6 (a) Distinguish between (i) ordinary, (ii) special and (iii) extraordinary resolutions. Indicate, in particular, the length of notices and matters in respect of which each resolution is required.

AND

(b) Fred is a managing director of Pine Wood Ltd. He also owns 25 per cent of the company's ordinary shares which carry voting rights. It has just been discovered by the other directors that Fred is acting as a consultant to another company which is in direct competition with Pine Wood Ltd. The other directors wish to propose an alteration of articles to restrict Fred's powers.

Advise the directors on whether and how they may alter the articles.

(*Glasgow Caledonian University*)

Test your knowledge

Four alternative answers are given. Select ONE only. Circle the answer which you consider to be correct. Check your answers by referring back to the information given in the chapter and against the answers at the back of the book.

1 Ouse Ltd has borrowed £10,000 from the Barchester Bank which is secured by an equitable charge over the company's freehold land. The charge, which states that it will rank in front of subsequent charges including fixed charges, has been registered. Later on Ouse granted a fixed charge over the freehold land to Onslow who had made it a loan. Onslow has not examined the Register of Charges at Companies House and has no other knowledge of the bank's equitable charge. Which charge has priority?

A The equitable charge taken by the bank because the first in time prevails.
B The equitable charge taken by the bank since registration is equivalent to notice of the contents of the charge.
C Onslow's legal charge because legal charges take priority to equitable charges.
D Onslow's legal charge since he had no notice of the equitable charge.

2 Thames Ltd is insolvent and is being wound up. The bank has a floating charge over its assets in regard to an overdraft which has not been registered. What is the effect of this?

A The charge is void against the liquidator and the bank proves as an ordinary creditor.
B The debt is void as against the liquidator and the bank will get nothing.
C The charge is voidable by the liquidator if the company was insolvent when the charge was created.
D The charge is void against subsequent secured creditors and the bank loses its priority accordingly.

3 Tay Ltd has assets of £10,000. Its trade creditors are worth £20,000 and it has an unsecured overdraft with the Barchester Bank of £20,000. Tay wants to increase the overdraft facility to £30,000. The bank has agreed and has been given a floating charge over Tay's assets to secure the overdraft. Tay Ltd is now in liquidation. Given that the overdraft is repayable on demand, how much is the bank entitled to as a secured creditor?

A £30,000 **B** £20,000 **C** Nothing **D** £10,000

4 Within how many days of its creation must a charge over the assets of a company be registered?

A Twelve days **B** Twenty-one days **C** Fifteen days **D** Fourteen days

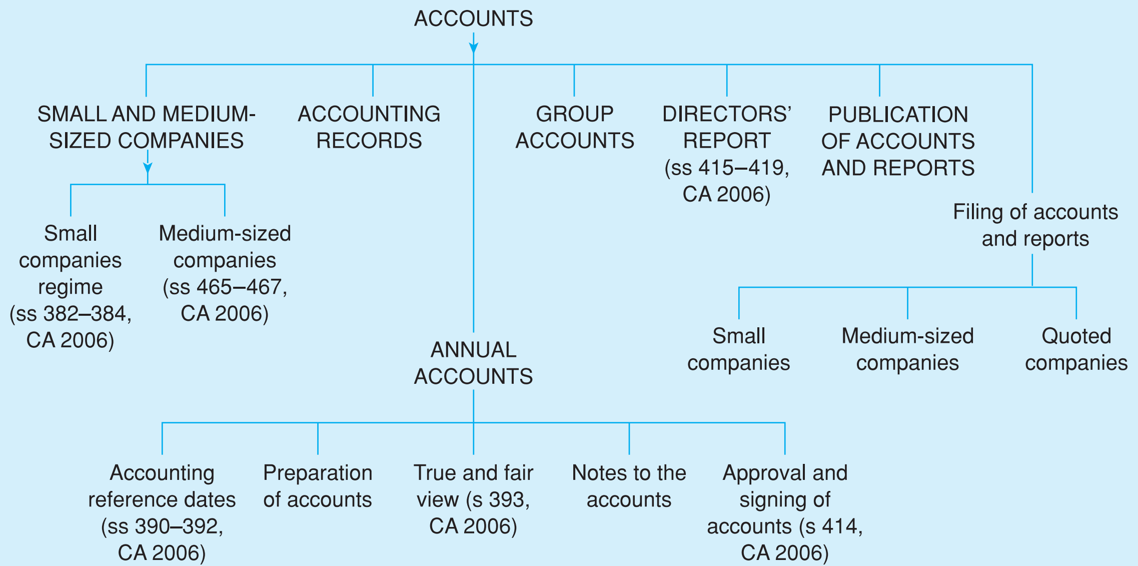
5 The Barchester Bank has just taken a floating charge over the assets of Derwent Ltd, a manufacturing company. Who can be appointed by the bank to safeguard its security should circumstances require this?

