

COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) BILL

(AS INTRODUCED IN THE HOUSE OF LORDS)

REGULATORY IMPACT ASSESSMENTS



DEPARTMENT OF TRADE AND INDUSTRY

DECEMBER 2003

URN 03/1606

**COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE)
BILL**

REGULATORY IMPACT ASSESSMENTS

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COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) BILL

OVERARCHING REGULATORY IMPACT ASSESSMENT

1. INTRODUCTION

1.1 This Regulatory Impact Assessment (RIA) supports the Companies (Audit, Investigations and Community Enterprise) Bill. The Bill includes measures to improve the regulation of the audit profession, strengthen the enforcement of certain aspects of financial reporting and increase the effectiveness of the company investigations regime. These measures form part of the Government's strategy to help restore investor confidence in companies and financial markets following the recent major corporate failures, notably in the United States. In addition, the Bill is intended to help social enterprise by creating a new type of company, the community interest company (CIC).

1.2 The measures have been foreshadowed by a number of consultation documents and reports covering the main proposals:

- on regulation of the audit profession, financial reporting and enforcement¹:
 - Interim report of the Co-ordinating Group on Audit and Accounting Issues to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer (July 2002, URN 02/1092);
 - Review of the Regulatory Regime of the Accountancy Profession - Report to the Secretary of State for Trade and Industry (January 2003, URN 03/589);
 - Final Report of the Co-ordinating Group on Audit and Accounting Issues to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer (January 2003, URN 03/567);
 - Review of the Regulatory Regime of the Accountancy Profession: Legislative Proposals (March 2003, URN 03/717);
- on company investigations:
 - Company Investigations: Powers for the 21st Century (consultation document, October 2001, www.dti.uk/cld/condocs);
- on community interest companies:

¹ The reports and reviews indicated under this heading can be found at: www.dti.gov.uk/cld/post_enron.htm

- "Private Action, Public Benefit: A Review of Charities and the Wider Not-For-Profit Sector" (Report of the Cabinet Office Strategy Unit, September 2002, www.pm.gov.uk/output/Page3714.asp);
- "Enterprise for Communities: Proposals for a Community Interest Company" (consultation document, March 2003, URN 02/1460, www.dti.gov.uk/cics);
- "Report on the Public Consultation and the Government's Intentions" (October 2003, URN 03/1344, www.dti.gov.uk/cics).

1.3 Individual RIAs have been produced for each of six specific areas of the Bill: regulation of the audit profession including funding of the Financial Reporting Council; enforcement of accounting requirements; disclosure of non-audit services provided by the auditor; auditors' rights to information; company investigations; CICs. The individual RIAs are attached at Appendices 1-6 to this document. Details of relevant official contacts are included at Annex A. This overarching document provides an overall assessment of the regulatory impact of the Bill.

1.4 The Bill will amend the Companies Acts 1985 and 1989. Detailed commentary on the measures in the Bill can be found in the Explanatory Notes published alongside the Bill.

2. PURPOSE AND INTENDED EFFECT

Objective

2.1 The Bill has two overall objectives:

- a) **"post-Enron" action to help restore investor and market confidence:** necessary legislative changes to complement a package of measures designed to strengthen corporate governance and audit practice: for example, changes to the Combined Code by the Financial Reporting Council in July 2003 following the review by Derek Higgs on the role and effectiveness of non-executive directors and Sir Robert Smith's guidance on Audit Committees in January 2003; greater transparency by audit firms in their annual reports (recommended by the Co-ordinating Group on Audit and Accounting Issues); audit partner rotation every five years (also recommended by the Co-ordinating Group on Audit and Accounting Issues); and the Financial Reporting Council taking over the functions of the former Accountancy Foundation;
- b) **promoting social enterprise:** making it possible to form a new type of company, the "community interest company", whose profits and assets must be used for the benefit of the community. The intention is to encourage the development of the social enterprise sector.

2.2 **Devolution.** Company law matters relating to Scotland are reserved to the UK Parliament under the Scotland Act 1998. Those relating to Wales have not been transferred to the National Assembly for Wales under the Government of Wales Act 1998. Company law in Northern Ireland is a transferred matter under the Northern Ireland Act 1998. With the following exceptions, therefore, the provisions in the Bill would affect the law in England, Wales and Scotland:

- the audit regulation provisions in the Bill would extend to England, Wales and Scotland. The main exception to this is in relation to the proposed power to impose a levy on business and the accountancy profession in respect of their contribution to the funding of the Financial Reporting Council, which will extend to Northern Ireland;
- the "gateway" allowing the Inland Revenue to pass information to the FRRP (as the person authorised under both the Companies Act 1985 and equivalent Northern Irish legislation to apply to court in respect of defective accounts) contains provisions applying in Northern Ireland by virtue of the fact that they amend certain Northern Ireland legislation. The power to appoint a body to look at aspects of periodic accounts and reports under listing rules extends to Northern Ireland because financial services and markets legislation covers the whole of the UK. Provisions making certain Northern Ireland legislation (allowing the Inland Revenue to disclose information) apply in a certain manner in relation to the above-mentioned appointed body extend to Northern Ireland;
- community interest companies: the Scottish Executive is considering issues arising from the impact of the CIC proposals on Scottish charity law, which is a devolved matter.

2.3 The purpose and intended effect of the main elements of the Bill, on which individual RIAs have also been produced, are as follows:

(i) Regulation of the audit profession: strengthening the independence of the system of supervising auditors (see also specific RIA at Appendix 1)

2.4 The provisions are intended to protect and improve the quality of accounts and audit by ensuring that the audit profession is regulated in the most effective way. They should be seen against the background of the expansion of the Financial Reporting Council (FRC) so as to create a new unified structure with four clear areas of responsibility: the setting of accounting and audit standards; their enforcement or monitoring; the oversight of the major professional accountancy bodies; and the promotion of good corporate governance. The provisions will make changes to the regulatory framework in the Companies Acts 1985 and 1989 to:

- require the professional accountancy bodies that supervise auditors² to sign up to independent standard-setting, monitoring and disciplinary processes. The Government expects that the bodies will fulfil these requirements by ensuring that their members follow technical and independent auditing standards set by the Auditing Practices Board; submit to monitoring by the Audit Inspection Unit in respect of the audits of listed companies and other large companies; and comply with investigation and disciplinary proceedings under the auspices of the Accountancy Investigations and Discipline Board. These bodies are part of the expanded FRC operation;
- delegate to an independent body (expected to be a board of the Professional Oversight Board for Accountancy, part of the expanded FRC) most of the Secretary of State's existing powers relating to company auditors and the recognition of bodies that supervise and/or set qualification requirements for them. This is intended to provide more effective oversight of the recognised bodies by ensuring that these functions are carried out by a body with audit and professional oversight responsibilities and experience;
- extend the existing grant power which allows the Secretary of State to make grants to bodies that are concerned with issuing or enforcing accounting standards or with overseeing and directing the issuing of such standards. The power will also cover the work of the new FRC subsidiaries engaged in the regulation of auditors and auditing, and with general oversight of accountancy regulation;
- give the Secretary of State a power to impose, where necessary, a levy to fund FRC activities. Currently, contributions towards FRC funding are made on a voluntary basis from three main sources: the accountancy profession; business (collected as part of FSA fees for listed companies); and the Government, with each contributing one third of the budget. The Government expects that this voluntary arrangement will continue. However, it is important that the regulator has security of funding to maintain the independence of the regulatory regime. If the voluntary arrangement were to break down, the Government would expect to apply the levy to those who currently contribute: listed companies and the bodies that make up the Consultative Committee of Accountancy Bodies (CCAB)³. The FRC's costs are expected to increase, primarily as a result of expansion and greater proactive enforcement of accounting requirements, from around £2.8 million at present (or, including the existing costs of the Accountancy Foundation, some £5.5 million) to around £12 million per year. It should be noted, however, that these actions in themselves are not required or initiated by the Bill. They flow from recommendations of the Co-ordinating Group on Audit and Accounting Issues and the Review of the Regulatory Regime of the Accountancy Profession. The Bill contains measures which support these actions.

² Institute of Chartered Accountants in England & Wales (ICAEW); Institute of Chartered Accountants of Scotland (ICAS); Institute of Chartered Accountants in Ireland (ICAI); Association of Chartered Certified Accountants (ACCA); Association of Authorised Public Accountants (AAPA).

³ ICAEW; ICAS; ICAI; ACCA; Chartered Institute of Management Accountants (CIMA); Chartered Institute of Public Finance & Accountancy (CIPFA)

(ii) Strengthening the enforcement of accounting requirements: the role of the Financial Reporting Review Panel (FRRP) (see also specific RIA at Appendix 2)

2.5 As noted above, the FRRP is to expand and become more proactive in the enforcement of accounting requirements. The move to proactivity does not in itself require legislation. The three related measures which do require legislation in this Bill are as follows:

- opening an information "gateway" from the Inland Revenue to the FRRP. At present the Inland Revenue may not disclose any information it obtains in the course of its work to the FRRP, even though it may find information suggesting non-compliance with accounting standards. The "gateway" rectifies that situation. The Revenue will have complete discretion as to what information it makes available to the FRRP. It will be a criminal offence for the information to be used for any other purpose or to be wrongfully disclosed to others;
- giving the FRRP powers to go to court to seek to compel companies to supply it with the information it needs to carry out its investigations. Currently, the FRRP relies on companies to cooperate. In practice it has always secured full co-operation. However, the FRRP will in future operate proactively and examine many more company accounts. Its relationship with those it is investigating may change such that it can no longer rely on voluntary cooperation. In addition, this measure will comply with a key principle of the Committee of European Securities Regulators that enforcers of accounting standards should have a power to require information from companies and auditors;
- extending the FRRP remit to cover periodic financial information required by the Listing Rules (in particular, interim accounts). The extension to periodic financial information supports the intention to achieve closer working between the FRRP and the Financial Services Authority in the scrutiny of financial information. Currently, the FRRP's powers are confined to the annual accounts of Companies Act companies. The FRRP does not currently have a role in respect of interim accounts or the accounts of entities such as building societies and overseas companies which may list in the UK but which are not Companies Act companies.

(iii) Reporting on non-audit services: extending the existing power to require companies to disclose fees paid for non-audit services (see also specific RIA at Appendix 3)

2.6 Firms of accountants may, in addition to auditing a company's accounts, provide it with a range of services (non-audit services) such as tax consultancy, legal services, IT and management services. The ratio of non-audit to audit services has increased rapidly and significantly as major audit firms have developed their range of business and built on their audit relationship. Fees for non-audit services in many cases exceed the fees for the audit itself. This has led to concern that an auditor whose income from any one audit client derives

mainly from non-audit services might face a conflict of interest which could result in a less robust appraisal of the company's accounts than would otherwise be the case, for fear of losing the lucrative non-audit business. Currently, the law requires companies to disclose in their annual accounts, the aggregate remuneration paid to their auditors for non-audit services as well as the amount spent on the audit itself.

2.7 The Co-ordinating Group on Audit and Accounting Issues found that existing aggregate figures for non-audit services do not provide sufficient information to reassure investors and others about an auditor's independence, in the light of the significant volumes of non-audit business being done. For example, an aggregate figure does not show whether an auditor is providing a particular non-audit service which may cause a conflict of interest. Requiring companies to provide a breakdown of both the value and the types of non-audit services will help users of accounts judge whether the auditor risks a conflict of interest. This measure will therefore extend the existing provision, to allow regulations to require a company to disclose not just its total spending on audit and non-audit services (as at present) but also details and cost breakdowns of the different categories of non-audit services it has purchased from its auditors.

(iv) Auditors' rights to information: giving additional powers to auditors to obtain information from companies and others; and requiring directors to state they are not aware of relevant information (see also specific RIA at Appendix 4)

2.8 Both these measures are intended to help rebuild confidence in company accounts by ensuring that auditors have the necessary access to the information they require to form their opinion as to whether the accounts are true and fair. The Co-ordinating Group on Audit and Accounting Issues strongly supported proposals to strengthen auditors' rights to information. The proposed measures will:

- extend the range of people from whom the auditors can require information. Currently, auditors already have a right to require directors and officers (eg the company secretary) to answer their questions. Yet there are good reasons to believe that relevant information may be held by others associated with the company, for example external accountants to whom the company has outsourced its accounting operations; and employees of the company. Accordingly, this measure will widen the category of persons from whom auditors have a right to obtain information and explanations beyond directors. It will be an offence to fail to provide information or explanations without reasonable excuse;
- require directors to make a statement that they are not aware of relevant information which has not been disclosed to the company's auditors. It is the responsibility of the directors to approve and sign off the accounts as a true and fair reflection of the position of the company. The auditors' job is to endorse that judgement (or not, as the case may be). It is important for directors to be aware of their responsibility in relation to their auditors and, in particular, to be aware of the importance of ensuring that the auditors

have all the information they need in order to come to their opinion. The purpose of this requirement is to ensure that directors disclose all relevant information to their auditors so as to improve the quality and reliability of the audit.

(v) Strengthening the company investigations regime (see also specific RIA at Appendix 5)

2.9 The regime of company investigation and inspection makes an important contribution to helping markets work effectively by providing a means of ensuring that investors, suppliers and customers are protected from unscrupulous or fraudulent practices. Both company inspectors (usually appointed from outside DTI and engaged in high-profile public cases leading to a published report) and investigators (usually DTI employees who investigate companies on a confidential basis - these form the majority of cases) have a range of powers to obtain information and documents.

2.10 Without powers of investigation, it would be impossible in many cases to find out exactly what is going on, where there is an allegation of wrongdoing. But limitations on those powers mean that it is not always possible to get all the facts. To be more effective, these powers must enable inspectors and investigators to have rapid and ready access to all relevant information.

2.11 In the consultation document, "*Company Investigations: Powers for the 21st Century*" (October 2001) the DTI set out proposals for comprehensive reform of the company investigations regime.

2.12 The priority measures included in this Bill for improving the effectiveness of the current company investigations regime are:

- powers for investigators to require production by any person of any relevant document and any sort of relevant information, including information held electronically (subject to existing protections for legally privileged material and banking information). Currently, the powers of investigators are limited to requiring the production of documents, copying such documents and requiring explanations of them; and requiring information about the whereabouts of documents not produced;
- a new power to require access to premises used for the business of the company under investigation and to remain on those premises for the purposes of the investigation. Currently, investigators do not have a legal right of access to premises (except by obtaining a search warrant - a relatively rare event) and operate by consent. Gaining access to premises and being able to remain on premises carry great practical benefits because investigators can see where and how, and by whom, business is done. These new powers will not carry powers to search and seize. There will be safeguards, including an obligation on inspectors or investigators to produce evidence of their identity, prepare a record of the visit and provide a statement of rights to an appropriate recipient on the premises;

- providing protection against breach of confidence claims to people who provide information voluntarily in response to informal DTI enquiries. Currently, there is no statutory immunity from breach of confidence claims for a person, for example a director, who voluntarily provides information to the DTI and, in doing so, breaches a contractual or other duty of confidence to the company. We wish to remove this deterrent from volunteering information which may prove crucial to a decision whether to launch a formal investigation.

(vi) Establishing a regime for community interest companies (CICs): promoting social enterprise (see also specific RIA at Appendix 6)

2.13 These measures form a major part of the Bill. They give effect to recommendations for establishing a regime for community interest companies first set out in a Cabinet Office Strategy Unit Report, "*Private Action, Public Benefit: A Review of Charities and the Wider Not-For-Profit Sector*" (September 2002). The proposals were subsequently developed through a consultation document, "*Enterprise for Communities: Proposals for a Community Interest Company*" (March 2003, URN 02/1460) and most recently in a *Report on the Public Consultation and the Government's Intentions* (October 2003, URN 03/1344).

2.14 The overall purpose of the proposals is to promote social enterprise by making it possible to establish a new type of company, to be known as a "community interest company" (CIC), whose profits and assets are to be used for the benefit of the community. It will also be possible to convert existing companies into community interest companies.

2.15 The CIC form will offer enterprises an additional option alongside existing forms such as the company limited by guarantee, the charitable company and the industrial and provident society.

2.16 Currently, there is no specific form of incorporation that combines the flexibility of the non-charitable company form with an assurance that the business will operate for the benefit of the community. The most significant feature of the CIC is a "lock" on company assets which prohibits the company from distributing its profits or assets to its members, thus ensuring that they continue to operate for the community benefit. While clauses preventing the distribution of profits may be inserted and entrenched in a company's constitution, the mechanisms for doing this are complex, technical and not always well understood.

2.17 The main proposals are as follows:

- a statutory "lock" on the profits and financial assets of CICs and, where a CIC is limited by shares, the requirement that any dividend on those shares must be subject to a "cap" fixed by a new independent regulator - the community interest company Regulator (see below);
- a requirement that, in order to be registered as a CIC, a company must pass a "community interest test";

- an additional annual reporting requirement, over and above the reporting requirements on ordinary companies. Each CIC will provide an annual "community interest report" to the Regulator showing how the activities have contributed to its community interest aims and how it has involved its stakeholders in those activities. The report will be made publicly available;
- a new, independent Regulator who will be responsible for ensuring that CICs comply with the relevant requirements. The Regulator will work closely with the companies registrar to provide one-stop-shop registration and reporting, and will have its own supervisory powers. The initial set-up costs of the Regulator are expected to be between £250,000 and £500,000 and ongoing running costs in the region of £310,000 per year, plus potential legal liabilities estimated at £50,000 per year.

3 RISK ASSESSMENT

3.1 The Government is committed to making the United Kingdom the best place in the world to do business. Appropriate, robust and effective regulation is key to achieving this aim. It is essential to learn the lessons from the recent major corporate failures in the United States and implement the changes recommended by the various subsequent reviews. There is a real economic cost to such crises: as a result of Enron and Worldcom etc, share prices plummeted and the cost of capital increased worldwide. And there is a perception of increased risk, as a result of those failures, to the effective operation of corporate and financial markets. By strengthening the existing regulatory regime an important step will have been taken in helping restore the confidence of investors in those markets. Measures contained in the Companies (Audit, Investigations and Community Enterprise) Bill give effect to those recommendations.

3.2 Thus, the Bill actively addresses the issues and risks identified in the various reports undertaken in the wake of the collapse of Enron and Worldcom by:

- strengthening the existing system of supervising auditors;
- strengthening enforcement of accounting requirements;
- extending disclosure of non-audit services to address concerns about auditor independence;
- strengthening auditors' rights to information and requiring directors to state they are not aware of relevant information;
- strengthening the company investigations regime.

3.3 The Bill will also boost social enterprise by establishing a regime for a new corporate vehicle, the CIC. The risk of doing nothing in this area is that the future prospects and potential of developing social enterprise will be diminished.

3.4 Risk assessments for each of the proposals, including discussion of issues of equity and fairness, are included in the individual RIAs.

4 OPTIONS

4.1 The measures amend existing legislation and require primary legislation to do so. All the main options relating to each of the proposals were considered and are set out in the individual RIAs for each proposal. The options chosen in each of the areas achieve the best balance between cost and benefits.

5 EXPECTED COSTS AND BENEFITS

5.1 The costs and benefits of the measures (and the other options that were considered) are set out in the individual RIAs for each proposal. The tables below summarise the costs and benefits for the main measures that are included in the Companies (Audit, Investigations and Community Enterprise) Bill.

