CAPS TECHNICAL BULLETIN

ISSUE No 138
JUNE 2016

ICAS

DISTRIBUTIONS IN A MEMBERS' VOLUNTARY WINDING UP – FINANCE BILL 2016

A consultation document was issued in December 2015 in which the Government was concerned that, as a result of its proposals to increase the rate of tax on company dividends, individuals would seek to try to convert income into capital by setting up companies which traded for a bit more than a year, accumulating cash, and which were then put into members' voluntary liquidation with the shareholders paying 10% capital gains tax as a result of entrepreneurs relief. Clause 35 of the Finance Bill 2016 includes provisions to counteract this perceived abuse.

Clause 35 is a Targeted Anti-Avoidance Rule which will apply to distributions made on or after 6 April 2016 when certain conditions are met. The legislation will appear in Section 396B of Income Tax (Trading and Other Income) Act (ITTOIA) 2005.

Distributions made in a winding up of a UK company will be subject to income tax if **all** of the following conditions are met:

A. Where the individual receiving the distribution held at least a 5% interest in the company before the winding up;

B. The company was a close company as defined by Section 439 Corporation Tax Act (CTA) 2010, or was a close company at some point in the two years prior to the beginning of the winding up;

C. The person who receives the distribution is at any time in the two years following the receipt involved with the carrying on of a trade or activity that is similar to that of the trade or activity carried on by the company which is wound up. Carrying on the trade includes directly as a sole trader, or in partnership, through a company in which he has at least a 5% interest, or through a person with whom the individual is connected. Therefore, if Jack the Joiner winds up his construction company, he has a problem if his wife Jackie sets up a similar business within the next two years; and

D. That it is reasonable to assume that the winding up forms part of arrangements designed to reduce the person's income tax liability.

The legislation will not apply where the distribution does not exceed the individual's capital gains tax base cost or where it comprises irredeemable shares which would occur in a Section 110

Insolvency Act liquidation demerger.

The 5% interest in the company at A above is in respect of ordinary share capital and voting rights.

Legislation is being introduced as Section 404 A of ITTOIA mirroring the above provisions but applying to distributions in respect of shares in non UK resident companies.

The background note explains that the Targeted Anti-Avoidance Rule is being introduced "*to rationalise and improve the tax treatment of payments to members from companies*". Whether affected members will view this as an "improvement" is at best unlikely and the world of government continues to spin ever faster.

The December 2015 consultative document raised a possibility that a members' voluntary liquidation of a cash rich company, or even the sale of such a company, may be brought within these income tax distribution rules, but the Finance Bill proposals relate only to what the document referred to as "Phoenixing".

Another aspect mentioned in the consultative document was in relation to Special Purpose Vehicles. A construction company may set up one or more companies to carry on one-off development projects which are perceived to carry risk. If the Special Purpose Vehicle shares are held by the construction company itself, then Clause 35 does not cause an issue. However, if the shareholders in the construction company own the shares in the Special Purpose Vehicle personally and, once the project has been completed and sold, if the SPV was wound up, then almost certainly conditions A, B and C above would be satisfied and the question would arise as to whether condition D was also satisfied? If the shares were held by individuals rather than the company, is it reasonable to assume that the winding up forms part of arrangements designed to reduce the person's income tax liability? The winding up would take place because there would be no further use for the company to avoid the future administrative and running costs of keeping it. If the shares were held by the construction company then it is likely that the distributable profits would be paid up by the SPV to the construction company resulting in no tax liability at all. If the shares were held by individuals then capital gains tax would be payable either at 20% or the 10% entrepreneurs relief rate.

Only the passage of time will tell what view HM Revenue & Customs will take on this but, in the meantime, being new legislation, this may be an area where a non-statutory clearance application may be made.

DIGITAL WORKING TOGETHER WITH HMRC – TIME TO GET INVOLVED

What is Digital Working Together?

Working Together is the mechanism which allows tax agents to work with HM Revenue & Customs (HMRC) to improve HMRC's operations. Its key purpose is to identify widespread issues affecting many agents and their clients so that HMRC can address them. Agents can see that issues they raise are added to an issues register which is updated by HMRC as actions are taken to address them.

Some of you may remember the old face to face Working Together meetings but these have now been replaced by digital Working Together. Until now the digital meetings have only been open to a limited number of agents so that the technology and processes could be fine-tuned. From now on all agents can get involved and a big advantage of the digital meetings is that you can take part from your office, your home or anywhere you choose.

Digital meetings 2016 – an opportunity

You can now sign up to receive invitations to the remaining Digital Working Together meetings of 2016 which will take place in July, September and November; each meeting lasts approximately an hour. The advantages of getting invitations are:

- If you register for a meeting (even if you can't attend it) you will receive the Agent Digest.
- Agent Digest includes the Issues Register ie the widespread issues which HMRC will work to address. You can use it to track progress in dealing with issues which affect your day-to-day work. You can report issues you think should be considered for the register through ICAS.
- Agent Digest also includes potential issues which will be added to the Register if there is evidence to demonstrate they are widespread: it is vital that agents affected by these issues tell HMRC through ICAS. If HMRC don't have evidence of the problem it won't be added to the register and it won't get fixed!
- The meetings involve discussions of new issues, potential issues and progress on existing issues, between professional body representatives and HMRC Specialist Agent Managers; you can submit comments either during the meeting or between meetings through ICAS.

If you are already involved in Digital Working Together you will know that until recently the meetings were run on a regional basis. However, the remaining meetings in 2016 will be run on a national basis so anyone can join in any, or all, of the meetings.

How do I sign up?

Send an email to **icas-tax@icas.com** with the subject "I want to join Working Together". We will contact our HMRC Specialist Agent Manager with your name and email address which will be added to the HMRC database. You will then receive a welcome email and invitations (from HMRC) to future meetings.

What if the issue I have only affects me?

Working Together and Agent Digest are only for widespread issues affecting many agents. If you have an issue specific to you or to one of your clients this should be raised through HMRC's Agent Account Manager team rather than Working Together. HMRC has produced a guide on how to use the Agent Account Manager service which can be found at: **https://www.gov.uk/guidance/agent-account-managers-in-hmrc.**

Talking points

In addition to Digital Working Together HMRC also provide Talking Points. These are weekly online digital meetings, lasting 45 minutes to an hour, designed specifically for tax agents and advisers. They cover topics that agents have highlighted they are interested in, or emerging issues jointly identified by agents and HMRC that may have widespread impact. Agents have the opportunity to put questions to HMRC subject matter experts. Details can be found on the HMRC Talking Points page which can be found at: **https://www.gov.uk/government/news/webinars-e-learning-and-videos-if-youre-a-tax-agent-or-adviser.**

Any questions?

Send an email to **icas-tax@icas.com** if you have any questions about Digital Working Together. You should also use this email address to report issues and potential issues to be considered for inclusion in the Issues Register. The ICAS Tax Team would also like feedback on Working Together or Talking Points sessions.

ISSUE OF "SECTION 50" LETTERS TO CLIENTS DELAYED

A requirement for tax advisers to send a specifically worded HM Revenue & Customs (HMRC) letter to clients who have received advice about offshore assets or income is imposed by Finance (no.2) Act 2015 s50. Only individuals who are clients of a practice on 30 June 2016 are due to receive the letters, and that population is further limited by details to be set out in the relevant Regulations. However, the publication of the final version of those Regulations has been delayed, so they now will not come into effect on 30 June 2016 as previously expected.