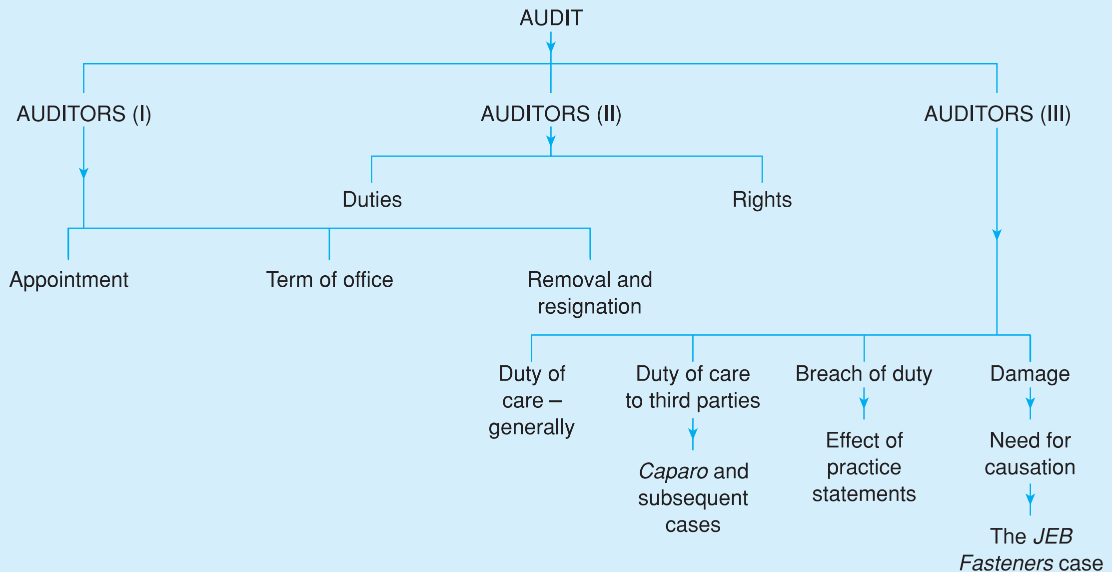
A The trustee for the debenture holder.
B The Official Receiver.
C An administrator.
D An administrative receiver.

The answers to test your knowledge questions appear on p. 617.

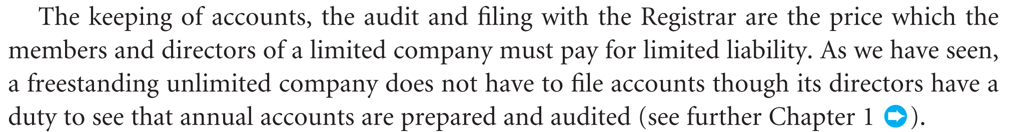
Visit **www.mylawchamber.co.uk/keenancompany** to access study support resources including practice exam questions with guidance, weblinks, legal newsfeed, answers to questions in this chapter, legal updates and further reading.

23 Accounts and audit





In this chapter we shall consider the main underlying principle of company law in regard to a company's accounts, which is to achieve disclosure of a company's financial affairs for the benefit of those who have invested in it and those who do business with it. The purpose of an audit by independent accountants is to add credibility to the financial statements forming part of the annual accounts and to ensure that they comply with regulations and give a true and fair view though small companies may take exemption from audit.