5.2 Costs and benefits of measures for regulating the audit profession:

Description	Costs	Benefits
Require the Recognised Supervisory Bodies (RSBs) to participate in independent standard setting, monitoring and disciplinary processes.	Some minor additional costs for RSBs and audit firms in complying with new requirements.	Greater public confidence in the effectiveness of the regulatory system for auditors. Regulatory attention concentrated on area of strongest public interest.
Delegate the Secretary of State's powers relating to company auditors and the recognition of bodies which supervise them.	Some additional costs to the delegated body in carrying out the Secretary of State's functions.	More effective oversight of RSBs and savings to public expenditure of approximately £17,500 per annum.
Give the Secretary of State the power to impose a levy if necessary towards the FRC's costs.	Non-legislative changes will increase costs of regulation from around £5.5m to around £12m. Estimated increases in costs to listed companies of funding the FRC from £400 to £1,600.	Security of funding for the FRC.

5.3 Costs and benefits of measures for enforcing accounting requirements:

Description	Costs	Benefits
Legal gateway enabling company information to	Small additional administrative cost to	Improved information for the FRRP to identify high

<p>be sent from the Inland Revenue (IR) to the Financial Reporting Review Panel (FRRP).</p>	<p>Government and FRRP.</p>	<p>risk companies and supports their new proactive role. Potential savings in reducing the need for FRRP to recruit extra staff, as in effect the FRRP will draw on the expertise and information of some 90 IR accountants.</p>
<p>Providing the FRRP with legal powers to require disclosure by directors.</p>	<p>There should be no additional costs to business from legal underpinning of the information-gathering function.</p>	<p>Improved position for FRRP as reduces reliance on voluntary approach.</p>
<p>Extending the FRRP's scope to cover listing requirements, in particular interim accounts</p>	<p>There will be some additional costs from a more proactive FRRP as a result of more companies being investigated (though greater proactivity is not dependent on the Bill). The expansion of remit could mean that entities not currently covered by the FRRP come within its remit - this will be determined by the secondary legislation. The average management time of a full FRRP inspection can range from 20 to 60 hrs, with costs of legal advice in about 20% of cases and auditors' costs (which may not always be charged to the company) of around £10,000.</p>	<p>Strengthens enforcement of financial information, giving FRRP a role to support FSA in respect of listing rules.</p>

5.4 Costs and benefits of measures on disclosure of non-audit services:

Description	Costs	Benefits
Power to impose duty on	Minimal compliance costs	Greater perceived and

companies to disclose nature and cost of non-audit services provided to them by their auditors.	to companies.	actual transparency in auditor/client relationship.
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5.5 Costs and benefits of measures on auditors' rights to information

Description	Costs	Benefits
Extension of existing legal provisions to widen the category of persons from whom auditors can require information	Some minor costs of alerting wider group of persons, in particular employees, to obligation to answer questions.	Adds to the ability of auditors to seek out information and thereby increases the chances of an effective audit.
Requiring directors to make a statement that they have provided all relevant information to the auditors	Some minor additional costs in terms of directors' time considering what information they have that is relevant to, but not in possession of the auditors, and in agreeing they can make the statutory statement.	Increases the likelihood that auditors will get all relevant information from the directors, again increasing the chances of effective audit.

5.6 Costs and benefits of strengthening the company investigations regime:

Description	Costs	Benefits
Power of company investigators and inspectors to require any person to produce any relevant documents or information.	Minimal additional costs as the main effect is to enhance existing powers. Investigators can require certain information under the existing legislation and they can obtain additional information, and access to premises, with the cooperation of the company and others.	The measures will improve the ability of company investigators and inspectors to detect and uncover misconduct by being able to gain fuller information and by being able to gain that information more easily.
Power of company investigators and inspectors to require access to, and remain on, premises.	The main cost burden arises from management and employee time of those under investigation and any additional legal or other professional assistance they may require. Any increased	
Protection against breach of confidence claims for disclosing information in response to informal DTI enquiries.		

	cost as a result of the enhanced ability to gather information will be marginal.	
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5.7 Costs and benefits of measures setting up the community interest companies regime:

Description	Costs	Benefits
Create new type of company to be known as a community interest company (CIC).	Normal company set-up costs with a minor additional registration cost (see below).	Lower costs of forming ready-made not-for-profit company. Estimated at approximately £1,500 to £2,000 per company depending on its complexity. Encourages growth of social enterprise sector.
Special registration requirement for CICs: "community interest test".	Extra registration cost anticipated at around £20 initially. But choice to become CIC is voluntary.	Provides credibility that the CIC will benefit the community.
CIC assets to be locked so that they can only be used for the community benefit.	Cost to the company/members but choice to become CIC is voluntary.	May help attract finance by increasing confidence of investors that profits and assets will be used for the community benefit.
CIC share dividends to be capped.	Limited profits for investors but choice to invest in CIC is voluntary.	
Ongoing additional reporting requirement: "community interest report".	Some minor admin costs on CICs but the information should be readily available from the companies' own internal resources.	Provides transparency and maintains confidence that the CIC is serving the community interest.
Office of independent CIC Regulator.	Requires dedicated regulatory framework which will impose both set up and recurring maintenance costs on central government. We	Provides confidence in the integrity of the system. Will strengthen the profile of the social enterprise sector through guidance etc.

	estimate set-up costs to be between £250,000 and £500,000 and running costs around £310,000/year, plus legal liabilities.	
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6 IMPACT ON SMALL BUSINESS

6.1 Overall, the impact on small business is expected to be minimal. The audit regulation measures will not impose any additional substantive requirements on audit firms. The accounting enforcement measures (IR/FRRP gateway; expanded powers of FRRP to obtain information and look at interim accounts and non-financial reports) will not apply to small businesses, since the FRRP deals with large companies only; neither will the measures on disclosure of non-audit services or those relating to auditors' rights to information (since small businesses are exempt or may opt out from the statutory requirement to have accounts audited). The strengthened company investigations regime will make no change to the existing basis for investigation, which makes no distinction between different types of company, and the additional cost impact is expected to be low. In practice, less than 0.04% of GB registered companies are investigated. The community interest company regime will apply to small businesses on a purely voluntary basis, because such businesses will only establish themselves as community interest companies if they consider it in their interest. Details of costs and benefits to small businesses are addressed in the individual RIAs.

7 RESULTS OF CONSULTATION

7.1 There has been wide public consultation on the main elements in the Bill through the various documents referred to in paragraph 1.2 above, spanning various periods from October 2001 to June 2003.

7.2 The results of consultation have been set out in the relevant documents also referred to in paragraph 1.2 above, in the form of final reports or Government responses to specific consultations.

7.3 The specific results of consultation are discussed in the RIAs for individual policy areas. The Government has taken these results into account in developing its proposals. Overall, the response justifies proceeding with the measures.

8 DEVOLUTION

8.1 This is addressed in paragraph 2.2 above. Devolution issues are also addressed in the RIAs for individual policy areas. The great majority of measures will apply in England, Wales and Scotland.

9 GUIDANCE, ENFORCEMENT AND EVALUATION

9.1 The table below outlines how compliance will be secured for the various measures in the Companies (Audit, Investigations and Community Enterprise) Bill.

Securing compliance and enforcement

Proposal	Securing compliance/enforcement
<p>Regulation of the audit profession; independent standard-setting, monitoring and disciplinary processes.</p> <p>Levy towards the FRC's costs (if imposed)</p>	<p>If an RSB (recognised supervisory body) does not comply with the statutory requirements relating to independent standard setting, monitoring and the disciplinary process, the Secretary of State may seek a court order directing the body to comply with the requirements and also has the power to derecognise the RSB. If the recognition function was delegated to an independent body, that body would have the same enforcement powers as the Secretary of State.</p> <p>Moneys due under the levy would be a civil debt to the FRC enforceable by them.</p>
<p>Legal gateway for information to be passed from IR to FRRP.</p> <p>Providing the FRRP with legal powers to require disclosure by directors.</p> <p>Extending the FRRP's scope to cover interim accounts.</p>	<p>Unauthorised use or disclosure of such information will be a criminal offence.</p> <p>If there is non-compliance with a requirement to provide the FRRP with relevant information the FRRP may apply to court for an order. A company which ignores such an order would be in contempt of court.</p> <p>For interim accounts, the FRRP will report to the Financial Services Authority (FSA) which will enforce compliance as necessary under its Listing Rules. For any enforcement of non-financial reports, the FRRP will use the existing procedure of applying to court (if necessary) for an order to re-state the report in question. (Thus far, no such court procedure has been necessary in respect of annual accounts which instead have been "voluntarily" re-stated.)</p>
<p>Disclosure of non-audit services</p>	<p>At present, directors who fail to comply with disclosure requirements face civil remedial action or a criminal penalty. There will be power for the Secretary of State to specify the sanctions for non-compliance with the new disclosure</p>

	<p>requirements in the Regulations. This will ensure that an appropriate sanction is imposed depending on where the disclosure is to be made.</p>
Auditors' rights to information	<p>It will be an offence for a specified person to fail to provide information or explanations when required by an auditor in the performance of their duties. Penalty on summary conviction will be a fine up to level 3 on the standard scale (currently £1000).</p> <p>It will also be an offence to knowingly or recklessly make a false statement to the auditor, punishable on conviction on indictment by imprisonment up to 2 years and/or an unlimited fine; or on summary conviction by imprisonment up to twelve months and/or a fine up to the statutory maximum (£5000).</p>
Company Investigations	<p>The existing offence for failure to provide relevant documents and information to an investigator will be repealed and replaced with a certification procedure. The investigator will certify to the court that there has been a failure to comply. The court will then be able, if appropriate, to deal with the non-compliance as if it were contempt of court.</p> <p>The same certification procedure will also apply to failure to comply with requirements to admit inspectors or investigators to premises.</p> <p>It will also be an offence to intentionally obstruct an inspector or investigator in the exercise of their right to gain access to, and remain on, premises; punishable by an unlimited fine if convicted on indictment; or, on summary conviction, by a fine up to the statutory maximum (£5000).</p>
Community Interest Companies	<p>CICs will be subject to all the normal requirements of company law.</p> <p>Use of the CICs name without authorisation will be a criminal offence.</p> <p>The CICs Regulator will have powers to: approve applications to become a CIC; set a cap on the dividends payable by CICs to investors; obtain information and direct an audit of a CIC; appoint, suspend or remove CIC directors; appoint a manager; vest assets in an Official Property Holder; freeze assets and restrict transactions and payments; apply to the court for a CIC to be wound up; bring a legal claim on behalf of a CIC eg against its directors if they breach their duties; divest of its</p>

	ownership any political party which has acquired control of a CIC; direct the distribution of residual assets on the winding up of a CIC; and receive information from and pass it to other regulators.
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Monitoring

9.2 Monitoring is addressed in the individual RIAs for the above proposals.

10 SUMMARY

10.1 The package of measures in the Companies (Audit, Investigations and Community Enterprise) Bill further strengthens audit regulation, financial reporting and enforcement including company investigations and by doing so will help to rebuild investor confidence in companies and financial markets. The measures in the Bill also provide a significant boost to social enterprise by creating the community interest company.

11 DECLARATION

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

Signed Jacqui Smith

Date: 1st December 2003

Jacqui Smith MP

Minister for Industry and the Regions and Deputy Minister for Women and Equality

Department of Trade and Industry

INDEX OF COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY INTEREST) BILL RIAs AND CONTACT DETAILS

The individual RIAs can be accessed on the following website: www.dti.gov.uk/cld/companies_audit_etc_bill; and the individual RIAs are available from the contacts listed below.

Audit regulation	<p>Rob Cottam Accounting and Audit Regulation Corporate Law and Governance Directorate Department of Trade and Industry Room 499 1 Victoria Street London SW1H 0ET Tel: 020 7215 0169 Email: Rob.Cottam@dti.gsi.gov.uk</p>
Strengthening enforcement of accounting requirements	<p>David Wagstaff Accounting and Audit Regulation Corporate Law and Governance Directorate Department of Trade and Industry Room 497 1 Victoria Street London SW1H 0ET Tel: 020 7215 0217 Email: David.Wagstaff@dti.gsi.gov.uk</p>
Reporting on non-audit services	<p>Jolanta Edwards Accounting and Audit Regulation Corporate Law and Governance Directorate Department of Trade and Industry Bay 4102 1 Victoria Street London SW1H 0ET Tel: 020 7215 0229 Email: Jolanta.Edwards@dti.gsi.gov.uk</p>
Auditors' rights to information	<p>John Grewe Accounting and Audit Regulation Corporate Law and Governance Directorate Department of Trade and Industry Room 495 1 Victoria Street London SW1H 0ET</p>

	<p>Tel: 020 7215 0223 Email: john.grewe@dti.gsi.gov.uk</p>
<p>Company investigations</p>	<p>Vivien Brighton Companies Investigation Branch Department of Trade and Industry Room 615 10 Victoria Street London SW1H 0NN Tel: 020 7215 3069 Email: vivien.brighton@dti.gsi.gov.uk</p>
<p>Community interest companies</p>	<p>Harry Taylor Community Interest Companies Corporate Law and Governance Directorate Department of Trade and Industry Bay UG 23 1 Victoria Street London SW1H 0ET Tel: 020 7215 3896 Email: harry.taylor@dti.gsi.gov.uk</p>

APPENDIX 1

**COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE)
BILL
REGULATION OF THE AUDIT PROFESSION - REGULATORY IMPACT
ASSESSMENT**

1. Proposal

1.1 Companies (Audit, Investigations and Community Enterprise) Bill 2003 – Regulation of Auditors.

2. Purpose and intended effect

(i) Objective

2.1 The objective of the provisions is to protect and improve the quality of accounts and audit by ensuring that the audit profession is regulated in the most effective way.

2.2 **Devolution:** The provisions will affect the law in England, Wales and Scotland, except in relation to the proposed power to impose a levy on business and the accountancy profession in respect of their contribution to the funding of the Financial Reporting Council (FRC), which will also extend to Northern Ireland.

(ii) Background

2.3 The term 'accountant' is not defined in statute and there are no qualification requirements in order for someone to practise as an accountant. However, for professional and/or commercial reasons, many accountants choose to qualify under the auspices of one of the professional accountancy bodies and pay to be a member of such a body. In 2000 a non-statutory oversight system for the regulation of the accountancy profession was established by the Consultative Committee of Accountancy Bodies (CCAB)⁴. The system consists of four boards established under the overall ambit of the Accountancy Foundation, an organisation wholly funded by the CCAB bodies themselves.

2.4 By contrast, the Companies Act 1989 prescribes a statutory scheme for the regulation of auditors, under which the Secretary of State for Trade and Industry recognises certain accountancy bodies as capable of training and supervising auditors.

2.5 Following an interim recommendation of the Co-ordinating Group on Audit and Accounting Issues (set up jointly by the Secretary of State for Trade and Industry and the Chancellor of the Exchequer to review the situation in the UK

⁴ Institute of Chartered Accountants in England & Wales (ICAEW); Institute of Chartered Accountants of Scotland (ICAS); Institute of Chartered Accountants in Ireland (ICAI); Chartered Institute of Management Accountants (CIMA); Chartered Institute of Public Finance & Accountancy (CIPFA); Association of Chartered Certified Accountants (ACCA)

following the Enron and WorldCom scandals), the Secretary of State announced on 24 July 2002 a review of the way the accountancy profession is regulated. A consultation document seeking views on the main issues was published in October 2002.⁵

2.6 The Secretary of State published the final report of the review on 29 January 2003 and accepted all the report's recommendations⁶. The main recommendations were:

- that the FRC should take on the Accountancy Foundation's functions to create a new unified and authoritative structure with three areas of responsibility: setting accounting and audit standards; their enforcement or monitoring; and oversight of the major professional accountancy bodies; and
- that independent regulation and review of audit by the FRC should be significantly strengthened. Specifically, that responsibility for setting auditor independence standards and monitoring the audit of listed companies and other significant entities should be transferred from the professional accountancy bodies to the FRC.

2.7 In her statement to Parliament, the Secretary of State said that there was a strong case for statutory underpinning to make the new body work, that she would consider this further, and that she would report her conclusions to the House. On 11 March 2003 a consultation document was published containing the Government's proposals for legislative provisions to support the new regulatory functions of the FRC⁷.

(iii) Risk assessment

2.8 High standards of financial reporting are essential for the UK economy, companies and capital markets, and the millions of people who invest in them (either as individuals or through their pension funds). Independent auditors play an important role in enhancing the reliability of financial information. It is important that the Government ensures that the public interest in financial reporting is fully met by securing public confidence in the impartiality and effectiveness of auditors and accountants. Effective oversight of the auditing profession is therefore critical to the reliability and integrity of the financial reporting process. There is a risk that a large corporate failure in the UK would have an adverse effect on confidence in companies and a corresponding effect on the UK's capital markets.

2.9 The review of the regulatory regime of the accountancy profession found no evidence that the UK's existing regulatory system was seriously flawed.

⁵ "Review of the Regulatory Regime of the Accountancy Profession" [URN 02/1340]

⁶ "Review of the Regulatory Regime of the Accountancy Profession – Report to the Secretary of State for Trade and Industry" [URN 03/589]

⁷ "Review of the Regulatory Regime of the Accountancy Profession: Legislative Proposals" [URN 03/717]

However, there were concerns about the perceived independence of key aspects of the arrangements.

2.10 For credibility and legitimacy reasons it is important that those who oversee auditors are, and are seen to be, independent of the auditing profession. One way in which the independence of the regulatory system could be compromised is if the regulatory arrangements were funded in a manner over which the accountancy profession and/or some other closely interested party were able to exercise control (e.g. in relation to its timing or amount). This could result in a perception that those subject to regulation exercise a measure of control over the activities and effectiveness of the regulator, which would reduce public confidence in the effectiveness of regulation.

2.11 While there is a public interest in the quality of all auditing, the public interest is particularly strong in relation to the audit of listed companies because these companies are economically significant to large numbers of individuals and other businesses; collectively these companies occupy a dominant role in many sectors of the economy; their value represents a large part of the savings of the population as a whole; and loss of faith in the credibility of their financial statements can undermine the capital market, restricting economic growth.

3. Options

3.1 A number of possible options were considered:

- **Option 1.** Retain the current statutory regulatory system for auditors unchanged.
- **Option 2a.** Retain the current statutory regulatory system for auditors but require supervisory bodies to participate in independent standard setting, monitoring and disciplinary processes. The Secretary of State to retain her role of recognising professional supervisory bodies. The FRC to be funded as at present, i.e. voluntary tri-partite funding by Government, business and the accountancy profession.
- **Option 2b.** Retain the current statutory regulatory system for auditors but require supervisory bodies to participate in independent standard setting, monitoring and disciplinary processes. The Secretary of State's powers relating to company auditors and the recognition of bodies which supervise them to be delegated to an independent body. The contribution to the FRC's costs by the business community and accountancy profession to be secured by if necessary a statutory levy.
- **Option 3.** Confer statutory status and powers on a body to regulate company auditing (such as the FRC).

4. Benefits

Option 1

4.1 There would be no additional benefits arising from this option.

Option 2a

4.2 This approach would build on the current framework for the regulation of audit and would improve public confidence in the effectiveness of the system of auditor oversight. The introduction of specialist monitoring arrangements focusing on the audits of listed companies would concentrate regulatory attention and resources on the area of the strongest public interest (for the reasons set out in para 2.11 above).

Option 2b

4.3 This approach would have the same benefits set out in para 4.2 above. Delegation of the Secretary of State's powers in relation to company auditors would result in more effective oversight of recognised bodies and qualifications as it would be carried out by a body with audit and professional oversight responsibilities and experience. There would also be some savings for the DTI in no longer having to carry out this function. It is estimated that these savings would be in the region of £17,500 per annum.

