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FOLLOWER NOTICES AND ACCELERATED PAYMENT NOTICES - WHAT SHOULD THE TAX ADVISER DO?

Finance Act (No.2) 2014 (enacted in July) confers wide-ranging powers to enable HM Revenue & Customs (HMRC) to bring forward the payment of disputed tax. The relevant legislation is to be found in Part IV of the Act under sections 199 to 229. This article is a summary of the actions that a tax adviser may wish to consider in relation to follower notices and advance payment notices that are, or may be, received by their clients.

There are two types of notice:

1. **A follower notice:** this is issued by HMRC following a judicial ruling of a case whereby similar tax arrangements are being used by a person. A follower notice requires the taxpayer to amend the return or claim, or to reach agreement with HMRC if there is an open appeal, which brings the possibility of disputing the tax bill to an end. If the taxpayer decides not to comply with the follower notice, for example, by continuing with an appeal, penalties may be assessed of up to 50% of the tax at stake for non-compliance with the follower notice. This is designed to deter continual delays in settling cases that have no likelihood of success in the appeal process.
2. **An accelerated payment notice:** as the name suggests, this brings forward the payment of tax where a tax avoidance scheme is involved but without impacting on the procedures to finalise any dispute resolution. There are late payment penalties of 5% and a further 5% at 5 months and 11 months if the sought-for tax is still outstanding.

What happens next?

A key question is timing of these notices being served. Some uncertainty remains around when those who have used tax planning schemes with a Disclosure of Tax Avoidance Schemes (DOTAS) number or that result in a 'Follower Notice' may be asked by HMRC for accelerated payment of tax.

Starting in August 2014, HMRC will phase the issue of notices to current users over approximately 20 months. Note, however, that an accelerated payment notice may only be issued if there is an open enquiry or appeal.

The list of scheme reference numbers

HMRC has published a list of those avoidance scheme reference numbers (SRNs) whose users may be issued with

an accelerated payment notice (APN) - **https://www.gov.uk/government/publications/tax-avoidance-schemes-on-which-accelerated-payments-may-be-charged-by-hmrc**.

It has said that the list is to be continually reviewed to ensure that only current and newly disclosed schemes whose users may receive an accelerated payment notice are included and the list will be refreshed at quarterly intervals to take account of any updates.

Note that the list has been issued as numbers and not scheme names as taxpayers will have used this to identify their use of an avoidance scheme when completing their Self-Assessment returns. Promoters of avoidance schemes are not required to provide the scheme name, but are required to send the scheme reference number to their clients. The SRN is all the user will need in order to identify whether their scheme is on the list. HMRC is considering whether it is possible to compile and publish a list of scheme names alongside the SRNs.

The list includes a full range of schemes that have been disclosed and issued SRNs since DOTAS was introduced in 2004. The list covers a wide variety of schemes, including sideways loss schemes, SDLT schemes (post-2010), self-employment schemes, artificial loss deduction schemes, capital gains schemes and employment schemes. Schemes which have been agreed by HMRC that there is no additional tax due are excluded from the list.

Clients who may be expected to receive a notice but have not yet done so

The tax adviser may wish to consider alerting the client that there may be a demand for payment in the near future. The client may also wish to consider how they plan to proceed in advance of receiving a notice, for example, considering cash flow and whether a "Time to Pay" arrangement may be needed.

Clients who have received a notice

The tax adviser may want to consider:

- Whether the calculation by HMRC is correct. The legislation gives little detail on how this might apply if taxes interact, and there may be subsequent relief, (so much might be left open to negotiation);
- Whether representations should be made to HMRC within the 90 day limit;
- Whether the client may need to request a "Time To Pay" arrangement, in which case early contact with HMRC may be needed to facilitate this; and
- Whether there are other consequences for the client's tax affairs.

There is no ability to appeal to a tribunal against an accelerated payment notice or a follower notice, although the taxpayer may put forward representations to HMRC within 90 days of the notice being given. Representations may object to the giving of the notice on the grounds that the conditions for its issue were not met; HMRC must consider any representations.

Practice points

HMRC has indicated in its Guidance (see below link, paragraph 2.2.14) that where applicable, copies of correspondence will also be sent to the taxpayer's agent.

Members may wish to seek the assistance of another member who specialises in dealing with these matters and, if so, appropriate procedures need to be adopted, including obtaining the client's permission to do so.

It may be that some clients may make a claim against their adviser. The claim may or may not have merit, but members need to consider their obligations to notify their professional indemnity insurers at the earliest opportunity.

Professional Conduct in Relation to Taxation

The guidance '*Professional Conduct in Relation to Taxation*' should be followed and, in particular, chapter 8 which addresses tax planning, tax avoidance and tax evasion. The guidance can be found at: **http://icas.org.uk/PCRT.pdf**.

The legislation in Finance Act 2014, Part 4 can be found at: **http://www.legislation.gov.uk/ukpga/2014/26/part/4/enacted**.

The HMRC guidance on these provisions can be found at: **https://www.gov.uk/government/publications/tax-avoidance-schemes-on-which-accelerated-payments-may-be-charged-by-hmrc**.

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SETTLEMENT OPPORTUNITY – TAX ON CONTRACTOR LOANS

HM Revenue & Customs (HMRC) has announced a settlement opportunity for participants in contractor loan schemes. These schemes are arrangements used to avoid tax whereby non-UK employers have paid untaxed income or given participants a loan in lieu of part of their salary.

The settlement opportunity is being offered until 9 January 2015 (last possible notification of intention to take part and make a disclosure), and applies to tax years up to and including 5 April 2011. Those wishing to take up the opportunity will be offered better terms than those who HMRC are pursuing through the courts.

A number of cases are being heard through the tribunal system and it will be a judgement for any client who may have participated in one of these schemes to decide whether or not they would be better off using this opportunity or "chancing their arm" via the courts. This is clearly going to be very much dependent on the individual client's circumstances, the amounts of tax involved, and the contractor loan scheme that they are a part of.

One such case was that of **Phillip Boyle (2013) (TC03103)** who was an IT contractor who received money from an offshore company in the form of a loan. He lost his case in October 2013 and HMRC has cited it as an example in its tax avoidance "spotlights" which can be accessed at: **www.hmrc.gov.uk/avoidance/spotlights.htm**.

More information on the scheme can be obtained at: **www.hmrc.gov.uk/avoidance/contractorloans.htm**.

