companies, a new enforcement regime would need to be put in place.

- iii. For the Secretary of State to prescribe the new requirements as self-standing corporate governance regulations. This approach would create a new disclosure regime, neither under the Companies Act accounting and reporting provisions nor part of the FSA Rules. The approach would involve the creation of a new criminal offence or offences to enforce the requirement.

3.57 Wherever possible the Government would wish to retain the “light touch” approach of the current regime which permits sufficient flexibility and transparency to distinguish between well and badly governed companies. Under any of the options set out above, the enforcement body would take action only if a company had failed to make the necessary disclosures or made a false statement.

3.58 The Directive also provides a Member State option for the corporate governance statement to be published in one of two locations:

- In a specific section of the annual report (in the UK, the directors’ report); or,
- In a separate report published together with the annual report.

3.59 Much of the information currently identified as being required in the corporate governance statement is already produced by companies in their annual report. It would, therefore, be consistent with this for the corporate governance statement to form a part of the annual report. However, this must be set against potential benefits to users of the report, particularly shareholders, from having certain information about the corporate governance of the company set out in an easily accessible format.

3.60 There is some overlap between new mandatory disclosures required under the Directive and disclosures currently made under the Combined Code, for example on the composition and operation of the board and committees. Depending on the approach chosen to implement the Directive, the FRC will need to consider whether consequential amendments should be made to the Code. If any changes are proposed, the FRC will carry out a separate consultation.

Audit Directive: Audit Committee

3.61 The Government is also consulting on options for implementing related provisions under Article 41 of the Audit Directive. This includes new requirements for public interest entities to have an audit committee

meeting the compositional and functional requirements of that Article or a body performing equivalent functions. There is clearly scope for combining the implementation measures for these requirements with those related to the corporate governance statement in the interests of simplicity and clarity for business. The Government has been mindful of this in identifying the range of implementation options. The Government's separate consultation document on the implementation of the Audit Directive can be found at:

<http://www.dti.gov.uk/consultations/index.html> .

Questions relating to the Corporate Governance Statement

Q.7 Can you identify any need to require further disclosure as regards the duty to include in the corporate governance statement (e) information concerning the operation of shareholders' meetings and a description of how shareholder rights can be exercised?

Q.8 Which of the 3 options: -

a.) Prescribe the reporting requirements as part of the Companies Act regime;

b.) Prescribe the reporting requirements through rules made by the Financial Services Authority; or

c.) Prescribe the reporting requirements as self-standing corporate governance rules made by the Secretary of State

do you think would be the best approach to implementing the requirement to produce a corporate governance statement?

Q.9 Should companies have the option of whether to publish the statement separate to the directors' report or should publication be restricted to the directors' report?

COLLECTIVE RESPONSIBILITY OF DIRECTORS

THE DIRECTIVE

3.62 Articles 1.8, 1.9, 1.10 and 2.3 of the Directive, set out a requirement for Member States to ensure that board members are collectively responsible at least towards the company for drawing up and publishing annual and consolidated accounts and reports and, where produced separately, the corporate governance statement.

3.63 However, whilst Member States are to refrain from opting for a system of responsibility limited to individual board members this does not preclude the ability of courts or other enforcement bodies to impose penalties on individual board members.

IMPLEMENTATION PROPOSAL

3.64 The provisions in the Directive covering the directors' duty and liability for drawing up and publishing the annual report and accounts are already transposed into the Companies Act 2006. They will be amended, as necessary, to encompass any separate corporate governance statement prepared in accordance with the Directive. No further action is necessary to meet these requirements in the UK.

BACKGROUND

3.65 This provision applies to all limited companies incorporated in an EU Member State and for the first time lays down an EU wide rule on this matter.

3.66 Collective responsibility for financial statements and the annual report reflects the current practice in the UK.

3.67 In the UK collective responsibility of the directors for preparing individual and group accounts is set out in sections 394 and 399 of the Companies Act 2006. Section 414 covers directors' duties for signing and approval of accounts, whilst section 415 covers their duty to prepare directors' reports and section 419 their duty to approve and sign those reports. Section 441 covers the duty to file accounts and reports with the registrar. Failure to comply with these requirements may result in criminal penalties (sections 414 and 419) or in civil enforcement action (Chapter 11 of Part 15), which may result in a court order against the directors (section 456).

Questions relating to Directors Responsibilities

Q.10 Do you agree that no further action needs to be taken to implement the Directive's provisions on the collective responsibility of directors (other than in relation to any separate corporate governance statement)?

SECTION 4: OTHER ISSUES

Timetable for implementation.

- 4.1 Member States are required to bring into force the laws, regulations and administrative provisions to comply with the Directive by 5 September 2008. They will be implemented in UK company law as part of the package of secondary legislation that will implement the accounting provisions in Part 15 of the Companies Act 2006.

Q.11 Do you have any views concerning the timescale for implementation of the Directive in UK law?

Cost savings and benefits

- 4.2 A draft regulatory impact assessment (RIA) is attached at Annex B.

Questions relating to the draft Regulatory Impact Assessment

Q.12 What are your views on the costs and benefits set out in the draft regulatory impact assessment?

Q.13 Apart from those set out in the draft regulatory impact assessment are there any other costs or benefits that should be taken into account when implementing the measures in the Directive?

Q.14 What other risks should be considered when implementing the provisions in the Directive: can any action be taken to reduce them?

Q.15 Are you aware of any unintended consequences or implications of implementing the provisions in the Directive?