4.4 The introduction of a statutory levy would have the benefit of providing security of funding for the regulatory activities of the FRC and thus ensure that its independence would not be compromised. This security of independence of funding will be important in the context of assuring overseas governments that the UK's regulatory environment is robust. This, in turn, will be important in persuading these governments that they do not need to impose additional requirements on UK firms auditing companies registered in their markets. It would ensure that the regulatory system is in accordance with the International Organisation of Securities Commissions' principle that auditor oversight bodies should have adequate funding that was not under the control of the auditing profession⁸.

Option 3

4.5 This option would ensure independent regulation of the auditing profession. It would send a clear message to the profession and the public about the Government's determination to improve the quality of financial reporting in the UK.

Business sectors affected

⁸ Principles for Auditor Oversight - Statement of the Technical Committee of IOSCO (October 2002)

4.6 The provisions will affect the market for audit services. As at 31 December 2002, there were 11,087 registered audit firms (including sole practitioners)⁹.

4.7 Auditing is mainly confined to medium-sized and large accountancy firms, reflecting the need for a considerable number of specially trained staff. The size of the UK market for accounting and audit services (i.e. the preparation and presentation of annual accounts) was estimated as approximately £3.3 billion in 2001, 66% of which was taken by the then Big Five (now the Big Four) accountancy firms.¹⁰

Issues of equity and fairness

4.8 The provisions relating to independent standard setting and disciplinary arrangements will apply to all the professional bodies that have Recognised Supervisory Body (RSB) status. The provisions relating to the delegation of the Secretary of State's recognition power will apply to all RSBs and Recognised Qualifying Bodies.

4.9 The provisions in relation to participation in independent monitoring arrangements will in practice be restricted to those RSBs whose members undertake audits of listed or other large companies. The majority of such auditors are supervised by the ICAEW.

4.10 As at August 2002, there were 87 audit firms registered with the ICAEW with one or more listed client.

⁹ Audit Regulation: Report to the DTI 2002 (ICAEW, ICAS, ICAI); Annual Report to the Secretary of State for Trade and Industry 2002 (ACCA).

¹⁰Key Note 2002 report on Accountancy - www.keynote.co.uk

5. Costs

(i) Compliance costs

5.1 The operating costs of the FRC for the year ending 31 March 2003 amounted to £2.8 million. The costs were funded on a one-third basis by Government; the CCAB; and listed companies and the banking/investment communities.

5.2 The operating charges of the Accountancy Foundation and its associated bodies for the year ended 31 December 2002 amounted to £2.57 million. These costs were met by the CCAB members.

5.3 It is provisionally estimated that the operating costs of the new FRC could eventually amount to up to £12 million annually. The anticipated increase in costs relates principally to the assumption of Accountancy Foundation functions, and the increased costs of pro-active consideration of accounts by the Financial Reporting Review Panel (which we estimate as approximately £3.0 million per annum). Neither of these measures results from the proposed legislative provisions, but the funding powers in the proposed legislation will be necessary in order to assure the availability of funding for them. These costs will be funded on an equal tri-partite basis by the Government, CCAB and listed companies, reflecting the FRC's current funding model.

Option 1

5.4 There would be no additional costs for this option.

Option 2a

5.5 There would be the same costs as set out in paras 5.1 to 5.3, although these will not be directly incurred as a result of the provisions.

5.6 There will also be some additional costs to RSBs in ensuring they comply with additional recognition criteria. However, we anticipate that the RSBs will comply with new criteria in respect of standard setting and discipline by, respectively, continuing to follow auditing standards set by the existing Auditing Practices Board and participating in the Accountancy Investigation and Discipline Board Scheme. We therefore do not anticipate significant additional costs for RSBs in complying with these requirements.

5.7 There will be some additional costs to RSBs and the audit firms registered by them in respect of the requirement for independent monitoring of the audits of listed and other large companies. As stated in para 4.9, the majority of audit firms that carry out such audits are registered with the ICAEW. We anticipate that this requirement will be fulfilled by the new Audit Inspection Unit of the FRC and estimate that the costs of this unit could be in the region of £1.3 million per

annum by 2007. These additional monitoring costs will to some extent be offset by the concomitant reduction in the costs of the existing monitoring regime.

Option 2b

5.8 There will be the same costs as set out for Option 2a above. There will also be additional costs for the independent body (which we anticipate to be the Professional Oversight Board for Accountancy of the FRC) in carrying out the delegated powers in relation to company auditors including that of recognition. The introduction of the power to impose a levy on business and the accountancy profession in respect of their shares of the FRC's costs would not of itself impose any additional costs as it is anticipated that the level of any levy would be set at the same rate as the relevant voluntary contribution, although the voluntary contribution will increase to reflect the overall increased costs of the FRC. It is intended that, should it be necessary to impose the levy on businesses, it will be collected on the same basis as the current (voluntary) business contributions – that is, as part of the Financial Services Authority's process for collecting the listing fee. Thus there will be no additional administrative cost.

Option 3

5.9 There would be additional costs for an independent body which became the statutory regulator of the auditing profession. It would have to take over the registration, monitoring and disciplinary arrangements for all auditors from the RSBs, and there would be additional costs for the body in developing rules on the eligibility of persons to act as auditors and the conduct of audit work, although this would to a certain extent be offset by a reduction of costs for the professional accountancy bodies that are RSBs. There would also be additional costs for auditors in re-registering with the statutory regulator.

(ii) Other costs

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

(iii) Costs for a typical business

5.11 The legislative proposals will not impose any additional substantive requirements on audit firms; the aim of the new requirements is to ensure that those who carry out standard setting, monitoring and disciplinary functions are independent of the RSBs. There will be no requirement for audit firms to register with a new body, nor to train e.g. staff in new requirements. There may be some additional costs to those audit firms that fall within the scope of the new independent monitoring arrangements through the increased focus on their audit work in relation to listed companies, although it is anticipated that this is unlikely to be substantial in comparison to the turnover charged by the firms.

5.12 We initially estimate that the cost to listed companies in respect of their contribution to the FRC and its associated companies' funding as a whole could

increase from £400 per listed company to in the region of £1,600. However, the vast majority of this increase would result from the new regulatory functions of the FRC which do not result from the legislative provisions (see paras 5.1 to 5.3 above). The FRC are in the process of consulting business about their share of funding for its increased costs; initial consultation carried out by the FRC suggests that the business community supports the strengthening of the regulatory regime and accepts the need to increase its contribution to the FRC.

6. Consultation with small business: the small firms' impact test

6.1 We consulted a number of small audit firms about the effect of any changes to the regulatory structure. Those firms which responded expressed concern about the effect of the proposals on the level of audit registration fees for all registered auditors. One respondent commented that an increase in fees could lead to smaller audit firms leaving the market and thus make it more difficult for smaller entities to obtain audit services. One respondent expressed concern that full statutory control could lead to a more bureaucratic and costly system.

6.2 We have no reason to believe that legislative provisions to increase the independence of audit regulation would significantly increase the costs to, or otherwise adversely affect small audit firms and small businesses. Nor do we have reason to believe that the changes would lead to increased costs of registration for audit services for customers, including small businesses, for the reasons set out in paras 5.6 to 5.7.

7. Competition Assessment

7.1 We have considered the impact of the proposed options in section 3 on competition between audit firms and we do not believe that any of these would have a detrimental impact on competition.

7.2 This view is based on the fact that the provision of a statutory basis for certain functions of the independent regulator would not change the functions of the regulator. The costs (and savings) of changes to the regulatory structure detailed in the options would not represent a significant proportion of the turnover of audit firms. As such, we do not believe that any of the options would be likely to affect the structure of the market, nor lead to higher costs for new or potential audit firms as compared to existing firms. We have not carried out a detailed assessment but believe the overall effect of the options on competition would be neutral.

8. Enforcement and sanctions

8.1 At present, in the event that an RSB does not comply with the statutory criteria set out in the Companies Act 1989 for the conduct of its supervisory role, the Secretary of State can seek a court order directing the body to comply with the requirements. The Secretary of State also has the power to derecognise an RSB.

8.2 The proposed additional requirements relating to independent standard setting, monitoring and disciplinary arrangements would be subject to the same enforcement mechanisms set out in para 8.1 above. If the recognition function was delegated to an independent body, then that body would also have the same enforcement powers.

8.3 Contributions towards the FRC's funding by companies and bodies which were the subject of a levy would constitute a civil debt owed to the FRC and, if not paid, would be enforceable by the FRC through the courts.

9. Monitoring and review

9.1 The Government will keep the new regulatory arrangements under review. The FRC will be required to report to the Secretary of State annually on the exercise of its regulatory functions.

10. Consultation

(i) Within Government

10.1 The DTI have consulted the Small Business Service, the Office of Fair Trading, HM Treasury and the devolved administrations.

(ii) Public consultation

10.2 The Government published a consultation document on 11 March 2003 seeking views on the proposed statutory provisions to support the regulatory functions of the FRC. Twenty five responses were received.

10.3 Respondents were generally supportive of the proposed changes. Of the 17 respondents who commented on the proposal to legislate to tie the professional bodies into the regulatory regime set by the FRC, but not to make the FRC a fully-fledged statutory body, 12 were in favour. The others were evenly split between those who thought that no legislation was necessary and those who thought that only a fully statutory regulator would be effective.

10.4 Fifteen respondents also commented on the draft RIA in the consultation document. A number of respondents considered that the proposals might reduce the number of firms which would be likely to engage in audit work which could impact adversely on consumers of audit and accountancy services.

10.5 A couple of respondents considered that the proposals did not go far enough as they did not extend to the whole of the accountancy profession, and that the reforms would therefore not benefit smaller companies or unincorporated businesses. A number of respondents also commented on the need to keep the cost effectiveness of the new regulatory regime under review.

11. Summary and recommendation

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

Description	Costs	Benefits
1 – retain current system unchanged	No additional costs. Non-legislative changes currently being carried out will increase costs of regulation from approximately £5.5 million to approximately £12 million. Estimated increase in costs to listed companies of funding the FRC from £400 to around £1,600.	No additional benefits.
2a – require RSBs to participate in independent standard setting, monitoring and disciplinary processes	Same costs as for option 1. Some additional costs for RSBs and audit firms in complying with new requirements, although these are not expected to be significant.	Improve public confidence in the effectiveness of the regulatory system for auditors. Concentrate regulatory attention on area of strongest public interest.
2b – as per Option 2a but also delegate Secretary of State’s recognition power and provide a power to impose a levy	Same costs as for option 2a. Some additional costs to independent body in carrying out the delegated recognition function.	Same benefits as for Option 2a. Also, more effective oversight of RSBs and savings to DTI of approximately £17,500 per annum. Security of funding for the regulator.
3 - confer statutory status and powers on a body to regulate company auditing	Additional costs to statutory body of registering, monitoring and disciplining all auditors. Additional costs to auditors in re-registering with statutory body.	Improve public confidence in the effectiveness of the regulatory system for auditors.

11.2 We recommend Option 2b. We believe that this option will offer the greatest net benefit by providing a more effective system for the regulation of audit which will improve public confidence in the effectiveness of the regulatory system.

12. Declaration

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

Signed *Jacqui Smith*.

Date: 1st December 2003

Jacqui Smith MP
Minister for Industry and the Regions and Deputy Minister for Women and Equality
Department of Trade and Industry

Contact point:

Rob Cottam
Accounting and Audit Regulation
Corporate Law and Governance Directorate
Department of Trade and Industry
Room 499
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 0169
E-mail: Rob.Cottam@dti.gsi.gov.uk

APPENDIX 2

**COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE)
BILL
STRENGTHENING ENFORCEMENT OF ACCOUNTING REQUIREMENTS:
ROLE OF THE FINANCIAL REPORTING REVIEW PANEL
REGULATORY IMPACT ASSESSMENT**

1. Proposal

1.1 To strengthen the enforcement role of the Financial Reporting Review Panel (FRRP) – the private body which is part of the Financial Reporting Council (FRC) and whose function is currently to review the annual accounts of large companies and, where the accounts are faulty, to go to court to require revised accounts to be prepared. The proposal is to (i) increase the scope of the FRRP (as the person who is authorised under s245C of the Companies Act 1985); (ii) to provide that person (ie the FRRP) with new powers; and (iii) open an information gateway from the Inland Revenue to the FRRP. Specifically, the Government proposes:

- extending the scope of the FRRP so that it can look at certain periodic accounts or reports required under the Listing Rules (and in particular interim accounts) in addition to the annual accounts required by company law. This would extend its potential remit¹¹ to include companies which list in the UK but which are not covered by the Companies Act (non-UK companies) as well as UK entities whose securities are listed but which are not companies (such as certain building societies)¹²;
- it will report to the Financial Services Authority (FSA) on any breaches of the accounting requirements of the Listing Rules which it uncovers. Responsibility for applying any sanctions will remain with the FSA;
- providing the FRRP with a statutory power to *require* the company (officers and employees) and its auditors to supply information that is relevant to the FRRP’s investigation;
- opening a legal gateway to enable the disclosure of confidential information by the Inland Revenue (IR) to the FRRP.

2. Purpose and intended effect

(i) Objective

¹¹ It is important to note that what is proposed is an enabling provision which will allow, but not require, the Secretary of State to designate the FRRP as the body to cover these aspects. The detail of precisely which, if any, non-company entities will be within its expanded remit will be determined by Statutory Instrument (secondary legislation). An RIA will be carried out ahead of the laying of this instrument.

¹² The RIA often uses the term “company” as a useful shorthand but it is not legally precise since the power could extend the FRRP’s remit to cover the accounts of all issuers with securities that are listed and traded in the UK – that is, it could apply to some entities such as mutuals which are not “companies”.

2.1 The objective of the three proposals taken together is to enhance the FRRP's ability to uncover and correct financial mis-statements, and to bring its work and the work of the FSA (which is responsible for regulating the stock market) closer together. This is part of a wider objective to strengthen the UK capital market, and in particular the financial reporting regime, following the high profile corporate collapses in the US which damaged credibility and confidence in the markets worldwide. Bolstering the scope and powers of the FRRP will also help to ensure that the UK complies with the CESRfin principles¹³ (Committee of European Securities Regulators on Financial Reporting) agreed by European regulators (though not legally binding on Governments), which require proactive enforcement of both annual and interim accounts.

2.2 To date, the FRRP's role has been limited to reviewing the annual accounts of listed and large private Companies Act companies¹⁴. It does so reactively, when a potential problem is brought to its attention (usually via press reports or 'tip-offs').

2.3 However, the CGAA¹⁵ (Co-ordinating Group on Auditing and Accounting Issues) reviewed this approach and concluded that it was no longer adequate. It recommended that there should be a risk-based pro-active element to the FRRP's enforcement role, and an expansion in its scope. It also recommended that the Government should consider opening a gateway for information to be passed from the Inland Revenue to the FRRP. No legislation is required for the FRRP to move to a proactive footing and it is already beginning to do so. It is hoped that in time this will extend to the proactive review of the equivalent of some 300¹⁶ accounts a year, chosen on the basis of risk analysis. To support this new proactive role it is proposed that:

- a) the FRRP's scope is extended beyond annual accounts, so that, for example, it can look at interim accounts and other accounts and

¹³ EU regulation 1606/2002 on EU financial reporting, recital 16 announces the Commission's intention to liaise with Member States, notably through CESR, to develop a common approach to enforcement. To this end CESR set up CESRfin and its sub-committee on enforcement to agree standards, principles and guidelines for definition of enforcement, selection techniques, powers to be attributed to the enforcers and cross border listings and offerings.

¹⁴ GB companies through the Companies Act 1985 and Northern Irish companies through the parallel NI legislation.

¹⁵ The CGAA was set up to review the UK's arrangements for audit and accountancy regulation, post-Enron. Its membership comprised representatives of the main independent regulatory bodies and independent experts, and it was chaired by HMT and DTI Ministers. A copy of the CGAA report is available on www.dti.gov.uk/cld/post_enron.htm. URN 03/567

¹⁶ FRRP Pro-activity Group proposals quoted in CGAA Final Report January 2003. The financial information selected for review will include, but will not be restricted to, detailed review of full sets of company accounts. The risk analysis will also be used to drive targeted reviews of compliance with selected accounting requirements or specific industry issues where consideration of accounts will be confined to relevant aspects of published financial information.

reports required under the Listing Rules to check for compliance with the accounting requirements of those rules;

- b) the FRRP should be provided with the power to require directors and auditors to provide them with the information they need to carry out their investigations. (Under the CESRfin principles, all competent authorities should have such a power). The FRRP's statutory function currently derives from its authorisation under s245C of the Companies Act 1985 to apply to the court for a declaration that the annual accounts of a company do not comply with the requirements of the Act. In order to establish whether a re-statement of the accounts is necessary the FRRP is currently wholly reliant on the co-operation of the company and its auditors;
- c) a legal gateway should be opened to allow information to pass between the IR and FRRP. The opening of a legal gateway between the two bodies will ensure that the FRRP are aware of any information which the Inland Revenue have uncovered in the course of their tax investigations which might indicate problems with a company's accounts. Currently, if the Revenue has any information about a company which may not be complying with its accounting requirements, they are prevented by law from revealing this information to the FRRP, even though it has responsibility for enforcing these requirements under the Companies Act 1985.

Devolution

2.4 In Scotland, company law is a reserved matter. It is not a transferred matter in relation to Wales. All of these provisions will extend to GB accordingly, under Westminster legislation. In addition, two provisions (the Inland Revenue gateway and the extension in scope to the Listing Rules) will apply directly to Northern Ireland. This is because tax and financial markets legislation are UK-wide, unlike companies legislation.

(ii) Background

2.5 The FRRP's statutory role at present is to examine departures from the accounting requirements of the Companies Act 1985, including applicable accounting standards, and if necessary to seek an order from the court to force the company to remedy them and re-state the accounts. The FRRP's authority in Great Britain derives from the order authorising it to apply to court for the purposes of section 245B of the Act (SI 1991/13). It has similar authority in Northern Ireland under equivalent Northern Irish legislation. The FRRP has brought about some 67 restatements since 1991 when it came into being, and in each case has released a press notice announcing the modifications. In 2002, two companies published corrective financial information as a result of FRRP investigations. It has not yet needed to go to court to ask for a restatement to be enforced. It has always obtained full co-operation from the companies it has investigated, notwithstanding the fact that it has no statutory powers to obtain the information it needs.

2.6 The strengthening of the role of the FRRP should be seen in the context of the accounting scandals surrounding the massive corporate collapses in the US over the last two years. The downfall of Enron and Worldcom among others (and the collapse of their auditors, Andersens, in the wake) had major repercussions not just in the US but also around the world. It is difficult to estimate the number of bad accounting practices in the UK, either deliberate or accidental. Enron may be seen as an extreme example of such practice, and an indication of the global repercussions that can follow. When it filed for bankruptcy in 2001 it soon became clear that it had been hiding debts and inflating revenues through a series of off-balance sheet ventures. While the economic damage done to the global capital markets by this and other collapses can never be accurately quantified, the enormous loss in trust, as well as in actual investment, is clearly vast, running into billions of pounds worldwide. Because the potential cost to UK business of another high profile failure is so large, in a simplistic sense one could argue that any action which will strengthen the enforcement regime for accounting standards must be justified on a simple cost/benefit analysis, even if the degree by which it reduces the likelihood of "a UK Enron" is fairly small. This Regulatory Impact Assessment is designed to get beyond this simplistic analysis by attempting to ensure that the proposals in respect of the enforcement of accounts are proportionate, and that they will not impose any significant negative impact on business.

2.7 In the UK, following the Enron and WorldCom scandals, the Co-ordinating Group on Audit and Accounting Issues (CGAA) was set up jointly by the Secretary of State for Trade and Industry and the Chancellor of the Exchequer to review the situation to see if any measures were needed to improve the UK system. The Secretary of State for Trade and Industry accepted the CGAA's recommendations on 29 January 2003.