The keeping of accounts, the audit and filing with the Registrar are the price which the members and directors of a limited company must pay for limited liability. As we have seen, a freestanding unlimited company does not have to file accounts though its directors have a duty to see that annual accounts are prepared and audited (see further Chapter 1).

See p. 2

Only matters of company law have been included. No attempt has been made to give a comprehensive survey of the subject matter of accounting and auditing. Some of the main regulations that concern this area:

- The Companies Act 2006 (Annual Return and Service Addresses) Regulations 2008;
- The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008;
- The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008; and
- The Partnerships (Accounts) Regulations 2008.

Small and medium-sized companies

The Companies Act 2006 has introduced a number of changes into this area, for example in the form of additional rules relating to the directors' remuneration report which is part of the annual reporting process of the board. It is also worth noting that a number of these additional reporting requirements for public limited companies are to be found in the Financial Services and Markets Act 2000 (FSMA) or in the form of rules produced by the Financial Services Authority (FSA). However, changes have also taken place at the other end of the spectrum with respect to small and medium-sized companies.

Small companies

A company which qualifies as small is now subject to different reporting regime (the 'small companies regime') which is less onerous in terms of what has to be reported and whether it needs to be verified by audit (s 381). The test as to whether a company qualifies as 'small' is outlined in ss 382–384 of the Companies Act 2006.

Section 382(1) states that a company will qualify as small in relation to its first financial year if it meets the qualifying conditions in that year as outlined in s 382(3), which goes on to state that a company meets the qualifying conditions in a year if it satisfies two or more of the following requirements: (i) turnover not more than £5.6 million; (ii) balance sheet total not more than £2.8 million; (iii) number of employees not more than 50. Note that the company does not have to satisfy all three criteria, meeting two will suffice.

Section 382(5) clarifies that the term 'balance sheet total' means the aggregate of the amounts shown as assets in the company's balance sheet. Section 382(6) goes on to state that the 'number of employees' means the average number of persons employed by the company

in the year, determined as follows: (a) find for each month in the financial year the number of persons employed under contracts of service by the company in that month (whether throughout the month or not); (b) add together the monthly totals; and (c) divide by the number of months in the financial year.

Section 382(2) sets down that a company will qualify as small in relation to a subsequent financial year if the qualifying conditions are met in that year and the preceding financial year; if the qualifying conditions are met in that year and the company qualified as small in relation to the preceding financial year; if the qualifying conditions were met in the preceding financial year and the company qualified as small in relation to that year. The purpose of these rather complex rules is to prevent a potentially small company from moving in and out of the 'small companies regime' if performance differs year-on-year, thus providing greater flexibility within the system to cater for such changes.

It is also worth noting that s 382(7) states that this test is subject to the requirements of s 383, which focuses on whether parent companies may qualify as small companies for the purpose of the CA 2006. Section 383(1) states that a parent company qualifies as a small company in relation to a financial year only if the group headed by it qualifies as a small group, the test for which is outlined in s 383(3) as follows:

> A group qualifies as small in relation to a subsequent financial year of the parent company: (a) if the qualifying conditions are met in that year and the preceding financial year; (b) if the qualifying conditions are met in that year and the group qualified as small in relation to the preceding financial year; (c) if the qualifying conditions were met in the preceding financial year and the group qualified as small in relation to that year.

Section 383(4) sets down the qualifying conditions for a group to qualify as small and states that a group must satisfy two or more of the following requirements in a year: (i) aggregate turnover not more than £5.6 million net (or £6.72 million gross); (ii) aggregate balance sheet total not more than £2.8 million net (or £3.36 million gross); (iii) aggregate number of employees not more than 50.

Importantly, s 383(6) goes on to clarify the term 'net' with respect to the aggregate figures for turnover and balance sheet total, stating that it means after any set-offs and other adjustments made to eliminate group transactions: (a) in the case of Companies Act accounts, in accordance with regulations under s 404; (b) in the case of IAS accounts, in accordance with international accounting standards. Section 383(6) also notes that 'gross' means without those set-offs and other adjustments. A company may satisfy any relevant requirement on the basis of either the net or the gross figure.

