

**DEPARTMENT FOR BUSINESS
ENTERPRISE & REGULATORY REFORM**

**CORPORATE GOVERNANCE
AND EUROPE**

Implementation of Directive
2006/46/EC on Company
Reporting – Amending
Accounting Directives

GOVERNMENT RESPONSE

JULY 2007

EUROPEAN COMPANY LAW AND CORPORATE GOVERNANCE

Implementation of Directive 2006/46/EC on Company Reporting - Amending the Accounting Directives

GOVERNMENT RESPONSE TO CONSULTATION

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EUROPEAN COMPANY LAW AND CORPORATE GOVERNANCE

Implementation of Directive 2006/46/EC on Company Reporting - Amending the Accounting Directives

Introduction

1. In March 2007, the government published a consultation document seeking views on the implementation of Directive 2006/46/EC on Company Reporting. The consultation period closed on 1 June 2007. This document contains a summary of responses and the government's response to the consultation.
2. The Directive amends Council Directives:
 - 78/660/EEC on the annual accounts of certain types of companies ("the Fourth Directive"),
 - 83/349/EEC on consolidated accounts ("the Seventh Directive"),
 - 86/635/EEC on the annual and consolidated accounts of banks and other financial institutions ("the Bank Accounts Directive") and
 - 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings ("the Insurance Accounts Directive").
3. The amendments introduced by the Directive are part of the short-term priorities under the Commission's EU Company Law and Corporate Governance Action Plan published in May 2003 (endorsed by the Competitiveness Council in September 2003). They seek to enhance confidence in financial statements and annual reports published by European companies by introducing:
 - An option for Member States to raise the financial thresholds defining small and medium companies by 20%.
 - An option for Member States to require or permit the valuation of further categories of financial instruments using "Fair Value" accounting in accordance with International Financial Reporting Standards (IFRS).
 - A requirement to extend disclosure requirements in respect of off-balance sheet transactions and related party transactions.

- A requirement for publicly traded companies¹ to include a corporate governance statement in their annual (directors') reports.
- A requirement to ensure the collective responsibility of board members towards the company for the annual accounts and reports.

4. The full text of the Directive is available from the following link: http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_224/l_22420060816en00010007.pdf

5. A copy of the consultation document is available from <http://www.berr.gov.uk/consultations/closedwithresponse/index.html>

¹ Companies whose securities are admitted to trading on a regulated market within the meaning of Article 4(1), point (14) of Directive 2004/39/EC.

The Government's Response

Summary

6. Member states are required to implement the provisions in the Directive by September 2008. In order to meet this requirement we intend to implement the accounting requirements of the Directive through regulations on the form and content of accounts to be made under Part 15 of the Companies Act 2006. The draft regulations will be available through the BERR Companies Act 2006 webpage at: <http://www.berr.gov.uk/bbf/co-act-2006/index.html>.

7. The requirements for publicly traded companies to prepare a corporate governance statement will be implemented by rules to be made by the Financial Services Authority (FSA) under Part 6 of the Financial Services and Markets Act 2000 (as amended by section 1269 of the Companies Act 2006).

8. To avoid unnecessary legislation and burdens to business we will take up all the exemptions in the Directive including the option to increase the thresholds defining small and medium-sized companies. The increased thresholds will also be applied to exempt some small companies from the requirement to have a statutory audit.

9. Officials of the Department for Business, Enterprise and Regulatory Reform (BERR) will work with the regulators and standard setters over the coming months to implement the requirements of the Directive. Our overall approach to implementation is set out below.

Small and Medium-sized Company Thresholds

10. The Government will take advantage of the option to raise the thresholds defining small and medium-sized companies and groups in line with the maximum limits offered by the Directive. See Part 2 of the draft Companies Act 2006 (Accounts and Reports) (Amendment) Regulations 2008 on the BERR web site.

Other Observations concerning Thresholds

11. The thresholds used to determine eligibility for an exemption from the requirement to have a statutory audit will be revised in line with the thresholds used to define small companies and groups. Applying the revised small company and group thresholds to audit exemption is a deregulatory measure that will deliver significant benefits for an important sector of business. The RIA published with the consultation paper in March showed that this would allow 6100 small companies to take up the audit exemption. Small companies will still

be able to choose to have their accounts audited if they consider it beneficial to do so, and under section 476 of the Companies Act 2006 shareholders will still have the right to request an audit.

