



RAISING THE THRESHOLDS

Consultation Document

JULY 2003



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Raising the Thresholds

Consultation Document
on Proposals to Increase the
Audit Exemption Threshold
and the Threshold Defining
Medium-sized Companies

July 2003

Contents

1	Summary and Questions	4 – 5
2	How to Reply	7
3	Background to the Audit Exemption Threshold.....	8 – 10
4	Research into the Previous Increase in the Audit Exemption Threshold.....	11 – 16
5	The Costs and Benefits of the Statutory Audit.....	17 – 20
6	The Threshold Defining Small and Medium-sized Companies	21 – 24
Annexes		
A	The Audit Exemption Threshold in EU Member States.....	A-1 – A-2
B	Partial Regulatory Impact Assessment on the Audit Exemption Threshold	B-1 – B-8
C	Partial Regulatory Impact Assessment on the Threshold Defining Medium-sized Companies	C-1 – C-7
D	Cabinet Office Code of Practice on Written Consultations.....	D-1

1 Summary and Questions

- 1.1 Under the Companies Act 1985 (“the 1985 Act”) there are separate thresholds below which:
 - (a) companies may opt out of the statutory audit;
 - (b) companies are classified as small companies for accounting purposes; and
 - (c) companies are classified as medium-sized companies for accounting purposes.
- 1.2 The small and medium-sized definitions are also used for certain other purposes, in particular in relation to corporation tax allowances. The Government has already made clear:
 - (i) that it is reviewing the audit exemption threshold in the light of recent research;
 - (ii) that it will increase the small company accounting threshold to the maximum permitted by EU law; and
 - (iii) that it intends also to increase the medium-sized threshold to the maximum permitted by EU law.
- 1.3 This document discusses these issues and invites further comment.

The Audit Exemption Threshold

- 1.4 All limited companies¹ are required, by the 1985 Act to prepare and file accounts with Companies House. Above a certain size criteria those accounts are required by statute to be independently audited. Private companies below the audit exemption threshold are exempt from the statutory requirement to audit their accounts, but may nevertheless choose to have their accounts audited.
- 1.5 The primary purpose of the audit is for auditors to report on the accounts of companies to the members of the company (“the shareholders”) and to provide an assurance as to the stewardship of their funds. The statutory audit brings benefits to companies, to users of accounts, and to creditors. However, the audit also helps to maintain the quality of information on the public record with the Registrar of Companies. The statutory audit also brings with it a cost burden on companies.
- 1.6 For ease of explanation the audit exemption threshold is referred to by the turnover level but see the full list of criteria at paragraph 3.9.

¹ In the context of this consultation document “limited companies” is to be read as including Limited Liability Partnerships.

- 1.7 The audit exemption threshold is currently £1 million (expressed by turnover). It was raised from £350,000 to £1 million with effect from July 2000. The Government has been carrying out research into the impact of that increase; the results to date are summarised in section 4 of this consultation document. In general the research to date is showing that there are benefits to the statutory audit but, on balance, the benefits to small companies in removing the requirement are greater.
- 1.8 **The Government is minded to increase the audit exemption threshold to the EU maximum of £5.6 million. The consultation document sets out the detailed arguments for and against increasing the audit exemption threshold at section 5. The 1985 Act sets out those companies for whom audit exemption is not available. The Government does not propose to alter the requirements for those companies to have an independent statutory audit.**

The Thresholds Defining Small and Medium-Sized Companies

- 1.9 The 1985 Act defines small and medium-sized companies by turnover, balance sheet total and number of employees (see paragraph 6.3). For ease of explanation these thresholds are also referred to by turnover level. When companies meet the qualifying conditions of a small company they are able to take advantage of the less onerous accounting requirements that are set out in the 1985 Act. Small and medium enterprises (including small and medium-sized companies) are also able to take advantage of certain tax allowances.
- 1.10 Following the recommendation of the independent Company Law Review² the Modernising Company Law White Paper³ stated that the small company definition would be increased to the maximum then allowed under EU law. On 9 April 2003 the Chancellor reaffirmed this, announcing the Government's intention also to increase the medium-sized company thresholds to the maximum available under EU law (see table at paragraph 6.2 for EU thresholds).
- 1.11 An increase in the medium-sized threshold will enable those businesses that are re-defined as medium to take advantage of modified accounting and filing provisions. In addition more medium-sized entities would be able to take advantage of tax allowances that are available to them.
- 1.12 **Section 6 of this consultation document discusses the Government's proposals for the increase in the medium-sized company threshold.**

The Proposals

- 1.13 Consultees are asked to respond to the following questions, giving reasons for their views, whilst having regard to the discussions in the main body of this document:

² Modern Company Law For a Competitive Economy, July 2001, URN 01/942

³ July 2002, Cm 5553-I

The audit exemption threshold

- 1 In the light of findings to date, the Government is minded to increase the threshold to the EU maximum, now £5.6 million (expressed as turnover). However, before taking a final decision, it wants to take careful account of the arguments of those who respond to this document and therefore welcomes respondent's comments.
- 2 The Government welcomes comment on the proposal to apply any increase in the audit exemption threshold for individual companies, to the threshold for groups.
- 3 Can you:
 - (a) identify any costs or savings for your business, or more generally, resulting from an increase in the audit exemption threshold to the maximum permissible under EU law?
 - (b) quantify those costs or savings?

The threshold defining medium-sized companies

- 4 The Government welcomes comment on the intention to increase the threshold defining medium-sized companies to the maximum permissible under EU law (£22.8 million).
- 5 The Government welcomes comment on the proposal to apply the increase in the threshold defining medium-sized companies to medium-sized groups.
- 6 Can you:
 - (a) identify any costs or savings for your business, or more generally, resulting from the proposal to increase the threshold defining medium-sized companies?
 - (b) quantify those costs or savings?

2 How to reply

- 2.1 We invite comments by 3 October 2003 at the latest. Earlier responses would be very welcome. **It is important that, when responding on behalf of a professional body or representative organisation, you state the size of your membership.**
- 2.2 Responses should be sent, by email if possible, to:

William Murphy
Company Law and Investigations Directorate
Department of Trade and Industry
Bay 4100
1 Victoria Street
London SW1H 0ET

Tel: 020 7215 0412
Fax: 020 7215 0235

E-mail: thresholds@dti.gsi.gov.uk

- 2.3 All responses will be acknowledged. In accordance with the code of practice on open government, comments will be made publicly available unless respondents specifically request otherwise in the body of the response. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

ADDITIONAL COPIES

- 2.4 This document is available electronically at www.dti.gov.uk/consultations. You may also photocopy it if you wish, or additional hard copies may be obtained by calling 0870 1502 333.

QUESTIONS

- 2.5 If you have questions about the issues discussed in this consultation document, please telephone Bill Murphy on 020 7215 0412.

