Title: UK implementation of the EU Accounting Directive: Chapters 1-9: Annual financial statements, consolidated financial statements, related reports of certain types of undertakings and general requirements for audit	Impact Assessment (IA)
	Date: 12/3/2014
	Stage: Final
	Source of intervention: EU
IA No: BISBE113	**Type of measure:** Secondary legislation
Lead department or agency: Department for Business, Innovation and Skills **Other departments or agencies:**	**Contact for enquiries:** John Conway john.conway@bis.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: Green

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
£392.1m	£392.1m	£-7.0m	Partially in Scope	OUT

What is the problem under consideration? Why is government intervention necessary?

UK incorporated undertakings prepare and file statutory accounts in compliance with rules set down in the Companies Act 2006 (derived from EU Directives). The EU has updated and consolidated existing Directives for statutory annual accounts and reports into a single new 'Accounting Directive'. The Directive introduces greater harmonisation of the small company regime and provides many options and flexibilities to allow Member States to reflect national frameworks and accounting traditions. Implementation of the Directive is required by July 2015. The Government must decide how best to implement it with the aim of reducing the number of unnecessary regulations that place a burden on business whilst maintaining confidence in the integrity of the UK's well-established accounting and audit frameworks.

What are the policy objectives and the intended effects?

To make the UK one of the best places in Europe to start, finance and grow a business by reducing unnecessary regulatory burdens associated with the preparation and publication of statutory annual reports. In particular to ensure the implementation of the EU harmonised small company regime effectively reduces the burdens on small companies whilst protecting the interests of third parties, such as creditors and tax authorities, and minimising any adverse impacts on the UK's established accounting and audit framework.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

0. Do nothing – this will not address the unnecessary burdens on business identified by the EU. Also this is not feasible, as the UK is required to demonstrate transposition of the Directive into UK law and must implement the mandatory elements introduced by it. Nevertheless, it should be considered as the status quo and the counterfactual against which to compare the impacts of each of the options. This option therefore maintains all parts of company law as it is.
1. Take the minimum action required by the Directive. Implement only those mandatory changes to the current system which are required by the Directive.
2. Take the minimum action required and take up the option to maximise the size thresholds for the small, medium and large companies' accounting regime only.
3. Implement the EU baseline – in addition to the minimum requirement, reduce the number of explanatory notes currently required by the UK's accounting framework to the accounts to the mandatory 8 notes, and take up the option to increase the size thresholds for small, medium and large companies' accounting regimes.
4. (Preferred Option). As Option 2. But including:
   - Allow the small companies' audit exemption threshold to increase in line with the small companies' accounting regime threshold (to avoid unnecessary confusion for companies were the thresholds to be misaligned, and make more companies eligible for exemption from audit)[1].
   - Remove the provision that the presence of a public company in a group makes the group an ineligible group for the purposes of the small companies' audit exemption.
   - Adopt the new Audit Directive[2] amendment so that new mandatory audit reporting requirements need only be based on the work undertaken in the course of an audit (rather than additional work).

[1] The Accounting Directive excludes all small companies (apart from Public Interest Companies) from the audit requirement.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 12/2020					
Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:**	**Non-traded:**	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: Jo Swinson Date: 26 March 15

[2] Directive 2014/56/EU

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 15.0	**High:** 306.7	**Best Estimate:** 86.4

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	1.8	1	0	**1.8**
High	5.9		0	**5.9**
Best Estimate	3.4		0	**3.4**

Description and scale of key monetised costs by 'main affected groups'

Option 1 will have familiarisation costs for companies totalling an estimated £3.1m. Familiarisation costs will apply both to companies preparing their own accounts and to accountants and book-keepers who prepare accounts for small companies. The familiarisation cost is estimated at £4.90 per company compiling their own accounts, and £4.20 for each accountancy firm. There will also be transition costs to Companies House relating to upgrading their systems. These have been estimated at around £287,000 (a slight increase over earlier estimates due to evidence received through consultation). Total one-off costs are thus £3.4m.

Other key non-monetised costs by 'main affected groups'

Unquantifiable costs arise from the new small company regime's minimum disclosure requirements: a loss of information for stakeholders, and possibly companies, resulting from reduced disclosures. There will be costs to HMRC as a company's accounts are the starting point for its Corporation Tax computation (i.e. staff costs associated with familiarisation with the new regulatory environment and potential adaptations to assessment processes). Audit companies will need to do additional work looking at an entity's activity to provide an opinion on the latter's strategic report's compliance – which could be passed onto companies.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	1	2.4	**20.7**
High	0		35.8	**308.2**
Best Estimate	0		10.4	**89.5**

Description and scale of key monetised benefits by 'main affected groups'

There will be benefits to 3.022m existing small businesses and a further 1,000 medium sized companies which will be classified as small as a result of the harmonisation of the small company regime and increased size thresholds. These benefits total an estimated £10.4m per annum and result from time savings to these companies and accountants/bookkeepers due to the reduction in the number of required disclosures to the accounts.

Other key non-monetised benefits by 'main affected groups'

Non-monetised benefits to companies arise from simplification of accounts, and greater comparability and consistency of their financial reporting (particularly for small companies) due to harmonised formats and group thresholds. Auditors' opinions on compliance of the management report should improve narrative reporting.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

Estimated savings from reduced notes to the accounts are based on survey evidence from the European Commission. However there is a risk that this overestimates the savings as some anecdotal evidence from the consultation on the Micros Impact Assessment (IA No: RPC12-FT-BIS-1676) in 2013 suggests that the preparation of notes is largely automated in the UK. As part of the Accounting Directive consultation we sought to test our saving assumption by asking stakeholders about the potential benefits of the proposed changes. (A prompt seeking data and supporting explanations was included against each question posed where it was appropriate to do so). Although no specific information on the estimated savings was provided by stakeholders to allow us to refine our savings estimate, stakeholders did not challenge the consultation stage Impact Assessment's savings estimates. The consultation indicated that companies might benefit from the greater flexibility but would need to consider more carefully the contents of their financial reports and no further information was received that would enable us to refine our estimates.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: 0.3	**Benefits:** 7.9	**Net:** 7.6	Yes	Out

Summary: Analysis & Evidence

Policy Option 2

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 15.0	**High:** 307.5	**Best Estimate:** 86.4

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	1.8	1	0	**1.8**
High	6.0		0	**6.0**
Best Estimate	3.4		0	**3.4**

Description and scale of key monetised costs by 'main affected groups'

The same familiarisation costs as for Option 1 will arise. There will be additional familiarisation costs incurred by an additional 360 medium-sized UK companies which fall into the scope of the increased thresholds for the small company regime, prepare their own accounts and will take up the exemption (£1,800). There will be familiarisation costs of £1,800 to similar ineligible medium-sized companies. Total one-off costs are still of the magnitude of £3.4m.

Other key non-monetised costs by 'main affected groups'

Non-monetised costs will be as in Option 1, but with the costs also affecting those medium-sized UK companies which fall into scope of the increased thresholds for the small company regime, who prepare their own accounts and who will take up the exemption. The non-monetised costs for this group resulting from the loss of information and transparency may be higher than for existing small companies.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	1	2.4	**20.7**
High	0		35.9	**309.0**
Best Estimate	0		10.4	**89.5**

Description and scale of key monetised benefits by 'main affected groups'

Benefits will be as in Option 1, but these will also apply to medium-sized UK companies which fall into the scope of the increased thresholds for the small company regime. We estimate benefits from the reduced number of notes of £20 per company, which will be realised by an estimated 130 companies who compile information especially to prepare the disclosures, prepare their own accounts and will take up the exemption. This results in an estimated additional benefit of £2,500 per annum above those achieved by Option 1. Annual average benefits are £10.4m.

Other key non-monetised benefits by 'main affected groups'

Additional non-monetised benefits arise to companies and stakeholders due to the simplification of accounts and a greater level of comparability and consistency of financial reporting across the EU, particularly for small companies. These would be expected to be greater than in Option 1 due to the wider coverage of the simplification i.e. slightly more companies will be classified as small and will therefore be able to take advantage of the simplification if they wish.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

There is a risk that the savings estimates from reduced notes to the accounts are overestimates, which we sought to test through the consultation. Although no specific information on the estimated savings was provided by stakeholders to allow us to refine our savings estimate, stakeholders did not challenge the consultation stage Impact Assessment's savings estimates. The consultation indicated that companies might benefit from the greater flexibility but would need to consider more carefully the contents of their financial reports. No further information was received that would enable us to refine our estimates.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies
Costs: 0.3	**Benefits:** 7.9	**Net:** 7.6	Yes	Out

Summary: Analysis & Evidence

Policy Option 3

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 40.8	**High:** 649.2	**Best Estimate:** 185.4

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	1.8	1	0	**1.8**
High	6.0		0	**6.0**
Best Estimate	3.4		0	**3.4**

Description and scale of key monetised costs by 'main affected groups'

Option 3's monetised costs are estimated at £3.4m. Familiarisation costs may be slightly higher than in Option 2 as the reduction in the number of mandatory notes represents a greater change from the status quo. Although the consultation did not provide sufficient evidence to quantify this difference, the majority of consultation responses confirmed that they expected that this option would lead to greater familiarisation costs and more uncertainty than other options.

Other key non-monetised costs by 'main affected groups'

Option 3 will have greater non-monetised costs than option 2 resulting from the removal of the 5 additional notes from the accounts. UK generally accepted accounting principles (GAAP) requires companies' financial statements to present a 'true and fair' view of their financial affairs. Whilst the information provided in some notes is considered non-essential for small companies, (i.e. dispensable without resulting in adverse impacts), these specific optional notes are considered essential to underpin the basis of the 'true and fair' view as required within UK company law. Without these notes, companies would need to consider further whether their annual accounts met this requirement, and if not, would have to present the necessary information to comply. This could lead to further costs and burdens [unquantifiable due to the potential for variability and lack of evidence in consultation responses] and would risk jeopardising the integrity of the UK accounting framework as perceived by third parties such as creditors and tax authorities. This view was almost unanimously supported by consultation respondents. They also agreed that since the 5 additional notes would not be relevant in every set of accounts they were unlikely to be burdensome for small companies generally.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	1	5.4	**46.5**
High	0		75.6	**650.7**
Best Estimate	0		21.9	**188.5**

Description and scale of key monetised benefits by 'main affected groups'

Benefits will be as in Option 2, with further benefits resulting from additional time savings from the removal of a further 5 notes from the accounts. Benefits will apply to the same companies as in Option 2.

Other key non-monetised benefits by 'main affected groups'

As Option 2. There will be additional non-monetised benefits to companies and stakeholders due to the simplification of accounts and a greater level of comparability and consistency of financial reporting across the EU as a consequence of abridged reporting formats and largely standardised reporting based on company size. Comparability is improved particularly for smaller companies as a result of a harmonised small company regime.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

-There is a risk that the savings estimates from reduced notes to the accounts are overestimates. Although no specific information on the estimated savings was provided by stakeholders to allow us to refine our savings estimates, stakeholders did not challenge the consultation stage Impact Assessment's savings estimates.

-UK GAAP requires companies' financial statements to present a 'true and fair' view of their financial affairs. Through discussions with stakeholders, including professional bodies, during the negotiation stage of the Directive, there was consensus that these notes are the minimum necessary to enable a company to provide a 'true and fair' view. Without these notes companies would certainly need to consider further whether their annual accounts met this requirement, and if not, would have to present the necessary information to comply. This view was confirmed by the majority of consultation respondents who stated that this option could lead to further costs and burdens, and risks of compliance failure as the need for 'true and fair' view stands regardless. However specific information on the level of these additional costs was not provided to enable us to refine our estimates.

