THE STATUTORY AUDIT REQUIREMENT
FOR SMALLER COMPANIES

A CONSULTATIVE DOCUMENT

OCTOBER 1999

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URN 99/1115

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Section 1: Introduction

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1. The Secretary of State for Trade & Industry, Stephen Byers, announced on 3 June that the Government intended to consult widely on raising the threshold at which there is a statutory audit requirement, from the existing level of a turnover of £350,000 to a higher level, possibly up to the maximum level set by the EU[1], at present around £4.2M. This document forms the basis for that consultation.

2. The key question is not whether an audit is desirable and/or valuable for companies, and smaller companies in particular, but whether the balance of costs and benefits supports a *mandatory* requirement for an external audit for companies of a certain size.

3. This Government has given a commitment that regulation will only be maintained, or new regulation introduced, where clearly justified; and, where regulation is necessary, to keep it as simple as possible.

Proposal for Change

4. The Secretary of State's initial view is that there is a good case for a significant increase in the threshold. However, the new level needs to be decided in the light of wide consultation and of a careful assessment of the relative costs and benefits.

Company Law Review

5. This consultation is separate from the longer term fundamental review of core company law (CLR). That wider review, announced by the Department in March 1998, led by an independent Steering Group, has the aim of simplifying and modernising company law to create a framework for modern competitive companies for the 21st century. Reforming the structure of accounting and reporting requirements is an important element within the CLR. However, the Government has always made it clear that it will progress the continuing reform of company law while the Review continues where the circumstances make a good case for change. The Review will in due course report on company law as a whole.

[1] Articles 11 and 27 of the Fourth Council Directive of 25 July 1978 on the annual accounts of certain types of companies, and Article 27 of the Seventh Council Directive, as amended most recently by 1999/60/CE of 17 June 1999. There is a 10% uplift for currency conversion.

Open Government

6. Unless you specifically request otherwise, your comments will be made available publicly under the Code of Practice on Open Government. A summary of comments will also be circulated to those who respond to this consultation.

Regulatory Impact Assessment

7. The draft Regulatory Impact Assessment (RIA) at Annex A includes a summary of the costs and benefits. One of the main purposes of this consultation is to obtain better evidence on the costs and benefits.

Your Comments

8. We would welcome comments on any aspect of the issues discussed in this consultation document. Please send your comments by **10 December 1999** to:

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9. This document will be available on the Internet at www.dti.gov.uk/cld/condocs.htm. You can also call 0171 215 0232 for additional copies.

Section 2: Background

10. The 1967 Companies Act introduced for the first time a requirement that all companies must file their annual accounts at Companies House: it abolished the previous exemption which private companies enjoyed from filing and also required those accounts to be audited by a qualified independent auditor. This gave effect to a recommendation of the Jenkins Committee[2] which in the early 1960's had emphasised the value to credit insurers of reliable information on the public record.

11. In 1981, in implementing the EC Fourth Company Law Directive[3], the then Government took advantage of the exemptions allowing small and medium-sized companies to file short-form ("abbreviated") accounts but, after consultation, decided to retain the audit requirement for all companies. This decision was reviewed in 1986 and again in 1988 but on each occasion it was decided to retain the status quo.

12. A further consultation in 1993, following implementation of the provisions of the EC Eighth Company Law Directive[4] on auditors' qualifications, led to a first cautious step, exempting very small private companies (with a turnover of £90,000 or less) from the audit and introducing an intermediate exemption regime for private companies with a turnover up to £350,000. Companies with a turnover of between £90,000 and £350,000 were given the option of filing a simpler audit exemption report (AER) in place of the full audit report. However, the AER was scrapped in 1997 leaving two types of companies - those with a turnover above £350,000 who are subject to a full statutory audit, and those with a turnover of £350,000 or less who are exempt[5]. There is protection for minority shareholders who might otherwise not be able to obtain accounts with any external assurance. Those holding at least 10% of the shares can require an audit.

13. Exemption from the audit removes the need for the directors to engage an independent, professionally qualified and regulated person but does not absolve the directors of their responsibility to prepare and file accounts which show a true and fair view of the state of affairs of the company and of the profit or loss for the year. The accounts must be prepared in accordance with generally accepted accounting practice (GAAP) in the UK[6].

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[2] Report of Company Law Committee, Cmnd 1749, 1962
[3] Fourth Council Directive of 25 July 1978 (78/660/EEC)
[4] Eighth Council Directive of 10 April 1984 (84/253/EEC)
[5] A company's balance sheet total must also not exceed £1.4M; see also the reference to charitable companies in paragraph 15 below.
[6] In practice the Financial Reporting Standard for Smaller Entities prescribes the basis for preparing and presenting the financial statements.