(i) Extending the scope of the FRRP so that it can look at interim accounts and so that it can look at non-UK companies and other entities which list in the UK

2.8 The CGAA's Final Report noted that the FRRP Pro-activity Group had proposed that its remit should be extended "to include all published financial information issued by listed companies... where such information is presented in accordance with mandatory requirements".

2.9 Interim reports, which are a requirement of the Listing Rules (not company law) already require accounting policies and presentation to be consistent with annual accounts. It makes sense for the same body to check both interim and annual accounts. The proposal is for the FRRP to extend their role to reviewing interim accounts, thereby providing a further level of reassurance to shareholders and investors, and to the public more generally. It will be able to do this as part of its pro-activity, helping to ensure compliance with reporting requirements of Listings Rules of issuers listed and traded in the UK.

(ii) Power to obtain information

2.10 The FRRP Pro-activity Group, which reported to the CGAA in December 2002, concluded at that time that it did not require additional disclosure powers, but that the question should be revisited in the future once the proactive approach was up and running.

2.11 However, the Government and the FRRP have since revisited the question. Their conclusion is that the FRRP does need to be granted such a power in order for pro-activity to operate effectively, for confidence to be restored, and for compliance with the CESRfin principles. Proactively reviewing some 300 sets of accounts a year will almost certainly change the FRRP's relationship with those it is investigating. In pure volume terms, the chance of one of the companies deciding not to co-operate is greatly increased. Unless the FRRP has a statutory power to require companies to hand over relevant information, its work will continue to depend on voluntary co-operation by the company concerned, albeit backed up by its power to go to court to require a restatement of accounts.

2.12 There are also strong European pressures to give the FRRP such a power. The Committee of European Securities Regulators (CESR) have drawn up a set of principles known as the CESRfin principles to strengthen the European enforcement regime, which it sees as critical to underpinning investors' confidence in the financial market. The FSA and regulators from other Member States have signed up to the principles on a 'best endeavour basis.' Whilst these are not legally binding, it would be difficult to defend a UK position of having weaker enforcement than the principles require.

2.13 Under Principle 7 of the CESRfin principles, the necessary enforcement powers should at least include the power to monitor financial information, require supplementary information from issuers and auditors, and take measures consistent with the purposes of enforcement.

2.14 It is also particularly important in terms of discussions with the US (where primary legislation has significantly strengthened enforcement powers (the Sarbanes Oxley Act) in response to Enron) that we can demonstrate that UK enforcers do not lack comparable legal powers.

(iii) Information gateway

2.15 The gateway from the Inland Revenue (IR) to the FRRP will be clearly and strictly defined. Information held by the IR is already subject to restrictions on disclosure, imposed by statute and common law. Information obtained by the FRRP through the gateway will only be for the intended purpose; and use of the information for any other purpose or disclosure will be a criminal offence. We understand that some companies may be concerned about the prospect of information about their accounts being passed to the FRRP by the IR without their knowledge. The IR will only be dealing with information that has come to it in the course of its normal business. We would expect therefore that there would already have been correspondence with the company and its auditors and anticipate that where a referral is made the company and auditors would already be aware of the IR's concerns. The IR plan to give the company a copy of any disclosure made to the FRRP.

(iv) Risk assessment

Extending the scope of the FRRP so that it can look at interim accounts and so that it can look at non-UK companies and other entities which list in the UK

2.16 Interim reports are used in a similar way to annuals, providing shareholders and investors with valuable information about listed companies. Mis-statements in interims can therefore have as large an impact on the market as mis-statement of final accounts. Extending the FRRP's scope does not necessarily increase the *actual volume* of FRRP activity (which is increasing as a result of the move to proactivity), but it extends the remit of items that can potentially be checked for compliance and the type of entity which may be investigated, thereby providing greater public and market reassurance and ensuring there is no "gap" between the work of the FSA and the FRRP. It will be for the FRRP to decide how many interim and other accounts it will pro-actively investigate. It will need to react to all complaints but will be able (as now) to set up a system whereby it sifts out complaints that do not require further action.

Statutory power to require the company (officers and employees) and auditors to supply information to the FRRP.

2.17 At present the FRRP relies on the voluntary co-operation of auditors and directors, who are not bound in law to release information to the FRRP. The chances of one of the companies deciding not to co-operate are greatly increased as the FRRP's pro-active stance increases and with the increased volume of accounts being examined. Unless the FRRP has a statutory power to

require companies to hand over relevant information its work will continue to depend on voluntary co-operation.

2.18 The proposal is that the FRRP should be able to apply to court if a person refuses to provide required material. The court may order the person to take such steps as it directs for securing that the material required is produced or provided. If the court considers that the material is not reasonably required by the FRRP for the purposes of the functions it has been authorised to perform it may decline to make any order.

Gateway

2.19 In the absence of a legal gateway, the IR, which already checks accounts against accounting standards as part of its tax investigations of large firms, could become aware of some questionable accounting practices but be unable to share the information with FRRP. This is counter-productive and at odds with what the Government is trying to achieve post-Enron, as well as being inconsistent with a more joined up approach across Government generally.

2.20 As a result of this proposal, there may be some risk that companies are less likely to be open about their information with the IR than at present, since they may be aware of the potential for information on them to be passed to FRRP. This could have a slight negative impact in terms of IR inspectors' ability to get full co-operation on tax matters – although it may be that many companies already assume such information flows can and do take place. In any case, this should be more than offset by the gains in improving the standards of accounts, if some companies are dissuaded from indulging in suspect accounting practices as a result of fears that the Revenue might pass information about them to the FRRP. Moreover, companies themselves will be aware of the FRRP's changed stance towards enforcement and recognise the need to restore public faith in the markets. The gateway therefore contributes to public reassurance more generally, and investor reassurance specifically in that it forms part of a package of measures to discourage and stamp out bad accounting practices.

2.21 As with increasing the scope, the gateway as such is unlikely to increase the *level* of FRRP activity – rather, it should increase the *quality of the targeting* of that activity.

3. Options

3.1

- **Option 1.** No change (ie no extension of scope, no powers to require disclosure and no gateway)
- **Option 2.** Fully supporting pro-activity by
 - extending the FRRP's scope
 - and providing the FRRP with legal powers to require disclosure by directors

- and introducing a legal gateway enabling information on company accounts to be sent from IR to FRRP
- **Option 3** Extension of scope only
- **Option 4** Powers to disclose only
- **Option 5** A legal gateway only

4. Benefits

4.1

- **Option 1.** No change (ie no increase in scope, no powers to require disclosure and no gateway)

4.2 The present situation has worked satisfactorily thus far and the FRRP has a good reputation. However, the CGAA and the Government do not believe that the present system of enforcement is sustainable in light of recent corporate scandals and the resulting collapse in confidence in the whole system of financial reporting. There is therefore an overall (very large but unquantifiable) benefit to the public, in terms of perceived and actual reassurance, from the proposal to strengthen enforcement of company accounting requirements in various ways. If accounts are not effectively enforced, and seen to be effectively enforced, the consequences on shareholders, on the market and on the economy generally could be catastrophic.

- **Option 2.** (Fully supporting pro-activity by increasing the FRRP's scope to interim accounts and others, and providing the FRRP with legal powers to require information and introducing a legal gateway enabling information to be sent from IR to FRRP.)

4.3 The power and scope will:

- strengthen enforcement of both annual and interim accounts of companies and potentially also of other listed entities;
- provide public reassurance that accounting requirements are robustly enforced;
- support the new proactive role of the FRRP;
- comply with CESRFIn principles;
- reassure US regulators that the UK has a robust system, different to but as effective as their system;
- ensure consistency of enforcement to coincide with the move to international accounting standards in 2005;
- pave the way for the FRRP to be asked to review the directors' report and, in due course, the operating and financial review.

4.4 On the gateway, although the numbers of potential transgressors expected to be provided by the IR are small, fewer than 10 a year, this is still a significant measure if it uncovers any major accounting malpractice. It provides important

public re-assurance that Government is “joined-up” when it comes to identifying problems with company accounts.

- **Option 3** Extension of scope only

4.5 As mentioned above, this provides public reassurance. It enables the FRRP to check compliance of other types of report than annual reports, and extends to companies not covered by the Companies Act.

4.6 However, without powers to require disclosure, its ability to obtain the information it requires to make decisions on a set of accounts or reports, in a timely manner, would be impeded. This would not comply with the CESRfin principles and may be criticised both domestically and in the EU and the US as being too reliant on goodwill from the companies under investigation.

- **Option 4** (Providing the FRRP with legal powers to require disclosure only)

4.7 This option would enable the FRRP to require companies and their auditors to co-operate with investigations and provide relevant information. The FRRP has no such power at present. Its authority stems from its power under the 1985 Companies Act to go to court to require a company to re-state its accounts. The threat of doing this has, thus far, been sufficient to secure the co-operation of all companies that have been investigated. However, as the scale of the FRRP’s activities increases with its new proactive approach¹⁷, it is likely that this alone will not always prove sufficient. Under European agreed principles of enforcement (the CESRfin Principles), all enforcement bodies should have a power to require companies to provide the relevant information. This measure would ensure the UK complies with that principle.

4.8 But it is only a partial solution. It does not enable the FRRP to look at interim reports. This would remain with the FSA – despite the fact that the information contained in those reports is so closely linked to the annual accounts which are the responsibility of the FRRP.

- **Option 5** (A legal gateway only).

4.9 This would be a small improvement on the status quo, in that a new source of information would be available to the FRRP. But it does not address the power and scope problems described above

Business sectors affected

¹⁷ The move to proactivity is an operational change, which does not itself require any legislation.

- 2. Balance sheet total Not more than £22.8million
- 3. Number of employees Not more than 250.

Equity and Fairness

4.15 This proposal will not have disproportionate effects on any particular groups, other than the extent to which the risk assessment carried out by the FRRP identifies certain categories of companies as higher risk than others. The risk assessment model will be evidence-based and continually reviewed and updated.

5 Costs of Options

5.1

- **Option 1.** No change (ie no extension in scope, no powers to require disclosure and no gateway)

No direct cost.

5.2

- **Option 2.** (Fully supporting pro-activity by increasing the FRRP's scope to interim accounts; providing the FRRP with legal powers to require disclosure by directors and introducing a legal gateway enabling information on company accounts to be sent from IR to FRRP.)

Costs from extending the FRRP's scope to interim accounts and other accounts.

5.3 **Cost to the company:** There are costs for companies in being subject to an FRRP inspection. Although the numbers of companies likely to be subject to FRRP activity is set to increase, this does not require legislation and so is not the subject of this RIA. However, the expansion of the FRRP's remit is proposed as part of the Bill and could lead to some issuers which are not currently within the FRRP remit falling within it for the first time. For those issuers only (for example, certain building societies which issue debt), there is therefore a potential cost. From soundings with accountancy practitioners, we can estimate the existing cost in time to an average company and its auditors of a single FRRP inspection in the following way:

- average management time: 20hrs to 60hrs (the finance director, audit partner, audit manager and technical partner may be involved in an enquiry from the FRRP);
- legal advice: sought in about 20% of cases;
- auditors' time: 20hrs to 60hrs;
- if finding is against company (which happens in about 25% of cases): additional 30hrs for auditors.

5.4 The auditor's time at the middle of the range would cost about £10,000. This will not always be charged to the company. It may be borne by the audit firm. The cost of the management time will depend entirely on the business in question.

5.5 It is important to emphasise that the increased scope of the FRRP will increase the pool of entities which may be subject to such a review. But it will not of itself affect the total number of cases, since that will be for the FRRP to determine in light of their resources. Nor does it affect the overall enforcement regime for the Listing Rules, which remain the responsibility of the Financial Services Authority. The FRRP role in regard to its expanded remit will be to

report its findings to the FSA. As now, it would be the FSA which would apply any sanction.

5.6 Cost to the FRRP. As noted above, the FRRP is currently a reactive body. Its operating costs for 2002/2003 were £320,000. On the recommendation of CGAA, the FRRP is to introduce an element of proactivity into its procedures. This development has been allowed for in the latest budget forecasts which are £1 million, £2 million and £3 million respectively for the next three years commencing 2003/4. This estimate includes the costs of FRRP proactivity in relation to Companies Act companies (including interim reports) and reviews conducted on the basis of information obtained through the Inland Revenue gateway.

5.7 Costs of power to require information from companies. The power is intended to give legal force to requests for information of a type that the FRRP currently makes on a voluntary basis to Companies Act companies. In practice, these companies have always co-operated with the FRRP and provided all the requested information about their accounts. There should be no additional cost to business from this legal underpinning.

5.8 Cost to business from the gateway. This allows the FRRP to draw on a wider range of information when determining which companies' accounts to investigate. For the reasons explained above, the gateway will not impose any direct additional costs on business. There may be additional costs to companies in dealing with FRRP requests and co-operating in investigations.

5.9 Cost to the public purse from the gateway. The IR broadly estimate an administrative cost of £1k per request, which will be charged to the DTI. Assuming a handful of referrals a year, this equates to perhaps a maximum £10-15k per year cost to the Department. This will be met from existing budgets. There will also be costs involved in developing the MOU between IR and FRRP and guidance for staff, which is expected to equate to the work of 1-2 F/T person for one week.

5.10 This is offset by potential savings in terms of reducing the need for recruiting extra staff for the FRRP (in effect, the FRRP will be tapping into the expertise and information of some 90 qualified Revenue accountants). One third of the FRRP's costs are borne by Government, and the other two thirds by the accountancy profession and by business (on a voluntary basis). The Bill is also providing the Secretary of State with a levy power to require these contributions – this is dealt with in a separate RIA on “Regulation of the Audit Profession” - see Appendix 1.

- **Option 3** (Extension of scope only)

5.11 Costs as in paragraphs 5.3 and 5.4 above

- **Option 4** (Providing the FRRP with legal powers to require disclosure by directors.)

5.12 Costs as in paragraph 5.7 above.

- **Option 5** (A legal gateway enabling information on company accounts to be sent from IR to FRRP).

5.13 Costs as in paragraphs 5.8 and 5.9 above.

6. Consultation with small businesses: Small Firms' Impact Test

6.1 We do not consider that there will be a direct impact on small businesses (as mentioned in paragraph 4.13).

6.2 We believe there will be an indirect benefit to all businesses including small ones, since the measures proposed will contribute to restoring public confidence in the whole system of capital markets and in particular financial reporting. Small businesses stand to benefit along with the rest of the economy.

7. Competition Assessment

7.1 The proposals do not create barriers to entry or benefit or disadvantage any specific market. They are about effective enforcement of existing requirements.

8. Enforcement and Sanctions

8.1 The FRRP will report to the Financial Services Authority on any breaches in respect of interim accounts. It will be for the FSA to determine the appropriate sanctions on the basis of the existing Listing Rules and provisions in the Financial Services and Markets Act.

8.2 If there is non-compliance with a requirement to provide the FRRP with relevant information the FRRP may apply to the court for an order. Refusal to comply with such an order would be a contempt of court.

8.3 The Inland Revenue gateway will be strictly limited in scope. Use of the information or disclosure of information, other than as defined, will be a criminal offence. A guilty person is liable on summary conviction to imprisonment for a term not exceeding twelve months or a fine not exceeding the statutory maximum or both. On conviction on indictment that person is to be liable to imprisonment for a term not exceeding two years or a fine or both.

9. Monitoring and review

9.1 The FRRP will report annually to the FRC on their objectives and the use of their legal powers. Information may be separated in their annual report to show the number of interim and annual accounts investigated, types of company/entity and the number of accounts investigated as a result of IR information.

9.2 **Information Gateway.** As part of their Memorandum of Understanding, the FRRP and IR will set up Management Information Systems and undertake regular reviews to see if the type of information being passed is achieving its aim in assisting the FRRP in identifying high-risk accounts and the eventual outcomes. FRRP will be able to pass to the IR any information it has obtained under its powers; this will help if the FRRP wishes to share with IR the outcome of any investigations prompted by IR information, in order to help both parties assess the value of its information. For example, if the Revenue had detected what it thought was a major accounting problem and passed this to the FRRP, who having contacted the company decided to take the case no further, it would be important that the FRRP were able to feedback to the Revenue the reasons for this decision.

10. Consultation

10.1 Internal

Within Government, we have consulted with the Inland Revenue and HM Treasury, Small Business Service (SBS), Office of Fair Trading and the devolved administrations.

10.2 External

We have consulted with the following organisations: FRRP, FSA and ICAEW. And we have spoken to individual practitioners to get an indication of costs to a company and its auditors of an FRRP investigation. The IR has a consultative board, consisting of large corporate companies, which discussed the gateway at their July 2003 meeting. Following the discussion, we wrote to representatives from this forum, and to the CBI and IoD for their views. No responses were received.

11. Summary and recommendation

11.1 The Secretary of State should: increase the scope of an authorised person (the FRRP) to monitor the compliance of certain periodic reports or accounts required under Listing Rules with the accounting requirements of those rules; provide a statutory power to *require* company directors, employees and auditors to supply information; and provide for a legal gateway to enable the disclosure of confidential information by the IR to a person authorised to perform the functions in question (the FRRP).

11.2 Collectively, this approach contributes to the restoration of credibility and confidence in the markets by strengthening FRRP's enforcement role.

11.3 The following table indicates the areas where we believe that costs and benefits are most likely to occur.

Option	Description	Additional Benefits	Additional Costs
1.	Retain existing arrangements	None	<p>No perceived or actual reassurance.</p> <p>Existing arrangements impact on the FRRP's ability to operate proactively.</p>
2	Fully support pro-activity by introducing legal gateway enabling information on company accounts to be sent from IR to FRRP <u>and</u> providing the FRRP with legal powers to require disclosure by directors and extending FRRP's scope.	<p>Strengthens enforcement by extending to interims and by extending the type of entity which may be investigated, thereby providing greater public and market reassurance that accounting requirements are robustly enforced. Improved information for FRRP to target high-risk companies and supports their new pro-active role. Potential savings in terms of reducing the need for recruiting extra staff for the FRRP (in effect, the FRRP will be tapping into the expertise and information of some 90 qualified Revenue accountants). Improved position for FRRP to prevent reliance on voluntary approach. Complies with CCSRfin principles. Reassures US</p>	<p>There should be no additional cost to business from legal underpinning.</p> <p>There could be additional costs from the extension of scope, in respect of entities not previously subject to FRRP investigations. These costs are difficult to quantify. Audit costs could average around £10,000 per investigation, borne by either the company or the auditor.</p> <p>Estimated administrative cost of £1k per request, charged to the DTI.</p>

		regulators that the UK has a robust system, different to, but as effective as their system.	
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12. Declaration

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

Signed: *Jacqui Smith*.

Date: 1st December 2003

Jacqui Smith MP
Minister for Industry and the Regions and Deputy Minister for Women and Equality
Department of Trade and Industry

Contact Details

David Wagstaff
Accounting and Audit Regulation
Corporate Law and Governance Directorate
Department of Trade and Industry
Room 497
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 0217
Email: David.Wagstaff@dti.gsi.gov.uk

APPENDIX 3

**COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE)
BILL**

**POWER TO REQUIRE COMPANY DISCLOSURE OF NATURE AND COST OF
SERVICES PURCHASED FROM AUDITOR**

REGULATORY IMPACT ASSESSMENT

1. Proposal

1.1 A power to require companies to give more detail in their annual accounts or reports on types and costs of services bought from their auditor or its associates, and in particular to set out in detail the types of non-audit services that the auditor has provided. Under present law, companies are required only to publish the aggregate amount paid to the auditor for non-audit services.

1.2 Potentially, the regulations made under this power could affect any company, but as a matter of policy we will be excluding small or medium-sized businesses (SMEs) from the requirement.