The reason for the delay is given as "*delays in publishing guidance on Gov.uk to support those affected by the measure*". In other words, the HMRC guidance to accompany and explain the Regulations isn't ready yet and it now can't be published before 24 June 2016 as the Civil Service has now gone into purdah mode in advance of the EU referendum.

HMRC commented: "*The period within which to comply with the regulations will similarly be extended from the original date of 30 April 2017 to an appropriate later date to allow for the obligation to be incorporated as far as is possible into normal communications with clients.*"

EMPLOYMENT CORNER - BUDGET - THE BEST BITS

The anticipated changes to IR35 did not emerge from the Budget except insofaras the public sector is concerned. The responsibility for ensuring the correct tax is paid on services supplied by a worker who is engaged through an intermediary now lies with the public sector body engager. Watch this space for potential eventual changes to the private sector.

New anti-avoidance provisions were also introduced to tackle "disguised remuneration" schemes which contains special blanket provisions to counter the use of loopholes in the legislation.

However, anticipated changes to salary sacrifice, IR35 (outside of the public sector), travelling and subsistence (outside of IR35) and PAYE and NICs alignment did not emerge - for this year, at least.

The only changes made to termination payments were that from April 2018, amounts paid exceeding £30,000 will also be subject to employer NICs, and legislative changes will render all Payments in Lieu of Notice (PILON) fully taxable regardless of the contractual arrangements. No doubt when this happens, NICs will be levied at the same time.

Employee shareholder shares acquired under Employee Shareholder Schemes (ESS) agreements entered into after 16 March 2016 will be subject to a lifetime limit of £100,000 on the capital gain which can be exempt from capital gains tax. As a reminder, ESS was introduced in 2013 and involved employees being allowed to acquire shares in the business worth between £2,000 and £50,000 in return for the forfeiture of certain employment rights. The shares were designated free of capital gains tax on disposal.

Employment case law

Some interesting cases have also emerged in recent months.

Childcare vouchers

First, the Employment Appeal Tribunal (EAT) has ruled (**Peninsula Business Services Ltd v Donaldson EAT/0249/15**) that it was not discriminatory that a childcare voucher scheme, provided to employees by way of salary sacrifice, was suspended for an employee who went on maternity leave. Whilst the case probably reached the right verdict, another issue emerged. Worryingly, the judge referred to the issue of salary sacrifice (the method under which the childcare vouchers were provided) as "*diversion of salary, which the employee has earned but which is redirected prior to it being placed within the employee's pay packet, in order to purchase vouchers to the value of the salary utilised.*" This statement implies that he does not consider that the salary was actually sacrificed in the first instance, which potentially makes it a non-valid transaction for tax purposes.

Employer liability for PAYE coding errors

The First-tier Tribunal (**Pendergate Ltd v HMRC [2016] UKFTT 0166 TC**) has held that an appellant, a large employer with a good PAYE compliance history, was not liable for a single under-deduction of PAYE caused by a change of PAYE coding. While the decision is reached on its facts, it illustrates that generally PAYE-compliant employers who make a small number of errors will not necessarily be liable for PAYE under-deductions.

Tax treatment of payments in lieu of notice

A payment described as a payment in lieu of notice (PILON) in a compromise agreement was determined by the First-tier Tribunal (**Michael Phillips v HMRC [2016] UKFTT 0174 TC**) as taxable as a termination payment rather than as earnings from the employment. The payment was not made pursuant to a contractual right or to compromise an "amicable unforced termination" but instead a damages payment.

This decision may be contrasted with the decision of a differently constituted First-tier Tribunal in **Goldberg v HMRC [2010] UKFTT 346**. In that case, the tribunal determined that a payment described as a PILON made in circumstances where the contractual notice terms were not clear, was taxable as earnings.

It appears that HM Revenue & Customs (HMRC) did not consider how the payments should be taxed; focusing instead on the timing of the tax liability (see below). If it had, it might have applied its published guidance that confirms that where the employer and employee agree to terminate without proper notice on payment of a PILON (assuming there is no contractual PILON), provided this is done as part of the process of termination, the payment will not be from the employment but from the agreed terms for its destruction. As such, it is taxed as a damages payment. Practitioners should apply this guidance when settling claims where there is no contractual (or automatic) PILON.

Unsurprisingly, the tribunal rejected the taxpayer's argument that the payment should be apportioned over two tax years even though it was received in one year. The legislation is clear that cash termination payments are taxed in the tax year of receipt.

Loss of pension rights

The First-tier Tribunal (**Reid v HMRC [2016] UKFTT 0079 TC**) has held that a lump sum payment made to compensate an employee for the loss of pension, share and other contingent rights on the transfer of a business to a new undertaking was taxable only in part. The tribunal found, as a fact, that the payment was not made to induce the taxpayer to become an employee of the transferee. It also determined that the reasons for making the payment were dissociable and that the lump sum should be apportioned between each lost right. The tribunal rejected HMRC's submission that the taxpayer's compliance with the terms of settlement agreement and, in particular, entering a new employment contract, was sufficient to make the payment an emolument of employment. Compliance was the trigger for the payment, not the reason for it. This illustrates the importance of recording the reasons for the payment in the settlement agreement.

Injury to feelings

The Upper Tribunal (**Moorthy v HMRC [2016] UKUT 13 TCC**), upholding the decision of the First-tier Tribunal, held that a settlement payment for injury to feelings made in connection with a termination of employment was taxable as a termination payment under section 401 of the Income Tax (Earnings and Pensions) Act 2003. The payment was made to settle all the taxpayer's claims against the employer including claims for age discrimination arising during the redundancy selection process.

The Upper Tribunal's decision confirms that the tax treatment of compensation for discrimination depends on whether the discrimination is connected with the termination. Here, the alleged discrimination arose from the termination itself and accordingly the compensation was taxable. Compensation for discrimination that occurs before termination is not connected with the termination and therefore is not taxable. This apparent anomaly arises from the wide scope of section 401. Practitioners should ensure that settlement payments are apportioned to reflect any pre-termination discrimination.

PAYE penalties

The First-tier Tribunal (**Fab Cleaning Management Ltd v HMRC [2016] UKFTT 031 TC**) has decided that an employer that recorded in returns the PAYE amounts that it actually deducted, even though those amounts were wrong, filed an accurate return so it was not subject to inaccuracy penalties The employer's (Fab) obligation was to state the amount actually deducted, which it did. The decision shows that, although the amount of tax disclosed in a return may be wrong, that need not mean that the return itself is inaccurate. Inaccuracy depends on the wording of the filing obligation.

Gender pay gap reporting

Draft regulations have now been published setting out the Government's plan to require large businesses to report their gender pay gap from April 2016. While the scale of the issue will not be known until the Government reports on the effectiveness of the new scheme next year, latest figures demonstrate that women in the UK still earn 20% less than men. Under the new rules, businesses with more than 250 employees are required to publish and reveal their pay gap information report every year and keep this report for three years. Employers will also be required to submit their findings directly to the Government.

PAYE LATE FILING PENALTIES

HM Revenue & Customs (HMRC) has announced that, following a review of the three day "easement" and the "risk-assessed approach" that it adopted last tax year which saw a significant reduction in returns filed late, it has decided to continue this approach for a further tax year. As a result employers will not incur penalties for delays of up to three days in filing PAYE information during the 2016/17 tax year.

Late filing penalties will continue to be reviewed on a risk-assessed basis rather than be issued automatically.

The three-day easement is not an extension to the statutory filing date which remains unchanged. Employers are required to file on or before each payment date unless the circumstances set out in the 'Sending an FPS after payday guidance' (**https://www.gov.uk/running-payroll/fps-after-payday**) are met. HMRC won't charge a late filing penalty for delays of up to three days after the statutory filing date, however employers who persistently file after the statutory filing date but within three days, will be monitored and may be contacted or considered for a penalty.

