

Financial Reporting Supplement Companies Act 2006

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Foreword

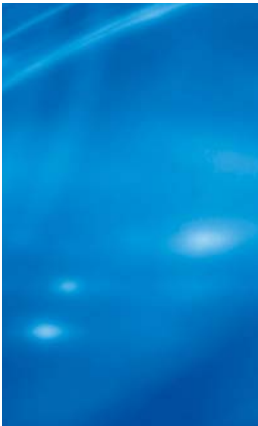
Welcome to this *Supplement* to KPMG's *Financial Reporting Update* series, published on the occasion of Royal Assent to the Companies Act 2006. The process started over eight years ago when the *Company Law Review* was launched. Since then the Government and business and professional bodies have devoted considerable time and careful thought to our company law. Of course some areas proved difficult, but overall we think the Act is a welcome package.

The Act contains a few very significant reforms such as in relation to Web site communication with shareholders, enfranchising beneficial shareholders, auditors (e.g., in the area of criminal offences as well as liability limitation) and codification of directors' duties together with associated narrative reporting (the business review). On the latter subject the Act makes clear that the company is to be run for the benefit of its shareholders but there is a legislative prompt towards considering other stakeholders. Beyond these high profile issues, a key feature of the Act is the very large number of small reforms and restatements for clarity.

Following Royal Assent, business and professionals must begin now to turn their attentions towards the practical effects of an Act of record-breaking length (perhaps over 1,300 sections). With that in mind, we have prepared this *Supplement* to our *Update* series. It covers not only the financial reporting aspects but also some of the related governance and procedural context. We intend the overview within the summary in this *Supplement* as an immediate briefing on the Act with the remainder forming a more detailed explanation that will, we hope, form a reference point for our readers over the coming months. I trust you find it informative.



Richard Bennison
Head of KPMG's Audit Practice
9 November 2006



1. Summary

For whom is the company run?

Since the launch of the *Company Law Review* in 1998, one of the major questions has been that of for whom the company is run. In codifying the case law of directors' duties, the Act provides that the directors are to run the company for the benefit of its members. However, in taking decisions to promote the success of the company for the benefit of members, directors are to take into account, in those decisions, specified corporate social responsibility factors.

The *Company Law Review* saw narrative reporting as an important component of this enlightened-shareholder-value model. It recommended the introduction of an Operating and Financial Review (OFR) that would provide shareholders with a narrative as to how the directors were seeking to run the company successfully for the benefit of members, including by taking into account corporate social responsibility factors. The government introduced the OFR into the 1985 Act in 2005, withdrew it before it became effective, and has now in effect almost reintroduced it in the shape of the enhanced business review. Taking matters beyond even the 1985 Act business review, the 2006 Act requires, to the extent necessary for an understanding of the development, performance or position of the business, trends and factors that may be relevant to the future and disclosure in the area of specified corporate social responsibility factors. These range from the environment through to – in a late addition at the Commons Report Stage – persons with whom the company has essential relationships/arrangements, e.g., potentially the supply chain. However, in recognition of the more forward-looking nature of this review, a safe harbour and an exemption from disclosure on the grounds of serious prejudice in certain cases are introduced.

For EU-regulated markets see www.europa.eu.int/comm/internal_market/en/finances/mobil/isd/. It includes the main listed market, but not the Professional Securities Market segment. It does not include AIM or OFEX.

Enfranchising beneficial owners

The Act recognises that in very many cases today the beneficial owners of shares in companies are not the legal owners, who are instead usually institutional investors through whom the beneficial owners have channelled their investment. For companies traded on EU-regulated markets (see left) the Act requires that they allow members (e.g., the institutional investor) to nominate others (e.g., the beneficial owner) to have a right to all communications that would otherwise be sent by the company to members (e.g., the annual accounts).

Company administration and communications

Company administration is one of those areas where the reforms are small and numerous but hold out the possibility of simplification and efficiency gains. First of all, the default position for a private company is that almost all resolutions can be written resolutions (rather than taken at meetings). There is no requirement for private companies either to hold an AGM or to lay the accounts before members in general meetings. The accounting deadlines are, however, reduced: a private company must file the accounts within nine months, and a public company must lay and file within six months. When it comes to filing documents with the registrar of companies, the Act provides for the first time that almost all filings may be done electronically (the registrar will specify the precise method etc.).

More significantly, the Act seeks to permit any communication by a company to its members – or nominated person – to be made in either hard copy, electronic form or by means of a Web site. They may always request a hard copy and may only receive an electronic communication (e.g., e-mail) if they have positively agreed to that. Communication by means of a Web site (placing a document on the Web site and notifying the member that it is there) also requires the member's/nominated person's agreement. However, he is taken to have agreed if his agreement has been sought and he has not replied within 28 days. As a further condition for the use of Web site communication with members, the company's members must have passed a resolution approving such communication generally or it must be set out within a provision of the company's articles.

Auditors

There are important changes in the area of offences, transparency and liability in relation to auditors. Significantly, an individual in an audit firm can be found to have committed a criminal offence if he knowingly or recklessly causes an audit report to be defective. The transparency measures require audit reports to be signed with the individual partner's own name, require the publication of audit engagement letters and facilitate audit-related questions at AGMs. In the case where an auditor ceases to hold office the transparency is considerably enhanced. For example, an auditor of a quoted company (see left) must always give the company a statement of the circumstances relating to his departure from office (previously only required where there were matters which he wished to bring to the attention of members or creditors). This statement must also be provided to an audit regulatory body who may then provide a copy to the Financial Reporting Review Panel (FRRP).

A company is quoted if it has equity share capital (statutory definition) on the official list in an EEA state or admitted to dealing on NYSE or NASDAQ.

On the other side of the coin an auditor will be permitted to negotiate to limit his liability by contract, although this will require the annual approval of the members.

Capital maintenance

A major reform in relation to a company's capital is the new facility for a private company to reduce its capital by special resolution supported only by a solvency statement, rather than by court confirmation as hitherto. The solvency statement will be on similar terms to the old whitewash. The DTI will be able to make regulations specifying whether reserves arising from capital reductions create distributable profits.

For private companies the financial assistance whitewash will now become a thing of the past: the prohibition of private companies' giving assistance is abolished.

Implementation

The Government has announced that the Act's communication provisions will come into force in January 2007; that they will consult in February on detailed plans for the rest of the Act; and that they intend October 2008 as the latest date for commencing the remainder. We think that the remainder will be commenced *en bloc* rather than piecemeal.



2. Governance matters

2.1 A company's constitution

Under the Act a company's constitutional documents will remain its memorandum and articles of association. However, the contents and status of the memorandum have changed. At present it contains the company's name, location of registered office (England and Wales or Scotland), its objects, whether it is to be limited and if so by guarantee or by shares, and the guarantee itself or the share capital as the case may be. Under the Act it will contain no more than a statement that the subscribers wish to form a company and have agreed to take at least one share each (where the company is limited by shares). The memorandum will be unalterable.

