THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

14 November 2007

Our ref: ICAEW Rep 113/07

Commissioner Charlie McCreevy
DG Internal Market and Services
European Commission
Rue de la Loi 200
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By email: Markt-F2@ec.europa.eu

Dear Commissioner

COMMUNICATION ON A SIMPLIFIED BUSINESS ENVIRONMENT FOR COMPANIES IN THE AREAS OF COMPANY LAW, ACCOUNTING AND AUDITING [COM(2007) 394]

The Institute of Chartered Accountants in England and Wales (the ICAEW) is pleased to respond to your request for comments on the above Communication.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

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ICAEW Representation

ICAEW REP 113/07

Communication from the Commission on a simplified business environment for companies in the areas of company law, accounting and auditing

Memorandum of comment submitted in November 2007 by The Institute of Chartered Accountants in England and Wales, in response to the European Commission consultation paper on a simplified business environment for companies in the areas of company law, accounting and auditing published in July 2007

Contents	**Paragraph**

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the consultation paper *on a simplified business environment for companies in the areas of company law, accounting and auditing* published by the European Commission.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

Support for the simplification programme

4. The ICAEW fully endorses the EU's Better Regulation principles and the objective of the simplification programme to boost the competitiveness of European businesses in a global environment. We welcome this consultation and the Commission's commitment to suppress unnecessary administrative burdens at all levels.

5. This exercise constitutes a valuable opportunity to re-evaluate the overall EU regulatory framework and to carry out extensive reforms that would genuinely strengthen the global competitiveness of businesses. This would also entail looking beyond these areas at the broader business model and the regulatory environment in the member states.

6. We stress that the simplification of administrative burdens should not just focus on costs measured simply in terms of use of resources, but also on the benefits that existing regulatory provisions bring to a company's management and the public interest. In this regard, we support the Commission's analysis as stated in the "Action Programme for Reducing Administrative Burdens in the European Union" [COM(2007)23]: "It is clear that these measures should not compromise the underlying purpose of the legislation and there are clearly cases where, inter alia, for reasons to do with (…) ensuring sound financial management, information obligations will remain necessary."

7. It is ultimately in businesses' interest that the right balance is achieved between the benefits and costs of regulation. Past experience has shown that proportionate public interest safeguards – far from constituting a burden – may

serve to enhance the performance of a business, in addition to being essential for maintaining business confidence and ensuring that the interests of consumers, investors, shareholders, creditors and other stakeholders are protected.

8. The simplification programme should be conducted with a pragmatic approach. Impacts on businesses and the third sector should be considered. The impact for different sized organisations should be stated, estimating the annual benefits and cost per organisation (excluding one-off costs) of the option or proposal under consideration for each of micro, small, medium and large organisations. In particular, to reduce the disproportionate regulatory burden faced by micro and small business, careful consideration must also be given to exemptions for these categories.

9. We welcome the Commission's interest to look at innovative alternatives to achieve simplification in light of economic and technological trends. In this respect, we would like to draw attention to the development of the ICAEW Assurance Service and a two-year consultation that the Institute is conducting on the needs of audit-exempt companies. Please see paragraph 93 below for further details.

Defining administrative burdens

10. It is clear that not all regulations can be simply classified as burdens. The document COM(2007)23 (cited above) is focused on "obsolete, redundant or repetitive IOs [information obligations]". The statutory audit requirement, by way of example, would not fit this description. It is necessary to clearly distinguish the purely administrative areas targeted by the simplification programme from other public interest requirements, which cannot be subject to identical impact assessments given their significance to a company's operations and the wider market-place.

11. It is crucial that a coordinated and streamlined approach is adopted to ensure that outcomes are balanced with regard to the overall burden encountered by a company. The ICAEW 2007 Enterprise Survey Report indicated that medium-sized businesses rank employment legislation and health and safety regulation as the most burdensome administrative tasks, whilst small businesses are likely to cite tax issues (employment, business and VAT) as most burdensome. By contrast, large employers, particularly publicly listed companies, were those which primarily cited corporate governance and financial reporting as burdensome.

Flexibility for member states

12. We welcome the Commission's approach to addressing legislation that mainly deals with domestic situations. Each piece of legislation should, however, be assessed individually in relation to its merits and simplification potential, as the retention of EU requirements could be advisable in some areas.

13. We particularly support the principle that repealing EU requirements in favour of granting flexibility to member states would allow for a faster and more efficient adaptation of regulatory requirements in line with shifting business demands and the environment in each Member State. As the Commission has noted, some member states already have simplification programmes underway: creating flexibility would not only assist these states but could also serve as a catalyst for other states to pursue reform.