12. It is appropriate that the threshold is increased again now, partly in line with inflation since 2004. It is also appropriate that the threshold for the audit exemption continues to be in-line with the threshold for the abbreviated profit and loss account and balance sheet requirements.

13. The thresholds will be raised through Part 2 of the draft Companies Act 2006 (Accounts and Reports) (Amendment) Regulations 2008 on the BERR web site.

Fair Value Accounting

14. The Government will take up the option to permit companies preparing accounts under the Companies Act 2006 using UK Financial Reporting Standards (FRS), to use fair value accounting in accordance with IAS 39 in both their individual and consolidated accounts. See the following regulations published on the BERR web site: the draft Small Companies and Groups (Accounts and Directors' Report) Regulations 2008, Schedule 1, paragraph 36(4); the draft Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 1, paragraph 36(4), Schedule 2 paragraph 44(4) and Schedule 3 paragraph 30(4).

Disclosure Requirements

Off Balance Sheet Transactions

15. The Government will implement the Directive's requirement to disclose "off-balance sheet arrangements" without further elaboration. BERR guidance will draw attention to Recital (9) to the Directive.

16. Small companies and groups will be exempt from this requirement. In drafting the regulations we also intend to utilise the Member State option to allow medium-sized companies to limit disclosure to information about the nature and business purpose of the arrangements. See Part 3 of the draft Companies Act 2006 (Accounts and Reports) (Amendment) Regulations 2008 on the BERR web site.

17. Officials will work with the standard setters to agree what action needs to be taken in respect of UK accounting standards.

Related Party Transactions

18. The Government will take up all the options to exempt or limit disclosure for small and medium-sized companies about transactions entered into by the company with related parties. In the light of concerns expressed by consultees, the implementing legislation will also be drafted to make clear that the disclosure is a minimum requirement, and that companies are free to make further disclosures in line with international accounting standards should they so wish.

19. See the following regulations published on the BERR web site: the draft Small Companies and Groups (Accounts and Directors' Report) Regulations 2008; the draft Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, regulation 4(2)(b), Schedule 1, paragraph 72, Schedule 2 paragraph 92 and Schedule 3 paragraph 90.

20. Officials will work with the standard setters to agree what action needs to be taken in respect of UK accounting standards.

Corporate Governance Statement

21. In light of the responses to the consultation, the Government has concluded, with the agreement of the FSA, that this requirement to issue a corporate governance statement should also be implemented via the FSA Rules made under Part 6 of the Financial and Market Services Act 2000 (as amended by section 1269 of the Companies Act 2006). Companies will be required under the new Rules to provide a discrete statement covering the specified information either in their director's report, or in a separate corporate governance statement cross-referenced in the director's report.

Directors Responsibilities

22. All respondents agreed that director's responsibilities as set out in the Directive are reflected in UK law and that further action is unnecessary. In light of these views no further action will be taken.

SUMMARY OF RESPONSES

23. There were 27 substantive responses, and one private response to the consultation on the implementation of Directive 2006/46 EC amending the 4th and 7th Accounting Directives. A summary of those responding is set out in the table below.

Summary of those responding to the consultation

Legal	1
Business	2
Trade / Business Associations / Representatives	5
Regulator	1
Accountancy / Audit	10
Finance / Investment	7
OGD / Public organisations	1
Total	27
Private	1

24. A full list of respondents is attached at Annex A. A summary of responses to each question is set out below.

Questions relating to the option to increase thresholds defining small and medium sized companies

Q1 What do you consider to be the risks associated with an increase in the thresholds used to define small and medium sized companies?

Q2 In your view, are the risks of increasing the small and medium sized company thresholds outweighed by the benefits?

25. The majority of respondents to this question confirmed that they considered that there are risks associated with an increase in the thresholds defining small and medium companies. However most thought the risks to be insignificant or outweighed by the benefits arising from the reduction in burdens on small and medium companies. A small minority of respondents did not believe that the benefits outweighed the risks associated with a potential loss or deterioration in quality of information or loss of information. The risks associated with an increase in the thresholds and their wider application are set out in response to Q3 below.