EBT SETTLEMENT OPPORTUNITY – WITHDRAWAL FROM 31 MARCH 2015

Employers who have used an Employee Benefit Trust (EBT) before 6 April 2011 have until 31 March 2015 to notify HM Revenue & Customs (HMRC) if they wish to take advantage of the beneficial terms of the EBT Settlement Opportunity (EBTSO) to settle any PAYE & NI liabilities that may have been underpaid.

This opportunity will only be available to employers who have notified HMRC of their intention to settle under the EBTSO before 31 March 2015. Apart from the deadline for notification of 31 March 2015, the opportunity will be relevant only for agreements that are subsequently entered into before 31 July 2015, whereby all amounts due under settlement agreement are either paid by that date, or with a signed "time-to-pay" agreement in place.

More information on the EBTSO can be found at: **www.hmrc.gov.uk/employers/employee-benefit-trusts.htm**.

DISCLOSURE OF TAX AVOIDANCE SCHEMES – FURTHER CONSULTATION

HM Revenue & Customs has opened consultation on proposals regarding means to strengthen the Disclosure of Tax Avoidance Schemes (DOTAS) regime. The consultation features a new targeted inheritance tax hallmark aimed at lifetime transfers, and includes draft regulations to introduce a new financial products hallmark. The consultation also extends to consider how the VAT Disclosure Regime might be updated to align more closely with DOTAS.

The consultation will close on 23 October 2014. More information on the consultation can be accessed at: **www.gov.uk/government/consultations/strengthening-the-tax-avoidance-disclosure-regimes**.

TEMPORARY INCREASE TO THE ANNUAL INVESTMENT ALLOWANCE

The Government has announced in Budget 2014 a temporary increase in the Annual Investment Allowance (AIA) capping to £500,000 to encourage business investment. AIA gives a 100% deduction on qualifying expenditure within the capping limit against taxable profits for that period. The temporary increase applies to expenditure incurred from 1 April 2014 (for corporation tax) and 6 April 2014 (for income tax) to 31 December 2015. The AIA capping will return to £25,000 from 1 January 2016. Examples of assets that would qualify for AIA relief include machines and tools, vans, lorries, diggers, office equipment, building fixtures and computers.

If we take the example of a business that spends £200,000 on a complete office refurbishment (new desks, chairs, redecoration etc) and a further £250,000 on a complete IT overhaul (new computers, servers etc), then it will be eligible for an overall deduction of £450,000 against its taxable profit, provided that all the expenditure qualifies and is incurred prior to 31 December 2015. The tax benefits are substantial; using the example above, the business if it is incorporated and taxed at the main rate of 21%, would make a saving of £94,500 in tax terms by timing their expenditure to fall during the enhanced AIA period.

HMRC has produced a blog, "working with tax agents". An edition which focuses on Annual Investment Allowance tips can be viewed at: **https://taxagents.blog.gov.uk/2014/06/25/annual-investment-allowance-tips/**.

Further HMRC guidance on the allowance can be found at: **www.hmrc.gov.uk/news/aia.htm**.

LIECHTENSTEIN DISCLOSURE FACILITY – FURTHER RESTRICTIONS ADDED

The Liechtenstein Disclosure Facility (LDF) is one of HM Revenue & Customs' (HMRC) longest running overseas disclosure arrangements and has yielded huge amounts of tax for HM Treasury. The facility will run until 5 April 2016 and has been subject to numerous changes over the years to ensure that the tax take is maximised.

Further circumstances have been added whereby a relevant person who participates in the LDF will not be entitled to access all of the terms normally available under the facility. These circumstances include instances where:

- The relevant person enters the LDF to settle liabilities that HMRC is already aware of;
- The issue being disclosed has already been subject to an intervention that started more than 3 months before the date of application;
- There is no substantial connection between the liabilities being disclosed and the offshore asset held by the relevant person as at 1 September 2009.

More information on the LDF can be accessed at: **www.hmrc.gov.uk/disclosure/liechtenstein-disclosure.htm**.

TAX IMPLICATIONS OF DIVERSIFICATION

A business may diversify because a new opportunity presents itself, or when an asset becomes surplus to existing requirements and is put to new use, or there has been a build-up of cash and some form of investment activity ensues, such as the acquisition and renting of property. As there can be differing considerations, the position for unincorporated businesses and companies are considered separately.

Unincorporated businesses

When a trading business starts a new activity, it will be a question of fact as to whether the new business is an expansion of the existing trade or whether there has been a commencement of a new trade. The practical implications of this are less now than in the days of when assessment was based on preceding-year basis; (does anyone remember that?) However, the point does need to be considered. In the case of **Maidment v Kibby [1993] STC 494**), a second fish-and-chip shop was purchased by a business in a nearby town. The second shop was integrated into the existing business by way of a change of name, and the purchases were centralised for both outlets, and the results of both shops were included in a single set of accounts. The Commissioners held that the new shop was an expansion of the existing trade and this was upheld in the High Court.

Whether the diversification is an expansion within an existing trade is a point to be determined by the facts. An expansion of an existing trade will be predicated on the similarity of the activity between the existing trade and the new trade. Hence, for example, if a

butcher's business diversifies into the buying and selling of second-hand cars, this will almost certainly be a new trade requiring separate sets of accounts, or divisionalised accounts and separate self-employed pages in the tax return.

If the new trade operates at a loss for the first few years, then if indeed it is a new trade rather than the expansion of an existing trade, the losses of the first four years can be offset against the total income of the previous three years under s72 Income Tax Act (ITA) 2007.

The diversification may result in the existing trade ceasing. More than twelve months profits could be taxed in the final year of assessment with a release of overlap relief which may result in a higher than normal taxable figure in the final year. A loss may be the subject of a terminal loss relief claim under s89 ITA 2007. The timing of income tax payments will be important and it may be possible to control whether the cessation takes place before or after 5 April.

The cessation of the existing trade as a result of diversification can give rise to opportunities where an asset is sold at the same time. In the recent tribunal case of **Jeremy Rice [2013] (TC32273)**, a second-hand car dealer sold his business premises and shortly thereafter began to trade on a more restricted basis from his home under a new trading name, dealing with mainly four wheel drive vehicles rather than the sports cars in which he had previously dealt. It was held that Mr Rice had ceased his "performance cars" business and had commenced a new trade, and that Entrepreneurs' Relief was available in respect of the disposal of this previous business, including the premises.