Capital maintenance reform

14. We believe that the simplification of the capital maintenance and distributions regime is the most important issue in the company law arena and urge the Commission to prioritise this particular reform. We believe that the current regime has become obsolete in an IFRS environment and, as explained below, argue that member states should be permitted to implement an optional alternative solvency-based regime, under which distributions would be determined by reference to the effect of distributions on company solvency and the need to preserve the company as a going concern.

15. The reform of this regime could be achieved by way of repeal of the relevant Second Company Law Directive provisions or by way of radical reform, enabling member states to introduce a solvency-based regime as an optional alternative. The Commission should evaluate the most appropriate course of action in this respect; however, it is important that any outcome at EU level solely comprises high level principles which give significant flexibility to member states to determine the appropriate type and level of regulation.

IFRS for SMEs

16. We note the Commission's reference to the exposure draft of an IFRS for SMEs published by the IASB. In our submission to the IASB, we explain that, whilst the eventual standard may be too complex to be suitable for application by most small companies, many large private companies that perceive an advantage in reporting in accordance with internationally-recognised standards are likely to be interested in utilising this new IFRS product. Indeed, this is what we would expect and recommend in the UK. It will therefore be important to ensure that the Commission's vision for simplifying reporting requirements takes due account of this ongoing work by the IASB and we call upon the Commission to ensure that there is clarity and consistency in the development of these work streams (a potential definition of "micro-business" would be an example of this).

Combined reporting

17. We note the Commission's interest in looking at combined reporting for different purposes. Although this could be an area for future consideration, much more research and practical work are necessary. We believe that, if the data and reporting requirements for the different purposes are sufficiently different, then combined reporting may not necessarily be the most appropriate option for achieving the simplification objectives. In such cases, moreover, the use of an electronic reporting standard will not of itself ensure that the reporting process is simplified, nor that the reported data is processed or used more efficiently. When it is clear, however, that combined reporting can potentially reduce the costs of compliance or achieve greater governmental efficiency, then electronic reporting format standards such as XBRL should be encouraged and used as widely as possible in order to maximise the efficiency of the processing that supports the use of the data.

RESPONSES TO SPECIFIC QUESTIONS/POINTS IN COMPANY LAW

18. In the area of company law, the ICAEW believes that absolute harmonisation across member states is not achievable as a legislative or political proposition. The current EU company law system does not achieve the benefits of complete harmonisation (uniformity) but is imposing costs (inflexibility that stifles evolution and responsiveness and over-regulation generally). We believe that the Commission should pare back significantly this legislation: we believe this approach would not lose much in the way of benefits but would significantly reduce costs.

Third and Sixth Company Law directives

19. These Directives deal with mergers and divisions within member states. The ICAEW would suggest that these be repealed, as we support the repeal of any EU regulation that addresses mainly domestic rather than cross-border issues. Furthermore, we are not aware of the mechanisms in the Third and Sixth Directives having ever been used by UK companies (there are plenty of other mechanisms used in the UK), so these Directives do not appear to be of any practical benefit in the UK.

Second Company law Directive

20. This Directive deals with the capital of public limited companies, including capital maintenance rules, distributions rules and pre-emption rights. We have a number of comments on the specific Articles of the Directive which we address below.

21. *Capital maintenance and distributions – Articles 15-16, 19-22, 30-34 and 35*
    As is explained in the paragraphs below, we call either for the repeal of these Second Company Law Directive provisions, or for their radical reform. Any replacement provisions should be high level principles, giving significant flexibility to member states to determine the appropriate type and level of regulation.

    We believe that simplifying the capital maintenance and distributions regime (including acquisition of own shares, reduction and redemption of capital) is the most important issue in the company law arena and is of the highest priority for the ICAEW, given the complexity of operating the current system in an IFRS environment. The ICAEW has been calling for this reform for a number of years because the concepts on which the legal framework is based are no longer valid, for example, in an IFRS environment. For instance, when do fair value gains become 'realised profits'; or how are the rules to be applied when the accounts treat share capital as debt?

    We believe these capital maintenance and distributions rules have become unworkable with the introduction of IFRS, and we draw attention to TECH 02/07 (which can be accessed at http://www.icaew.com/index.cfm?route=143529) recently issued by ICAEW and the Institute of Chartered Accountants of Scotland, which contains lengthy distributable profits guidance for companies using IFRS or converged UK GAAP. The fact that this guidance runs to nearly 100 pages demonstrates the level of complexity that needs to be tackled before dividends can be paid based on accounts prepared under accounting standards developed in recent years. Whilst we hope this will assist directors, this guidance is no substitute for repeal or radical reform. We also note that, despite having the option of using IFRS in their individual accounts, many listed companies in the UK are instead choosing to remain on UK GAAP in their individual accounts. This undermines the benefits of having international standards, and also increases costs for such groups, which have to run two sets of GAAP.

