**EXPLANATORY MEMORANDUM TO
THE COMPANIES ACT 1985 (INVESTMENT COMPANIES AND ACCOUNTING AND AUDIT AMENDMENTS) REGULATIONS 2005**

2005 No. 2280

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.

2. DESCRIPTION

2.1 This statutory instrument makes minor amendments to the accounting and distribution provisions of the Companies Act 1985 ("the 1985 Act"). It
removes the requirement to adjust non-comparable prior year amounts in accounts and clarifies one aspect of the distribution provisions as they apply to investment companies. Both of these amendments are consequential on the introduction of International Accounting Standards (IAS). In addition, it restores certain accounting and audit exemptions for small companies.

3. MATTERS OF SPECIAL INTEREST TO THE JOINT COMMITTEE ON STATUTORY INSTRUMENTS

3.1 None.

4. LEGISLATIVE BACKGROUND

Recent changes to Part 7 of the 1985 Act

4.1 The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004[1] ("the 2004 Regulations") amend the accounting requirements in the 1985 Act (Part 7 and the related schedules) to ensure the effective application in Great Britain of Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards[2] (the "IAS Regulation"), and implement Member State options in that Regulation.

4.2 The IAS Regulation requires companies governed by the law of a Member State, whose securities are admitted to trading on a regulated market in any Member State in the EU ("publicly traded companies") to prepare their consolidated accounts on the basis of accounting standards issued by the International Accounting Standards Board that are adopted by the European Commission.

4.3 The IAS Regulation also permits Member States to extend use

[1] SI 2004/2947
[2] OJ L243 of 11.9.2002, Page 1

of IAS. The 2004 Regulations extend use of IAS to the individual accounts of publicly traded companies and to the individual and consolidated accounts of other companies on a permissive basis. Companies that are not required or do not choose to use IAS will continue to comply with UK accounting requirements.

4.4 The 2004 Regulations also implement Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EE and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings[3] (the "Accounts Modernisation Directive"). The Accounts Modernisation Directive amends accounting requirements in Part 7 of the 1985 Act and related schedules to enable companies to follow modern, more transparent accounting practices that are consistent with IAS.

Distribution rules for investment companies

4.5 Section 265(1) of the 1985 Act allows investment companies to make a distribution out of accumulated, realised revenue profits less realised and unrealised losses. This is subject to certain conditions including an asset adequacy test, intended to ensure that a distribution will be made only if the assets are sufficient to ensure a reasonable margin of protection to creditors. This test derives from Article 15.4 of the Second EC Council Directive 77/91/EC on the co-ordination of safeguards in respect of the formation of public limited companies and the maintenance and alteration of their capital[4]. Under the asset adequacy test, a distribution can be made only if assets are at least equal to one and a half times total liabilities and provided that the distribution does not reduce assets to less than that amount. Section 270 of the 1985 Act determines assets and liabilities for distribution purposes by reference to assets and liabilities as stated in the accounts of the company.

4.6 The 2004 Regulations introduced a requirement (stemming from the Accounts Modernisation Directive) for companies to present items within the balance sheet and profit and loss account formats having regard to their commercial substance. The combination of this amendment and developments in accounting standards will lead to the reclassification of many preference shares. Preference shares that contain obligations to transfer cash will need to be presented under a liabilities heading within the balance sheet (rather than, as formerly) within capital and reserves.

4.7 Part 2 of the Regulations amends section 265 to reflect more precisely the wording of the 2nd Directive and so to clarify that only liabilities to creditors should be counted as liabilities for the purposes of the assets test (and not preference shares).

Adjustment of non-comparable prior year amounts

4.8 Paragraph 4 of Schedule 4 to the 1985 Act requires companies to show in their accounts corresponding amounts for the financial year immediately preceding that to which the balance sheet and profit and loss account relate. Where a corresponding amount is not comparable to the current amount, it must be adjusted and details of the adjustment and the reasons for it must be disclosed. Equivalent provisions for small companies, banks and insurance companies are contained in the other accounting Schedules to the 1985 Act.

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[3] OJ L178 of 17.7.2003, Page 16

[4] OJ L26 of 31 January 1977, Page 1

4.9 These requirements have their origin in the Fourth Council Directive of 25 July 1978 (78/660/EEC) based on Article 54(3)(g) of the treaty on the annual accounts of certain types of companies[5], which imposes a requirement for corresponding amounts for the balance sheet and profit and loss account. That directive also contains a Member State option to require adjustment where corresponding amounts are not comparable. The 1985 Act takes up that option.

4.10 There are also requirements in the accounting Schedules to the 1985 Act for corresponding amounts to be given for items in the notes to the accounts. These requirements are domestic in origin and do not have an EC derivation.

4.11 Part 3 of the Regulations amends the 1985 Act to provide for companies to have a discretion rather than an obligation to make adjustments to non-comparable prior-year amounts, and to remove from the 1985 Act the obligation for comparatives to be given in the notes to the accounts. The detailed requirements on adjustment of non-comparable prior year amounts and disclosure of prior year amounts in the notes will in future be a matter for accounting standards.

Small and medium-sized companies

4.12 Part 4 of the Regulations concerns accounting and audit exemptions available to small and medium-sized companies. Regulation 12 restores the exemption for small companies not to have to disclose particulars of their staff which was inadvertently removed when the obligation to make the disclosure was moved by the 2004 Regulations from Schedule 4 to the 1985 Act to a new section 231A.