HMRC will continue to review its approach to PAYE late filing penalties beyond 5 April 2017 in line with the wider review of penalties and will continue to focus on penalising those who deliberately and persistently fail to meet statutory deadlines, rather than those who make occasional and genuine errors for which other responses might be more appropriate.

HMRC UPDATE

VAT compliance pilot scheme

As part of a pilot project to test what HM Revenue & Customs (HMRC) calls "*an enhancement of our current compliance approach*", around 1,300 businesses which have already been selected for a VAT visit will be contacted during the spring and summer of 2016, and offered the option to take part in a short, voluntary phone questionnaire before the visit. If a business chooses to take part, HMRC may then reconsider the need for a VAT visit at that time, although it expects that a visit will remain appropriate for some participating businesses.

HMRC wants to see if, by asking businesses a few questions earlier on in the process, it can avoid some businesses receiving a VAT inspection at their premises. If successful, it will consider rolling it out more widely at a later date.

The pilot started with a small sample group of businesses in April, with the remaining businesses being contacted during the summer months. The letter and phone call stage will then end but the pilot will continue to run until the second half of 2017.

Paying HMRC by credit card

With HM Revenue & Customs' (HMRC) focus on collecting money in quicker, and the increase in calls to "customers" asking for payment, your clients may be tempted to pay by credit card to get HMRC "off their backs" and to gain a little breathing space.

Up until 1 April 2016, there was a uniform 1.5% "fee" for paying by credit card. This has now changed with the little publicised introduction of the Fees for Payment of Taxes etc by Credit Card Regulations (SI 2016/333) which introduces a range of fees depending on which card you use.

In short, using a personal card will be cheaper, with rates between 0.415% and 0.606%, whereas paying with a business card will be more expensive, with rates between 1.508% and 2.134%. The reason for the difference in rates between personal and business cards is linked to an EU Regulation introduced in December 2015 which caps the 'interchange' element of the charge for personal credit cards at 0.3%, but which does not apply to corporate credit cards.

HMRC TASKFORCE RESULTS

Just because you haven't heard much about them recently, doesn't mean they've gone away! Since they were launched in 2011, HM Revenue & Customs (HMRC) taskforces have recovered more than £540 million. The carefully targeted bursts of enforcement activity have brought in progressively higher amounts every year, with nearly £250 million raised in 2015/16 alone, over ten times the amounts recovered in 2011/12. Since 2011, HMRC has set up more than 140 taskforces targeting sectors that are at the highest risk of tax fraud including the retail sector, the tobacco industry and the adult entertainment industry.

Nearly 50 new taskforces were launched last financial year, including ones targeted at property, partnerships and hidden wealth. In 2015, a single taskforce focused on Income Tax led to 45 arrests for tax evasion and fraud.

HMRC used to routinely post details of current taskforces on its old website, but since the move to .gov.uk, this information has been conspicuous by its absence. This is reportedly due to "resourcing issues".

Money brought in through taskforces in previous years amounted to:

Year	2011/12	2012/13	2013/14	2014/15	2015/16
Taskforces yield	£24.3 million	£47 million	£85 million	£138.1 million	£248 million

THE CAPITAL GOODS SCHEME – BACK TO BASICS

The Capital Goods Scheme (CGS) is a mechanism for adjusting the amount of input tax claimed on certain capital expenditure over a determined period of years in order to reflect the change of use of that asset. It is particularly important for any business that makes exempt supplies or undertakes non-business activity. However, even if a business currently does neither, the acquisition of a CGS asset should be properly recorded, as it may become relevant in the event of a future change of use, an exempt sale of either the asset or a sale of the business itself, or the transfer of the business as a going concern (TOGC).

The scheme, although complex, is very fair as it ensures that the appropriate amount of input tax is reclaimed on an asset by reference to its use throughout its life, rather than just the amount based on its taxable use at the time it is acquired.

The relevant assets

The CGS applies to the following assets which have been capitalised and on which VAT has been suffered (all values are VAT exclusive):

1. Land such that VAT bearing capital expenditure of at least £250,000 has been incurred on its acquisition.
2. A building (or part of) where at least £250,000 of VAT bearing expenditure has been incurred on its acquisition, construction, refurbishment, alteration or extension.
3. Civil engineering works (or part of) where at least £250,000 of VAT bearing expenditure has been incurred on its acquisition, construction, refurbishment, alteration or extension.
4. An item of computer equipment where VAT bearing expenditure of at least £50,000 has been incurred on its acquisition.
5. An aircraft where at least £50,000 of VAT bearing expenditure has been incurred on its acquisition, construction, refurbishment, alteration or extension.
6. A ship, boat or other vessel where at least £50,000 of VAT bearing expenditure has been incurred on its acquisition, construction,

refurbishment, alteration or extension.

7. From 1 October 2012, a property used by the owner to make supplies of self-storage where the owner has decided to treat the item as a capital item. This applies to expenditure of £1 or more.

It is important to note that the expenditure must have been capitalised.

The value of the item

For CGS purposes, the value of the item is the total VAT exclusive value of the VAT bearing (be it at the standard or reduced rate) expenditure incurred. The value of land should not include any associated costs such as legal fees. However, it should include the VAT bearing costs involved in making the building ready for use such as:

- Architects' and surveyors' fees
- Demolition costs
- Building materials and services
- Security
- Equipment hire
- Fitting out and
- Landscaping

With respect to a refurbishment project, only the supply of goods and services affixed to the property should form part of the CGS (such as windows, air conditioning and lighting). Goods that do not form part of the property (such as carpets, machinery and office furniture) should be excluded.

The adjustment periods

The length of time over which CGS adjustments need to be made depends upon the type of CGS item. The adjustment period is normally 10 successive intervals for items 1, 2 and 7 above and 5 for the rest.

The first interval starts on the day that the owner first uses the item and ends on the day before the start of his next VAT year. Thereafter, the intervals are usually for a complete year ending at the end of the VAT year.

There is no adjustment at the end of the first interval. The initial baseline recovery is based on business/ non-business and partial exemption principles.

The formula for calculating the CGS adjustments (for the second interval onwards) is:

$$\frac{\text{Total VAT on purchase/acquisition}}{\text{Number of years (10 or 5) x (initial base line \% - actual \% for that interval)}}$$

This adjustment is made in the second VAT return following the end of the relevant VAT year and will be an amount due to HMRC (if the recovery rate has fallen) or an amount due from HMRC (if the recovery rate has increased).

Sale adjustments

When a CGS item is sold within the total adjustment period, two adjustments must be made, the normal CGS adjustment, as described above (for the full year, irrespective of when the item is sold) and the sale adjustment.

The sale adjustment follows the normal CGS method for the remaining years of the asset's CGS life. Thus, if a sale is taxable, it is assumed that the asset would have been used 100% for taxable purposes for the remaining intervals and if exempt, 100% exempt for the remaining intervals.

There is an anti-avoidance capping measure which restricts the amount of input tax that may be claimed with respect to certain capital items. When total input tax recoverable over the whole period of ownership exceeds the amount of output tax charged on the sale of the asset, such a restriction will apply. This capping is rarely applied.

Transfer as a going concern

On a TOGC, if a CGS item is included in the assets being sold, the purchaser is treated as taking over the CGS item and becomes responsible for applying the adjustments for the asset's remaining CGS life. Thus it is necessary for the seller to transfer to the purchaser, a full CGS record for any such assets.