2. Purpose and intended effect

(i) Objective

2.1 The objective is to increase transparency about the relationship between the company and its independent auditor, so that those with an interest, particularly shareholders, can form a judgement about whether the auditor may be subject to a conflict of interest in forming an opinion on the accuracy of the accounts. The proposed power will enable companies to be required to disclose more detail than is currently required about exactly what they have paid to their auditor and its associates. And they will be required to provide a breakdown of the types of services their auditor has been supplying, in addition to the statutory audit. Separate RIAs will be produced for the first set of Regulations made under this power and for any further modification of the Regulations.

2.2 **Devolution:** Company law matters relating to Scotland are reserved to the UK Parliament under the Scotland Act 1998. Those relating to Wales have not been transferred to the National Assembly for Wales under the Government of Wales Act 1998. Company law in Northern Ireland is a transferred matter under the Northern Ireland Act 1998.

(ii) Background

2.3 Firms of accountants may, in addition to auditing, provide companies with a range of services (non-audit services), such as tax consultancy, legal services, IT and management services.

2.4 Since 1991, companies have been required to disclose the aggregate of remuneration paid to the auditors for the statutory audit, and the aggregate remuneration paid to auditors and their associates for services 'other than those of the auditors in their capacity as such.' There is an exemption for small and medium-sized companies from the requirement to disclose aggregate remuneration for non-audit services (see definition in paragraph 4.5).

2.5 The ratio of non-audit services to audit services has increased rapidly in recent years, as major audit and accountancy firms have developed their range of businesses and built on the audit relationship. The fees for this work may exceed the fees payable for the audit itself. Public concern about this issue has been greatly heightened by the collapse of Enron in the US in 2001, which raised issues about the effect the provision of non-audit services had on the independence of Enron's auditor, Andersens.

2.6 Following the Enron/Andersens collapse, the issue of auditor independence has been under the spotlight, with many commentators suggesting that companies should be prevented by law from purchasing services other than the audit itself (and other "audit-related services") from their auditor.

International Scene

2.7 In the US, new legislation (the Sarbanes Oxley Act) passed in July 2002 drew up a list of non-audit and audit services which were proscribed, including financial information systems design and implementation, internal audit, appraisal or valuation services, and legal services.

2.8 As well as banning certain non-audit services, the US also has disclosure requirements. These apply to all companies who wish to prepare or issue audit reports on US public companies. The rules require separate disclosure of audit fees; audit-related fees; tax fees and all other fees.

2.9 In May 2002 the European Commission produced a Recommendation on auditor independence which did not advocate a ban on the provision of non-audit services by auditors, instead recommending mandatory disclosure of audit and non-audit fees paid by companies to auditors. This approach builds on the UK's existing disclosure requirement. The proposed disclosures are similar to the US Securities and Exchange Commission (SEC) requirements, with total fee income to be broken down into four categories:

- Statutory audit services
- Further assurance services
- Tax advisory services
- Other non-audit services (which itself should be broken down into financial information technology; internal audit; valuation; litigation; and recruitment).

2.10 The Commission Recommendation is not binding on Member States. However, in June 2003 the Commission published a Communication on Statutory Audit in which it proposed, among other things, to bring forward a modernised 8th Directive on statutory audits which would include the auditor independence principles.

Domestic scene

2.11 In the UK, the Co-ordinating Group on Audit and Accounting Issues (CGAA) was set up jointly by the Secretary of State for Trade and Industry and the Chancellor of the Exchequer to review the situation in the UK and propose measures to restore public confidence in audited accounts. The Secretary of State for Trade and Industry accepted its recommendations on 29 January 2003.

2.12 The CGAA Final Report included a recommendation that the existing regulations should be widened in scope to require disclosure by large and listed companies not only of the value (the cost to the company) of the non-audit services provided but also of their nature.

2.13 It noted that the existing powers in primary legislation did not appear to provide a sufficient legal basis for making such changes and that the primary legislation would need to be amended, to empower the Secretary of State to require companies to disclose this information. It is therefore proposed that sections 390A(3) and 390B of the Companies Act 1985 be replaced with a regulation-making power to require disclosure of audit and non-audit services provided to a company and its associates, including the power to require a breakdown of the nature of those services. The extent of disclosure will be determined by secondary legislation.

2.14 The ICAEW (The Institute of Chartered Accountants in England and Wales) has developed guidance for directors of UK companies on the form and extent of disclosure in their annual reports of the nature and value of services provided by their auditors. This follows the principles of the European Commission Recommendation, taking into account the CGAA Report conclusions, and also aligns as far as possible with the SEC's approach to the classification of fees, in order to enable UK companies that are also SEC registrants to prepare and present information that serves all purposes. The ICAEW consulted on their draft Guidance early in 2003 and has recently published it. The DTI has been closely involved in this exercise and will be monitoring and evaluating companies' and audit firms' reactions to it ahead of drafting the first Regulations under the new Companies Act power which is the subject of this RIA.

(iii) Risk assessment

2.15 Existing disclosure requirements raise concerns about actual and perceived auditor independence. At present, shareholders and Audit Committees may not be in a position to make fully informed decisions as to the extent of an auditor's reliance on non-audit fees from the company they are auditing, and

whether there are tensions resulting from the supply of different services in addition to the statutory audit service.

2.16 The existing aggregate figures do not provide sufficient information to reassure investors and others about auditor independence. To make a sensible judgement about whether a particular service may lead to a conflict of interest, it is necessary to know more about the non-audit services that have been provided.

2.17 A voluntary approach to disclosure of this information, even coupled with guidance, would be at the discretion of the companies themselves and not legally enforceable. In the Government's judgement this would fail to provide the necessary public reassurance or allow proper comparisons to be made across companies.

2.18 The introduction of legislation requiring non-audit disclosure by type and cost would give greater transparency, in fact and appearance. It would provide shareholders and Audit Committees with detailed information to assess the extent to which a non-audit fee calls into question an auditor's independence. It would be extremely valuable for shareholders in differentiating between those services that raise substantial concerns over independence and those which are routine or do not give rise to any potential conflicts of interests.

2.19 While a complete ban on the provision of certain services where there could be a potential conflict of interest (such as is now in place in the US) has been considered, there could be an economic cost. Although there are differing views on the extent to which synergies exist, it is likely that in at least some cases there are efficiency gains for the company in purchasing services other than the audit from its auditor. A ban would therefore mean that a company would be forced to buy the non-audit service from another provider even when it made economic sense for the existing auditor to provide the service, and when the risk of any conflict of interest had already been considered and discounted by the company. It has also been argued that audit quality could suffer, as a firm which has provided a number of other services to a company in addition to carrying out the audit will have greater all round knowledge of the company it is auditing.

2.20 As a matter of basic principle, the choice of supplier of a service should be left to the customer unless there is a very good reason for outlawing it. The CGAA report, which looked at the question of non-audit services in great detail, concluded that a ban was not appropriate. But the CGAA and the Government recognised the legitimate public interest concerns in this area and has asked the Auditing Practices Board of the Financial Reporting Council to look carefully at the standards of auditor independence in this area.

2.21 The Combined Code Guidance on the role of Audit Committees²⁰ is also being significantly toughened to ensure that the Committee understands its role

²⁰ Sir Robert Smith's report and guidance on the role of audit committees was published in January 2003. 'Audit Committees: Combined Code Guidance' is available on the FRC website at www.frc.org.uk/publications. On 23 July the FRC agreed and published the final text of the new Combined Code. The new Code will come into effect for reporting years beginning on or after 1 November 2003.

within the company in approving the purchase of any non-audit services and ensuring auditor independence generally.

2.22 A consistent classification of services by companies will be useful to shareholders and other users of accounts in making comparisons between companies. A broad classification of types of non-audit services is currently envisaged, but a more detailed definition of the nature of the services will be considered, if necessary (for example, if the approach was being abused, by manipulating the wide categorisation of services).

2.23 This is essentially a market-driven rather than regulatory approach. The Government's intention is to enable Audit Committees and shareholders to be in a position to consider the economic dependency of the company/auditor relationship and come to their own judgement about its appropriateness.

3. Options

3.1 The following options have been identified:

- **Option 1**

Retain existing arrangements.

- **Option 2**

Voluntary disclosure of detail of non-audit services, supported by guidance. It would fall to the company to make the choice as to whether and to what extent it discloses information on non-audit services.

- **Option 3**

Require companies to give more details in their annual accounts and reports on types and costs of services bought from the auditor or its associates, and in particular to set out in detail the types of non-audit services that the auditor has provided.

- **Option 4**

Ban on the provision of non-audit services to an audit client

4. Benefits

- **Option 1.** (Retain existing arrangements)

4.1 This is the status quo option. It would impose no additional costs on companies but deliver no benefits in terms of greater transparency over the auditor/client relationship.

- **Option 2.** (Voluntary disclosure of detail of non-audit services, supported by guidance)

4.2 This would give greater transparency than the existing process, but would not be legally binding and may not result in consistent disclosure.

- **Option 3.** (Require those companies already subject to the disclosure requirements under sections 390A and 390B of Companies Act 1985 to give more details in their annual accounts and reports on types and costs of services bought from the auditor or its associates, and in particular to set out in detail the types of non-audit services that the auditor has provided.)

4.3 The introduction of a power to require non-audit disclosure by type and cost would give greater transparency, and require all companies covered by the secondary legislation (which will not include SMES) to provide the relevant information. Therefore, there is a larger benefit than at option 2, which relies on voluntary agreement and which may result in inconsistencies between the type and nature of information disclosed by companies. It would provide shareholders with detailed information to assess the extent to which a non-audit fee calls into question an auditor's independence. It would be extremely valuable for the Audit Committee and shareholders in differentiating between those services that raise substantial concerns over independence and those which are routine or do not give rise to any potential conflicts of interests.

- **Option 4** (Ban on the provision of non-audit services to an audit client)

4.4 This would put the matter beyond doubt by outlawing the provision of any service by an audit firm where there could be a conflict of interest with its function as statutory auditor.

Business sectors affected

4.5 The current requirement to disclose aggregate remuneration for non-audit services applies to all companies which are not SMEs (there are an estimated 224,000 companies with a turnover over £11m)²¹. The proposal is to apply the new disclosure requirement for non-audit services to the same classes of companies. SMEs will therefore be exempt from the new requirement, as they are from the existing one. SMEs are defined in section 247 of the Companies Act 1985. The Department recently consulted on changing the qualifying conditions for SMEs, and announced in November 2003 that the upper limit on qualifying as an SME for company law purposes will be increased, with effect from early in 2004, to include satisfying two or more of the following requirements:

Medium-sized company

1. Turnover Not more than £11.4million

²¹ Information from Financial Analysis Made Easy (FAME) May 2003

- | | |
|------------------------|----------------------------|
| 2. Balance sheet total | Not more than £22.8million |
| 3. Number of employees | Not more than 250. |

They will still be required to disclose the audit fee (where relevant).

4.6 In addition the Secretary of State will be empowered to extend the disclosure requirement to other entities which are not companies, such as pension schemes. Disclosure requirements do not vary by business sector. We will determine its scope in the regulations and a separate RIA will be produced for the regulations.

Issues of Equity and Fairness

4.7 This proposal will not have disproportionate effects on particular groups. The proposals cover all companies equally (SMEs will be exempted by the secondary legislation which imposes the requirement) and are intended to provide greater transparency.

5. Costs of Options

- **Option 1** (Retain existing arrangements)

5.1 There are no direct costs associated with this option. However this option does nothing to reassure or restore confidence, and could have a negative impact on equity values and therefore impose a large but unquantifiable cost to the economy overall.

- **Option 2** (Voluntary disclosure of detail of non-audit services, supported by guidance.)

5.2 This approach is a flexible one, since companies could decide for themselves whether or not to follow the guidance, and therefore not all companies will incur costs, as not all companies will disclose the information. There is a financial cost for companies adopting this approach, which would be lower than for the options detailed below. In practice, all listed companies following the Combined Code will already need to ensure that their own processes are sufficient to capture necessary information for Audit Committees.

5.3 However, shareholders and others would not be sure of receiving the required type and level of information on a particular company, or of being able to make comparisons with other companies. The public may not perceive this approach as sufficiently transparent and may have concerns about levels of compliance where there is no compulsion. It is unlikely to have the same levels of reassurance as Option 3 for shareholders and restore market confidence.

- **Option 3** (Require companies to give more details in their annual accounts and reports on types and costs of services bought from the auditor or its associates, and in particular to set out in detail the types of non-audit services that the auditor has provided.)

5.4 There would be a cost to all companies, (except SMEs), in obtaining this information and including it under required categories in the annual accounts and reports. However this is likely to be minimal. It has been suggested that with a computerised system, minimal effort will be involved in having additional nominal accounts to analyse different headings of expenditure and include them in the accounts.

- **Option 4** (Ban on the provision of non-audit services to an audit client)

5.5 Preventing auditors from providing, and companies from buying, additional services would have an economic cost, since it introduces inefficiencies to the market. The size of these inefficiencies is a matter for debate, but it is clear that a complete ban would prevent companies from purchasing a service they wanted from their own auditor, even when it made economic sense and when the risk of any conflict of interest has already been considered and discounted by the company.

5.6 In 2002 the Office of Fair Trading (OFT)²² considered the competition implications of banning non-audit services. It concluded that such a ban would restrict the choice of firms in carrying out this work, as many businesses choose to purchase non-audit services from their auditors for business reasons of efficiency and synergy. It would be a significant, and potentially efficiency reducing, restriction to prevent them from doing so. As they noted in their Professions Report²³, it is necessary to balance the public interest benefit from the maintenance of auditor independence – bearing in mind that the ‘consumer’ of audit services is the public and not just the business paying for its audit – with the efficiency gains that result from co-provision of audit and non-audit services.

5.7 It could also lower audit standards, since it is argued that having the auditor as the supplier of some other services can enhance audit quality, gained through a deeper knowledge of the company’s business and management. The audit profession has argued that an auditor providing an audit service will often be in a position to pick up on nuances, which will be less obvious to an auditor arriving aloof and detached. As explained above, the Government believes that existing principles of auditor independence are sufficient to ensure that inappropriate work is not carried out by the auditor, and this will be further enhanced by separate measures being taken, for example strengthening the role of the audit committee and giving the independent Audit Practices Board the responsibility for setting standards on auditor independence, as well as the disclosure requirements which are the subject of this RIA.

6. Consultation with Small Businesses: The Small Firms’ Impact Test

6.1 The subject of this RIA is the provision of a power to require companies to make disclosures about non-audit services. As a matter of policy, we intend to exempt SMEs from this requirement, although they will still have to disclose the audit fee (if any). It is anticipated that there will therefore be no significant impact on small and medium-sized businesses (SMEs). On this basis we have only consulted internally with the SBS, who are content with this approach.

7. Competition assessment

²² OFT considered competition implications and issued a press release 22 November 2002.

²³ Competition in Professions: A report by the Director General of Fair Trading. March 2001, para 48.

7.1 There is no negative impact from this proposal. Although there is a small additional cost associated with the disclosure of non-audit services, this will apply to all companies above the SME threshold.

7.2 Overall, the market will benefit directly from greater transparency and indirectly from better quality audited accounts.

8. Enforcement and sanctions

Enforcement

8.1 For public and large private companies it is the Financial Reporting Review Panel that takes civil remedial action. Any new requirements would be enforced in the same way.

Sanctions

8.2 At present, directors of companies are responsible for preparing accounts that comply with the accounting provisions of the Companies Act, including the provisions in and under sections 390A(3) and 390B requiring disclosures in the notes to the accounts. Directors who fail to comply with the requirements face civil remedial action or a criminal penalty or both. On conviction on indictment this could be an unlimited fine. On summary conviction this could be a fine up to the statutory maximum. There will be power for the Secretary of State to specify the sanctions for non-compliance in the Regulations. This will ensure that an appropriate sanction is imposed depending on where the disclosure is to be made: in the notes to the accounts, the directors' report, or the auditors' report.

8.3 There is no direct sanction on auditors as regards the duty to give information to directors in order to enable them to comply with their disclosure obligations. If the directors failed to obtain requested information from the auditors then they would be expected to report this fact in the notes to the accounts. Non-co-operation could be a matter for the auditor's supervisory body since as a requirement of recognition, supervisory bodies must have adequate rules and practices designed to ensure that auditors are fit and proper. Existing disciplinary processes would be applied by the supervisory body.

9. Monitoring and Review

9.1 The Government and the CGAA have welcomed the initiative by the ICAEW, who undertook a public consultation on the disclosure of the nature and value of services provided by auditors. The DTI will monitor the impact of the ICAEW guidance, and use the results to inform the drafting of the new regulations.

10. Consultation

(i) Within Government

10.1 The DTI has consulted the SBS, OFT and the devolved administrations.

(ii) Public consultation

10.2 Earlier this year, the ICAEW undertook a public consultation on the disclosure of the nature and value of services provided by auditors. The results of the consultation indicate widespread agreement to the principles of increased disclosure and have been used by the ICAEW to develop guidance as to the form and extent of disclosure of non-audit services for UK companies in their annual accounts and reports. But it should be noted that all the respondents to the consultation were audit or accountancy firms or their representatives rather than companies or their representatives.

10.3 The DTI has spoken to the 100 Group of Finance Directors who have also indicated their support to the proposal.

11. Summary and recommendations

11.1 There should be a requirement on companies to disclose more details in their annual accounts and reports on types and costs of services bought from its auditor or its associates, and in particular to set out in detail the types of non-audit services that the auditor has provided. This should be achieved by amending the existing power in the Companies Act, followed by regulations made under the new power. These regulations will follow the European Commission recommendation and will also be informed by US requirements and by the ICAEW guidance and its impact, which the Department will be monitoring. There will be a full public consultation on draft regulations.

11.2 The following table indicates the areas where we believe that costs and benefits are most likely to occur in relation to each option.

Description	Additional Benefits	Additional Costs
1. Retain existing arrangements	None	Will do nothing to restore faith in auditor independence. Large but unquantifiable cost in terms of loss of public faith in reliability of audited accounts
2. Voluntary approach	Greater transparency than existing process	Financial costs for companies adopting this approach, but no uniform requirement. Lack of perception of transparency and lack of enforcement
3. New law requiring	Greater actual and perceived transparency.	Financial costs (minimal) to companies to comply with

disclosure of nature and costs of services provided by auditors for companies	Part of package of measures to address auditor independence issues and restore faith in financial reporting. Follows Commission recommendation and is closer to US requirements	additional disclosure
4. Ban on non-audit services	Clear message that Government believes auditors should only audit. Should reduce conflicts of interest within audit firm to almost zero	Economic Cost. Costs to companies required to get alternative provider for non-audit services. With proper principles and safeguards, new ethical standards, and enhanced role for audit committees, there should be no threat to independence

12. Declaration

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

Signed *Jacqui Smith*

Date 1st December 2003

Jacqui Smith MP
Minister for Industry and the Regions and Deputy Minister for Women and Equality
Department of Trade and Industry

Contact point:

Jolanta Edwards
Accounting and Audit Regulation
Corporate Law and Governance Directorate
Department of Trade and Industry
Bay 4102
1 Victoria Street

London SW1H 0ET

Tel: 020 7215 0229

E-mail: Jolanta.Edwards@dti.gsi.gov.uk

APPENDIX 4

COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE)

BILL

**AUDITORS' RIGHTS TO INFORMATION
REGULATORY IMPACT ASSESSMENT**

1. Proposal

1.1 Strengthening the rights of company auditors to obtain information and explanations.

2. Purpose and intended effect

(i) Objective

2.1 The objective is to increase the ability of company auditors to carry out their duties effectively and thus increase the reliability of, and confidence in, the accounts of companies subject to audit.