One effect of this is that the company's share capital will no longer be stated, or limited, by its constitutional documents (see 8.4). Instead a statement of capital is furnished to the registrar on incorporation and on all subsequent occasions when there is any change in the capital (e.g., by subscription or reduction). The statement must contain various data including the number of shares, aggregate nominal value, rights and amounts paid and unpaid. It must be given for each class. For a guarantee company there is an equivalent statement of guarantee.

2.2 Exercise of members' rights by others

Facilitating enfranchisement of indirect investors

One of the major matters that the Act seeks to address is the enfranchisement of indirect or beneficial investors in a company, e.g., individuals investing in units in a unit trust that invests in shares in the company.

The Act first makes provision to the effect that all companies are free to empower a member to nominate other persons to enjoy his rights. A member may nominate several persons to exercise his rights, so as to accommodate the splitting up of the exercise of the rights among numerous investors with the beneficial interests in them. This applies to all rights of members, save for the right to transfer a share. However, a nominated person cannot commence an action against the company to enforce any rights delegated to him.

Mandatory for certain companies – information rights

The Act next makes provision that a company whose shares are admitted to trading on an EU-regulated market *must* allow its members to nominate others to enjoy 'information rights'. These are rights to receive copies of communications that the company sends to its members (or to a class of members that includes the nominating member). This applies in particular to the rights to copies of the accounts and reports; the summary financial statement (SFS) arrangements are, however, extended so that the company can provide SFS to the nominated persons in the same way as for members. Where these rights are exercised, the default method of communication to nominated persons is by means of a Web site, although the nominated person will always have the right to a hard copy if he wishes to exercise it.

The nominated person's rights do not terminate automatically. For example, if he ceases to have a beneficial interest in a company's shares, that person or the nominating member needs to take positive action to notify the company. However, the company is permitted to enquire annually as to whether the nominated person wishes to retain his rights. Failure to respond within 28 days means that the rights will terminate.

The Act does not provide for these nominated persons to exercise voting rights (although, as discussed above, the company would be free to recognise the attribution of voting rights to that person). However, where the company sends a meeting notice to a nominated person, the notice must be accompanied by a statement informing the person that he may have a right under contractual arrangements with the member to require him to appoint a proxy (perhaps the nominated person) or to give instructions to the member as to voting.

The Secretary of State is given secondary legislative power to amend or extend the rights discussed above.

Participation in requisitions to the company

Finally, the Act gives those with beneficial interest in a company's shares the right to participate in certain requisitions. Those requisitions are for the circulation of a statement in advance of a general meeting, the circulation of an AGM resolution, requiring an independent report upon a poll (see 3.1) and requiring the Web site publication of audit concerns (see 6.5). Each such person counts towards the requisition thresholds. E.g., 100 beneficial owners (with a minimum investment each) may requisition a meeting even though those persons relate to fewer than 100 members (which would otherwise be the usual test).

2.3 Directors

Codification of directors' general duties

In order to overcome the inaccessibility of the common law, whereby 250 years of precedent establish that directors are (*inter alia*) subject to fiduciary duties of good faith and honesty, as well as separate duties of care and skill, the Act introduces a statutory statement of a director's seven general duties (see panel). The duties are cumulative obligations: directors must comply with each one that applies to a particular case.

Seven general duties of a director:

- to act within the company's powers;
- to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (*inter alia*) to specified matters;
- to exercise independent judgment;
- to exercise reasonable care, skill and diligence (as would be expected of a reasonably diligent person carrying out the functions of the director, as well as based on the director's actual knowledge, skill and experience);
- to avoid conflicts of interest;
- not to accept benefits from third parties;
- to declare interests in a proposed transaction or arrangement with the company.

The second duty has proved the most contentious. A director must act in a way that he considers, in good faith, most likely to promote success for the shareholders. In so doing, however, he is required to have regard to: likely long-term consequences; employees' interests; fostering of business relationships with suppliers, customers and others; effect on the community and the environment; desirability of maintaining a reputation for high standards of business conduct; and the necessity of acting fairly as between members of the company.

By thus enshrining a principle of 'enlightened shareholder value', the new duty insists that the effect of wider corporate social responsibility factors, upon shareholders' interests, be considered by directors when making decisions.

The general duties will, as before, be owed to the company. They will apply to directors, shadow directors and, in certain cases, to former directors. The duties are the same whether a director is an executive or a non-executive.

Directors' transactions

Although the rules relating to shareholder approval in respect of directors' long-term service contracts, substantial property transactions, loans, quasi-loans, credit transactions and *ex gratia* payments for loss of office have been comprehensively rewritten, the Act makes few substantive changes.

One key change is that the Act reforms the current prohibitions on loans etc. to directors, to allow them where the members approve it. Thus the Act now permits, subject to shareholder approval, a public company or a private company in a group that contains a public company, to make loans, quasi-loans, enter into a credit transaction, give guarantees or provide security in connection with a loan, quasi-loan or credit transaction, to a director or a connected person. For companies within wholly private groups (i.e., no public company in the group) there continues to be no prohibition in relation to quasi-loans or credit transactions and no prohibition on loans to connected persons.

Member approval is not required for money-lending companies (as defined), nor is it required where certain transactions fall within defined financial limits. With respect to such limits, the Act has raised the maximum amounts permitted under the exception for expenditure on company business (£50,000, previously £20,000), the exception for small loans and small quasi-loans (£10,000, previously £5,000) and the exception for small credit transactions (£15,000, previously £10,000).

Shareholder approval will now be required for directors' long-term service contracts in excess of two years (previously five years). Also, any member of the company is now entitled, on request and on payment of a fee, to be provided with a copy of the directors' service contracts. Under the 1985 Act, members were entitled only to inspect them.

Registers of directors and interests

Companies must maintain their existing register of directors (which is open to public inspection) but this need now only contain the service addresses of directors (which may be the company's registered office). A new requirement obliges companies to keep a register of its directors' usual residential addresses. This will not be open to public inspection. Another change to the existing register of directors is that details of other directorships held will no longer require disclosure.

The requirement to maintain a register of directors' interests has been abolished.

Age limits

The Act relaxes the present law by permitting persons over 70 to act as directors of public companies without specific shareholder approval. It also tightens the law by introducing a minimum age of 16 for directors.

2.4 Derivative actions

What is a derivative action?

Derivative actions are concerned with the case where an individual member may bring an action, on behalf of the company, against a director. It is not normally the case that such an action can be brought because a director owes his duties to the company as a whole rather than to individual members. Thus an action against a director is usually brought by a company where, e.g., its board or its liquidator decides to do so. Hitherto the ability to bring a derivative action rested in a complex area of common law. Broadly speaking this permits a derivative action where there has been conduct amounting to a fraud on the minority; where the wrong is ratifiable no action is usually possible.

A statutory procedure

The Act does not displace the common law but introduces a statutory derivative action procedure in parallel. Under the Act the cause of action must arise from negligence, default, breach of duty or breach of trust by a director. Thus it is irrelevant, for example, whether the director has benefited from the negligence or breach.

This is a source of concern to companies in the light of the statutory statement of directors' duties, in particular the duty to promote the success of the company. Whilst that duty is to promote success for the benefit for the members as a whole, the Act, as discussed above, insists that the effect of wider corporate social responsibility factors, upon shareholders' interests, be considered by directors when making decisions. The concern is that 'activist' shareholders may seek to over-use the provisions to bring vexatious claims.