3 Background to the Audit Exemption Threshold

The Statutory Audit

- 3.1 Part of the price paid by companies for the privilege of limited liability is disclosure of information. All limited companies are required to prepare and file accounts with Companies House. Companies above a certain size are required to have their accounts independently audited by a professionally qualified and regulated accountant. Section 249A of the 1985 Act sets out the criteria for those companies exempt from the requirement to have their statutory accounts audited (see paragraph 3.9 below). This requirement was introduced by the Fourth Directive⁴.
- 3.2 The purpose of financial statements is to provide information about the financial position and performance of companies, first and foremost for shareholders, but also to help a wide variety of stakeholders to make informed decisions. The reliability of those accounts are important for shareholders, including owner-managers, to understand how their business is performing and for other users to decide whether they would wish to invest in, provide finance to, or trade with that business.
- 3.3 The statutory audit provides an independent, external, professional opinion that those accounts provide a true and fair view. It is a part of the framework that supports company reporting generally and provides confidence to investors in our capital markets.
- 3.4 The responsibilities of the independent auditor are established in the United Kingdom by statute in sections 235 to 237 of the 1985 Act. In addition, auditing standards are issued by the Auditing Practices Board and auditors have regard to the ethical standards set for the profession.
- 3.5 The primary purpose of the audit is for auditors to report on the accounts of the company to the members of the company. It provides an assurance as to the stewardship of their funds by the management of the company. However, many small companies are owner-managed, where the directors are also the shareholders of the company.

⁴ Fourth Council Directive, 25 July 1978 (78/660/EEC) based on Article 54(3)(g) of the treaty on the annual accounts of certain types of companies. OJ L222/11 of 14 August 1978

a. The Audit Exemption Threshold

- 3.6 The 1967 Companies Act introduced a requirement that all companies file their annual accounts at Companies House and that those accounts be audited. This put into effect a recommendation of the Jenkins Committee⁵ which had emphasised the value to credit insurers of reliable information on the public record.
- 3.7 In 1978, the Fourth Directive introduced an audit requirement but gave Member States the option to exempt certain companies from it. The Government did not take advantage of this option until 1993. Then, small companies with a turnover of £90,000 or below were exempted from the requirement to have an independent audit⁶. At the same time small companies with a turnover between £90,000 and £350,000 were given the option of filing a simplified report in place of the full audit report.
- 3.8 In 1997 the option to use the simplified report was removed (other than for charitable companies) and the audit exemption threshold was increased to £350,000. Following further consultation it was increased again to £1 million with effect from 26 July 2000⁷.
- 3.9 Section 249A of the 1985 Act provides that small companies meeting the following criteria are exempt from the requirements to have an audit:

Turnover (not more than)	Balance sheet total (not more than)
£1 million	£1.4 million

- 3.10 The 1985 Act permits companies within a group to take advantage of the audit exemption (in respect of both the individual and consolidated accounts), but only where the total turnover of the group does not exceed the threshold for individual company exemption.
- 3.11 In July 2001 the Final Report of the independent Company Law Review recommended that the turnover threshold, below which small companies are not required to have an audit, should be raised from £1 million to £4.8 million (the maximum then allowed under EU law). This reflected a concern that, for some small companies, the benefits of a statutory audit may not be sufficient to justify the cost. The Review also explored the possibility of a statutory independent professional review (IPR) that could replace the full audit for private companies below a certain size limit, but this was abandoned following trials.

5 Report of the Company Law Committee, Cmnd 1749, 1962

6 The Companies Act 1985 (Audit Exemption) Regulations 1994, SI 1994/1935

7 The Companies Act 1985 (Audit Exemption)(Amendment) Regulations 2000, SI 2000/1430

3.12 The Modernising Company Law White Paper announced that the Government would assess the impact of the July 2000 increase in the audit exemption threshold and consult further before making a final decision on a further increase. In his 9 April 2003 budget statement, the Chancellor announced that the Government was minded to raise the threshold to the maximum possible, subject to the outcome of the consultation.

b. Safeguards for shareholders

3.13 Although companies that meet the requirements are able to take advantage of exemption from the independent statutory audit there are safeguards in company law to protect the interests of external shareholders. Section 249B(2) of the 1985 Act allows shareholders holding at least 10% of the share capital of a company to require an audit of the accounts.

c. Companies not exempted from audit

3.14 Section 249B of the 1985 Act sets out those companies for whom exemption from audit are not available. Those not exempt from audit include public companies, registered insurance brokers, persons or representatives authorised under the Financial Services and Markets Act 2000, certain companies as defined in the Trade Union and Labour Relations (Consolidation) Act 1992, or companies within a group where group turnover exceeds the threshold.

4 Research into the Previous Increase in the Audit Exemption Threshold

- 4.1 The Government has commissioned research in a number of areas designed to give an indication of the impact of the previous increase in the audit exemption threshold. The results of this research to date are set out below. The Government is also being assisted by a number of organisations who are carrying out research.

Independent Research

- 4.2 Jill Collis, a researcher at Kingston University has been commissioned to gather views on issues relating to audit exemption from the directors of companies that fell within the pre-May 2003 EU threshold defining small companies (£4.8m). The study is based on a survey of 790 independent private limited companies that fall within that definition in their 2002 accounts. It is intended that the final report ("The Collis Report") will be published in September 2003 and will also be made available on the DTI's internet site.
- 4.3 The initial findings of this study show that:
- As is typical of the small business sector, 68% of the sample companies are wholly family owned and 90% of companies have between 1 and 4 shareholders. In 74% of companies all the shareholders had access to external financial information, which implies that they are owner-managed.
 - In 85% of companies an external accountant prepares the statutory accounts, although 35% employ a qualified accountant in a financial role within the business. In a large proportion of companies the external accountant also provides tax and audit services as well as advice and information relating to the annual accounts. There was evidence of a strong relationship with the external accountant. 10 years was the typical length of time with the current auditor and £1,000 was the typical fee for auditing last year's accounts.
 - Using turnover as a proxy for eligibility, last year 64% of companies with a turnover up to £350,000 took up audit exemption, compared with 38% of companies above this level but not exceeding £1 million. Lower accountancy fees were the main reason for filing unaudited accounts, but very few companies were able to report the specific amount saved.

- The proposal to raise the audit exemption threshold to £4.8 million was supported by 57% of companies. Nevertheless, in 56% of companies, the directors see sufficient benefits in having their accounts audited that they would continue to do so if they became exempt. One of the main reasons for continuing with the audit is the benefit of having an independent check on the figures and the associated assurance this provides. A second factor revealed by the research relates to size, with the likelihood of directors choosing to have the accounts audited increasing with the size of the company as measured by turnover.

Companies House

- 4.4 Between 1 March 2003 and 31 May 2003 Companies House monitored the number of complaints received in respect of company accounts and have provided information to determine the size of the company by turnover and whether the accounts of those companies have been audited. During that period Companies House received 986 complaints on accounts filed on the public register. An analysis of the complaints gives the following breakdown between audited and unaudited accounts:

Audit exempt abbreviated accounts	Audit exempt full accounts	Audited abbreviated accounts	Audited full accounts
51.8%	41.5%	2.2%	4.5%

- 4.5 Companies House statistics show that 42.5% of all accounts filed in the financial year 2001/2002 were audit exempt⁸. Our analysis of the complaints shows that 93.3% of complaints were on unaudited accounts, but looking back to the period when those accounts were filed, there were complaints on less than 0.2% of the accounts filed.

The Insolvency Service

- 4.6 Between 1 February 2003 and 31 May 2003 the Insolvency Service provided information from two of their regional offices that has enabled us to identify the accounting information filed at Companies House by those insolvent companies. During that period the two regional offices reported details of 118 companies. Of this total, 25 (21.2%) companies did not file accounts and 6 (5.1%) companies filed dormant accounts. Of the remaining 87 companies, 25 (21.2%) filed their last set of accounts prior to the last increase in the audit exemption threshold and 62 (52.5%) filed their accounts after the last increase in the audit exemption threshold. An analysis of those companies that filed accounts shows the following:

⁸ Companies in 2001-2002, table F2, The Stationary Office, ISBN 0-11-515487-6

	Audited accounts	Audit exempt accounts
Pre July 2000 Increase	16 (64%)	9 (36%)
Post July 2000 Increase	40 (64.5%)	22 (35.5%)

- 4.7 The sample of companies is small and there is no data available for which comparisons can be made. However, the information available would appear to indicate that there has been no change in the number of companies taking advantage of the audit exemption who are, for whatever reason, subsequently subject to compulsory liquidation.