2.2 **Devolution** Company law matters relating to Scotland are reserved to the UK Parliament under the Scotland Act 1998. Those relating to Wales have not been transferred to the National Assembly for Wales under the Government of Wales Act 1998. Company law in Northern Ireland is a transferred matter under the Northern Ireland Act 1998.

(ii) Background

2.3 All limited companies are required to prepare and file accounts with Companies House. Certain types of companies and all companies above a certain size (see paragraph 2.8 below) are required to have their accounts independently audited by a professionally qualified and regulated accountant.

2.4 The Final Report of the Company Law Review Steering Group²⁴ published in July 2001 recommended extending existing rights of auditors to information. Whilst those proposals differed in detail from what is now proposed, the overall objective was the same: to strengthen auditors' rights. There was a consultation last year on those proposals as part of a wider consultation on company law reform²⁵. There were only a small number of comments, which the present proposals take into account.

2.5 Major US corporate failures in 2001/2002, notably Enron and WorldCom, and related audit failures by Andersens, further focused attention on ways of developing the effectiveness of audit. The Co-ordinating Group on Audit and

²⁴ The Steering Group's Final Report to Government was published in July 2001, and is available on www.dti.gov.uk/cld/review.htm.

²⁵ Modernising Company Law White Paper July 2002 Ref: URN 02/1044.

Accounting Issues (CGAA), set up by Government in 2002, strongly supported proposals to strengthen auditors' rights to information²⁶.

2.6 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.

2.7 Sections 235 to 237 of the Companies Act 1985 set out the responsibilities of company auditors in Great Britain²⁷. In addition, auditors are required to follow auditing standards issued by the Auditing Practices Board.

2.8 Most small companies - currently those with a turnover of not more than £1 million and a balance sheet total of not more than £1.4 million – have the option not to have an audit, though this is not available to financial services companies, public companies or charitable companies. The Department recently consulted on increasing the threshold for audit exemption, and announced in November 2003 that it will increase to a turnover level of £5.6m and a balance sheet total of £2.8m. It is expected that these measures will be implemented in early 2004 and will take a further 69,000 companies outside the requirement to have an audit.

2.9 The proposals which are the subject of this RIA are designed to enhance auditors' rights to obtain and receive information (for example the directors' statement) and explanations from those in the company likely to have relevant information. These proposals strengthen the auditors' position. In particular, they:

- widen the category of persons from whom auditors have a right to obtain information and explanations, to include: any officer or employee of the company; any person holding or accountable for any of the company's books, accounts and vouchers; any officer of a GB incorporated subsidiary undertaking of the company; any employee of a GB incorporated subsidiary undertaking; any person holding or accountable for any books, accounts or vouchers of a GB incorporated subsidiary undertaking; any auditors of a GB incorporated subsidiary; any auditors of a GB incorporated subsidiary undertaking; any person who was a person falling within any of the above categories at a time to which the information and explanations required by the auditors relate;
- introduce new penalties for breaches;
- require the directors' report to contain a statement that the directors are not aware of relevant information which has not been disclosed to the company's auditors.

²⁶ CGAA Interim Report, July 2002, included a section on the 'Rights of Auditors to Information'. Ref: URN 02/1092.

²⁷ There is equivalent provision in Northern Ireland.

2.10 These measures make it more likely that auditors will have all the relevant information about the company and its finances on which to base their opinion. In particular, the last requirement should encourage directors to reveal material information to the auditors even if this information has not been required by those auditors.

(iii) Risk assessment

2.11 Under current law, the auditor has a right to access the company's books, accounts and vouchers and an entitlement to such information and explanation from the company's officers (that is to say, the directors and the company secretary) as he thinks necessary for the performance of his duties.

2.12 High quality company audits are an essential element in underpinning confidence in the corporate sector and in the capital markets. One determinant of audit quality is the availability to the auditors of information, which is material to the final audit opinion.

2.13 Both the Company Law Review and the Coordinating Group concluded that there were limitations in the existing rights of auditors to information. They identified the risks that a company audit is ineffective because someone closely involved with a company either will not answer an auditor's questions or, more likely, will give incomplete or misleading information. Whilst there is no evidence that this is widespread, the consequences of a single case involving a major company could be enormous; thus any measure which reduces the risks of this occurring, is significant.

2.14 The Government proposes to reduce these risks by:

- requiring a statement in the company accounts to the effect that the directors are not aware of relevant information which has not been disclosed to the company's auditors;
- entitling the auditor to require information and explanations from a wider group of persons than at present - essentially to include employees but also including others (see paragraph 2.9 above);
- making it an offence where a person fails to provide information or explanations.

2.15 In terms of requiring a statement, we have considered the risk that directors might feel that they have to disclose to the auditors everything they know about the company. This could be counter-productive, with both directors and auditors spending time in providing and assessing information which was immaterial in the context. In practice we believe that this proposal will make directors think carefully about what information they must disclose to the auditors without imposing unreasonable or unduly burdensome additional requirements on them.

2.16 We have also considered the risk of adding significantly to burdens on business by entitling the auditor to require information and explanations from a wider group of persons than at present. We do not consider this to pose any significant risks, as in practice few companies would deny the auditors the ability to question staff. This proposal simply strengthens the auditors' position in those cases where employees (and others) are not minded to respond to the auditors' enquiries, but in the overwhelming majority of cases does not involve a significant departure from the existing process.

2.17 It is impossible to quantify the positive impact of these changes on the effectiveness of audits in any meaningful way. What is important to emphasise is that even one major audit failure can have enormous repercussions not only for stakeholders in that company but also more widely for confidence in capital markets. Providing shareholders and others with a purportedly 'clean' audit opinion, which is not in fact soundly based, can provide them with a false sense of security. Increasing the chances that the auditors will obtain all necessary information can therefore bring substantial benefits and we believe the measures outlined in this RIA are helpful in this respect.

3. Options

3.1 Four possible options are identified below:

- **Option 1.** Retain the current statutory requirements
- **Option 2** Extend the groups of persons from whom auditors can require information and explanations
- **Option 3.** Extend the group of people from whom auditors can require information **and** require the directors' report to contain a statement that the directors are not aware of relevant information which has not been disclosed to the company's auditors
- **Option 4.** require the directors' report to contain a statement that the directors are not aware of relevant information which has not been disclosed to the company's auditors

4 Benefits

Option 1. (Retain the current statutory requirements)

4.1 This is the status quo. It does nothing to strengthen the information-gathering powers of auditors and there would be no additional benefits.

Option 2. (Extend the range of persons from whom auditors can require information and explanations)

4.2 This will strengthen the auditors' information gathering powers and ability to put together a reliable audit.

Option 3. (Extend the group of people from whom auditors can require information **and** require directors to sign a statement that they are not aware of relevant information which has not been disclosed to the company's auditors)

4.3 In addition to the benefits outlined in paragraph 4.2 above, this requirement should ensure that directors are more willing to reveal relevant information to the auditors even when it has not been required by those auditors, and less tempted to be economical with or to conceal the truth. Taken with other 'post-Enron' measures, this will further reassure shareholders and investors. The reliability of accounts is important for shareholders to understand how their business is performing and for other users to decide whether they would wish to invest in, provide finance to, or to trade with that business.

Option 4. (Require the directors' report to contain a statement that the directors are not aware of relevant information which has not been disclosed to the company's auditors)

4.4 This strengthens auditors' powers by providing the benefits outlined in option 3, but does not go as far, as it does not include option 2 and does not expand the category of person from whom the auditor may require information.

Business sectors affected

4.5 The proposals will affect all companies subject to a statutory audit. There are some 320,000 above the existing £1million turnover threshold, for whom an audit is at present mandatory. As noted above, the Government has announced that it is raising the threshold to a turnover of £5.6million. It is estimated that some 250,000 companies have a turnover above that figure. The proposals also affect all registered audit firms (11,087 entities holding registered auditor status)²⁸. For companies subject to audit, a wider group of people than at present will need to be aware of having some responsibilities to the auditors. Currently, those required to answer auditors' questions are any GB incorporated subsidiary undertaking of the company whose accounts are being audited and the auditors of that undertaking. The proposal is to broaden this group to include the officers and employees of the company whose accounts are being audited (see paragraph 2.9 for the full list). Auditors will need to remind the directors of their responsibilities and those of their employees. The directors will be expected to remind employees. The proposal may lead to some modest additional questioning of key employees by the auditors. In practice, auditors already have access to wide groups of people, and companies rarely restrict access, as it is in their interests to co-operate for a successful audit.

²⁸ Audit Regulation: Report to the DTI 2002 (ICAEW, ICAS, ICAI) and Annual Report to the SOS for Trade and Industry 2002 (ACCA).

4.6 In addition, directors will have to think through carefully whether they have information which has not previously been disclosed to the auditors but which is necessary to enable the auditors to form their opinion. They will be required to make a statement effectively saying that there is no information in their possession or control which is necessary to the auditors in forming an opinion and which has not been disclosed. This should not present a significant additional burden for the vast majority of directors who are competent and wish to cooperate fully with the auditors. But it puts pressure on incompetent directors or directors contemplating distorting or withholding information from the auditors.

4.7 As noted above, most companies with a turnover below £1 million are able to opt out of the audit requirement. For most small businesses therefore statutory audit is optional - we estimate that well over 50% do not have an audit. As noted elsewhere, the threshold is to be increased to a turnover figure of £5.6 million. Therefore, the number of small businesses affected is likely to be low, and will fall further when the threshold is increased. We consider that the additional burden on small businesses will be extremely small. We do not believe that it is possible to quantify this in a way which is meaningful or helpful.

Issues of equity and fairness

4.8 This proposal will not have disproportionate effects on particular groups, as it will affect all companies subject to a statutory audit.

5 Costs

(i) Compliance costs

Option 1 (Retain the current statutory requirements)

5.1 There are no direct costs. There are indirect costs to the economy, as the risks of audits being based on incomplete or false information are higher than if auditors had these additional information gathering powers. There are potential benefits for confidence in capital markets and in company accounts more generally.

Option 2 (Extend the groups of persons from whom auditors can require information and explanations)

5.2 We do not consider that this option will incur significant costs, although there may be some costs in awareness raising within the company, so that employees know that they not only may be questioned by the auditors (as is already the case) but also that they may be required to provide information.

Option 3 (Extend the group of people from whom auditors can require information **and** require the directors' report to contain a statement that the directors are not aware of relevant information which has not been disclosed to the company's auditors.)

5.3 As for option 2, in respect of extending the range of people from whom information may be required.

5.4 Costs associated with the provision of a statement by directors are difficult to quantify and likely to vary between companies, depending on individual company arrangements and the directors themselves. Directors will need to consider more carefully what information is required by the auditors; we consider that in a small number of cases the directors will conclude that they have to provide additional information to the auditors; and in those cases there will be some additional costs for the auditors in considering the information provided.

Option 4 (Require the directors' report to contain a statement that the directors are not aware of relevant information which has not been disclosed to the company's auditors.)

5.5 See paragraph 5.4.

(ii) Other costs

5.6 There should be no additional costs imposed on sectors other than business.

(iii) Costs for a typical business

5.7 The costs from this proposal are difficult to quantify, but expected to be small. Proposals may lead to some modest additional questioning of key employees by the auditors. As indicated above, in practice, auditors already have access to wide groups of people, and companies rarely restrict access, as it is in their interests to co-operate for a successful audit. In some cases the additional powers could even reduce the costs of the audit, since information provided as a result of these powers may avoid the need for costly alternative work by the auditors.

5.8 In terms of the directors' statement, the costs are expected to be minimal. There may be some additional cost as directors think more carefully about what information to provide to the auditors; and any additional material supplied to auditors may incur additional auditor costs.

6 Consultation with Small Businesses: the Small Firms' Impact test

6.2 We do not consider that there will be a direct impact on small businesses. On this basis we have only consulted internally with the Small Business Service.

7 Competition Assessment

7.1 We do not consider that there are realistic circumstances in which the options in this RIA would impact on competition amongst audit firms or amongst firms subject to audit.

8 Enforcement and sanctions

8.1 It will be an offence for a specified person to fail to provide information or explanations when required by an auditor in the performance of his duties. A person found guilty will be liable on summary conviction to a level 3 fine on the standard scale (currently, £1,000).

8.2 It will be an offence to knowingly or recklessly make to the company's auditors a written or oral statement in compliance with a requirement by an auditor to provide information or explanations which is misleading, false or deceptive in a material way. A person found guilty on indictment will be liable to imprisonment for up to two years and/or an unlimited fine and on summary conviction to up to twelve months imprisonment and/or a fine up to the statutory maximum (£5,000).

8.3 Those in a parent company responsible for failing to take steps to obtain information from a non-GB subsidiary are also guilty of an offence, for which the penalty on summary conviction is a fine of up to level 3 on the standard scale (£1,000).

9 Monitoring and review

9.1 We will review the impact of these changes with auditors and with large and small companies once the changes have been in place for a couple of years, to assess evidence of (i) value to the auditors in carrying out their work and (ii) costs for business.

10 Consultation

(i) Within Government

10.1 The DTI has consulted the Small Business Service, Office of Fair Trading and the devolved administrations.

(ii) Public consultation

10.2 The "Modernising Company Law" White Paper in July 2002 (Cm 5553) consulted on a form of these proposals. In addition, we consulted on a smaller scale in Summer 2003 with some audit firms, the accounting profession and representatives of larger companies.

11 Summary and recommendations

11.1 There should be a strengthening of the rights of company auditors to obtain information and explanations through changes to existing statutory provisions. These will widen the category of persons from whom auditors have a right to obtain information and explanations and require directors to state that they have disclosed to the auditors all relevant information in relation to the audit.

11.2 The following table indicates the areas where we believe that costs and benefits are most likely to occur in relation to each option.

<i>Description/option</i>	<i>Additional Benefits</i>	<i>Additional Costs</i>
1. Retain existing arrangements	None	This does nothing to strengthen the information-gathering powers of auditors
2. Extend persons from whom auditors can require information; but do not require statement by directors on information they hold	Adds to the ability of the auditors in seeking out information and therefore increases chances of effective audit	Costs of alerting wider group of persons (in particular employees) to the obligation to answer questions; additional time to provide information etc
3. As 2 plus requirement on directors to make a statement that they are not aware of relevant information which has not been disclosed to the Company's auditors	As 2 plus Enhances the likelihood that auditors will get all relevant information from the directors, again increasing chances of effective audit	As 2 plus Cost for the directors in thinking carefully what information they have and is relevant but which the auditors do not possess; and in making the statutory statement
4. Requirement on directors to make a statement that they not aware of relevant information which has not been disclosed to the Company's auditors	As 3, without 2	As 3, without 2

12. Declaration

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

Signed *Jacqui Smith*

Date: 1st December 2003

Jacqui Smith MP
Minister for Industry and the Regions and Deputy Minister for
Women and Equality
Department of Trade and Industry

Contact point:

John Grewe
Accounting and Audit Regulation
Corporate Law and Governance Directorate
Department of Trade and Industry
Bay 4102
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 0223
E-mail: john.grewe@dti.gsi.gov.uk

**COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY
ENTERPRISE) BILL**

AMENDMENT TO COMPANIES ACT 1985:

COMPANY INVESTIGATIONS

REGULATORY IMPACT ASSESSMENT

1. Proposal

1.1 Targeted amendment of the company investigations regime.

2. Purpose and intended effect

(i) Objective

2.1 The objective is to make certain targeted amendments to the company investigations regime to ensure that it operates as effectively and efficiently as possible.

2.2 **Devolution:** The amendments will extend to England, Scotland and Wales; the regulation of business associations is a reserved matter under the Scotland Act 1998 and no relevant functions have been transferred in Wales. The regulation of companies is a transferred matter under the Northern Ireland Act 1998.

(ii) Background

2.3 For a free market to work successfully, all those who deal with companies, whether as investors, suppliers or consumers, need to be protected from unscrupulous or fraudulent practices and have confidence to take part in the market. The Secretary of State has powers (under section 432 of the Companies Act 1985) to appoint inspectors to carry out full-scale investigations where, for example, fraud or misfeasance is suspected. She can also carry out confidential investigations (under section 447 of the Act) where there is good reason to do so. Such investigations are fact-finding inquiries but, depending on what is found, they may lead to (among other things) the winding up of a company or the disqualification of directors or to criminal investigation and prosecution.

2.4 We wish to improve the effectiveness of the company investigations regime in two ways:

- by widening the powers and strengthening the sanctions for confidential investigations under section 447 of the Companies Act 1985 and enhancing the powers of inspectors; and
- by making it easier for relevant information to be obtained informally.

Widening investigation powers

2.5 Major business failures in 2002 in the US (Enron and Worldcom) have made it necessary to demonstrate that the UK has a corporate framework in which participants can be confident. The overall effectiveness of investigations into company affairs is an important contributor to that confidence: it is important that there are effective powers to detect and pursue companies and their directors who breach the responsibilities that flow from the benefit of limited liability.

2.6 The value of company investigations in uncovering malpractice has been demonstrated over many years by the successful prosecutions, disqualification of directors, winding up of companies and other outcomes that have followed. Without powers of investigation, it would be impossible in many cases to find out exactly what is going on where there is a suspicion of wrongdoing. But existing limitations on those powers (and on the powers of inspectors, although the appointment of inspectors is relatively rare in practice), mean that it is not always possible to get at all the facts. To be more effective, these powers must enable inspectors and investigators to have rapid and ready access to all relevant information. This includes the ability to gain access to premises without delay or obstruction.

Making it easier to get relevant information informally

2.7 When vetting complaints made to it about companies (the vetting process is described in more detail in paras 4.2 to 4.6), DTI's Companies Investigation Branch (CIB) may find it helpful to make enquiries of the company in question and the individuals associated with it. No formal investigation will have been launched at this stage, so statutory powers are not generally used. However, responses to such enquires are not always as forthcoming as they might be because there are no statutory provisions guaranteeing immunity from breach of confidence claims to a person who provides information in response to such an enquiry.

(iii) Risk assessment

2.8 Since the Companies Acts were enacted in the second half of the 1980s, the way in which business is conducted has been evolving. In addition, there is a steady rise in the number of complaints received about companies: while the number of registered companies rose by 23% there were 44% more complaints in 2002/03 than five years earlier in 1998/99. There is anecdotal evidence, too, from investigators that problems are being caused by increasing resistance on the part of company directors and their advisors to investigations. As a result, we believe there are three areas which need to be addressed if the investigations regime is to continue to be effective:

(i) A power to require any person to produce any relevant documents or information

This relates only to investigations under section 447 of the Companies Act 1985. The people carrying out such investigations already have powers to require production of documents relevant to their investigation, to require explanations of documents produced and to ask where documents are which have not been produced. What is needed, however, is a clear power to obtain any relevant document from anyone. In addition, a new power is needed to require information from anyone about anything relevant to the investigation (subject to existing protections in the Companies Act for privileged material and banking information). The latter power will include, but will not be limited to, requiring explanations of documents or their whereabouts.

(ii) A power to require access to, and remain on, premises

The absence of a legal right of access to premises for section 447 investigators, other than by use of a search warrant under section 448, increases the possibility of delay and obstruction by companies under investigation. To be able to gain access to, and spend time on, company premises in the course of an investigation carries with it great practical benefits. In particular, it enables the inspectors or investigators to exercise more effectively their statutory powers to require the production of documents and information. More generally, it also offers inspectors and investigators the opportunity to see the company operations in practice.

