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Company Audit Exemptions

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Summary

A compulsory, external, audit is one of the fundamental ways in which investors (owners) can evaluate the stewardship of a company by its management. It forms the basis of financial performance assessment as well as contributing to the veracity of tax returns and compliance with a host of governance issues.

In cases of small firms, where the managers and the owners may well be the same person the value of an audit is less clear and the not inconsiderable costs start to look excessive. Hence successive government shave invoked lesser requirements for small and medium sized companies as part of broader de-regulation aims.

De-regulation here comprises definitions of who is eligible for special treatment and, if eligible, what lessening of the normal standards are reasonable. The Business, Innovation and Skills Department has recently consulted on fresh ‘derogations’ (there is a new EU accounting Directive which needs to be implemented anyway) and further legislation is expected.

1. Background

Ever since 1967 private companies have been required to file annual accounts at Companies House and to have these accounts audited by a qualified independent auditor.

The 'philosophical' justification is that the managers of companies have to demonstrate the stewardship of the company's to the owners of the company. This is done by the audit carried out by an external auditor.

In the case of small firms however, the distance between owners and management is much smaller than for large companies. In many cases the owners are also the managers. The cost of an audit is therefore harder to justify.

In terms of the overall burden of regulation the two key elements are the definition of *who* 'small' (or medium) is and *what* they must do. So to reduce the burden one could either increase the thresholds or require those firms to report on fewer things.

In 1981 the UK took advantage of an exemption provided for in the EC's Fourth Company Law Directive and allowed small and medium sized companies to file abbreviated accounts at Companies House.[1] The option to exempt small companies from the statutory audit requirement was rejected on that occasion, and again when the matter was reviewed in 1986, and 1988.

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In 1993, when a further EC Directive was being implemented, the UK took advantage of the scope for audit exemptions for the first time. Companies with low turnovers (£90,000 or less) were exempted; companies with slightly higher turnovers (£90,000 to £350,000) could opt for a simpler Audit Exemption Report (AER). In 1997, the AER was abolished and the exemption from audit extended to all companies with a turnover below £350,000.[2] Legislation

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1 78/660/EEC

2 The Companies Act 1985 (Audit Exemption) (Amendment) Regulations 1997 SI 1997 No 936

2. Current rules

2.1 Threshold size

The limits and thresholds determining the auditing requirements for companies were raised by, first, the *Companies Act 1985 (Audit Exemption) (Amendment) Regulations 2000* and later by *The Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008*[3] which set the current limits. Further amendments were made by the *Companies and Limited Liability Partnerships (Accounts and Audit Exemptions and Change of Accounting Framework) Regulations 2012*[4] which affected things like subsidiaries and dormant companies.

The different account filing obligations of different sized companies are set out in Chapter 10 of the CA 2006 (SS444-448C).

A company is 'small' if it satisfies two or more of the following conditions:

Small company definitions

Turnover	Not more than £6.5 million
Balance sheet total	Not more than £3.26 million
Number of employees	Not more than 50

S382 Companies Act 2006

A similar qualification exemption exists for small groups:

Small group company definitions

Aggregate turnover	Not more than £6.5 million net (or £7.8 million gross)
Aggregate balance sheet total	Not more than £3.26 million net (or £3.9 million gross)
Number of employees	Not more than 50

S383 Companies Act 2006

Net is net of inter group transactions. Certain types of small company are unable to take advantage of the exemption (S.384 CA 2006). These include public companies, banks, insurance companies, UCITS companies and financial services companies.