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies
Costs: 0.3	**Benefits:** 16.7	**Net:** 16.4	Yes	Out

Summary: Analysis & Evidence

Policy Option 4

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2014	PV Base Year 2015	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 316.8	**High:** 774.5	**Best Estimate:** 392.1

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	5.7	1	0	**5.7**
High	17.4		0	**17.4**
Best Estimate	11.0		0	**11.0**

Description and scale of key monetised costs by 'main affected groups'

The same transitional costs as for Option 2 will arise. In addition, allowing the small company audit exemptions threshold to rise in line with the increased small company accounting regime generates additional familiarisation costs for affected companies' managers/directors, estimated at £36,500. The total cost of micro-entities familiarising themselves with the removal of the requirement to prepare a Director's Report is estimated at £7.6m. Total costs will be £11.0m

Other key non-monetised costs by 'main affected groups'

Non-monetised costs will be as in Option 2, but with the additional costs (loss of information and transparency for stakeholders) affecting eligible companies which take up the small company audit exemption. The costs will also apply to micro-entities which no longer produce a Director's Report (although these are expected to be negligible). There may be additional non-monetised costs for this group resulting from the loss of information and assurance provided by auditing. More undertakings will be exempt from undergoing an audit, which will provide less assurance to shareholders, investors and third parties with an interest in these undertakings.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0	1	38.8	**334.0**
High	0		90.6	**779.9**
Best Estimate	0		46.8	**402.8**

Description and scale of key monetised benefits by 'main affected groups'

Benefits will be as in Option 2, but will also include additional annual benefits to companies that become eligible for, and take-up, the small companies' audit exemption. These savings will be two-fold: 1) companies taking up the exemption will no longer have to pay an audit fee; and 2) they will save management time which would have been spent on engaging with their auditors. A truncated average audit fee for companies that become eligible is estimated at £12,200, leading to a savings of £36.4m across companies who take up the exemption. The average corporate manager and director hourly wage is £29.58 (uplifted for non-wage labour costs). An estimated 2 hours of engagement with auditors per manager, leads to savings of around £175,000 across companies who take up the exemption.

Other key non-monetised benefits by 'main affected groups'

The non-monetised benefits of Option 2 apply. There will be non-monetised administrative savings to micro-entities that no longer produce Director's Reports. Additional non-monetised benefits also arise from taking up the part of the new Audit Directive[1] which allows auditors to express an opinion on the compliance of the management report with applicable legal requirements, based only on the work undertaken during the audit. This should improve narrative reporting and enable shareholders, investors and creditors to make more balanced judgements about companies' performance, but be more proportionate for audit companies than Option 1.

Key assumptions/sensitivities/risks — Discount rate (%): 3.5

-Increasing the small company audit exemption threshold will give rise to additional familiarisation costs (affecting company managers and directors of companies that become eligible for exemption under the new threshold).
-40% of companies newly eligible for the exemption will take it up (assumed based on an ICAEW 2014 research).
-The average audit fee of companies eligible for the exemption is £12,200 (a 1.5% truncated average, in line with a past audit exemption IA). This method excludes outlying, high audit fees that may distort the savings estimates.

BUSINESS ASSESSMENT (Option 4)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies
Costs: 0.9	**Benefits:** 7.9	**Net:** 7.0	Partially in Scope	OUT

[1] Directive 2014/56/EU

Executive summary

The Accounting Directive introduces updated terminology and refers to undertakings and financial statements. It provides a definition of financial statements (as a minimum) which will comprise the balance sheet, the profit and loss account and the notes to the financial statements. For the purposes of this document we have continued to use the terms ‘company’ and ‘accounts’ which are commonly used in the UK.

1. Problem under consideration and rationale for intervention

The Accounting Directive applies to all incorporated companies and establishes the minimum legal requirements for the preparation and publication of annual statutory accounts at EU level. The EU has identified the preparation of financial statements as one of the most burdensome obligations for incorporated companies[2]. The previous Accounting Directives focused on the requirements for large and listed companies to ensure the accounts provide relevant and adequate information to assist shareholders and management to make informed decisions on the allocation of capital, and to protect the interests of users of those accounts and reports. The previous Directives provided a range of exemptions and Member State options to relieve Small and Medium-Sized Enterprises (SMEs) from certain requirements/obligations, but on the whole, SMEs were still required to prepare accounts in compliance with burdensome and complex financial reporting procedures that are designed for large and listed companies.

The Accounting Directive provides over 100 Member State options to enable Member States to adapt the Directive effectively and in accordance with national accounting frameworks. It also introduces, for the first time, a harmonised small company regime, which will enable greater simplification and burden reduction for small companies within the EU. The harmonised regime will also lead to a greater level of comparability and consistency of financial reporting across the EU, particularly for small companies.

It is also proposed to allow[3] the small companies’ audit exemption threshold to rise in line with the small companies’ accounting regime threshold; and to remove from the small companies’ exemption the provision that public companies in a group make the group an ‘ineligible group’.

The Accounting Directive takes a different approach to earlier Accounting Directives in respect of the audit requirement for small companies. The Directive no longer includes small companies, other than those that are Public Interest Entities, within the audit requirement.

The Government’s objective of reducing administrative burdens, particularly for small companies, is of key importance, and aspects of the Accounting Directive support these aims. However, the Government recognises that any changes to the rules governing statutory accounts should not impact on the integrity of the UK’s well established accounting framework; and companies must continue to provide assurance on the information contained in the accounts for third parties such as creditors, shareholders and tax authorities. Similarly changes to the auditing framework must be balanced against the need to maintain the integrity of the UK’s audit framework.

The Department believes that the current approach of allowing the small companies’ audit exemption thresholds to increase in line with the small companies’ accounting regime threshold should be retained. This reflects:

- the longstanding process to align the thresholds;
- the view that even those companies between the current and increased thresholds would not generally have more than a small number of shareholders who would normally be expected to

[2]http://ec.europa.eu/internal_market/accounting/docs/sme_accounting/review_directives/SEC_2011_1289_1_en.pdf

[3] We are “allowing” the increase in the small companies’ audit exemption thresholds, in the sense that no amendment is needed to Part 16 of the Companies Act 2006 in order to introduce this change, alongside that to increase the thresholds in the small companies’ accounting regime. This is because, rather than setting out the small company thresholds again for the purposes of the small companies’ audit framework, as the same thresholds currently apply, the Companies Act simply cross-refers to the thresholds set out in the Companies Act on small companies’ accounts. This is a result of a previous decision as to the legislative drafting of the Act, which would not need to be disturbed if we were to allow both the accounting and audit thresholds to be increased in line with one another. Were a divergence between the accounting and audit the thresholds to be implemented, the current drafting approach would need to be revised. However while the current approach is in place, the decision to allow the increase in the audit exemption thresholds would still be a deliberate effect of UK policy and an active decision would need be taken as to the effect of the amended regulations on the accounting and audit frameworks.

take sufficient interest in the company to secure an audit when one was needed and are likely to have information upon how the board has sought to prepare the accounts;

- the view that the value of audit, as a signal to lenders and investors that can lead to a reduction in the cost of capital to the undertaking, is increased where that audit is voluntary rather than mandatory; and
- the comparatively small number of undertakings that we think are affected – for the Impact Assessment on this change we identified approximately 7,400 companies.

Overall the EU's **rationale for intervention** is to address the disproportionate impact of **government failure** in some Member States **by reducing the unnecessary administrative burdens on small companies** arising from existing regulations; and to enable companies to focus their resources on growing their businesses, and innovating products and services as part of wider economic growth. The UK has taken up options previously available to reduce the mandatory obligations on small companies. However, the new small company regime offers the opportunity to reduce burdens further by increasing the small company threshold criteria and bringing more companies within the scope of the regime.

2. Options and policy objectives

The Government's objective is to reduce administrative burdens associated with: 1) the preparation and publication of statutory annual accounts, in particular to implement effectively the new harmonised small company regime; and 2) preparing for, and undertaking, annual audits. The government aims to achieve these objectives while maintaining the integrity of the UK's established company law framework (and its associated benefits).

- **Option 0: Do nothing.**

  This would not address the regulatory failure of current unnecessary regulations placing a burden on business as identified by the EU. Also it is not feasible as the Directive must be implemented by 20 July 2015.

- **Option 1: Take the minimum action required by the directive. Implement only those mandatory changes to the current system which are required by the Directive**

  Reduce the number of notes to the accounts to the mandatory 8, take up the member state option in Article 16(2) of the Directive to require small companies to provide an additional 5 disclosures in the notes to the accounts which are currently required in UK company law and which support the presentation of a true and fair view of the financial position of the company; and implement the new mandatory small company threshold criteria of €8,000,000 net turnover and €4,000,000 balance sheet total (approximately £6.8 million and £3.3 million, up from £6.5 million and £3.26 million respectively). This option also takes action to change which dormant and subsidiary companies qualify for the small company audit exemption[4]; and it requires auditors to express an opinion on the compliance of the management report with applicable legal requirements and state whether any material misstatement has been identified.

- **Option 2: Take the minimum action required, plus take up the option to the increase the size threshold for the small companies' accounting regime.**

  As Option 1, plus take up the Member State option to increase the size threshold for small companies to a maximum of €12,000,000 net turnover and €6,000,000 balance sheet total (approximately £10.2 million and £5.1 million respectively). Increase the size threshold for medium companies to a maximum of €40,000,000 net turnover and €20,000,000 balance sheet total (approximately £36 million and £18 million respectively); and increase the size threshold for large companies to a minimum of €40,000,000 net turnover and €20,000,000 balance sheet total. This would require an amendment to Part 16 of the Companies Act 2006 to insert specific audit exemption thresholds as small companies' audit exemption thresholds would no longer align with the small companies' accounting regime thresholds.

[4]To change the references in the subsidiary audit exemption and the dormant company audit exemption from 'quoted companies' being excluded from the exemptions to 'companies with securities admitted to trading on a regulated market' being excluded from the exemptions.

- **Option 3: Implement the EU baseline – reduce the notes to the accounts to the mandatory 8 notes, and take up the option to increase the size threshold for small companies.**

  This option is considered to be the EU baseline and will create the lowest administrative burden on companies. However the removal of the 5 additional notes risks jeopardising the integrity of the UK accounting framework for third parties such as creditors and tax authorities.

- **Option 4 (preferred option): As Option 2. But including:**
  - Allow the small companies' audit exemption threshold to increase in line with the small companies' accounting regime threshold in line with current policy. However, because the application date of the proposed increased thresholds for the small companies' audit exemption relates to financial statements for financial years commencing on or later than 1 January 2016, there is time to consider further whether specific audit thresholds should be applied through later amendment. We intend to use the intervening period between now and the application date to seek further views on whether such thresholds are needed.
  - Remove the provision that public companies in a group make the group an ineligible group for the purposes of the small companies' audit exemption.
  - The new Audit Directive amendment so that new mandatory audit reporting requirements need only to be based on the work undertaken in the course of an audit.
  - Greater simplification of the audit regime as a consequence of the removal at EU level of small companies from scope of mandatory audit and the ability to relax the definition of what is an ineligible group from the from the exemption threshold.
  - Remove the obligation for micro-entity companies to prepare a Directors' Report.

3. Costs and Benefits

Option 0 will not address the problem of the unnecessary burden on small companies identified by the EU. Also it is not considered feasible. The Directive imposes changes – e.g. raised thresholds, changes to the small company regime and removal of some notes etc. - which are not consistent with the UK's existing legal framework. The Directive must be implemented by 20 July 2015, and the Government's objective is to ensure that companies obtain the maximum benefit from the changes, whilst maintaining the integrity of the UK's accounting and company law framework. Therefore the focus of the analysis is limited to options 1-4.

The **benefits** associated with implementing the Directive primarily result from the reduction in administrative burdens for small companies due to the reduced disclosures mandated by the harmonised small company regime, and to further simplification of financial reporting, as well as raising the threshold for the small companies' audit exemption in line with the small companies' accounting regime. This has the aim of enabling small companies to focus resources on other aspects of their businesses.

<u>Option 1</u>

- This option will impact all small companies, as well as around 1,000 medium-sized companies[5] who will fall under the revised small company thresholds.
- There will be one-off familiarisation costs for preparers of accounts, including 327,000[6] accountants, 3,500 book-keepers[7] and an estimated 345,000[8] companies who prepare their own accounts and are expected to take-up the exemption and file abbreviated accounts.