We would like to give investigators a new power to require access to premises which are used for the business of the company under investigation. Inspectors will be given this power expressly too. This will not be a power to search, and it will not be possible to use force to gain entry; the power will only be exercisable at reasonable times. We also propose to give inspectors and investigators an express power to remain, for the purposes of their investigation, on premises to which they have gained access by exercising the new power of entry, but only if the circumstances are such that it is reasonable for them to remain. There will be a number of safeguards relating to the exercise of these new powers, including an obligation on the inspectors or investigators to provide a statement of rights to an appropriate recipient on the premises and an internal authorisation procedure.

(iii) Protection against breach of confidence claims for disclosure of information

Statutory powers are not used for enquiries carried out when vetting complaints about companies because they precede the launch of any formal investigation (assuming the need for one is established). There are, therefore, no statutory provisions guaranteeing immunity from legal action to a person who, in breach of a contractual or other duty of confidence, provides information in response to one of these enquiries. This could deter that person from volunteering information that might be crucial to our enquiries and we therefore would like to provide clear

statutory immunity for any person who discloses information in these circumstances in breach of a duty of confidence. There would be limitations, however. Only disclosures which are proportionate and made in good faith would be protected, and the provisions will not override the duties of confidence owed by banks to their customers or lawyers to their clients. Privileged material will be protected. Statutory duties of confidence (for example, under the Data Protection Act 1998) will not be affected.

2.9 The improvements identified in each of these three areas are needed to ensure that malpractice is detected and its full extent discovered.

3. Options

3.1 Two possible options have been identified:

- **Option 1:** Retention of the current statutory system.
- **Option 2:** Targeted amendments to the current statutory system.

4. Benefits

4.1 There are no additional benefits to be gained from option 1. Option 2 will improve the ability of DTI's Companies Investigation Branch to detect and pursue malpractice by being able to gain fuller information and by being able to gain information more easily. This should allow some investigations to be concluded more quickly and so free up investigators to move to other investigations more quickly. These benefits are in addition to the broader benefits of contributing to confidence in the UK corporate framework (see para 2.5).

Business sectors affected

4.2 Companies Act investigations are carried out in relation to companies in all business sectors²⁹ As para 2.3 explains, the Secretary of State may appoint inspectors to carry out full-scale investigations or, alternatively, she can carry out confidential investigations. However, almost all the 400 investigations carried out in 2002/03 were confidential investigations, repeating a continuing trend.

²⁹ The powers are not limited to "companies" as defined in section 735 of the Companies Act 1985. They apply also to (broadly speaking) "unregistered companies" covered by s718 and certain bodies corporate incorporated outside Great Britain (by virtue of s453). Certain of the powers are also applied to European Economic Interest Groupings (EEIGs) and Limited Liability Partnerships (LLPs) and in the winding up of unincorporated associations.

4.3 The decision to investigate is largely complaints-driven,³⁰ with complaints emanating from a variety of sources, a high proportion from members of the public or those in a trading relationship with the company concerned. In 2002/03, 33%³¹ of complaints came from members of the public. A further 40% of complaints for investigation were generated internally from different directorates or agencies within DTI. In 2002/03 some 5,000 complaints against companies were received.

4.4 CIB considers each complaint received. Each complaint passes through a vetting process to establish whether there is good reason to investigate. In 2002/03 some 1,000 of the 5,000 complaints were formally considered for use of statutory investigative powers. Ultimately, only some 400³² of these were accepted for investigation. This comprised investigation of some 600 companies, less than 0.04% of GB registered companies.³³ Complaints may be refused in the absence of a good reason to investigate or because the powers available to the Department are unlikely to obtain the information or are not the most effective. Many complaints are referred to other bodies where it would be more suitable for them to take action.

4.5 It can be seen, therefore, that any sort of company could be affected if the circumstances are appropriate for investigation. In practice, the number of companies investigated is tiny in comparison with the total number of registered companies. The companies investigated are predominantly small.

Issues of equity and fairness

4.6 Companies and their directors have obligations under company law. Neither option changes the scope of the existing company investigations regime. Investigations will only be initiated where it is appropriate to do so.

5. Costs

5.1 There are obligations attached to the rights and benefits that come with running a company. These obligations can carry a cost. Currently, where a complaint is made against a company and an investigation is initiated there will be a cost in management, and possibly advisors', time in responding to the requirements of the investigation. These costs will vary depending upon the company and advisor concerned. In a small number of cases these fact finding enquiries may establish that there is nothing wrong.

³⁰ Although referred to as "complaints", they may not all be complaints in the conventional sense, eg where a request comes from another regulator.

³¹ All figures are drawn from the Companies Annual Report for 2002/03.

³² The number of cases is not an indicator of the total number of companies investigated since a single request for investigation may have resulted in the investigation of more than one company.

³³ Approx 1.6m companies were on the register in 2002/03.

Compliance costs

5.2 As option 1 is retention of the current system it would not create any additional costs beyond those which already arise. We consider that the additional cost impact of option 2 will be low: the main effect is to improve access for investigators to information. The main burden is the cost of management and employee time of those under investigation and of legal or other professional assistance. Investigators can require certain information under the existing legislation and they can obtain additional information, and access to premises, with the cooperation of the company and others.

6. Consultation with small business: the Small Firms' Impact Test

6.1 Having sought the advice of the Small Business Service, we invited 355 small or medium enterprises trade associations to comment on our proposals. The paucity of responses has meant that it is not appropriate to draw robust conclusions. However, the responses received agreed in principle with the need for an effective company investigations regime. None volunteered cost estimates but all were concerned that the new powers should be used prudently in order to avoid having a disproportionate effect on "the innocent".

7. Competition Assessment

7.1 The proposed targeted amendments under option 2 will make no distinction between businesses or between sectors. Having sought the views of the Office of Fair Trading, we have concluded that option 2 will have no significant effect on competition since costs will only adhere to those businesses which are the subject of an investigation and we expect these costs to be low.

8. Enforcement and sanctions

8.1 Failure to comply with a requirement imposed by an investigator under section 447 is an offence. We propose to repeal this offence. Instead, a certification procedure similar to that in section 436 (which currently applies only in relation to inspectors' powers) will apply. Under this procedure an investigator or the Secretary of State will certify to the court that there has been a failure to comply. There is then a hearing and the court can, if it is satisfied that there was no reasonable excuse, deal with the non-compliance as though it were a contempt of court. This procedure is more effective than prosecution as a means of dealing with alleged non-compliance with investigators' requirements. This is because, at the same time as the potential sanctions for contempt act as an effective deterrent, there is also flexibility: among other things, the procedure enables the court to give the alleged

“offender” a precise indication of what it determines is needed to comply in order to escape punishment.

8.2 We propose that the certification procedure will also apply to failure to comply with requirements to admit inspectors and investigators to premises.

8.3 In addition, we plan to create a new offence to apply where a person intentionally obstructs an inspector or investigator in the exercise of their right to remain on the premises. It is to be punishable in the same way as the existing offence under section 448(7) of the Companies Act 1985 (obstructing the exercise of rights conferred under a warrant). Thus, the maximum penalty on conviction on indictment will be a fine; or, on summary conviction, a fine corresponding to the statutory maximum (currently £5,000).

9. Monitoring and review

9.1 The Companies Act 1985 requires the Secretary of State to prepare and lay before Parliament a general annual report. The report reviews the latest developments in company law including developments in European Community legislation and accounts and auditing. It also reports on the activities of Companies House, Companies Investigations Branch and The Insolvency Service, including the number of investigations completed each year.

10. Consultation

(i) Within Government

10.1 The proposals have been given policy clearance within Government. In particular, there has been consultation with the Home Office and the Department for Constitutional Affairs and with the Small Business Service.

(ii) Public consultation

10.2 A consultation document was published in October 2001, *Company Investigations: Powers for the 21st Century*. This set out broad proposals for modernisation of the investigations regime. 113 copies of the consultation paper were sent out to industry groups, including small business groups, legal bodies, accountancy bodies, those with banking or insolvency interests, other interest groups and individual companies. The consultation paper was also made available on the DTI website. Only 11 written responses were received. A summary of those responses is available from the DTI website.

11. Summary and recommendation

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

<i>Description</i>	<i>Costs</i>	<i>Benefits</i>
1. Retention of the current statutory system	No additional costs.	No benefits to be gained
2. Targeted amendments to the current statutory system	Minimal additional costs as the main effect is to enhance existing powers. Investigators can require certain information under the existing legislation and they can obtain additional information, and access premises, with the cooperation of the company and others. The main cost burden comes from the cost of management and employee time of those under investigation and of any additional legal or other professional assistance they may require. Any increased cost as a result of the enhanced ability to gather information will be marginal	The measures will improve the ability of company investigators and inspectors to detect and uncover misconduct by being able to gain fuller information and by being able to gain that information more easily.

11.2 We recommend option 2. As business processes change and develop, it is vital that powers of company investigation keep pace so that there is an effective mechanism in place to examine suspected wrongdoing and malpractice. We wish to strengthen the current regime, without changing the basis for investigation.

11.3 In particular, we want to ensure that the widest range of relevant information is available to investigators to allow them to pursue their enquiries more easily and develop a comprehensive understanding of a company's activities. As part of strengthening the process of information-gathering, we also want to make sure that individuals feel able to volunteer relevant information at an early stage in the process in response to enquiries, without risk of being legally pursued for breach of confidence. We intend, too, to place an obligation on a company (in response to a requirement) to admit an inspector or investigator to premises where that would materially assist the investigation. This is in order to enhance the ability to gather information and to enable inspectors and investigators to gain an impression of the day-to-day running of the company.

11.4 It is important for market confidence that there is effective enforcement of company law and that malpractice is pursued. We consider that the strengthening of the company investigations regime, as proposed in option 2, represents an appropriately balanced up-dating of a critical part of the enforcement regime, taking account of the need to make investigations more effective at the same time as considering burdens on business.

12 Declaration

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

Signed: Jacqui Smith

Date: 1st December 2003

Jacqui Smith MP
Minister for Industry and the Regions and Deputy Minister for Women and Equality
Department of Trade and Industry

Contact Details

Vivien Brighton
Companies Investigation Branch
Department of Trade and Industry
Room 615
10 Victoria Street
London SW1H 0NN
Tel: 020 7215 3069
Email: vivien.brighton@dti.gsi.gov.uk

**COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY
ENTERPRISE) BILL
COMMUNITY INTEREST COMPANIES
REGULATORY IMPACT ASSESSMENT**

1. Proposal

1.1 Companies (Audit, Investigations and Community Enterprise) Bill-measures to establish a new type of company, the 'community interest company' (CIC).

2. Purpose and intended effect of proposals

(i) The Objective

2.1 The objective is to create a new type of company, the 'community interest company' (CIC), which will be based on existing company law but will have certain additional constraints and features which make it suitable for use in particular by not-for-profit social enterprises. More broadly, the intention is to encourage the development of the social enterprise sector. A social enterprise is a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profits for shareholders and owners. Social enterprises are active in a wide range of markets such as waste recycling, local transport, social housing, and the provision of care services to children and the elderly. The decision to become a CIC will be a voluntary one.

2.2 **Devolution.** Company law in Northern Ireland is a transferred matter under the Northern Ireland Act 1998. Company law matters relating to Scotland are reserved to the UK Parliament under the Scotland Act 1998, and those relating to Wales have not been transferred to the National Assembly for Wales under the Government of Wales Act 1998. The provisions concerning CICs would therefore affect the law in England, Wales and Scotland. We have consulted the Scottish Executive and National Assembly for Wales and their view and our view is that these provisions relate to reserved matters (or, respectively, to matters which have not been transferred).

The Scottish Executive is considering issues arising from the impact of the CIC proposals on Scottish charity law, which is a devolved matter.

(ii) Background

2.3 The Government published its strategy for developing the social enterprise sector generally in July 2002: 'Social Enterprise: a strategy for success'. The report undertook to follow up subsequent recommendations on legal forms for social enterprises addressed in the Cabinet Office Strategy Unit Report 'Private Action, Public Benefit: A Review of Charities and the Wider Not-For-Profit Sector' (September 2002).

2.4 The Cabinet Office Strategy Unit report recommended creating the 'community interest company'. Consultation on this report from September 2002 to December 2002 demonstrated considerable enthusiasm for this recommendation within the sector and a demand for further information. The DTI, in association with the Home Office and Treasury, subsequently launched a 12-week public consultation in March 2003 ("Enterprise for Communities: Proposals for a Community Interest Company"), which presented more detailed proposals on the CIC. In October 2003 the DTI published a report on the consultation and the Government's intentions.

2.5 The main features of CICs as reflected in the proposals are as follows:

- Maintaining continuity with existing company law (in particular the Companies Act 1985) so that CICs are constituted as companies limited by guarantee or companies limited by shares (including public limited companies). As such they will be subject to the disclosure and reporting requirements of ordinary companies;
- Adding certain specific requirements on these types of companies, notably:
 - (a) A company will have to pass a "community interest test" before it can be registered as a CIC and will be required to continue to pursue activities in the community interest;
 - (b) CICs will be subject to an asset lock, which prevents the distribution of profits or financial assets to members of a company or investors both during its lifetime and on winding-up. The asset lock will be entrenched by statutory means (with only a limited possibility of issuing shares upon which a capped dividend may be paid). It will be open to CICs limited by shares to issue shares that pay a dividend, but any dividend will be subject to a cap set by the CIC Regulator;
 - (c) CICs must submit an annual "community interest report" to the CIC Regulator, alongside the normal accounts and reports required from all companies. The community interest report will detail, for example, the activities the company has undertaken in pursuit of its community interest aims, and what it has done to involve its stakeholders in its activities.
- Creating the office of an independent Regulator who will be responsible for ensuring that CICs comply with the relevant requirements.

(iii) Risk Assessment

2.6 The purpose of introducing the CIC is to increase choice by adding to the existing forms of incorporation available to social enterprises (such as charitable companies and Industrial and Provident Societies), thus encouraging future growth in the sector.

2.7 The CIC is not intended to replace the alternative forms of incorporation. Instead it will increase the options available to social enterprises, allowing them to choose the form which best suits their particular community interest purposes. Social enterprises will also continue to be able to make use of the existing unmodified forms of company limited by shares and company limited by guarantee. The risks to the social enterprise sector of not setting up a CICs regime are set out in detail in Section 3. They include the possibility that the sector as a whole may be unable to achieve sustainable financing as a result of being unable to use the flexibility of the company form or of a lack of certainty from potential investors that their money will be used for the community benefit. At an individual level some social enterprises may thus be left without a suitable legal vehicle for achieving their aims; or the lack of an effective asset lock could increase the risk that profits or financial assets may be inappropriately distributed.

2.8 It is intended to provide an effective and proportionate regulatory regime for CICs. There is a risk that if the CIC form is established without adequate regulation, it could lose credibility and therefore fail to achieve its potential in helping to implement the Government's social enterprise strategy.

2.9 The regulatory structure proposed will address the specific risks of:

- Companies with unsuitable purposes becoming registered as CICs;
- CICs failing to act so as to further the community interest;
- CIC assets and/or profits being distributed to shareholders (beyond the permitted limits) or otherwise misused;
- CICs failing to comply with any other statutory requirements.

3. Options

3.1 The following table summarises the options which we have identified, their benefits and the impact on achieving the government's objectives for CICs. They are addressed in the succeeding paragraphs of text. Of these, option 5 is the proposal being taken forward in the Bill.

Option	Benefits	Impact
1. Use existing forms of company	<ul style="list-style-type: none">• No further legislation required	<ul style="list-style-type: none">• Sector remains unchanged• Identified need for CICs not addressed• Sustainable financing for the sector

		<p>not achieved</p> <ul style="list-style-type: none"> Identified need for transparent asset lock not achieved
2. Voluntary Codes of Practice for Social Enterprises	<ul style="list-style-type: none"> No further legislation required Flexibility in developing guidance 	<ul style="list-style-type: none"> Not legally enforceable Variation in consistency of implementation No obligation to report Limited government ability to promote the growth and development of the sector Identified need for transparent asset lock not achieved
3. Combined self-regulation and legislation	<ul style="list-style-type: none"> Administered by the sector Flexibility in scope of test and reporting Limited legislation required 	<ul style="list-style-type: none"> No obvious locus for self-regulation given the diversity of the sector Lack of regulatory definition and variation in implementation
4. Amend existing Charitable and I&PS Law	<ul style="list-style-type: none"> Avoid new powers Form of community interest test exists Asset lock in place for charities Strong stakeholder input 	<ul style="list-style-type: none"> Some social enterprises are left without a suitable legal vehicle for achieving their aims Existing test for charitable status does not suit all types of social enterprise Governance and reporting arrangements for these forms of organisation may not be suitable for all social enterprises Unqualified asset lock may not be suitable for all social enterprises e.g. those which wish to issue investor shares Potential of regressive effect on existing organisations within the sector
5. Introduce Community Interest Companies as proposed	<ul style="list-style-type: none"> Consistency of implementation Statutory framework to achieve government objectives Protects assets and community 	<ul style="list-style-type: none"> Legislation required Regulation gives rise to one-off and recurring central government costs Additional statutory regulation placed on CICs but no requirement to become a CIC CICs must pay an additional CICs registration fee

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(i) Use existing company forms to grow the social enterprise sector

3.2 Currently there is no specific form of incorporation that provides an effective statutory asset lock whilst retaining the flexibility of the company form. Unless special provision is made in the constitution of a company, the company's members are ultimately those who will be entitled to the company's surplus assets (either by way of distribution of profits during the lifetime of the company, or on its winding up).

3.3 Currently therefore, social enterprises have to customise existing company forms if they wish to lock assets into the company. This can be relatively expensive, since it will usually involve legal advice. There is also a lack of certainty: although existing company law permits the entrenchment of asset-lock provisions in a company's constitution, the mechanisms for doing this are complex, technical and not widely understood. There can also be a lack of transparency because such 'community interest' and 'not for profit' companies are not readily identified as such if they are not charitable. Furthermore, current company forms place no statutory obligations on social enterprises to operate in the community interest or to report on their contacts with stakeholders. The combination of these factors can mean that potential investors lack confidence that their money would be used in the community interest. The use of existing company forms to grow the social enterprise sector would therefore fail to meet the Government's policy.

(ii) Developing Voluntary Codes of Practice within the sector

3.4 A voluntary code of practice would avoid the need for legislation and ongoing regulation of the sector. However, the diversity of social enterprise activities makes it difficult for voluntary codes of practice to work effectively, to provide an established legal identity for not-for-profit companies and to ensure compliance with voluntary systems across the sector. The implementation of a voluntary code of practice would not be legally enforceable and would not ensure a transparent asset lock. This would result in variations of consistency in terms of best practice and assurances offered to interested stakeholders. Therefore voluntary codes of practice would not deliver the strategic benefits underlying the Government's policy.

(iii) Co-regulation

3.5 Co-regulation of the sector would involve self-regulation under which the social enterprise sector would develop and administer its own arrangements, but government would provide some legislative framework for arrangements to be enforced. This approach would have the advantage of enabling appropriate arrangements to be led, generated and administered by the sector. The difficulty is that there is no obvious locus for self-regulation of key CIC features such as the asset lock, given the diversity of the sector's activities. This would be likely to lead to a lack of consistency in regulation.

(iv) Amend existing Charitable and IPS Law

3.6 The Strategy Unit report recommended changes to IPS and charity law alongside the introduction of the CIC. The Government published its response to those recommendations in July 2003 (“Charities and Not-for-profits: a modern legal framework”, Home Office), and intends to take forward most of the Strategy Unit recommendations.