4.13 Regulations 13 to 17 provide that companies which would otherwise be unable to claim certain accounting and audit exemptions, because they require authorisation under the Financial Services and Markets Act 2000 ("FSMA"), can continue to take advantage of the exemptions. The companies concerned are those that conduct certain mortgage and insurance-related activities.

4.14 Regulation 14 brings forward the operation of exemptions from directors' report disclosures for certain small companies that would otherwise be unable to claim the exemptions because they are members of groups that contain a public or FSMA-regulated company.

Scrutiny

4.15 **IAS Regulation** – DTI Explanatory Memorandum 6365/01 was submitted on 16 March 2001. The Commons European Scrutiny Committee considered it not legally or politically important and cleared it (Report No. 1, Item 22162, Session 00/01). The Lords Select Committee on the EU did not report on it (Progress of Scrutiny 13.04.01, Session 00/01).

4.16 **Accounts Modernisation Directive -** DTI Explanatory Memorandum 9730/1/02 REV1 COM (2002) 25912 Final was submitted on 26 February 2002. The Commons

[5] OJ L222 of 14.8.78, Page 11

European Scrutiny Committee considered it politically important and cleared it (Report No 37, Item 23522, Session 01/02). The Lords Select Committee on the EU cleared it on 09.07.02 (Progress of Scrutiny 22.07.02, Session 01/02).

4.17 DTI Explanatory Memorandum OTNYREM was submitted on 05 December 2002. The Commons European Scrutiny Committee considered it politically important and cleared it (Report No. 5, Item 24060, Session 02/03). The Lords Select Committee on the EU did not report on it (Progress of Scrutiny 21.12.02, Session 02/03).

5. EXTENT

5.1 This instrument applies to Great Britain.

6. EUROPEAN CONVENTION ON HUMAN RIGHTS

6.1 The Parliamentary Under-Secretary of State (Minister for Employment Relations and Consumer Affairs), Gerry Sutcliffe, has made the following statement regarding Human Rights:

> In my view the provisions of the Companies Act 1985 (Investment Companies and Accounting and Audit Amendments) Regulation 2005 are compatible with the Convention rights.

7. POLICY BACKGROUND

Distribution rules for investment companies

7.1 If the re-classification on preference shares as liabilities for accounts purposes were to apply to the asset adequacy test for distribution purposes., this could have severe adverse consequences for investment companies. Many investment companies issue forms of preference share that are redeemable after a specified period. Such shares would be affected by the reclassification described above. Total liabilities shown in the balance sheet will increase. As a distribution to shareholders can be made only if assets are at least equal to one and a half times total liabilities, the amount that could be distributed would be reduced. Investment companies might be prevented from paying dividends to their shareholders.

7.2 Uncertainty regarding the impact of the interaction is unhelpful to companies and their shareholders. The Government supports strongly the introduction of IAS (and UK accounting standards based upon IAS), but considers that this possible effect on investment companies was unintended and may be inappropriate. The purpose of the amendments made by the Regulations is to maintain the current position regarding investment company distributions.

Adjustment of non-comparable prior year amounts

7.3 The UK's Accounting Standards Board (ASB) has an ongoing programme of converging UK accounting standards with IAS, to ensure that there is maximum

comparability between IAS and non-IAS accounts. As part of this programme, the ASB has issued and will issue new UK accounting standards based on IAS.

7.4 In general, IAS requires restatement of corresponding amounts on transition to IAS and on introduction of new or revised accounting standards. However, IAS also includes important exceptions to this general principle. As the 1985 Act does not provide similar exceptions, the ASB are at present hindered from including such exceptions in UK accounting standards. Therefore, companies applying ASB standards based on IAS could face more onerous requirements than companies applying IAS directly under the IAS Regulation.

7.5 The amendments in the Regulations will allow the ASB to maintain a level playing field between IAS and non-IAS companies in this area. The ASB have published a proposed new standard dealing with corresponding amounts which is expected to maintain the general principle that corresponding amounts should be comparable, but will allow more flexibility to deal with specific circumstances.

Small and medium-sized companies

7.6 The exemption for small companies not to have to disclose particulars of their staff was removed unintentionally, and this amendment simply restores the previous, intended position.

7.7 The 2004 Regulations impose requirements for disclosures in the directors' report on certain small companies that are members of groups containing a public or FSMA-regulated company. Subsequent regulations[6] provide an exemption from directors' report disclosure for such companies. However, the different effective dates of the two sets of regulations mean that these companies would have to make certain disclosures imposed by the 2004 regulations for one year only. This is considered to be an unnecessary burden for these companies. These Regulations therefore bring forward the effective date of the exemption.

7.8 Recent amendments to financial services legislation have meant that some small companies (those that engage in certain mortgage and insurance-related activities) are no longer able to take advantage of exemption from audit of their statutory accounts. This is considered to be an unnecessary restriction. The Regulations therefore restore the audit exemption option to these companies.

Consultation

7.9 A public consultation covering distribution rules for investment companies and corresponding amounts was held in Spring 2005 (*Company Reporting: A consultation on extending use of summary financial statements and other minor changes, March 2005, URN 05/900*). Interest was largely confined to the accountancy bodies, major accountancy firms and a few large companies. This is essentially a minor technical reporting issue, so there was no media interest. Those who responded to the consultation were overwhelmingly in favour of this amendment. A summary of responses can be found at www.dti.gov.uk/cld.