Where assets become surplus to requirements, such as farm cottages, these may be let out to produce another source of income. In such instances, diversification can lead to the dilution of the farming business activities that attract IHT reliefs such as Agricultural Relief and Business Property Relief (BPR) that can be vital in protecting the farming estate from being broken up. In **Executors of Farmer (deceased) v IRC [1999] STC (SCD) 321**, and also the **Balfour** case **2009 UK FTT 101**, (and subsequently **2010 UK UT 300**), for example, the central issue was whether a business consisting of farming and the letting of properties on the farm still qualify for Business Property Relief. The extent of diversification is important in assessing whether the business consisted mainly of the making or holding of investments. Although the lettings were more profitable than the farm, the overall context of the business, the capital employed, the time spent by the employees and consultants, and the levels of turnover supported the conclusion that the business consisted mainly of farming. Accordingly, when the whole business was considered "in the round" and predominance was not given to any one factor, the business consisted mainly of farming and not of making or holding investments, and was therefore relevant business property qualifying for relief. Each case will, however, be considered on its merits and it may well be that the introduction of property letting or the like will cause a loss of business property relief, not only in respect of the letting activity, but in respect of the entire business.

While tax is clearly an important consideration, one must not forget the new activity must be undertaken for sound commercial reasons. To that end, a sole trader or partnership should look at the commercial factors for the new activity before all else and consider a business structure that is appropriate. For example, if the diversification is into a risky venture, then perhaps this new activity should be carried out by a limited company. Where the diversification is into the acquisition and letting of property then this asset will potentially be at risk from the commercial failure of the existing business.

Companies

In the context of companies, the question as to whether there has been an expansion of an existing trade, or whether the existing trade has ceased and a new one has commenced, will again be determined by the facts. The practical relevance of this determination concerns mostly with losses brought-forward, as trading losses in a corporate context can only be relieved against future losses of the same trade.

Trading companies which have built up surplus cash sometimes diversify into property holding and letting, and it is often the case that the property investment and rental activity are less risky than the existing trading activity. In these circumstances, it is worth considering interposing a new holding company between the shareholders and the existing trading company, and this can be achieved by a share-for-share exchange under the advance clearance procedure with HM Revenue & Customs (HMRC). The trading company can lend or pay up the cash to the new holding company by way of dividend, which will generally be tax free as inter-company dividends. The new holding company could make the property investments, as well as acting as a holding company of the riskier trading company.

Where a company has built up substantial cash deposits from trading surpluses, HMRC often agree that the company is a trading company for Entrepreneurs' Relief purposes, so long as it can be determined by the facts of the case that substantially all of its turnover, profits and management time arise from or are spent in the trade rather than the generation of the investment income, say in this case, in the form of deposit account interest. Depending on the extent of diversification into investment, diversifying into non-trading (ie: investment) activities may mean that the company is no longer accepted as a trading company for Entrepreneurs'

Relief purposes. In order to ensure that the new operation qualified for Entrepreneurs' relief, it may be worth considering ring-fencing its activity in a separate company (thus avoiding a mix of trading and investment activities in the one company).

Where a trading company has surplus cash then the surplus may represent an "excepted asset" in determining how much of the value of the shares qualifies for Business Property Relief for inheritance tax purposes. Using the cash to diversify into other trading activities will improve this position. However, if the diversification is into an investment activity, such as property letting, then the shares will only qualify for BPR if the company is wholly or mainly a trading company. Mainly means more than 50%. For BPR purposes, a company is able to carry on significant investment business and, provided this is smaller than the trading activities it carries on, the full value of the shares will qualify for Business Property Relief.

The "wholly or mainly" test is not an easy test to apply. The **Farmer** case involved a landed estate on which a business was run which had both farming and letting elements. In reaching her decision, the Special Commissioner took into account the following factors:

- the overall context of the business
- the capital employed ie value of assets employed in the trading side of the business
- the time spent by the directors and employees
- how turnover is split between trading and investment elements
- the amount of profit derived from the investment and non-investment sides of the business.

Having examined these factors, the Special Commissioner said it was necessary to stand back and consider "in the round" whether the business consisted mainly of making or holding investments. In this case, the Commissioner concluded that the business did not consist mainly of making investments and so BPR was allowed in full.

These tests were also considered in the later case of **Clark and Another v HMRC (2005 - STC 823)**. In that case it was decided that the investment side of the business predominated, and so the relief was precluded.

The situation may be complicated where the asset value and income is mainly attributable to investment but there is a large trading turnover. In these circumstances, further information needs to be assessed, including:

- ratios of asset values and profit attributable to the two activities
- ratio of turnover to investment income
- degree of activity involved on the trading as opposed to the investment side of the business (eg by the size of the labour force)
- any particular reasons for low trading profits eg fact that the company is engaged in a low profit making sector/high degree of competition
- whether the investments/their income were being used to subsidise trading losses
- how the company was described in the directors' report to the annual accounts.

As a side note, it seems that, when the trading activity is via a company rather than a sole trader/partnership structure, there is a greater degree of flexibility regarding the mix of investment/trading activity (ie a larger percentage of investment activity permitted) which still allows BPR to be claimed.

The existence of an investment business within a company can also affect the ability to obtain full holdover relief under s165 Taxation of Chargeable Gains Act (TCGA) 1992 when shares are gifted.

In respect of diversification in a corporate context, the points that have been discussed above are with reference to the possibility of any diversification taking place in a new company, and the new company can be a subsidiary, a new parent company or indeed a standalone company owned by the present shareholders. Each of these possibilities has its own advantages and disadvantages. Within a group, there is the possibility of no gain/no loss transfers of chargeable assets, dividends being paid from a subsidiary to a parent with no tax cost, group relief for trading losses and substantial shareholdings exemption on the sale of the subsidiary.

Diversification of a business is always interesting but it can engender a number of tax implications with long-term consequences which should be considered in detail, once the commercial decision to proceed has been made.

HIGH VOLUME REPAYMENT AGENTS – FOLLOW UP

The focus of HM Revenue & Customs (HMRC) on agents with large numbers of repayment clients was covered in Issue 124 of Technical Bulletin. A little more water has passed under the bridge and further information is coming out in relation to some of HMRC's activities in this area.

