



## Which Businesses Need an Audit?

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## Which Businesses Need an Audit?

### Introduction

In September 2012, the Department for Business Innovation & Skills (BIS) announced changes to the exemptions from audit for certain UK companies and Limited Liability Partnerships (LLPs). According to BIS nearly 200,000 smaller private companies, subsidiaries and dormant companies would not now need an audit, saving millions of pounds in audit fees.<sup>1</sup>

There are two important broad exemptions which can apply to UK companies and LLPs which allows many to prepare annual accounts of a simplified form and content and to be exempt from audit. Until the recent BIS changes, the qualifications for these exemptions were not aligned.

This technical note sets out which companies need an audit and which can now claim an exemption if they want to. The position set out applies to all accounting periods beginning on or after 1st October 2012.

### Requirement for an Audit

The relevant UK legislation for companies is to be found in Companies Act 2006 s475, which requires a company's annual accounts for a financial year to be audited unless it is exempt under one of four headings:

- Small companies
- Dormant companies;
- Small subsidiaries; or
- Non-profit making companies subject to public sector audit

Under s476 CA 2006, even if a company is entitled to exemption from audit, it must obtain an audit if shareholders representing not less than 10% of the share capital by value give the company notice.

UK companies legislation is subject to the overriding requirements of the EU 4th Company Law Directive. Articles 51 (2) and 57 of that directive set out the maximum exemptions which member states may apply. The changes made with effect from 1st October 2012 apply the exemptions to the maximum permitted by the Directive.

Audits are also required for certain LLPs. Reg. 3 of the regulations set up under the Limited Liability Partnerships Act 2000, applies the Accounts and Auditing requirements of the Companies Acts to LLPs.

<sup>1</sup> Department of Business Innovation & Skills: Audit Exemptions and Change of Accounting Framework, Government Response to Consultation 6th September 2012

## The Exemptions from Audit

There are three exemptions from audit: small companies and LLPs, dormant companies and LLPs and subsidiary companies and LLPs.

### Small companies and LLPs

s382 and s477 CA 2006 set out the conditions which must be met in respect of a financial year and is now aligned with the accounting thresholds for small companies. The conditions are that in respect of any financial year the company must meet two or more of the following requirements:

- Its turnover is not more than £6.5 million; and
- Its balance sheet total<sup>2</sup> is not more than £3.26m
- Its number of employees<sup>3</sup> are not more than 50

For a financial year which is not in fact a year, the maximum turnover is proportionately adjusted.

### Dormant companies and LLPs

Under s480 CA2006, a dormant company which is not a subsidiary is exempt from the requirement to prepare accounts for a financial year.

“Dormant” is defined in s1169 CA2006 as meaning that it has no significant transaction for a complete accounting period which needs to be entered into the accounting records. The following transactions may be disregarded:

- Those arising from an undertaking given by a subscriber for shares on incorporation
- Fees or penalties payable to the Registrar of Companies for a change in name, re-registration of the company, failure to file accounts or the annual return.

A new s394A has significantly extended the exemption for dormant companies to many dormant subsidiaries where the subsidiary has been dormant throughout the whole of the accounting period and the parent is established in an EEA State. This is subject to certain conditions which are applicable to all subsidiaries and are covered below.

<sup>2</sup> Balance sheet total is defined in s382 as the aggregate of the amounts shown as assets in the balance sheet

<sup>3</sup> The number of employees is defined in s382 as the average number of employees employed by the company determined as follows:

(a) find for each month in the financial year the number of persons employed under contracts of service by the company in that month (whether throughout the month or not),

(b) add together the monthly totals, and

(c) divide by the number of months in the financial year.

### **Subsidiary companies**

The definition of a subsidiary under the Companies Acts is defined in s1159 and Schedule 6 CA2006 and is complex but broadly applies where one company holds the majority of the voting rights in another or is a shareholder and has the right to appoint or remove a majority of the directors.