Final comment

The identification of a CGS item is often overlooked, particularly by fully taxable businesses. Such a business may become partially exempt within the CGS life of the asset, or indeed start to use the asset for non-business purposes, either of which event would generate the requirement to make adjustments. Further, if the business is sold as a TOGC, the asset must have been identified in order to transfer its history.

VAT: THE OPTION TO TAX – TIMING

A VAT option to tax (OTT) allows a person to treat certain supplies of land and property that would otherwise be exempt from VAT as liable to VAT at the standard rate. The obvious advantage in doing so is to enable input tax recovery on costs incurred with respect to the opted property.

In fact, opting to tax has two stages, making the decision to opt and notifying HM Revenue & Customs (HMRC) of that decision. Making the decision might take place in a board meeting or often it is made in a less formal situation, such as in a meeting with a tax adviser. Whatever way the decision is taken, it should be clearly documented that the option is to apply to a specific property and the date on which the election is made. However, in order for an option to tax to be effective, it must be notified to HMRC in writing. Notification should be done within 30 days of the election being made (or within a longer time frame, if HMRC allow it).

The process of making the election often causes problems in practice. Common issues are described below, together with suggested solutions, where any exist.

Given that an OTT is often in place for at least 20 years, a very common problem arises when a property is being sold, having been purchased by a business many years ago, often by previous management. In such circumstances, the current owners or management may not know whether the property has been opted to tax. The purchaser will likely want to be certain that VAT is charged appropriately, or, in the case of a transfer of a business as a going concern, whether it is necessary for the purchaser to also make an OTT on or before taking ownership. In both cases, the purchaser may want written evidence to prove an OTT exists.

Assuming that there is no written evidence that the OTT was ever made, a solution may be to ask HMRC whether it has been notified in the past. The writer has made this request on several occasions and never once obtained confirmation of the existence or otherwise of an OTT. This emphasises the need to keep written confirmation on file that an OTT has been made and notified.

It could be that the property has always been treated as though it were opted, with VAT charged on all income earned from the property. In this situation, assuming that there is no written proof that the OTT was notified to HMRC, there is a persuasive argument to say that the option has in fact been made but possibly not notified to HMRC. HMRC will generally accept a late notification of an OTT if it is possible to prove that the decision was taken to opt and this decision is supported by the action of charging VAT on supplies of the property since that decision was taken. In this situation, it would be ideal to find a board minute or a note of meeting with advisers, that demonstrates that the decision was taken and the date of that decision. However, if no such evidence is available, HMRC would normally accept a written statement from the business as to when the election was made plus evidence that:

- All of the relevant facts have been given;
- Output tax has been properly charged and accounted for from the date of the supposed election; and
- Input tax has been reclaimed consistent with the business having made the election.

However, HMRC will not accept a late notification if:

- There has been correspondence with HMRC concerning the liability of supplies of the relevant property and no mention had ever been made of an OTT; or
- If the business had previously put forward an alternative explanation for charging VAT on supplies of the property (for instance, the supply of land as a sports facility).

Essentially, HMRC will generally accept late notifications of options to tax (often many years late) as long as there is clear evidence that the option was actually made.

Consider a different scenario. A fully taxable business uses a property for many years wholly for its own taxable activity and it was never let. A decision is taken to sell the building and in anticipation of the sale, expenditure of £75,000 plus VAT is incurred in order to improve the condition of the property. In the absence of an OTT, the sale is exempt from VAT and there is no input tax recovery for the VAT of £15,000 incurred prior to sale. Had the property been opted to tax, the sale would be liable to VAT and the input tax on the refurbishment would be fully recoverable. Assuming that the purchaser would be able to recover the VAT charged on the sale price, the seller might be tempted to consider revisiting the OTT. However, in this case, unfortunately no OTT has been made, or at least no evidence of one can be found. As the property was never let, the question of the OTT probably never arose. If no OTT has been made, it is not possible to make a late notification of something that never happened. There is no scope to make a retrospective OTT. What should have happened in this scenario is that the seller should have considered making (and notifying) an election prior to undertaking the refurbishment.

By way of conclusion, the OTT position should be considered in respect of all property interests held by a business and the question of making an OTT should be revisited prior to any significant expenditure or possible sale or letting of a property. Any decision about making the election should be formally documented and notified to HMRC in writing, with a copy safely held on file to avoid problems in the future.

FRC ETHICAL STANDARD – SECTION 6 PROVISIONS AVAILABLE FOR AUDITS OF SMALL ENTITIES

Introduction

The audit exemption thresholds were increased for accounting periods commencing on or after 1 January 2016. The thresholds to be applied are as per section 382 of the Companies Act 2006:

- Turnover of not more than £10.2m
- Balance sheet total (fixed plus current assets) of not more than £5.1m
- Not more than 50 employees.

The two-year rule still applies ie a company's size classification is only changed when conditions are not met for two consecutive years, other than in its first year.

The FRC recently issued its finalised Ethical Standard (FRC ES) which consolidates its existing ethical standards 1-5, the Ethical Standard for Reporting Accountants and its Provisions Available for Smaller Entities (PASE) into one combined standard. The new standard will be known as the Financial Reporting Council's Ethical Standard ('FRC ES'). The combined standard includes revisions and new requirements to primarily, but not solely, take account of EU Audit Legislative requirements which took effect on 17 June 2016.

The increase in the audit thresholds means that more companies will now be able to take advantage of audit exemption. This also means that for those entities who voluntarily decide to have an audit, Section 6 of the Financial Reporting Council's (FRC) Ethical Standard will be applicable to a larger population of entities. Section 6 is entitled "Provisions Available for Audits of Small Entities (PAASE)". The PAASE has been subject to some small revisions to align it with changes made to the main Ethical Standard but is substantively similar to the current extant version (PASE) and also took effect on 17 June 2016.

Summary of changes to the PAASE

- It is specifically highlighted that the PAASE is not applicable for the audit of 'public interest entities' (PIEs) as defined in the EU legislation.
- References have been revised throughout section 6 to align it to the requirements in sections 1-5 of the FRC ES, and developments such as the establishment of the FCA.
- Paragraph 6.1 highlights that the FRC ES sets out the overarching principles, supporting ethical provisions and specific requirements, that auditors are required to comply with in order to discharge their responsibilities in respect of their integrity, objectivity and independence.
- The detailed paragraphs which explained the relevant provisions in respect of which an alternative provision, or in some cases an exemption is conferred in the FRC ES, have been removed to streamline the document.
- As per the FRC ES Sections 1-5, references to audit engagement partner now refer to "engagement partner".
- In relation to the exemption pertaining to persons joining an audit client this has been revised and now covers "Partners and Other Persons Approved as a Statutory Auditor".
- The tense in certain sentences is revised eg "*An audit firm takes appropriate steps to determine that there is (previously "has been") no significant threat to the audit team's integrity, objectivity and independence…*".
- Reference to where disclosure should be made in the auditor's report in respect of highlighting that advantage has been taken of the PAASE is not now as specific with regards to the location although it does state that it should be in a separate paragraph of the audit report. The extant version requires this disclosure to be included in the Basis of Audit Opinion section.
- No example illustrative audit reports are provided in contrast to the extant version.

Alternative provisions

As per the extant PASE. two alternative provisions are included which are as follows:

(i) **Economic dependence**

Paragraph 4.51 of the FRC ES provides that, where it is expected that the total fees for services receivable from a non-listed audited entity and its subsidiaries relevant to a recurring engagement (which includes audit) will regularly exceed 10% of the annual fee income of the firm or the part of the firm by reference to which the engagement partner's profit share is calculated, but will not regularly exceed 15%, the engagement partner shall disclose that expectation to the Ethics Partner/Function and to those charged with governance of the entity and the firm shall arrange an external independent quality control review of the engagement to be undertaken before the firm's report is finalised.