4.3 LIST OF CONSULTATION QUESTIONS

Questions relating to the option to increase thresholds defining small and medium-sized companies

- Q1 Are there any risks associated with an increase in the thresholds used to define small and medium-sized companies?
- Q2 If so, in your view, are the risks of increasing the small and medium-sized company thresholds outweighed by the benefits?
- Q.3 What are your views on current and proposed reporting provisions (thresholds, exemptions, disclosure requirements, etc.) for small and medium-sized companies – do they merit further review?

Questions relating to the use of “Fair Value” Accounting

- Q.4 Do you agree with the Government’s proposals to take up the option to extend the application of “Fair Value” accounting?

Questions relating to off-balance sheet arrangements

- Q.5 What are your views on the proposals for implementing disclosure requirements in respect of off-balance sheet arrangements?

Questions relating to related party transactions

- Q.6 Do you have any comments concerning the proposed approach to implementing the requirements in respect of related party transactions? In particular do you think the UK should take advantage of the following options,

option b - to exempt medium-sized companies (which are not public companies) from the obligation to disclose related party transactions;

option c - in respect of medium-sized companies, which are public companies, to restrict the disclosure obligation as regards related party transactions in certain respects.

Questions relating to the Corporate Governance Statement

- Q.7 Can you identify any need to require further disclosure as regards the duty to include in the corporate governance statement (e) information concerning the operation of shareholders’ meetings and a description of how shareholder rights can be exercised?

Q.8 Which of the 3 options: -

a.) Prescribe the reporting requirements as part of the Companies Act regime;

b.) Prescribe the reporting requirements through rules made by the Financial Services Authority; or

c.) Prescribe the reporting requirements as self-standing corporate governance rules made by the Secretary of State

do you think would be the best approach to implementing the requirement to produce a corporate governance statement?

Q.9 Should companies have the option of whether to publish the statement separate to the directors' report or should publication be restricted to the directors' report?

Questions relating to Directors Responsibilities

Q.10 Do you agree that no further action needs to be taken to implement the Directive's provisions on the collective responsibility of directors (other than in relation to any separate corporate governance statement)?

Questions relating to the timetable for implementation

Q.11 Do you have any views concerning the timescale for implementation of the Directive in UK law?

Questions relating to the draft Regulatory Impact Assessment

Q.12 What are your views on the costs and benefits set out in the draft regulatory impact assessment?

Q.13 Apart from those set out in the draft regulatory impact assessment are there any other costs or benefits that should be taken into account when implementing the measures in the Directive?

Q.14 What other risks should be considered when implementing the provisions in the Directive: can any action be taken to reduce them?

Q.15 Are you aware of any unintended consequences or implications of implementing the provisions in the Directive?

BACKGROUND TO DIRECTIVE 2006/46/EC ON COMPANY REPORTING

1. On 27 October 2004 the European Commission published its proposal for a Directive of the European Parliament and of the Council to amend the Fourth and Seventh Directives. The proposal was part of the short-term priorities under the Commission's EU Company Law and Corporate Governance Action Plan published in May 2003 (endorsed by the Competitiveness Council in September 2003). It sought to enhance confidence in financial statements and annual reports published by European companies. The proposal contained three main elements:
 - a.) ensuring the collective responsibility of board members towards the company for the annual accounts and report;
 - b.) extending disclosure requirements relating to off-balance sheet arrangements and related party transactions; and
 - c.) new requirements for companies whose securities are traded on a regulated market to draw up a corporate governance statement.
2. Negotiations on the proposal started in December 2004. Many UK stakeholders will have helped shape the final Directive through participation in the public consultations held by the Commission on the content of the Action Plan in 2002 and the pre-proposal consultation on amending the Fourth and Seventh Directives between April and June 2004.
3. The DTI published a consultation document "Directive Proposals on Company Reporting, Capital Maintenance and the Transfer of the Registered Office of a Company"¹³ on 10 March 2005 seeking views on the draft EU Directive to amend the Fourth and Seventh Directives (company reporting). The Government response and summary of responses to the consultation was published in September 2005¹⁴.
4. The European Council reached a provisional agreement to a modified version of the Commission proposal at the ECOFIN Council on 7 June 2005. The agreed text was based substantially on the three main elements of the Commission proposal published in October 2004 but included changes reflecting comments made by UK consultees. In particular:

¹³ A copy of the consultation document can be found at <http://www.dti.gov.uk/files/file14584.pdf>

¹⁴ A copy of the government response and summary of responses is available at <http://www.dti.gov.uk/files/file14585.pdf>

- The scope of the proposed new “off-balance sheet” disclosure requirements had been clarified;
 - Greater consistency was achieved between the proposal requiring “related party transactions” to be disclosed and International Financial Reporting Standards (IFRS);
 - Clarifications were made to reflect the different corporate governance reporting structures within EU Member States;
 - An option had been provided to Member States to make the corporate governance statement a part of the annual (directors’) report or allow companies to produce the statement as a separate document; and
 - The Directive’s scope was expanded to encompass the Bank Accounts and Insurance Accounts Directives.
5. In order to achieve a more proportionate proposal, the European Parliament pressed hard for measures relieving small and medium-size companies (SMEs) from some of the burdens of the proposal and the accounting Directives more generally. In particular, they sought exemption of medium-sized companies from new accounting disclosures and stressed a need for a major rise in “SME” thresholds. As a result the Directive provides some relief for medium-sized companies from the new reporting requirements and an option for Member States to raise by 20% (Euros) the financial thresholds defining small and medium-sized companies, from which various provisions of the Fourth and Seventh Directives may be dis-applied.
6. The finally agreed Directive was published on 16 August 2006. Member States are required to bring into force the laws, regulations and administrative provisions to comply with the Directive by 5 September 2008.