[6] The Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005 (S,I.2005/1011).

7.10 The small and medium-sized companies amendments were not subject to a public consultation, as the original amendments were largely unintentional.

8. IMPACT

8.1 Regulatory Impact Assessments on distribution rules for investment companies and corresponding amounts are attached at Annexes A and B respectively. As the original amendments were largely unintentional, the small and medium-sized company amendments are not covered by Regulatory Impact Assessments.

8.2 There is no impact on the public sector as this Statutory Instrument only applies to companies.

9. CONTACT

Valerie Carpenter at the Department of Trade & Industry (telephone 020 7215 0225 or email valerie.carpenter@dti.gsi.gov.uk) can answer any queries regarding this Statutory Instrument.

FULL AND FINAL
REGULATORY IMPACT ASSESSMENT
ON DISTRIBUTION RULES
FOR INVESTMENT COMPANIES

1. Proposal

1.1 To amend and clarify one aspect of the distribution rules as they apply to investment companies. This will preserve the existing treatment of preference shares for the purposes of those rules by clarifying that it should be applied by reference to "liabilities to creditors." This is implemented by the Companies Act 1985 (Investment Companies and Accounting and Audit Amendments) Regulations 2005.

1.2 The other aspect of the regulations, relating to the adjustment of corresponding amounts, is the subject of a separate Regulatory Impact Assessment.

2. Purpose and intended effect

Objective

2.1 The objective of the amendment is to preserve the existing operation of the capital maintenance provisions for investment companies in the Companies Act 1985 (the 1985 Act), in order to avoid uncertainty and potentially adverse unintended consequences for such companies and their shareholders.

2.2 The change is minor and is mainly consequential to:

- Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of International Accounting Standards (OJ L243/1, 11 September 2002) (the IAS Regulation);

- the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 (SI 2004/2947 (the 2004 Regulations); and

- related developments in UK Generally Accepted Accounting Practice.

Devolution

2.3 Company law matters relating to Scotland are reserved to the UK Parliament under the Scotland Act 1998. Those relating to Wales have not been transferred to the National Assembly for Wales under the Government of Wales Act 1998. Therefore, any changes to company legislation will also apply in Scotland and Wales. Company law in Northern Ireland is a transferred matter under the Northern Ireland Act 1998. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the

Northern Ireland Departments, subject to the direction and control of the Secretary of State for Northern Ireland.

Background

Investment companies

2.4 Investment companies are a specialist form of company, defined in section 266 of the 1985 Act. Investment companies' primary activity is to invest funds, mainly in securities, with the aim of spreading investment risk and for the benefit of their members. Investment companies are required to be public companies, to notify the Registrar of Companies of their status, to restrict their percentage holding in any single investee to no more than 15%, and not to retain more than 15% of their income from securities.

2.5 Investment companies are able to benefit from certain adaptations in company law that recognise their specialist status. In addition, investment trust companies (ITCs) qualify for certain special tax treatments. ITCs are a sub-category of investment company that meet criteria set out in the Income and Corporation Taxes Act 1988 and have been approved by the Inland Revenue. One criterion is that ITCs must be listed on the London Stock Exchange.

2.6 There are approximately 350 UK-registered ITCs, with a total market capitalisation of around £44 billion (source – AITC website, September 2004). The DTI understands that there are few 1985 Act investment companies that are not also ITCs.

Distribution Rules

2.7 The 1985 Act includes provisions designed to ensure that companies can make distributions (normally in the form of dividends) only where it is appropriate to do so. The basic effect is that companies can pay dividends only out of accumulated realised profits less realised losses (section 263 of the 1985 Act). Hence, dividends cannot be paid out of capital profits, which are held as a "buffer" to protect the company's creditors. Guidance on the determination of realised profits and losses has been produced by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland.

2.8 Section 264 of the 1985 Act sets out additional provisions for public companies, including a "net assets test." Under this test, distributions can be made only if the company's net assets are not less than its share capital and non-distributable reserves (which includes any excess of unrealised losses over unrealised profits).

2.9 Section 265(1) of the 1985 Act allows investment companies to make a distribution out of accumulated, realised "revenue profits" less realised and unrealised losses. Revenue profit is not defined in legislation but, in simple terms, is generally considered to comprise profit excluding net capital gains or losses. This permission is subject to certain conditions including an asset adequacy test. The asset adequacy test is intended to ensure that a distribution will be made only if the assets are sufficient to ensure a reasonable margin of protection to creditors. This test derives from Article 15.4 of the Second Council Directive of 13 December 1976 (77/91/EEC) on the co-ordination of safe guards in respect of the formation of public limited companies and the maintenance and alteration of their capital (OJ L26/1 of 31 January 1977). Under this test, a distribution can be made only if total assets of

the company are not less than one and a half times total liabilities (and provided that the distribution does not reduce assets to less than that amount).

2.10 Section 265 provides an additional option for investment companies. It recognises that such companies are vehicles for holding investments on behalf of their members. Hence, subject to appropriate creditor protection, members should be able to receive income generated by the underlying investments. Without this provision, investment companies whose investments have fallen in value would more often be prevented from distributing their revenue profits. This would occur because available revenue profits may from time to time be cancelled out by net capital losses.