Finally, it is necessary to refer to s 384 which sets out those companies which are excluded from this regime. Section 384(1) states that the regime does not apply to a company that is, or was at any time within the financial year to which the accounts relate: (a) a public company; (b) a company that (i) is an authorised insurance company, a banking company, an e-money issuer, an ISD investment firm or a UCITS management company; or (ii) carries on insurance market activity; or (c) a member of an ineligible group (see s 384(2)).

Medium-sized companies

A company which qualifies as medium is also subject to different reporting regime and for some reason is outlined in ss 465–467 of the Companies Act 2006. The general test as to whether a company qualifies as 'medium' is outlined in s 465 which states that a company

qualifies as medium-sized in relation to its first financial year if the qualifying conditions are met in that year (s 465(1)). These qualifying conditions are outlined in s 465(3) which states that a company meets them in a year in which it satisfies two or more of the following requirements: (i) turnover not more than £22.8 million; (ii) balance sheet total not more than £11.4 million; (iii) number of employees not more than 250.

Section 465(5) clarifies that the term 'balance sheet total' means the aggregate of the amounts shown as assets in the company's balance sheet. Section 465(6) goes on to state that the 'number of employees' means the average number of persons employed by the company in the year, determined as follows: (a) find for each month in the financial year the number of persons employed under contracts of service by the company in that month (whether throughout the month or not); (b) add together the monthly totals; and (c) divide by the number of months in the financial year.

Section 465(2) sets down that a company will qualify as medium-sized in relation to a subsequent financial year if the qualifying conditions are met in that year and the preceding financial year; if the qualifying conditions are met in that year and the company qualified as medium-sized in relation to the preceding financial year; if the qualifying conditions were met in the preceding financial year and the company qualified as medium-sized in relation to that year.

It is worth noting that s 465(7) once again states that this test is subject to the requirements of s 466, which focuses on whether parent companies may qualify as medium-sized companies for the purpose of the CA 2006.

Finally, it is necessary to refer to s 467 which sets out those companies which are excluded from the medium-sized company regime. Section 467(1) states that the regime does not apply to a company that is, or was at any time within the financial year to which the accounts relate: (a) a public company; (b) a company that: (i) has permission under Part 4 of the Financial Services and Markets Act 2000 (c. 8) to carry on a regulated activity; or (ii) carries on insurance market activity; or (c) a member of an ineligible group (s 467(2)).

Accounting records

Under s 386 of the Companies Act 2006, the directors of a company must keep adequate accounting records sufficient to show and explain the company's transactions (s 386(1)) and to disclose with reasonable accuracy, *at any time* throughout the financial year, the financial position of the company *at that time* (s 386(2)). They must also enable the directors to ensure that any accounts required to be prepared comply with the requirements of the Companies Act 2006 and the IAS Regulation (s 388(3)(b)).

In addition to this, s 386(3) goes on to state that the records must contain (a) entries from day to day of all sums of money received and expended with details of transactions; and (b) a record of assets and liabilities.

Equally, under s 386(4) a company dealing in goods must keep statements of stock held at the end of the financial year, and of stocktaking from which the year-end statement is made up and of all goods sold and purchased, other than retail trade transactions, showing goods, buyers and sellers, so as to allow identification.

Under s 388(1) accounting records must be kept at its registered office or such other place as the directors think fit, and must be open for inspection by the officers of the company

at all times. Section 388(4) goes on to note that these records must be kept for six years (public company) and three years (private company) from the date on which they are made (s 388(4)(a) and (b)).

As regards statements of work in progress, the Act does not specifically require these to be kept, on the grounds that many small companies have little or no work in progress and those for whom it is significant will have to keep statements as part of the general requirement to keep records sufficient to disclose the financial position of the company and to enable accounts to be prepared.