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

DRAFT REGULATORY IMPACT ASSESSMENT

1. PROPOSAL

1.1 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 aims to give effect in UK law to this Directive.

1.2 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

2. OBJECTIVE

2.1 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.

2.2 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 2003¹⁵. 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.

2.3 The Government agrees with this view. The proposed additions to the financial and non-financial information provided by companies together

¹⁵Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:NOT>

with the clarity of the responsibility of directors will provide common standards on content and reliability of information published across the EU, and are designed to allow investors to make comparable assessment of companies regardless of the Member State in which they are incorporated.

2.4 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 and reporting 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 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 small and medium-sized groups 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 and small and medium-sized groups from this requirement.

(e) Introducing an annual corporate governance statement.

A requirement applicable to: Publicly traded Companies¹⁶

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

¹⁶ Regulated markets are 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>

A requirement applicable to: All companies.

- 2.5 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 and possibly to financial services rules.
- 2.6 The accounting requirements for other entities such as limited liability partnerships, banking undertakings and 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, although not necessarily in the same time frame.

3. **BACKGROUND TO THE DIRECTIVE**

- 3.1 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.
- 3.2 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.
- 3.3 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.
- 3.4 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.

- 3.5 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 hazard¹⁷ 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.
- 3.6 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 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 capital¹⁸. 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."¹⁹
- 3.7 There has been little evidence to assess the intuitive link between transparency and the cost of capital although Leuz²⁰ and Hail²¹'s work

¹⁷ Moral hazard – the perverse incentive whereby agents are not held responsible for their actions which encourages them to engage in risky behaviour.

¹⁸ 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>>

¹⁹ 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>>

²⁰ " 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."

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 Luez 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.

4. ASSESSMENT OF RISK

- 4.1 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.
- 4.2 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.²²
- 4.3 The options in the Directive covering the increase in the thresholds defining small and medium-sized businesses do not address a particular risk but are measures aimed at relieving businesses of

²¹ 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

²² 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>

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).

- 4.4 Existing and revised thresholds are set out in appendix A of this RIA. The population of companies, small, medium-sized and large that are affected by the changes in the Directive is shown at appendix B.

5. **HOW THE PROPOSALS WILL WORK, THEIR COSTS AND BENEFITS**

- 5.1 Where the requirements are mandatory there will be costs and benefits should they differ from what UK companies are already doing. 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.

- 5.2 A one off cost has been incurred by the DTI in developing and disseminating the policy estimated at £100,000²³, whichever option is pursued.

5.3 **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 it is able to take advantage of the less onerous accounting and reporting requirements that are set out in the Companies Act.

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.

Benefits: It is estimated that a further 3,100 small companies and 1,600 medium-sized companies will be eligible to prepare and file less detailed accounts at Companies House²⁴. It is not possible to state how many of these companies will take advantage of the option to reduce reporting requirements. If we assume that the reduced reporting

²³ Based on DTI ready reckoner and an estimate of staff time and overheads, spent on implementing the Directive.

²⁴ These figures refer to private companies only – public companies would not be eligible.

requirements would lead to a saving of only 6 hours of accountancy time per year, using an hourly rate of £26.00²⁵ the savings per company would be in the region of £156 per annum. This results in a reduced burden for all 4,700 companies amounting to a total saving of up to £0.73M per annum. However, those 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. 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 accounts audited. It is not possible to assess the percentage of companies that would take advantage of this option, the form of any alternative assurance that might be sought as to the contents of the accounts of such companies or the costs and benefits arising as a consequence. Comments are invited, in particular, on these issues. It is also estimated that around 2,100 companies may also be eligible for first year capital allowances provided by the tax system.

5.4 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.

²⁵ 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.

http://www.statistics.gov.uk/downloads/theme_labour/ASHE_2006/2006_occ4.pdf

5.5 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.

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. If we assume 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. Comments are invited on this.

5.6 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.

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.

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 and medium-sized companies (48k), 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 of up to £2.5M.

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. Comments are invited on this.

5.7 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 1,300²⁶ 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 (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.

6. OPTIONS

Option 1

- 6.1 **Do Nothing:** The Directive will be applicable throughout the EEA and will require implementation once agreed. It is not possible therefore, to take no action.

²⁶ 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/>

Option 2

- 6.2 **Implement the mandatory elements of the Directive only:** 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.
- 6.3 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.
- 6.4 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 (£2.50M)
 - Increased disclosure of off-balance sheet arrangements (£2.50M)
 - Compilation of the Corporate governance statement (£68k)
- No additional costs are associated with the measure in respect of the collective responsibility of directors.

Option 3

- 6.5 **Implement the mandatory and optional elements of the Directive:** 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.
- 6.6 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. Cost and saving would accrue as follows:

- Increased disclosure of related party transactions – possible costs up to £2.50M;
- 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 up to £0.73M.

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

6.8 Equally, companies will have the option to adopt fair value accounting – a more modern, transparent accounting practice in line with IFRS.

7. WHO WILL BE AFFECTED?

7.1 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.

7.2. 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.