Safeguards

With the intention of balancing matters, the Act gives the courts power to prevent an action from coming to trial if there is no *prima facie* case, including by reference to whether the claimant is acting in good faith, whether a person acting in accordance with the duty to promote the success of the company would not seek to continue the claim, and whether the cause of action has been or could be ratified. The court may also seek evidence as to the views of disinterested members of the company. If the court dismisses the application it may make any consequential order it considers fit, e.g., awarding costs against the claimant.

Unfair prejudice

In parallel to the common law and the new statutory derivative claim procedure, the Act continues the statutory right of a member to apply to the court for an order on the grounds that a company's affairs are being conducted in a manner that is unfairly prejudicial to the interests of all or a part of the members.

2.5 Secretaries

The Act retains the requirement that a public company must have a company secretary and that the person appointed must hold certain qualifications. However, a private company will no longer be required to appoint a company secretary (previously a company secretary was required albeit there were no qualification requirements). Where a private company chooses to appoint a company secretary, that person has all the usual rights and powers that the Act provides for a company secretary (whereas at an earlier stage it had been proposed not to recognise such persons at all in the legislation).

3. Resolutions, meetings and communications

3.1 Resolutions and meetings

Private companies – written resolutions and no AGM

The 1985 Act contained complicated provisions whereby a company was required to hold an AGM and to pass resolutions in meetings, overlaid with exemptions whereby private companies' AGMs could be dispensed with and written resolutions adopted.

Under the new Act matters are considerably simplified. For a private company the default position is that there is no statutory requirement for an AGM (although the articles could impose a requirement) and, save only for two exceptions, any resolution may be passed as a written resolution. The two exceptions are the removals of a director and of an auditor before the expiry of their terms.

Moreover, whereas the 1985 Act required written resolutions to be passed unanimously, they may now be passed by their usual majorities (i.e., a simple majority for ordinary resolutions, 75 percent for special resolutions).

A public company continues to be required to hold AGMs and to pass resolutions at meetings.

It should be noted, however, that the Act neither codifies nor overturns the common law unanimous consent rule (sometimes called the *Duomatic* principle). This rule, which may require careful legal consideration, broadly provides that anything that could be done by the company's passing a resolution in general meeting may be done by the company without a meeting but with the unanimous agreement of the members.

Notice periods and other time limits

The notice period for meetings remain as in the 1985 Act, i.e., 21 days for an AGM (now public companies only) and 14 days for other meetings, clarified as being on a clear-days basis. A listed company will of course have to have regard to the provisions of the Combined Code which ask for AGM notice of 20 working days. The meeting notice may be given in hard copy, electronic form or by means of a Web site in line with the general provisions in this area (see 3.2).

A public company's AGM must now be held within six months of the end of the previous financial year, thus aligning it with the new, shortened timing for the laying of the annual accounts and reports in general meeting.

Members' requisitions of meetings etc.

The rights of the members to requisition a general meeting are essentially unchanged (e.g., a requisition is required from members representing 10 percent of the voting capital), but there are some changes in the area of the members' rights to requisition a resolution and circulation of a statement in relation to an AGM. The thresholds for these remain the same (5 percent of the voting rights or 100 members each with a minimum investment) but the arrangements as to cost have been varied. Going forward the company will bear the costs of circulating the requisitionists' statement, and their AGM resolution (public companies only), if the requisition is received by the company before the end of the previous financial year.

Polls – results and independent assessment

Where a poll is taken at a quoted company's general meeting, the Act requires that the results be published on a Web site.

More importantly, the members are given the power to require an independent report on any poll taken or to be taken. The threshold for this is 5 percent of the rights to vote at the poll in question or 100 members with a minimum investment and having voting rights at the poll. The independent assessor could be, but need not be, the company's auditor. It must be an independent person whom the directors consider appropriate.

He must report his opinion as to whether (*inter alia*) the procedures of the poll were adequate, the votes cast were fairly and accurately recorded and the validity of proxy appointments was fairly assessed. His report must be placed upon the Web site. The independent assessor is given rights to information and rights to attend meetings so as to assist him to discharge his duties.

3.2 Communications methods

Some of the most important practical provisions of the Act are quietly tucked away near the end of the Act under the heading *Companies: Supplementary provisions*. These are the provisions relating to company communications. The default position under the Act is that all communications to or from a company may be done under the general provisions of this Part, relating to their being in hard copy, electronic form or by means of a Web site. Electronic form means, for example, by e-mail. A communication is sent by means of a Web site if it is made available on a Web site and the intended recipient is notified of its presence there, the Web site and page addresses and how to access the document.

Hard copy – a fall-back right for members

The provisions facilitate the use of hard copy in all cases and provide a right for a member (or nominated person) or debenture holder always to request a hard copy of a document or information that he has received in electronic form or by means of a Web site.

Communications to a company

Communications from one company to another are governed by provisions relating to the sending company. Communications from an individual to a company may be in electronic form if the company so agrees unless a provision of the Act specifies otherwise. For example, the Act provides that members may communicate in electronic form their requisition of a general meeting, a statement to be circulated at a general meeting, or a resolution for an AGM.

From the company in electronic form

For a company to send a communication to another person in electronic form, that person must have agreed specifically or generally to receive it in that form.

From the company by means of a Web site

A company may communicate with its members and debenture holders by means of a Web site if the other person has agreed and certain conditions are met. Significantly, in this case the agreement of the other person may be obtained by asking the person individually to accept communication by means of a Web site and the person will be deemed to agree if he does not respond within 28 days. A company may not make such requests more frequently than annually.

The conditions are that: for communications to members, this must be supported by a members' resolution or a provision of the articles; for communications to debenture holders, the holders must have resolved to accept the use of a Web site or the instrument creating the debenture must contain a provision to that effect.



4. Accounts

4.1 Restatement and re-arrangement

In the 1985 Act, Part VII covered both accounts and (some aspects of) audit. This has now been split into two in the 2006 Act, with one part covering accounts and a separate part covering audit.

Addressing different sizes/types of company

One of the abiding issues with the old Act was the complaint that it was written in a complicated and, for many, an inaccessible fashion. In particular, the old accounting provisions were written with large companies in mind and were then overlaid with a web of complicated exemptions and modifications for small and medium-sized companies and for other special categories. In the 2006 Act the legislation has been completely rewritten so as to address first the 'small companies regime' and then to make additional provision for larger and other category companies in a manner that is intended to be more easily navigable. This is a key part of the Government's 'think small first' approach to drafting the Act. Thus even for those who are not small companies, on the page the law will look rather different.

Replacing the old schedules with regulations

A further change to the drafting/layout of the Act relates to the schedules. Under the 1985 Act a company would look to its schedules for the form and content of its directors' report, directors' remuneration report (if quoted) and its accounts (if using UK GAAP). In contrast, the 2006 Act contains no schedules for these matters at all. These will be provided instead in self-standing secondary legislation known as regulations – i.e., statutory instruments (SIs). Although there are as yet no regulations drafted, the substance of the eventual regulations is unlikely to differ from those of the old schedules, not least because in large part those schedules implement EC directives (e.g., form and content of accounts) or are otherwise settled policy matters (e.g., directors' remuneration report).