As a reminder, HMRC's approach was to ask high volume agents (HVAs) to sign a memorandum of understanding (MOU) which covered 8 agreements. The agents served with MOU were asked to agree, for example, that they would ensure:

- Clients would be required to view and approve their completed returns by signing their acceptance to the submission of their returns in the agreed figures.
- For returns submitted on behalf of subcontractors with expenses to turnover ratios of 10-20%, these

returns are to be based on records that are maintained, and with sample assurance tests having been conducted on these records being used for the preparation of accounts.

HMRC's latest activity has seen them write to agents with a high number of repayment clients. The letters, which have an educational emphasis, cover issues such as what level of record keeping is deemed to be adequate. They also itemise some of the specific issues that have been identified so far by their visits to agents, such as:

- Inconsistent application of the "wholly and exclusively" tests when considering whether certain expenses have met the conditions to be tax deductible;
- Speculative, estimated or round-sum amounts claimed routinely without any attempt by the agent to test their validity;
- Little (or often, no) assurance work carried out before the submission of the return to HMRC;
- Returns filed with an absence of evidence to support entries therein or, where that evidence was available, insufficiency of checking to validate the accuracy or authenticity of the evidence.

HMRC's intention is to follow up these letters with visits to the agents whom have been addressed, and to review their processes and procedures. This engagement with HMRC is not obligatory but if a firm failed to engage at all with HMRC then they should expect HMRC to insist on some kind of review into their client files on the basis that non-engagement might suggest that the agents could be hiding something.

The letter goes on to say that HMRC aims to ensure that firms adopt "best practice", such as:

- A firm would submit income tax self-assessment returns which are based on accurate information provided by its clients;
- The firm would satisfy itself that the contents of returns meet all statutory requirements;
- The firm holds in writing clients' formal approval that the information in the return is correct and complete to the best of their knowledge and belief.

Reporting from firms who have been visited, it seems that although at the outset HMRC indicated that it would be taking a relaxed approach to agents who had signed the MOU, this has not always been the case. Some agents have reported that, when HMRC officers conducted their follow-up visits, they requested that adjustments be processed for accounting years preceding those for which the MOU was signed, and in some cases requesting the agents to amend their clients' accounts and returns until they deemed them acceptable.

This does seem to imply that HMRC have used this initiative as a way of getting a "foot in the door" to some practices. One cannot dispute the validity of HMRC's objective, to change the behaviour of agents (some of whom may not be entirely honest). However, the way in which they have gone about it in this instance appears to have a bit of smoke and mirrors about it.

We would be interested to hear if any firms have received such letters or visits (although we do not expect CA firms to be targeted as such) and welcome any input on this subject at: **tax@icas.org.uk**.

TAX TRANSPARENCY – PRACTICAL IMPLICATIONS

There has been much media coverage and public debate on the issue of tax paid (or, more accurately, avoided being paid) by multi-national businesses. Much of the comment has not been well-informed and to try to encourage a positive discussion of the issues, the ICAS tax team arranged two events on "Tax and Transparency" to focus on how members can contribute to this debate.

The Organisation for Economic Co-operation and Development (OECD) have been working on proposals for international measures to counter against Base Erosion and Profit Shifting (BEPS). An update on this initiative that would involve changes to the international tax regime can be found in Issue 127 of Technical Bulletin. The final proposal for changes to the international tax regime is scheduled to be announced by the OECD in September 2014, and may well be implemented in next year's Finance Bill, which would mean implementation by 31 December 2015 for many groups.

What are the issues for businesses and their advisers?

The key issues we expect businesses to face are:

1. More challenges from tax authorities – the coverage of the issues by the media has created more awareness within tax authorities of the strategies adopted by multi-national enterprises and some businesses are beginning to see this reflected in questions about their international operations.
2. Higher compliance burdens – businesses can expect their compliance costs in dealing with transfer pricing, documenting risks across the business and reporting to increase.
3. Communication on tax issues – businesses should anticipate questions on their tax strategies and make sure that they are able to communicate and explain their tax affairs to internal and external stakeholders.
4. A change to the international tax environment – The OECD BEPS project is still on-going and the final

picture is not yet clear. However, businesses need to be aware of the impact of the changes on their international structures and the existing network of double tax treaties.

Businesses have to address the need for tailored and appropriate tax accountability to move the focus back to the role of governments and address the reputational issues associated with certain tax strategies. The explanations that businesses provide must be in a format that is relevant and accessible.

The ICAS debate so far suggests an integrated report or other management commentary as appropriate formats to take this forward, a task that your larger clients will likely need some assistance with. ICAS is currently considering its response through the Corporate Reporting Task Force and its conclusions will be reported in due course.

HMRC'S HIGH NET WORTH UNIT – YIELDS ON THE RISE

HM Revenue & Custom's (HMRC) High Net Worth Unit, which focuses on individuals with net assets in excess of £20m, has had some success in recouping underpaid tax by the super wealthy. The unit was set up in 2009 and deals with the tax affairs of the 6,200 wealthiest individuals in the UK.

Customers are assigned a relationship manager who has detailed oversight, and develops a close understanding of the tax risks among these wealthy individuals. The co-ordinated approach on these individuals appears to be yielding extra revenue for HMRC, and this is borne out in the recently published yields as shown in the table below. The effectiveness of this unit can be assessed by the actual yield of tax having consistently exceeded the target, and in the five years since the unit's existence, the yield has more than tripled.

Year	Yield (£m)	Target (£m)
2013-14	268	210
2012-13	222	200
2011-12	200	195
2010-11	162	153
2009-10	85	80

More information on the high net worth unit can be found at: **www.hmrc.gov.uk/menus/hnwu.htm**.

DIGITAL SUPPORT FOR AGENTS

HM Revenue & Customs (HMRC) have confirmed that they are seeking to provide more of their support services through digital channels. One recent development has involved HMRC re-organising their Business Customer and Strategy teams into one team called *Digital Support for Business and Agents*.

This new team will be tasked with working with agents and their professional bodies to develop new methods for supporting agents digitally. This will involve a degree of withdrawal from face-to-face engagement. One area that HMRC would like to improve relates to their webinars which are being developed into a channel for building on and enhancing the agent experience.

There are two official channels for reporting on any issues in respect of the interface between HMRC and tax agents. The first channel is through the local Working-Together Group to which the agent belongs, and the second official channel is the *Agent Account Manager Issues Resolution service*. Any particular issues with HMRC can also be addressed to the ICAS tax team at: t**ax@icas.org.uk**. The tax team will keep a watching brief on the development of the Digital Support service for the purpose of updating members, and of feeding into the development any issues that are arising.