7.3 All business sectors will be affected by the proposal.

8. ISSUES OF EQUITY AND FAIRNESS

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

9 CONSULTATION WITH SMALL BUSINESS: THE SMALL FIRMS' IMPACT TEST

9.1 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.

9.2 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.

- 9.3 Small companies can be exempted from disclosing any off balance sheet arrangements and related party transactions. However the ASB's Financial Reporting Standard for Smaller Entities does require disclosure of RPTs.
- 9.4 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.
- 9.5 The 3,300 additional small companies will be eligible to take advantage of reduced reporting requirements and some would be exempt from the requirement to have a statutory audit. These small companies would be eligible to take advantage of the less onerous accounting and audit requirements available to small companies. Some may also be able to take advantage of the first year allowance (FYA) for investments on plant and machinery provided by the tax system²⁷.

10. **COMPETITION ASSESSMENT**

- 10.1 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.
- 10.2 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.
- 10.3 Information produced by the Professional Oversight Board in March 2006²⁸, noted a 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 are currently prevented from doing by their position as auditor.

²⁷ Further details of the scheme are available from the HM Revenue & Customs website at: http://www.hmrc.gov.uk/capital_allowances/investmentschemes.htm#a

²⁸ 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>

11. ENFORCEMENT AND SANCTIONS

11.1 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: DTI

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

Civil liability: the courts

- **Corporate Governance statement**

Dependent on the final legislative route taken to implement the Directive, the Financial Services Authority / UK Listing Authority, DTI or FRRP (or a combination of all or some of these bodies).

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

12 CONSULTATION

12.1 Within government

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

12.2 Regulators and Public Bodies

DTI 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.

12.3 Public consultation

Prior to the proposal, DTI 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 difference 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.

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

12.5 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.

12.6 The DTI 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.

13. SUMMARY AND RECOMMENDATIONS

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

Table of Options

Option	Cost per annum	Benefit per annum
1. Do nothing	Risk of infraction proceeding for failure to implement the requirements of the Directive and other legal uncertainties.	No benefits.
2. Implement only the mandatory elements of the Directive	One off costs for DTI in developing and disseminating policy of £100k. Disclosure of off-balance sheet transactions admin costs	Enhanced confidence in the financial statements and annual reports published by UK companies through shareholders and other stakeholders having easy access to reliable and

Option	Cost per annum	Benefit per annum
	<p>for up to 50% of 96k small and medium-sized companies (48k) companies required to apply the extended reporting requirement. Costs £2.50M.</p> <p>Disclosure of related party transactions admin costs for up to 50% of 96k small and medium-sized companies (48k) companies required to apply the extended reporting requirement. Costs £2.50M.</p> <p>Corporate Governance Statement 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. Costs £68k.</p> <p>Collective responsibility of Directors – no additional cost for companies as provisions in the Directive are already met.</p> <p>Total Costs £5.17M.</p>	<p>complete information. This will lead to increased confidence in the EU capital markets and reduced malpractice, and facilitation of cross-border investments and improved EU-wide comparability.</p>
<p>3. Implement the mandatory and optional elements of the Directive</p>	<p>One off costs for DTI in developing and disseminating policy of £100k.</p> <p>Disclosure of off-balance sheet transactions admin costs for up to 50% of 96k</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</p>

Option	Cost per annum	Benefit per annum
	<p>small and medium-sized companies (48k) companies required to apply the extended reporting requirement. Costs £2.50M.</p> <p>Disclosure of related party transactions admin costs for up to 50% of 96k small and medium-sized companies (48k) companies required to apply the extended reporting requirement. . Costs £2.50M.</p> <p>Corporate Governance Statement 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. Costs £68k.</p> <p>Collective responsibility of Directors – no additional cost for companies as provisions in the Directive are already met.</p> <p>Fair Value Accounting – this option will increase companies' flexibility to use current market values to evaluate certain liabilities.</p> <p>Raising thresholds May lead to reduced disclosure for users of the accounts of the 3,100 companies that would</p>	<p>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>Raising thresholds - no compliance costs for companies but potential reduction in admin costs for those companies eligible to take up the option. Savings £0.73M.</p> <p>Flexibility to use fair value estimates in line with more flexible and transparent reporting in line with International Accounting Standards.</p>

Option	Cost per annum	Benefit per annum
	become small and 1,160 that would become medium-sized Total costs: £5.17M.	

- 13.2 The Government recommends option 3. 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. However unlike option 2 this option 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 medium-sized companies and 6,100 small companies would become eligible to take up the option not to have accounts audited.
- 13.3 The DTI 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.
- 13.4 The DTI will endeavour to ensure that the final implementation proposal offers business options for flexibility that keep extra bureaucracy to an absolute minimum.

Ian McCartney
Minister of State for Trade and Investment
DEPARTMENT OF TRADE AND INDUSTRY

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Appendix A

Thresholds used to define Small and Medium-Sized Companies

	Existing Thresholds			Proposed Thresholds	
	Turnover (not more than)	Balance sheet total (not more than)	Number of employees (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.

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%)

Appendix B

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, DTI'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 COMPANY²⁹

	Private	Public ³⁰	Other ³¹	TOTAL
A. Existing Thresholds				
Large	25700	26700	3000	55400
Medium-sized	35400	4500	4300	44100
Small	1407700	6500	97200	1511400
B. Proposed Thresholds				
Large	24100	26300	2900	53300
Medium-sized	33900	4600	4000	42500
Small	1410800	6900	97600	1515300
C. Changes in Population				
Large to medium-sized	1600	400	100	2100
Medium-sized to Small	3100	300	400	3800
D. Changes in eligibility for audit exemption³²				
Medium-sized to small audit exempt	1100	100	200	1400
Small to audit exempt	6100	200	600	6900

²⁹ 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.

