

1 Audit exemption for subsidiary companies (Lecture A690 – 12.46 minutes)

1.1 Background

For accounting periods ending on or after 1 October 2012, companies that are subsidiaries of EEA parents will, irrespective of size, be entitled to audit exemption subject to fulfilment of a number of detailed conditions. The most onerous of these conditions is that the parent undertaking must give a guarantee under section 479C in respect of the liabilities of the subsidiary.

1.2 Brexit

At the time of writing the future of this exemption for holding companies outside the UK is in doubt. A no-deal Brexit would remove the exemption for all companies except those with a UK holding company who gives the guarantee.

1.3 Refresher Q&As

The legislation has given rise to a number of practical questions and some of these are included below.

Q1. My client is a subsidiary of a parent company based in Guernsey. Can they take advantage of audit exemption as a subsidiary company of an EEA parent?

No. See quote below from www.gov.gg:

'Guernsey is neither a separate Member State nor an Associate Member of the European Union. The terms relating exclusively to the Channel Islands and the Isle of Man were subsequently embodied in Protocol No. 3 of the Treaty of Accession of the United Kingdom to the EEC, signed on 22 January 1972.'

Further extracts from that website are:

Protocol No. 3 placed the Channel Islands and the Isle of Man within the Common Customs territory of the Community and the Common External Tariff of the European Economic Community. Broadly speaking this means that no customs duties are applied to goods exported to members of the customs union but a common customs tariff applies to goods imported into the customs union from non-member countries.

Protocol 3 also provides that Guernsey is 'within' the EU for most of the purposes of the free movement of goods but outside the EU for other purposes, in particular non-customs related fiscal matters and the free movement of persons and services. The Island is not eligible for assistance from the Union's structural funds or under the support measures for agricultural markets.

Ratification of the EEA Agreement by the United Kingdom had the effect of extending the Agreement to the Crown Dependencies from 1 January 1995, by virtue of the Community Treaties enshrined in the UK Treaty of Accession. However, the

EEA Agreement applies to the Crown Dependencies only to the extent that is consistent with Protocol 3.

Q2: If one subsidiary in a group wishes to take advantage of audit exemption, is it necessary for all subsidiaries in the group to take advantage of audit exemption?

No.

Q3: X Ltd is a subsidiary of a parent company in Germany. The ultimate parent company is based in the USA. Can X Ltd take advantage of audit exemption under S479A and, if so, which parent needs to provide the guarantee?

X Ltd is entitled to audit exemption under S479A. The German parent will provide the guarantee.

One possible sticking point is that X Ltd must be included in accounts drawn up by the German parent and these must be filed in the UK with a translation into English or Welsh. It may be that the German company enjoys an exemption from preparing group accounts (similar to our exemption in S401 of CA 2006) and are not willing to prepare them for this purpose.

In passing, what would the situation be if the immediate parent was the US company and the ultimate parent was the company in Germany? In this case, X Ltd could still claim exemption. The German parent will provide the guarantee and include X Ltd in the group accounts.

The reason why this is the case can be found in s1162, CA 2006. Subsection 2 gives the general definition of a parent, holding a majority of the shares etc. Subsection 3 then goes on to say: *'For the purposes of subsection (2) an undertaking shall be treated as a member of another undertaking if any of its subsidiary undertakings is a member of that undertaking.'*

So where you have Company A which owns Company B which owns Company C, then Company A is the parent of C for the purposes of claiming exemption under s479A. A parent company can therefore be the ultimate parent or any intermediate parent in the chain.

Q4: My client is a UK company which is the parent of a UK group. It is keen to adopt audit exemption for all of its subsidiaries. They have asked whether the guarantee required under S479C can follow a standard form or whether they need to take their own legal advice.

Companies are required to confirm the guarantee for each year to Companies House. The guarantee statement should be prepared by a solicitor. Apparently, there are legal difficulties in having a standard guarantee that all companies could use.

This cost was envisaged by the government when BIS (as it was previously known) published the government's response to its consultation in September 2012. This included the following comments:

'The Impact Assessment anticipates there may be a one-off cost for external legal and accounting advice in the range of £2,000–£5,000 per group holding company when the guarantee is first made and valued, and a subsequent ongoing annual cost for internal legal advice regarding the continued provision of the guarantee.'

'However, in accordance with responses from consultees for more clarity as to the guarantee, the legislation implementing the policy provides that the parent guarantee is given under statute. This should make it more straightforward for parents and creditors, and reduce the legal advice necessary.'

'In terms of ongoing costs, the Impact Assessment estimates that each group will require 4-10 hours of internal legal advice.'

We wait to see developments in this area but, at the moment, the only advice you could give to a client is that they need to take legal advice.

Q5. What debts are covered by the guarantee? Is it just the debts in the subsidiary's balance sheet or does it go further than that?

S479C(3) of the CA 2006 states:

'A guarantee given under this section has the effect that:

- (a) the parent guarantees all outstanding liabilities to which the subsidiary is subject at the end of the financial year to which the guarantee relates, until they are satisfied in full, and*
- (b) the guarantee is enforceable against the parent undertaking by any person to whom the subsidiary company is liable in respect of those liabilities.'*

The guarantee is in force for all liabilities that exist at the balance sheet date until they are satisfied. Notice that the above quote does not refer to liabilities recognised in the balance sheet therefore we need to consider other possible amounts as well.

The article *'Every rose has its thorn'* published in *Audit and Beyond* addresses this question somewhat. It says that, although the Regulations fail to define *'all outstanding liabilities'*, the Consultation Report indicates that the wording of the guarantee is deemed to cover liabilities in tort and contingent liabilities.

Contingent liabilities will not be recognised in the balance sheet (if they were we would call them provisions) and may not even be disclosed (if they are remote). The contingent liability arising in 2012 could come back to haunt the parent company many years in the future.

What about obligations under operating leases as disclosed in the notes to the accounts? We know that they do not need to be recognised as liabilities in the balance sheet but are they *'liabilities to which the subsidiary is subject at the end of the financial year'*? If so, they are caught within the guarantee.

Liabilities with respect to finance leases are included in the balance sheet net of interest costs which are not yet due but are these future interest costs '*liabilities to which the subsidiary is subject at the end of the financial year*'?

Observe also that the guarantee could relate to liabilities arising in previous years since the guarantee covers all outstanding liabilities to which the subsidiary is subject at the end of the financial year not just the ones that arose during the financial year.

So, to quote the article again: '*the liabilities guaranteed can stretch endlessly into the past and the parent remains potentially liable for these liabilities infinitely into the future*'.

And this indefinite future survives even the sale of the subsidiary – although presumably the sale agreement could arrange for the new owners to take over the guarantee from the previous owners.

This uncertainty over the scope of the guarantee is another reason why the parent should seek legal advice before going ahead.