The current regime also imposes limits on company distributions by reference to the historical amounts contributed by investors, which is an arbitrary measure that bears no direct relation to the financial viability of a company. This was always the case, but previously its arbitrary nature was compensated for by its relative simplicity which has now disappeared if using IFRS or converged accounting standards. The current rules can therefore fail to achieve the objective of protecting creditors, but at the same time impose unwarranted burdens on business and may impede the development of financial reporting.

We believe member states should be able to implement an alternative solvency-based regime, under which distributions would be determined by reference to the effect of distributions on company solvency and the need to preserve the company as a going concern, which would be simpler and more cost effective, whilst also protecting creditors and allowing investors appropriate returns. Other jurisdictions have systems along these lines. If the EU is to have a dynamic rather than static law, and if burdens that blunt competition are to be removed, member states must be given the freedom to reform and evolve their laws in this area.

This change could be by way of repeal of these Second Company Law Directive provisions or by way of radical reform, enabling member states to introduce a solvency-based regime as an optional alternative. On the one hand, we understand the argument that there should be a minimum set of creditor protection principles at EU level, in view of limited liability. However, on the other hand, most cross-border trade is conducted with non-public subsidiaries that are not subject to the current regime, and we are not aware of any issues arising from this lack of minimum protections for the creditors of private companies. If the current provisions are replaced at EU level it is important that the new provisions are high level principles, requiring member states to implement the measures they think fit taking into consideration the interests of creditors but giving significant flexibility to member states to determine the appropriate type and level of regulation.

We note that consequential amendments to the ‘realised profits’ requirements in the Fourth Company Law Directive would also be required.

22. *Article 1*
This deals with the scope of the Directive (applicable to public companies) and should be retained.

23. *Articles 2-5*
These Articles deal with constitutional matters in relation to formation. We believe that they should be repealed, and that these matters should instead be dealt with in the First Company Law Directive (i.e. applicable to private and public companies). This could be by way of a cut down version of these measures, requiring the real basics such as disclosure of registered office and value of shares, but should not contain provisions on pre-incorporation contracts as we see no case for those to be dealt with at EU level.

24. *Article 6*
This imposes minimum capital requirements. We do not believe that minimum capital is a principle worth pursuing as it is even more arbitrary than the distribution rules. We therefore recommend that this Article should be repealed.

25. *Articles 7-12*
These Articles deal with the pricing and consideration for the allotment of shares on incorporation or authorisation (shares cannot be issued at a discount to nominal value (or accountable par), must be 25% paid up, cannot be paid up by an undertaking to perform work or supply services). They also set out the requirement for a report on non-cash consideration, and provide that a subscriber cannot be relieved of the obligation to make his payment.

If the capital maintenance rules are to be changed, to allow distributions based on solvency, then this would move away from the arithmetic maintenance of capital rules and thus render the rules on nominal share value meaningless. These Articles would therefore be mostly capable of repeal, with certain provisions retained such as those setting out what can be tendered as consideration.

This would pave the way for no-par-value shares, which are a logical goal – nominal amount of share capital is completely arbitrary and needs to be abolished.

26. *Articles 13-14*
These miscellaneous provisions apply to Articles 2 to 12 and should therefore be subject to consequential adaptations or repeals as appropriate.

27. *Articles 15-16*
These Articles contain the distributions rules based on the concept of realised profits – please see the general capital maintenance comments above.

28. *Article 17*
This Article deals with serious loss of capital, providing for a general meeting to be called when assets fall below half of subscribed capital. With a move towards a solvency basis for distributions, such arithmetic maintenance of capital rules would become redundant and should be repealed.

29. *Articles 18 and 19-22*
See the general capital maintenance comments above. Article 18 contains a prohibition on subscribing for own shares and Articles 19-22 contain a prohibition on acquisition of own shares (see also Article 35 below for redemptions and buy backs). If the distributions provisions are repealed then these Articles should similarly be repealed. If a replacement distributions regime is retained at EU level, this should permit a solvency basis for distributions, and these provisions prohibiting subscription for own shares would need to be adapted to require that own shares must be acquired from assets capable of being distributed. These Articles also contain many redundant provisions that should be repealed.