The Inland Revenue

- 4.8 The Inland Revenue considers that the audit provides an independent assurance as to the quality of the financial information in the accounts. However, it does not rely solely on the audited accounts but is able to seek information beyond the audited accounts in order to satisfy itself as to the veracity of the information provided to it.
- 4.9 The Inland Revenue has looked at whether the last increase in the audit exemption threshold has had an impact on the quality of financial information provided to it. It has attempted to determine whether there has been an increase in the number of enquiries they have had to carry out into the accounts of companies who have been able to take advantage of the new threshold.
- 4.10 The Inland Revenue are not able to provide specific detailed data on companies due to the lack of a legal gateway for provision of this information. They are able to provide a baseline figure for the number of enquiries made into accounts of companies that have filed Corporation Tax returns, with an annual accounting period ending before 30 June 2000. The baseline figure would enable subsequent comparison. However, it is not yet possible for the Inland Revenue to review this data for comparison in a meaningful or statistically reliable way as not enough time has elapsed since the last increase in the audit exemption threshold.

Survey of Members of the Institute of Credit Management (ICM)

- 4.11 The Institute of Credit Management (ICM) is the largest professional credit management organisation in Europe. Its 9,000 members hold appointments in trade, consumer and export credit as well as in related activities such as collections, credit reporting, credit insurance and insolvency practice.
- 4.12 In March 2003 following a request from the DTI the ICM sent a questionnaire to its members. The questionnaire sought the views of the members on statutory accounts and the audit exemption threshold. The DTI received 113 responses to the survey. Responses can be summarised as follows:

- 50% of the respondents said that the audit exemption threshold should remain at £1 million;
- Of those respondents that said the audit exemption threshold should be changed, 43% said that it should be decreased;
- 98% of respondents used the statutory accounts in assessing the creditworthiness of companies;
- 88% of respondents said that unaudited accounts affected the creditworthiness of companies;
- 64% of respondents said that they would adjust the credit ratings of companies that took advantage of the audit exemption threshold; 25% said that it would depend on the individual company and 11% said they would not adjust the credit rating of such a company; and,
- Of those who commented 70% of respondents said that the last increase in the audit exemption threshold did have an effect on the credit rating of companies; 30% said the increase did not have an effect.

4.13 Respondents commented that, as a result of the previous increase in the audit exemption threshold, companies had their credit ratings changed and additional security was required, credit limits were reduced or cancelled, credit became more expensive, more work went into assessing the creditworthiness of companies, and further references were required, causing delay.

Survey of Members of the British Bankers Association (BBA)

4.14 The British Bankers' Association (BBA) is the leading trade association in the banking and financial services industry representing banks and other financial services firms operating in the UK. It has over 1,200 members, as well as many associate members, which fund its not-for-profit activities.

4.15 In March 2003, the BBA circulated a DTI questionnaire to its members and is currently co-ordinating the responses. The DTI expects to receive the results by the end of the consultation period.

Small Practitioners Association (SPA)

4.16 The Society of Professional Accountants (SPA), (formerly known as the Small Practitioners Association), is an association of professionally qualified accountants in practice. Current membership stands at over 1,500 practices representing more than 1,800 partners or sole practitioners. Over 1,100 are registered to carry out statutory audit and collectively, members serve some 45,000 corporate clients.

4.17 In June 2003 the SPA submitted to the DTI a report entitled "The Beneficial Impact of Raising Audit Thresholds from £350,000 to £1,000,000" ("the SPA Report"). The SPA Report is available on the internet at www.spa.org.uk. The findings of the SPA

Report can be summarised as follows:

- Introduction of the higher audit threshold of £1 million has generally been warmly received by smaller practices, the large majority of whose fee income has risen despite fewer audits being undertaken;
- The transition has been unremarkable in terms of encountered difficulties, with corporate clients benefiting from lower annual professional charges and better use of managerial time;
- Extremely few instances were noted of problems experienced by third party users of accounts of companies not now audited;
- The SPA argue that there appear to be few persuasive commercial, professional or statutory arguments why the European threshold of £4.8 million should not be introduced, and point to the economic benefits to smaller companies which they estimate might save £100 million per annum in reduced professional charges;
- The opportunity remains for the statutory audit to be performed voluntarily or on demand for third party interests;
- The SPA would prefer that, to ensure continuity of compliance with accounting standards, company and taxation law relating to small limited company accounts, a professional qualified accountant should be appointed to every limited company before it commences trade and that this appointment should form part of Companies House Annual return information. Such an appointment should provide consistency and reliability of all corporate accounts whether audited or not.

The Institute of Chartered Accountants in England and Wales

- 4.18 The Institute of Chartered Accountants in England and Wales (ICAEW) has over 124,000 members working in business and public practice, both in the UK and overseas. It also has over 9,000 students.
- 4.19 The Audit and Assurance Faculty of the ICAEW, in conjunction with the Institute's Research Centre, has recently conducted a web-enabled survey of Chartered Accountants in business and in practice to seek views on the impact on the costs and benefits of the last increase in the audit exemption threshold (to £1m) and on the potential impact should the threshold be increased further.
- 4.20 In particular, views have been sought on:
- The demand for audits in the absence of a legal requirement;
 - Who are the principal users of audited accounts;
 - The likely cost savings of not having an audit;
 - The impact on the quality of information in financial statements where an audit is not performed;

- The potential consequences of a perceived or expected deterioration in the quality of financial information and possible preventative measures; and
- The potential impact on the market for registered auditors and training of Chartered Accountants in practices.

4.21 The Institute is currently analysing the results of its survey and further information will be available over the next few months on its website at www.icaew.co.uk.

The Association of Chartered Certified Accountants (ACCA)

4.22 The Association of Chartered Certified Accountants has over 300,000 members and students in both the UK and internationally. The members are employed in industry, financial services, the public sector and public practice.

4.23 In January 2001 the ACCA published a members' survey on fraud and the small company which is available at www.accaglobal.com. The survey was sent to 1,250 accountancy firms. On average, those firms had 215 clients, so the report covered some 260,000 UK companies. The survey found that the principal cause of fraud was personal gain by management that often involved manipulation of records to disguise, suppress or alter transactions. In those cases management overrode financial controls to let fraud be effected. In 45% of cases, it was external auditors that detected the fraud.

4.24 The ACCA is conducting a survey of members and the DTI expects to receive the results by the end of the consultation period. The results will be made publicly available by the ACCA.

5 The Cost and Benefits of the Statutory Audit

The Principal Purpose of the Audit

- 5.1 The audit promotes and helps to maintain confidence in the market place and an integrity and honesty in business. The principal purpose of the statutory independent audit is to provide a reasonable assurance that a company's financial statements are free from material misstatement and show a true and fair view of the company's state of affairs. This is first and foremost for the benefit of shareholders of companies, although suppliers of finance, goods and services also place a reliance on whether or not the accounts are audited.