14. Not all private companies below the threshold can take advantage of the exemption[7]. Financial services companies, including banks and insurance companies are not able to do so. Nor can companies whose balance sheet total in the relevant accounts exceeds £1.4M, nor companies which form part of a group whose aggregate turnover for that year exceeds £350,000 on a consolidated basis[8].

15. The audit of charitable companies raises special considerations; at present there are no exemptions for **charitable companies** whose income exceeds £250,000, and for charities with an income between £90,000 and £250,000 the Audit Exemption Report (AER) is still required[9]. The accounting requirements of charitable companies, including the audit regime, will be the subject of separate consultation by the Charity Commission and the Department.

16. Changes to the thresholds below which small and medium companies can file abbreviated accounts in place of full accounts are being considered separately in the light of recent consultation URN 99/660.

Numbers Of GB Companies By Size

17. An analysis of data for some 750,000 companies whose accounts filed at Companies House include turnover data gives the following:

TURNOVER INTERVAL	NO OF COMPANIES
UP TO £350K	520,000
OVER £350K TO £1MN	110,000
OVER £1MN TO £2MN	40,000
OVER £2MN TO £3MN	20,000
OVER £3MN TO £4.2MN	15,000
OVER £4.2M	45,000
TOTAL	750,000

Of these companies, some 180,000 which are at present subject to audit would be able to opt out were the threshold to be raised to £4.2M.[10]

18. In addition some 380,000 companies file abbreviated accounts which do not include turnover figures. A rough estimate is that some 90,000 of these would no longer be required to have an audit were the threshold to be increased to the maximum permitted. In **total** therefore our estimate is that approximately 250,000 additional companies would be entitled to dispense with the audit were the threshold to be raised to £4.2M; with a £1M threshold the number of companies would be of the order of 150,000.

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[7] The detailed requirements are set out in sections 249A and section 249B of the 1985 Act. Only the principal exceptions to the basic exemption provision are set out here.
[8] £420,000 gross
[9] see Section 249A(2) and (3A) and section 249C and 249D.
[10] There are also some 180,000 dormant companies on the register.

Take Up Of Audit Exemptions

19. It is also useful to look at the proportion of eligible companies who take up the exemption option. Our estimate, based on a limited analysis of accounts filed at Companies House, is that around 50% of eligible companies below the £350,000 threshold no longer have an audit. A study for the ICAEW[11], though based on a small sample, suggests that around 50% of eligible companies took advantage of the exemption in 1995 but by 1997 that had increased to around 60%. A survey by MORI for the ACCA[12] asked companies in the turnover range £350K to £1.5M if they would take advantage of audit exemption were it available. Roughly 40% said that they would do so. Within the larger companies in this group - the £750K to £1.5M range - almost 50% said that they would do so.

20. We have no information on what proportion of companies above £1.5M would dispense with the audit were they to fall below a new threshold. Whilst the absolute savings might be the greatest for such companies, the savings as a proportion of turnover would be lower. Also, whilst such companies are more likely to have in-house accounting expertise - and therefore feel more comfortable with dispensing with external expertise than smaller firms - they may also come under greater pressure from outside interested parties - the banks etc. - to have an independent audit.

Position In Other Countries

21. **Annex B** sets out the audit exemption regimes in other EU countries and in some countries outside Europe. In most of these countries the threshold is substantially above the current UK level, typically in the range £2M to £4M. The principal exceptions are the Nordic countries and Ireland[13], which require an audit for all companies, and New Zealand, which has much the same regime as the UK. In the United States there are very few company audit requirements at State level and the main requirement for audit is for listed companies subject to SEC rules.

22. However, care is needed in interpreting the raw data. The audit regime is part of the wider raft of company law and reporting requirements, set in differing legal traditions. For example, in France, where the threshold is around £2M, there is a requirement for a professional accountant to be involved in the preparation of all accounts. In Ontario, where the size test for audit exemption is $100M in assets or turnover, there is a requirement that financial statements filed with corporate tax returns comply with generally accepted accounting practice. The need to demonstrate compliance provides a compelling reason for continuing to have an audit. In other countries, in Greece for example, there are much higher minimum

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[11] The Uses of the Accounts of Small and Medium-sized Companies and the Effects of the Audit Exemption Regime by Cliff Pratten, ICAEW 1998

[12] Small Company Audits, Research Study conducted by MORI for the Association of Chartered Certified Accountants October 1998.

[13] Though it is proposed to introduce an audit exemption threshold in Ireland of 250,000 punt.

capital requirements for companies, which, some would argue, reduce the need for small company audit.

23. Company populations and their size distribution in different countries are also factors which need to be taken into account in making comparisons. The company vehicle has been significantly more popular a vehicle for doing business, particularly small business, in the UK than in most other European countries. There are a number of reasons for such differences - history, the ease of company formation, tax structure. But the key point is that where the majority of small business activity is carried out through vehicles which do not enjoy limited liability, then the audit regime for smaller businesses has been much less of an issue.