3.7 However; the proposed changes to charity and IPS law will not provide the anticipated benefits of CIC legislation. For instance, charity law offers an asset lock and a definition of public benefit, but by comparison with the CIC proposals, charitable status is more narrowly defined and charities are more tightly regulated given the fiscal benefits that they attract. IPSs, and particularly the community benefit society, are used as a vehicle by those social enterprises that wish to commit themselves to democratic “one member one vote” structures, and it is expected that reforms to IPS law will include the introduction of an asset lock for community benefit societies. The Government is committed to maintaining its support for the co-operative sector and recognises the importance of the IPS as a legal form. However, the constitutional and governance requirements of IPS status are not appropriate for all social enterprises.

3.8 Amending existing legislation in either of these areas to provide an equivalent to the CIC would inevitably reduce the distinctiveness of the existing legal forms, and their value to current users. It would also be likely to constrain the growth of the social enterprise sector since, for instance, the tight regulation associated with charitable status could deter many social enterprises that do not require this level of regulation.

(v) Introduce community interest company legislation

3.9 CICs will complement existing options available to social enterprises for delivering their community objectives, in recognition of the diversity of enterprise activity and the demand for a variety of delivery mechanisms to achieve these objectives. This will result in a new regulatory regime which will apply a community interest test, support the statutory entrenchment of an asset lock (while allowing for a limited degree of distribution of profits) and promote stakeholder involvement, while increasing the range of legal forms available to enterprises within this diverse sector.

4. Benefits

4.1 The benefits realised will be primarily of a strategic nature, bringing about change in the sector, rather than specific financial benefits to individual CICs.

4.2 Strategic benefits to the social enterprise sector will include:

- encouraging the growth of the sector through the introduction of a simple and transparent not-for-profit company form;
- raising the profile of the social enterprise sector;
- helping non-charitable social enterprise companies to access finance (e.g. loans and grants) by increasing confidence in their social purpose and not-for-profit distribution status;

4.3 Direct financial benefits to the sector will include:

- reducing the costs of establishing organisations to act on a not-for-profit basis in pursuit of the community interest by providing this off-the-shelf company form. We estimate that the minimum cost of seeking legal advice to set up an asset lock would be in the region of £1,500 - £2,000 (more complex structures would be more expensive); and
- such savings are likely to be passed to stakeholders through reduced transaction costs.

4.4 General benefits to CICs and stakeholders will include:

- encouraging philanthropic investors and others to fund CICs with the confidence that assets will be locked into the company for the community benefit;
- recognition within social enterprises that the CIC will benefit from the flexibility and legal certainty offered by existing company law; and
- through the annual production of a community interest report.

Business Sectors Affected

a. Social Enterprise Sector

4.5 The proposals affect the social enterprise sector, which is active in a diverse range of markets and services, referred to above. The nature of and current developments in the sector are reviewed in the Government's report: 'Social Enterprise – a Strategy for success'. Before outlining the likely additional costs it is important to note, as indicated by a variety of consultees, that becoming a CIC would be a voluntary decision that would only be taken if the benefits outweighed the costs.

4.6 There are some tentative estimates of the relative size of the social enterprise sector available. Campbell (2000) [<http://www.ecotec.com/semg/report/>] suggested that the wider social economy accounts for roughly 7.3% of employment in the UK measured as part of a European study. The report further suggests that social enterprises may account for 10-20% of this. In addition, valuable insights into social enterprise have been obtained through a number of regional and local studies. However, a complete picture of social enterprise across the UK cannot easily be produced by compiling and comparing existing regional studies as they have used differing methodologies and definitions according to their individual remits.

4.7 It is expected that the CIC will initially be used mainly by new enterprises, rather than by existing enterprises which have already customised an appropriate legal form. Take-up is hard to estimate given the lack of data on start-ups in the sector, but our working assumption is that initially there may be between 100 and 300 new CICs registering each year. This figure was considered to be low by some consultees but no evidence was provided to produce an accurate forecast of the initial uptake.

b. Finance Sector

4.8 The introduction of CICs should complement other work being done in the social enterprise sector to attract sustainable investment, through improved access to obtainable and affordable finance from financial institutions. For instance, there are links between the ability of CICs to issue shares that pay a (capped) dividend to investors and the potential development of the market in “patient capital”, as described in the Bank of England’s May 2003 report on the financing of social enterprises. Over time, this may result in the development of a market in such financial instruments and in improved lending capacity to accommodate the financial needs of the social enterprise sector.

c. Charitable Sector

4.9 The charitable sector has raised concerns regarding the possible restructuring of the existing sector following the introduction of CICs (see section 15 of the October 2003 consultation report). We believe it unlikely that many charities would convert to CICs, because of the resulting loss of tax breaks. Whilst a small number of charitable companies may decide to convert to a CIC, this should not significantly impact on the charitable sector. The CICs proposals are not aimed at redefining or restructuring the existing incorporations within the sector. It is envisaged that CICs will help grow the sector through the introduction of a more flexible form rather than create competition. Competition aspects are discussed in Section 8.

4.10 During consultation, voluntary organisations and charities have raised concerns regarding the possible dilution of funding currently available for charities following the introduction of CICs since they may also compete for existing finance. However, it is envisaged that CICs will help grow the social enterprise sector through the introduction of a more flexible form, and that this may result in increasing the level of funding available to all participants.

4.11 Some charitable foundations can already fund non-charitable organisations and will be able to provide funds to CICs. Our discussions with charitable foundations suggest that the introduction of the CIC will not significantly reduce the funding currently available to the charitable sector, or in any other way affect the charitable sector disproportionately. This is partly because many foundations are inhibited, for legal or policy reasons, from funding non-charitable organisations. However, it is hoped that over time the introduction of the CIC, with its entrenched asset lock, will encourage at least charitable foundations to finance CICs alongside charitable organisations.

4.12 Most organisations with purely charitable objectives will prefer the charity form rather than the CIC form due to the fiscal benefits available.

5. Issues of Equity and Fairness

5.1 We have identified no groups that will be disproportionately affected by the legislation. However, to ensure that the Regulator does not become involved in debate about whether particular political purposes may be beneficial, it is proposed that political parties and political campaigning organisations will be unable to incorporate as a CIC.

5.2 There are concerns from the co-operative sector about a “level playing field” for CICs and Industrial and Provident Societies in respect of the profile of social enterprises, registration fees, and the cost and timescale of registration (see section 15 of the October 2003 consultation report). The Financial Services Authority in consultation with HM Treasury will be taking forward work on legal and registration issues for IPSs in the light of the CIC proposals.

6. Costs and Income

Identifying Costs

6.1 The regulatory arrangements for CICs would impose costs on central Government, including:

- (i) costs of the Regulator’s staff, an appeals officer, accommodation and services procured;
- (ii) costs of developing and publishing guidance to CICs on their obligations; and
- (iii) operational costs associated with making community interest reports available to the public, and investigating and taking action on complaints.

Quantifying the Costs

a. Operating Costs (including non-recurring)

(i)	Recurring staff costs (est. 8 staff)	=£260,000 p.a.
(ii)	Recurring liabilities (legal costs)	=£50,000 p.a.
(iii)		
(iv)	Recurring infrastructure costs	=£40,000 p.a.
(v)	Recurring charges from Companies House	=£10,000 p.a.
(vi)	Non-recurring set-up costs	= <i>between</i> £250,000 and £500,000 (see 6.3)

Total estimated costs: £310,000 staff and infrastructure running costs and £50,000 estimated legal liabilities per year, and between £250,000 and £500,000 one-off.

6.2 Recurring staff costs are the total costs of employment including salaries, pension, and services procured e.g. personnel, facilities, training, accommodation etc. and other employer costs. Our cost estimate assumes that the Regulator's staff will be located outside London, possibly in Cardiff. Staff costs are estimated based on similar activities undertaken at Companies House for the registration of ordinary companies. We also include staff costs for additional activities for issuing guidance, applying the community interest test, investigating complaints and publishing and reviewing community interest reports.

6.3 Estimated non-recurring set-up costs include:

- i) recruitment costs and salaries for a 'shadow' Regulator and skeleton staff in the period before the Regulator opens for business (estimate just under £100,000); and
- ii) accommodation fit-out, website development and provision for contracting-out production of some initial guidance to experts from the social enterprise sector (estimate up to £100,000); and
- iii) establishing information systems and changing existing (including Companies House) systems. The scale of these costs is uncertain at present, pending analysis of the need for system changes. Our conservative estimate is that they will fall in a range between £50,000 and £300,000.

This gives a total estimate of set-up costs in a range between £250,000 and £500,000.

6.4 Recurring infrastructure costs include running costs (IT networks, telephony communications), and service charges.

6.5 Recurring liabilities include funded legal costs, award of legal costs and audits.

6.6 Recurring charges from Companies House includes cost incurred by Companies House to provide basic administrative functions for the initial handling of CICs registrations.

b. Specialist Non-Recurring Costs

6.7 Specialist costs may be incurred through procuring specialist advice in order to enable the Regulator to fulfil its obligations, e.g. to issue guidance.

c. Regulatory Impact Costs

6.8 The Regulator may undertake formal or informal assessments of the regulatory impact of his activities.

d. Costs to Small and Medium Sized Social Enterprises

6.9 It is not anticipated that the proposed regime will have a particular impact on small firms. It is envisaged that financial costs incurred by all firms in the normal set up of a company will remain unchanged with the exception of the additional procedures and costs for registering as a CIC. It is expected that to register a company as a CIC will cost considerably less than the current costs incurred by those companies wishing to set up using an asset lock, who have to customise existing company forms to meet their objectives.

e. Costs to Stakeholders

6.10 The setting up of a CIC should present minimal overheads to those forming the company. Any savings as a result of a less legally complex registration would be likely to benefit stakeholders within the social enterprise concerned, through reduced transaction costs and savings being diverted to other enterprise activity.

f. Regulatory and Community Interest Compliance Costs

6.11 The Regulator will be a distinct, legally independent office, but it is envisaged that the Regulator will be co-located with Companies House in Cardiff. Where possible the Regulator will draw on existing expertise and resources in Companies House and in other bodies such as the Charity Commission and DTI Companies Investigation Branch. It is also envisaged that access to the CICs registration service will be provided via a 'one stop shop' utilising the front office services of Companies House. These arrangements should help to reduce the Regulator's ongoing operational and overhead costs.

6.12 In summary, the main regulatory requirements on CICs likely to affect cost will be:

- (i) Application for registration as a CIC. This will include the process of registering as an ordinary company, with some additional elements, and will be designed as a 'one stop shop' so that applicants do not

need to contact both the CIC Regulator and Companies House. The Regulator will apply a community interest test in deciding the application, but given the self-selected constraints of CIC status (lock on profits, regulatory requirements etc) we expect that a large majority of applicants will pass this test easily. An additional fee will be payable for registration as a CIC, on top of the Companies House fee for company registration. In order to avoid deterring potential applicants, it is intended that this will be comparable with the latter fee, currently £20.

- (ii) Filing an annual 'community interest report' with the Regulator, in which each CIC will record the action it has taken in pursuit of its community interest objectives, including the action it has taken (if any) to involve stakeholders in its activities. The report is intended to be short and straightforward. The reporting requirement will impose some administrative costs on CICs, but the information required should be readily available from their own internal governance procedures where these have been formalised.

g. Regulatory Enforcement Costs

6.13 The CIC Regulator will have powers to investigate complaints that CICs are not observing the statutory requirements of CIC status, such as pursuit of community interest, and to take action if such complaints are justified. Such action could include freezing bank accounts, replacing directors or applying to have a CIC wound up.

6.14 These powers will not have any cost impact on CICs provided they observe the statutory requirements. The Regulator will develop guidance to help CICs in meeting these requirements. There will be an internal appeals mechanism to consider complaints about regulatory decisions. The costs of exercising these powers, producing guidance and considering appeals are included in the overall costs of the Regulator.

h. Monitoring and Review Costs

6.15 Given the small size of the Regulator, the Regulator's accounting and reporting arrangements will be linked to DTIs monitoring and reporting arrangements as far as possible.

Regulatory Income

6.16 Fees will offset some of the costs of the Regulator, although it is not expected that fees will fully cover those costs, at least in the early years of operation. The Government will therefore subsidise the cost of regulation, at least initially.

6.17 Regulatory income will not be quantifiable until such a time as the fee is set. The level of fee will be influenced by the level of funding provided by the DTI.

7. Consultation with small business: the Small Firms' Impact Test

7.1 Small and medium size businesses will be eligible to take advantage of CIC status where appropriate. As the decision to become a CIC is voluntary, there will not be an extra compliance cost. The impact on SMEs who choose to become a CIC will be as outlined above, and should not be disproportionate to the burden involved in setting up an ordinary company. It is envisaged that the majority of new CICs will be start-ups and as such will be SMEs.

7.2 In addition to the public consultation, we consulted with a group of eight social enterprises on the impact of the costs and benefits of the CICs proposals on SMEs. Five of the consultees did not have any relevant comment to make and the remaining three anticipated legal savings on costs but were unable to quantify. Four of the consultees noted that the proposals would result in an increase in administrative cost but regarded this to be small.

8. Competition Assessment

8.1 The introduction of the CIC will affect the social enterprise sector, which is active in a wide range of markets. Examples include waste recycling, local transport, social housing, and the provision of care services to children and the elderly. Within each of these markets, social enterprises are characterised by a high level of diversity, in terms of both economic scale and legal structure.

8.2 The costs associated with CIC status (e.g. to register and fulfil reporting requirements) will only apply to those that choose to use this new type of company - this will not impose a barrier to those wishing to enter the markets in which social enterprises operate. Those who do not wish to use the CIC form will have other options available to them, including conventional company forms.

8.3 The CIC will make it quicker and cheaper for aspiring new entrants to the social enterprise sector to incorporate as companies on a not-for-profit basis, thus facilitating entry into a range of markets with the aim of ultimately growing the overall size of the sector. There is, therefore, some potential for increased competition between purely commercial participants and not-for-profit participants within specific markets. A CIC might, among certain potential customers (as with any other form of non-profit-making enterprise) enjoy some competitive advantages over commercial enterprises operating within the same market, due to the absence of a requirement to generate profits for shareholders and owners. However, we have not identified any markets in which the scale of new entry that is likely to be stimulated by the introduction of the CIC would be sufficient to alter the current structure of competition.

9. Enforcement and sanctions

9.1 The Regulator will work closely with Companies House and other government bodies in preparing guidance and ensuring ongoing compliance with CIC statutory requirements. Depending on the nature of their business, a CIC may be affected by other sectoral regulatory regimes.

9.2 As companies CICs will be required to comply with company law, and all the usual sanctions and means of enforcement will apply, for example in the event of a failure to provide reports and accounts in time. Those sanctions will be extended to the requirement, placed on all CICs, to submit an annual "community interest report".

9.3 In addition the Regulator will have a number of powers designed to ensure that CICs properly pursue community interest purposes, and that their assets are adequately protected. In particular, the Regulator will have powers to:

- obtain information, and direct an audit of a CIC;
- appoint, suspend and remove directors;
- appoint a manager;
- vest assets in an official property holder;
- freeze assets, and restrict transactions and payments;
- apply to the court for the CIC to be wound up;
- bring a legal claim on behalf of the CIC (for instance against directors who are in breach of their duties);
- divest of its ownership a political party which has acquired control of a CIC; and
- give directions as to the disposal of surplus assets on the winding up of a CIC.

9.4 There will also be powers enabling the Regulator to receive information from (and disclose information to) other regulators.

10. Monitoring and Review

10.1 In accordance with the Government's goal of light touch regulation, the CIC Regulator will be obliged to use his supervisory powers only to the extent necessary to maintain confidence in CICs.

10.2 The Regulator will be required to report annually to the Secretary of State who will be required to lay the report before Parliament.

11. Results of consultation

11.1 The results of the 2003 public consultation on CICs are summarised below. They are also documented in detail in the final consultation report which can be found on the DTI website (www.dti.gov.uk/cics/).

(i) Within Government

11.2 The proposals were agreed within Government. We consulted the Cabinet Office, DTI, Home Office, Department of Health, Scotland Office, Wales Office and HM Treasury among others. We have also consulted the Small Business Service and the Office of Fair Trading.

(ii) Public Consultation

11.3 A public consultation was launched at the Social Enterprise Conference on 26th March 2003, and lasted 12 weeks. The consultation was warmly welcomed and received positive feedback.

11.4 The launch of the CIC proposals was followed up by a proactive consultation programme involving one-to-one discussion with sector representatives, specialist group meetings, participation in seminars with representative organisations and a programme of Road Shows throughout the UK. In addition to this we approached a number of representative organisations to involve their members. This included the National Council for Voluntary Organisations, Association of Charitable Foundations, Development Trusts Association, the co-operative movement, Charity Law Association, Social Enterprise Coalition and National Housing Federation.

11.5 In Scotland we approached the Scottish Council for Voluntary Organisations, Community Enterprise Strathclyde, Social Enterprise Network Scotland, Scotland Office and the Scottish Executive to deliver a fully integrated consultation Seminar.

11.6 In Wales we worked with the National Assembly for Wales to make initial contact with the Social Economy Foundation Working Party to raise awareness of the proposals. Following on from this we worked with the Wales Office and National Assembly for Wales to identify potential stakeholders. We then made contact with the Social Economy Network and Welsh Council for Voluntary Associations to finalise a consultation seminar in Cardiff.

11.7 We received 134 written responses to the proposals. 122 of these commented on the overall proposal to create a community interest company, of which 77% were broadly in favour, 9% were against and 14% were neutral. The objections were, in the main, related to the lack of a perceived need for the additional company form. Details of the consultation responses are set out in the DTI's October 2003 report on the consultation.

12. Summary and Recommendation

12.1 The anticipated costs and benefits of the measures setting up the community interest companies regime are set out in the table below:

Description	Costs	Benefits
Create new type of	Normal company set-up	Lower costs of forming

company to be known as a community interest company (CIC)	costs with a minor additional registration cost (see below)	ready-made not-for-profit company. Estimated at approximately £1,500 to £2,000 per company depending on its complexity. Encourages growth of social enterprise sector
Special registration requirement for CICs: "community interest test"	Extra registration cost anticipated at around £20 initially. But choice to become CIC is voluntary	Provides credibility that the CIC will benefit the community
CIC assets to be locked so that they can only be used for the community benefit	Cost to the company/members but choice to become CIC is voluntary	May help attract finance by increasing confidence of investors that profits and assets will be used for the community benefit
CIC share dividends to be capped	Limited profits for investors, but choice to invest in CIC is voluntary	
Ongoing additional reporting requirement: "community interest report"	Some minor admin costs on CICs but the information should be readily available from the companies' own internal resources	Provides transparency and maintains confidence that the CIC is serving the community interest
Office of independent CIC Regulator	Requires dedicated regulatory framework which will impose both set up and recurring maintenance costs on central government. We estimate these costs to be between £250,000 and £500,00 for set up and £310,000 a year running costs, plus legal liabilities	Provides confidence in the integrity of the system. Will strengthen the profile of the social enterprise sector through guidance etc

12.2 The proposed creation of the community interest company and the associated regulatory regime has been broadly welcomed by interested

parties within the social enterprise sector. As well as establishing this new regulatory office, the measures set out in the proposals will ensure that the Regulator is equipped with the right mix of duties and powers to allow the sector to develop and protect the community interest.

12.3 The creation of this new type of company with its independent Regulator is expected to produce substantial benefits for the sector in the long term.

13. Declaration

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

Signed *Jacqui Smith*

Date: 1st December 2003

Jacqui Smith MP

Minister for Industry and the Regions and Deputy Minister for Women and Equality

Department of Trade and Industry

Contact Point:

Harry Taylor
Community Interest Companies
Corporate Law and Governance Directorate
Department of Trade and Industry
Bay UG 23
1 Victoria Street
London SW1H 0ET
Tel: 020 7215 3896
Email: harry.taylor@dti.gsi.gov.uk