Under s 387(1) failure to keep accounting records as required is an offence for which officers of the company in default are liable. The offence is punishable with a maximum of two years' imprisonment and/or a fine (s 387(3)). In addition, under s 388(1) if a company fails to comply with s 388(1) to (3) of the Act, an offence is committed by every officer of the company who is in default.

Annual accounts

The term 'annual accounts' is commonly used in business and is now in fact an expression used in company legislation. For legal purposes it can be taken to mean the year end balance sheet together with the related profit and loss account and directors' and auditors' reports. Section 475(1) of the Companies Act 2006 provides that a company's annual accounts for a financial year must be audited in accordance with this Part 16 of the Act unless the company is exempt from audit under s 477 (small companies), s 480 (dormant companies), or is exempt from the requirements of Part 16 of the Act under s 482 (non-profit-making companies subject to public sector audit). Section 475(2) goes on to state that a company is not entitled to any such exemption unless its balance sheet contains a statement by the directors to that effect. A company is not entitled to exemption under any of the provisions mentioned above unless its balance sheet contains a statement by the directors to the effect that (a) the members have not required the company to obtain an audit of its accounts for the year in question in accordance with s 476; and (b) the directors acknowledge their responsibilities for complying with the requirements of the Companies Act 2006 with respect to accounting records and the preparation of accounts (s 475(3)).

Accounting reference dates

Sections 390 to 392 outline the company's financial year which depends upon the company's 'accounting reference period' (ARP) and its 'accounting reference date' (ARD) which is the date on which the company's ARP ends in each calendar year.

Section 390(2) states that a company's first financial year begins with the first day of its first accounting reference period, and ends with the last day of that period or such other date, not more than seven days before or after the end of that period, as the directors may determine. Section 390(3) goes on to note that the company's subsequent financial years begin with the day immediately following the end of the company's previous financial year, and end with the last day of its next accounting reference period or such other date, not more than seven days before or after the end of that period, as the directors may determine.

Section 391 defines in greater detail the ARD of companies incorporated in Great Britain and divides them between those incorporated before 1 April 1990 and those incorporated on or after 1 April 1990. Section 391(2) states that the ARD of a company incorporated in Great Britain before 1 April 1996 is: (a) the date specified by notice to the Registrar in accordance with s 224(2) of the Companies Act 1985; or (b) failing such notice: (i) in the case of a company incorporated before 1 April 1990, 31 March; and (ii) in the case of a company incorporated on or after 1 April 1990, the last day of the month in which the anniversary of its incorporation falls. Section 391(4) goes on to note that the ARD a company incorporated in Great Britain on or after 1 April 1996 and before the commencement of the Companies Act 2006, or after the commencement of this Act, is the last day of the month in which the anniversary of its incorporation falls.

Section 391(5) goes on to outline that a company's first accounting reference period is the period of more than six months, but not more than 18 months, beginning with the date of its incorporation and ending with its accounting reference date. Its subsequent accounting reference periods are successive periods of 12 months beginning immediately after the end of the previous accounting reference period and ending with its accounting reference date (s 391(6)).

However, a company may choose a new ARD for its current, future and previous ARPs under s 392(1) of the Companies Act 2006 by giving notice to the Registrar specifying a new ARD. Section 392(2) states that the notice must state whether the current or previous accounting reference period (a) is to be shortened, so as to come to an end on the first occasion on which the new accounting reference date falls or fell after the beginning of the period; or (b) is to be extended, so as to come to an end on the second occasion on which that date falls or fell after the beginning of the period.

It should be noted that s 391(5) places a restriction on this process, stating that an accounting reference period may not be extended so as to exceed 18 months and a notice under this section is ineffective if the current or previous accounting reference period as extended in accordance with the notice would exceed that limit. Equally, s 391(4) provides that a notice under this section may not be given in respect of a previous accounting reference period if the period for filing accounts and reports for the financial year determined by reference to that accounting reference period has already expired.