Section 3: The Statutory Audit

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24. The requirement for companies to prepare and publish accounts is an important element of the framework of company law; it is often described as part of the price paid for the privilege of limited liability. The audit is regarded as an integral part of this arrangement because the reliability of accounts matters.

25. The purpose of financial statements is to provide information about the financial position and performance of an enterprise that is useful to a wide range of users both for assessing the stewardship role of management and as a basis for a range of economic decisions - whether to lend money, whether to invest, whether to do business with a company. Reliable accounts therefore facilitate dealings between businesses and help to reduce the cost of capital.

26. Audit increases the reliability of accounts and thus their value to users. In almost every country the law requires that at least the larger companies must have their accounts independently audited.

27. Whilst most would acknowledge, in varying degrees, that the audit adds value, this does not of itself demonstrate the case for the statutory audit. There are costs as well as benefits to take into account - most obviously the cost of the audit. Such costs are proportionately greater the smaller the company. The balance of advantage therefore changes as company size increases.

28. There is a further important consideration. As suggested, a primary purpose of the audit is to provide assurance to shareholders about the stewardship of their funds by the management. However, many smaller companies are owner-managed and there is no separation between the ownership and management. For such companies there is a less persuasive case for a mandatory audit simply to protect the interests of shareholders - where the owner manager sees a net benefit he or she can simply continue with the audit. Even where there are external shareholders, the interests of minorities can be protected within an audit exemption

regime, by allowing a minority interest to require an audit.[14]

29. Were these the only considerations, most people would conclude that the case for a statutory audit was weak, given adequate protection for minority shareholders.

30. Reliable accounts are not, however, simply of interest to shareholders. Those who place reliance on the audit include potential investors, actual and potential creditors, lenders, suppliers, employees, regulatory bodies and arms of Government such as the Inland Revenue. Their interests need to be carefully weighed in the balance. The strength or otherwise of these arguments is discussed in Section 5.

31. Equally, it is important not to overstate the level of assurance which an audit offers. It is for example commonly thought that the audit should guarantee detection of fraud. Whilst the audit is undoubtedly a significant deterrent against fraud, detecting organised fraud by management is not easy for the auditors. Detecting fraud by employees will usually not be material to the accounts and may be incidental to the purpose of the audit. Nor indeed do auditors owe a duty of care to all groups who might place reliance on the auditors' report. The *Caparo* case[15], which subsequent decisions of the courts have in general upheld, determined that the auditors owe a duty of care to the company and to the shareholders as a group, but not more widely.

32. Determining the level of turnover below which audit should be a voluntary matter therefore depends on an assessment of the balance of the costs and benefits. The audit needs to bring real benefit for those dealing with companies and, in relation to a particular size threshold, those benefits need to outweigh the costs. A principal aim of this consultation exercise is to gather together evidence on the costs and benefits, as well as views on the appropriate threshold.

[14] Under the current exemptions, shareholders holding at least 10% of the share capital can require an audit.

[15] Caparo v Dickman [1990] 2 AC 605 laid down tight limits upon when a professional owes a duty of care and can be sued by a person other than his client.

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Section 4: The Burden Of The Audit

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33. The main costs of audit for a company are the direct cost and the management time absorbed.

34. There is a wide range of estimates of the cost of audit for the smaller company. One estimate puts the typical cost of an audit for a £1M turnover company at around £5,000 or 0.5% of turnover. Below that the cost would fall in absolute terms but rise as a percentage of turnover. On this basis a potential saving for small businesses of some £500 million a year might arise if the exemption level were raised to £1m. The actual savings would of course depend on the proportion of companies which chose to take advantage of the exemption.[16]

35. Others put lower figures on the savings which would result from abolition of statutory audit - of the order of £1,000 to £2,000 per annum for companies in the range £350,000 to £1M turnover. Even at this lower level of estimate the potential savings would be at least £150M a year.

36. Part of the explanation for these differing estimates lies in the fact that, for smaller companies in particular, the auditor usually does other work for the company - preparing the accounts, tax work etc. This makes it difficult to calculate the net savings. In some cases a company will seek additional help from its accountants in preparing the accounts once there is no audit requirement. The MORI study[17] suggests that, up to an audit exemption level of around £1M, most auditors would expect to be able to replace any loss of revenue. Only 1 in 5 of the auditors who took part in that survey took the view that it would be “fairly” or “very difficult” to compensate for a reduction in audit fee income.

37. Other costs of audit which fall on the company - in particular the diversion of management time - can be significant and proportionately greater for the smaller company. The MORI study[18] suggests that the main burden lies in addressing queries from the auditors and providing evidence.

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[16] see paragraph 19 above
[17] see footnote 12 above
[18] see footnote 12 above.