Q3 What are your views on current and proposed reporting provisions (thresholds, exemptions, disclosure requirements, etc.) for small and medium sized companies – do they merit further review?

26. The risks associated with an increase in the thresholds used to define small and medium companies included deterioration in the quality of financial information, non compliance with accounting disclosures, inaccuracies in reports, loss of a deterrent/detection for fraud and money laundering activities, loss of audit provision/expertise. It was also noted that the possible loss of audit expertise could have an adverse impact on charities and pension schemes which are not companies – but which also require the services of a registered auditor. A number of respondents thought that not having audited accounts would have an adverse affect on the credit ratings of small companies. A small number of respondents indicated that further review and/or consultation should be undertaken before the increase in thresholds is applied to the audit exemption.

27. The accounting institutions generally oppose the increase in the thresholds in respect of the audit exemption and provided more substantial responses to these questions. A number of respondents indicated that the thresholds defining small and medium companies and those determining eligibility for exemption from the requirement to have an audit should not automatically be the same.

Questions relating to the use of “Fair Value” Accounting

Q4 Do you agree with these proposals to take up the option to extend the application of “Fair Value” accounting?

28. All those responding to this question supported the proposal to take up the option to extend the application of Fair Value accounting commenting that it would even-out inconsistencies between UK legislation on accounting and International accounting standards.

Questions relating to off-balance sheet arrangements

Q5 What are your views on the proposals for implementing disclosure requirements in respect of off-balance sheet arrangements?

Summary of Responses

29. Most of the respondents to this question supported the government’s approach to implementation. However many also expressed concerns about the lack of clarity of the definition of a “company’s arrangements”. Some respondents felt the use of the term “arrangements” may capture items not intended by the Directive. It was felt that the lack of clarity may lead to inconsistencies in approach. A number thought that a more accurate definition should be provided by the standard setter in guidance rather than in law in order to facilitate a flexible approach to change. One respondent indicated that

guidance in the form of a shopping list of off-balance sheet arrangements may adversely affect the quality of reporting.

30. There was a small and mixed response to the take up of exemptions, the majority of those responding indicating we should take up the small company exemption. A small majority of respondents also supported the take up of the exemptions for medium-sized companies.

Questions relating to related party transactions

Q6 Do you have any comments on the proposed approach to implementing the requirements in respect of related party transactions?

31. Again most respondents to the question expressed support for the Government's approach to this. However many also expressed concerns about lack of clarity of definitions in the Directive. In particular the term "not under normal market conditions" was felt to be unclear and as a consequence would lead to inconsistent disclosures. Respondents thought that the requirements should indicate that they covered all related party transactions not just those conducted at "arms length". Again most respondents indicated that clarity should be provided by the standard setter rather than in law.

32. There was a small and mixed response to the take up of exemptions. On balance responses were in favour of taking the exemption for small companies, and a smaller number, but still a majority, were in favour of the exemption for medium companies.

Questions relating to the Corporate Governance Statement

Q7 Can you identify any need to require further disclosure as regards the duty to include in the corporate governance statement information concerning the operation of shareholders' meetings and a description of how shareholder rights can be exercised?

33. All those responding to this question confirmed the view that no further disclosure was required concerning the operation of shareholders' meetings and a description of how shareholder rights can be exercised.

Q8 Which of the 3 options:-

a) Prescribe the reporting requirements as part of the Companies Act regime;

b) Prescribe the reporting requirements through rules made by the FSA; or

c) Prescribe the reporting requirements as self-standing corporate governance rules made by the Secretary of State

do you think would be the best approach to implementing the requirement to produce a corporate statement?

34. Most of the respondents to this question expressed a preference for the Corporate Governance statement to be implemented through rules made by the Financial Services Agency (FSA). The main reasons in support of this approach include:

- One of the main requirements of the corporate governance statement is that companies whose shares are publicly traded on an EU regulated market should disclose whether or not they apply a Corporate Governance Code; explain the extent they comply with such a Code; and give explanations where they depart from the Code. This is similar to the current situation imposed by the FSA through UK listing rules.
- As the statement is only applicable to UK companies trading on a regulated market in the EU (and not to companies more generally), FSA rules would appear to be the most appropriate approach as the FSA are the regulators for listed companies.
- The criminal sanctions associated with a Companies Act and SoS regime are not considered a “light touch” approach and may inhibit meaningful disclosure.