Preparation of accounts: form and content

Directors must prepare accounts for each financial year under s 394 of the Companies Act 2006 and are referred to as the company's 'individual accounts'. Section 395(1) provides that a company's individual accounts may be prepared: (a) in accordance with s 396 ('Companies Act individual accounts'); or (b) in accordance with international accounting standards ('IAS individual accounts').

Section 395(3) goes on to state that after the first financial year in which the directors of a company prepare IAS individual accounts ('the first IAS year'), all subsequent individual accounts of the company must be prepared in accordance with international accounting standards unless there is a relevant change of circumstance. There is a relevant change of circumstance if, at any time during or after the first IAS year: (a) the company becomes a subsidiary undertaking of another undertaking that does not prepare IAS individual accounts; (b) the company ceases to be a company with securities admitted to trading on a regulated market in an EEA State; or (c) a parent undertaking of the company ceases to be an undertaking with securities admitted to trading on a regulated market in an EEA state (s 395(4)).

Section 396(1) goes on to provide that Companies Act individual accounts must comprise: (a) a balance sheet as at the last day of the financial year; and (b) a profit and loss account. Section 396(2) goes on to state that the accounts must: (a) in the case of the balance sheet, give a true and fair view of the state of affairs of the company as at the end of the financial year; and (b) in the case of the profit and loss account, give a true and fair view of the profit or loss of the company for the financial year. Furthermore, the accounts must comply with provision made by the Secretary of State by regulations as to: (a) the form and content of the balance sheet and profit and loss account; and (b) additional information to be provided by way of notes to the accounts (s 396(3)).

Section 397 of the CA 2006 deals with the requirements for IAS individual accounts and provides that where the directors of a company prepare IAS individual accounts, they must state in the notes to the accounts that the accounts have been prepared in accordance with international accounting standards.

True and fair view

Section 393(1) of the Companies Act 2006 provides that the directors of a company must not approve accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss (a) in the case of the company's individual accounts, of the company; (b) in the case of the company's group accounts, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

This is an overriding principle and as such, s 396(4) provides that if compliance with the regulations, and any other provision made by or under the Companies Act as to the matters to be included in a company's individual accounts or in notes to those accounts, would not be sufficient to give a true and fair view, the necessary additional information must be given in the accounts or in a note to them. This is repeated under s 404(4) with respect to group accounts discussed below.

Equally, s 396(5) goes on to state that if, in special circumstances, compliance with any of those provisions is inconsistent with the requirement to give a true and fair view, the directors must depart from that provision to the extent necessary to give a true and fair view. Furthermore, particulars of any such departure, the reasons for it and its effect must be given in a note to the accounts. Once again, this is repeated in s 404(5) with respect to group accounts.

Notes to the accounts

Section 472(1) provides that information required by Part 15 of the Companies Act 2006 to be given in notes to a company's annual accounts may be contained in the accounts or in a separate document annexed to the accounts. Section 472(2) goes on to state that references in Part 15 of the Act to a company's annual accounts, or to a balance sheet or profit and loss account, include notes to the accounts giving information which is required by any provision of this Act or international accounting standards, and required or allowed by any such provision to be given in a note to company accounts.

Section 411 of the CA 2006 provides that in the case of a company not subject to the small companies regime, the following information with respect to the employees of the company must be given in notes to the company's annual accounts: (a) the average number of persons employed by the company in the financial year; and (b) the average number of persons so employed within each category of persons employed by the company.

In addition, s 413(1) states that in the case of a company that does not prepare group accounts, details of: (a) advances and credits granted by the company to its directors; and (b) guarantees of any kind entered into by the company on behalf of its directors, must be shown in the notes to its individual accounts. Section 413(2) goes on to provide that in the case of a parent company that prepares group accounts, details of: (a) advances and credits granted to the directors of the parent company, by that company or by any of its subsidiary undertakings; and (b) guarantees of any kind entered into on behalf of the directors of the parent company, by that company or by any of its subsidiary undertakings, must be shown in the notes to the group accounts.