The PAASE substitutes an alternative provision in paragraph 6.5 which removes the requirement for an external independent quality control review, nevertheless the audit engagement partner is required to disclose the expectation that fees will amount to between 10% and 15% of the firm's annual fee income to the Ethics Partner and to those charged with governance of the audited entity.

(ii) **Self-review threat – Non-audit services**

When undertaking non-audit services for a small audited entity, the audit firm is not required to apply safeguards to address a self-review threat provided:

(a) the audited entity has 'informed management'; and
(b) the audit firm extends the cyclical inspection of completed audit engagements that is performed for quality control purposes.

The audit firm extends the number of engagements inspected under the requirements of ISQC (UK and Ireland) 1 'Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements' to include a random selection of audit engagements where non-audit services have been provided. Particular attention is given to ensuring that there is documentary evidence that 'informed management' has made such judgments and decisions that are needed in relation to the presentation and disclosure of information in the financial statements.

Those inspecting the engagements are not involved in performing the engagement. Small audit firms may wish to use a suitably qualified external person or another firm to carry out engagement inspections. This service is avaialble to member firms through the Practice Review Service. For more information contact Linda Laurie on 0131 347 0249 or **llaurie@icas.com**.

In addition to the documentation requirements of ISQC (UK and Ireland) 1, those inspecting the engagements should document their evaluation of whether the documentary evidence that 'informed management' made such judgments and decisions that were needed in relation to the presentation and disclosure of information in the financial statements is sufficient.

Exemptions

As per the extant PASE, three exemptions are provided in the PAASE:

(i) **Management threat – Non-audit services**

When undertaking non-audit services for small audited entities, the audit firm is not required to adhere to the prohibitions in Section 5 of Part B of the FRC ES relating to non-audit services that involve the audit firm undertaking part of the role of management provided that:

(a) It discusses objectivity and independence issues related to the provision of non-audit services with those charged with governance, confirming that management accept responsibility for any decisions taken;
(b) It discloses the fact that it has applied the FRC Ethical Standard – Provisions Available for Audits of Small Entities.

(ii) **Advocacy threat – Non-audit services**

The audit firm of a Small Entity is not required to comply with paragraphs 5.97 (tax services that involve acting as an advocate) and 5.140(b) (restructuring services that involve acting as an advocate) of section 5 of Part B of the FRC ES provided that it discloses the fact that it has applied the FRC ES PAASE.

(iii) **Partners and other persons approved as a statutory auditor joining an audited entity**

The audit firm of a Small Entity is not required to comply with paragraphs 2.53 (partner or other person approved as a statutory auditor is appointed to a client as a director, audit committee member, or key management position) and 2.57 (former partner or another person personally approved as a statutory auditor joins an entity as a director, audit committee member, or key management position) of Section 2 of Part B of the FRC's ES provided that:

(a) It takes appropriate steps to determine that there is no significant threat to the audit team's integrity, objectivity and independence; and
(b) It discloses the fact that it has applied the FRC ES PAASE.

Provision (a) requires

(i) Assessing the significance of the self-interest, familiarity or intimidation threats, having regard to the following factors:

- The position the individual has taken at the audited entity;
- The nature and amount of any involvement the individual will have with the audit team or the audit process;
- The length of time that has passed since the individual was a member of the audit team or firm; and
- The former position of the individual within the audit team or firm.

(ii) If the threat is other than clearly insignificant, applying alternative procedures such as:

- Considering the appropriateness or necessity of modifying the audit plan for the audit engagement;
- Assigning an audit team to the subsequent audit engagement that is of sufficient experience in relation to the individual who has joined the audited entity;

- Involving an audit partner or senior staff member with appropriate expertise, who, where the firm already audits the entity, was not a member of the audit team, to review the work done or otherwise advise as necessary; or
- Undertaking an engagement quality control review of the audit engagement.

Disclosure

No disclosure in the auditor's report is required if use has been made of either of the alternative provisions.

Where use has been made of one of the three exemptions then the auditor's report must disclose that fact and disclosure is required in either the financial statements, or the auditor's report regarding the types of non-audit services provided to the audited entity or the fact that a former engagement partner, or other person personally approved as a statutory auditor, has joined the audited entity. The fact that an audit firm has taken advantage of an exemption provided by the FRC ES PAASE is set out in a separate paragraph of the audit report. It does not affect the Opinion paragraph.

Although in some circumstances you can "double up" provisions and exemptions it is not possible to combine the provisions in paragraph 6.7 (self-review alternative provision) and paragraph 6.11 (management threat exemption).

One of the requirements of the alternative provision under paragraph 6.7 is that the audit client has "informed management" (ie that the firm does not undertake part of the role of management). If the firm is already providing a non-audit service with an associated self-review threat and is applying the exemption under paragraph 6.11, then it cannot also apply the alternative provision under paragraph 6.7 as they are logically exclusive. So if, for example an audit firm provides accounting services to a small entity audit client with no "informed management", the firm can apply Section 6 of the FRC ES which allows them to undertake work which would give rise to a management threat, but the firm needs to introduce safeguards to counter the self-review threat. Paragraph 6.7 which offers the alternative provision in relation to the self-review threat specifically requires for there to be "informed management".

It is possible for advantage to be taken of more than one provision from PAASE at a time.

ISSUES ARISING IN RELATION TO ACCOUNTING FOR SOCIAL HOUSING LOANS

Many entities are currently in the process of applying Financial Reporting Standard (FRS) 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland' for the first time. Therefore, as there are many areas where FRS 102 is silent or could possibly be interpreted in different ways, it is only natural that preparers of accounts and indeed auditors may have different views as to how certain transactions should be accounted for. Ultimately, of course, preparers and auditors need to exercise professional judgement in their given circumstances (see below).

Sector

The Financial Reporting Council (FRC) was recently made aware of issues of interpretation that have arisen in relation to accounting for loans by registered providers of social housing, which could have a significant impact on such entities' financial statements. Of course, similar loans may exist in other sectors, though at present it would appear that they are most prevalent in the social housing sector.

The Issue

The issue relates to the classification of loans as either 'basic' or 'other' financial instruments, which then impacts on whether the loans are measured on a cost or fair value basis. If such loans are deemed to be 'basic' in nature, then section 11 (amortised cost model) of FRS 102 would be applicable, while if they do not meet the criteria set out in section 11, then they would require to be accounted for under section 12 (fair value model) of FRS 102.

Requirements of FRS 102

Paragraph 11.9 of FRS 102 sets out the conditions that a loan needs to meet in order for it to be classified as basic and consequently measured on a cost basis. This states:

"The conditions a debt instrument shall satisfy in accordance with paragraph 11.8(b) are:

(a) The contractual return to the holder (the lender), assessed in the currency in which the debt instrument is denominated, is:

(i) a fixed amount;
(ii) a positive fixed rate or a positive variable rate; or*
(iii) [not used]
(iv) a combination of a positive or a negative fixed rate and a positive variable rate (eg LIBOR plus 200 basis points or LIBOR less 50 basis points, but not 500 basis points less LIBOR).

** A variable rate for this purpose is a rate which varies over time and is linked to a single observable interest rate or to a single relevant observable index of general price inflation of the currency in which the instrument is denominated, provided such links are not leveraged.*

(aA) The contract may provide for repayments of the principal or the return to the holder (but not both) to be linked to a single relevant observable index of general price inflation of the currency in which the debt instrument is denominated, provided such links are not leveraged.