[5] Data taken from the FAME database
[6] Financial Reporting Council 'Key facts and trends in the Accountancy Profession' (2014)
[7] The Institute of Certified Book-keepers advised in response to the 'Micro-entities exemption' consultation in March 2013 that there are around 3,500 practising book-keepers in the UK.
[8] See assumptions and calculations later in main text based on 3.027m small companies (FAME database)

- There will be one-off development costs for providers of accountancy software (not quantified in this IA as it is not a requirement of the legislation that such software is used and therefore has to be changed i.e. software providers need not embed the changes within their packages in order for this to provide accounts which are compliant). Also, since software companies would only develop new or upgraded software if the benefits outweighed their costs and customer companies would only buy the product if the benefits outweighed the price, our view is that this would not result in a direct net cost.
- There is a potential for non-monetised costs which could arise from a loss of transparency for stakeholders in small companies, leading to increased costs of raising capital for these companies, where there may be uncertainty over the financial health of the company.
- The requirement for an 'auditors' opinion' on compliance of the management report with applicable legal requirements and for auditors to state whether any material misstatement has been identified. This is likely to increase the cost of an audit for companies (though this is currently un-quantified due to a lack of robust evidence about the potential impact these changes will have on auditors' practice). It is expected audit companies' costs will increase because auditors will be required to do additional work to comply with this requirement. For example, they potentially will have to look back over all the audited entity's activities, including things that are currently outside the scope of a statutory audit and accounting regulations, in order to ensure legal requirements have been met. These costs are likely to be a disproportionately large cost to companies and a significant amount of work for auditors relative to the benefits of providing additional assurance for shareholders, investors and creditors company stakeholders and for mitigating the potential risk of undertakings misleading auditors.

- There will be on-going, monetised benefits associated with the time savings from the reduction in the number of disclosures required on the accounts to 13 (8 mandatory and the additional 5). These time savings are associated with inputting data into the system, rather than preparing/collecting data for the accounts, as the latter won't change.
- Savings may also be limited if companies are subsequently required to provide the information no longer in the public domain to lenders and other third parties after these changes. In these cases, it may be in the company's interest to file full accounts, which we assume 50% of existing small companies and 70% of medium sized companies reclassified as small will do. Before the changes introduced by the Directive are implemented, it will be very difficult for stakeholders to predict the extent to which they will be required to provide the additional information, so we will continue to apply these assumptions relating to uptake of the exemption, and assume all those who do take up the exemption will benefit from the reduced disclosures.
- The requirement for 'auditors' opinions' on compliance of the management report is likely to lead to non-monetised benefits. It should provide additional assurance to stakeholders in the company about the quality and integrity of its narrative reporting and enable shareholders, investors and creditors to make more balanced judgements about companies' performance.

Option 2

- Familiarisation costs will be slightly higher than Option 1 given the wider scope. Also potentially greater non-monetised costs will result from reduced transparency for stakeholders of the additional medium-sized companies falling into scope.
- Benefits will be as for Option 1, with additional minor benefits in the form of time savings for medium-sized UK companies which fall into scope of the new increased thresholds for the small company regime, taken up as a Member State flexibility. We used the FAME database to identify the number of current medium-sized UK companies which fall into the scope of the new increased thresholds for the small company regime as approximately 10,000, in addition to the 1,000 which will fall into scope through the changed threshold covered by Option 1.

Option 3

- Option 3 has additional non-monetised costs compared to Option 2, associated with the risk to the integrity of the UK accounting framework for third parties such as creditors and tax authorities. These costs are considered to create a significant risk of this option. Without these

notes, companies would need to consider further whether their annual accounts met the UK's "true and fair" requirement, and if not, would have to present the necessary information to comply. This could lead to further costs and burdens and would risk jeopardising the integrity of the UK accounting framework as perceived by third parties such as creditors and tax authorities. This view was almost unanimously supported by consultation respondents. Stakeholders confirmed our view that, *where relevant*, disclosures contained in the notes were necessary to show a true and fair view. They also agreed that the 5 additional notes were not going to be relevant in every set of accounts, and were therefore unlikely to be onerous or burdensome for small companies, generally.

- Benefits will be as Option 2, with additional benefits in the form of time savings to all those additional companies within scope which file abbreviated accounts, associated with the removal of the 5 additional notes from the accounts.

Option 4

- The costs arising under Option 2 will also occur under this option. Allowing the increase in the thresholds for the small company audit exemption, so that they remain in line with the increased small company accounting regime exemption thresholds, is expected to generate additional familiarisation costs for affected companies' managers and directors. There will potentially be familiarisation costs associated with the removal of the obligation for 1.55m micro-entity companies to prepare a Directors' Report.

- Benefits will be as Option 2, with additional benefits in the form of time and cost savings for medium-sized UK companies which fall into scope of the increased thresholds for the small company audit exemption. Analysis of the FAME database suggests approximately 7,400 will become eligible after the threshold changes. A 2014 ICAEW business survey[9] found that approximately 60% of medium sized businesses would still use audit services even if they were no longer mandatory. Based on this new evidence we infer that 40% of the 7,400 medium-sized companies who become eligible for the small companies' exemption will take it up (around 3,000). Quantified savings from not having an audit are two-fold: 1) no longer having to pay the auditor an annual audit fee for their audit services; and 2) management time savings. The estimation of these benefits follows the approach taken in a previous IA[10].
- Additional benefits – in terms of reduced administrative burdens on company owners - will come from the option to remove the obligation for micro-entity companies to prepare a Directors' report. The FAME database suggests that there are approximately 1.55m micro-entities in the UK who could potentially benefit from this saving. However, due to insufficient evidence on micro-entity's current practice it has not been possible to quantify this administrative saving. It is also possible that some micro companies will continue to produce Directors' Reports.
- An auditors' opinion on legal compliance of the management report with applicable legal requirements is likely to lead to non-monetised benefits – i.e. additional assurance to stakeholders in the company about the quality and integrity of its narrative reporting and enable shareholders, investors and creditors to make more balanced judgements about companies' performance. However, the requirement to base the 'auditor's opinion' on the work undertaken during the course of the audit provides a more proportionate (less burdensome) approach for audit companies than under Option 1.

Direct Cost to Business following OITO Methodology

Option 1 involves taking the minimum action required by the Directive – i.e. implementing only those mandatory changes to the current system which are required by the Directive. This option is in-scope of OITO, as it is not possible for the UK to take up all the derogations in the Directive (even under an option that represents the minimum action required by the Directive). It has an EANCB of £-7.6m, and counts as an OUT.

[9] ICAEW (2014), 'The 99.9%: small and medium-sized businesses; Who are they and what do they need?'
[10] Audit Exemptions IA, BIS 0301, http://www.legislation.gov.uk/ukia/2014/286/pdfs/ukia_20140286_en.pdf

Option 2 takes up Member State flexibility to maintain additional notes for small company disclosures already required by UK Company Law and UK accounting standards. These additional notes will go beyond the minimum requirement of the Directive and therefore this option is in-scope of OITO. However this option represents a reduction in the number of notes currently required by UK regulation and reduces the gold-plating compared to the existing UK higher-standards. This option carries a negative EANCB of £-7.6m and therefore counts as an OUT.

The RPC case histories[11], 'existing higher standards' section, suggests 'if some or all of the existing higher standards are removed, this is a reduction in gold plating relative to the counterfactual ['Do Nothing'] and so qualifies as an OUT'. Therefore Option 3 should be classified as in-scope of OITO Option 3, and classified as an OUT. Option 3 has a negative EANCB of £-16.4m.

Option 4 is the preferred option. This measure contains the same policies as Option 2, but with some additional changes regarding audit and an exemption for producing Directors' reports for micro-entities. It is partially in scope of OITO. The reduction in the number of accounting notes, also included under Option 2, is in-scope of OITO for the reasons stated above. The net benefit to business of the increase in the audit exemption thresholds is not in-scope of OITO, as the de-regulatory effect is of EU origin (i.e. it was prompted by the Directive's change in the accounting size thresholds). Option 4 has a negative EANCB of £-7.0m and counts as an OUT.

Net Present Value

We propose Option 4 as the preferred approach to implementation. This option is the more beneficial to companies - in net present value terms than other proposed options.

Option	Best Estimate of Net Present Value of Business Benefits Minus Business Costs
Option 0	£0m
Option 1	£86.4m
Option 2	£86.4m
Option 3	£185.4m
Option 4	£392.1m

[11] Regulatory Policy Committee, Impact Assessment Case Histories

Background

This Impact Assessment relates to proposals to implement the measures contained in Chapters 1 – 9 of the Accounting Directive (2013/34/EU). Chapter 10, which deals with the reporting of payments to governments by companies active in the extractive industries, has been implemented separately.

Problem under consideration

The EU has identified the preparation of the statutory annual accounts as one of the most burdensome obligations for incorporated companies[12]. EU-level consultations and analysis indicate that micro and small companies face higher administrative burdens compared to medium and large companies. The analysis highlights that a large company may spend €1 per employee to comply with a regulatory duty; this cost rises to €4 per employee for a medium sized company, and for small companies with the highest burden may be up to €10 per employee. The Directive aims to simplify the statutory accounts to make them less burdensome and more suited to users' needs.

Current EU accounting requirements subject small companies to the same financial reporting obligations as larger companies. In particular, disclosures in the notes to the accounts at the same level of detail as large companies are required. The EU IA noted that without a definition of materiality in the previous directives, many small companies are providing unnecessary information to meet regulatory requirements.

The UK's existing small company regime incorporates Member State options exempting small companies from certain financial reporting obligations. The Companies Act 2006 requires all companies to prepare and circulate the full accounts to all members of the company, but permits medium sized and small companies to file abbreviated accounts at Companies House.

The Accounting Directive updates the current 4th and 7th Company Law directives which set down the financial reporting obligations for limited liability companies. It modernises the language to adopt current terminology and consolidates the rules for individual statutory accounts and group accounts into the one measure. The EU has introduced a principles-based approach to the rules and restructured the measure to reflect a building-block approach. The Directive now sets out more clearly the information that all companies must provide, with increasing levels of disclosure dependent on company size, resulting in the largest companies, and those categorised as public interest entities, providing the greatest level of disclosure.

The Directive has introduced a harmonised small company regime with mandatory minimum thresholds for small companies to bring about greater consistency and comparability across Member States. The Directive also revises, and makes mandatory, the financial thresholds for medium and large companies.

A small company is defined as not exceeding two out of the following three criteria:

Balance sheet total: €4,000,000 (£3,392,800)

Net turnover: €8,000,000 (£6,785,600)

Average number of employees during the financial year: 50

A medium sized company is defined as not falling into the small company definition and not exceeding two out of the following three criteria:

Balance sheet total: €20,000,000 (£16,965,000)

Net turnover: €40,000,000 (£33,930,000)

Average number of employees during the financial year: 250

In addition, the EU has introduced a further flexibility enabling Member States to increase the small company accounting thresholds and small company audit exemption thresholds to the following:

[12] http://ec.europa.eu/internal_market/accounting/docs/sme_accounting/review_directives/SEC_2011_1289_1_en.pdf

Balance sheet total: €6,000,000 (£5,089,200)
Net turnover: €12,000,000 (£10,178,400)
Average number of employees during the financial year: 50

The UK Government proposes to take up this flexibility to enable more companies who meet the criteria to opt into the small company regime. The FAME[13] database indicates that approximately 11,000 companies currently classified as medium-sized will be in scope of the harmonised small company regime following an increase to the thresholds. 1,000 of these would be classified as small as a result of the new minimum threshold, and a further 10,000 would be classified as small as a result of taking up the flexibility to increase the threshold to the higher level.

Furthermore, under the preferred option, the UK Government intends to allow the small companies' audit exemption thresholds to rise to the same levels as the small company accounting regime thresholds. Reflecting current policy this change would make company law simpler for companies whom are assessing whether they are eligible for exemptions – compared to having differing accounting and audit thresholds. It will also make more companies eligible for an exemption from audit – saving companies time and resources that could be deployed for other uses.