Section 5: The Possible Benefits Of Audit

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38. As suggested, a range of parties may benefit from the imposition of a statutory audit. Those possible benefits most often cited as supporting the case for the statutory audit are discussed below.

Benefits for shareholders

39. For the many smaller companies where managers and owners are one and the same, there is no need for a statutory audit requirement to ensure their needs as shareholders are met. And, as noted, there are already arrangements to protect minority shareholders: it is not proposed to remove these. In other words, shareholders not involved in the management will in general be able to obtain audited accounts where they see value in doing so.

40. There is however, the further question of whether the existing arrangements adequately protect the interests of minority shareholders. Were the audit threshold to rise, there may be a case for reducing the percentage of share capital needed to require an audit below the existing 10%, say to 5%. We would welcome views on this.

Benefits for the company's directors and management

41. The MORI study[19] found that almost four-fifths of businesses agreed with the view that "companies already know most of the information provided by the audit". The general view was that the audit provided no insight as to the future direction of the business. Only two-fifths regarded the information provided as essential or very useful to the business itself. However, those proportions increased as the size of the company decreased - for example, for companies with a turnover of up to £350,000, 58% of companies said that they found the information essential or very useful. And a majority of companies considered that the audit was of substantial value to those outside the company - and particularly to the banks and the Inland Revenue.

42. There is a view that, even if the audit does not offer great benefits to the company itself, the guarantee of professional accountancy involvement is important in a more general sense for the long term health of the company. However, this supports a *statutory* requirement only if one takes a view that the company's management cannot be left to judge what is in the company's best interests. There is also an alternative view that freeing up the resources devoted to audit should

[19] see footnote 12 above

provide an opportunity for SMEs and their accountants to develop a more fruitful relationship.

Benefits for the main lenders such as banks

43. Banks use the statutory accounts for a variety of purposes, though they are only one source of information on customers. The banks may take reassurance as much from the involvement of a professional accountant/auditor as from the audit itself. The MORI study[20] suggests that around four-fifths of bank lenders feel that the statutory audit is essential or very useful for their purposes.

44. The key question, however, is the extent to which this supports a *statutory* requirement. The banks can always insist on audit as part of their terms. They may also have other more up to date information on a company's financial position, not least from the company's bank account. Whilst there is considerable force in this argument, one counter is that, in a competitive market for lending, lenders may find it hard to insist on requirements such as audited accounts: this would lead to a relatively inefficient market, in which risks were hard to assess. On this argument the statutory audit is seen as a more effective and efficient way of providing reliable information. It reduces the need for special reports at least at an initial stage of considering requests for finance and gives reassurance for example that the company is keeping proper accounting records. We would welcome views on the strength of these arguments.

Benefits for general creditors

45. The position of general creditors is different from that of the bank lenders in that, although their power to demand financial information in relation to corporate customers will vary enormously, it will in general be less than that of the banks. As the ICAEW study[21] notes, credit management is important for many companies, which may have credit management departments or make use of credit rating agencies. Credit rating agencies regard readily available and reliable accounts as of critical importance, though it is unlikely that many successful credit agencies rely solely or principally on audited accounts. Annual accounts have acknowledged limitations - they remain essentially backward-looking and, for small private companies, do not have to be filed until ten months after the end of the year to which they relate - both points which are being considered within the Company Law Review (CLR). For example, were there a substantial shortening of the gap between year end and the placing of the accounts on the public record, the value of those accounts to creditors is likely to increase. Arguably this places a greater premium on the quality of information on the public record and would increase the value of the audit to creditors and other lenders.

46. It must also be borne in mind that companies which qualify as small under the Companies Act - in simple terms with a turnover below £2.8M - are able to file

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[20] see footnote 12 above
[21] see footnote 11 above

abbreviated accounts at Companies House[22]. This already results in a significant reduction of the information publicly available to third parties.

47. Nevertheless, the argument is that an extension of the statutory audit exemption will further weaken the ability of companies to assess credit risks accurately: this would either require suppliers to take on additional risk or make them more wary of their customers. This could increase the cost of credit, though a company which appreciated this could decide to stick with the external audit. The more difficult question is to determine how significant a risk this is in practice. At its worst this could create a general wariness amongst trade creditors as to the financial soundness of their small firm customers. We would welcome views on the impact on general creditors.

Other Possible Benefits of the Audit

48. It is worth considering more general benefits which may be derived from a statutory audit requirement. Put in its most general form, the argument is that the audit promotes, and to some degree polices, integrity and honesty in business, which is important both for its own sake and for maintaining confidence in markets. Left to their own devices those companies least in need of an external check are those most likely to retain the audit, whilst those companies with an interest in concealing an accurate financial position, with the attendant risk of financial loss for others, are most likely to take advantage of exemptions from audit. We would welcome views on the strength of this argument.