Protection for Shareholders

- 5.2 However, the majority of small companies are owner-managed and the statutory audit may be seen as an unnecessary burden where there are no outside shareholders. The larger the company becomes the more likely it is to have external shareholders. However, even where there are external shareholders, there are arrangements for their protection. As previously mentioned, under section 249B(2) of the 1985 Act, shareholders of 10% per cent of the shares can require an audit of the company's accounts.

The Cost of the Audit

- 5.3 The statutory audit has a cost to companies both in the financial cost of the audit and in the management time spent on the audit. (The interim findings of the Collis Report shows that a typical audit fee is £1,000.) It is difficult to assess the cost in management time. The time spent on the audit by the management may also be more significant for the small companies who are likely to have fewer directors or employees to share the burden. An alternative view would be that time spent with the auditors may bring its own benefits to the managers and the company.
- 5.4 The removal of the statutory requirement for audit would give the owner/managers more choice and flexibility in running their business. If they felt that the audit was valuable to them they would continue to pay for it, but they may feel their limited resources could be put to better use. The SPA Report found that smaller practices generally provide a package of services to corporate clients that include accounts production, audit and taxation, for which single annual fees are frequently found. The respondents found that such annual fees had been reduced by on average 10% where the audit had been removed following the last increase in the audit exemption threshold.

Involvement of a Professionally Qualified Accountant

- 5.5 There is no requirement for statutory accounts to be prepared by a professionally qualified accountant, though there is a requirement that the accounts present a true and fair view of the financial position of the company. Removal of the requirement on companies to have an independent audit conducted by a professionally qualified and regulated auditor may therefore increase the risk that statutory accounts could include errors or may not be prepared in accordance with legal requirements. This is likely to increase the risk that incorrectly stated accounts are available to shareholders and other users of accounts, who may then make different decisions relating to the company than if correct information had been available. Errors in the accounts of companies would also lead to a degradation of the quality of information available on the public register and that could lead to further deterioration of the quality of information over time.
- 5.6 We estimate that an increase in the audit threshold to the EU maximum will benefit some 66,000 companies. In the financial year 2001/2002, 68%⁹ of companies who could take advantage of audit exemption chose not to audit their accounts. If the audit exemption threshold is increased to the EU maximum and the same percentage of companies took advantage of the audit exemption it could result in a cost saving of £45 million to companies. However, the proportion of companies opting out of the audit declines as company size increases and the figure would be significantly less.
- 5.7 Without an audit, companies would lose the benefit that professional accountancy involvements brings to them in providing to the management of the business an independent check and corroboration of their financial strategy. However, the interim findings of the Collis Report show that the larger the company the less likely it is to dispense with audit.
- 5.8 Although the audit is not designed to detect fraud, it may do so. The lack of professional involvement may increase the risk of undetected fraud. The involvement of a professional accountant may also act as a deterrent against fraud on the company in the preparation of accounts and more generally. A members' survey by the ACCA in January 2001 found that the principal cause of fraud was personal gain by management that often involved manipulation of records to disguise, suppress or alter transactions. In those cases management overrode financial controls to let fraud be effected and in 45% of cases, external auditors detected the fraud.
- 5.9 It can be argued that a large increase in the audit exemption threshold may facilitate the use of companies for illegal purposes such as money laundering. Businesses with a turnover of £5.6 million per annum (£107,000 per week) have a significant sum of money passing through their accounts. If the threshold were increased, these accounts would not be subject to scrutiny by an independent qualified accountant.

⁹ See paragraph 4.3 of the Regulatory Impact Assessment

- 5.10 Although an audit did not prevent the Enron and WorldCom failures, those events have led to reviews of the audit and accountancy profession in the UK and abroad. It can be argued that to remove the audit from more - and larger - companies in Great Britain may be sending the wrong signals at a time when there is a need to increase confidence in company accounts.

The Reassurance of the Statutory Audit

- 5.11 Providers of finance such as banks may take reassurance from the independent check on the reliability and accuracy of the accounts provided by the statutory audit. Without that reassurance, companies who choose not to have an audit may be required to go to the extra expense of providing additional financial information, or may have to pay higher rates of interest, if they need external finance.
- 5.12 Credit managers regard the statutory audit as important in their assessment of creditworthiness. A DTI survey of members of the ICM shows that 98% of respondents use the statutory accounts in assessing the creditworthiness of companies and 88% of respondents said that unaudited accounts affected the creditworthiness of companies. In addition, 64% of respondents said that they would adjust the credit rating of companies that took advantage of the audit exemption threshold, while 25% said that it would depend on the individual company (11% said they would not adjust the credit rating of such a company).
- 5.13 Although credit agencies and suppliers of finance do place a reliance on the audited accounts it must be noted that the financial information contained in the statutory accounts is not current. The providers of finance are in a position to require a company to provide current financial information before deciding to do business with them.
- 5.14 The ordinary creditor, who may also be a small company, is in a different position to that of finance providers and their ability to secure financial information will vary widely. They may place a reliance on the audit of a business in their decision to provide a company with goods and services. However, the ordinary creditor is also able to make use of the credit scoring of credit reference agencies in deciding whether to do business with a company.

Proposal

- 5.15 If the audit exemption threshold were increased companies would be able to decide for themselves whether they want an audit or whether the money saved is best used elsewhere to the companies advantage. Shareholders will still be able to require the company to audit their accounts. Suppliers of credit would still be able to look behind the audited accounts of the company, as can regulatory authorities. Where this is important companies would be less likely to dispense with this requirement. Suppliers of goods and services can take an informed decision according to the credit rating of the company they intend to supply.

In the light of findings to date, the Government is minded to increase the threshold to the EU maximum, now £5.6 million (expressed as turnover). However, before taking a final decision, it wants to take careful account of the arguments of those who respond to this document and therefore welcomes respondent's comments.

Treatment of Groups

- 5.16 When the original exemptions from audit were introduced in 1994 companies within a group were not able to take advantage of the audit exemption provisions. This was amended in 1997¹⁰ to allow companies within a group of companies and companies that had been dormant throughout the accounting period to take advantage of the audit exemption threshold in order to remove a burden on those companies.
- 5.17 Section 249B of the 1985 Act permits a parent or subsidiary company to take advantage of the audit exemption only where the total turnover of the group does not exceed the threshold for individual company exemption (currently £1million net of consolidation adjustments or £1.2 million gross). This applies to the individual accounts and to the group accounts. The Government sees no reason to change this approach and proposes that the audit exemption threshold for groups would increase in line with the threshold for individual companies.

The Government welcomes comment from respondents on the proposal to apply any increase in the audit exemption threshold for individual companies to the threshold for groups.

- 5.18 The attached Partial Regulatory Impact Assessment (Annex B) seeks comment on the likely costs and benefits of the proposal to increase the threshold below which small companies are not required to have an independent audit. It indicates where costs and benefits are likely to occur and offers initial estimates for those. It would be helpful if respondents could comment on the potential costs and benefits, for their business or more generally, of any or all of these options. Information on additional costs and benefits would also be welcomed.

Can you:

- (a) identify any costs or savings for your business, or more generally, resulting from an increase in the audit exemption threshold to the maximum permissible under EU law?
- (b) quantify those costs or savings?