The new harmonised regime is deregulatory in effect. It limits the amount of information Member States may obtain from small companies by introducing a mandatory level of disclosure consisting of eight notes to the accounts, and provides a Member State option for a further five notes specified in the Directive. These disclosures currently are considered to underpin the basis of a 'true and fair' view of companies' financial affairs in the UK's accounting framework.

The UK has already adopted existing options that enable UK companies to take advantage of certain exemptions to assist in the reduction of administrative burdens, most of which are now an integral part of the Companies Act 2006 small company regime. However, there are some new Member State options contained in the Directive on which the Government has consulted. After the close of the consultation the Government is now considering how best to implement the Accounting Directive in the UK.

A. Rationale for intervention

The Government wants to reduce the number of unnecessary regulations that place a burden on businesses whilst retaining the integrity of the UK accounting, audit and company law frameworks. The EU measures are designed to address a regulatory failure where existing regulations are not fit for purpose and impose a disproportionately high burden relative to the benefits achieved. The measures here are expected to reduce the unnecessary administrative costs imposed on small companies by the previous directives, and enable companies to focus on growing their businesses and creating employment opportunities. This deregulatory aspect of the Directive could potentially lead to a small cost in terms of lost transparency and assurance for investors. However, some stakeholders (banks, other finance providers and HMRC) have the power to request extensive financial information from companies, and so do not necessarily rely only on company financial statements. Furthermore, public interest entities (e.g. listed companies and credit institutions) will still be mandated to have an audit under the Directive.

The rationale for company reporting requirements is best represented as a principal-agent problem. Shareholders (the principal) delegate the responsibility of company management to company executives (the agent). It is this separation of ownership and control, which generates a potential informational asymmetry because shareholders, and other stakeholders[14], do not have full information on the performance of their executives. Financial reporting requirements for companies aim to reduce this asymmetry by making companies as transparent as possible.

However, for many small companies, this principal-agent arrangement does not hold as strongly as the financial statements are not the main source of information for shareholders and other stakeholders in small companies. Of the 3.022m small companies (source: *FAME database*) on the

[13] FAME description
[14] E.g. lenders, trade creditors, employees etc.

UK register, 67%[15] have only 2 or fewer shareholders. In such circumstances, the shareholder is likely to be closely associated with the management of the company and have access to its financial records. Therefore the costs associated with financial reporting requirements may be disproportionate to the value of the financial statements for shareholders and other stakeholders and may not deliver significant benefit to them.

The majority of respondents who expressed an opinion (68%) to the public consultation supported a change to maximise the small company thresholds and provide as many eligible companies as possible with the opportunity to access the small company accounting regime. The general view was that this change would benefit many companies without a corresponding cost or disadvantage and that the increase in thresholds would reduce the burden on small businesses. Grant Thornton commented that, “we agree that the small company accounting thresholds should be maximised. In our view to set a lower threshold would reduce the competitiveness of smaller UK companies not only domestically but also internationally, in particular with other EU Member States that are intending to take advantage of the maximum thresholds permitted”. Furthermore, the majority of respondents who expressed an opinion (55%) wanted small companies who are members of a group which includes a public company to be able to access the small companies’ accounting regime as well. Deloitte commented that “Small companies which are members of a group which includes a Public Interest Entities (PIE) should be able to access the small companies accounting regime. We believe this could substantially reduce the reporting burden for otherwise small companies within what are currently termed “ineligible groups” and that the Government should take advantage of the opportunity to remove the concept of an “ineligible group” from company law”.

In relation to audit, the Government’s view is that allowing the extension of the small companies’ audit exemption to encompass more companies will reduce administrative burdens without causing deterioration of the quality of financial information. A similar view was highlighted by a number of the consultation respondents, who welcomed the simplification and reduced burdens that resulted from continuing to align the audit and accounting small companies’ thresholds. CIMA commented that, “CIMA does not see any discernible benefit for the audit exemption framework in the Companies Act to have to explicitly set out the current thresholds so that those thresholds continue to apply for the purpose of audit exemption, while the thresholds that apply for the purpose of the small companies accounting regime are increased. CIMA believes that the thresholds for the small companies audit exemption should be increased in line with thresholds for the small company regime for accounting purposes”.

A further consideration affecting the small companies’ audit threshold is the expected implementation of the new Audit Directive and Regulation. It is arguable that allowing companies, should they wish to, to take up audit exemption ahead of the implementation of the Audit Directive may be preferable to the impact of the audit changes that would be experienced if they continued to have to be audited. This is what we are proposing here.

In any case, HMRC has powers to ask for additional explanations and information, where it feels this is necessary. Banks will also be able to request that companies to whom they lend produce additional information or verification as a condition of their lending. A recent ICAEW report[16] indicates a substantial proportion of small and medium-sized businesses did not feel the need for a mandatory audit. These companies may choose to implement more appropriate alternative services, which are less burdensome and more useful, or to put their resources to better use if able to be exempt from audit.

There are, however, concerns arising about certain companies being able to take advantage of the audit exemption. This is why, alongside allowing the increase in thresholds, we will continue to exclude public companies and all companies with securities admitted to trading on a regulated market from this exemption in view of the nature of the relationship between these companies and the investing public.

[15] Collis 2012, Determinants of voluntary audit and voluntary full accounts in micro- and non-micro small companies in the UK

[16] ICAEW (2014), ‘The 99.9%: small and medium-sized businesses; Who are they and what do they need?’

In addition to the reduced costs, the Department believes that the current approach of aligning the small companies' audit exemption thresholds with the small companies' accounting regime threshold is the right judgement and has retained this arrangement. This reflects:

- a longstanding process to align the thresholds;
- the view that even those companies between the current and increased thresholds would not generally have more than a small number of shareholders, who would normally be expected to take sufficient interest in the company to secure an audit when one was needed and are likely to have information upon how the board has sought to prepare the accounts;
- The comparatively small number of undertakings that we think are affected – for the Impact Assessment on this change we identified approximately 7,400 companies.

Another alteration with regards to audit policy is to enable small companies in the same group as a public company to access the small companies' audit exemption. This change needs to be considered in the context of the change to the accounting rules, so that small companies who are members of a group which includes a public company are able to access the small companies' accounting regime. The results of the public consultation show that a number of stakeholders want a consistent approach to be applied across both audit and accounting exemptions. EY commented that, "We consider that the exclusions should be consistent for the purposes of the small companies' audit exemption and accounting exemptions, unless there is a good reason". Another respondent said that the same rules should apply to the small companies' accounting exemptions and audit exemptions. Another argued there was no reason to introduce inconsistencies in this area. One response argued that a small company should not be prevented from taking the exemption simply because another entity within the group is public. The change will mean a reduction of burdens for small companies in the situation of being in the same group as a public company, and simplification because businesses will not need to manage issues around different exemptions for accounting and audit purposes.

All consultation respondents who expressed a view were in favour of Option 4's proposal that the auditors' opinion on compliance of the management report with applicable legal requirements need only be based on the work undertaken in the course of the audit.

There are 1.55 million micro-entities in the UK according to the FAME database. These companies will potentially benefit from the deregulatory measure to remove the requirement for them to produce a Director's Report. In many micro-entities the members of the company and the company directors are the same individuals, and therefore it is unlikely in many cases that benefits arise from the preparation of the Director's Report. This change was supported by 65% of consultation respondents who expressed an opinion and is likely to reduce administrative burdens further on micro-entities related to accounts.

B. Policy objectives

The 'Plan for Growth'[17] published in March 2011, set out the Government's ambition "to make the UK one of the best places in Europe to start, finance and grow a business". It identified that this could be achieved, partly, by lessening the domestic regulatory burden on business. The Accounting Directive offers government the opportunity to reduce the regulatory burden on small businesses and offer benefits to small companies by enabling them to focus on their business performance and growth rather than administration.

The policy objectives are:

- to reduce administrative burdens associated with the preparation and publication of statutory annual accounts, whilst continuing to protect the interests of third parties such as creditors, shareholders and tax authorities;
- to implement effectively the new harmonised small company regime;
- to ensure the changes are implemented effectively whilst maintaining confidence in the integrity of the UK's established accounting and audit framework; and

[17] https://www.gov.uk/government/publications/plan-for-growth--5

- To maintain the link between the small company accounting and audit regime size thresholds, to: 1) avoid unnecessary regulatory complexity that may arise if the thresholds were not aligned, and 2) reduce administrative burdens on companies by making more eligible for exemptions.

C. Options considered

We propose four options, including do nothing. Option 0 would not address the unnecessary burdens on small businesses identified by the EU. Also it is not considered feasible. The Directive introduces changes which are not compatible with the UK's existing framework – e.g. the UK currently has around 17 notes to the accounts which are required to meet minimum requirements, and these must be reduced to a maximum of the mandatory 8 and optional 5 notes. The Directive must be implemented **by 20 July 2015**. Certain aspects of the Directive are mandatory and will be implemented.

There are a very large number of Member State options in the Accounting Directive. In the consultation document, we said that in implementing the provisions of the new Accounting Directive, the Government's priority is to maintain the integrity of, and confidence in, the UK's well-respected accounting and financial reporting framework. The Directive does not set out to make significant changes to the fundamentals of the EU financial reporting and, as such, most of the Member State options previously available were retained. For the majority of these previously available Member State options, the UK has well-established positions. The consultation document noted that it is not intended that these positions will change. A technical reference table[18] of options indicating the UK's position on each was published alongside and was referenced by the consultation document. In the consultation package[19] we highlighted options, such as maximising small company thresholds and abbreviated accounts, which could offer savings. Subsequent re-evaluation and consultation[20] has not provided any evidence that our position should change. In particular, none of the responses received argued against the proposed approach or sought a review of options not considered as part of the consultation. To avoid unnecessary costs it is important to maintain continuity and only make changes that are beneficial to users and preparers of accounts. Therefore we have taken up the options which offer real savings to industry such as the thresholds.

The Government's objective is to ensure that undertakings obtain the maximum benefit from the changes, whilst maintaining the integrity of the UK's accounting and company law framework. Full implementation of all the options permitted the Directive could result in confusion and a loss of confidence in the UK's accounting framework, potentially leading to wider economic consequences. *Therefore the focus of the analysis is limited to options 1-4.*

- **Option 0: Do nothing.**

  Option 0 would not address the unnecessary burdens on small businesses identified by the EU. Also it is not feasible as the Directive must be implemented by 20 July 2015.

- **Option 1: Take the minimum action required by the directive. Implement only those mandatory changes to the current system which are required by the Directive**
  - Reduce the number of notes to the accounts to the mandatory 8, plus take up the Member State option in Article 16(2) of the Directive to require small companies to provide an additional 5 disclosures in the notes to the accounts. Adjust the small company threshold in line with the mandatory requirement. The inclusion of the 5 additional notes specified in Article 16(2) for small companies will ensure that these companies will more readily continue to comply with UK Generally Accepted Accounting Practice (UK GAAP). Small companies with the simplest business models will not need to consider the requirement to provide more information. This

[18] A technical reference table can be found at https://www.gov.uk/government/consultations/eu-accounting-directive-smaller-companies-reporting. The Government, working with stakeholders, considered every option set out in the Accounting Directive (2013/34/EU). Where the UK already has a well-established position and there are no obvious areas for concern, no change was proposed.

[19] The consultation package presented all the options to stakeholders with commentary on their purpose and status. https://www.gov.uk/government/consultations/eu-accounting-directive-smaller-companies-reporting

[20] The consultation package presented all the options to stakeholders with commentary on their purpose and status. https://www.gov.uk/government/consultations/eu-accounting-directive-smaller-companies-reporting

will reduce the burden imposed upon those companies. This approach will enable UK companies to benefit from simplification and burden reduction measures in the preparation and publication of their accounts, whilst enabling the UK to retain key disclosures in the financial statements that stakeholders consider necessary to underpin the presentation of the 'true and fair' view required by company law. All small companies may voluntarily continue to disclose more information if they wish - some small companies will continue to need to provide additional disclosures, as relevant, where their more complex business structures/activities trigger additional requirements. This option also takes action to change which dormant and subsidiary companies qualify for audit exemption[21], and require auditors to express an opinion on the compliance of the management report with applicable legal requirements and to state whether any material misstatement has been identified.