We understand, moreover, that the DTI is minded to produce a separate regulation for each different type of company. Thus, for example, a small company would look to a single SI for the form and content of its directors' report and its accounts; or, for example, a quoted insurance company would look to a single SI to cover the form and content of its directors' report, directors' remuneration report and its insurance accounts (if using UK GAAP).

This attempt to rearrange the rules in relation to the form and content of each type of company's annual accounts and reports will not however be perfect. The rules for the content of the directors' report will be split between regulations and the primary legislation, the latter dealing, in particular, with the enhanced business review (see 4.5). In addition, the annual accounts disclosures in relation to employee numbers and costs and to directors' loans, etc. will remain in the primary legislation.

4.2 Small and medium-sized companies

As mentioned earlier, the base case of accounting and reporting requirements are referred to as the 'small companies regime'. To be within the regime the company must both qualify as small according to size tests and must not be excluded according to ineligible categories of company. The size tests and their manner of operation (e.g., two-year rolling basis) are the same as in the 1985 Act. The excluded categories are aligned with those as very recently amended in the 1985 Act, the effect of which is that certain types of regulated activity under Part 4 of the Financial Services and Markets Act 2000 (FSMA) no longer give rise to exclusion.

The Act also carries forward the previous tests for companies which may take advantage of exemptions for medium-sized companies. There are, however, two changes to the size-based consolidation exemption. In the past medium-sized companies were exempt. In future only companies within the small companies regime are exempt (although on a 'think small first' basis the Act is framed so as to give those in the small companies regime an option to prepare consolidated accounts, with a requirement imposed only for the rest).

In addition, the operation of the excluded categories rule, for the purposes of the consolidation exemption, has changed. Previously a company was excluded if it or a member of the group headed by it, fell within one of the excluded categories; under the new Act a company is excluded if it, or any member of a group of which it forms a part – e.g., a higher group – falls within an excluded category. The excluded categories themselves are the same as in the 1985 Act.

4.3 Accounting records

All companies are required to keep accounting records, as was the case in the past of course. However it has now been phrased as a requirement to keep 'adequate' accounting records. It was hitherto the case that the auditor had to report, by exception, if he considered that the company had not maintained 'proper' accounting records. The audit report requirement has also been changed to refer to 'adequate' accounting records so that for the first time the directors' and auditor's requirements in relation to accounting records are articulated in the same terms.

4.4 Accounts form and content

True and fair

When the previous Act was amended to introduce IFRSs as adopted by the EU (EU-adopted IFRS) an inconsistency in terminology, and in apparent requirements, as between directors and auditors in relation to the accounts, was inadvertently produced. For a company preparing EU-adopted IFRS accounts, the only accounting requirement upon the directors was for preparation in accordance with EU-adopted IFRS; there was no direct statutory reference to the true and fair view, although the IAS 1 requirement for a fair presentation is considered to be equivalent. The auditor, on the other hand, was nevertheless required to report upon the accounts in terms of whether or not they gave a true and fair view (in that case by reference to EU-adopted IFRS). This was a cause of some confusion and debate.

The DTI has addressed this by including an additional section in the Act that requires that, irrespective of the basis of preparation of the accounts, they should not be approved unless the directors are satisfied that they give a true and fair view. Thus an explicit true-and-fair requirement is restored in the legislation in relation to EU-adopted IFRS accounts. It should be noted, however, that the new section does not include an override. For companies not using EU-adopted IFRS the long-standing override continues in another section of the Act; and for EU-adopted IFRS the override facility is contained within IAS itself (although use of this override is widely expected to be rare).

Directors' transactions

The requirements of old Schedule 6 in relation to disclosure, in the annual accounts, of directors' loans and other transactions have been replaced with a new requirement contained within the primary legislation itself. The new requirement is articulated very differently from the old and is essentially a simple copy-out exercise from the Fourth Directive's requirements. The DTI's intention appears to be to re-implement this aspect of the directive without any gold-plating. Presumably the existence of accounting standards in this area (FRS 8 or IAS 24) had some influence here.

One of the main changes brought about by this new section is that only advances, credits and guarantees in relation to directors are caught. No other transactions are addressed. Moreover no transactions with connected persons of directors are addressed at all.

On the other hand, however, it is perhaps unfortunate that the requirement relates to the undefined terms 'advances, credits and guarantees', whereas in determining whether a financial transaction with a director is lawful (see 2.3), the Act uses the well understood terms 'loans', 'quasi-loans' and 'credit transactions' which may not be synonymous with the language of the accounting requirements.

4.5 Directors' report – the enhanced business review

Quoted companies – where necessary, more forward-looking and corporate social responsibility disclosure

One of the main areas of change in company reporting is in relation to the directors' report. The 1985 Act was recently amended to introduce the enhanced business review. The 2006 Act takes that business review a stage further still. The first of three important changes in this area is that of additional disclosure to be made by quoted companies.

Under the 1985 Act such companies are required to give a balanced and comprehensive analysis of the development, performance and position of the company's business (consistent with its size and complexity); to the extent necessary for such an understanding, analysis using a financial and non-financial key performance indicator (KPIs); and a description of the principal risks and uncertainties facing the company. Under the new Act quoted companies will also be required to disclose, first of all, the main trends and factors likely to affect the future developments, performance or position of the business to the extent necessary for an understanding of the development, performance or position of the business.

In addition such companies are also required to provide information about environmental, employment, social and community issues and, subject to an exemption discussed below, about parties with whom the company has arrangements that are essential to its business. Information in these categories is, once again, required to be provided only to the extent that it is necessary for the understanding of the development, performance or position of the business. However, if no information is given on a particular category of matters then this fact has explicitly to be stated in the report. It is difficult to predict how much additional disclosure will be necessary in relation to the extra requirements, in particular in the essential-arrangements category which was introduced by the Government as a very late amendment to the Bill at the Commons Report Stage and without prior consultation.

With the business review requirement as it now stands it is fair to say that it is little different from the former OFR that was abolished in an earlier U-turn. The essential differences from the former OFR are that there is no requirement in the Act for disclosure about company strategy, shareholder returns or capital structure, although few companies are likely to leave out such matters anyway; there is no provision in the Act for reporting standards to be promulgated in relation to the business review; and the auditor's opinion on the business review does not extend beyond considering its consistency with the accounts.

Although these additional disclosures are framed as for quoted companies, it will not necessarily be the case that the subject matter of them is automatically irrelevant to any other company. (It should be recalled that the business review requirements apply to subsidiaries, for example.) This is because the additional disclosures that are specified as being for quoted companies are required to the extent necessary for an understanding of the development, performance or position of the business. Since all companies have to make a disclosure about the development, performance and position of the business then it is possible that some level of regard may need to be had to these matters on some occasions in order to satisfy the basic requirement.

Seriously prejudicial exemptions

The developments in the business review for quoted companies do make it considerably more forward-looking (although hitherto it was not purely historical). Partly in recognition of that, the Act contains, first of all, a provision that disclosure is not required in relation to impending developments or matters in the course of negotiation if to do so would be seriously prejudicial to the interests of the company.