(aB) The contract may provide for a determinable variation of the return to the holder during the life of the instrument, provided that:

(i) the new rate satisfies condition (a) and the variation is not contingent on future events other than:

(1) a change of a contractual variable rate;

(2) to protect the holder against credit deterioration of the issuer;

(3) changes in levies applied by a central bank or arising from changes in relevant taxation or law; or

(ii) the new rate is a market rate of interest and satisfies condition (a).

Contractual terms that give the lender the unilateral option to change the terms of the contract are not determinable for this purpose.

(b) There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.

(c) Contractual provisions that permit the issuer (the borrower) to prepay a debt instrument or permit the holder (the lender) to put it back to the issuer before maturity are not contingent on future events other than to protect:

(i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or

(ii) the holder or issuer against changes in levies applied by a central bank or arising from changes in relevant taxation or law.

The inclusion of contractual terms that, as a result of the early termination, require the issuer to compensate the holder for the early termination does not, in itself, constitute a breach of this condition.

(d) [Not used]

(e) Contractual provisions may permit the extension of the term of the debt instrument, provided that the return to the holder and any other contractual provisions applicable during the extended term satisfy the conditions of paragraphs (a) to (c)."

It is common for loan agreements to include a provision setting out amounts to be paid by the borrower to the lender as compensation should the borrower repay the loan early and current market interest rates are lower than the fixed rate specified in the agreement. FRS 102 explicitly states that such provisions do not prevent the loans being classified as basic (Please refer to paragraph 11.9 (c) (ii) of FRS 102 (as included above). However, it has emerged that many otherwise straight-forward fixed rate loan agreements, particularly in the social housing sector, include a variant of such a provision. These provisions require the borrower to pay the lender or the lender to pay the borrower, depending on whether current market interest rates are below or above the agreed fixed rate. FRS 102 does not explicitly address compensation that can be paid to the borrower.

Differing views as to appropriate accounting treatment

It appears there are divergent views as to the appropriate accounting treatment for such loans, based on differing interpretations of one of the qualifying conditions, over whether such loans can be classified as basic. Those advocating a basic classification have also argued that the resulting measurement of the liability, based on cost, provides more relevant information, by better reflecting the intentions of the contracting parties in entering into the agreement and their expectations of future actions.

FRS 102 does not explicitly address every transaction, other event or condition that an entity may need to account for, and preparers and auditors will need to apply judgement in the application of FRS 102. This may lead to diversity in practice in some areas. In some cases the FRC may take action to reduce diversity in the future by making amendments to standards.

In situations where standards do not specifically address the required accounting, different, valid interpretations can, and do, occur. The classification of loans with two-way compensation clauses appears to be one such case. The FRC reviews areas where it is aware of significantly conflicting interpretations emerging, and in this case will consider any need to revise the requirements of FRS 102, in due course, and after due process, with a view to clarifying the accounting requirements whilst ensuring that the economic substance of the agreements is reflected.

Need to disclose judgements

In relation to this specific issue, as the FRC has noted, diversity in practice may arise and it has therefore sought to remind preparers that FRS 102 (paragraph 8.6) requires disclosure about judgements that have had a significant effect on the amounts recognised in the financial statements.

Triennial Review of FRS 102

Looking forward, the FRC is starting work on its triennial review of FRS 102, and expects to reconsider the conditions in paragraph 11.9 as part of that process. As well as considering this specific compensation clause, its review will also include consideration of any other issues raised in relation to the application, in practice, of paragraph 11.9. Any amendments that are subsequently made to FRS 102 will reflect wide experience of applying the standard. The FRC expects to consult on any proposed amendments early in 2017. Any such amendments are likely to have an effective date of accounting periods commencing on or after 1 January 2019, although early application may be available.

DEREGULATORY CHANGES MADE FOR LLPS AND QUALIFYING PARTNERSHIPS

The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016 (S.I. 2016/575) have been enacted, implementing deregulatory changes for Limited Liability Partnerships (LLPs) and qualifying partnerships. The regulations came into force on 17 May 2016. The Financial Reporting Council (FRC) has also made consequential amendments to FRS 105 'The Financial Reporting Standard Applicable to the Micro-entities Regime'.

In 2013, BIS introduced the Small Companies (Micro-Entities' Accounts) Regulations 2013 (S.I. 2013/3008) which implemented an option in the EU Accounting Directive to introduce a micro-entities regime for companies. The regime was not applied to qualifying partnerships at that time.

Then in 2015, BIS introduced the Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (S.I. 2015/980) and the Companies, Partnerships and Groups (Accounts and Reports) (No.2) Regulations 2015 (S.I. 2015/1672) to implement certain provisions of the EU Accounting Directive. These made changes to the financial reporting framework, in relation to the preparation and publication of accounts, for limited companies and qualifying partnerships.

LLPs are not subject to the EU Accounting Directive. They are, however, subject to a very similar accounting regime to limited companies, including the requirements as to the filing of accounts at Companies House; and the content of, and the auditing of, accounts. The 2016 Regulations introduce similar changes to the financial reporting framework for LLPs as have been introduced for companies, including the creation of a new micro-entities regime for applicable LLPs. The changes will not fundamentally alter the financial reporting regime for LLPs but they will allow very small LLPs to have the option to apply the provisions applying to micro-entities.

There are approximately 58,000 LLPs in the UK, the vast majority of which (around 98%) are small. The changes will also provide certain reliefs to some medium-sized and large LLPs as well as groups which include both companies and LLPs within their structures.

In line with the changes already made to the financial reporting framework for companies, the main changes to the accounting and audit requirements for LLPs will be to:

(i) increase the thresholds used to determine the size of LLPs to the same as for companies i.e. turnover of not more than £10.2 million; a balance sheet total of not more than £5.1 million and not more than 50 employees. About 400 medium-sized LLPs are likely to be re-categorised as small and therefore able to access the less burdensome small LLPs' accounting and audit regime. Similarly, around 40 large LLPs will be re-classified as medium-sized and therefore able to access a reduced reporting regime;
(ii) reduce the number of mandatory notes to the accounts required of small LLPs;
(iii) provide LLPs with the opportunity to adapt the profit and loss account and balance sheet formats, provided that the information given is at least equivalent to the information required by the standard formats;
(iv) allow a small LLP to prepare and publish an abridged balance sheet and profit and loss account if approved by all the members of the LLP; and
(v) permit the use of the "equity method" in individual LLP accounts.

The Regulations will also amend the application of section 405(3)(b) of the Companies Act 2006 to LLPs. Under this provision, a subsidiary undertaking of a parent LLP can be excluded from inclusion in consolidated accounts if the costs of obtaining the necessary information would be disproportionate or obtaining that information would cause undue delay to completion of the consolidated accounts. Under the amended provision, a subsidiary will only be able to be excluded in "extremely rare circumstances". Examples of such circumstances may include where a subsidiary is located overseas and legal or political circumstances (such as the imposition of sanctions, or impounding of records pending an investigation or conflict) mean that the cost of obtaining the information would be disproportionate or a potentially hazardous situation is preventing the obtaining of the information.

Micro-entities

LLPs are eligible to apply the micro-entities regime, provided they meet the relevant conditions, which mirror the requirements of sections 384A and 384B of the Companies Act 2006. Therefore, an LLP qualifies as a micro-entity in relation to its first financial year if the qualifying conditions are met in that year and in relation to a subsequent financial year, where on its balance sheet date an LLP meets or ceases to meet the qualifying conditions, that affects its qualification as a micro-entity only if it occurs in two consecutive financial years.