- **Option 2: Take the minimum action required, plus take up the option to increase the size threshold for small companies.**

  As Option 1, plus take up the Member State option to increase the size threshold for small companies to a maximum of €12,000,000 net turnover and €6,000,000 balance sheet total (approximately £10 million and £5 million respectively). The increased threshold would enable around 11,000 UK companies currently classified as medium sized to take advantage of the small company regime.

- **Option 3: Implement the EU baseline – reduce the notes to the accounts to the mandatory 8 notes, and take up the option to increase the size threshold for small companies.**

  - This option is considered the EU baseline and will create the lowest administrative burden on companies, however the removal of the 5 additional notes risks jeopardising the integrity of the UK accounting framework for third parties such as creditors and tax authorities. The additional notes are considered by stakeholders and professional bodies as necessary to underpin the presentation of a true and fair view of a company's financial position i.e. they provide information which is necessary for the user to reasonably form an opinion. This has been confirmed by the consultation responses of which 95% of those who expressed an opinion stated that where relevant the 5 additional notes underpin the presentation of a true and fair view of a company's financial position i.e. they are needed for the user of accounts to reasonably form an opinion about the financial position of a company. Therefore if relevant this information would need to be disclosed either as a note or in an alternative format. Furthermore since the additional notes do not need to be provided unless they are relevant they would be unlikely to be burdensome for many small companies generally.

- **Option 4: As Option 2. But including:**

  - Allow the small companies' audit exemption threshold to increase in line with the small companies' accounting regime threshold.
  - Remove the provision that public companies in a group make the group ineligible for the purposes of the small companies' audit exemption.
  - The new Audit Directive amendment so that new mandatory audit reporting requirements need only to be based on the work undertaken in the course of an audit.
  - Remove the obligation for micro-entity companies to prepare a Director's Report.

Option 4 is the preferred option.

We have consulted on the likely take up of options where significant alterations have been made relative to previous Directives for accounting and auditing. We propose to take up the Member State option to require small companies to provide an additional 5 disclosures in the notes to the accounts. Consultation has confirmed the view that these notes underpin the basis for determining if the accounts present a "true and fair" view of the undertaking's financial affairs in the UK, and are therefore make up an important and necessary part of the accounts. However

[21]Change the subsidiary audit exemption and the dormant company audit exemption reference from 'quoted companies' to 'companies with securities admitted to trading on a regulated market'.

sufficient information to allow the estimation of the monetised costs and benefits of retaining these notes was not provided by stakeholders in the consultation.

D. Monetised and non-monetised costs and benefits of each option

Option 1: Take the minimum action required by the directive. Implement only those mandatory changes to the current system which are required by the Directive

Benefits

The new small company regime will consist of the minimum disclosures, a total of eight mandatory notes. Option 1 takes up the option to require an additional 5 notes to the accounts. This nonetheless represents a reduction in the number of disclosures required to the accounts.

The EU's impact assessment identified that, of the numerous disclosures required by the accounting directives, the preparation of the notes are the most laborious and time consuming. This is because the notes are descriptive and require additional analysis which is not always possible to obtain directly from accounting software. It finds that approximately 50% of the time allocated to preparing the accounts is spent on the preparation of the notes. Thus there will be some benefit in the number of notes being reduced.

However, respondents to the consultation on the implementation of the 'Micro entities' exemption in March 2013 noted that in many instances the process is largely automated where the relevant data are input into the accountancy software, and the notes are automatically produced. On occasions, where changes have occurred in the company, the input of an accountant/book-keeper is required to offer additional narrative. We do not have information as to how regularly accountants need to feed into the notes but it was suggested that it would be limited, and likely to occur when the control environment of the company changed in some way, such as when a small company becomes a parent company and is required to prepare consolidated accounts.

This narrative is supported by our own subsequent discussions with stakeholders comprising professional accountancy bodies and practitioners, as well as by responses to the 2009 European Commission consultation paper[22] on the review of the Accounting Directive. The latter found that, out of 22 responses, 8 commented to say they had to compile information specially to prepare the disclosures, and 5 responded to say that no further information needed to be prepared. Some respondents stated that additional information needed to be produced to prepare disclosures in the areas of fair value, financial instruments, deferred tax, contingent liabilities, other financial commitments and remuneration. The decision as to which notes will require additional information to be produced depends on the specific circumstances of the company and is difficult to generalise or predict. Furthermore, the majority of the disclosures identified will remain within the revised mandatory requirements on accounts so cannot represent a saving.

Costs of preparing disclosures:

Two respondents provided a range of estimates of cost of preparing disclosures that are between £81 and £200[23]. In order to estimate the impact of a partial reduction in the number of notes to the accounts, we assume the reduction in the number of notes is reflected in a proportionate reduction in the cost of preparing the relevant disclosures.

The Companies Act 2006 sets down numerous requirements for particular disclosures (20 plus). However, the company may not be required to prepare all 20 plus notes; the number needed will depend on the company's financial affairs in the preceding year. Therefore, it is difficult to identify the typical number of notes contained in small company accounts. For the purposes of this assessment, it

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[22] European Commission summary report on the responses received to the consultation paper on review of the accounting directive. http://ec.europa.eu/internal_market/accounting/docs/200910_accounting_review_consultation_report_en.pdf

[23] Between €100 and €250

is presumed that approximately 17 notes are prepared on average as we understand that there are around 17 which are most commonly prepared, but we recognise that the actual average may be slightly lower or significantly higher. Based on this, the estimated saving per company of preparing the reduced number of notes (totalling 13 notes, including the 5 additional notes covered by the Member State option in Article 16(2) of the Directive) is:

((Current number of notes – reduced number of notes) / current number of notes) * cost of preparing full set of notes
Best estimate: ((17 – 13)/17) * £81 = £19
High estimate: ((17 – 13)/17) * £200 = £47
Based on the information above suggesting that the most burdensome notes will remain to the accounts, we use £19 as the best estimate of savings resulting from the removal of notes from the accounts, and savings of £47 as a high estimate.

Our consultation gave stakeholders an opportunity to provide information on the level of notes typically contained in small companies' accounts and the related costs of preparing these notes; and on the potential benefits that may be gained from a reduction in the notes to the accounts. Concern was expressed by consultation respondents about how some small companies will ensure accounts are true and fair when only 13 notes are mandatory. However specific information on the number of notes prepared on average was not provided by stakeholders and our estimated savings were not challenged.

Savings to companies preparing own accounts:

As 8 out of 22 respondents to the European Commission's consultation[24] suggested they had to compile additional information, our best estimate would be that 36% of companies would incur this saving, though it could in principle apply to all.

We apply this percentage to all small companies defined as currently set out in the Companies Act, 3.022m based on FAME, as well as a further 1,000 who fall into the new revised mandatory threshold set out in section B of this impact assessment. At this stage we assume that the savings from the reduced requirements on medium-sized companies are the same as for small companies. BIS consultation respondents did not express an opinion on this assumption.

We estimate the benefits to those who compile their own accounts separately from those who use an external accountant or book-keeper.

Analysis undertaken by Collis in 2012[25] estimated that 23% of small companies compile their own accounts and research by POBA and Companies House suggests between 50-70%[26] of small companies file small company accounts. Based on the evidence available, we use 50% as the central assumption and 70% as the high estimate.

Those medium-sized companies who move into the small company regime as a result of the revised threshold are larger companies and have different characteristics. Companies with a greater number of external investors and external lenders are more inclined to produce full disclosures in the accounts. We expect that a number of the companies at the upper end of the new threshold limit will have a larger number of investors, so are more likely to voluntarily file full accounts, and are also more likely to use an external professional to prepare their accounts.

[24] European Commission summary report on the responses received to the consultation paper on review of the accounting directive. http://ec.europa.eu/internal_market/accounting/docs/200910_accounting_review_consultation_report_en.pdf
[25] Collis, J. (2012) 'Determinants of voluntary audit and voluntary full accounts in micro and non-micro small companies in the UK' found that 77% of small companies used an external accountant.
[26] The Professional Oversight Board for Accountancy (POBA) reported that research it commissioned to examine 355 sets of accounts at Companies House in 2006 found approximately 60% were abbreviated, which was comparable with the findings of its questionnaire survey of 600 small and medium-sized companies, where just over 50% reported they had filed abbreviated. Collis 2012 finds that in 2006 49% of those surveyed had filed abbreviated accounts. Companies' house data suggests that around 70% of small companies file small company accounts.

A BERR report[27] from 2006 suggests that 88% of medium sized firms use an external accountant to prepare their accounts, indicating that 12% prepare their own accounts. This reflects the fact that larger companies are more likely to have more complex businesses for which there is a greater need for the use of external professionals to prepare the statutory annual accounts.

At present, medium-sized companies (who meet eligibility criteria) have the option to file abbreviated accounts. FAME provides information which suggests that at least 20% of medium-sized companies file abbreviated accounts. The BERR report indicates that over 70% of medium-sized companies would voluntarily audit their accounts; companies who choose to undertake a voluntary audit are also likely to file full accounts. Based on this, and assuming that those eligible medium-sized companies who currently choose to file abbreviated will take up the option to abbreviate further as a small company, and that those who file full accounts will continue to do so under the small company regime, we estimate that between 20 and 50% (based on the best estimate for current small companies) of eligible medium sized companies will file abbreviated accounts under the small company regime, with a best (and conservative) estimate of 30%.

At this stage we assume that the savings from the reduced requirements on medium sized companies are the same as for small companies.

We therefore estimate a saving from the removal of the notes from the accounts for companies who prepare their own accounts of £2.4m, with a high estimate of £8.2m. This is based on the following calculation: (number of small companies * percentage that requires additional information to be compiled for notes * percentage that takes up exemption * percentage that prepares own accounts * cost per company of preparing notes) + (number of medium-sized companies captured by revised threshold * percentage that requires additional information to be compiled for notes * percentage that takes up exemption * percentage that prepares own accounts * cost per company of preparing notes)

Company size	Case	No. of companies	% requiring additional info to prepare notes	% that take up exemption	% that prepare own accounts	Cost to company of preparing accounts (£)
Small	Low	3.022m	36	50	23	19
	Best	3.022m	36	50	23	19
	High	3.022m	36	70	23	47
Medium	Low	1,000	36	20	12	19
	Best	1,000	36	30	12	19
	High	1,000	36	50	12	47

Low estimate = (3.022m * 36% * 50% * 23% * £19) + (1,000 * 36% * 20% * 12% * £19) = £2.4m
Best estimate = (3.022m * 36% * 50% * 23% * £19) + (1,000 * 36% * 30% * 12% * £19) = £2.4m
High estimate = (3.022m * 36% * 70% * 23% * £47) + (1,000 * 36% * 50% * 12% * £47) = £8.2m

Savings to companies using external accountants:

The average wage for an accountant is £25.00[28], which indicates that the cost to accountants of preparing notes to the accounts is £87 as the best estimate and £169 as the high estimate (£200/£29.58 * £25.00 = £169). A low estimate of costs would be £0 based on the assumption that accountants would not adjust their charges on the basis of a small change to workload. Adjusted for the proportion of the notes which will be removed we obtain an estimated saving per company of £19, within a range of £0 to £47.

[27] BERR, Collis, Directors' Views on Accounting and Auditing Requirements for SMEs.
[28] ASHE revised data 2013, adjusted into 2014 prices using HMT GDP deflators, and uplifted by 18.1% to account for non-wage labour costs.