As well as this general exemption, there is a further exemption relating only to the disclosure in the area of persons with whom the company has arrangements that are essential to its business. The exemption is applicable only if disclosure would be both seriously prejudicial to that other person and contrary to the public interest. Thus this exemption is narrow. The Government has said that it is designed to protect persons from threat by extremist protestors.

Safe harbour

The Act also contains a section which is being termed a 'safe harbour' for disclosure in the review. The section attempts to give an answer to concerns about the extent to which directors may be liable for the business review. It therefore sets out a statutory basis of directors' liability to the company in relation to statements in the directors' report (and also in the directors' remuneration report and any summary financial statement derived from the directors' report or directors' remuneration report). A director will be liable in relation only to statements that have proved untrue/misleading on a knowingly/recklessly basis, or if the director knew that an omission was a dishonest concealment. The aim of this section is to exclude the courts from developing a common law approach to directors' liability that goes any further than this statutory statement.

4.6 Publication of accounts and reports

Quoted companies – Web site publication

In the field of publication of accounts and reports, there is a new provision for quoted companies. Such companies are required to publish their annual accounts on their Web site. They are required to do this as soon as reasonably practicable (and see 5.2 for the effect of the Transparency Directive on accounts timing). The Act's requirement is likely to bring further pressure to bear to make the accounts publicly available on the internet very shortly after their approval by the board of directors. Companies should begin to plan for this.

Laying and filing

In terms of delivering the accounts to shareholders, the Act maintains the previous requirement that a copy be sent to all shareholders (albeit the general provisions in relation to communications will apply here (see 3.2)). However, the requirement to lay the accounts before members in general meeting is now restricted to public companies. This is in contrast to the previous Act where the default position was that all companies should do so but that private companies could avail themselves of exceptions; the default position is now that a private company is not required to do so unless its articles so provide.

The time limit for a public company to lay the accounts in general meeting has been reduced from seven months to six months. The time limit for a public company to deliver its accounts to the registrar has been similarly reduced to six months, and for a private company reduced from ten months to nine.

The operation of the time limits for delivery of accounts to the registrar have been reformed by the Act to remove what was previously a source of common confusion and mistake. Suppose a private company's financial year ends on 30 June. Nine months from that date, for the filing of that company's accounts, is now computed as ending on the last day of the following March, i.e., 31 March. This is of course the logical outcome, but it was previously the law that delivery would have fallen due on 30 March. Many companies previously incurred late filing penalties as a result of the old rule.

As discussed later (see 7) the Act aims to facilitate electronic delivery of documents to the registrar. For that reason, there is no longer a requirement for the filed copy of the accounts and reports (including auditor's report) to be a signed copy.



5. Transparency directive implementation

5.1 Transparency directive

FSA rule-making power

The EC Transparency Obligations Directive¹ is required to be implemented by 20 January 2007. The chosen method of implementation is chiefly through the making of FSA rules. However, to meet Community obligations these rules must have the force of law. Therefore the Act amends the FSMA so that it now gives the FSA the power to make transparency rules. Broadly speaking, the scope of the rules covers periodic reporting (e.g., annual and half-yearly) and the successor to the substantial shareholdings notification system (previously ss198-220 of the 1985 Act). In future the latter will be dealt with almost entirely by FSA rules.

The main element of the previous substantial shareholdings regime reproduced in the Act is the facility for a public company to give notice to a person which it knows or has reasonable cause to believe to be or have been interested in its shares at any time during the previous three years, requiring the person to state whether that is or is not the case and to provide certain further information (i.e., the old s212 investigation).

The amendment to the FSMA will also give the FSA power to require information or documents from various parties (including the company and its auditor) in relation to the operation of the transparency rules, and will give it the power of censure or suspension of companies for non-compliance with the rules.

Company's liability to investors

The Act also amends the FSMA to include a statutory liability regime in relation to periodic reporting documents and preliminary announcements. The effect of this is to make a company, that has securities traded on a regulated UK market, liable to compensate a person who has acquired securities in reliance on information in the document at a time when it was reasonable to rely on that information. To be liable the information must be untrue or misleading or there must be an omission in the document, and a person in the company discharging managerial responsibilities must have known or been reckless as to whether it was untrue or misleading or a dishonest concealment. The documents to which this regime relates are, first, those reports and statements published under the relevant FSA rules implementing the directive's periodic reporting provisions (see 5.2). However, in a late amendment, this regime is now extended to cover preliminary announcements also.

That Act gives HM Treasury secondary legislative power to amend the liability regime.

Immediately effective

These provisions of the Act are some of the very few that became effective immediately on Royal Assent. However, it should be appreciated that whilst the FSA's rule-making powers become immediately effective, the FSA will determine the effective date of any rules that they make under the power.

¹ Directive 2004/109/EC

For the FSA consultation paper and proposals following responses, see

www.fsa.gov.uk/pages/Library/Policy/CP/2006/06_04.shtml and www.fsa.gov.uk/pages/Library/Communication/PR/2006/106.shtml.

5.2 Proposed FSA rules on periodic reporting

Arrangement and scope of rules

Earlier in 2006 the FSA consulted upon draft rules to implement the transparency directive. At the time of writing the FSA now has the power to make final rules but has not yet done so. What follows is based on the draft rules (see left) and the directive's requirements. HM Treasury and FSA have, however, announced that the implementation date for the periodic reporting rules will be years commencing on or after 20 January 2007.

After it has brought in new rules, the full suite of the FSA's rules under Part 6 of the FSMA will consist of Prospectus Rules, Listing Rules (LR) and Disclosure and Transparency Rules (DTR). The periodic reporting provisions will appear in the DTR rather than, as previously, in the LR. This is because the LR apply only to companies with listed securities, whereas the DTR usually apply to companies with securities admitted to trading on a regulated UK market. There are exceptions to the periodic reporting rules for some cases where the securities are debt securities.

Annual accounts and reports

The forthcoming DTR will provide that a company must publish its annual accounts and directors' report within four months of the year end. It will require that the accounts and reports contain a sign-off statement by the directors that the accounts give a true and fair view; and that the directors' report gives a fair review of the development, performance and position of the business together with a description of the principal risks and uncertainties faced.

Half-yearly reports

Half-yearly reports will be required within two months of the half-year end. The financial information must be in accordance with IAS 34, which will require somewhat more extensive disclosure than has hitherto been the practice. The narrative must contain (*inter alia*) a description of the principal risks and uncertainties for the remaining six months of the year. The directors will be required to make a sign-off statement that (*inter alia*) the report complies with IAS 34 and is not misleading. An auditor's review will remain on a voluntary basis.

'Interim management statements'

The DTR will also require what will be termed 'interim management statements'. These will consist of an explanation of material events and transactions during the relevant period and a general description of the financial position and performance of the company. One such statement is required part way through the first six months (at the earliest ten weeks after its beginning and at the latest six weeks before its end). A second such statement is required in the equivalent period in the second six months. In effect then, this is a requirement for first and third quarter trading statements.

