The Companies Act 2006

Julie Butler asks: 'What does it really mean to the small business?'

On 8 November 2006, Parliament finally enacted the *Companies Act 2006*. The content is based on the recommendations of the Company Law Review Steering Group, first published as *Modern Company Law for a Competitive Economy* in July 2001, followed by the White Papers *Modernising Company Law* (July 2002) and *Company Law Reform* (March 2005). The Group recommended a major revision of company law to make it more accessible to small businesses, with requirements as unrestricting and easy to understand as possible. So has this been achieved?

The Act amends and restates many provisions of the 1985 Act, with two-thirds of that Act repealed. Its provisions will cover companies registered under the new Act and the 1985 Act. Implementation is expected to be in stages commencing in October 2007.

As finally enacted, the new legislation fills 760 pages and contains 1,300 sections and 16 Schedules, as a result of which it is the longest Parliamentary Act in history. The list of parts, chapters, sections and schedules at the start of the Act alone runs to 59 pages – can that be described as 'accessible'?

Copies of the Act can be downloaded from *www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en.pdf* and some excellent explanatory notes from *www.opsi.gov.uk/acts/en2006/ukpgaen_20060046_en.pdf*.

The audit report and the criminal offence

The principal direct impact of the Act on practitioners concerns the framing of the audit report. There is to be a new criminal offence, introduced by section 507, which will apply where the auditor knowingly or recklessly includes in his audit report any matter which is misleading, false or deceptive in a material particular or where he omits any required statement within the report – for example, in circumstances where the legislation requires the auditor to make a statement to the effect that the accounts are not consistent with the accounting records and returns.

There is an irony between the Companies Act establishing an incorrect audit report as a criminal offence at much the same time as the Auditing Practices Board (APB) issued an Ethical Standard on the provision of non-audit services such as taxation.

Under the Ethical Standard, tax services cannot be provided to an audit client where this would involve acting as an advocate for the client, before a tax appeal tribunal or Court, in the resolution of an issue material to the financial statements, or where the outcome of the tax issue depends on an audit judgment. Subject to the relaxations for the audit of small enterprises (set out in *APB Ethical Standard – Provisions Available for Small Entities* (PASE)), this is a complete prohibition – there are no safeguards considered adequate to counter the perceived threat that arises through representing a client before the General or Special Commissioners.

Online incorporation

Companies House proposes to offer businesses the option to incorporate online during 2007.

Business reviews

The implications of the Companies Act 'Business Review' requirements have been well documented. Accounts for years ending 31 March 2006 onwards must contain:

- A fair review of the business and company; *and*
- A description of the principal risks and uncertainties facing the company.

Small companies escape the business review

The requirement for all companies, other than those meeting the small company criteria, to include a business review in their Directors' Reports is now set out in section 234ZZB of the 1985 Act and is effective for financial years which began on or after 1 April 2005.

'Key performance indicators' (KPIs) are factors that measure effectively the development, performance or position of the business of the company (section 234ZZB(5)). This definition is rather vague and leaves it open to the directors to set such KPIs as they see fit. Whilst undertaking this task the tax position of the company or LLP cannot be overlooked. The DTI guidance says that it is for the directors to decide exactly what information to include about their particular company, provided the information is relevant to an understanding of the business. In the absence of a requirement to use the same KPIs on a year-by-year basis, it leaves scope for abuse, such as selectively using those KPIs that show the company's performance in a favourable light – and this includes tax.

Transactions requiring approval by members

Chapter 4 of Part 10 of the *Companies Act 2006* (sections 188 to 226) governs approval by members for the following transactions with directors: long-term service contracts; substantial property transactions; loans, quasi-loans and credit transactions; and payments for loss of office.

Loans, quasi-loans and credit transactions (defined as in the 1985 Act) to a director (or connected person) of the company or of its holding company will no longer be illegal for relevant companies, but must only be made if approved by the members of all companies. In the light of the detail on connected parties (for the definition see below) this might raise some interesting considerations on the exact definition of family relationships.