2.11 Section 270 of the 1985 Act requires that assets, liabilities and certain other accounting terms referred to in the distributions provisions be determined by reference to the accounts of the company. This link to the accounts has the affect that changes in accounting legislation and standards can affect the amount that a company may lawfully distribute.

IAS and Related Developments

2.12 The IAS Regulation requires companies governed by the law of a Member State, whose securities are admitted to trading on a regulated market in any Member State in the European Union (publicly traded companies), to prepare their consolidated accounts for financial years beginning on or after 1 January 2005 on the basis of accounting standards issued by the International Accounting Standards Board and adopted by the European Commission. The IAS Regulation also contains options allowing Member States to extend the use of IAS.

2.13 The Government welcomed the Regulation and strongly supports the use of IAS. For publicly traded companies, adherence to global accounting standards should help to reduce the cost of capital by making their accounts more accessible to potential investors across the EU and worldwide.

2.14 Following consultation, the Government decided that publicly traded companies should be permitted to use IAS for their individual accounts, and that all other companies (except companies which are charities) should be permitted to use IAS for their individual and/or consolidated accounts. Changes to the 1985 Act to give effect to this decision, and to ensure that IAS accounts could be accommodated within the statutory framework, were made by the 2004 Regulations and have effect for financial years beginning on or after 1 January 2005. The changes also, as far as possible, eliminated obstacles within company law to the convergence of UK accounting standards with IAS.

Risk Assessment

2.15 The potential issue relates to the interaction of the interaction of the change in accounts presentation and the section 265 assets test. Many investment companies have issued preference shares that are redeemable after a specified period. Such shares would be affected by an accounting change related to IAS 32 *Financial Instruments: Disclosure and Presentation,* described below. Total liabilities shown in the balance sheet will increase as a result of this change. The amount that could be distributed without reducing the level of assets to less than 1.5 times total liabilities would then be reduced. Hence, investment companies might be prevented from paying dividends to their shareholders.

2.16 IAS 32 deals, amongst other things, with the classification (or presentation) in company balance sheets of financial instruments. Instruments with the legal form of share capital are included in the definition of financial instruments. In an IAS balance sheet, share capital needs to be presented within liabilities or within equity depending on its economic characteristics. Many common forms of preference share include obligations to pay dividends, or to redeem the shares in future. Such types of share would be classified as liabilities under IAS 32. Non-IAS accounts are, from 1 January 2005, subject to similar rules; the UK's Accounting Standards Board has introduced a standard, FRS 25, based on IAS 32. The UK standard builds upon certain changes to the 1985 Act's accounting provisions and applies to listed companies.

2.17 The category of ITCs most likely to be affected are UK based split capital investment trusts. These are ITCs with different classes of share capital in issue, with each class entitled to payments in a set order of priority. Typically, a split capital ITC will have two classes of share – ordinary shares and zero-rated preference shares. The "ordinaries" are entitled to dividend income, and the "zeros" are generally redeemable at a fixed amount on a certain date, subject to availability of assets. Split capital investment trusts generally have a limited life.

2.18 The Association of Investment Trust Companies has estimated that, should zero-rated preference shares issued by split capital investment trusts need to be treated as liabilities for the purpose of the section 265 assets test, some 33 ITCs, managing £2.8 billion of assets, might be prevented from paying a dividend. Another 14 ITCs, managing £1.6 billion of assets, would be in a marginal position. The main adverse impact of a curtailment in dividend payments would be on ordinary (income) shareholders. The capital value of those shares is closely related to the expected future dividend payments, and hence would be affected also.

2.19 There is an argument that a curtailment in dividends to ordinary shareholders will increase the security for creditors and preference shareholders. For creditors, the value of this additional margin is however likely to be small because of the existing requirement to maintain a 50% margin of assets over liabilities. The affect on the position of preference shareholders will depend in part on the terms of the share instrument, and on the ITC's Articles of Association. The DTI understands that the Articles commonly require any undistributed income to be paid to ordinary shareholders on liquidation. In those cases, the undistributed income would not be available to fund any shortfall to preference shareholders, and would eventually be paid out to ordinary shareholders. The ordinary shareholders would however have borne the adverse impact of delays in receiving income, and those delays will in some cases extend for several years.

2.20 Any re-distributive effects of the change in accounting practices would be an unintended consequence of that change. Creditors to an ITC and purchasers of different classes of its shares would not, the DTI considers, have entered in to these arrangements with a valid expectation that their relative positions would be affected by accounting changes.

3. Options

3.1 Two main options were considered.

Option 1: Do Nothing

3.2 This would have meant that more investment companies could have been prevented from paying dividends to shareholders. A widespread disruption of current dividend policy and practices could also have an adverse impact on general confidence in the sector and possibly the wider capital markets.

Option 2: Make the amendment

3.3 Section 265 of the 1985 Act (and a related section) has been amended such that the net assets test is based on the excess of assets over liabilities to creditors. Liabilities to creditors would include debenture loans, trade creditors, amounts owed to credit institutions, bills of exchange payable etc. Preference shares, even if presented within a liabilities caption of a balance sheet, are not considered to form part of liabilities to creditors for capital maintenance purposes. The unintended consequence of the accounting change is therefore avoided and the operation of the 1985 Act's capital maintenance provisions for investment companies is preserved.