We will keep members up to date with any further digital developments in future issues of Technical Bulletin.

DISCLOSURE REGIMES AND ANTI-EVASION

There have been a number of developments recently under the auspices of the Organisation for Economic Co-operation and Development (OECD) on the automatic exchange of information and combatting tax evasion. The co-operation between tax administrations is regarded as critical in the fight against tax evasion and protecting the integrity of the international tax system. For this reason, the (OECD) are working on enhancing the powers of governments to enter into automatic information exchange arrangements with other governments as part of the project to counter Base Erosion and Profit Shifting (BEPS).

On 21 July 2014 the OECD released the Standard for Automatic Exchange of Financial Account Information in Tax Matters; the document can be accessed at: **www.keepeek.com/Digital-Asset-Management/oecd/taxation/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters_9789264216525-en#page1**.

The Standard calls on Governments to obtain detailed account information from their financial institutions and exchange that information on an annual basis with other jurisdictions. The Standard will be formally presented to G20 Finance Ministers at their meeting on 20-21 September.

As a way to persuade taxpayers to comply with the new measures to be legislated into the national tax systems, there have been moves by some tax administrations to offer pre-emptive initiatives. For example, the Australian Taxation Office (ATO) has announced Project DO IT see: **https://www.ato.gov.au/General/Correct-a-mistake-or-dispute-a-decision/In-detail/Project-DO-IT/Project-DO-IT/**. This has been described as a 'last chance' for taxpayers to disclose offshore income before enhanced information sharing between tax jurisdictions starts to close the net. The ATO offers the following to try and encourage the uptake of the opportunity:

- Penalties are reduced to a maximum of 10% of any income tax shortfall;
- The look-back period is limited to the last four assessment years; and
- The ATO will not proceed with criminal prosecutions.

The ATO is also offering concessions for taxpayers who wind up their offshore structures. The deadline for disclosures is 19 December 2014, after which the ATO will proceed with aggressive audit and prosecution activity.

Similar moves have been made by HM Revenue & Customs (HMRC) in the UK. There have been consultation documents issued on strengthening civil deterrents against offshore tax evasion – (**https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/345236/140819_Tackling_offshore_tax_evasion_-_Strengthening_civil_deterrents.pdf**) as well as on introducing a new strict liability or criminal offence for failing to declare offshore income and gains – (**https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/345370/140819_Tackling_offshore_tax_evasion_-_A_new_criminal_offence.pdf**). The proposed changes would mean that where a taxpayer does not disclose any income or gains from an offshore account, this would be automatically classified as a criminal offence. This is an important departure and an escalation of the classification of severity from the current position, where criminal intent has to be proved in court for an offence involving the undeclared income or gains to be classified as criminal. Currently, accidental omission of offshore accounts is treated as a civil offence and subject to civil penalties and clearly it is vital that accidental omissions do not give rise to criminal convictions. Practitioners should be aware of the changing landscape in this area and the implications for current and potential clients. The consultation period ends on 31 October 2014.

For clients seeking to remedy past omissions, the Liechtenstein Disclosure Facility remains open at the current time, although the scope of matters that can be dealt with through the facility has been narrowed recently. For further details of the changes, please see the article on page 4.

RTI PENALTIES – IN-YEAR FILING

HM Revenue & Customs (HMRC) have released a statement informing us when in-year filing penalties for tax year 2014/15 could arise. Generally speaking, if businesses fail to file their Full Payment Submissions (FPSs) on time, or if they fail to send the expected number of returns to HMRC, in-year filing penalties may become applicable. The relevant dates for the application of the in-year filing penalties will be determined by the number of employees in each individual business.

50 or more employees - start 6 October 2014

For those businesses having 50 or more employees or pension recipients, in-year filing penalties will apply from 6 October 2014. To avoid these penalties, businesses should make sure that all their Real-Time returns are fully up to date by 5 October 2014, and for the remainder of the current tax year 2014/15, all future RTI returns are complete and submitted on time. However, no penalty will arise for the first month in each tax year, where there is a filing failure.

<50 employees - start 6 March 2015

For those businesses with 49 or fewer employees or pension recipients on their returns, in-year filing penalties will apply from 6 March 2015. To avoid these penalties, businesses should make sure all their Real-Time returns are fully up-to-date by 5 March 2015 (and ensure that, in future their returns are complete and submitted on time).

Businesses may be charged a penalty for not sending their FPS on time or failing to send the expected number of returns between 6 March 2015 and 5 April 2015. The phased introduction of the new penalty regime related to Real-Time filing is intended to operate whereby no employers will qualify for un-penalised failure for the tax year 2014/15.

If a business gets a penalty

Businesses which are charged with a filing penalty will be notified by post accordingly. The penalty notice will include information on how to appeal, if the penalty is believed to be incorrect, or if there was a reasonable excuse for the delay that caused a filing failure.

The quickest way to appeal is online, by selecting the 'Appeal a Penalty' link from the PAYE online account when the penalty notice is received. This will not only allow appeals to be submitted electronically and timeously; but also in some cases, HMRC may be able to accept and settle the appeal entirely online.

If businesses have not already done so, HMRC have recommended that they set up an email alert so that they can be aware of the timing when a notification has been issued. The email alert can be set up through the PAYE Online system under "options".

Details of how the new RTI In-Year filing penalties will operate can be found at: **www.hmrc.gov.uk/payerti/reporting/late-reporting.htm**.

HMRC has also produced an updated PAYE late payment penalties help sheet in view of this phasing-in. **www.hmrc.gov.uk/news/paye-late-pen.pdf**.

COMPENSATION FOR FINANCIAL MIS-SELLING COMPENSATION – TAX ISSUES

There have been a number of cases in recent years where individuals and businesses have been awarded compensation in respect of financial products which are treated as having been mis-sold by the Financial Conduct Authority (FCA), or one of its predecessor organisations. The types of products that have been at issue to date are:

- Mortgage endowment policies
- Personal pensions
- Retirement annuities
- Free-standings additional voluntary contributions (AVCs)
- Payment protection insurance policies
- Interest rate hedging products

Legislation which exempts from tax compensation when certain conditions are met is to be found at section 148 Finance Act (FA) 1996, along with Extra Statutory Concession (ESC) A99. The exemption covers any interest received, and the areas exempted are payments relating to:

- Personal pensions
- Retirement annuities
- Free-standings AVCs

For other types of payments not covered by these exemption provisions, the tax treatment requires careful consideration. Currently, the redress payments in respect of interest rate hedging products have gone through a review, and it seems appropriate to use this as an illustration of the tax treatment of the amounts that have been received, or will be received, by businesses and individuals who have made a claim in relation to this type of product.

