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In Practice

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The new audit exemption for subsidiary companies and the requirement of a statutory parent company guarantee

INTRODUCTION AND POLICY BACKGROUND

The Companies and Limited Liability Partnerships (Accounts and Audit Exemptions and Change of Accounting Framework) Regulations 2012 (SI 2012/2301) (the Regulations) which came into force on 1 October 2012, amongst other things, exempt subsidiary companies from mandatory statutory audit provided they fulfil the conditions set out in the Regulations. The Regulations apply to subsidiary companies in respect of financial years which end on or after 1 October 2012.

The Government expects that around 83,000 subsidiary companies will benefit from the audit exemption leading to savings of between £100m–£390m per year and, together with the other exemptions and changes under the Regulations, preventing UK businesses from being at a disadvantage compared to their European competitors.

EXEMPTIONS AVAILABLE UNDER THE REGULATIONS

Aside from the audit exemption for non-dormant subsidiary companies contained in the new ss 479A–479C of the Companies Act 2006 (the Companies Act), the Regulations also allow dormant subsidiary companies to claim an exemption from the preparation and/or filing of their accounts (new ss 394A–394C and 448A–448C of the Companies Act). The same exemptions and changes under the Regulations apply to Limited Liability Partnerships under the new provisions of the Limited Liability Partnership (Accounts and Audit) Applications of Companies Act 2006) Regulations 2008. This In Practice article focuses on the exemption of non-dormant subsidiary companies from mandatory statutory audit and, in particular, the requirement for a statutory guarantee to be provided by the parent company.

CONDITIONS FOR THE AVAILABILITY OF THE AUDIT EXEMPTION FOR SUBSIDIARY COMPANIES

Under the new s 479A, a subsidiary that wishes to rely on the audit exemption needs to fulfil the following conditions:

- its parent must be established under the law of a member state of the European Economic Area (EEA);
- all the shareholders of the subsidiary must agree to the exemption in respect of the financial year in question;
- its parent must give a guarantee (under the new s 479C) in respect of all outstanding liabilities of the subsidiary at the end of the financial year to which the guarantee relates (the Guaranteed Liabilities) until they are satisfied in full;
- the subsidiary must be included in the consolidated accounts drawn up for that financial year or to an earlier date in that year by the parent prepared in accordance with: (i) the provisions of the Seventh Directive (83/349/EEC); or (ii) international accounting standards;
- its parent must disclose in the notes to the consolidated accounts that the subsidiary is exempt from the relevant audit requirements of the Companies Act by virtue of s 479A; and
- the directors of the subsidiary must deliver to the Registrar on or before the date that they file the accounts for that year:
  - a written notice of the ag]reement of all of the shareholders of the subsidiary to the exemption in respect of the financial year in questions;
  - a statement from the parent under the new s 479C that it guarantees all the Guaranteed Liabilities until they are satisfied in full – in the form of a correctly completed Form AA06;
  - a copy of the consolidated accounts of the parent;
  - a copy of the auditor's report on those accounts; and
  - a copy of the consolidated annual report drawn up by the parent on those accounts.

In order for the audit exemption to apply, the subsidiary must deliver the documents referred to in the sixth bullet point above to the Registrar before the filing deadline for its accounts. If it does not do so, then its accounts must include an auditors' report or they will be rejected. In addition, the subsidiary must include an audit exemption statement on the balance sheet of its accounts. Companies House has issued guidance regarding the wording of this statement and the availability of the audit exemption generally (see: *Life of a Company, Part I – Annual Requirement, GP* – November 2012). No declaration of solvency by the directors of the parent company is required. Certain subsidiary companies are excluded from the audit exemption pursuant to the new s 479B of the Companies Act, namely: (i) quoted companies within s 385(2) of the Companies Act; (ii) authorised insurance companies, banking companies and certain other companies carrying on insurance market activity; and (iii) trade unions or employers' associations.

THE PARENT COMPANY GUARANTEE

The statutory nature of the guarantee

In order to provide clarity for creditors and make it easier for companies to take up the audit exemption, the Government decided, in a change from its original proposals, that the parent company guarantee should take the form of a statutory guarantee.The new s 479C sets out in detail what the declaration of guarantee to be given by the parent must contain. This has been incorporated in Companies House Form AA06. The following details need to be provided:

- the name of the parent;
- if the parent is incorporated in the UK, its registered number;
- if the parent is incorporated outside the UK and registered in the country in which it is incorporated, the identity of the register and the relevant registration number;
- details of the section of the Companies Act under which the guarantee is being given;
- the name and registered number of the subsidiary in respect of which the guarantee is being given;

- the date of the statement; and
- the financial year to which the guarantee relates.