4. Benefits

Option 1: Do nothing

4.1 There would be no benefits from this option.

Option 2: Make the amendment

4.2 The main benefit of this option is that it avoids the
unintended possible consequence of certain developments in accounting. Without this change, new requirements on balance sheet presentation for certain forms of share capital may at worst severely restrict or defer the ability of several investment companies to pay dividends to their ordinary shareholders. The change preserves the status quo, such that the dividend capacity of affected companies would remain very similar to what it would have been under previous accounting practices.

Business Sectors Affected

4.3 This change will potentially affect all 350 investment companies in Great Britain, although those most affected will be companies that have issued redeemable forms of preference share, mainly the split capital investment trust company sector, of which there are estimated to be around 130.

Issues of Equity and Fairness

4.4 The Government considers that the proposal will not bring disproportionate benefits or have disproportionate effect on particular groups. Creditors to an ITC and purchasers of different classes of its shares would not, the DTI considers, have entered in to these arrangements with a valid expectation that their relative positions would be affected by accounting changes.

5. Costs

Compliance Costs

Option 1: Do nothing

5.1 Doing nothing could result in a delay to and/or reduction in the level of dividends paid to shareholders. The level of reduction is subject to a number of complex factors including future investment performance. It is estimated that approximately 33 split capital investment trusts could however be forced to defer or reduce dividend payments. The level of reduction is estimated at up to £16.8m per annum (based on AITC estimates of funds managed by companies affected and certain assumptions concerning normal returns to ordinary shareholders). It is estimated that most of this amount would however be paid out in future years, although there may also be a relatively minor redistributive effect between different classes of shareholders and between creditors and shareholders. There would be no direct cost to the companies themselves. It could also have an adverse impact on general confidence in the sector and possibly the wider capital markets, although this is impossible to isolate from other factors and quantify.

Option 2: Make the amendment

5.2 There are no costs for this option. The cost of determining the amount of distributable profit will be no higher.

Other Costs

5.3 The DTI considers that these changes will not impose costs on any non-business sector.

Costs of a Typical Business

5.4 The DTI considers that these changes will not impose any costs on a typical business. The impact will not extend beyond the specialist investment company sector, and there are no costs for that sector.

6. Consultation with small business: The Small Firm's Impact Test

6.1 These proposals will have no impact on small businesses. The impact will not extent beyond the specialist investment company sector, and those companies are not small businesses.

7. Competition Assessment

7.1 The changes have the potential to affect all investment trust companies. It is not anticipated that the proposal will: affect some of these businesses more than others; affect

market structure; change the number or size of those businesses; lead to higher start-up costs for those businesses; or lead to higher on-going costs than at present.

8. Enforcement and Sanctions

8.1 In Great Britain there is already a well-regarded enforcement regime in place for ensuring that company financial statements meet the requirements of existing legislation. In addition to criminal penalties, the Financial Reporting Review Panel (FRRP) has legal authority to review companies' accounts and if necessary to go to court to compel a company to revise its accounts. The FRRP shares this responsibility with the Secretary of State. By administrative agreement, the FRRP deals with the accounts of public and large private companies, and the Secretary of State (through Companies House) with the rest.

8.2 There are no criminal sanctions for making an unlawful distribution to shareholders. However, the recipient of such a distribution may be liable to repay it (section 277 of the 1985 Act), as may the directors who authorised the distribution.

9. Monitoring and Post-Implementation Review

9.1 Government officials will engage in ongoing post-implementation dialogue with stakeholders from business and the accountancy profession to confirm that the changes have achieved their intended effect.

9.2 The European Commission has announced an intention to undertake a study into alternative capital maintenance regimes, which may include an analysis of the impact the impact of recent IAS-related accounting changes on the existing Second Council Directive regime. The study is expected to be completed by the end of 2006; the Commission will then need to consider its response. The Government will review the outcome of this study and the Commission's response in due course and consider the appropriateness or otherwise of the 1985 Act's existing provisions in the light of its findings.

10. Consultation

Within Government

10.1 The proposals were discussed with officials at HM Treasury, the Financial Services Authority and the Department of Enterprise, Trade and Industry of Northern Ireland prior to public consultation.

Public Consultation

10.2 Prior to consultation, the proposed changes were discussed with the AITC. Informal discussions were also held with staff at the ASB and other members of the accountancy profession.

10.3 On 17 March 2005 the Department of Trade and Industry published a consultation document on this proposal. The consultation was announced by way of a press notice announcing wider company law reforms. Notice of the consultation was sent to approximately 1200 companies, professional bodies, representative organisations, and individuals. The consultation document was available to download from the Department's website (http://www.dti.gov.uk/consultations), and photocopies were provided to those without internet access. The deadline for comments was 10 June 2005.

10.4 Twenty-five responses were received. The majority were supportive of the proposals. There were suggestions for more explicit clarification, and for a complete overhaul of the current capital maintenance provisions. However, the amendment was intended to be a narrow one, designed to maintain the status quo and clarify a particular point of interpretation. It was not intended to amend the effect of the existing provisions in any material way. In addition, the Government is constrained in any wider amendment by the provisions of the Second Council Directive (referred to at paragraph 9.2).

11. Implementation Plan

11.1 The Regulations will be laid in early August and will come into force on 1 October 2005, the next available common commencement date.