30. *Article 23*
This Article sets up the prohibition on financial assistance for the acquisition of own shares. The continuity of this Article should be reviewed in light of the Market Abuse Directive and the approach to distributions generally. In the UK we believe there is widespread opinion that this is a provision whose usefulness is long passed.

31. *Articles 24-24a*
These miscellaneous provisions apply to the foregoing Articles and should therefore be subject to consequential adaptations or repeals as appropriate.

32. *Articles 25-28*
These Articles provide the procedures for an increase in capital and the amount and nature of the consideration. In relation to the latter, it is the familiar '25% of nominal plus all of the premium' rule. They also impose the requirement for reports on non-cash consideration. They also make short provision for cases where an increase is not fully subscribed.

These Articles should be mostly capable of repeal in the same way as Articles 7-12 (see above).

33. *Article 29*
These Articles set out the pre-emption rights for cash increases in subscribed capital, together with the facility and procedures for dis-application of that right.

We believe that the EU should prescribe minimum non-dilution protections for the shareholders of companies with securities traded on a market. In principle, we believe pre-emption rights should be applied to companies traded on a market, but if it is not practical to define such markets on an EU wide basis then public companies might be an appropriate alternative.

We believe at least some of the detailed procedures are unnecessary and should not be retained, for example, the requirement to for a written report from management justifying the proposed issue price.

Subject to our comment above regarding unnecessary provisions, we recommend that these measures should be retained at EU level, but suggest they should instead be applicable to companies with securities traded on a market, and that they be dealt with in some other directive more naturally related to the topic, such as market-related directives or the Shareholder Rights Directive.

34. *Articles 30-34*
These Articles deal with reduction in subscribed capital, addressing the procedures for the decision to reduce capital and/or create the creditors' rights on such occasions. Please see general capital maintenance comments above. If the distributions provisions are repealed then these Articles should similarly be repealed. If a replacement distributions regime is retained at EU level, this should permit a solvency basis for distributions, and these provisions restricting reduction of capital would need to be adapted to be on a solvency basis.

35. *Article 35*
This Article deals with redemption and buy-back of shares out of distributable profits. Please see the general capital maintenance comments above. If the distributions provisions are repealed then this Article should similarly be repealed. If a replacement distributions regime is retained at EU level, this should permit a solvency basis for distributions, these provisions would need to be adapted to require that shares must be redeemed or bought back using assets capable of being distributed.

36. *Articles 36-38*
These are miscellaneous provisions. They provide for the withdrawal of shares acquired by the company itself. We recommend that the EU should consider whether these provisions are necessary at EU level. If they are then we suggest they should be moved to the Shareholder Rights Directive.

They also provide for the reduction of subscribed capital by compulsory withdrawal of shares. This is a Member State option that the UK has chosen not to implement and we believe it should be repealed.

Article 38 applies to the foregoing Articles and should therefore be subject to consequential adaptations or repeals as appropriate.

37. *Article 39*
This Article lays down the conditions by reference to which a company may issue redeemable shares. We see no reason why this should be dealt with at EU level and therefore we suggest this should be repealed.

38. *Articles 40-42*
These are miscellaneous provisions, setting out the voting majorities required pursuant to certain foregoing Articles, and providing derogations for employee share ownership or workers' shares, and should be subject to consequential adaptations or repeals as appropriate

They also contain a very short Article providing for equal treatment of shareholders. This is open to interpretation – some of which from time to time have been excessively cautious. We are not aware that it has, since 1977, been a piece of EU law that has brought demonstrable benefits; we urge its repeal.

Twelfth Company Law Directive

39. This Directive facilitates the establishment of subsidiaries in other member states, as it removes the need for a second share to be held through a nominee, and can avoid the need to instruct local counsel. This is an area where we believe the need for deregulation should be balanced against the advantages of consistency across the common market. We are therefore not in favour of repeal of the entire Directive.

40. We note, however, that that this Directive contains requirements for supporting internal procedures, including:

- the need to make an entry in the share register when a company becomes a single member company because all its shares come to be held by a single person;
- the need for decisions of the single member taken at the general meeting to be recorded in writing; and
- contracts between the member and the company to be recorded in the minutes or drawn up in writing.

We consider that these requirements for supporting internal procedures are unnecessary as we see no reason why single member companies require specific provision at EU level in relation to such matters. We therefore recommend that these Articles be repealed.