¹⁰ Companies Act 1985 (Audit Exemption) (Amendment) Regulations 1997, SI 1997/936

6 The Threshold Defining Small and Medium-sized Companies

Definition of Small and Medium-sized Companies

(i) DEFINITIONS IN THE EU

- 6.1 Articles 11 and 27 of the Fourth Directive set out the thresholds for small and medium-sized companies respectively (expressed as turnover, balance sheet total and number of employees). Article 53(2) of the Fourth Directive provides that every five years the Council of Ministers, acting on a proposal from the European Commission shall examine and, if need be, revise the amounts expressed in euros in the Directive, in the light of economic and monetary trends in the European Community. The thresholds have been reviewed and on 13 May 2003 the Council of Ministers adopted a Directive¹¹ increasing the thresholds by 16.8%. The Directive came into force on 15 May 2003. The increases, expressed in euros, are shown in the table below.
- 6.2 Under Article 12(2) of the Fourth Directive, Member States may also increase the thresholds specified in the Directive by a maximum of 10%. This was originally to take account of conversion from ecus into national currencies. It remains an option for all Member States, in order to maintain the principal of equal treatment. The pounds sterling figure¹² provided in the table below takes account of the 10% increase.

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

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

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

(ii) DEFINITIONS IN THE 1985 ACT

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

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

- 6.4 When a company meets the qualifying conditions of a small company it is able to take advantage of the less onerous accounting requirements that are set out in the 1985 Act¹³. Small and medium-sized companies are also able to prepare and file less detailed accounts at Companies House. The accounting requirements for small and medium-sized companies are currently under review.
- 6.5 The Modernising Company Law White Paper accepted the recommendation of the Company Law Review¹⁴ that the small company definition be increased to the maximum then allowed under EU law (£4.8 million expressed by turnover). The Regulatory Impact Assessment on small and private companies is available online at www.dti.gov.uk/companiesbill.
- 6.6 On 9 April 2003 the Chancellor announced the Government's intention to also increase the medium-sized company thresholds to the maximum available under EU law.

Modernisation of Accounting Directives

- 6.7 On 6 May 2003 the Council of Ministers adopted a Directive to modernise the Fourth and Seventh Directives on the annual and consolidated accounts of companies (Directives 78/660/EEC, 83/349/EEC respectively) and the Directives on the annual and consolidated accounts of banks and other financial institutions and insurance undertakings (Directives 86/635/EEC and 91/674/EEC respectively) ("the Modernisation Directive").
- 6.8 The Modernisation Directive includes a Member State option to exempt medium-sized companies from the requirement to include non-financial information in their annual report (the Fourth Directive allows Member States to exempt small companies from the requirement to prepare an annual report entirely). The Government considers that the reporting of non-financial information could be unduly burdensome

¹³ Section 246 of the 1985 Act

¹⁴ Modern Company Law For a Competitive Economy, July 2001, URN 01/942

on medium-sized companies, many of which may be family businesses or subsidiaries. An increase in the threshold defining medium-sized companies will allow an additional 16,000¹⁵ medium-sized companies to benefit from the exemption.

Capital Allowances for Spending on Plant and Machinery

- 6.9 The thresholds for medium-sized companies in the 1985 Act are also used as the thresholds for capital allowances for spending on plant and machinery. Capital allowances allow the costs of capital assets to be written off against the business's taxable profits. They take the place of depreciation charged in the commercial accounts, which is not allowed for tax. The generally available rate of capital allowances for spending on plant and machinery is 25% a year on the reducing balance basis. First-year capital allowance schemes enable businesses to claim a greater proportion of the cost in the year in which the expenditure is incurred. This can provide a helpful cash-flow boost. Small and medium-sized businesses can claim 40% first-year capital allowances on their spending on plant and machinery. Increasing the threshold for small and medium-sized enterprises would enable more businesses to claim the first-year allowances.

Proposals

- 6.10 In light of these factors the Government proposes to increase the threshold defining medium-sized companies from the current level to the maximum permissible under EU law (£22.8 million expressed by turnover). This is consistent with the commitment to increase the small company threshold.

The Government welcomes comments from respondents on the proposal to increase the threshold defining medium-sized companies to the maximum permissible under EU law.

Treatment of Groups

- 6.11 Medium-sized groups are able to take advantage of the 40% first-year capital allowances for spending on plant and machinery. The Government therefore proposes that the increase in the medium-sized company threshold would also be applied to threshold for medium-sized groups. This is in line with the current position on small-sized company groups.

¹⁵ Financial Analysis Made Easy (FAME) 2003

The Government welcomes comments from respondents on the proposal to apply the increase in the threshold defining medium-sized companies to medium-sized groups.

6.12 The attached Partial Regulatory Impact Assessment (Annex C) seeks comment on the likely costs and benefits of the proposal to increase the threshold defining medium-sized companies. It indicates where costs and benefits are likely to occur and offers initial estimates for those. It would be helpful if respondents could comment on the potential costs and benefits, for their business or more generally, of any or all of these options. Information on additional costs and benefits would also be welcomed.

Can you:

- (a) identify any costs or savings for your business, or more generally, resulting from the proposal to increase the threshold defining medium-sized companies?
- (b) quantify those costs or savings?

Annex A

The Audit Exemption Threshold in EU Member States

Country	Size criteria for exemption for statutory audit ¹	Turnover ² £(millions)	Turnover €(millions)
Austria	Private limited liability company, general partnership, limited partnership ³ . (Assets: €3.125 million, Turnover: €6.25 million, 50 employees)	4.5	6.25
Belgium	Private limited liability company, incorporated partnership, general partnership, limited partnership. (Assets: €2.45 million, Turnover: €4.9 million, 50 employees)	3.5	4.9
Denmark	Exemption for a limited number of very small enterprises (enterprises and societies with limited liability and co-operative societies with limited liability). This exemption does not include companies. (Assets: Dkr 4 million, Turnover: Dkr 10 million, 10 employees)	0.9	1.3
Finland	No exemptions from statutory audit. ("Layman" auditors are accepted for the smallest companies. The thresholds for defining smallest companies are Assets: €0.68 million, Turnover: €0.34 million, 10 employees)	0.2	0.3
France	Private limited liability company, general partnership, limited partnership. (Assets: €1.55 million, Turnover: €3.1million, 50 employees)	2.2	3.1
Germany	Stock corporations. Partnerships limited by shares, limited liability companies, specific general partnerships, limited partnerships ⁴ . (Assets: €3.438 million, Turnover: €6.875 million, 50 employees)	4.9	6.8

- 1 The types of entity which are exempt may not exceed for two consecutive years two of the three size criteria, presented between brackets. Furthermore, all general and limited partnerships mentioned in this table are partnerships of which all of the unlimited liability members are constituted either as public or as private limited liability companies.
- 2 Conversions to £ sterling and euro have been calculated using one year £ spot forward exchange rates as at close on Monday 21 June 1999. The value of exchange rates will have changed between the setting of the limits and the present. This may produce a spread of values where, originally, different countries thresholds may have been set at the same level. However the data is useful for indicative purposes.
- 3 General and limited partnerships are partnerships of which all of the unlimited partnerships are constituted as private limited liability companies (see also Belgium).
- 4 Defined in EU Directive 90/605/EEG.