35. Reasons given in support of the Companies Act Regime were that FSA rules would not cover all those companies covered by the scope of the Directive, and that implementation via a Companies Act Regime may offer a way to provide a unified approach.

36. Respondents also commented that the same approach should be adopted in implementing the Corporate Governance statement and the Audit Committee provisions required by the article 41 of Audit Directive in order to avoid regulatory overlap.

Q9 Should companies have the option of whether to publish the (Corporate Governance) statement separate to the directors’ report or should publication be restricted to the directors’ report?

37. Most of the respondents to this question supported the proposal for companies to have the option to publish the Corporate Governance statement as a separate report or in the directors’ report. Only one respondent expressed a preference for publication of the statement to be restricted to the directors’ report.

A number of respondents commented that the facility to cross reference - as available for the Business Review - should be available in respect of the corporate governance statement to avoid duplication when information is required elsewhere.

Questions relating to Directors Responsibilities

Q10 Do you agree that no further action needs to be taken to implement the Directive's provisions on the collective responsibility of directors (other than in relation to any separate corporate governance statement)?

38. All respondents to this question agreed that no further action was required to implement these provisions which are already fully implemented in UK law.

Questions relating to the timetable for implementation

Q11 Do you have any views concerning the timescale for implementation of the Directive in UK law?

39. Those responding agreed with the proposals set out in the consultation document linking implementation of the provisions in the Directive to the implementation of the Companies Act 2006, but one or two felt there should be further clarity about actual commencement dates. The regulations will take effect for financial years starting on or after 6 April 2008.

Questions relating to the draft Regulatory Impact Assessment

Q12 What are your views on the costs set out in the draft regulatory impact assessment?

Q13 Apart from those set in the draft regulatory impact assessment are there any other costs or benefits that should be taken into account when implementing the measures in the Directive?

Q14 What other risks should be considered when implementing the provisions in the Directive, can any action be taken to reduce them?

Q15 Are you aware of any unintended consequences or implications of implementing the provisions in the Directive?

40. 6 respondents provided further information in response to these questions. One or two stated that the cost of disclosure could be higher than the estimates provided, and that the RIA does not reflect cost and benefits of the audit exemption or tax allowances.

41. Respondents mentioned possible unintended consequences from increasing the thresholds defining small and medium-sized companies. These included the loss of quality information, the loss of deterrent and detection of fraud and money laundering activities, the impact on the audit market and those requiring the services of a registered auditor which are not companies e.g. pension schemes and charities.

What happens next?

42. Draft regulations implementing the accounting requirements of the Directive will form part of the package of secondary legislation under the Companies Act 2006. The draft regulations will be published on the BERR website for comment on 20 July 2007 for two months.

43. There are a number of technical issues to be resolved concerning the implementation of the measures in the Directive. These issues will be resolved over the coming months. Officials will work with the FSA, the Financial Reporting Council (FRC), and Financial Reporting Review Panel (FRRP) and the Accounting Standards Board (ASB) to implement the measures.

44. Additional copies of this document are available from the BERR website at:

<http://www.berr.gov.uk/consultations/closedwithresponse/index.html>

45. Copies of original responses are available for public inspection on request. Please contact Julie Ford on 020 7215 2162 or via email at Julie.Ford@berr.gsi.gov.uk should you wish to see individual responses.

List of respondents to consultation

1. UK Shareholders Association
2. London Investment Banking Association
3. Royal Bank of Scotland
4. Grant Thornton
5. Institute of Credit Management
6. Prudential
7. Northern Ireland Court Service
8. Confederation of British Industry (CBI)
9. Chartered Institute of Management Accountants
10. Institute of Chartered Accountants in England and Wales
11. Association of Investment Companies
12. Quoted Companies Alliance
13. Institute of Directors
14. Institute of Chartered Accountants of Scotland
15. London Stock Exchange
16. Ernst & Young
17. Law Society
18. Deloitte
19. KPMG
20. Institute of Chartered Secretaries and Administrators
21. BioIndustry Association
22. Financial Services Authority
23. Association of Chartered Certified Accountants
24. PricewaterhouseCoopers
25. BDO Stoy Hayward
26. Association of British Insurers
27. Investment Management Association.
28. Private Response



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