First Company Law Directive

41. The Communication does not propose repeal of this Directive, but instead proposes some specific simplification proposals. We agree with the proposal of moving from Gazette to internet disclosure but, given that parties such as banks routinely review the Gazette for liquidations/capital reductions, if the Gazette is to be replaced by electronic resource it should include a daily transactions list on one website. We also note that it can still be difficult to search registers in other

member states, for instance where they have several regional registers rather than one single register – for this reason we believe that there should be a requirement for each Member State to have one single register.

42. We acknowledge that this Directive has recently been updated, allowing electronic filing of documents with national registries and enabling electronic searches of the registries. However, we consider there is scope for further reform. We see no reason why pre-incorporation contracts, certification formalities on formation, and conditions for nullification in the absence of such certification, need to be dealt with at EU level, and we therefore suggest that Articles 7 to 12 should be repealed, leaving these requirements to be dealt with by member states in their domestic legislation.

Eleventh Company Law Directive

43. This Directive requires an EU company to supply specified information to the host state registry when it sets up a branch there. Companies must supply translations, and host member states are free to impose requirements on formalities such as certification and notarisation. It is proposed that the host State should be required to accept the certified translation prepared in the home State of the company. We support this proposal; the important point is the ability to access information in the language of the Member State in which the branch is established.

44. The consultation document also proposes a future review of this Directive once further progress is made in establishing electronic links between national registries (the BRITE project, a common multi-language interface enabling access to registers in other member states), which could eventually permit branches to file branch particulars in the member state where the company is registered, thereby eliminating double reporting. This would seem to offer a way forward provided searchers in the host Member State are able to obtain information in the host language.

European Company Statute

45. The consultation document proposes a small change to abolish the requirement for registered and head offices of European Companies to be located in the same Member State, in the light of European Court of Justice case law. We would support this simplification, which would afford European companies greater flexibility in structuring their administrative operations. However, we note that very few SEs have been established and so we do not believe this measure should be prioritised over the other proposals. We also note the EU is consulting on a possible European Private Company, which in our view should not be prioritised (we will be responding separately to that consultation).

46. We would also suggest an additional simplification; in addition to the proposals for the First company law Directive, the Commission should consider dispensing with EU requirements for company information to be published in the Official Journal of the EU. Therefore, we would recommend that Article 14 of the Regulation on the Statute for a European Company should be deleted.

RESPONSES TO SPECIFIC QUESTIONS/POINTS IN ACCOUNTING

47. We welcome the review by the Commission of a number of important aspects of the current European financial reporting regime. However, in our view the purpose and scope of the accounting directives should be subject to a more fundamental review given the many changes in the business environment since they were enacted. The objective should be the production of modernised and more principles-based requirements, ideally produced on a 'think small first basis'.

Introduction of "micro-entities"

48. We agree that there is a *prima facie* case on deregulatory and cost-benefit grounds for exploring whether member states should be able to exempt very small entities from the full rigours of the accounting directives.

49. The economic and legal ramifications of such a change are, however, likely to be complex. For example, the existing rules on distributions would need amending for micro companies. It would also be important to seek to avoid unintended consequences and the scope for abuse. The Commission should therefore ensure that any more detailed proposals in this area are based firmly on the results of relevant research and are subject to rigorous public debate. Evidence relating to the experience of jurisdictions that do not require micro and/or small companies to produce and file statutory financial statements, for example Australia, will be of particular relevance in this context.

50. Following any changes in EU law, national jurisdictions would of course need to consider the minimum reporting requirements appropriate for such entities to satisfy the information needs of national authorities. We would envisage in the UK a requirement for very simple accounts drawn-up in accordance with the recognition and measurements requirements of accounting standards as they apply to small companies, but with very few disclosures and a single straightforward format, with any detailed reporting requirements developed outside of the law.

Definition of "micro-entities"

51. The proposed thresholds for micro companies are, inevitably, arbitrary, and we recommend that further research in this area is undertaken if the Commission proceeds with the proposal. Account should also be taken of any existing definitions of very small entities in other areas of EU law.

52. The proposed thresholds might be regarded as high if a typical micro-entity is regarded as one owned and managed by just one or two individuals, unlikely to make a significant economic impact in its local environment and with few significant creditors. If the results of the research recommended above are not conclusive, the Commission should initially err on the side of caution, adopting lower thresholds than those suggested pending a review of the impact of any first steps towards deregulation of this sector.

53. In the 2003 EC Recommendation referred to in the Communication, the limit for employees (the 'staff headcount criterion') was identified as the main criterion which had to be met for an entity to be categorised as a micro-entity. Only one of the two financial criteria (annual turnover and annual balance sheet total) had to be met. The current proposals do not clearly identify which of the criteria have to

be met for an entity to qualify as a micro-entity. This should be remedied; we would support the current formula of ‘any two out of three’.