Country	Size criteria for exemption for statutory audit	Turnover £(millions)	Turnover €(millions)
Greece	Public limited liability company, private limited liability company, general partnership, limited partnership. (Assets: €1.45 million, Turnover: €2.9 million, 50 employees)	2.1	2.9
Ireland	Public limited liability company, private limited liability company, general partnership, limited partnership (where all the members of the general or limited partnership have limited liability) (Assets: €1.904 million, Turnover: €0.317 million, 50 employees)	0.2	0.3
Italy	Public limited liability company, private limited liability company, incorporated partnership. (Assets: €1.55 million, Turnover: €3.1 million, 50 employees)	2.25	3.1
Lichenstein	Public limited liability company, private limited company, limited partnership. (Assets: CHF 5.55 million, Turnover: CHF 11.1 million, 50 employees)	5.2	7.2
Luxembourg	Public limited liability company, private limited liability company, incorporated partnership, general partnership, limited partnership. (Assets: €3.125 million, Turnover: €6.25 million, 50 employees)	4.4	6.25
Netherlands	The threshold exemptions apply to all legal persons that have a profit-making aim. (Assets: €3.5 million, Turnover: €7 million, 50 employees)	5.0	7.0
Norway ⁵	No exemptions	-	-
Portugal	Private limited liability company, general partnership, limited partnership. (Assets: €1.45 million, Turnover: €2.9 million, 50 employees)	2.1	2.9
Spain ⁶	Public liability company, private limited liability company, incorporated partnership, general partnership, limited partnership. (Assets: €2.374 million, Turnover: €4.748 million, 50 employees)	3.4	4.7
United Kingdom	Private limited liability company, unlimited company, general partnership, limited partnership, limited liability partnership. (Assets: £1.4 million, Turnover: £1 million, 50 employees)	1.0	1.3

5 For Norway, the exemptions are applicable to entities which require an audit according to the auditing requirements of the Fourth, Seventh, Bank Accounts, Insurance Accounts, Partnership and UCITS Directives, which in the context of this study, are implemented by Norway.

6 Insurance companies are to be exempted on the grounds of size. The Regulations on the obligation of insurance companies is established in the legislation on insurance and in the Additional Provision Five to the Royal Decree 1636/1990, of 20th December 1990, that approves the Regulations to develop Act 19/1988, of 12th July 1988, on Auditing.

Annex B

Partial Regulatory Impact Assessment on the Audit Exemption Threshold

1 **Proposal**

- 1.1 To increase the audit exemption threshold to the maximum permissible under EU law (turnover not more than £5.6 million; balance sheet total not more than £2.8 million by Statutory Instrument).

2 **Purpose and intended effect**

(i) OBJECTIVE

- 2.1 The increase in the audit exemption threshold level will relieve small companies and Limited Liability Partnerships (collectively referred to as companies for ease of reference) of the requirement to have their statutory accounts independently audited.
- 2.2 **Devolution:** Responsibility for company law matters lies with the Secretary of State for Trade and Industry. Company law is a reserved area under the Scottish and Welsh devolution legislation and therefore any resulting changes to companies legislation will also apply in Scotland and Wales. In Northern Ireland, matters arising from the proposal would normally be the responsibility of the Northern Ireland Executive Ministers. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments subject to the direction and control of the Secretary of State for Northern Ireland.

(ii) BACKGROUND

- 2.3 In July 2001 the Final Report of the independent Company Law Review¹ recommended that the threshold below which small companies are not required to have an audit should be raised from £1 million to the then EU maximum of £4.8 million (expressed by turnover). This reflected a concern that, for some small companies, the benefits of a statutory audit may not be sufficient to justify the cost.
- 2.4 The Modernising Company Law White Paper² announced that the Government would assess the impact of the July 2000 increase in the audit exemption threshold and consult further before making a final decision. In his budget statement on 9 April 2003, the Chancellor said that the Government was minded to increase the threshold, subject to consultation.

(iii) RISK ASSESSMENT

- 2.5 There are concerns that the statutory audit places a burden on small companies that outweighs the benefits that the audit gives to shareholders and suppliers of credit (in both the financial sectors who provide financial backing, and the goods and services sector who are suppliers of credit in that their goods and/or services are supplied prior to payment being received).
- 2.6 If the audit exemption threshold were increased to the maximum permissible under EU law, those companies relieved from the statutory audit would be able to decide for themselves whether audited accounts were of benefit to them.
- 2.7 Increasing the audit exemption threshold to the maximum would mean that more than 863,000³ companies would no longer be required under the 1985 Act to have their accounts audited.

3 Options

- 3.1 The two main options are as follows:

Option 1:

- 3.2 **The threshold at or below which companies can be exempt from the requirements of the statutory audit remains at a turnover level of not more than £1 million, a balance sheet total of not more than £1.4 million and no more than 50 employees. The threshold also applies to groups.**
- 3.3 The risks of option 1 are discussed at paragraphs 2.5 to 2.7 above.

¹ Modern Company Law for a Competitive Economy, July 2001, URN 01/942

² Cm 5553-I, July 2002

³ Source: Financial Analysis Made Easy (FAME) 2003. Total number of companies that filed accounts for financial year 2001/2003: 1,115,000

Option 2:

- 3.4 **The threshold at or below which companies can be exempt from the requirements of the statutory audit should be increased to the maximum permissible under EU Directives (turnover not more than £5.6 million; a balance sheet total of not more than £2.8 million). The threshold will also be applied to groups where the total turnover of the group does not exceed the new maxima.**
- 3.5 The principal purpose of a statutory audit is to provide a reasonable assurance that a company's financial statements are free from material misstatements and fraud and show a true and fair view of the company's state of affairs. This is first and foremost for the benefit of shareholders of companies, although suppliers of finance, goods and services also place a reliance on the audit.
- 3.6 The risks of removing the requirement for small companies to have a statutory audit of their accounts are that:
- There is an increased risk that statutory accounts will include errors or not be prepared in accordance with legal requirements as there is no requirement for statutory accounts to be prepared by a professionally qualified accountant;
 - Errors in the accounts of companies could lead to a degradation in the quality of information filed at Companies House;
 - Companies may lose the external, independent check on their financial position, which protects the interests of shareholders and suppliers of finance or goods and services against incompetent or fraudulent managers;
 - It could lead to increases in the risk of undetected fraud against companies. (The statutory audit is not designed to detect fraud but it may do so and, it also acts as a significant deterrent);
 - It may facilitate the use of companies for illegal purposes such as money laundering;
 - It may lead to higher costs to companies of borrowing capital from lenders;
 - It removes the assurance for other suppliers of credit, goods and services (who may themselves be small companies).
- 3.7 It should be noted that the interests of minority shareholders⁴ are protected, whilst suppliers of credit can look behind the unaudited accounts and request more detailed financial information. Suppliers of goods and services are able to take an informed decision, by looking at the credit rating of the company they intend to supply.
- 3.8 Although there will be a cost saving to business in no longer having to pay for a statutory audit, there may be an increase in the cost of obtaining finance from lenders from not providing audited accounts. It would fall to the company to make the choice to dispense with the audit and incur instead any higher credit fees.

⁴ Section 249B(2) of the 1985 Act allows shareholders of at least 10% of the share capital to require an audit.

- 3.9 There is a risk that the audit profession's revenue will be reduced by the loss of audit fees. In 2001 there were around 11,300 entities holding registered auditor status. If all companies with a turnover between £1 million and £5.6 million (66,000) choose not to have an audit, there would be a loss to the profession of £66 million (based on a cost of £1,000 per audit).
- 3.10 Research shows that up to 68% (see paragraph 4.3) of companies in the £0 to £1 million turnover range have taken advantage of the last increase in the audit exemption threshold. Research also shows that the larger the company the less likely it is to take advantage of exemption from audit. However, if 68% of companies in the £1 million to £5.6 million turnover range take advantage of audit exemption then a further 45,000 companies will exempt themselves from audit with a loss to the profession of £45 million.
- 3.11 The SPA Report found that small practices generally provide a package of services to corporate clients for which single annual fees are frequently found. Respondents reported that annual fees had been reduced on average by 10% where the audit had been removed following the last increase in the audit fee.