5.3 FSA power to make corporate governance rules

The Act also gives the FSA power to make 'corporate governance rules' applicable to companies with shares admitted to trading on a UK regulated market. (Similar powers are also given to the Secretary of State.) This is in anticipation of implementation of amendments to the EC Fourth and Seventh Company Law Directives (see left) that will require those companies to give a comply-or-explain statement in relation to an appropriate corporate governance code. The UK is required to implement this directive by 5 September 2008.

For Directive 2006/46/EC, amending the Fourth and Seventh Directives, see www.eur-lex.europa.eu/LexUriServ/site/en/oj/2006/L_224/L_22420060816en00010007.pdf.

The current LR requirements in relation to corporate governance disclosures are expected to meet these requirements, albeit the rules will need to be moved into the DTR to give them the necessary, wider scope of application. At this stage it is not known whether the FSA will implement that directive by requiring companies to gather together the appropriate governance disclosures in a formally identified corporate governance statement or to include it within the directors' report (the directive permits both).



6. Audit

A single part of the Act draws together all of the requirements in relation to audit that were hitherto spread around the 1985 Act: e.g., the audit requirement, the audit exemptions, provisions for appointment, removal etc. Again, the intention is to provide a more coherent presentation of related requirements.

6.1 Audit exemptions

The audit exemptions in relation to small companies and dormant companies are almost unchanged. However, that for charitable companies has been deleted, leaving that matter instead to charities legislation, including the new Charities Act 2006. The 1985 Act is also changed to remove the charities exemption, although the implementation of this repeal will not be immediate (presumably it will coincide with implementation of the Charities Act 2006, which may be earlier than that of the Companies Act 2006).

On the other hand, a new exemption from audit under the 2006 Act has been created, albeit one of little relevance to the private sector. Non-Departmental Public Bodies that are companies can be subject to public sector audit (e.g., by the Comptroller and Auditor General) under other legislation and thus be exempt from the Companies Act audit provisions.

6.2 Auditor appointment

In the 1985 Act, the provisions in relation to the appointment of auditors were complicated. The default position was that there should be annual appointment of auditors but there were exceptions to that for private companies. The new Act makes the default position for private companies that of continued appointment (once the appointment is made by the members) rather than annual reappointment. Annual appointment is still required for public companies.

6.3 Audit opinions

In terms of the audit report itself, there are two matters that will change the wording. At present an auditor is required to report, *inter alia*, that the accounts give a true and fair view in accordance with the applicable GAAP. There was some concern with this formulation, which came in with the introduction of EU-adopted IFRS. The concern was that the GAAP compliance reference might have been read as a qualification or limitation on the true and fair view – perhaps suggesting in readers' minds that true-and-fair meant merely compliance with the relevant GAAP. In the new Act there is a requirement for separate opinions on truth and fairness and on GAAP compliance to help avoid this potential confusion.

The other change is in relation to the reporting by exception on accounting records. The auditor will now report where he has concluded that the accounting records are not adequate, whereas previously he reported if they were not proper. The requirement for the directors to maintain accounting records is also now articulated in consistent language (see 4.3).

6.4 Offences

The most significant changes, however, are in the area of offences, transparency and liability.

Under the Act a person will commit a criminal offence if he knowingly or recklessly causes the audit opinion upon the accounts, directors' report and directors' remuneration report to be misleading, false or deceptive in any material particular. The test of liability is whether the person knowingly or recklessly caused the audit report to be misleading etc. The class of persons who are within the scope of the offence are those individuals within the audit firm who are eligible for appointment as auditor of the company. It therefore covers the audit partner and, depending upon the circumstances, others involved who are responsible individuals (in the terminology of audit regulation).

The auditor's consideration of the adequacy of accounting records is outwith the scope of the offence.

6.5 Transparency measures

Signing the report, questions at the AGM, publishing the engagement letter, regulatory bodies

The transparency measures mainly implement proposals discussed by the Audit Quality Forum, a body convened by the Institute of Chartered Accountants in England and Wales (ICAEW) at the request of the Secretary of State for Trade and Industry. The first measure is that audit reports will now be signed in the name of the individual audit partner on behalf of the firm. There are exceptions to the need to state the names of the audit partner and the firm in those cases where to do so would create a serious risk that the person or firm will be subjected to violence or intimidation (e.g., campaigns by certain pressure groups).

Secondly, members will have enhanced rights to raise questions about the audit. Members with over 5 percent of the voting rights (or 100 members with more than a minimum investment) may require a quoted company to publish on its Web site a statement of the requisitionists' concerns about the audit report, the conduct of the audit or a change of auditor, that they intend to bring up at the next accounts meeting. The effect of this will be to alert other shareholders to the concerns in advance of the meeting.

Another provision of the Act gives the DTI secondary legislative power to require the publication of audit engagement letters. The DTI has said that it intends to use this power to require Web site publication in relation to quoted companies.

In a very late amendment, a body to whom the Secretary of State delegates audit regulatory functions – which will be an audit-related operating body of the Financial Reporting Council (FRC) – will now be within the Freedom of Information Act 2000.

Statement by an auditor on ceasing to hold office

The final reform in the area of transparency relates to the occasion when an auditor ceases to hold office. At present the auditor is required to provide the company with a statement of any circumstances he wishes to bring to the attention of members or creditors or to state that there are no such circumstances; where there are such circumstances the statement must be circulated to members and delivered to the registrar.

The new Act will change this fundamentally: transparency will be much more extensive and the procedures rather more complicated. First of all, on ceasing to hold office a quoted company's auditor must always make a statement of circumstances connected with his ceasing to hold office. That is to say, there is no filtering required as to whether matters need to be brought to attention; in all cases a quoted company's auditor must state the circumstances of his departure. The old rules apply for unquoted companies.

Circulating a cessation statement to members and the registrar

On receiving such a statement a quoted company must circulate it to its members. An unquoted company need only circulate the statement if it is of circumstances to be brought to the attention of members or creditors, as under the old Act.

The auditor is required to file the statement with the registrar in all cases regardless of whether the company is quoted or unquoted or, in the case of an unquoted company, whether the auditor has circumstances to be brought to members' or creditors' attention (previously only statements of circumstances were filed).

All of the above are subject to the usual right of the company to seek a court direction not to circulate the statement.

Informing the appropriate audit authority of cessation

There is then further disclosure, to an 'appropriate audit authority'. In the case of a major audit this is either the Secretary of State or a body to which he has delegated audit regulatory functions, which will be the FRC or one of its audit-related operating bodies. A major audit is defined as that of a listed company or of a company whose financial condition is a matter of major public interest (undefined). In the case of other audits the appropriate audit authority will be the relevant supervisory body, e.g., the ICAEW.

In cases of early termination of office, the company must inform the appropriate audit authority of that fact and the company must give the reasons for the termination or, unless it is a statement of no circumstances, provide a copy of the auditor's statement. In other words the company always gives the reason.

The auditor is also required to inform the appropriate audit authority in all cases of cessation of office (early or otherwise) in relation to a major audit, and to provide a copy of the statement given to the company. However, where (perhaps unlikely) the major audit is of an unquoted company and the auditor stated that there were no circumstances to be brought to the attention of members or creditors, then the auditor nevertheless has to inform the appropriate audit authority of the circumstances of termination. For audits that are not major audits the auditor must inform the appropriate audit authority of the same information but only in the case of early termination.