Thresholds for SMEs

54. We do not believe from a financial reporting perspective that there is a compelling case for changing the current transition periods. In our experience movement between the existing size bands is not common and an expanding company which moves into a higher band is likely to stay there for some considerable period. If the Commission presents evidence at the next stage of the consultative process that, for example, an increase from two to three years would alleviate the reporting burden in a substantial number of cases where companies are moving between the thresholds, we will assess the available evidence at that time. However, we strongly believe that a five year transition period is too long and that the evidence will bear this out.

55. We recognise that companies in decline may benefit from moving into the small company reporting regime at an earlier stage than at present. However, if the decline is only a temporary one there will be a cost burden associated with moving from one reporting regime to another and back again within a short period. A one year transition may also be open to abuse. We therefore conclude that the two year transition period should remain in place for companies ceasing to exceed the thresholds.

56. Please see paragraphs 84-86 in the Auditing section below for further comments on this matter.

Procedure for the adaptation of thresholds

57. We are unclear about the specific point being addressed in the Communication in relation to the adaptation of thresholds. We assume that this is the built-in indexation of the thresholds which takes place every 5 years (the next one being due in 2008). This is dealt with in Article 53 of the Fourth Company Law Directive, which is cited in the consultation document. If this is the case, we see no problem in supporting the simplification of the procedure as this is just an inflationary adjustment, thus leaving this adaptation to the Commission assisted by the Accounting Regulatory Committee with scrutiny rights for the Council and European Parliament.

58. The point at issue may however be the adaptation of thresholds, such as the optional 20% increase that was approved in 2005. In principle, we support the simplification of legislative procedures to allow for swift decision-making in light of economic trends. However, we note, as we have done in the past, that this increase was approved without an impact assessment to support it. We are not against simplification of the institutional decision-making process should the Commission pursue this course of action, but we reiterate that this should not in any way undermine the process of consultation and impact assessment required before any such measure is adopted. The setting of thresholds is a complex matter which needs to take into account a number of factors. Given its importance to European businesses and the economy, the issue merits careful consideration from the EU institutions in close consultation with relevant stakeholders.

59. Finally, for the avoidance of doubt, we would reiterate that member states should retain full discretion to set thresholds below the EU maxima, regardless of any changes made to procedure at European level.

Relieve from publication requirements for small companies

60. We do not think that the Commission has made a convincing case for exempting small companies from the requirement to publish their accounts. The additional costs involved where a company is already preparing and distributing its financial statements are negligible.

61. We recognise, however, that the benefits of small companies *producing* statutory financial statements in the first place are poorly understood, and that some developed economies appear to function efficiently without any such requirement. This issue merits further consideration. Any decision to exempt small companies from producing - and publishing - statutory financial statements should not, of course, be taken lightly. It would need to be based very firmly on the results of rigorous research into the users and uses of small company financial statements and the experience of other jurisdictions, and might necessitate the introduction of a number of statutory safeguards. However, we anticipate that the removal of the blanket requirement for every small company to produce statutory financial statements – which applies irrespective of the demand from its lenders and other stakeholders – could involve significant cost savings for many businesses. Accordingly, we encourage the Commission to continue to explore the public interest case for more fundamental reform of the SME accounting and reporting regime.

Wider use of small company exemptions – owner managed companies

62. We are not convinced that there is a sound case for extending to medium-sized companies managed by their owners the existing significant exemptions available to small companies. Medium-sized companies are often entities of substantial economic significance with a number of stakeholders interested in their accounts. Any moves in this direction should, again, only follow rigorous research into the uses to which the financial statements of such companies are put and the consequences for creditors, minorities and other stakeholders of providing access to the exemptions available to much smaller companies. We would welcome an early indication of the Commission's intentions in this area.

63. The Communication refers to the application of a 'risk-based' approach; we would point out that the risks to be assessed would extend far beyond share-ownership. It also suggests that exemptions should be extended provided that no member who is not a director 'has more than 5%'. We assume that this criterion will be expressed in terms of shares controlled, rather than owned. Even so, we question whether this would provide adequate protection for minority shareholders with smaller holdings.

64. We would also point out that, in our experience, the substantial practical difficulties attached to any definition of "owner-managed" may militate against the use of the concept of owner-management in the context of accounting exemptions. In any case, in our view the key to any assessment of the case for extending the reach of small company exemptions is a very clear understanding of the needs of the users of the general purpose financial statements of the types of entity that would newly benefit from those exemptions.