11.2 Guidance on the Regulations will be available on the DTI website when the Regulations are laid (www.dti.gov.uk/cld). It will be incorporated in *"Guidance for British Companies on Changes to the Accounting and Reporting Provisions of the Companies Act 1985"*, which was published in October 2004 to accompany the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 (SI 2004/2947). The new sections of the guidance will be flagged up so that users can easily identify them.

11.3 The usual three month period between regulations being made (and guidance being published) and coming into force has been shortened in this case because these Regulations are largely facilitative, and therefore do not have an immediate impact on companies.

12. Summary and Recommendation

12.1 The table below shows a summary of the costs and benefits of the proposal.

Option	Total cost per annum	Total benefit per annum
1. Do nothing.	Costs arise through disruption to existing dividend practice. The potential impact on annual dividend payments to ordinary shareholders may be up to £16.8m per annum, although the effect may be primarily on timing.	None

2. Amend the net assets test to be based on the excess of assets over liabilities to creditors.	None	Benefits arise through avoidance of disruption to existing dividend practice. The potential impact on annual dividend payments to ordinary shareholders may be up to £16.8m per annum, although the effect may be primarily on timing.

12.2 The Government has implemented Option 2. This maintains the status quo regarding the treatment of preference shares in the distribution rules for investment companies. It ensures that there is no uncertainty about the circumstances in which ITCs can pay dividends. It avoids the potential costs of disruption to existing dividend practice arising from Option 1 (doing nothing).

13. Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

SIGNED …………………………………………..

DATED …………………………………………..

GERRY SUTCLIFFE, PARLIAMENTARY UNDER-SECRETARY OF STATE (MINISTER FOR EMPLOYMENT RELATIONS AND CONSUMER AFFAIRS)

Any comments on this Regulatory Impact Assessment should be addressed to:

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FULL AND FINAL
REGULATORY IMPACT ASSESSMENT
ON ADJUSTMENT OF CORRESPONDING AMOUNTS IN ACCOUNTS

1. Proposal

1.1 To remove the requirement to adjust corresponding amounts from the previous year's accounts where these are not comparable to the current year's amounts. This is implemented by the Companies Act 1985 (Investment Companies and Accounting and Audit Amendments) Regulations 2005.

1.2 The other aspect of the proposed regulations, relating to the distribution of profits by investment companies, is the subject of a separate Regulatory Impact Assessment.

2. Purpose and intended effect

Objective

2.1 The objective of the regulations is to ensure that companies preparing their accounts under the Companies Act 1985 (the 1985 Act) and UK accounting standards do not face more onerous requirements than companies preparing their accounts under International Accounting Standards (IAS) when disclosing corresponding prior year amounts in their accounts.

2.2 The changes are consequential to:

- Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards (OJ L243/1, 11 September 2002) (the IAS Regulation);
- the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 (SI 2004/2947) (the 2004 Regulations); and
- related developments in UK Generally Accepted Accounting Practice (GAAP).

Devolution

2.3 Company law matters relating to Scotland are reserved to the UK Parliament under the Scotland Act 1998. Those relating to Wales have not been transferred to the National Assembly for Wales under the Government of Wales Act 1998. Therefore, any changes to company legislation will also apply in Scotland and Wales. Company law in Northern Ireland is a transferred matter under the Northern Ireland Act 1998. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments, subject to the direction and control of the Secretary of State for Northern Ireland.

Background

IAS

2.4 The IAS Regulation requires companies governed by the law of a Member State, whose securities are admitted to trading on a regulated market in any Member State in the European Union (publicly traded companies), to prepare their consolidated accounts for financial years beginning on or after 1 January 2005 on the basis of accounting standards issued by the International Accounting Standards Board and adopted by the European Commission. The IAS Regulation also contains options allowing Member States to extend the use of IAS. The Government welcomed the Regulation and strongly supports the use of IAS. For publicly traded companies, adherence to global accounting standards should help to reduce the cost of capital by making their accounts more accessible to potential investors across the EU and worldwide.

2.5 Following consultation, the Government decided that publicly traded companies should be permitted to use IAS for their individual accounts, and that all other companies

(except companies which are charities) should be permitted to use IAS for their individual and/or consolidated accounts. Changes to the 1985 Act to give effect to this decision, and to ensure that IAS accounts could be accommodated within the statutory framework, were made by the 2004 Regulations and have effect for financial years beginning on or after 1 January 2005.

2.6 Companies that prepare their accounts in accordance with IAS (IAS companies) will not generally be bound by the accounting provisions of the 1985 Act. This amendment will therefore have no effect on IAS companies. Companies that do not use IAS will continue to prepare their accounts in accordance with the accounting provisions of the 1985 Act and UK accounting standards.

2.7 The UK's Accounting Standards Board (ASB) has a programme of converging UK accounting standards with IAS, to ensure that the accounts of those companies not using IAS are still broadly comparable to IAS accounts.

Accounting requirements for corresponding prior year amounts

2.8 The 1985 Act requires companies to show corresponding amounts from the immediately preceding financial year in the balance sheet and profit and loss account. Where that corresponding amount is not comparable with the current amount, the former amount has to be adjusted, and details of the adjustment and the reasons for it must be disclosed. There is also a similar requirement for corresponding amounts to be shown in the notes to the accounts. Equivalent provisions for small companies, banks and insurance companies are contained in the other accounting Schedules to the 1985 Act.