For similar reasons the CA 2006 also provides definitions of medium sized companies. Again, the company, or group, must meet two of three qualifying conditions:

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3 SI 2008/393
4 SI 2012/2301

Medium sized company definitions

Turnover	Not more than £25.9 million
Balance sheet total	Not more than £12.9 million
Number of employees	Not more than 250

S.465 Companies Act 2006

Medium sized group company definitions

Aggregate turnover	Not more than £25.9 million net (or £31.1 million gross)
Aggregate balance sheet total	Not more than £12.9 million net (or 15.5 million gross.)
Number of employees	Not more than 250

S.465 Companies Act 2006

The Gov.UK website has more information on the current requirements. It notes for example that

Your company must have an audit if at any time in the financial year if it's been:

- a public company (unless it's dormant)
- a subsidiary company (unless it qualifies for an exception)
- an authorised insurance company or carrying out insurance market activity
- involved in banking or issuing e-money
- a Markets in Financial Instruments Directive (MiFID) investment firm or an Undertakings for Collective Investment in Transferable Securities (UCITS) management company
- a corporate body and its shares have been traded on a regulated market in a European state[5]

2.2 The Requirements

For qualifying firms, what has to be delivered to Companies House is set out in the *Small Companies and Groups (Accounts and Directors' Report) Regulations 2008* [6] in particular in Schedule 4 of the regulation. Schedule 5 sets out the matters and form of the Director's Report.

5 *Audit exemption for private limited companies* Gov.UK
6 SI 2008/409

3. Change

3.1 The adoption of small firm exemptions

The intellectual underpinning of the argument for lower audit requirements was a report commissioned by the then Department for Business Enterprise and Regulatory Reform. This was the *Collis Report* published in October 2003.[7] A summary of its findings is shown below:

> The main reason for filing unaudited accounts in 2002 was lower accountancy fees, but very few directors were able to report the specific amount saved. Of those that did, the typical reduction in fees was £1,000. The inability of the directors to report the actual amount saved implies that it may not have been a significant saving or that it was offset by other charges.
>
> The main reasons for filing audited accounts in 2002 were the desire to do so (46% of those responding) and the continuation of company policy (38%). The main users requesting the accounts to be audited in 2002 were shareholders (30% of those responding) and the bank and other providers of finance (27%).
>
> The proposal to raise the audit exemption threshold to £4.8m is supported by 57% of the sample companies. If the requirement for a statutory audit were removed, 42% of companies predict that they would have the accounts audited on a voluntary basis, compared with 56% who would discontinue the.
>
> Among companies that would be eligible for exemption for the first time (i.e. those with a turnover above £1m), the majority (79%) predict that they will have a voluntary audit.
>
> Analysis of the factors that have a significant influence on the audit decision reveals that the directors are more likely to have a voluntary audit if the company has the following characteristics:
>
> It is larger in terms of turnover and the directors consider that the audit improves the quality of the financial information,
>
> it has a positive effect on the company's credit rating score and provides a check on accounting records and systems;
>
> it is not wholly family-owned and has shareholders without access to internal financial information;
>
> and the directors normally give a copy of the statutory accounts to the bank and other providers of finance.
>
> The study provides evidence that size is not a sufficient measure on its own for capturing the costs and benefits of the audit. There are other qualitative factors that have a significant influence

[7] The Collis Report by Jill Collis, Director's views on Exemption from the statutory audit, October 2003

> on the directors' decision on whether or not the accounts will be audited on a voluntary basis.
>
> The finding that the vast majority of companies (79% of those that are likely to be eligible for exemption for the first time if the turnover threshold is raised to £4.8m) predict that they will have a voluntary audit will be reassuring to small practitioners who rely on audit fee income from small company clients. It will also be reassuring to lenders and other providers of credit who rely on audited financial statements for assessing risk. However, these parties have the economic power to ensure that their requirements are met and it is important that future regulation continues to protect the needs of shareholders requiring the additional assurance of an external audit.

3.2 Future exemptions?

Following a recent Business, Innovation and Skills (BIS) Departmental consultation the expectation is that there will be a further relaxation in the small firm's regime.