49. A further consideration is that the audit helps to maintain the quality of the information on the public record. It is possible to make too much of this - many of the companies in the size range discussed in this document are able at present to file abbreviated rather than full accounts. Arguably this limits their value to third parties. Nevertheless, removing the audit requirement for an additional substantial number of companies will inevitably increase the number of company accounts on the public record which are inaccurate, either because of simple errors in preparation, or because of a deliberate wish to mislead.

[22] There are more modest concessions for medium-sized companies.

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Section 6: Options

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50. We attach more importance in this consultation to establishing the strength of the arguments and the evidence of costs and benefits than to a simple count of the number of consultees who favour setting the threshold at a particular level of turnover. It would be valuable therefore to have your assessment of the balance of argument in relation to the various possible new levels for the threshold as well as an indication of your favoured option.

Other Issues: Treatment of Groups

51. When the original exemptions from audit were introduced in 1994 companies which were holding companies or subsidiary undertakings were automatically excluded from the audit exemption. This was amended, firstly to allow companies which had been dormant throughout the period to benefit from audit exemption; and secondly to remove the exclusion from companies within a group, on the grounds that it was unnecessarily burdensome and restrictive. However, the conclusion was that there still needed to be safeguards so that companies above the threshold could not restructure the group to avoid the audit requirement. The current legislation therefore permits a parent company or a subsidiary company to take advantage of audit exemption but only where the total turnover of the group does not exceed the threshold for individual company exemption[23].

52. The other relevant background is that, subject to certain exceptions, a parent company need not prepare group accounts where that group qualifies as a small or medium-sized group[24]. In other words, for quite sizeable groups, only individual company accounts are required.

53. The intention is that any increase in the audit threshold would be reflected also in the threshold for the total turnover of a group. More companies which are members of a group than at present would therefore be eligible for exemption from the audit.

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[23] It is slightly more complicated than this - section 249B(1C) sets the group turnover threshold at £350,000 net of consolidation adjustments or £420,000 gross. There are other requirements not of great immediate relevance.

[24] A medium-sized group is a group which meets two of the following three conditions:

1. Turnover not more than £11.2M net or £13.44M gross
2. Balance sheet total not more than £5.6M net or £6.72M gross
3. Not more than 250 employees.

For details see section 249(3) of the 1985 Act as amended by SI 92/2452

54. We would welcome views on what changes might be made to the requirements for audit where there is a group.

Other Issues: Asset Test

55. Most of this document has been written on the premise that turnover is and should remain the principal determinant of audit exemption. However, the existing conditions for audit exemption include a requirement that the company's gross assets for the year in question do not exceed £1.4M[25]. In practice this condition will determine access to the audit exemption in only a small number of cases where a company is asset rich but with a relatively low turnover. Nevertheless this raises the question as to whether the gross asset requirement should be increased in relation to a higher turnover threshold[26]. It also raises the wider question as to what measure or combination of measures is the most appropriate for determining exemption from statutory audit. We should welcome comments on both these points.

[25] Section 249A(3)(c) of the 1985 Act.
[26] The Fourth Company Law Directive sets a maximum gross asset test of £2.4M.

Annex A

Draft Regulatory Impact Assessment

1. Title

The Statutory Audit Requirement for Smaller Companies

2. The Issue and Objective

Issue. Companies with a turnover of above £350,000 are subject to an annual external statutory audit of their accounts. Below this threshold they can choose to dispense with an audit. The Government considers that there is scope for a significant increase in the threshold, possibly up to £4.2M - the maximum allowed under EU law, but wishes to consult widely on the costs and benefits to provide the best basis on which to set the new threshold.

Objective The objective is to remove statutory burdens and costs on smaller businesses where the benefits in the wider public interest are not commensurate.

3. Identify, Quantify and Value the Benefits

Raising the threshold for statutory audit removes the direct cost of the audit for companies which opt not to have one. It also saves management the time involved in answering queries from the auditors and providing evidence. (Many companies - the evidence suggests around half - will continue with audits even if they no longer have to.)

There are widely differing estimates of the savings which a smaller company might make by dispensing with the audit. For example the typical cost of an audit for a company with in the range £350,000 to £1M turnover has been put variously at from £1000 to £5000. Part of the explanation for these differences may lie in the difficulty of separating out work in preparing the accounts or tax returns from strictly audit work.

The total savings for the small company sector from raising the threshold will also depend on the number of additional eligible firms and the proportion of those firms who choose to take advantage of the exemption option. We estimate that, were the threshold raised to £1M, an additional 150,000 companies might be entitled to exemption; at £4.2M that figure would be 250,000. Roughly half might be expected to dispense with the audit.

4. Business Sectors Affected

Companies with a turnover above £350,000 up to a maximum of £4.2M; the users of the accounts of those companies, for example banks, general creditors and the tax authorities.