2.9 These requirements have their origin in the European Fourth Council Directive of 25 July 1978 (78/660/EEC) based on Article 54(3)(g) of the treaty on the annual accounts of certain types of companies (OJ L222/11 of 14 August 1978), which imposes a requirement for comparative amounts for the balance sheet and profit and loss account. That directive also contains a Member State option to require adjustment where corresponding amounts are not comparable. The 1985 Act takes up that option.

2.10 As part of its ongoing programme of converging UK accounting standards with IAS, the ASB has issued and will issue various new UK accounting standards based on IAS. As the ASB has a general policy of ensuring that the requirements of UK accounting standards are the same as those of IAS, the new UK standards are subject to transitional arrangements that replicate those under IAS. In general, IAS requires restatement of comparatives on transition to IAS and on introduction of a new or revised standard. However, IAS also includes important exceptions to this general principle. The 1985 Act does not provide similar exceptions, so the requirements of the 1985 Act would have limited the extent to which companies applying UK standards could have benefited from transitional relief.

2.11 The regulations would replace the requirement for corresponding amounts in company accounts and the notes to the accounts to be adjusted if not comparable with a discretion to make such adjustments. The ASB have published a proposed new standard dealing with corresponding amounts which is expected to maintain the general principle that corresponding amounts should be comparable, but will allow more flexibility to deal with specific circumstances.

Risk Assessment

2.12 The proposal is intended to address the risk that companies preparing their accounts in accordance with the accounting requirements of the 1985 Act and UK accounting standards could face more onerous requirements than companies using IAS, with regard to the calculation and disclosure of corresponding amounts. The introduction by the ASB of accounting standards based on IAS will mean that British companies must adopt various new accounting practices. However, the requirements in the 1985 Act would have prevented them from benefiting from the transitional relief available to IAS companies. This would have penalised companies not using IAS. For a number of companies, particularly smaller unlisted companies, the costs of switching to IAS at the current time would outweigh the benefits.

3. Options

3.1 Two main options were considered.

Option 1: Do nothing

3.2 This option would mean that companies preparing their accounts in accordance with the accounting requirements of the 1985 Act and UK accounting standards could face more onerous requirements than IAS companies, with regard to the calculation and disclosure of corresponding amounts.

Option 2: Make the amendments

3.3 This option would mean that the requirements regarding the calculation and disclosure of corresponding prior year amounts could be the same for all companies. Companies continuing to prepare their accounts in accordance with the accounting requirements of the 1985 Act and UK accounting standards would not face more onerous requirements in this area than companies using IAS.

4. Benefits

Option 1: Do nothing

4.1 There would be no benefits arising from this option

Option 2: Make the amendments

4.2 Companies that continue to prepare their accounts in accordance with the accounting requirements of the 1985 Act and UK accounting standards will benefit from the amendment. They will not face more onerous requirements with regard to the calculation and disclosure of prior year corresponding amounts than IAS companies. They will be able to take advantage of transitional relief provisions included within UK accounting standards based on IAS.

4.3 The impact of the proposed changes is however difficult to quantify, as it will depend on the extent to which changes in UK GAAP or companies' choice of accounting policies give rise to instances of possible non-comparability. The most significant relevant change to the 1985 Act accounting requirements is the introduction of optional "fair value accounting" for certain financial instruments, given effect by the 2004 Regulations. In the RIA relating to those regulations *(Final RIA on the Use of Fair Value Accounting for Certain Financial Instruments for Companies and Building Societies URN 04-1668, published October 2004)*, it was estimated that 22,000 companies would take up optional fair value accounting. The ongoing cost of using fair value accounting was estimated to be on average £500. Those 22,000 companies would therefore be in a position to benefit from the proposed change to the requirements on corresponding amounts, and would avoid a total one-off cost of £11m (in the year of switching to fair value accounting).

Business Sectors Affected

4.4 This changes will potentially affect all companies in Great Britain that do not use IAS. There are currently approximately 2 million active companies on the register at Companies House. Listed companies (some 1464) will be required to use IAS (at least for their consolidated accounts). Companies listed on the Alternative Investment Market (of which there are currently approximately 1000) are expected to be required to adopt IAS from 2007. It is not possible to say how many of the remaining companies will choose to adopt IAS. It is expected that the initial take up rate will be low and confined mainly to subsidiaries of listed companies, but will increase as IAS becomes more familiar to companies. If the initial take up rate is 10%, then approximately 1.8 million companies will continue to follow UK accounting requirements and will potentially benefit from these changes.

Issues of Equity and Fairness

4.5 The Government considers that the changes will not bring disproportionate benefits or have a disproportionate effect on particular groups.

5. Costs

Compliance Costs

Option 1: Do nothing

5.1 This option would mean that those companies affected would be unable to benefit from transitional relief regarding the calculation and disclosure of prior year corresponding amounts. This would mean that their accounts would be more complicated to prepare, necessitating more time and possibly higher professional fees. The estimated cost is a one-off total of £11m for 22,000 companies (see paragraph 4.3).

Option 2: Make the amendments

5.2 There will be some minor cost for this option, as companies and accountancy firms will have to become familiar with the changes to the 1985 Act. However, the cost will be minimal and it is be difficult to separate this cost from the cost of familiarisation with other

recent and proposed changes to accounting requirements and accounting standards. The cost may only be the time cost of reading DTI guidance notes or information in professional journals.