Approval and signing of accounts

Section 414(1) provides that a company's annual accounts must be approved by the board of directors and signed on behalf of the board by a director of the company. Under s 414(2), the signature must be on the company's balance sheet. Section 414(3) goes on to state that if the accounts are prepared in accordance with the provisions applicable to companies subject to the small companies regime, the balance sheet must contain a statement to that effect in a prominent position above the signature.

Section 414(4) goes on to provide that if annual accounts are approved that do not comply with the requirements of the Companies Act 2006 (and, where applicable, of Art 4 of the IAS Regulation), every director of the company who: (a) knew that they did not comply, or was reckless as to whether they complied; and (b) failed to take reasonable steps to secure compliance with those requirements or, as the case may be, to prevent the accounts from being approved, commits an offence.

Small company accounts

The statutory format for the Companies Act accounts of a small company is simpler than that outlined above and is set out in the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409).

Group accounts

If a company has subsidiaries, s 399(2) of the Companies Act 2006 provides that group accounts showing the state of affairs and profit or loss of the company and the subsidiaries must be prepared. Section 404 goes on to provide details of the requirements for Companies Act group accounts, while s 406 deals with IAS groups accounts.

Section 404(1) states that Companies Act group accounts must comprise: (a) a consolidated balance sheet dealing with the state of affairs of the parent company and its subsidiary undertakings; and (b) a consolidated profit and loss account dealing with the profit or loss of the parent company and its subsidiary undertakings. Section 404(2) goes on to provide that the accounts must give a true and fair view of the state of affairs as at the end of the financial year, and the profit or loss for the financial year, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

The accounts must comply with provision made by the Secretary of State by regulations as to: (a) the form and content of the consolidated balance sheet and consolidated profit and loss account; and (b) additional information to be provided by way of notes to the accounts (s 404(3)).

Section 405(1) provides that where a parent company prepares Companies Act group accounts, all the subsidiary undertakings of the company must be included in the consolidation, subject to the exceptions outlined in s 405(2) and (3). Section 405(2) notes that a subsidiary undertaking may be excluded from consolidation if its inclusion is not material for the purpose of giving a true and fair view. Additionally, under s 405(3) a subsidiary undertaking may be excluded from consolidation where: (a) severe long-term restrictions substantially hinder the exercise of the rights of the parent company over the assets or management of that undertaking; or (b) the information necessary for the preparation of group accounts cannot be obtained without disproportionate expense or undue delay; or (c) the interest of the parent company is held exclusively with a view to subsequent resale.

Section 407 deals with the consistency of financial reporting within a group, with s 407(1) providing that the directors of a parent company must secure that the individual accounts of: (a) the parent company; and (b) each of its subsidiary undertakings, are all prepared using the same financial reporting framework, except to the extent that in their opinion there are good reasons for not doing so.

Finally, ss 400–401 of the Companies Act 2006 set out exemptions for companies included in EEA and non-EEA group accounts of larger companies.

The directors' report

The directors are required under s 415(1) to prepare a directors' report for each financial year of the company. Failure to comply with this requirement is an offence committed by every person who was a director of the company immediately before the end of the period for filing accounts and reports for the financial year in question, and failed to take all reasonable steps for securing compliance with that requirement (s 415(4)).

Section 416 goes on to set down the general contents of directors' report, with s 416(1) providing that the directors' report for a financial year must state the names of the persons who, at any time during the financial year, were directors of the company, and the principal activities of the company in the course of the year. Section 416(3) states that except in the case of a company subject to the small companies regime, the report must state the amount (if any) that the directors recommend should be paid by way of dividend.

Furthermore, according to s 417 of the Companies Act 2006, unless the company is subject to the small companies' regime, the directors' report must contain a business review. The purpose of the business review, set down in s 417(2), is to inform members of the company and to help them assess how the directors have performed their duty under s 172 (duty to promote the success of the company). Section 417(3) provides that the business review must contain: (a) a fair review of the company's business; and (b) a description of the principal risks and uncertainties facing the company. In this regard, s 714(4) goes on to state that the review required is a balanced and comprehensive analysis of the development and performance of the company's business during the financial year, and the position of the company's business at the end of that year, consistent with the size and complexity of the business.