5. Identify, Quantify and Value the Costs

It is important to stress that companies would still be able to choose to have an audit where they judge it to be in their interests. The main cost therefore of increasing the threshold below which there is no requirement for an audit is the reduction in the reliability of the information in company accounts for users, principally lending institutions, general creditors and the Inland Revenue. There may also be more general public benefits to the extent that the audit promotes integrity and honesty in business and helps to maintain confidence in markets.

It is extremely difficult to assess and quantify these benefits. Many smaller companies can file abbreviated accounts; and accounts of small companies do not have to be filed until 10 months after the year end. These limit the value to users. Some users, such as the banks, are well placed to require companies either to continue with the audit or to provide detailed financial information or have other ways of assessing companies' credit worthiness. Nevertheless these alternatives have their own costs attached and readily accessible reliable financial information is seen by users as of real value.

An important purpose of the consultation is to get hard information and views on the value to users of the statutory audit, as a basis for reaching evidence-based policy conclusions.

6. [Results of Consultation]

7. [Recommendation]

October 1999

Annex B

ANNEX OF AUDIT IN OTHER EU MEMBER STATES AND SELECTED OTHER COUNTRIES

Audit exemption practice in other countries

1. It is useful to consider the audit exemption regimes of other countries as compared to that in the UK. However, it is difficult to produce data for different countries which are directly comparable and care should be taken not to draw conclusions based on this data alone. The audit regime is not an isolated piece of legislation in each country but, rather, part of a wider raft of company law and reporting provisions - each of which will affect the need for small companies to be audited and the value of those audits.

2. For example in the UK there is no statutory requirement for limited liability companies to hold a minimum amount of share capital. Different countries may impose such requirements. Where companies are not required to keep a minimum capital it may, on balance, be prudent to have a stronger audit regime for the protection creditors and others in the case of insolvency. However, even this will vary from country to country. In Greece there is a requirement that companies keep a minimum share capital equivalent to around £40,000 and companies with a turnover up to £1.95 million may dispense with an audit. However, in Finland there is a minimum share capital requirement equivalent to £5,300 and all companies are required to have an audit. Other differences might include the requirements of the local tax regime, political considerations and the generally accepted national financial practices.

3. It should also be noted that the populations of companies and their distribution in terms of size and vehicle may also affect the need for audit. The United Kingdom has, by far the largest population of limited liability companies of any European country and the largest number of both listed companies and small companies. Table 1 below shows the distribution of the company population in Europe and selected non-EU countries.

4. In countries where the majority of economic activity is carried out by businesses which do not enjoy limited liability (e.g. partnerships, sole traders, self-employed) there is less of a perceived need for an audit regime for small firms since creditors may, if necessary, pursue the owners of these businesses to the extent of their personal wealth. Where there is a larger proportion of limited liability vehicles, an audit is seen more as a protection to help assure shareholders and creditors of the financial health of companies.

European Union Member States

5. The company law of EU member states is constrained by the EU Company Law Directives. The 4th[27] and 7th[28] EU Company Law Directives set out the reporting and accounting requirements for companies in EU member states with respect to individual company and consolidated company accounts, respectively.

6. Within the 4th Directive there are various definitions, thresholds and exemptions which are available to small companies. Article 11 of the 4th Directive defines the maximum level for the definition of a small company (below which they may take advantage of those accounting exemptions within the Directive which the member state decides to allow). The current thresholds are:

> *That a company falls below two of the following three criteria:*
> *balance sheet total: 2,500,000 Euro,*
> *net turnover: 5,000,000 Euro,*
> *average number of employees during the financial year: 50.*

Article 51 of the 4th Directive allows member states to relieve those companies referred to in Article 11 from the requirement to have their accounts audited.

7. In June 1999 the Council of Ministers agreed a Commission proposal to raise the thresholds to the following levels to take account of inflation and economic growth. This new level will come into effect later in the year:

> *That a company falls below two of the following three criteria:*
> *balance sheet total: 3,125,000 Euro,*
> *net turnover: 6,250,000 Euro,*
> *average number of employees during the financial year: 50.*

8. The Directives are drafted so that member states are allowed to set the thresholds for filing abbreviated accounts and for filing unaudited accounts at any level up to and including the above maximum limits. Different EU member states, therefore, have their exemptions set at different levels. Table 2, below, gives a brief summary of the levels at which audit exemption levels are set for EU member states and selected non-EU countries.

EU countries:

9. Figure 1 below, derived from the data in Table 2, demonstrates that the EU member states fall into three broad groupings based on their audit exemption regimes.