The statement must be authenticated by the parent (which is done on the Form AA06 by printing the name of the person making the statement on behalf of the parent) and signed by a director of the subsidiary company.

The effect of the guarantee

Section 479C(3) explains the effect of the guarantee given by the parent under that section, namely that:

- the parent guarantees all Guaranteed Liabilities; the guarantee takes effect when it is delivered to the registrar[1] and it remains in force until all of the Guaranteed Liabilities have been satisfied in full; and
- the guarantee is enforceable against the parent by any person to whom the subsidiary is liable in respect of the Guaranteed Liabilities.

A creditor who has obtained a judgment against the parent in a UK court will, as a general principle, be able to enforce that judgment in any other EEA jurisdiction without the need to issue separate proceedings there[2]. With regard to the potential impact of the guarantee on the parent, its directors will need to consider whether providing the guarantee is likely to promote the success of the company for the benefit of its members as a whole. In order to be able to answer this question, they will need to balance the savings resulting from the audit exemption with the potential exposure under the guarantee. It may, under certain circumstances, be necessary for the directors to disclose the guarantee as a contingent liability in the parent's balance sheet. This, in turn, may impact on the parent's distributable reserves and thus its ability to make dividend payments to its shareholders. If the parent is a business which is regulated by the Financial Services Authority, the contingent liabilities under the guarantee may also have an impact on its capital resources requirements.

On the other hand, a parent may already have guaranteed significant liabilities of its subsidiary (for example to a lending bank) and/or, may be commercially (if not legally) required to cover for a defaulting subsidiary in order to avoid damage to its reputation or creditors withdrawing supplies to other members of the group[3]. In the event the subsidiary is to be sold, the parent may need to consider obtaining a cross-guarantee from the buyer. While the audit exemption does not apply to a subsidiary which, at any time within the relevant financial year, was a quoted company, it does apply where the parent is listed and it may thus be necessary to determine whether the giving of the guarantee by the parent constitutes a "significant transaction" under the Listing Rules.In terms of costs, potential savings in respect of audit fees for the subsidiary will need to be balanced against legal and accounting fees incurred by the parent for advice in respect of the provision of the guarantee.

Wider considerations and concerns in respect of the audit exemption

The Government recognises that there may be circumstances in which qualifying subsidiaries may not be able or may not want to rely on the available audit exemption. This is the case, for example, where loan agreements, other commercial agreements, trading partners, regulators or Government grants require audited accounts or the sale or flotation of the subsidiary is being contemplated, the latter of which will require at least two years of audited accounts[4].

In addition, audits may assist directors in meeting their legal obligation to prepare financial statements which give a true and fair view of the company's state of affairs at the end of the relevant financial year and to decide whether there are sufficient distributable reserves to pay any proposed dividends to the company's shareholders. During the consultation process, stakeholders raised certain concerns, in particular, with regard to the need to protect users of accounts and creditors. The Government felt, however, that any reduction in the availability, quality and reliability of financial information resulting from the audit exemption was insignificant as information relating to each subsidiary is still required to be included in the publicly available audited consolidated parent accounts. These should allow stakeholders and potential creditors to be able to assess the potential level of risk, such risk being further reduced by the giving of the parent guarantee[5]. Moreover, banks and other finance providers are able to request additional financial information from the subsidiary, including current information which is not contained in statutory accounts and may well be able to negotiate a contractual obligation to provide audited accounts. The interests of shareholders continue to be protected by existing safeguards whereby, under s 476 of the Companies Act, shareholders holding at least 10% of the share capital of the company may require an audit. In addition, all of the shareholders of the subsidiary company must agree to the exemption from mandatory audit in respect of the relevant financial year.

OUTLOOK

The Government plans to review the operation of the different policies implemented by the Regulations in 2017. Companies House will collect data on the number of companies claiming the audit exemption and the Government will consider, in particular, any negative effects on businesses, auditors and creditors. In addition, the EU is currently reviewing its Fourth Company Law Directive which may lead to changes of the audit exemption thresholds. ■

1 See *Life of a Company, Part I – Annual Requirement, GP* – November 2012, Chapter 11, s 4.

2 It can do so either by virtue of Council Regulation (EC) No 44/2001 on the jurisdiction, recognition and enforcement of judgment in civil and commercial matters (the "Brussels Regulation") or the 2007 Lugano Convention on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters.

3 See *Deloitte, iGAAP Alert, Audit exemptions*, September 2012.

4 See *Deloitte, iGAAP Alert, Audit exemptions*, September 2012.

5 See *Department for Business, Innovation & Skills, Audit Exemptions and Change of Accounting Framework*, Government Response to Consultation, 6 September 2012.

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