In August 2014 BIS published a consultation on the *UK Implementation of the EU Accounting Regime* chapter 8 of which discussed a 'New small company regime'. The consultation deals first with the threshold question – who is small - and appears to favour a de liberalised approach:

> 8.14 The Commission applied its "think small first" approach to this Directive29. In doing so, it has created a small company regime that enables companies to prepare profit and loss accounts, balance sheets and notes that are more proportionate to their size and to the information needs of the users of their financial statements. By increasing the thresholds more undertakings will be considered as small. As noted above, we expect approximately 11,000 could benefit from reduced administrative burdens by maximising the increase in small company thresholds.
>
> 8.15 The Directive imposes a new, largely harmonised small company regime. Several of the changes introduced do not impact on the UK as we already operate a small company regime e.g. we recognise "small" as a size category, allow small companies to publish only an abbreviated balance sheet etc. However, other changes either require or allow the Government to further reduce the administrative burden associated with the preparation and publication of statutory accounts.[8]

Later the consultation considered the question of abbreviated accounts – the what should they do. It stated:

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[8] *UK Implementation of the EU Accounting Regime*, p22

> 8.20 Small companies are already permitted to *publish* abbreviated accounts under the provisions of the previous Accounting Directives and may choose only to publish an abbreviated balance sheet if they wish. The UK already takes up this option and many small companies take advantage of this flexibility when submitting their accounts to Companies House. The Accounting Directive also provides an option for small companies to *prepare* an abbreviated balance sheet and an abbreviated profit and loss account34. This option has not previously been taken up in the UK. Currently all companies, except those eligible for the micro-entity regime, must prepare a full balance sheet and profit and loss account with accompanying notes. This set of "full accounts", which must present a true and fair view of the company's financial position, is what the company circulates to its shareholders.
>
> 8.21 Clearly, it is important that directors of companies give their shareholders the information they need to properly assess the company's performance and financial position. Equally, there are considerable differences between the size and complexity of companies falling within the small company regime. For some small companies there will be an agency relationship between the shareholders as owners and the directors as managers of the business. Here, the need for greater levels of detail in the financial statements will be justified. By contrast, for other small companies the owners may be the managers, and possibly the employees too. In such situations, the agency relationship is not present and the need for the detail in the accounts is reduced. The Government believes that companies – shareholders and directors together – should have a choice about the level of detail included in their accounts having regard to the size and nature of their business. Therefore, we propose to take up the option and to allow eligible small companies to *prepare and publish* abbreviated accounts if they wish.[9]

In January 2015 it published the *Government Response to the consultation.* The main proposals covering a wide range of accounting/auditing / size threshold issues are shown below:

- Adopt the maximum thresholds available to determine the size of small companies. This will enable 11,000 medium-sized companies to be re-categorised and access the less burdensome small companies regime. (Mandatory increases in the thresholds for medium-sized and large companies will also be applied.)

[9] *UK Implementation of the EU Accounting Regime*, p24

- Reduce the number of mandatory notes required of small companies to 13 notes, where these are appropriate. (It is estimated that currently most small companies must provide a minimum of 17 notes).
- Permit small companies to prepare an abbreviated balance sheet and abbreviated profit and loss account if approved by all of the company's shareholders. This strikes a balance between enabling simplification and protecting minority shareholder interests.
- Give companies in the same group as a public company which is not a listed company access to the small or medium-sized companies regimes.
- Provide companies with the opportunity to use alternative layouts when preparing their profit and loss account and the balance sheet provided that the information given is at least equivalent to the information otherwise required by the standard formats. (This option is intended to reduce the burden of consolidation for those in a group using international accounting standards.)
- Require that, in exceptional circumstances, where the useful life of goodwill cannot be reliably estimated that it shall be written off over no more than 10 years.
- Require that information on subsidiaries included with the consolidated financial statements is only provided as a note to those statements;
- Remove the requirement for micro-entity companies to prepare a Directors Report;
- Permit the use of the "equity method" in individual company financial statements.[10]

As one might expect parts of the accountancy profession are less keen on proposals to remove 10,000 more firms from audit requirements, commenting in one article on the ACCA website that it was a 'shape changer' for the profession which would lose many clients.

[10] BIS; Response to consultation on the UK Implementation of the EU Accounting Directive: Chapter 1-9 Financial statements and general requirements for audit, pp 4-5; January 2015

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