The first step in arriving at the correct tax treatment of an amount received or receivable as a result of a claim is to identify the constituent components of the amount from a legal perspective. Typically, the amount of compensation that a customer receives is made up of a number of elements:

- Basic redress – this is the difference between the actual payments made and the payments that would have been made if the breaches of the relevant regulatory requirements had not occurred.
- Interest – this is the opportunity cost of being deprived of the money awarded as a basic redress.
- Consequential loss – there are various types of consequential loss, and cover quantifiable amounts related to the loss of profits over and above the interest paid on basic redress, bank charges, certain legal expenses and tax.

The Financial Conduct Authority has more detail on the definition of the constituent components of compensation, and how this should be calculated. Advisers who are involved in determining the tax position will find the background details on the official website useful: **www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products/determining-the-level-of-redress**.

Having ascertained the legal identity of the constituent parts in the amount received, the tax treatment of the various elements of the compensation can still be complex, but as a general guide, the principles are as follows:

- Basic redress – the amounts paid as basic redress are deemed to put the business back to the position it would have been in if the regulatory breach had not occurred. If the amount payable as basic redress is referable to trading operations, then it is normally treated as a trade receipt and taxed accordingly. The underlying principle is that for amounts that have been originally claimed as a business expense for tax purposes, then the compensation in the form of "basic redress" would be taxable as a trading or income receipt. This would cover interest-rate hedging products where the interest was treated as an expense for income tax or corporation tax. In contrast, if the original payments have not been treated as a tax deductible expense, as in the case of payment protection insurance premiums where no tax deductibility is relevant, then receipt related thereto in the form of "basic redress" are generally not taxable.
- Interest – any interest received, or amount economically equivalent to interest, is chargeable to tax in line with the provisions of section 369 Income Tax (Trading and Other Income Act) (ITTOIA) 2005, or the loan relationship rules under sections 296-301 Corporation Tax Act (CTA) 2009 for companies. So while the treatment of interest is in some

instances taxable like basic redress payment, the basis on which interest is to be taxed differs from redress. For individuals and partnerships, interest is taxable under section 370 ITTOIA 2005 for a particular tax year on a receipt basis; this has the effect therefore of taxing interest in the tax year when it is received or made available to the recipient. Interest is treated as made available if it is credited to an account on which the account holder is free to draw. For companies, the loan relationship credit will be taken into account in the accounting period in which the amount is credited in the accounts and aggregated with any other loan relationship debits and credits for the period. Such a treatment is in accordance with provisions under section 302(1)(b) CTA 2009.

- Consequential loss – any amounts received under this heading create difficulties from a tax perspective. Under HMRC guidance BIM40105, if a sum resulting from a claim to compensation or damages is referable to trading operations, then it will normally be a trade receipt. If that is the case, then the receipt is a trade receipt and represents "the profits" of the trade under section 5 of ITTOIA 2005 for an unincorporated business, or section 35 CTA 2009 for companies. However, it is not to be assumed that any incoming payment of this nature is a trade receipt solely because nothing would have been received had the trade not been carried on (ie an amount cannot be treated as taxable income just because it would not have been received in the absence of a trade). There are instances where a compensation payment made to the trader is to be regarded as a personal matter (such as personal injury to a trader) rather than in his capacity as a trader. In such cases, it is unlikely that the receipt will be chargeable as a trading receipt, and it is important to review the facts giving rise to the compensatory payment to establish its tax treatment. It is to be noted though that amounts which are not treated as trading receipts may still be taxable as an amount "economically equivalent to interest" as noted above.

For the payments being made, and to be made, under the FCA arrangements for interest-rate hedging products, the option of the 8% simple interest award is available and is intended to remove the need for many customers to consider consequential loss claims. HMRC have issued a note on their interpretation of the position: **www.hmrc.gov.uk/news/redress-payments.htm**. They have indicated in this document that for interest rate hedging products they believe that the full amount of the compensation is likely to be taxable and should be included on tax returns if it has been previously treated as a business expense. The guidance does note that different approaches may apply if:

- The business has ceased trading;
- The product was for a non-business loan;
- The product was a hedging product where its fair value was recognised in the accounts of the business.

If the amount is not a taxable trading item, the next consideration is whether there are any capital gains tax consequences in respect of the receipt of compensation. The right of action against another person for compensation is itself an asset and the settlement of the action is a disposal of that right. Practitioners are probably aware, that this is a difficult area and there is a substantial amount of case law that may be relevant depending on the precise legal position along with Extra Statutory Concession D33. The exposure in this area, however, appears to be theoretical rather than actual as there are not publicised instances of HM Revenue & Customs (HMRC) seeking to pursue this argument. Nevertheless, it is an area where it would have been helpful for HMRC to clarify the position.

The most common type of receipt that practitioners are likely to encounter will be payments made as redress for the mis-selling of payment protection insurance. The basic redress payments are not normally taxable as indicated above, but any interest element of the amount received is taxable. As part of the tax return preparation, it should be ascertained whether any receipts in this regard include any interest element that stands to be separately reported as outlined above in the return.

HMRC CAMPAIGNS AND TASKFORCES

HMRC targeting government departments

After targeting numerous sections of the population for underpayment of tax arising from offshore and then onshore arrangements, it seems that HM Revenue & Customs (HMRC) are now targeting their attention closer to home with the focus being on government departments like themselves. Information has come to light that both the Ministry of Defence (MoD) and National Health Service (NHS) Foundation Trusts have been approached in relation to issues arising from the employment status of contractors in the case of the MoD, and locum doctors in the case of the NHS. There is evidence that the Ministry of Justice has also been approached.

In the case of doctors, individuals have been sent letters requesting them to call a designated telephone number to arrange an appointment with a tax inspector to discuss the nature of their employment. Furthermore, the individuals are required to provide documentation relating to their terms and conditions of work in order that HMRC can decide on their employment

status. The letters state that attendance at an HMRC meeting is not obligatory but "*may help speed up the time it takes us to decide what your employment status is*".

