PKF FRANCISCLARK

Chartered accountants & business advisers

Audit exemption: the current regime

The revised audit exemption regime that came into force for financial years ending on or after 1 October 2012 has been a mixed blessing according to Stephanie Henshaw, Technical Partner at PKF Francis Clark.

The simplification of the small company audit exemption rules has benefitted a considerable number of property investment companies whose gross asset levels previously forced them to have an audit. This is because the audit requirement is based on exceeding two out of three limits, rather than either of two limits as in the past.

However, the "guaranteed subsidiary" exemption from audit comes with a number of conditions attached. Those conditions have not proved attractive to all the potentially eligible groups.

The "guaranteed subsidiary" exemption entitlement is available to all UK subsidiaries, irrespective of their size or the group to which they belong provided all the following criteria are met:

1. The company is a subsidiary of a parent incorporated in the EEA;
2. The subsidiary's members unanimously agree;
3. The parent company guarantees the subsidiary's liabilities;
4. The subsidiary is included in consolidated accounts prepared by the guaranteeing parent company;
5. The members' agreement, the guarantee notice and the consolidated accounts are filed at Companies House.

The key practical problem with the exemption is the parent company guarantee. A separate guarantee must be given for each financial year for which audit exemption is required, so this is an annual process. The guarantee covers all liabilities outstanding at the balance sheet date until they are settled so if there are long term liabilities it may be several years before the potential obligations created under the guarantee unwind. "Liabilities" include contingent liabilities so guarantors need to consider the implications of potential, as well as actual, liabilities.

If a group has been set up specifically to ring fence risky or loss making activities, giving the guarantee effectively undermines that strategic objective. Therefore, it is suitable only where there is no doubt whatsoever as to the group's willingness to support a failing part of its operations. Companies that have given extensive cross-guarantees of borrowings may consider there is little additional risk in giving the audit exemption guarantee. However, groups that have resisted them may be very reluctant to replace them with another form of guarantee.

Parent company directors need to consider whether it is in the best interests of that company to give the guarantee and what might be the implications for the company's ability to service its own debts. Will it have sufficient resources to perform under the guarantee without undermining its own status? There could be implications for directors in terms of their fiduciary duty to the company if they have not thought through the potential consequences.

Notwithstanding these considerations, however, for some groups the 'guaranteed subsidiary' exemption has proved useful.

The small company audit exemption is less onerous as it is simply based on the size of the company, but directors have needed to consider whether it is appropriate to take it up. For some small entities, for example those which are not wholly owner-managed, which are looking to sell up or which rely on grant funding, the audit may continue to be relevant to confirming the integrity of the accounting and reporting systems and staff. In any case, members holding 10% or more of the share capital can request an audit and some directors have not taken up exemption in anticipation of such a request.

Audit exemption brings commercial considerations, too. For example, we recommend directors to check their banking and other commercial agreements to identify whether audited accounts are a condition of the contract and to confirm whether there will be any consequences if the audit exemption entitlement is taken up.

Francis Clark LLP is supportive of the simplification to the small companies audit exemption regime but recognises that the "guaranteed subsidiary" audit exemption presents considerable practical challenges and so is not appropriate for all groups. Guarantor parent companies will have to prepare audited group accounts and so some of the audit work that would otherwise be done as part of the subsidiary audit is still necessary. Consequently, there are unlikely to be significant cost savings overall. All companies still have to prepare annual accounts that give a true and fair view and we are happy to continue to assist with this.

We work with our clients to help them decide the most appropriate approach to meet their strategic, commercial and practical objectives.

13/8/14_U

PKF Francis Clark has eight offices in the South West: Exeter, New Forest, Plymouth, Poole, Salisbury, Taunton, Torquay and Truro. Please visit www.pkf-francisclark.co.uk for contact details of your nearest office.