We therefore estimate a saving from the removal of the notes to the accounts for companies who hire an external accountant to prepare their accounts of £7.9m as a best estimate, a low estimate of £0 and a high estimate of £27.6m. This is based on the following calculation: (number of small companies * percentage that requires additional information to be compiled for notes * percentage that takes up exemption * percentage that uses an external accountant to prepare accounts * cost per company of preparing notes)
Low estimate = (3.022m * 36% * 50% * 77% * £0) + (1,000 * 36% * 20% * 88% * £0) = £0m
Best estimate = (3.022m * 36% * 50% * 77% * £19) + (1,000 * 36% * 30% * 88% * £19) = £7.9m
High estimate = (3.022m * 36% * 70% * 77% * £47) + (1,000 * 36% * 50% * 88% * £47) = £ 27.6m

This results in a total estimated annual saving of between **£2.4m – £35.8m,** with a best estimate of **£10.4m.**

	Total savings for small companies preparing own accounts	Savings per medium-sized company preparing own accounts	Total savings for small companies using accountant	Savings per medium-sized company using accountants	Total benefits
Low	£2.4m	£170	£0	£0	£2.4m
Best	£2.4m	£250	£7.9m	£1,800	**£10.4m**
High	£8.2m	£1,000	£27.6m	£7,500	£35.8m

This is a best estimate based on the information available, but we believe this may overestimate the savings which may result from removing mandatory notes from the accounts. As stated above, respondents to the consultation on the implementation of the 'Micro entities' exemption and other stakeholders consulted since, have noted that the process is largely automated and additional work is only required when changes have occurred in the company. This is likely to occur only when the control environment of the company changes in some way – given that this will happen to a minority of companies, and would not occur on an annual basis, the actual savings resulting from removal of notes from the accounts are likely to be lower. Prior to the launch of consultation we informally consulted with stakeholders to try and better understand the frequency of these occurrences, and the costs of reporting in these cases. Due to the fact that they are significant changes which happen to a minority of companies any given year, stakeholders found it difficult to predict when they may impact their reporting processes. Information on costs/benefits was requested as part of the consultation. However no information was received which would enable us to further refine our estimates.

There will also be benefits to an estimated 3,300[29] large companies, who will be classified as medium sized as a result of changes to the company size thresholds. We would estimate that between 20-50% of these (with a best estimate of 30%) would take up the option to file medium sized company abbreviated accounts. During consultation we sought views on the potential savings which might apply to these companies as a result of this reduced requirement. No information was received which would enable us to provide a monetised estimate.

Wider and non-monetised benefits:

- The removal of unnecessary information from small company financial reports will make the accounts more user-friendly and easier to understand for both preparers and users. It may encourage more small companies to prepare their own accounts if they feel confident about the changes and simplifications to the accounts.

- It will relieve administrative burdens on existing companies and support the development of a 'light touch' regulatory environment for small UK businesses; and may further encourage individuals to set up their own companies. The proposals are part of the general movement towards deregulation, particularly for smaller companies.

- Currently it is not expected that any companies will newly require an audit because of the changing of the subsidiary audit exemption and the dormant company audit exemption reference from 'quoted companies' being excluded from the exemption, to a reference to

[29] Based on FAME data

'companies with securities admitted to trading on a regulated market' are excluded from the exemption (i.e. listed companies that have shares or debt admitted to trading on a regulated market). This is because FCA listing rules already require such companies to be audited.

- The requirement for 'auditors' opinions' is likely to lead to non-monetised benefits. It should provide additional assurance to stakeholders in the company about the quality and integrity of its narrative reporting and enable shareholders, investors and creditors to make more balanced judgements about companies' performance.

Costs

1. *One-off costs*

Minimum implementation would require only the mandatory aspects of the Directive to be implemented and only those options where a change from the UK's current approach has occurred would need to be considered by companies. This would limit the level of familiarisation required by preparers and users of statutory annual accounts.

There will nevertheless be one-off costs associated with familiarisation around the reduced number of disclosures to small company accounts. These costs, of understanding the new requirements and regulations, will apply to those who prepare company accounts. This will apply to all chartered and certified accountants as well as practising book keepers, who will compile company accounts. In addition to this, an estimated 23%[30] of small companies will prepare their own accounts, and around half of these will take up the exemption and prepare abbreviated accounts and incur familiarisation costs.

It should be noted that the accountancy and bookkeeping professional bodies require their members to maintain up-to-date knowledge as part of their day-to-day work. Each body sets down its own requirements for the number of hours expected to maintain a satisfactory level of CPD. This includes reading latest notices, keeping up to date with articles etc., through to understanding the application and implications of any new or revised accounting standards, directives etc. We assume that these additional changes will, however, result in an opportunity cost of their time.

We expect familiarisation costs to be in line with those experienced in understanding the changes made in the Micros-Exemption Impact Assessment[31]. This analysis estimated the time taken to familiarise with presentational changes to be between 5 and 15 minutes, with a best estimate of 10 minutes to understand the changes. This is on the basis that the changes in the accounting regulations which will apply in the UK are also mainly presentational and are therefore relatively straightforward to understand.

In terms of the number of accountants and book-keepers in the UK, the Financial Reporting Council notes in its report of 'Key facts and trends in the Accountancy Profession' (2014)[32] that in 2013 there were over 327,000 members of the seven accountancy bodies in the UK. The Institute of Certified Book-keepers advised in response to the 'Micro-entities exemption' consultation in March 2013 that there are around 3,500 practising book-keepers in the UK. We have assumed that these figures provide reasonable estimates of the number of professionals affected by the Accounting Directive.

Analysis undertaken by Collis in 2012 estimated that 23% of micro-entities compile their own accounts and around half of all micro-entities had taken up the exemption allowing them to file small company accounts.

In terms of the number of companies who prepare their own accounts, there are currently approximately 3.022m small companies and a further 1,000 that will fall under the small company regime as a result of the mandatory changes to the small company threshold criteria. Of the 3.022m

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[30] Based on 2006 accounts. Collis, J. (2012) 'Determinants of voluntary audit and voluntary full accounts in micro and non-micro small companies in the UK' found that 77% of small companies used an external accountant.
[31] http://www.legislation.gov.uk/ukia/2013/162/pdfs/ukia_20130162_en.pdf
[32] https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Key-Facts-and-Trends-in-the-Accountancy-Profession.pdf

small companies, 23% (700,000) are assumed to prepare their own accounts[33] and 50-70%[34] of these will prepare abbreviated accounts. On this basis around 350,000 small companies are expected to undertake some familiarisation with the changes[35], with a high estimate of 490,000. Of the 1,000 medium sized companies which will become small companies, 12% are assumed to prepare their own accounts and 20-50% of these will prepare abbreviated accounts totalling some 24-60 companies (see assumptions in benefits section). On this basis around 350,000 small companies are expected to undertake some familiarisation with the changes, with a high estimate of 490,000.

We expect the familiarisation will take a company preparing their own abbreviated accounts around the same amount of time as an accountant or book-keeper.

Using the revised 2013 Annual Survey of Hours and Earnings data we obtain the wages for accountants and book-keepers. We uprate these into 2014 prices using GDP deflators from the Treasury, and then adjust non-wage labour cost (an uplift of 18.1%[36]). This gives wages of £25.00 per hour and £15.40 per hour respectively. We assume for companies preparing their own accounts, the company manager/corporate director would be responsible for familiarising themselves with the revised regulations. The wage for corporate manager or director is £29.58 (the 2013 revised ASHE results are uprated using GDP deflators, and an 18.1% non-wage labour cost uplift applied).

Thus the total one-off familiarisation costs will be £1.5m to £5.7m, with a central case of **£3.1m**. The detailed calculations are the same for each exemption with a difference around the amount of time taken for each one. The calculation is as follows:

Time x (((Accountant wage + 18.1% uplift) x (Number of accountants)) + ((Book-keeper wage + 18.1% uplift) x (Number of book-keepers)) + ((Company owner wage + 18.1% uplift) x (Number of companies completing own accounts x percentage that prepare small company accounts)))

Low: 5/60 * ((£25.00 * 327,000) + (£15.40 * 3,500) + (£29.58 * 3.022m * 23% * 50%) + (£29.58 * 1,000 * 12% * 20%)) = £1.5m
Central: 10/60 * ((£25.00 * 327,000) + (£15.40 * 3,500) + (£29.58 * 3.022m * 23% * 50%) + (£29.58 * 1,000 * 12% * 20%)) = £3.1m
High: 15/60 * ((£25.00 * 327,000) + (£15.40 * 3,500) + (£29.58 * 3.022m * 23% * 50%) + (£29.58 * 1,000 * 12% * 20%)) = £5.7m

The total one-off familiarisation costs to business will be:

	Costs for accountants	Costs for book-keepers	Costs for small companies	Total costs
High	£2.1m	£13,000	£3.6m	£5.7m
Best	£1.4m	£9,000	£1.7m	**£3.1m**
Low	£0.7m	£4,000	£0.9m	£1.5m

2. Software changes

There will be one-off development costs associated with the updating of accounts software to incorporate the changes to the accounts. Companies and accountancy firms may opt to use the web-based filing service offered by Companies House or more bespoke platforms offered by alternative software providers.

There are approximately 20 accounting software companies which provide software systems that enable the electronic filing of accounts by firms with HMRC and Companies House. We have engaged with Companies House on this issue in order to try and obtain estimates of the development costs which will be incurred by these companies based on past experience. However, Companies House was unable to obtain estimates from the software companies without more certainty on the

[33] See note 5
[34] See note 7
[35] We assume that those companies who use accountants will not incur familiarisation costs, as this will be left to the accountant
[36] Based on Eurostat data: http://europa.eu/rapid/press-release_STAT-13-54_en.htm?locale=en

changes which would be implemented. It is only at this point that software companies can be expected to consider the software changes that are necessary and the associated development costs (or even if there is a market for a revised product.) Since software companies would only develop new or upgraded software if the benefits outweighed their costs and customer companies would only buy the product if the benefits outweighed the price, our view is that this would not result in a direct net cost.

There are however likely to be implementation costs incurred by certain public sector bodies i.e. Companies House, who will need to consider what changes may need to be made to their systems etc. Companies House has estimated that the development of a new interface to enable accounts to be filed at Companies House would be likely to result in costs of approximately **£287,000**. This figure has been used as an indicative cost.

Non-monetised costs

There is a potential loss of transparency for stakeholders, particularly for those medium-sized companies that may qualify as small companies under the increased thresholds. The reduced disclosures could lead to a loss of information for stakeholders, and possibly the company themselves.

Business information providers, such as credit rating agencies, use information contained in the annual accounts to supply information on companies to the market. Therefore, such providers may find it more difficult to provide information on small companies if they have to rely on requests for additional information. However, the EU's IA for the Accounting Directive states that many of the notes required by the previous directives are not relevant to the stakeholders of small businesses.

It is not certain that the removal of these notes will impact on the data used in the scoring models in the credit granting process. A reduction in the information provided could result in slower credit decisions and potentially raise the cost of capital for the companies where uncertainty over the financial health of the company remains. Indeed four respondents to the consultation did express concern about the risk that disclosure may not be sufficient in all cases to show a true and fair and enable outside parties to undertake proper checks. This could affect credit availability and cost for the small company.

The requirement for an 'auditors' opinion' on compliance of the management report with applicable legal requirements and to state whether any material misstatement has been identified is likely to increase the cost of an audit for companies. The change is expected to increase auditors' costs because auditors will be required to do much additional work to comply with this requirement. For example, they potentially will have to look back over all the audited entity's activities, including things that are currently outside the scope of a statutory audit and accounting regulations, in order to ensure legal requirements have been meet. The costs to audit companies are likely to be a disproportionately large relative to the benefits of providing additional assurance for shareholders, investors and creditors company stakeholders; and mitigating the potential risk of undertakings misleading auditors. However, this cost to audit firms is currently un-quantified due to a lack of robust evidence around how this policy change would impact on audit practice (e.g. to quantify the amount of extra work auditors would have to do, and the numbers and types of staff involved).