4 Benefits

Option 1:

- 4.1 The benefits of retaining the current audit exemption threshold are that:
- It provides an independent check on the reliability and accuracy of company accounts, for management, shareholders and others;
 - It provides assurance for suppliers of credit, goods and services (who may themselves be small companies);
 - It may detect fraud against companies;
 - It may prevent companies from incurring a higher cost for credit;
 - It may prevent the degradation of information available from Companies House.

Option 2:

- 4.2 This option gives directors of small companies the opportunity to decide whether they want to subject their statutory accounts to an independent audit or whether any resulting cost savings can be put to better use within the business.
- 4.3 There are costs savings to a company in choosing not to audit their accounts. In the financial year 2001/2002, 68% of companies (542,393⁵) who could take advantage of the audit exemption threshold chose not to audit their accounts. If the threshold is increased to £5.6 million a further 66,000⁶ companies will no longer be required

⁵ FAME

⁶ FAME

to have their accounts audited. If the same percentage of companies took advantage of the new threshold there would a cost saving of some £45 million (45,000 X £1,000 (cost of audit)) to businesses (although it is likely that the larger the company the less inclined it would be to take advantage of the threshold).

BUSINESS SECTORS AFFECTED

- 4.4 An increase in the audit exemption threshold level to the maximum permissible would allow all small companies (with some exceptions⁷) with a turnover at or below £5.6 million to take advantage of the exemption from audit.

ISSUES OF EQUITY AND FAIRNESS

- 4.5 The Government considers that the proposal to increase the audit exemption threshold will not bring disproportionate benefits or have disproportionate effects on particular groups other than business.

5 Costs

(i) COMPLIANCE COSTS

Option 1:

- 5.1 The requirement to have statutory accounts independently audited places a cost burden on business. The cost of an audit varies depending on the size and complexity of the business. The initial findings of the Collis Report found that £1,000 was a typical fee for auditing accounts (see paragraph 6.1 below).
- 5.2 There are in the region of 66,000 companies in the £1 million to £5.6 million turnover range. If the audit exemption threshold is retained at its current level of £1 million the cost to companies in complying with the statutory requirements would be in the region of £66 million (66,000 X £1,000 (cost of audit)).

Option 2:

- 5.3 Increasing the audit threshold to the maximum permissible under EU law will not impose compliance costs on business.

(ii) Other costs

- 5.4 The Government considers that the option to increase the audit exemption threshold to the maximum permissible under EU law will not impose costs on sectors other than business. There will be a cost to the audit sector in loss of audit fees (see paragraphs 3.9 - 3.11 above).

⁷ Section 249B of the 1985 Act - Those not exempt include public companies, registered insurance brokers, persons or representatives authorised under the Financial Services and Markets Act 2000, a special registered body or employers' association as defined in the Trade Union and Labour Relations (Consolidation) Act 1992, or a parent company or subsidiary undertaking

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

- 6.1 Jill Collis, a researcher at Kingston University has been commissioned by the DTI to gather views on issues relating to audit exemption from the directors of companies that fall within the EU threshold defining small companies. The study is based on a survey of 790 independent private limited companies that fall within the EU definition of small in their 2002 accounts. It is intended that the final report ("the Collis Report") will be published in September 2003.
- 6.2 The initial findings of the Collis Report show that whilst directors of small companies can see benefits in retaining the audit and having an independent check on their accounts, the proposal to increase the audit exemption threshold is supported by them.
- 6.3 In June 2003 the Society of Professional Accountants (SPA) (formerly known as the Small Practitioners Association) submitted to the DTI a report entitled "The Beneficial Impact of Raising Audit Thresholds from £350,000 to £1,000,000" ("the SPA Report"). The SPA Report is available on the internet at www.spa.org.uk.
- 6.4 The SPA Report shows that the last increase in the audit exemption threshold was welcomed by small professional accounting practices. Their corporate clients benefited from lower fees, few instances of problems by third party users of accounts were experienced and a further increase to the EU maximum was supported.

7 Competition Assessment

- 7.1 The proposal has the potential to affect all small private companies in all markets. It is not anticipated that the proposal will: affect some of those businesses more than others; affect market structure; change the number or size of those businesses; lead to higher set-up costs for those businesses; or lead to higher on-going costs, than at present.
- 7.2 One particular business sector identified as being affected by this change is the auditing profession. The cost to the audit profession has been discussed in paragraphs 3.9 - 3.11 above.
- 7.3 If a large number of companies took advantage of the removal of the requirement to have an audit, it is possible that some registered auditors may review the need for their registration. There are currently some 11,300 entities holding registered auditor status. If there was a significant decrease in that number, it is possible that a two-tier structure of professional accountants could develop, with firms polarised between, those who work with the accounts of small companies and do not audit, and those who work with medium and large companies and do have the expertise to audit. **The Government welcomes comments from respondents on this assessment.**

8 Enforcement and Sanctions

- 8.1 The proposal to increase the threshold below which small companies are not required to have their statutory accounts audited removes a burden on business. No further enforcement is required other than that which already exists for enforcing the standards for small company accounts.

9 Monitoring and Review

- 9.1 The thresholds defining small companies (and therefore the audit exemption threshold) in the EU are reviewed every five years. When the EU thresholds change, it is proposed that the audit exemption threshold in Great Britain would also be reviewed.

10 Consultation

(i) WITHIN GOVERNMENT

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

(ii) PUBLIC CONSULTATION

- 10.2 In July 2003, the Government published a consultation document on the proposal to increase the audit exemption threshold. The consultation was sent to approximately 1,000 businesses, professional bodies, representative organisations and individuals. The deadline for comments is 3 October 2003.

11 Summary and Recommendation

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

Option	Total cost per annum	Total benefit per annum
1 No change	Cost of audit fees to companies - £66 million (66,000 X £1,000 (cost of audit fee)).	Benefit to shareholders, credit suppliers, suppliers, investors, and regulatory authorities from the comfort of the audit - Unquantifiable.
2 Increase the audit threshold to the maximum permissible	Cost to audit profession £45 million (45,000 X £1,000 (cost of audit fee)).	Benefit to companies of saving in audit fees £45 million (45,000 X £1,000 under EU law (cost of audit fees))

11.2 The Government recommends option 2. An increase in the audit exemption threshold to the EU maximum will benefit some 66,000 companies with a potential cost saving of £45 million to those companies.

- Companies will be able to decide for themselves whether they want an audit of their statutory accounts or whether the money saved from not paying an audit fee is best used elsewhere to the company's advantage.
- Shareholders will still be able to require the company to audit their accounts if they consider that necessary.
- Suppliers of credit can also look behind the audited accounts of the company and can request more detailed financial information, as can regulatory authorities such as the Inland Revenue.
- Suppliers of goods and services can take an informed decision according to the credit rating of the company they intend to supply.

Annex C

Partial Regulatory Impact Assessment on the Threshold Defining Medium- sized Companies

1 Proposal

- 1.1 To increase the threshold defining a medium-sized company to the maximum possible under EU law (turnover not more than £22.8 million, balance sheet total £11.4 million, not more than 250 employees) by Statutory Instrument.