Informing the accounting authorities of cessation

The Act also recognises 'accounting authorities'. These are the Secretary of State and the FRRP. Where the appropriate audit authority receives any notice from an auditor or a company, as set out above, then it must inform the accounting authorities. It must forward to them the statements received from the company and the auditor, as it thinks fit.

6.6 An auditor's liability

In a welcome deregulatory move, the Act introduces a permissive facility for the limitation of an auditor's liability. An auditor will be able to negotiate with the company to limit liability by contract (a Liability Limitation Agreement, or LLA). The limitation is as to the 'amount' of liability to a company, but this cannot be less than an amount that is 'fair and reasonable in all the circumstances'. Thus the legislation uses the language both of fixed and proportionate caps. However, the DTI is given secondary legislative power to require or prohibit certain terms from being included in LLAs, although it is not yet clear how the powers will be used. A separate LLA will be required for each year's audit, and each one must be approved by the members of the company (i.e., annually). Disclosures may be required in the annual accounts and reports in relation to an LLA.

7. The registrar

Facilitates electronic filing of all documents

Hitherto only certain filings with the registrar of companies were able to be made in electronic form. The 2006 Act changes this fundamentally. Henceforth almost all documents to be delivered to the registrar will be capable of being delivered by electronic means; the registrar will specify the precise form, authentication and manner of delivery. The Act requires the registrar to secure that this is possible from 1 January 2007. In practice, however, the real date for the commencement of electronic filing across the full range will be determined by the date at which the DTI brings this provision into force (see 9).

Whilst this provision is facilitative, and still permits hard copy delivery, the Act gives a reserve power to the Secretary of State to require electronic delivery.

Managing the register

The Act gives the registrar wider powers with regard to the register than hitherto. She now has a statutory facility to reject documents, e.g., if they do not contain the required particulars or the authentication is incorrect; she may omit material from a document when placing it upon the register if that material is not required to be delivered and made public; unnecessary material may be removed from the register; and the register may be rectified, including under a court order.

Directors' residential addresses – off the public record

Significantly, certain information on the register will no longer be available for public inspection. Chiefly this means directors' residential addresses. This will apply in all cases. There will be no need to apply for privacy or to state a case for it.

In relation to these provisions, the Act gives the Secretary of State power to introduce a system of unique identifiers for directors. It is thought that this may be necessary to distinguish between directors of the same name when the public register will no longer show their residential addresses by which they could previously have been distinguished.



8. Capital maintenance

The Act's provisions concerning the raising and maintaining of share capital and the distribution of assets, cover over 200 sections. In large part they are a restatement of what went before in the 1985 Act, seasoned with a number of reforms. In fact, it was originally proposed that all of these provisions would remain in the 1985 Act and that the new Act would merely amend a small number of them. However, the Government recognised the disadvantage of leaving substantial portions of the legislation in a cut-down 1985 Act. Accordingly, over the summer the DTI consulted upon the restatement of all of those measures into the new Act and this has now been done.

8.1 Redenomination of share capital

The Act contains a new provision to enable the redenomination of share capital between currencies. Previously this could be achieved only by cumbersome methods such as cancellation and re-issue of all shares. Under the Act the company may pass a resolution to redenominate from one currency to another, with the nominal value being translated at a spot or average rate within the 28 days preceding the resolution. This will of course yield new nominal values that are not convenient, round amounts. However, another provision permits the company to reduce the nominal values by up to 10 percent in order to achieve such a convenient figure, with a corresponding credit to a new reserve known as the 'redenomination reserve'. This new reserve can be used to pay up fully paid bonus shares and can only be reduced by the same procedures as applicable for share capital (similarly to a capital redemption reserve).

Practical issues arising

This simple facility is very welcome and is expected to work well where a company redenominates from sterling to a foreign currency. However, the implications are less clear were the procedure to be used to redenominate from foreign currency into sterling (or, perhaps, into whatever is the functional currency for accounting purposes). Suppose, for example, that a company (with a functional currency of sterling) has in issue dollar share capital which it redenominates into sterling. The new capital will be the current sterling value of the former dollar nominal amounts. However this will be a greater or lesser amount than the historical – i.e., original issue date – sterling worth of the dollars. The questions arise as to whether any increase crystallises a capital increase and whether any decrease crystallises a distributable profit. These are difficult legal issues; they are present throughout the period of the capital's being denominated in the foreign currency, but are brought to the fore by the redenomination. For example, the judge's remarks in the case of *Re Scandinavian Bank Group PLC* may suggest that a reduction was not capable of being paid by way of dividend. Uncertainty remains in this area.

8.2 Private company capital reduction by solvency statement

Reduction process

One of the major reforms in the area of share capital is the new provision by which a private company may reduce its capital by the passing of a special resolution supported by a solvency statement. (The existing facility to have a reduction confirmed by the court will, however, remain as an alternative route.) The statement is modelled on that of the old whitewash. It is one to the effect that each of the directors is of the opinion that the company will be able to pay its debts as they fall due in the following twelve months and that immediately after the reduction there will be no grounds on which the company could then be found unable to pay its

debts; in so saying, the directors must take into account the company's contingent and prospective liabilities. The statement does not need to be made in the form of a statutory declaration and there is no requirement for an auditor's report in relation to the directors' statement. There is no facility for creditors to object to the court.

Whether the resulting reserve is distributable

In relation to capital reductions generally the DTI has recognised that the question of the distributability of resulting reserves is one for statutory codification rather than ICAEW guidance (TECH 7/03, which was in any event based on legal advice). That guidance provided that a reserve thrown up by a court-approved reduction was a realised profit unless the court had stipulated otherwise, whereas one arising outwith a court procedure in the case of an unlimited company² was realised only to the extent that the original subscription for that capital was in the form of Qualifying Consideration³. Under the new Act the DTI has the power to specify by secondary legislation the extent to which capital reductions, including the new private company solvency-based reductions, are to be treated as realised profits. We think that they would at least reproduce the current position, but whether they consider that some solvency-based reductions should be prohibited from giving rise to a realised profit is something that remains to be seen.

8.3 Redemption and purchase of shares

Redemptions on deferred terms

Turning to the redemption of shares, there is a helpful innovation in as much as companies will now be able to redeem shares on deferred payment terms. It was previously the case that the redemption price had always to be discharged in cash at the point of redemption. This is therefore a welcome deregulation.

Unfortunately, however, the legislation does not address the consequences of deferral.

It does not specify whether or not the redemption price – for the purpose of determining the distributable profits or fresh issue proceeds required to cover the redemption at the point of redemption – should be determined by the simple amount of the eventual cash payment or by the value at the time of redemption of the undertaking to pay in the future (which would, of course, be a lesser figure). The Act has thus created a new legal uncertainty.

It should be noted that where the transaction amounts to a purchase of shares rather than a redemption, then there remains no facility for deferred payment. Purchase consideration must still be discharged in cash at the time of purchase.