Wider use of small company exemptions – unlimited companies

65. In general, creditor protection is not an issue with respect to unlimited companies. We agree in principle that the proposed exemptions should be made available to

such companies. Indeed, the Commission might consider a general exemption for unlimited companies from the requirement to produce statutory financial statements, alongside adequate safeguards, including for minorities.

Consolidation

66. We recognise that there is uncertainty over whether or not parent companies that have subsidiaries of no material significance fall under the IAS Regulation and are thus required to prepare IFRS financial statements. This is clearly undesirable.

67. However, this is symptomatic of a wider uncertainty. We have called on a number of occasions for the Commission to clarify the relationship between the accounting directives and the IAS Regulation. We again urge the Commission to explain clearly how the directives and the Regulation interact, appending any advice received from its lawyers on this issue, in the interests of clarity and certainty.

68. We have no comments on the proposals to abolish requirements for consolidated accounts for personal holdings, which have not been implemented in the UK.

Accounting for deferred taxes

69. The Fourth Company Law Directive does not require that deferred tax be provided, only that it should be disclosed (where provided). The requirement to provide for deferred tax is found in accounting standards. Accordingly, any change to the requirements of the directives in this regard would not involve any substantial savings.

70. We are not aware of any evidence that the cost of accounting for deferred taxes outweighs the benefits to users. On the contrary, our experience is that information on deferred tax liabilities is valuable, including to the owner-managers of many small companies.

Disclosures

71. We agree that the directives should prescribe a minimum number of disclosures in financial statements: detailed requirements should be included in accounting standards rather than legislation. However, we are reluctant to suggest the withdrawal of any particular disclosure requirements without a better understanding of the views of users.

72. We strongly recommend that a full list of the disclosures currently required by the directives is circulated to relevant users groups with a request that they identify items they find especially useful and explain how the information is used. Disclosures can only be justified if they are useful and used - those that are not should be removed from the law.

RESPONSES TO SPECIFIC QUESTIONS/POINTS IN AUDITING

73. The Communication's proposed measures in relation to audit primarily focus on the eligibility of certain types of companies for audit exemption. These proposals are as follows:

    - Trespassing thresholds for SMEs (proposal 2) and changes to the procedures by which thresholds are amended. This has implications for the ability of a company to claim audit exemption.
    - Extension of exemptions for medium-sized entities where there are no particular external user needs (proposal 4). This may result in some medium-sized companies being eligible for audit exemption.
    - Simplification for all companies – consolidation (proposal 5). This may mean that some SME subsidiaries are no longer required to have audited accounts.

    The overall effect of these proposals would be to allow more companies to benefit from audit exemption.

Benefits of the statutory audit

74. As stated earlier, the ICAEW is in principle supportive of measures that might help to simplify and reduce the administrative burden faced by small and medium-sized entities and we would not support a requirement for a statutory audit where there was no public interest need or where the perceived benefits did not outweigh the costs.

75. There has always been much discussion about the potential costs of a statutory audit and whilst it is necessary to seek to assess these costs, it is also important not to overlook the valuable qualitative benefits that the statutory audit provides for various stakeholders. Many of these benefits might be difficult to measure in a regulatory assessment but they are important and should not be ignored.

76. Historically, part of the price paid by companies for the privilege of limited liability has been seen as the public disclosure of information in the form of the accounts and the statutory audit thereon. Whilst the primary purpose of the statutory audit is to report to shareholders on the truth and fairness of the accounts, there are a number of other stakeholders who might benefit from the audit, such as customers, suppliers, employees and lenders. The audit might help to give these stakeholders confidence in the reliability of the information in accounts upon which they may make significant decisions.

77. The statutory audit provides information on how the stewardship of the company has been exercised by its directors; it can help companies to keep up-to-date and well maintained records and can help to identify issues of relevance to the management of the company, for example, in areas such as the company's ability to trade for the foreseeable future. It can also help to deter fraud. It plays a critical role in strengthening accountability and reinforcing confidence and trust in financial reporting and thus the wider economy.

78. Extending the eligibility for audit exemption does allow for market forces to play a greater role in the audit market. Those companies that see value in the audit will continue to request a voluntary statutory audit but a concern remains over the volume of companies that will choose not to have an audit and its impact on the potential public interest issues identified below.

Other public interest issues

79. There are a number of critical issues to consider when extending eligibility for audit exemption. Firstly, the impact this might have on the quality of information in accounts. Whilst we note the Commission's proposal to relieve small companies from the filing of accounts, this would not appear to remove the need to prepare accounts and these might be distributed to third parties. Extending the eligibility for audit exemption might not have an immediate impact; the quality of information is likely to deteriorate over time as companies experience changes in staff and accounting requirements.