A number of contractors have reported receiving letters from the MoD, in which they are asked to confirm various details, including their IR35 status.

The MoD contractor letters come directly from the MoD and ask for evidence based on the arrangements that are in place for the respective contractors. The arrangements are classified into three categories:

1. Those paying temporary contractors taxable contributions through a PAYE deducted at source arrangement;
2. Those who are within the scope of IR35;
3. Those who are classified as low risk for IR35 or for their Personal Service Company's result on the HMRC Business Entity Test.

Acceptable evidence for the three categories is given as follows:

Cat 1: Payslips showing salary and PAYE deductions;

Cat 2: A statement committing to a tax payment, or a "deemed calculation". (The deemed calculation requires the worker to consider all of the income for the year on a particular contract that is within IR35, make a deemed payment to HMRC for employers NICs and pay employee NICs and PAYE on the remainder of the income).

Cat 3: Either a certificate from HMRC indicating that their business is low risk for IR35 or their Personal Service Company's result on the HMRC Business Entity Test.

Details of the Business Entity Test can be obtained at: **http://www.hmrc.gov.uk/ir35/guidance.pdf.**

Security industry taskforce expanded

A previous taskforce launched during autumn 2013 has been targeting VAT evaders in the Security industry in London and the South-East (eg providers of security staff to bar and music venues). This taskforce has been expanded to cover self-employed door staff as well, who are perceived to be in a high-risk mode of employment for incomplete declaration of income.

Let-property continuing to be targeted

As part of HMRC's let-property campaign, letters have been sent to landlords who have not made a disclosure under the campaign, asking them to confirm that the details of their tax returns are correct.

In what seems like a bit of a two-pronged attack, a new property taskforce focusing on property owners in the South-West and South Wales has also recently been launched. This taskforce is targeted at those who have sold one or more properties but haven't paid capital gains tax or disclosed rental income.

TAX CASES

Mr and Mrs Baldwin t/a Ventnor Towers Hotel v Commissioners for HM Revenue & Customs [2014] UKFTT 03755 (TC)

Point at issue: Whether the taxpayers could rely on misleading advice from HM Revenue & Customs (HMRC) and whether the taxpayers had a clear and legitimate expectation of a VAT repayment as a result of that advice. The underlying technical issue – the VAT liability of supplies of hotel services to customers based outside the UK – is straightforward as it is covered in VAT Notice 741 but the issue of an EC Sales List and discussions with HMRC gave rise to confusion on the position for the taxpayers.

Background: Mr and Mrs Baldwin ran a hotel on the Isle of Wight. Their guests include both those who made direct reservations as well as others who booked through a travel agent. The business treated all supplies as standard-rated, but the issue to the business of an EC Sales List along with accompanying notes made the taxpayers question the treatment of supplies that they made via travel agents based overseas.

The taxpayers then wrote to HMRC to clarify the position on supplies made to overseas customers and indicated that they did not believe UK VAT was chargeable as the services should be treated as being supplied from where the customer was based. HMRC's response to the taxpayers' letter in 2010 was to point out that the supply of hotel accommodation is covered in VAT Notice 741 and the place of supply is to be treated according to where the land is situated.

The taxpayers continued to receive EC Sales Lists from HMRC and formed the opinion that they had overpaid output tax and submitted a VAT return which claimed a refund of the VAT previously accounted for on supplies to foreign travel agents. This VAT was repaid.

The taxpayers had a visit from HMRC in June 2012 after the repayment was made. During the visit the VAT Inspectors discussed the treatment of the supplies made to overseas agents with the taxpayers and indicated that they would take specialist advice. The review of the position resulted in HMRC confirming that an EC Sales List was not required as this only covers the sale of goods and that VAT should be charged on all supplies by the taxpayers. The repayment that had been made by HMRC was in error, and an assessment of £20,374 was raised in connection with the VAT that had been refunded.

Argument: The Baldwins made a number of additional points in their appeal against the assessment:

- The complexity of the legislation makes it difficult to access and understand;
- HMRC's own officers seemed unsure of its meaning and application with different advice being given by different officers;
- HMRC publications did not give advice consistent with the officers' views;
- There had been significant confusion over the need to complete and file EC Sales statements;
- The fact that they had been told that they needed to complete EC sales statements implied that their non UK/ EC supplies were not chargeable to VAT;
- Omissions in the correspondence between themselves and HMRC had made things even more confusing.

HMRC's position was that the supplies made by the business should be subject to VAT in accordance with the UK legislation.

Judgement: In coming to its decision, the Tribunal expressly mentioned that it does not have the power to address the breadth of the Baldwins' concerns about the actions of HMRC and the administrative errors that were made. The Tribunal is limited only "*to consider those matters in respect of which appeals may be brought*".

In relation to the place of supply of the hotel accommodation, the judges referred to Articles 44 to 47 of the VAT Directive which states that "*the supply of hotel accommodation made by Mr & Mrs Baldwin to EC travel agents who were established outside the UK is treated by the Directive as made in the UK*".

The appeal was therefore dismissed.

Commentary: The case is of interest as it demonstrates the misunderstandings that can arise in the communication between HMRC and the taxpayers on what would appear to be a straightforward issue. HMRC Officers appeared to be unsure of the position on the supply of hotel accommodation via foreign travel agents, and the Tribunal commented on the inconsistencies in HMRC's advice given and the burden this had placed on the taxpayers. It is interesting that the matter only arose because of the EC Sales List issued to the taxpayers erroneously. Advisers will be aware that these can be issued in error for businesses that do not have to make returns, but not all businesses will have access to good advice in this area to understand that the EC Sales List addressed to the businesses is not relevant for their particular type of business.

To view the full transcript of the decision, access: **www.bailii.org/uk/cases/UKFTT/TC/2014/TC03755.html**

Peter Figg v Commissioners of HM Revenue & Customs [2014] UKFTT 03703 (TC)

Point at issue: Whether a taxpayer's relocation package should be treated as exempt from tax and whether he had a reasonable excuse for late filing of his self-assessment tax returns.

Background: The appellant in this case, Peter Figg, was recruited by BG International Ltd (BGI) to work for them in Berkshire in 2009/10. As he lived in Horsham, Sussex, he was given a "relocation package", and was informed that this would be exempt from tax under s271 Income Tax (Earnings and Pensions) Act (ITEPA) 2003.