Other Costs

5.3 DTI considers that the changes will not impose costs on any non-business sector.

Costs for a Typical Business

5.4 The DTI considers that these changes will impose some cost on business in familiarising themselves with the changes, but this cost will be minimal.

6. Consultation with small business: The Small Firm's Impact Test

6.1 It is considered that this proposal is unlikely to affect small businesses. The recent accounting change most relevant to this proposal is fair value accounting. Discussions with small accountancy firms serving the small business sector in the context of the *Regulatory Impact Assessment on the use of Fair Value Accounting for Certain Financial Instruments for Companies and Building Societies* indicated that it was unlikely that many small businesses would choose to use fair value accounting. The UK accounting standard for small companies, the Financial Reporting Standard for Smaller Entities, does not presently permit fair value accounting, although the ASB expects to reconsider this in a future update.

6.2 On this basis, prior to consultation we only consulted internally with the Small Business Service, who were content with this approach.

6.3 No comments were made during consultation that contradicted this view.

7. Competition Assessment

7.1 The changes have the potential to affect all public and private companies that do not use IAS in all markets, and all accountancy firms. It is not anticipated that the proposal will: affect some of these businesses more than others; affect market structure; change the number or size of those businesses; lead to higher start-up costs for those businesses; or lead to higher on-going costs than at present.

8. Enforcement and Sanctions

8.1 In Great Britain there is already a well-regarded enforcement regime in place for ensuring that company financial statements meet the requirements of existing legislation. In addition to criminal penalties, the Financial Reporting Review Panel (FRRP) has legal authority to review companies' accounts and if necessary to go to court to compel a company to revise its accounts. The FRRP shares this responsibility with the Secretary of State. By administrative agreement, the FRRP deals with the

accounts of public and large private companies, and the Secretary of State (through Companies House) with the rest.

9. Monitoring and Post-Implementation Review

9.1 Government officials will engage in ongoing post-implementation dialogue with stakeholders from business and the accountancy profession and with the ASB to confirm that the changes have achieved their intended effect. Officials will also monitor whether the amended provisions match up to emerging international and European accounting requirements.

9.2 The Regulations affect the accounting and reporting requirements for companies. Annual accounts and reports are prepared some months after the end of the accounting and reporting period. Several annual accounting and reporting cycles will need to elapse before it becomes clear whether the changes have achieved their intended effect. Therefore, it would not be sensible to carry out a review before late 2008/early 2009. This could be done in conjunction with a review of the UK's implementation of the optional regime for use of IAS

10. Consultation

Within Government

10.1 The proposals were discussed with officials at HM Treasury, the Financial Services Authority and the Department of Enterprise, Trade and Industry of Northern Ireland prior to public consultation.

Public Consultation

10.2 Prior to public consultation, the proposal was discussed with the ASB and with other representatives of the accountancy profession.

10.3 On 17 March 2005 the Department of Trade and Industry published a consultation document on this proposal. The consultation was announced by way of a press notice announcing wider company law reforms. Notice of the consultation was sent to approximately 1200 companies, professional bodies, representative organisations, and individuals. The consultation document was available to download from the Department's website (http:www.dti.gov.uk/consultations), and photocopies were be provided to those without internet access. The deadline for comments was 10 June 2005.

10.4 Twenty-five responses were received. They were overwhelmingly in favour of removing the requirement to adjust corresponding prior year amounts in the balance sheet and profit and loss account and the requirement to provide corresponding amounts in the notes to the accounts, and of leaving future requirements in this area to the ASB (Option 2).

11. Implementation Plan

11.1 The Regulations will be laid in early August and will come into force on 1 October 2005, the next available common commencement date.

11.2 Guidance on the Regulations will be available on the DTI website when the Regulations are laid (www.dti.gov.uk/cld). It will be incorporated in *"Guidance for British Companies on Changes to the Accounting and Reporting Provisions of the Companies Act 1985"*, which was published in October 2004 to accompany the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 (SI 2004/2947). The new sections of the guidance will be flagged up so that users can easily identify them.

11.3 The usual three month period between regulations being made (and guidance being published) and coming into force has been shortened in this case because these Regulations are largely facilitative, and therefore do not have an immediate impact on companies.

12. Summary and Recommendation

12.1 The table below shows a summary of the costs and benefits of the proposal:

Option	Total cost per annum	Total benefit per annum
1. Do nothing	£500 per company in more time spent preparing accounts and higher professional fees, giving a total of £11m for all companies affected.	**None**
2. Make the amendments	Minimal cost to business in familiarising themselves with the change.	Not having the extra cost outlined above.

12.2 The Government has implemented Option 2. This will benefit companies that continue to prepare their accounts in accordance with the accounting requirements of the 1985 Act and UK accounting standards. They will not face more onerous requirements with regard to the calculation and disclosure of corresponding amounts than companies using IAS, as they will be able to take advantage of similar exceptions to the requirements. Option 1 (do nothing) would have provided no benefits, and imposed additional costs on companies in more time spent preparing accounts and higher professional fees.

13. Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

SIGNED ………………………………………..

DATED ………………………………………..

GERRY SUTCLIFFE, PARLIAMENTARY UNDER-SECRETARY OF STATE (MINISTER FOR EMPLOYMENT RELATIONS AND CONSUMER AFFAIRS)

Any comments on this Regulatory Impact Assessment should be addressed to:

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