³⁰ "Public" - Public Quoted, Public Quoted Investment Trust, Public A.I.M., Public Not Quoted, Public Quoted OFEX

³¹ "Other" - Unlimited; Guarantee; Limited Partnership; Royal Charter; European Economic Interest Grouping; Foreign Companies; Industrial/Provident; Limited Liability Partnerships; Not Companies Act and "Other other".

³² To be eligible for an audit exemption a company must be small, and meet criteria in respect of turnover and balance sheet total.

(Acts whose publication is obligatory)

**DIRECTIVE 2006/46/EC OF THE EUROPEAN PARLIAMENT AND OF 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**

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN
UNION,

Having regard to the Treaty establishing the European Community, and in
particular Article 44(1) thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Economic and Social
Committee ⁽¹⁾

Acting in accordance with the procedure laid down in Article 251 of the Treaty
⁽²⁾,

Whereas:

(1) On 21 May 2003, the Commission adopted an Action Plan announcing
measures to modernise company law and enhance corporate governance in
the Community. As a short-term priority, the Community was to confirm the
collective responsibility of board members, increase transparency in
transactions with related parties and off balance-sheet arrangements and
improve disclosure about corporate governance practices applied in a
company.

⁽¹⁾ OJ C 294, 25.11.2005, p. 4.

⁽²⁾ Opinion of the European Parliament of 15 December 2005 (not yet published in the Official Journal) and Council
Decision of 22 May 2006.

(2) Pursuant to that Action Plan, members of the administrative, management and supervisory bodies of a company were, as a minimum requirement, to be collectively responsible towards the company for drawing up and publishing annual accounts and annual reports. The same approach was also to apply to members of the administrative, management and supervisory bodies of undertakings drawing up consolidated accounts. Those bodies act within the competences assigned to them by national law. This should not prevent Member States from going further and providing for direct responsibility towards shareholders or even other stakeholders. On the other hand, Member States were to refrain from opting for a system of responsibility limited to individual board members. However, this should not preclude the ability of courts or other enforcement bodies in the Member States to impose penalties on an individual board member.

(3) Liability for drawing up and publishing annual accounts and consolidated accounts as well as annual reports and consolidated annual reports is based on national law. Appropriate liability rules, as laid down by each Member State under its national law or regulations, should be applicable to members of the administrative, management and supervisory bodies. Member States should remain free to determine the extent of the liability.

(4) In order to promote credible financial reporting processes across the European Union, members of the company body that is responsible for the preparation of the company's financial reports should have the duty to ensure that the financial information included in a company's annual accounts and annual reports gives a true and fair view.

(5) On 27 September 2004 the Commission adopted a Communication on preventing and combating financial and corporate malpractice outlining *inter alia* the Commission policy initiatives regarding internal control in companies and responsibility of board members.

(6) At present Fourth Council Directive 78/660/EEC ⁽¹⁾ and Seventh Council Directive 83/349/EEC ⁽²⁾ only provide for disclosure of transactions between a company and the company's affiliated undertakings. With the objective of bringing companies whose securities are not admitted to trading on a regulated market closer to companies applying the international accounting standards for their consolidated accounts, disclosure should be extended to cover other types of related parties, such as key management members and spouses of board members, but only where such transactions are material and not carried out at arm's length. Disclosure of material transactions with related parties that are not carried out under normal market conditions can assist users of annual accounts to assess the financial position of the company as well as, when the company belongs to a group, the financial situation of the group as a whole. Intra-group related party

¹ OJ L 222, 14.8.1978, p. 11. Directive as last amended by Directive 2006/43/EC of the European Parliament and of the Council (OJ L 157, 9.6.2006, p. 87).

² OJ L 193, 18.7.1983, p. 1. Directive as last amended by Directive 2006/43/EC.

transactions should be eliminated in the preparation of consolidated financial statements.

(7) Definitions of a related party as set out in the international accounting standards adopted by the Commission in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards ⁽³⁾ should apply to Directives 78/660/EEC and 83/349/EEC.

(8) Off-balance-sheet 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.

(9) Such off-balance-sheet arrangements could be any transactions or agreements which companies may have with entities, even unincorporated ones, that are not included in the balance sheet. Such off-balance-sheet arrangements may be associated with the creation or use of one or more Special Purpose Entities (SPEs) and offshore activities designed to address, *inter alia*, economic, legal, tax or accounting objectives. Examples of such off-balance-sheet arrangements include risk and benefit-sharing arrangements or obligations arising from a contract such as debt factoring, combined sale and repurchase agreements, consignment stock arrangements, take or pay arrangements, securitisation arranged through separate companies and unincorporated entities, pledged assets, operating leasing arrangements, outsourcing and the like. Appropriate disclosure of the material risks and benefits of such arrangements that are not included in the balance sheet should be set out in the notes to the accounts or the consolidated accounts.