Option 2: Take the minimum action required and take up the option to maximise the size threshold for the small companies' accounting regime

Benefits:

Benefits will be as in Option 1, but with additional benefits accruing to those companies which will fall within the increased small company threshold criteria. The flexibility to increase the small company threshold above the minimum threshold required by the Directive will bring an additional 10,000 companies currently classified as medium-sized into the scope of the small company regime, over and above those falling within the new mandatory small company threshold criteria. As in Option 1,

we assume that the savings to this group of companies from the reduced filing requirements are the same as for small companies.

We apply the same assumptions to this group of companies as we applied to those medium-sized companies falling within the new mandatory threshold in Option 1.

On this basis we estimate a saving to companies preparing their own accounts from the take up of the Member State flexibility to increase the small company threshold to the higher level of **£1,700 - £10,200**, with a best estimate of **£2,500**. This is based on the following calculation: (number of medium-sized companies falling within the higher threshold * percentage that requires additional information to be compiled for notes * percentage that takes up exemption * percentage that prepares own accounts * cost per company of preparing notes)
Low: (10,000 * 36% * 20% * 12% * £19) = £1,700
Best estimate: (10,000 * 36% * 30% * 12% * £19) = £2,500
High: (10,000 * 36% * 50% * 12% * £47) = £10,200

We make the same assumptions regarding savings to new "small" companies who use external accountants or book-keepers to prepare their accounts as applied to companies in Option 1. This estimates a saving from the change in the small company threshold criteria for medium sized companies who use external professionals of **£0 - £74,500**, with a best estimate of **£18,100.** This is based on the following calculation: (number of companies * percentage that requires additional information to be compiled for notes * percentage that takes up exemption * percentage that uses an external accountant to prepare accounts * cost per company of preparing notes)
= (10,000 * 36% * 30% * 88% * £0) = £0
= (10,000 * 36% * 40% * 88% * £19) = £18,100
= (10,000 * 36% * 50% * 88% * £47) = £74,500

Added to the benefits for Option 1, we get total benefits for Option 2 of between **£2.4m – £35.9m**, with a best estimate of **£10.4m.** The additional benefits over option 1 are small.

Costs:

Monetised costs that occur under Option 1 will also arise.

There will be additional familiarisation costs relating to medium sized companies.

Additional familiarisation costs for those medium sized companies who fall into scope as a result of the revised threshold are derived as follows:

Time x (((Company owner wage + 18.1% uplift) x (Number of companies * percentage completing own accounts * percentage that prepare small company accounts)))

Low: 5/60 * (£29.58 * 10,000 * 12% * 20%)) = £600
Central: 10/60 * (£29.58 * 10,000 * 12% * 30%)) = £1,800
High: 15/60 * (£29.58 * 10,000 * 12% * 50%)) = £4,400

The potentially could also be some familiarisation costs amongst companies just above the revised threshold (i.e. companies who check whether they fall under the revised threshold, but do not). The FAME database shows that there are 20,000 medium sized companies who fall out of scope of the revised threshold. As a low estimate we assume that 0% of these companies will familiarize themselves with the revised threshold, and as a high estimate that 100% of these companies will familiarize themselves with the revised threshold – with a best estimate of 50%. The costs are then worked out in the same way as above:

Time x (((Company owner wage + 18.1% uplift) x (Number of companies * percentage completing own accounts * percentage that prepare small company accounts)))

Low: 5/60 * (£29.58 * (20,000 * 0%) * 12% * 20%)) = £0
Central: 10/60 * (£29.58 * (20,000 * 50%) * 12% * 30%)) = £1,800

High: 15/60 * (£29.58 * (20,000 * 100%) * 12% * 50%)) = £8,900

Accountants and book-keepers will have no additional familiarisation costs as a result of the additional companies eligible to file small company accounts, as their familiarisation costs have already been included in Option 1. Therefore, overall total familiarisation costs under this option will still be of the magnitude of £3.1m (with a range of £1.5m-£5.7m).

Total one off costs for option 2 will therefore be between **£1.8m** and **£5.6m** with a best estimate of **£3.4m**. As well as the described additional familiarisation costs, these costs also include the £287,000 Companies House costs described under Option 1.

There may be additional non-monetised costs relating to the loss of transparency for stakeholders as described in Option 1, but also applying to those medium sized companies who are eligible and who take up the option to file small company accounts. The cost of this may be greater for those medium-sized companies that may qualify as small companies under the increased thresholds, as they are more likely to be raising external finance and capital.

Option 3: Implement the EU baseline – reduce the notes in the accounts to the mandatory 8 notes, and take up the option to increase the size threshold for small companies.

Benefits:

Benefits are of the same nature as those set out in Option 2. There may be some additional benefits resulting in the further reduction in the number of notes to the accounts.

We use the same approach as used in Options 1 and 2 to estimate the scale of these additional benefits:

Additional saving per company from removal of the 5 additional notes:
Best estimate: (5/17) * £81 = £24
High estimate: (5/17) * £200 = £59

We first estimate the savings for all companies who prepare their own accounts:

Low estimate = (3.022m * 36% * 50% * 23% * £0) + (11,000 * 36% * 20% * 12% * £0) = £3.0m
Best estimate = (3.022m * 36% * 50% * 23% * £24) + (11,000 * 36% * 30% * 12% * £24) = £3.0m
High estimate = (3.022m * 36% * 70% * 23% * £59) + (11,000 * 36% * 50% * 12% * £59) = £10.3m

There will also be savings to companies who use and external accountant to prepare their accounts:

Based on methodology above,
Savings per company using an accountant = (Cost to corporate director of doing 5 notes/mean wage of corporate director) * mean wage of accountant[37]
Best estimate = ((£24/£29.58) * £25.00) = £20
High estimate = ((£59/£29.58) * £25.00) = £50

Based on these estimates, the additional saving to companies resulting from the removal of the 5 additional notes would be:

Low estimate = (3.022m * 36% * 50% * 77% * £0) + (11,000 * 36% * 20% * 88% * £0) = £0m
Best estimate = (3.022m * 36% * 50% * 77% * £24) + (11,000 * 36% * 30% * 88% * £20) = £8.5m
High estimate = (3.022m * 36% * 70% * 77% * £59) + (11,000 * 36% * 50% * 88% * £50) = £29.3m

Summing these estimates provides additional saving of between £3.0m and £39.6m with a best estimate of £11.5m.

[37] All wage data is revised 2013 ASHE data, put into 2014 prices using HMT GDP deflators, and then uplifted by 18.1% to account for non-wage labour costs.

Adding this to the benefits of Option 2 provides a total benefit of Option 3 of between **£5.4m** and **£75.6m** with a best estimate of **£21.9m**.

As stated above, discussions with stakeholders have indicated this may be an overestimate of the savings, due to the fact that additional information needs to be gathered for the preparation of notes only when the control state of the company changes. We used the consultation to test the assumption regarding the scale of the burden resulting from the preparation of notes and how frequently it is incurred further as part of the consultation. Although respondents supported our preferred option to mandate 13 notes, as already stated, they did not provide additional specific information to use to refine our estimates.

Costs:

Total one-off costs are assumed to be the same as in Option 2 (**£3.4m**), as the same groups will be affected. There may be slightly higher familiarisation costs for this option as it represents a greater change from the status quo; however any difference in the familiarisation costs has not been quantified. Although the consultation did not provide sufficient evidence to quantify this difference, it was clear from the size of the majority in favour of 13 mandatory notes confirms concerns that this option would lead to greater familiarisation costs and more uncertainty than other options.

UK GAAP requires companies' financial statements to present a 'true and fair' view of their financial affairs. The additional notes underpin the basis of the 'true and fair' view. Companies would need to consider further whether their annual accounts met this requirement, and if not, would have to present the necessary information to comply. This could lead to further costs and burdens as this additional task would have to be undertaken each time the annual statutory accounts were prepared.

Option 4: As Option 2, but including:

- Allowing the small companies' audit exemption threshold to rise in line with the small companies' accounting regime thresholds.
- Remove the provision that public companies in a group make the group and ineligible group for the purposes of the small companies' audit exemption.
- The new Audit Directive amendment so that new mandatory audit reporting requirements need only to be based on the work undertaken in the course of an audit.
- Remove the obligation for micro-entity companies to prepare a Directors' Report.

Benefits

Benefits will be as Option 2, with additional benefits in the form of time and cost savings for medium-sized UK companies which fall into scope of the increased thresholds for the small company audit exemption. Analysis of the FAME database suggests approximately 7,400 will become eligible after the threshold changes. A 2014 ICAEW business survey[38] found that approximately 60% of medium sized businesses would still use audit services even if they were no longer mandatory. Based on this new evidence we infer that 40% of the 7,400 medium-sized companies who become eligible for the small companies' exemption will take it up (around 3,000). Quantified savings from not having an audit are two-fold: 1) no longer having to pay the auditor an annual audit fee for their audit services; and 2) management time savings. The estimation of these benefits follows the approach taken in a previous IA[39]. The mean audit fee (£13,000) amongst these companies is upwardly biased by the presence of a few companies with very high, unrepresentative audit fees. Therefore, following the analytical approach set out in a previous IA, we use a trimmed mean fee of (£12,200), which removes the top 1.5% of audit fees (i.e. annual audit fees above £44,000). This gives rises to annual benefits of £36.2m across newly eligible companies that take-up the exemption (with a high estimate of £54.3m and a low estimate of £36.2m). As before, we assume that annual audits take up 2 hours of corporate managers'/directors' time per company per annum. Their wage rate is £29.58 (the revised

[38] ICAEW (2014), 'The 99.9%: small and medium-sized businesses; Who are they and what do they need?'
[39] Audit Exemptions IA, BIS 0301, http://www.legislation.gov.uk/ukia/2014/286/pdfs/ukia_20140286_en.pdf

2013 ASHE data uprated to 2014 prices using HMT September 2014 GDP Deflators[40]. and then uplifted to account for 18.1% non-wage labour costs[41]). Across all affected companies these time savings are estimated at £175,000 (with a high estimate of £302,000 and a low estimate of £149,000).

Therefore, with the benefits that also arose under Option 2, the total benefits under this option are **£46.8m**, with a range of £38.8m-£90.56m**.**

Non-monetised benefits

An auditors' opinion on legal compliance of the management report with applicable legal requirements is likely to lead to non-monetised benefits – i.e. additional assurance to stakeholders in the company about the quality and integrity of its narrative reporting and enable shareholders, investors and creditors to make more balanced judgements about companies' performance. However, the requirement to base the 'auditor's opinion' on the work undertaken during the course of the audit provides a more proportionate approach for audit companies than under Option 1.

The proposed changes under Option 4 will see micro-entities no longer required to produce Director's Reports for members of the company. In many micro-entities the members of the company and the company directors are the same individuals, and therefore it is unlikely in many cases that benefits arise from the preparation of the Director's Report. This change, supported by the 65% of the consultation respondents, is likely to reduce administrative burdens further on micro-entities related to accounts production, although this is not quantified due to insufficient evidence on how micro-entities currently operate, and could react to the change. It is also possible that some micro companies will continue to produce Director's Reports.

Costs

The costs arising under Option 2 will also occur under this option.

The increased threshold for small company audit exemptions, so that it is in line with the increased small company accounting regime exemptions, is expected to generate additional familiarisation costs for affected companies' managers and directors. Our central is that these costs are £30,700 across all affected companies (with a range between £15,400 and £46,100). These have been estimated as set out below.

Time x ((Company owner wage + 18.1% uplift) x (Number of companies eligible for audit exemption))

Low: 5/60 * (£29.58 * 7,400) = £18,300
Central: 10/60 * (£29.58 * 7,400) = £36,500
High: 15/60 * (£29.58 * 7,400) = £54,800

There are also expected to be familiarisation costs arising as a result of micro-entities, familiarising themselves with the removal of the requirement to prepare a Director's Report. These costs have been estimated using the same approach as other familiarisation costs. Micro-entity owners are expected to spend between 5 and 15 minutes familiarising themselves with the removal of the requirement.