Retention of private companies' payment out of capital

The facility for a private company to redeem or purchase its own shares out of capital (a Permissible Capital Payment, or PCP) has been carried forward into the new Act. However, the directors' statement of solvency to be made on such an occasion has been changed from being a statutory declaration to merely a statement, in order to align with the procedures for the solvency-based capital reduction. (There are remaining procedural differences, however, in that the PCP regime requires an auditor's report upon the directors' statement, and permits members or creditors to take the matter to court.)

² Under the old and the new legislation unlimited companies may reduce their share capital simply by passing a special resolution.

³ See paragraphs 16(g), 16(h) and 18 of TECH 7/03, ICAEW.

The PCP regime has been retained, notwithstanding the very high degree of similarity with the solvency-based capital reduction regime, because it is thought that it facilitates a greater amount of capital return than a reduction route would permit. This is because it is thought to be the legal position that on a reduction of capital the maximum amount that can be returned to a shareholder – as a payment – is the original amount subscribed for the share in question. However, in the PCP regime the maximum amount that can be returned is limited not by the original subscription proceeds but by the aggregate amounts of the company's share capital, share premium, capital redemption reserve and revaluation reserve.

8.4 Other reforms

Abolition of authorised share capital

As noted earlier, the concept of authorised share capital is abolished. This is achieved by the memorandum of association no longer being required to state what is the company's share capital. Companies are therefore free, subject to any provisions in their articles, to issue fresh shares without limit.

Tightening restrictions on use of share premium account

The rules in relation to the use of the share premium account arising on the issues of shares have been changed. It is now the case that, aside from bonus share issues, the only use to which it can be put is the absorption of expenses and commissions on the issue of the shares upon which the premium arises. Thus the share premium that arose on one issue of shares cannot be used to absorb the write-off of issue expenses on different shares, nor can it be used to absorb preliminary expenses or debenture redemption premiums.

Private companies – abolition of financial assistance prohibition

Another major reform is the abolition, but only for private companies, of the prohibition on providing financial assistance for the acquisition of own shares. It is retained for public companies because this is required under the EC Second Company Law Directive. In addition, the prohibition is retained in relation to financial assistance provided by a private company in relation to the acquisition of shares of its holding company if that holding company is a public company; and it is similarly retained in relation to a public company subsidiary's assisting acquisitions of its private holding company's shares.

8.5 Distributions

Clarifying an effect of *Aveling Barford*

In the area of distributions, there is only one major change, whereby the legislation has clarified an effect of the *Aveling Barford* case. The case, as is well known, has the effect (*inter alia*) that a sale at an undervalue to a parent or a fellow subsidiary undertaking is a distribution. There is a new provision in the Act that clarifies that the distribution is to be measured on a book value basis in the case where a company has enough distributable profits to cover the distribution measured on that basis.

Suppose that a company has an asset that is worth £100 and is carried in the books at £80. It proposes to sell it to its parent company for book value i.e., £80. If the company had no deficit of distributable profits, say it had a balance of £1, then the distribution would be measured at nil, being the book value of the asset less the price charged, and the sale would be found to be lawful because the distribution so measured is covered by the £1 of distributable profits. On the other hand, if the company had a deficit, say of £5, the transaction could not proceed because a

distribution, even of nil, is not covered if there is a deficit; instead, the book value basis does not apply at all and the (prohibited) distribution would be accorded its real value of £20 (the real value of the asset less the price charged).

The future of the distribution rules?

Some, but not all, of the provisions in the area of capital maintenance are now, for the first time, covered by secondary legislative powers given to the DTI. These powers allow, without the need for primary legislation, the amendment, repeal or the making of such other provision as appears necessary in relation to certain areas. Unfortunately, in a very late change, the specified areas exclude the distribution rules.

Earlier in the Parliamentary process the DTI had been persuaded of the fact that the distribution rules were increasingly cumbersome to operate (e.g., the disconnect between many EU-adopted IFRS measures and traditional ideas of realisation, e.g., reporting certain shares as debt). Thus at that stage the distribution rules were within the secondary legislative powers. However, in response to a critical report from a Parliamentary committee on delegated powers, the Government withdrew the power in relation to distributions.

As a result, any reform of distributions law can now be effected only by a further Act of Parliament (and, in the case of public companies, if the EC Second Company Law Directive is changed).

9. Implementation

Fewer than 30 sections of the Act became effective immediately on Royal Assent. For the rest of the Act, as is usual, the DTI is given secondary legislative power to commence its provisions, at a date of its choosing, by a form of SI known as a commencement order.

Government practice is usually to commence new legislation semi-annually on either 1 April or 1 October, and in wholesale rather than piecemeal fashion. An exception will, however be made for this Act. The Government has announced that, first of all, it will commence the communication provisions in January 2007. This is to enable companies to take advantage of the potential cost savings in this area as soon as possible. It should be borne in mind, however, that before a company can use Web site communication with its members it must (*inter alia*) have a members' resolution to that effect, or an appropriate provision in its articles.

With respect to the rest of the Act, the Government has said that it intends to consult in detail on implementing measures in February 2007. Some of these measures will address transitional issues. For example, there is a question as to whether the statement of authorised share capital in old style memorandum and articles should be deemed to be deleted or should be deemed to be retained as a non-statutory limit in the articles on the directors' authority to issue shares; there are other potential problem areas such as this. Some of these transitional issues may require companies to take action in their articles and thus companies need certainty on such matters in good time before the AGM season preceding implementation.

In addition, the Government may need a large number of other supporting regulations, many of which may be straightforward propositions, such as regulations re-enacting the provisions of the old accounting schedules. All told, there could be as many as 100 commencement orders and



For the Government's announcement, see Hansard, Lords Debates, 2 November 2006, column 432/ 433, available from www.publications.parliament.uk/pa/ld199697/ldhansrd/pdvn/home.htm.

other SIs necessary for full implementation. A further key component for implementation is the need for the registrar to introduce fully electronic filing systems (see 7).

In terms of when the rest of the Act will be fully implemented, the Government has said only that it intends to provide business with time to gear up to the new law and to commence everything *by* October 2008. This appears to keep the Government's options open as to whether to commence it in tranches over a period to October 2008, to bring it in wholesale in October 2008 or to bring it in wholesale at an earlier date agreed through consultation. We think that the piecemeal route can probably be discounted (other than, perhaps, for a few self-standing matters), and that in the main the choice consulted upon will be as to the date on or before October 2008 for the rest *en bloc*.

The Companies Act 2006 is expected soon to be available at www.opsi.gov.uk/acts/acts2006a.htm.

A further question is whether provisions that relate to financial years will apply to those commencing or ending on/after a date, say 1 October 2008. We think that it would be highly unusual to introduce laws so as to have retrospective effect and thus we think that a 'commencing on or after' formula is very likely (e.g., this is how the Companies Act 1989 was commenced) – indeed, to do otherwise would be to take away the extra time that Government is giving business to prepare.

Repealing the old legislation

The provisions of the old legislation will be repealed as their replacements in the new Act come into force. When it is fully in force it will not, however, completely replace the old legislation. The 1985 Act will continue to cover investigations of companies; and the 2004 Act will still cover certain of the FRRP's powers, the funding of the FRC and matters connected with Community Interest Companies.

"Annotated Companies Acts" (Oxford University Press)

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