Under s479A CA2006, in order for a subsidiary to be exempt from audit, all of the following conditions need to be fulfilled:

- (a) its parent is established under the law of an EEA state;
- (b) all the subsidiary's shareholders must unanimously agree to dispense with an audit in the financial year in question;
- (c) the parent must give a statutory guarantee of all the outstanding liabilities to which the subsidiary is subject at the end of the financial year;
- (d) the company must be included in the consolidated accounts drawn up by the parent undertaking, which must be prepared in accordance with Directive 83/349/EEC (the Seventh Company Law Directive);
- (e) the use of the exemption by the subsidiary must be disclosed in the notes on the consolidated accounts drawn up by the parent;
- (f) the following documents must be filed by the directors of the subsidiary at Companies House on or before the date that they file the subsidiary's accounts:
  - i. written notice of the agreement in (b);
  - ii. a statement by the parent that it guarantees the subsidiary company as required under the statutory guarantee
  - iii. a copy of the consolidated report and accounts referred to in (d) and the auditor's report on those accounts;
- (g) the subsidiary is not itself quoted;
- (h) it is not an authorised insurance company, a banking company, an e-Money issuer, a MiFID investment firm or a UCITS management company, or carries on insurance market activity; and
- (i) it is not a "special register body" such as a trade union or an employer's association.

These new conditions are potentially much looser than the conditions which applied up until 1st October 2012, when, broadly subsidiaries could not be exempt unless the whole group met the "small group" criteria.

### **The Statutory Guarantee**

A statutory guarantee is required for both the small subsidiary and the dormant subsidiary legislation. The parent company must guarantee all outstanding liabilities to which the subsidiary is subject at the end of the financial year until they are satisfied in full. The guarantee is also enforceable against the parent by any person to whom the subsidiary is liable in respect of the liabilities.

The statement of guarantee must be authenticated by the parent (i.e. signed on its behalf) and must specify:

- the parent's name;
- if incorporated in the UK, its registered number or if incorporate out side the UK, the country in which it is incorporated, the register on which it is registered and the number;
- The name and registered number of the subsidiary in respect of which the guarantee is being given;
- the date of the statement;
- the financial year to which the guarantee relates.

### **Audit Exemption Statements**

In order for accounts to be filed at Companies House, the balance sheet of a company using an exemption must contain the following statements above the signature of the director signing:

*"Audit Exemption Statement*

*For the year ending (dd/mm/yyyy) the company was entitled to exemption from audit under [section 477 of the Companies Act 2006 relating to small companies/section 48-Companies Act 2006 relating to dormant companies – use as applicable].*

*Directors' responsibilities:*

*the members have not required the company to obtain an audit of its accounts for the year in question in accordance with section 476,*

*the directors acknowledge their responsibilities for complying with the requirements of the Act with respect to accounting records and the preparation of accounts".*

### **Audit Review Comment: The Use by Groups of the Exemptions**

One of the intentions of the changes announced in September 2012 was to permit more small and dormant group companies to dispense with an audit, although the accounts of those companies will, of course, usually be subject to inclusion within a group audit.

Many groups will be put off from applying the exemptions by the headline need to guarantee their subsidiaries. However, Audit Review believe that groups should carefully consider the effect of the guarantee and how detrimental it might be. The following points should be considered:

- whether the subsidiary is 100% owned or whether there are minority shareholders. There is no provision in the act for minority shareholders to guarantee their share and thus 100% of any liability will fall upon the parent. However, it may be possible to agree reciprocal proportionate guarantees with minority shareholders if required.
- whether the subsidiary was incorporated for reasons other than to limit liability. Some group service companies, for instance, are set up primarily for tax purposes and, in practice would not be allowed to fail.
- dormant subsidiaries often have no third party liabilities. The guarantee therefore might only benefit other group entities.
- the effect of the liability may be significantly mitigated by the time the accounts are signed and filed at Companies House. Most subsidiaries have up to 9 months to file accounts and if they are filed and the guarantee given close to the end of this time limit, many of the liabilities at the last balance sheet date may have been extinguished. In any event, the guarantee will only remain for a further 3 months. Many financial liabilities, for instance bank loans, which are for longer than 12 months may already be subject to more stringent parent company guarantees.
- there are other advantages to having an audit and the directors and/or minority may wish to receive the benefits of independent scrutiny.

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## Further Reading

**Companies Act 2006** *UK Legislation*

<http://www.legislation.gov.uk/ukpga/2006/46/contents>

**The Companies and Limited Liability Partnerships** (Accounts and Audit Exemptions and Change of Accounting Framework) **Regulations 2012** *UK Legislation*

<http://www.legislation.gov.uk/uksi/2012/2301/introduction/made>

**4th Company Law Directive 78/660/EEC** *European Union 1971*

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31978L0660:en:HTML>

**Limited Liability Partnerships Regulations 2001** *UK Legislation*

<http://www.legislation.gov.uk/uksi/2001/1090/contents/made>



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