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[27] *Fourth Council Directive of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies. (78/660/EEC).*

[28] *Seventh Council Directive of 13 June 1983 based on Article 54 (3) (g) of the Treaty on consolidated accounts. (83/349/EEC).*

10. The three groupings are, first, the "Nordic" member states (Denmark, Finland, Norway and Sweden) which require all limited liability companies to have their accounts audited. Ireland does not currently operate an audit exemption regime. However we understand that they are planning to introduce a scheme similar to that in the UK with the threshold set at Ir£250,000. The second grouping of Greece, Italy, Portugal and France set the threshold below which companies may opt to file unaudited accounts at around half the maximum allowed under the Directives. The final grouping Germany, Austria, Belgium, Luxembourg the Netherlands and Spain set the audit thresholds at about the maximum allowed under EU law. The UK currently lies between the first and second groupings with a threshold of £350,000.

Non-EU Countries:

11. Australia: Companies with a turnover of less than Aus$ 10 million which are not controlled by overseas companies may opt to dispense with an audit.

12. Canada: The law in Canada is complex and provisions are dependent on a mixture of both national and provincial law. Broadly, the Canadian Business Corporations Act requires all limited liability companies whose securities in whole or in part, are held by the public, to file audited accounts. In most provinces the Provincial law allows closely held companies to apply not to appoint an auditor provided that there is unanimous agreement of all shareholders. Ontario additionally imposes a threshold of Can$ 100 million, above which an audit is mandatory, and a Can$ 600 application fee.

13. New Zealand: The regime in New Zealand is broadly similar to that in the UK. Any company with assets of less than NZ$ 450,000 and turnover less than NZ$ 1 million can opt to dispense with an audit provided it does not own a subsidiary and is not the subsidiary of another company.

14. United States: There is no federal, statutory requirement for the accounts of companies to be audited. The main requirements for audit rest with the SEC (for registered companies) and under the FDICIA (for banks). Certain other industries are subject statutory requirements at State level, for example benefit plans, credit unions etc. However, other than some state requirements relating to not-for-profit organisations, these are not determined by size-based criteria. They also apply across a range of corporate vehicle, not simply US LLCs. However, many entities in the US do have audits where none is required by law. These are primarily for credit purposes and are not determined by size or corporate status.

Figure 1: Audit exemption thresholds for EU and selected non-EU countries (£ sterling)

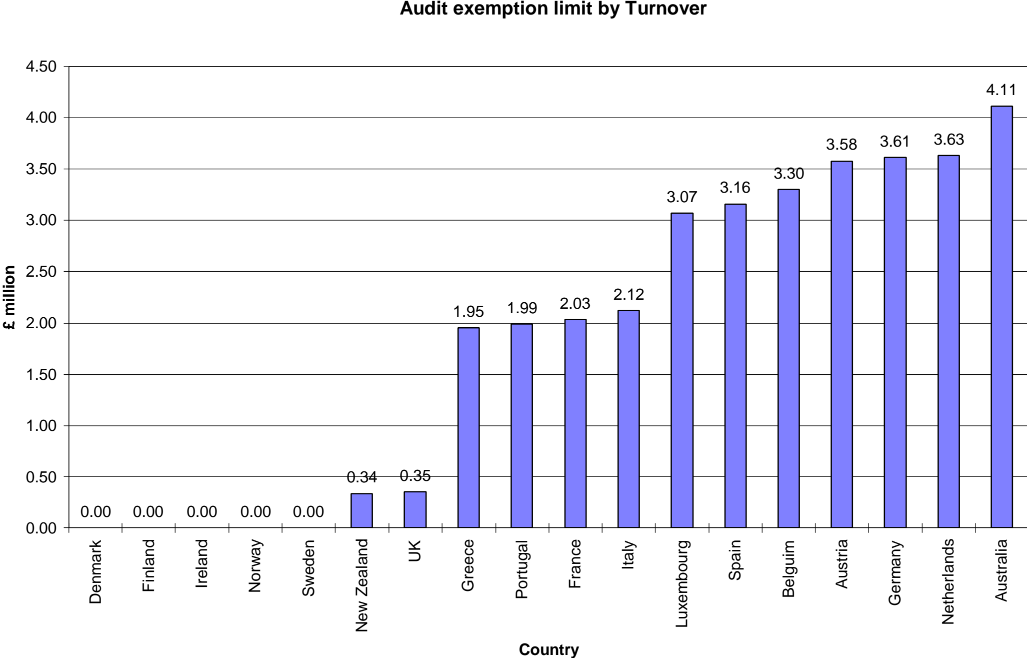

Table 1. Distribution of company population in EU and selected non-EU countries

Country	Total no. of limited liability companies[29]	Total no. of listed companies[3]	Total no. of plc's (or equivalent)[3]	Total no. of private companies[3]	Total no. of small companies[3]
Austria	43,400	939		42,400	
Denmark	82,500	260		82,250	81,000
Finland	160,000	139		100,000	
Greece		285			5,000
Ireland	170,000	100	700	160,000	140,000
Italy	440,000	213			
Netherlands	137,000	363	1010	136,000	129,000
Norway	150,000	232	600	149,000	140,000
Portugal					
Spain	950,000	≈400			≈930,000
Sweden					
UK	1.4m	2,400	12,500	1.3m	750,000
Australia	1.03m	-	18,000	1.03m	1.02m
Canada	743,000	2,500	-	740,000	708,000
New Zealand	199,000	114	-	-	-
United States	1.0m				

[29] Entries have been left blank where no information was available on that particular category. In some cases this may be because information is not collected in that form in the State. A dash (-) indicates that the criterion does not apply under that state's system.