(10) Companies whose securities are admitted to trading on a regulated market and which have their registered office in the Community should be obliged to disclose an annual corporate governance statement as a specific and clearly identifiable section of the annual report. That statement should at least provide shareholders with easily accessible key information about the corporate governance practices actually applied, including a description of the main features of any existing risk management systems and internal controls in relation to the financial reporting process. The corporate governance statement should make clear whether the company applies any provisions on corporate governance other than those provided for in national law, regardless of whether those provisions are directly laid down in a corporate governance code to which the company is subject or in any corporate governance code which the company may have decided to apply. Furthermore, where relevant, companies may also provide an analysis of environmental and social aspects necessary for an understanding of the company's development, performance and position. There is no need to impose the requirement of a separate corporate governance statement on undertakings drawing up a consolidated

³ (3) OJ L 243, 11.9.2002, p. 1.

annual report. However, the information concerning the group's risk management system and internal control system should be presented.

(11) The various measures adopted under this Directive should not necessarily apply to the same types of companies or undertakings. Member States should be able to exempt small companies, as described in Article 11 of Directive 78/660/EEC, from the requirements concerning related parties and off-balance-sheet arrangements under this Directive. Companies which already disclose information about transactions with related parties in their accounts pursuant to international accounting standards as adopted in the European Union should not be required to disclose further information under this Directive, as the application of the international accounting standards already results in a true and fair view of such a company. The provisions of this Directive concerning the corporate governance statement should apply to all companies, including banks, insurance and reinsurance undertakings and companies which have issued securities other than shares admitted to trading on a regulated market insofar as they are not exempted by Member States. The provisions of this Directive concerning duties and liabilities of board members as well as penalties should apply to all companies to which Council Directives 78/660/EEC, 86/635/EEC ⁽¹⁾ and 91/674/EEC ⁽²⁾ apply and to all undertakings which draw up consolidated accounts in accordance with Directive 83/349/EEC.

(12) At present Directive 78/660/EEC makes provision for examination every five years of, *inter alia*, the maximum thresholds for balance sheet and net turnover which Member States may apply in determining which companies may be exempted from certain disclosure requirements. In addition to those five-yearly examinations, an additional one-off increase in those balance sheet and net turnover thresholds may also be appropriate. There is no obligation on Member States to make use of those increased thresholds.

(13) Since the objectives of this Directive, namely facilitating cross-border investments and improving EU-wide comparability and public confidence in financial statements and reports through enhanced and consistent specific disclosures, cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale and the effects of this Directive, be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve those objectives.

(14) This Directive respects the fundamental rights and observes the principles recognised in particular by the Charter of the Fundamental Rights of the European Union.

¹ OJ L 372, 31.12.1986, p. 1. Directive as last amended by Directive 2003/51/EC of the European Parliament and of the Council (OJ L 178, 17.7.2003, p. 16).

² OJ L 374, 31.12.1991, p. 7. Directive as amended by Directive 2003/51/EC.

(15) In accordance with paragraph 34 of the Interinstitutional agreement on better law-making ⁽³⁾, Member States are encouraged to draw up, for themselves and in the interests of the Community, their own tables illustrating, as far as possible, the correlation between this Directive and the transposition measures, and to make them public.

(16) Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC should therefore be amended accordingly,

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Amendments to Directive 78/660/EEC

Directive 78/660/EEC is hereby amended as follows:

1. in Article 11, the first paragraph shall be amended as follows:
 - (a) in the first indent the words 'balance sheet total: EUR 3 650 000' shall be replaced by the words 'balance sheet total: EUR 4 400 000';
 - (b) in the second indent the words 'net turnover: EUR 7 300 000' shall be replaced by the words 'net turnover: EUR 8 800 000';
2. in Article 11, third paragraph, the words 'the Directive setting those amounts in consequence of the review provided for in Article 53(2)' shall be replaced by 'any Directive setting those amounts';
3. in Article 27, the first paragraph shall be amended as follows:
 - (a) in the first indent the words 'balance sheet total: EUR 14 600 000' shall be replaced by the words 'balance sheet total: EUR 17 500 000';
 - (b) in the second indent the words 'net turnover: EUR 29 200 000' shall be replaced by the words 'net turnover: EUR 35 000 000';
4. in Article 27, third paragraph, the words 'the Directive setting those amounts in consequence of the review provided for in Article 53(2)' shall be replaced by 'any Directive setting those amounts';
5. in Article 42a, the following paragraph shall be added:
 - (5a) By way of derogation from the provisions of paragraphs 3 and 4, Member States may, in accordance with international accounting

³ OJ C 321, 31.12.2003, p. 1.

standards as adopted by Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (), as amended until 5 September 2006, permit or require valuation of financial instruments, together with the 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 of the Council of 19 July 2002 on the application of international accounting standards (**).

6. Article 43(1), the following points shall be inserted:

‘(7a) the nature and business purpose of the company’s arrangements that are not included in the balance sheet and the financial impact on the company of those arrangements, provided that the risks or benefits arising from such arrangements are material and in so far as the disclosure of such risks or benefits is necessary for assessing the financial position of the company.

Member States may permit the companies referred to in Article 27 to limit the information required to be disclosed by this point to the nature and business purpose of such arrangements;

(7b) transactions which have been entered into with related parties by the company, including the amount of such transactions, the nature of the related party relationship and other information about the transactions necessary for an understanding of the financial position of the company, if such transactions are material and have not been concluded under normal market conditions. Information about individual transactions may be aggregated according to their nature except where separate information is necessary for an understanding of the effects of related party transactions on the financial position of the company.