80. Secondly, there is a risk that extending eligibility for audit exemption could increase opportunities for criminals and lead to a rise in economic crime, such as fraud and money laundering. The prevalence of fraud is increasing and these proposals would result in more companies being exempt from the need to ever open themselves up to an independent qualified accountant with money laundering reporting obligations. It is also important to examine whether any simplification initiatives proposed may conflict with other policy initiatives being undertaken, such as efforts in relation to the fight against money laundering.

81. Thirdly, any extension of eligibility for audit exemption is likely to impact on competition and choice in the audit market. If fewer companies require an audit, some firms are likely to cease their audit registration and this might limit choice for other entities such as pension schemes and charities that still require an audit. It might be more difficult for these entities to find locally based expertise at affordable prices.

82. Finally, there may be implications with regard to tax revenues as without an independent check on the reliability of information in the accounts, companies may manipulate information or there may be accidental errors in the accounts which lead to an understatement of profit. This might result in the various tax authorities implementing more stringent inspection regimes with a consequential increase in administration for companies.

83. We look forward to reviewing the Commission regulatory impact assessment of these potential consequences and we would urge the Commission to conduct thorough research in these areas where there are concerns about their pervasiveness.

Thresholds for SMEs

84. From an audit exemption perspective we are also not convinced of the arguments in favour of changing the two-year transition period for crossing the thresholds. We believe that the focus should be on understanding the rationale behind the existing rules rather than exempting as many companies for as long a period as possible from the requirement to have an audit. We are not aware of any concerns that have arisen with the application of the existing rules and these new rules might just serve to complicate the situation further.

85. If a small company is growing rapidly and likely to exceed the thresholds over the next couple of years the company is very likely to want and need an audit. There is much that can happen in five years. Likewise, if a company is medium-sized but then has one difficult year which means it would fall into the small company thresholds, we question whether it is right to classify it as a small company when the following year it is trading as medium-sized again, which means that potentially another five years would have to pass before it is required to be

audited again. By contrast, that one difficult year might actually represent the start of financial difficulties for the company, which an audit might have picked up on.

86. Please see paragraphs 54-59 in the Accounting section above for further comments regarding this issue and on the procedure for adapting thresholds.

Wider use of small company exemptions

87. We refer to the comments included on this topic under the Accounting section above, and would add that if some medium-sized companies are no longer required to prepare audited accounts, or for that matter, file any accounts at all, it might be far more costly for these other stakeholders, such as suppliers, customers, employees and lenders to obtain the information they need.

Consolidation

88. In principle the ICAEW can see some merits, such as potential cost savings to groups of companies, in proposals to exempt certain SME subsidiaries from the requirement for an audit so long as the group auditor has the right to require an audit if he/she considers it necessary. This might be of particular value to the significant volume of small subsidiaries of larger public interest entities.

89. There are, however, some concerns with such proposals. It is not clear why so few member states have previously taken up this option. This might be because there is a potential concern that such provisions may mean that certain companies will start creating more complex group structures so as to avoid having aspects of their accounts audited. Smaller companies have very different risk profiles to the larger public interest entities and there might potentially be more scope here for the use of group structures for illegitimate purposes. An example of this might be where a subsidiary revalues its stock above cost, thereby understating direct costs and overstating profits. Without the audit, there would be no independent check on this.

90. These proposals also have potential implications for other users of the accounts, who might lose the ability to access audited financial information (or if the filing requirement disappears, any financial information) about the company. This might be particularly relevant to cross-border groups.

91. Another potential issue concerns the robustness of the guarantees given by the parent companies. For example, if a parent company claims that it has given a guarantee, what procedures will there be to check that this is actually in place and is effective and how will stakeholders be able to access information about this?

Position in the UK

92. Whilst we have pressed for more research into the consequences of raising the thresholds in the UK, the ICAEW has been proactively considering the changes in the SME market and relevant stakeholder views.

93. As a result of changes to the audit exemption thresholds in the UK, the demand for audit at the small company level is driven by the market and to better understand the changes in the market place the ICAEW is currently undertaking a two-year consultation into the needs of audit-exempt companies. We have developed new interim guidance on an assurance service positioned between the voluntary statutory audit and accounts compilation, the ICAEW Assurance

Service. This is an additional, voluntary service that might be offered to companies that do not require an audit. We are aware of increasing interest in this project among the various stakeholders and will keep the Commission updated as our consultation progresses as a source of information that may assist the Commission's own research in this area.

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