Qualifying conditions

1. Turnover - Not more than £632,000.
2. Balance sheet total - Not more than £316,000.
3. Number of employees - Not more than 10.

The qualifying conditions are met by an LLP in a year in which it satisfies two or more of the above requirements.

As per companies legislation, a parent LLP only qualifies as a micro-entity in relation to a financial year if the LLP qualifies as a micro-entity in relation to that year, and the group headed by the LLP qualifies as a small group.

LLPs excluded from being treated as micro-entities

The following entities are specifically excluded from taking advantage of this regime:

(a) an LLP excluded from the small LLPs regime by virtue of section 384;
(b) investment undertakings;
(c) financial holding undertakings;
(d) credit institutions; and
(e) insurance undertakings.

The micro-entity provisions also do not apply in relation to an LLP's accounts for a financial year if:

(a) the LLP is a parent LLP which prepares group accounts for that year as permitted by section 398; or
(b) the LLP is not a parent LLP but its accounts are included in consolidated group accounts for that year.

Qualifying partnerships

The Regulations also introduce a micro-entities regime for qualifying partnerships – the UK has an option to do so in the Accounting Directive. Qualifying partnerships are usually formed for investment purposes. A qualifying partnership is defined in regulation 3 of the Partnerships (Accounts) Regulations 2008 (SI 2008/569) as:

"*(1)A partnership which is formed under the law of any part of the United Kingdom is a qualifying partnership for the purposes of these Regulations if each of its members is:*
(a) a limited company, or
(b) an unlimited company, or a Scottish partnership, each of whose members is a limited company."

The rules for a qualifying partnership to qualify as a micro-entity are the same as those for a company.

Amendments to Financial Reporting Standard (FRS) 105

The amendments to FRS 105 are applicable for accounting periods beginning on or after 1 January 2016, with early application permitted from 1 January 2015 in conjunction with the changes in legislation. The use of the micro-entities regime remains optional.

Early application by a micro-entity that is an LLP or a qualifying partnership is:

(a) permitted for accounting periods beginning on or after 1 January 2015 provided that 'The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016' (SI 2016/575) are applied from the same date; and
(b) required if the LLP or qualifying partnership applies 'The Limited Liability Partnerships, Partnerships and Groups (Accounts and Audit) Regulations 2016 (SI 2016/575) to a reporting period beginning before 1 January 2016'.

The FRC's amendments merely take into account the different nature of LLPs. For example, the 'Statement of Financial Position' requirement is amended at paragraph 4.3 of FRS 105 as follows:

"*A micro-entity shall present a statement of financial position in accordance with one of the formats set out in Section C of Part 1 of Schedule 1 to the Small Companies Regulations or Section C of Part 1 of Schedule 1 to the Small LLP Regulations.*

LLPs shall describe the items as set out in the Small LLP Regulations. In particular, 'Called up share capital not paid' shall not be used and 'Loans and other debts due to members' and 'Members' other interests' shall be used instead of 'Capital and reserves'."

Similarly, in relation to its profit or loss for a period at paragraph 5.3 of FRS 105:

"*5.3 A micro-entity shall present its profit or loss for a period in an income statement in accordance with Section C of Part 1 of Schedule 1 to the Small Companies Regulations or Section C of Part 1 of Schedule 1 to the Small LLP Regulations.*

LLPs shall describe this item as 'Profit or loss for the financial year before members' remuneration and profit shares'."

In accordance with Regulation 30 of the Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911), the notes to the financial statements of an LLP which qualifies as a micro-entity shall be presented at the foot of the statement of financial position and shall include financial commitments, guarantees and contingencies as required by paragraph 55 of Part 3 of Schedule 1 to the Small LLPs Regulations.

No amendments have been made to the recognition and measurement requirements of FRS 105.

'Amendments to FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime Limited Liability Partnerships and Qualifying Partnerships' is available at: **https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Amendments-to-FRS-105-The-Financial-Reporting-Sta.pdf**.

LLP SORP

The LLP SORP Committee will now consult on the required changes to the SORP. Although the Committee has previously stated that some changes may be required, it believes that these will be minor in nature and would not affect any of the recommended practices set out in the SORP.

OSCR CLARIFIES POSITION ON EARLY ADOPTION OF CHARITIES SORP UPDATE BULLETIN

Following the publication of Statement of Recommended Practice (SORP) Update Bulletin 1, Office of the Scottish Charity Regulator (OSCR) has clarified that Scottish charities are not permitted to adopt the Bulletin early.

Update Bulletin 1, (**http://www.charitiessorp.org/choose-sorp-modules/charities-sorp-frs102**) makes a number of changes to the Charities Statement of Recommend Practice (SORP) (FRS 102), to reflect changes to the Financial Reporting Standard applicable in the UK and the Republic of Ireland (FRS) 102. The changes to the Charities SORP (FRS 102) apply to accounting periods commencing on or after 1 January 2016.

There had been a degree of uncertainty as to whether the Bulletin could be adopted early by Scottish charities. OSCR's statement (**http://www.oscr.org.uk/hot-topics/reminder-charities-sorp-frs-102-update-bulletin-early-adoption-is-not-permitted-in-scotland**) now clarifies that Scottish charities cannot early adopt the Update Bulletin on the grounds that this is not permissible under Scottish charity law.

Amendment regulations (**http://www.legislation.gov.uk/ssi/2016/76/made**) to the Charities Accounts (Scotland) Regulations 2006 only permit the changes to the Charities SORP (FRS 102) to apply to periods commencing on or after 1 January 2016. Incidentally, the amendment regulations also give effect to the withdrawal of the Charities SORP (FRSSE) for Scottish charities from the same date.

The most significant change to the Charities SORP (FRS 102) intended to be brought about by the Update Bulletin is an exemption for smaller charities from preparing a statement of cash flows. OSCR's statement therefore specifies that Scottish charities applying FRS 102 ***must include a statement of cash flows*** in their accounts for periods commencing on or after 1 January 2015 and before 1 January 2016. There is one exception to the rule, not widely available, which is explained below.

The Update Bulletin amends the definition of 'smaller' to provide a consistent definition across the UK. Charities wishing to take advantage of any concessions afforded by the Charities SORP (FRS 102), and their advisers, should be mindful of the revised definition.

Definition of 'smaller' within the Charities SORP (FRS 102)

For periods commencing on or after 1 January 2015 but before 1 January 2016, a smaller charity is a charity which meets the size criteria for audit exemption within its jurisdiction and for its legal form.

For periods commencing on or after 1 January 2016 a smaller charity is a charity with gross income of £500,000 or less.

How does the statement of cash flows requirement work?

The drafting of the current version of the Charities SORP (FRS 102) has caused a bit of confusion as Module 14, which deals specifically with the preparation of the statement of cash flows, refers to an exemption being available. However, the introductory material in the SORP states that all charities must prepare a statement of cash flows (paragraph 26).

Module 14, paragraph 14.1 states that:

"Charities preparing their accounts under FRS 102 must provide a statement of cash flows except where the disclosure exemptions permitted by this SORP have been taken."

ICAS has clarified with OSCR, a member of the joint SORP-making body, that the disclosure exemptions referred to is the concession in paragraph 7.1A of Section 7 of FRS 102 on 'Statement of cash flows', which states that:

"This section ......do[es] not apply to...... investment funds that meet all of the following conditions:

i) substantially all of the entity's investments are highly liquid;
ii) substantially all of the entity's

investments are carried and market value; and

iii) the entity provides a statement of changes in net assets."

In charity terms, this exemption can be taken by a charity which operates as a closed common investment fund.