The resolution to be approved by the members must set out:

- The nature of the transaction with the director
- The amount of the loan or quasi-loan and the purpose for which it is required
- The extent of the company's liability under any transaction connected with the loan or quasi-loan

But no approval by the members is required for:

- Loans, quasi-loans, credit transactions and related guarantees or security to meet expenditure on company business. The total value of transactions under

this exception made in respect of a director and any person connected to him must not exceed £50,000 (previously to be repaid in six months in the case of a private company and limited to £20,000 for a relevant company) (section 204).

- Money lent out to fund a director's costs for legal proceedings: proceedings in connection with negligence, default, breach of duty or breach of trust by the director in relation to the company (section 205) or in connection with regulatory action or investigation (section 206).

- Small loans and quasi-loans: as long as the total value of such loans and quasi-loans made in respect of a director and any person connected to him does not exceed £10,000 (no time restriction on quasi-loans and all extended to connected persons) (previously £5,000) (section 207(1)).

- Small credit transactions: as long as the total value of such credit transactions made in respect of a director and any person connected to him does not exceed £15,000 (previously £10,000) (section 207(2)).

The *Companies Act 2006* has focused on the legality, approval and disclosure of the loans to directors as set out above. One may then ask: 'How will the tax legislation deal with these changes?'

Tax-efficient withdrawals from the company

Where does this leave tax compliance and tax planning for the average owner-managed business?

Can it be said that this revision to company law does make it more accessible to the small business? On the basis that UK GAAP (Generally Accepted Accounting Practice) = tax treatment, then where will this leave the tax treatment of loans to directors?

The effect of accounting standards on taxable profits has been well documented. Will this accounting standard stamp the tax treatment of these loans?

How will the Companies Act requirements surrounding withdrawing monies from the company impact upon tax planning and the whole subject of tax-efficient withdrawals from the company and the rôle of the tax adviser?

The definition of connected persons

Persons connected to a director will include, under the 2006 Act:

- The director's spouse or Civil Partner

- Any other person with whom the director lives as a partner in an enduring family relationship, excluding grandparents, grandchildren, siblings, uncles, aunts, nephews and nieces – this is similar to, although less strict than, the FRS 8 concept of 'family members or members of the same household who may be expected to influence or be influenced by' and more strict than the IAS 24 concept of 'family members'

- The director's children or stepchildren

- Children (who have not attained the age of 18) and stepchildren of any other person with whom the director lives in an enduring family relationship

- The director's parents

- A body corporate with which the director is connected (as defined in section 254 – interested in 20% of the share capital or entitled to control more than 20% of the voting power)

- A person acting in his capacity as trustee of a trust
  - the beneficiaries of which include the director or a person who by the family link is connected with him; *or*
  - the terms of which confer a power on the trustees that may be exercised for the benefit of the director or any such person, other than a trust for the purposes of an employee share scheme or a pension scheme

- A firm that is a legal person under the law by which it is governed and in which
  - the director is a partner;
  - a partner is a person who, by virtue of the family link, *etc*, is connected with the director; *or*
  - a partner is a firm in which the director is a partner or in which there is a partner who by the family link, *etc,* is connected with the director

This will involve much greater transparency and much harder work for all concerned, both directors and auditors.

The related party transaction

What of the need to disclose related party transactions in the notes to the accounts? How easy will it be for an enthusiastic HMRC officer to obtain vast information from the notes to the company accounts? Perhaps some family companies have enjoyed the ability to direct company profits to various (previously distant) family members or connected parties in a very tax-efficient manner. Will the disclosure of connected parties help the detection thereof?

Nervous audit clerks and family relationships

Please also feel some consideration for the innocent (and possibly nervous) audit clerk who, ever mindful of the *Companies Act 2006* disclosure requirements, has to ask the confident (and possibly scary) managing director the status of civil partners and the children of the people with whom the director lives. It might just be that senior members of the accountancy practice have failed to leave the full notes on the director's 'household' needed for *Companies Act 2006* compliance. Perhaps the questions should be delicately asked by the partner in charge of the audit . . . . .

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