Member States may permit the companies referred to in Article 27 to omit the disclosures prescribed in this point unless those companies are of a type referred to in Article 1(1) of Directive 77/91/EEC, in which case Member States may limit disclosure to, as a minimum, transactions entered into directly or indirectly between:

- (i) the company and its major shareholders,
- and

() OJ L 261, 13.10.2003, p. 1. Regulation as last amended by Regulation (EC) No 108/2006 (OJ L 24, 27.1.2006, p. 1).

(**) OJ L 243, 11.9.2002, p. 1.’

- (ii) the company and the members of the administrative, management and supervisory bodies.

Member States may exempt transactions entered into between two or more members of a group provided that subsidiaries which are party to the transaction are wholly owned by such a member.

“Related party” has the same meaning as in international accounting standards adopted in accordance with Regulation (EC) No 1606/2002.’

7. the following Article shall be inserted:

‘Article 46a

1. A company whose securities are admitted to trading on a regulated market within the meaning of Article 4(1), point (14) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments ^(*) shall include a corporate governance statement in its annual report. That statement shall be included as a specific section of the annual report and shall contain at least the following information:

- (a) a reference to:

(i) the corporate governance code to which the company is subject,

and/or

(ii) the corporate governance code which the company may have voluntarily decided to apply,

and/or

(iii) all relevant information about the corporate governance practices applied beyond the requirements under national law. Where points (i) and (ii) apply, the company shall also indicate where the relevant texts are publicly available; where point (iii) applies, the company shall make its corporate governance practices publicly available;

- (b) to the extent to which a company, in accordance with national law, departs from a corporate governance code referred to under points (a)(i) or (ii), an explanation by the company as to which parts of the corporate governance code it departs from and the reasons for doing so. Where the company has decided not to apply any provisions of a

(*) OJ L 145, 30.4.2004, p. 1.

corporate governance code referred to under points (a)(i) or (ii), it shall explain its reasons for doing so;

(c) a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process;

(d) the information required by Article 10(1), points (c), (d),(f), (h) and (i) of Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids^(**), where the company is subject to that Directive;

(e) unless the information is already fully provided for in national laws or regulations, the operation of the shareholder meeting and its key powers, and a description of shareholders' rights and how they can be exercised;

(f) the composition and operation of the administrative, management and supervisory bodies and their committees.

2. Member States may permit the information required by this Article to be set out in a separate report published together with the annual report in the manner set out in Article 47 or by means of a reference in the annual report where such document is publicly available on the company's website. In the event of a separate report, the corporate governance statement may contain a reference to the annual report where the information required in paragraph 1, point (d) is made available. Article 51(1), second subparagraph shall apply to the provisions of paragraph 1, points (c) and (d) of this Article. For the remaining information, the statutory auditor shall check that the corporate governance statement has been produced.

3. Member States may exempt companies which have only issued securities other than shares admitted to trading on a regulated market, within the meaning of Article 4(1), point (14) of Directive 2004/39/EC, from the application of the provisions of paragraph 1, points (a), (b), (e) and (f), unless such companies have issued shares which are traded in a multilateral trading facility, within the meaning of Article 4(1), point (15) of Directive 2004/39/EC.

8. the following Section shall be inserted:

‘SECTION 10A

Duty and liability for drawing up and publishing the annual accounts and the annual report

^(**) OJ L 142, 30.4.2004, p. 12.’

Article 50b

Member States shall ensure that the members of the administrative, management and supervisory bodies of the company have collectively the duty to ensure that the annual accounts, the annual report and, when provided separately, the corporate governance statement to be provided pursuant to Article 46a are drawn up and published in accordance with the requirements of this Directive and, where applicable, in accordance with the international accounting standards adopted in accordance with Regulation (EC) No 1606/2002. Such bodies shall act within the competences assigned to them by national law.

Article 50c

Member States shall ensure that their laws, regulations and administrative provisions on liability apply to the members of the administrative, management and supervisory bodies referred to in Article 50b, at least towards the company, for breach of the duty referred to in Article 50b.'

9. Article 53a shall be replaced by the following:

'Article 53a

Member States shall not make available the exemptions set out in Articles 11, 27, 43(1), points (7a) and (7b), 46, 47 and 51 in the case of companies whose securities are admitted to trading on a regulated market within the meaning of Article 4(1), point (14) of Directive 2004/39/EC.'

10. the following Article shall be inserted:

Article 60a

Member States shall lay down the rules on penalties applicable to infringements of the national provisions adopted pursuant to this Directive and shall take all the measures necessary to ensure that they are implemented. The penalties provided for must be effective, proportionate and dissuasive.'

11. Article 61a shall be replaced by the following:

Article 61a

Not later than 1 July 2007, the Commission shall review the provisions in Articles 42a to 42f, Article 43(1)(10) and (14), Article 44(1), Article 46(2)(f) and Article 59(2)(a) and (b) in the light of the experience acquired in applying provisions on fair value accounting, with particular

regard to IAS 39 as endorsed in accordance with Regulation (EC) No 1606/2002, and taking account of international developments in the field of accounting and, if appropriate, submit a proposal to the European Parliament and the Council with a view to amending the abovementioned Articles.’