Another aspect of FRS 102 which seemed to offer hope of an exemption to some subsidiaries with charitable status is effectively shut down by the Charities SORP (FRS 102).

Under paragraph 1.12 of FRS 102, a 'qualifying entity' is afforded a number of exemptions including a statement of cash flows exemption. The definition of a 'qualifying entity' in FRS 102 is: "*A member of a group where the parent of that group prepares publically available consolidated financial statements which are intended to give a true and fair view and that member is included in the consolidation*"

However, the more onerous requirement in paragraph 26 of the Charities (SORP FRS 102) trumps this exemption, meaning that a charitable subsidiary included in the consolidated accounts of a parent must include a statement of cash flows in their individual accounts.

Charities applying the FRSSE and the Charities SORP (FRSSE)

Scottish charities using the Financial Reporting Standard for Smaller Entities (FRSSE) and applying the Charities SORP (FRSSE) for periods commencing before 1 January 2016 can continue to prepare these without a cash flow statement.

ACCOUNTING AND AUDITING QUERIES

Query: *I am a partner in a medium sized accountancy practice in the UK. My firm has a number of unincorporated clients which until now have applied the Financial Reporting Standard for Smaller Entities (FRSSE) in preparing their accounts. Once the FRSSE is withdrawn for accounting periods commencing on or after 1 January 2016 what accounting standards will apply to such small unincorporated entities.*

Answer: Subject to any other accounts requirements that may apply to certain entities, for many unincorporated entities the main requirement for the need to prepare a set of accounts comes from UK tax legislation ie the need for the taxable profit to be based on the accounting profit subject to any specific adjustments required by tax law. The tax law refers to Generally Accepted UK Practice. Primarily in new UK GAAP for smaller entities this means Financial Reporting Standard (FRS) 102 'The Financial Reporting Standard in the UK and Ireland' and FRS 105 'The Financial Reporting Standard Applicable to the Micro-entities Regime'.

HM Revenue & Customs have advised that unincorporated entities are entitled to use either standard provided the entity concerned meets the relevant criteria. Therefore, unincorporated entities which would meet the micro-entity qualifying conditions (other than not being a company, limited liability partnership or qualifying partnership) have the option to use FRS 105 for preparing their financial statements. It is envisaged that all larger (than micro) unincorporated entities and those which are micro in size but which decide not to apply FRS 105, would apply FRS 102. Also, those entities satisfying the small company qualifying conditions (other than not being a company) are entitled to take advantage of the disclosure concessions offered by section 1A of the standard.

Query: *I am a financial controller in a large private parent company which is applying Financial Reporting Standard (FRS) 102 for the first time. Could you please assist me to identify under what circumstances it would be appropriate to have a foreign currency exchange movement reserve. We have an overseas subsidiary and have intercompany loan accounts and trade debts with this company. The sales to the subsidiary are at arm's length. Due to foreign exchange movements my company (the parent) is suffering ongoing exchange losses on the sales and intercompany debts. Currently, I believe the foreign exchange losses should be written off to the Profit and Loss Account as incurred but some individuals are of the opinion these could be debited against a new foreign exchange reserve. However, doing this would probably result in this reserve having a large debit balance initially and for the foreseeable future. Can you provide any guidance on this situation?*

Answer: Foreign currency transactions are dealt with in section 30 of FRS 102. At the end of each reporting period this requires that

(a) foreign currency monetary items are translated using the closing rate;
(b) non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction; and
(c) non-monetary items that are measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

Therefore, foreign exchange adjustments in relation to the translation of debtor balances are translated using the closing rate at the year-end date. The company then needs to recognise, in the profit or loss account for the period in which they arise, exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous periods.

However, FRS 102 does recognise that an entity may have a monetary item that is receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future. In substance, such items which may include long-term receivables or loan items form part of the entity's net investment in that foreign operation, and are therefore accounted for as follows:

Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation shall be recognised in profit or loss in the separate financial statements of the reporting entity or the individual financial statements of the foreign operation, as appropriate. However, such exchange differences can be recognised in Other Comprehensive Income in the consolidated accounts and never recycled to profit and loss. FRS 102 does not specify a time period that might qualify as the 'foreseeable future'. Therefore, the term 'foreseeable future' is not meant to imply a specific time period, but rather is an intent-based indicator, ie an intra-group receivable or payable may qualify as part of the net investment in the foreign operation where:

- the parent does not intend to require repayment of the intra-group account (which cannot be represented if the debt has a maturity date that is not waived); and
- the parent's management views the intra-group account as part of its investment in the foreign operation.

A history of repayments is likely to be indicative that an advance or loan does not form part of the investment in a foreign operation.

PEOPLE WITH SIGNIFICANT CONTROL (PSC) REGISTER

From 6 April 2016, Companies, Limited Liability Partnerships (LLPs) and Societes Europaea (SEs) need to keep a register of people with significant control ('PSC').

A PSC is anyone in a company, LLP or SE who meets one or more of the conditions listed in the legislation. This is someone who:

- Owns more than 25% of the company's shares;
- Holds more than 25% of the company's voting rights;
- Holds the right to appoint or remove the majority of directors;
- Has the right to, or actually exercises significant influence or control; and
- Holds the right to exercise or actually exercises significant control over a trust or company that meets one of the first four conditions.

This information now needs to be filed with Companies House on incorporation and updated when the company submits later 'Confirmation Statements' (see below).

If a company was incorporated before 30 June 2016, then it will also need to provide this information in its first Confirmation Statement.

It's a criminal offence to not provide this information. If a company discovers that it does not have a PSC, or are still trying to identify one, there'll be forms that the company will need to file to confirm this. BIS guidance can be found at GOV.UK.

The PSC's usual residential address won't be available on the public register, and the day of birth will be suppressed.

All other PSC information will be available on the public register, much like directors' and members' details are currently held.

In some exceptional cases, it may be that a PSC is at risk of violence or intimidation. For example, this might be because they're linked to a company that might be targeted by activists due to its activities. In these cases, the company may apply to have such details protected, so they aren't available to credit reference agencies.

If a company is granted protection, then it will still need to send its PSC information to CH when it's required (for example on the Confirmation Statement), and the information will still be available to the police.

REPLACEMENT OF COMPANY ANNUAL RETURNS

From 30 June 2016, the annual return is being replaced. Instead, companies will now file a Confirmation Statement at least once a year. Directors will need to check and confirm the company information that Companies House (CH) holds on the company and advise CH if there are any changes.

In order to complete the Confirmation Statement companies will need to:

- Check the information that CH holds on the company's registered office, directors and location of registers.
  Any changes require to be notified on a separate form before completing the Confirmation Statement.
- Check and if necessary update the company's shareholder information, statement of capital and standard industry classification (SIC code).

- Check and confirm that the company's record is up to date.
- Pay the £13 fee to file online or £40 by paper.

Companies can update their record as many times as necessary, but they'll only be charged once a year. For most companies, this will also be the first time that they are required to notify CH of people with significant control (PSC). New companies will provide this information on their incorporation documents.

CH will send an email alert or a reminder letter to a company's registered office when the Confirmation Statement is due.

The due date is usually a year after the incorporation of the company or the date the company filed its last annual return. The Confirmation Statement can be filed up to 14 days after the due date.

If a company's made up date is between now and 30 June 2016, then it will still need to file an annual return. For example, if the made up date is 20 June 2016, then a company will have until 18 July 2016 to file its annual return (due to the annual return's 28-day grace period).

Confirmation Statements can be filed online at Companies House.

TECHNICAL BULLETIN

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