<u>Table 2. Summary of audit exemption criteria in EU and selected non-EU countries</u>

Country	Size criteria for exemption for statutory audit[ii]	Turnover[i] (based on exchange rates @ 6/99)	
		£	Euro
Austria	Private limited liability company, general partnership , limited partnership[iii] (Assets: AtS 37 million, Turnover: AtS 74 million, 50 employees).	3.58m	5.38m
Belgium	Private limited liability company, incorporated partnership, general partnership, limited partnership. (Assets: BFr 100 million, Turnover: BFr 200 million, 50 employees)	3.30m	4.96m
Denmark	Audit required for all limited liability companies. General partnership, limited partnership (Assets: DKr 4 million, Turnover: DKr 10 million, 10 employees)	-	-
Finland	No exemptions	-	-
France	Private limited liability company, general partnership, limited partnership (Assets: FFr 10 million, Turnover: FFr 20 million, 50 employees)	2.03m	3.06m
Germany	Public limited liability company, private limited company, incorporated partnership (Assets: DM 5.31 million Turnover: DM 10.62 million, 50 employees)	3.61	5.42m
Greece	Public limited liability company, private limited liability company, general partnership, limited partnership. (Assets: Dr 500 million, Turnover: DR 1000 million, 50 employees)	1.95m	2.93m
Ireland	No exemptions. (Currently proposals to set limit at Ir£ 250,000)	-	-
Italy	Public limited liability company, private limited liability company, incorporated partnership. (Assets: LIT 3090 million, Turnover: LIT 6180 million, 50 employees)	2.12m	3.18m
Luxembourg	Public limited liability company, private limited liability company, incorporated partnership, general partnership, limited partnership. (Assets: LFr 93 million, Turnover: LFr 186 million, 50 employees)	3.07m	4.61m
Netherlands	Public limited liability company, private limited liability company, general partnership, limited partnership[iv]. (Assets: NlGu 6 million, Turnover: NlGu 12 million, 50 employees)	3.63m	5.45m
Norway[v]	No exemptions	-	-
Portugal	Private limited liability company, incorporated partnership, general partnership, limited partnership. (Assets: Es 350 million, Turnover: Es 600 million, 50 employees)	1.99m	2.99m
Spain[vi]	Public liability company, private limited liability company, incorporated partnership, general partnership, limited partnership. (Assets: Pta 395 million, Turnover: Pta 790 million, 50 employees)	2.38m	4.75m
Sweden	No exemptions	-	-
UK	Private limited liability company, unlimited company, general partnership, limited partnership. (Assets: £ 1.4 million, Turnover: £ 350 thousand)[vii]	350,000	0.53m

Country	Size criteria for exemption for statutory audit[ii]	Turnover[i] (based on exchange rates @ 6/99) £	Euro
Australia	Small proprietary companies (not controlled by foreign companies). (Gross assets: Au$ 5 million, Turnover: Au$ 10 million, 50 employees)	4.11m	6.17m
Canada	Varies between Provinces but limited to companies which do not distribute their shares to the public. For example, in addition Ontario has a threshold of Can$ 100 million (assets or turnover) and an application fee of Can$ 600.	(42.84 m)	(64.35m)
New Zealand	Limited liability companies. (Assets: NZ$ 450,000, Turnover: NZ$ 1 million, must not own a subsidiary or be part of a group)	335,000	0.50m
United States	No statutory requirement for audit. State rules may require certain classes of companies (e.g. credit unions, benefit plans etc.) and charities to be audited.	-	-

[i] Conversions to £ sterling and Euro have been calculated using one year £ spot forward exchange rates as at close on Monday 21 June 1999. Values 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 in Table 2 is useful for indicative purposes.

[ii] 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.

[iii] , General and limited partnerships are partnerships of which all of the unlimited members are constituted as private limited liability companies (see also Belgium).

[iv] General and limited partnerships are partnerships of which all of the unlimited liability members are constituted either as foreign public limited liability companies or as foreign private limited liability companies.

[v] 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.

[vi] Insurance companies are to be exempted on the grounds of size, but the regulations have not been implemented.

[vii] The types of entity mentioned may not exceed both size criteria for exemption from statutory audit.