2 Purpose and intended effect

(i) OBJECTIVE

- 2.1 The increase will mean that more medium-sized companies and Limited Liability Partnerships (collectively referred to as companies for ease of reference) can be relieved from the burden of the more onerous reporting requirements in the Modernisation Directive¹ when this is implemented in British law. The increase in the medium-sized company threshold will allow SME's to benefit from the 40 per cent first year capital allowance on their spending on plant and machinery.
- 2.2 **Devolution:** Responsibility for company law matters lies with the Secretary of State for Trade and Industry. Company law is a reserved area under the Scottish and Welsh devolution legislation and therefore any resulting changes to companies legislation will also apply in Scotland and Wales. In Northern Ireland, matters arising from the proposal would normally be the responsibility of the Northern Ireland Executive Ministers. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments subject to the direction and control of the Secretary of State for Northern Ireland.

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

(ii) BACKGROUND

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

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

- 2.4 When a company meets the qualifying conditions of a small company it is able to take advantage of the less onerous accounting requirements that are set out in the 1985 Act². Small and medium-sized companies are also able to prepare and file less detailed accounts at Companies House. The accounting requirements for small and medium-sized companies are currently under review.
- 2.5 The Modernising Company Law White Paper accepted the recommendation of the Company Law Review³ that the small company definition be increased to the maximum then allowed under EU law. On 9 April 2003 the Chancellor announced the Government's intention to increase the medium-sized company threshold to the maximum possible under EU law.
- 2.6 Articles 11 and 27 of the Fourth Directive set out the thresholds for small and medium-sized companies respectively (expressed as turnover, balance sheet total and number of employees). Article 53(2) of the Fourth Directive provides that every five years the Council of Ministers, acting on a proposal from the European Commission shall examine and, if need be, revise the amounts expressed in euros in the Directive, in the light of economic and monetary trends in the European Community. The thresholds have been reviewed and on 13 May 2003 the Council of Ministers adopted a Directive⁴ increasing the thresholds by 16.8%. The Directive came into force on 15 May 2003. The increases, expressed in euros, are shown in the table below.
- 2.7 Under Article 12(2) of the Fourth Directive Member States may also increase the thresholds specified in the Directive by a maximum of 10%. This was originally to take account of conversion from ecus into national currencies. It remains an option for all Member States, in order to maintain the principal of equal treatment. The pounds sterling figure⁵ provided in the table below takes account of the 10% increase.

² Section 246 of the 1985 Act

³ Modern Company Law For a Competitive Economy, July 2001, URN 01/942

⁴ Council Directive amending Directive 78/660/EEC concerning amounts expressed in euro.

⁵ The exchange rate used is that published in the Official Journal of the EU on 15 May 2003 (£1 = 0.7118 euros)

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

(iii) RISK ASSESSMENT

- 2.8 The proposal to increase the threshold that defines medium-sized companies is not addressing a particular risk but is a deregulatory measure that will relieve those businesses of a burden.

3 Options

- 3.1 The Government has identified the following options:

Option 1:

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

- 3.3 If the threshold defining medium-sized companies is not increased when the Modernisation Directive is implemented into GB law more companies will be subject to the requirements to report on non-financial indicators relevant to the particular business. In addition fewer businesses will benefit from the 40 per cent first year capital allowance on their spending on plant and machinery.

Option 2:

- 3.4 **The threshold defining medium-sized companies should be increased to the maximum possible under EU law (turnover not more than £22.8 million, balance sheet total £11.4 million, employees not more than 250). The threshold increase will also be applied to group accounts where the turnover for the group does not exceed the new maxima.**

- 3.5 The risks identified in making this increase are that 16,000⁶ additional companies falling under the new definition would be eligible to file abbreviated accounts at Companies House, although they would still have to prepare full accounts for shareholders.
- 3.6 Although there is little difference between the content of the abbreviated accounts⁷ and the full accounts available to shareholders, this may add confusion to the financial information available to investors and creditors and could hamper comparability. Currently some 14% (8,400⁸) of medium-sized companies file abbreviated accounts.

4 Benefits

Option 1:

- 4.1 There is no benefit to companies in keeping the medium-sized company threshold at its present level.

Option 2

- 4.2 When the provisions in the Modernisation Directive are implemented into GB law, the Government intends to take advantage of the Member State option to exempt small and medium-sized companies from the requirements to include non financial information in their annual report. If the threshold defining medium-sized companies is increased to the EU maximum, it would relieve an additional 907,000 companies in total from additional reporting requirements. In addition, more SME's will benefit from the 40 per cent first year capital allowances on their spending on plant and machinery.

BUSINESS SECTORS AFFECTED

- 4.3 An increase in the threshold defining medium-sized companies would affect all companies that meet the criteria set by the new definition in all business sectors.

ISSUES OF EQUITY AND FAIRNESS

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

6 Financial Analysis Made Easy (FAME) 2003

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

8 FAME

5 Costs

(i) COMPLIANCE COSTS

Option 1:

- 5.1 Medium-sized companies will become subject to the additional reporting requirements placed on large companies by the Modernisation Directive. If the threshold is not increased, it will not be possible to exempt the further 16,000 companies falling under the new threshold. The cost of complying with the reporting requirement is estimated to be £500 a company (cost of preparing report).

Option 2:

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

(i) OTHER COSTS

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

(i) COSTS FOR A TYPICAL BUSINESS

- 5.4 The Government considers that this proposal has no significant costs for business. **The Government welcomes comments from consultees on the costs for their business.**

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

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

7 Competition Assessment

- 7.1 It is not anticipated that the proposal will: affect some of those businesses more than others; affect market structure; change the number or size of those businesses; lead to higher set-up costs for those businesses; or lead to higher on-going costs, than at present. **The Government welcomes comments from respondents on this assessment.**

8 Enforcement and Sanctions

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

9 Monitoring and Review

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

10 Consultation

(i) WITHIN GOVERNMENT

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

(ii) PUBLIC CONSULTATION

- 10.2 In July 2003, the Government published a consultation document on the proposed increase in the medium-sized company threshold. The consultation was sent to approximately 1,000 businesses, professional bodies, representative organisations and individuals. The deadline for comments is 3 October 2003.

11 Summary and Recommendation

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

Option	Total cost per annum	Total benefit per annum
1 No change	Costs to companies in being subject to the reporting requirements of large companies that are proposed in the Modernisation Directive - £21.8 million.	None.
2 The medium-sized company threshold be increased to the maximum permissible under EU law	None.	Benefits to SME's from the 40% first year capital allowance on their spending on plant and machinery - not quantified. Benefit to companies in not being subject to the reporting requirements of large companies that are proposed in the Modernisation Directive - £21.8 million.

11.2 The Government intends to adopt option 2. An increase in the threshold defining medium-sized companies will reduce burdens on the 43,500 medium-sized companies that meet the new criteria. They will be able to take advantage of the proposed Member State option in the Modernisation Directive to exempt them from the burden of reporting on issues of corporate social responsibility and the company's environmental impact. An increase in the threshold defining medium-sized companies will allow medium-sized enterprises to take advantage of the 40% first year capital allowance on their spending on plant machinery.

Annex D

Code of Practice on Written Consultations

The following criteria apply to all UK national public consultations, and have been applied to this consultation paper.

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 reasons for decisions finally taken.
7. Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure the lessons are disseminated.

Responses to the consultation should be sent to the address given at paragraph 2.2 of the consultation document. If, however, you wish to make any comments about the handling of this consultation, please contact:

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Further information about this code of practice can be found at:
www.cabinet-office.gov.uk/servicefirst/index/Consultation.htm.