Article 2

Amendments to Directive 83/349/EEC

Directive 83/349/EEC is hereby amended as follows:

1. In Article 34, the following points shall be inserted:
 - ‘(7a) The nature and business purpose of any arrangements that are not included in the consolidated balance sheet, and the financial impact of those arrangements, provided that the risks or benefits arising from such arrangements are material and in so far as the disclosure of such risks or benefits is necessary for assessing the financial position of the undertakings included in the consolidation taken as a whole.
 - (7b) The transactions, save for intra-group transactions, entered into by the parent undertaking, or by other undertakings included in the consolidation, with related parties, including the amounts of such transactions, the nature of the related party relationship as well as other information about the transactions necessary for an understanding of the financial position of the undertakings included in the consolidation taken as a whole, if such transactions are material and have not been concluded under normal market conditions. Information about individual transactions may be aggregated according to their nature except where separate information is necessary for an understanding of the effects of the related party transactions on the financial position of the undertakings included in the consolidation taken as a whole.’
2. In Article 36(2), the following point shall be added:
 - ‘(f) a description of the main features of the group’s internal control and risk management systems in relation to the process for preparing consolidated accounts, where an undertaking has its securities admitted to trading on a regulated market within the meaning of Article 4(1), point (14) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments ^(*). In the event that the consolidated annual report and the annual report are presented

^(*) OJ L 145, 30.4.2004, p. 1.’

as a single report, this information must be included in the section of the report containing the corporate governance statement as provided for by Article 46a of Directive 78/660/EEC. If a Member State permits the information required by paragraph 1 of Article 46a of Directive 78/660/EEC to be set out in a separate report published together with the annual report in the manner prescribed by Article 47 of that Directive, the information provided under the first subparagraph shall also form part of that separate report. Article 37(1), second subparagraph of this Directive shall apply.

3. The following Section shall be inserted:

‘SECTION 3A

Duty and liability for drawing up and publishing the consolidated accounts and the consolidated annual report

Article 36a

Member States shall ensure that the members of the administrative, management and supervisory bodies of undertakings drawing up the consolidated accounts and the consolidated annual report have collectively the duty to ensure that the consolidated accounts, the consolidated annual report and, when provided separately, the corporate governance statement to be provided pursuant to Article 46a of Directive 78/660/EEC are drawn up and published in accordance with the requirements of this Directive and, where applicable, in accordance with the international accounting standards adopted in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards ^(*). Such bodies shall act within the competences assigned to them by national law.

Article 36b

Member States shall ensure that their laws, regulations and administrative provisions on liability apply to the members of the administrative, management and supervisory bodies referred to in Article 36a, at least towards the undertaking drawing up the consolidated accounts, for breach of the duty referred to in Article 36a.

4. In Article 41, the following paragraph shall be inserted:

‘1a. “Related party” has the same meaning as in international accounting standards adopted in accordance with Regulation (EC) No 1606/2002.’

^(*) OJ L 243, 11.9.2002, p. 1.’

5. the following Article shall be inserted:

‘Article 48

Member States shall lay down the rules on penalties applicable to infringements of the national provisions adopted pursuant to this Directive and shall take all the measures necessary to ensure that they are implemented. The penalties provided for must be effective, proportionate and dissuasive.’

Article 3

Amendment to Directive 86/635/EEC

The first sentence of Article 1(1) of Directive 86/635/EEC shall be replaced by the following:

‘Articles 2, 3, 4(1), (3) to (6), Articles 6, 7, 13, 14, 15(3) and (4), Articles 16 to 21, 29 to 35, 37 to 41, 42 first sentence, 42a to 42f, 45(1), 46(1) and (2), 46a, Articles 48 to 50, 50a, 50b, 50c, 51(1) and 51a, 56 to 59, 60a, 61 and 61a of Directive 78/660/EEC shall apply to the institutions mentioned in Article 2 of this Directive, except where this Directive provides otherwise.’

Article 4

Amendment to Directive 91/674/EEC

The first sentence of Article 1(1) of Directive 91/674/EEC shall be replaced by the following:

‘Articles 2, 3, 4(1), (3) to (6), Articles 6, 7, 13, 14, 15(3) and (4), Articles 16 to 21, 29 to 35, 37 to 41, 42, 42a to 42f, 43 (1), points 1 to 7b and 9 to 14, 45(1), 46(1) and (2), 46a, 48 to 50, 50a, 50b, 50c, 51(1), 51a, 56 to 59, 60a, 61 and 61a of Directive 78/660/EEC shall apply to the undertakings mentioned in Article 2 of this Directive, except where this Directive provides otherwise’

Article 5

Transposition

1. Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 5 September 2008 at the latest.

When Member States adopt these measures, they shall contain a reference to this directive or shall be accompanied by such a reference on the occasion of their official publication. The methods of making such reference shall be laid down by Member States.

2. Member States shall communicate to the Commission the text of the main provisions of national law which they adopt in the field covered by this Directive.

Article 6

Entry into force

This Directive shall enter into force on the 20th day following its publication in the *Official Journal of the European Union*.

Article 7

Addressees

This Directive is addressed to the Member States.

Done at Strasbourg, 14 June 2006.

For the European Parliament
The President
J. BORRELL FONTELLES

For the Council
The President
H. WINKLER

CODE OF PRACTICE ON CONSULTATIONS

The Consultation Code of Practice Criteria

1. Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.
2. It should be clear who is being consulted, about what questions, in what timescale and for what purpose.
3. A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.
4. Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others) and effectively drawn to the attention of all interested groups and individuals.
5. Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation.
6. Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and the reasons for decisions finally taken.
7. Departments should monitor and evaluate consultations, designating a consultation coordinator who will ensure the lessons are disseminated. The complete code is available on the Cabinet Office's web site, address

http://archive.cabinetoffice.gov.uk/servicefirst/2000/consult/code/_consultation.pdf