Time x ((Company owner wage + 18.1% uplift) x (Number of micro-companies))

Low: 5/60 * (£29.58 * 1.55m) = £3.8m
Central: 10/60 * (£29.58 * 1.55m) = £7.6m
High: 15/60 * (£29.58 * 1.55m) = £11.4m

Overall, familiarisation costs for this option are expected to be £10.7m - with a range of £5.4m-17.2m.

[40] https://www.gov.uk/government/statistics/gdp-deflators-at-market-prices-and-money-gdp-september-2014-quarterly-national-accounts

[41] Based on Eurostat data: http://europa.eu/rapid/press-release_STAT-13-54_en.htm?locale=en

Total costs for Option 4 estimated at **£11.0m** – with a range of £5.7m to £17.4m (with the inclusion of Companies House software costs explained earlier in the Impact Assessment).

Non-monetised costs

Option 4 will have the same type of non-monetised costs as Option 2, but with potentially greater levels of costs ensuing from less assurance for shareholders, investors and third parties with an interest in the medium-sized companies that fall into scope, and take up, the small companies' audit exemption. However, because these undertakings are smaller, the consequences of misstatements in their accounts would not be as severe as the consequences for large undertakings and public interest entities (which would not be exempt from undergoing an audit regardless of their size). With regards to third parties, banks will be able to request, from undertakings to which they lend, additional information or verification as a condition of their lending. Also, HMRC has powers to ask for additional explanations and information, where it feels this is necessary.

It is likely that there will be a reduction in costs to business in Option 4 compared to Option 2 in relation to the new requirements for auditors to express an opinion on the compliance of the management report with applicable legal requirements. This is because Option 4 includes applying part of the new Audit Directive[42] which allows auditors to base this opinion only on work undertaken in the course of the audit. This requirement is a more proportionate approach for audit companies, and will take up less time and resource, than the Auditor's Opinion requirement under Option 1. Under Option 1 auditors would be required to do additional work to comply - for example, they potentially will have to look back over all the audited entity's activities, including things that are currently outside the scope of a statutory audit and accounting regulations, in order to ensure legal requirements have been met.

Rationale and evidence that justify the level of analysis used in the IA (proportionality approach)

Our analysis of the changes introduced by the Directive, discussions with stakeholders and responses to the consultation have informed the assessments of the costs and benefits of the options outlined, as well as information obtained from the limited data and research available.

Risks and assumptions

The key assumptions in terms of costs and benefits are:

- that accountants and book-keepers can familiarise themselves relatively quickly with the changes, but these actions are additional to the Continuous Professional Development requirements

- that owners of small businesses can familiarise themselves with the changes to the small company regime in the same amount of time that it would take an accountant or book-keeper.

- That owners can familiarise themselves in a similar amount of time with the new company size thresholds to the small companies' audit exemption.

- the owner or corporate director within the company would be responsible for preparing the accounts and familiarising themselves with any changes

- that the number of small companies who produce their own accounts and who take up the small company exemptions reflects the analysis undertaken by Collis in 2012[43].

[42] Directive 2014/56/EU
[43] Collis, J. (2012) 'Determinants of voluntary audit and voluntary full accounts in micro and non-micro small companies in the UK' found that 77% of small companies used an external accountant.

- that the number of medium sized companies who produce abbreviated accounts reflects Companies House data and estimates from Collis, 2008[44].

- that the number of medium sized companies who prepare their own accounts reflects the analysis undertaken by Collis in 2012[45].

- that estimates of the cost of preparing notes are reflective of the true costs, and that the reduction in the number of notes reflects a proportionate reduction in the cost of preparing these notes. Anecdotal evidence suggests this may not be the case, and that some notes are more burdensome than others.

- that, as suggested by the European Commission's consultation and our subsequent survey work responses[46], less than a third of companies will benefit from a reduction in costs as a result of the reduced number of notes to the accounts. This reflects anecdotal evidence that the burden of preparing notes is not incurred every year, but instead is only incurred when the control state of the company changes.

- that around 40% of newly eligible medium sized companies will take up the small companies' audit exemption, based on ICAEW 2014 research. This is a lower take-up than assumed in a previous IA.

- the average audit fee of companies eligible for the exemption is £12,200 (a 1.5% truncated average, in line with a past audit exemption IA). This method excludes outlying, high audit fees that may distort the savings estimates.

The underlying risks arise from the potential loss of transparency. As highlighted in the non-monetised cost section, there is a potential risk to small companies in terms of access to finance and cost of capital. However, as mentioned, many of the notes required by the previous directives are not relevant to stakeholders of small companies. Therefore, key stakeholders will still have access to the same information as they currently have now, which will act to mitigate this risk.

There is a greater risk associated with Option 3 in relation to the removal of the five notes specified as a Member State option in the Directive. These disclosures currently form the basis of a 'true and fair' view of companies' financial affairs in the UK's accounting framework. UK GAAP requires companies' financial statements to present a 'true and fair' view of their financial affairs. In the absence of these notes, companies would need to consider further whether their annual accounts met this requirement, and if not, would have to present the necessary information to comply. This could lead to further costs and burdens as this additional task would have to be undertaken each time the annual accounts were prepared.

Direct costs and benefits to business calculations (following OITO methodology)

The direct costs to business are estimated for Option 1-4, and shown in the table below

Option 1 involves taking the minimum action required by the Directive – i.e. implementing only those mandatory changes to the current system which are required by the Directive. This option is in-scope of OITO, as it is not possible for the UK to take up all the derogations in the Directive (even under an option that represents the minimum action required by the Directive). It has an EANCB of £-7.6m, and counts as an OUT.

Option 2 takes up Member State flexibility to maintain additional notes for small company disclosures already required by UK Company Law and UK accounting standards. These additional notes will go beyond the minimum requirement of the Directive and therefore this option is in-scope of OITO. However this option represents a reduction in the number of notes currently required by UK regulation

[44] BERR, Collis, Directors' Views on Accounting and Auditing Requirements for SMEs
[45] Collis, J. (2012) 'Determinants of voluntary audit and voluntary full accounts in micro and non-micro small companies in the UK' found that 77% of small companies used an external accountant.
[46] European Commission summary report on the responses received to the consultation paper on review of the accounting directive. http://ec.europa.eu/internal_market/accounting/docs/200910_accounting_review_consultation_report_en.pdf

and reduces the gold-plating compared to the existing higher-standards. This option carries a negative EANCB of £-7.6m and therefore counts as an OUT.

The RPC case histories[47], 'existing higher standards' section, suggests 'if some or all of the existing higher standards are removed, this is a reduction in gold plating relative to the counterfactual ['Do Nothing'] and so qualifies as an OUT'. Therefore Option 3 should be classified as in-scope of OITO Option 3, and classified as an OUT. Option 3 has a negative EANCB of £-16.4m.

Option 4 is the preferred option. This measure contains the same policies as Option 2, but with some additional changes regarding audit and an exemption for producing Directors' reports for micro-entities. It is partially in scope of OITO. The reduction in the number of accounting notes, also included under Option 2, is in-scope of OITO for the reasons stated above. The net benefit to business of the increase in the audit exemption thresholds is not in-scope of OITO, as the de-regulatory effect is of EU origin (i.e. it was prompted by the Directive's change in the accounting size thresholds). Option 4 has a negative EANCB of £-7.0m and counts as an OUT.

Wider impacts

Statutory Equality Duties

After screening the potential impact of this proposal on race, disability and gender equality, it has been decided that there will be no impact. It is not expected to have any impact on the Convention Rights of any person or class of persons as the measure regulates incorporated businesses rather than individuals, and applies to all businesses within the stated size threshold.

Economic Impacts

Competition Impact Test

There are no obvious direct concerns in this area.

Small and Micro Business Assessment

The regulatory proposals outlined in this Impact Assessment are European in origin rather than domestic – and therefore a Small and Micro Business Assessment is not required. However, as described more fully in the body of the Impact Assessment, the options contained in it will be deregulatory for UK companies – in particular small and micro businesses to which the proposals are explicitly directed.

With respect to micro-businesses, accounts simplifications for micro entities arising from the Accounting Directive were introduced in December 2013, which mean that micro-entities meeting eligibility criteria have been able to prepare and publish simplified accounts[48].

At this point all the micro exemption options in the Accounting Directive were taken up, except one which was not and still is not deemed suitable for the UK. The option to exempt micro-entities from the obligation to present 'Prepayments and accrued income' and 'Accruals and deferred income' in respect of certain transactions only was considered inappropriate. The option would create a form of hybrid accounting (neither cash nor wholly accruals-based) and consequently is considered to pose a risk to confidence in the UK's financial reporting system.

The proposed changes under Option 4 will see 1.55m micro-entities no longer required to produce Director's Reports for members of the company. In many micro-entities the members of the company and the company directors are the same individuals, and therefore it is unlikely in many cases that benefits arise from the preparation of the Director's Report. This change, supported by 65% of the consultation respondents, is likely to reduce administrative burdens further on micro-entities related to

[47] Regulatory Policy Committee, Impact Assessment Case Histories
[48] See Micros Impact Assessment (IA No: RPC12-FT-BIS-1676)

accounts production, although this is not quantified due to insufficient evidence on how micro-entities currently operate, and could react to the change. It is also possible that some micro companies will continue to produce Director's Reports.

With respect to small businesses, the proposals outlined in this Impact Assessment will lead to on-going, monetised benefits for small companies associated with the time savings from the reduction in the number of disclosures required on the accounts – which will outweigh the administrative costs arising as small companies familiarise themselves with the new regulations. These savings will occur under Options 1-4. Small companies make up the majority of UK companies affected by the changes. The savings to small businesses will be higher under Option 3 – due to the reduction of the number of mandatory notes to the account to just 8 notes. However, as noted, the removal of the 5 additional notes risks jeopardising the integrity of the UK accounting framework for third parties such as creditors and tax authorities. The consultation confirmed that the majority of stakeholders view the additional notes as necessary to underpin the presentation of a true and fair view of a company's financial position.

Small audit firms are likely to benefit from the taking up of the part of the new Audit Directive,[49] which allows auditors to express an opinion on the compliance of the management report with applicable legal requirements, based only on the work undertaken in the course of the audit. This change should improve company narrative reporting and enable shareholders, investors and creditors to make more balanced judgements about companies' performance, while being more proportionate for audit companies (including small audit companies) than the proposals outlined in Option 1.

Environmental impacts

There are no obvious direct concerns in this area.

Social Impacts

Health and Well-Being:

No obvious concerns in this area.

Human Rights:

No obvious concerns in this area.

Justice System

No obvious concerns. No changes are envisaged to the existing system of criminal sanctions or civil penalties for non-compliance.

Rural Proofing

No obvious concerns in this area.

Summary and preferred option with description of implementation plan

We propose Option 4 as the preferred approach to implementation. This option has a negative EANCB of £-7.0m and counts as an OUT. Option 4 is more beneficial to companies - in net present value terms - than other proposed options (see below).

Option	Best Estimate of Net Present Value of Business Benefits Minus Business Costs
Option 0	£0m
Option 1	£86.4m

[49] Directive 2014/56/EU

Option 2	£86.4m
Option 3	£185.4m
Option 4	£392.1m

The Accounting Directive updates the 4th and 7th company law directives for individual and consolidated annual statutory accounts. It seeks to reduce burdens in the preparation and publication of financial statements, and provide a greater level of comparability and consistency of financial reporting in EU Member States. The Directive provides Member State options to reduce burdens on undertakings further through the additional flexibility to increase the small company threshold at domestic level, thereby enabling more undertakings (where eligible) to benefit from the new harmonised small company regime, as well as allowing the threshold for the small companies' audit exemption to rise to the same level. It will also involve: 1) removing the provision that public companies in a group make the group and ineligible group for the purposes of the small companies' audit exemption; 2) the new Audit Directive[50] amendment so that new mandatory audit reporting requirements need only to be based on the work undertaken in the course of an audit; and 3) removing the obligation for micro-entity companies to prepare a Directors' Report.

[50] Directive 2014/43/EC