Shortly after beginning the new role, Mr Figg came to the conclusion that BGI had misrepresented the nature of the work. In January 2011, Mr Figg and BGI came to an agreement that his employment would be terminated by mutual consent on 31 October 2011. Under this agreement, Mr Figg was to be paid £30,000 compensation for loss of employment and was also paid an amount of accrued holiday pay. Throughout this time, Mr Figg continued to live in Horsham, commuting to Berkshire during the week and spending his relocation package on temporary accommodation during the week.

BGI filed a P11D form in respect of benefits in kind paid to Mr Figg by virtue of his employment in June 2010. On this, they included taxable benefits of £4,498 in respect of the relocation package.

Mr Figg was served a notice to file a tax return for 2009/10, and as the deadline of 31 January 2011 was fast approaching, he decided to file it online and called HMRC on 17 January in order to obtain a password so that this would be possible and registered for HMRC's online services the following day. In order to file a return, Mr Figg needed to obtain a PIN from HMRC and he spent the period 17-24 January contacting HMRC by telephone to find out when this would be received. The date was fast approaching the 31 January filing deadline. After getting nowhere with his numerous calls to HMRC, Mr Figg wrote to HMRC to inform them that it would be impossible for him to meet the filing deadline. He eventually received his PIN at the end of January and by 18 February he had activated his online services and was ready to input his tax return information. He did not, however, go on to file a return.

At the beginning of March 2011, HMRC wrote to Mr Figg to apologise for the problems with their telephone helpline and also to remind him that his tax return for 2009/10 remained outstanding. It also informed him that a penalty had been charged because he was late in filing. Mr Figg appealed the late filing surcharge on 6 April 2011.

On 20 January 2012, Mr Figg's tax returns for 2009/10 and 2010/11 were filed online by a tax agent.

The Arguments: Mr Figg wrote to HMRC on 11 March 2012 to appeal against the penalty and interest. He argued that the reason for his late filing of tax returns was due to poor communication from HMRC and as a result he was unaware of the shortfall in the tax that was due. He further

contended that his previous employer had wrongly classified his relocation expenses as a taxable benefit per his P11D, and that he had had to engage an accountant to file his 2009/10 and 2010/11 tax returns as a result of HMRC's system not working properly.

In response, HMRC submitted that in respect of Mr Figg's late filing penalty, he was notified of the requirement to file a tax return for 2009/10 on 6 April 2010 and thus had adequate time to register for HMRC online services. That he waited until two weeks before the deadline to register could not be attributed as the fault of HMRC's failure to communicate. He could have also filed a paper return had he wanted to, by 31 October 2010.

Furthermore, HMRC contended that the accountant's fees that were treated as an allowable expense in the tax returns are not tax deductible as the fees do not satisfy the criteria as having been incurred "solely, exclusively, and necessarily" in relation to his employment.

Relocation package

The relocation package was not mentioned in HMRC's submission because it was the subject of an existing appeal which would come under separate proceedings. The Tribunal, however, did give an opinion and stated that it should not be treated as such, since there was no actual relocation. Although the intention was to relocate, this ultimately did not happen and the reality of the situation was that it was a subsidy for long-distance commuting. For a package to qualify for tax relief the conditions in s273 ITEPA 2003 must be met, these are:

- The change in residence must result from the employee being employed;
- The change in residence is made wholly or mainly to allow the employee to reside within reasonable daily travelling distance of his new employment location; and
- The employee's current residence is not within reasonable daily travelling distance of his new employment location.

Decision: The Tribunal dismissed the appeal in full, concluding that:

1. Mr Figg did not have a reasonable excuse for the late filing of his 2009/10 tax return and the late payment of his outstanding tax liability for the year.
2. The accountancy fees were not a deductible expense against his employment income.
3. The Tribunal has no jurisdiction in relation to his appeal against interest charged on late paid tax and therefore had to strike out that part of Mr Figg's appeal.
4. Regarding the overpaid tax on relocation expenses, HMRC is yet to come to a decision regarding Mr Figg's appeal over the treatment of the £4,498. As such, this part of Mr Figg's appeal had to be struck out as well.

Commentary: The First-tier Tax Tribunal agreed with the view of HMRC that the employee needs to have moved home for the tax exemption for relocation payments to apply and that it is not sufficient for an initial intention that had occasioned the payment, and to allow subsequent events to override that initial intention. The decision regarding whether the taxpayer has a "reasonable excuse" for filing a return late confirms previous decisions on this subject. The case illustrates how the law expects individuals to be diligently compliant with their obligations as taxpayers, and the penalty regime is there to encourage compliance and penalise non-compliance. While "reasonable excuse" subsists as a ground for mitigation, the bar is high for "reasonable excuse" to be successfully argued.

UK GOVERNMENT PROPOSES INCREASE IN SMALL COMPANY THRESHOLDS BUT NO INCREASE IN AUDIT EXEMPTION THRESHOLDS

As part of the process to implement an EU Directive issued in 2013, the UK Government published a consultation paper entitled "*UK Implementation of the EU Accounting Directive*" on 29 August 2014. Department for Business, Innovation and Skills (BIS) Consultation paper Chapters 1 – 9 of the Accounting Directive provide the legal foundations upon which the UK's financial reporting framework is to be built, and include the proposals to increase the Small Company Thresholds without an increase in Audit Exemption Thresholds.

The EU Directive published in June 2013 adopted a new Accounting Directive – "*EU Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings*".

The Directive is available from **http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:182:0019:0076:EN:PDF**.

This new Directive consolidates, modernises, and updates the previous 4th and 7th Company Law Directives governing this area of regulation. The UK is required to transpose the 2013 Accounting Directive into UK law no later than 20 July 2015. It is proposed to take up the option permitting that the changes may first apply to financial years beginning on or after 1 January 2016 but BIS are inviting views on whether adoption of the new reporting framework ahead of this date may be desirable or

practicable. The Government proposes to introduce legislation implementing the Directive early in 2015.

This consultation closes on 24 October 2014.

Summary of UK Government proposals

- Raise the thresholds for determining company size (small, medium-sized and large) in line with the mandatory thresholds imposed by the Accounting Directive.
- For small companies, the turnover and balance sheet total (fixed plus current assets) thresholds would be raised to the maximum amounts allowable ie £10.2 million and £5.1 million respectively. They are currently £6.5 million and £3.26 million respectively. This would allow around 11,000 additional companies to access the small company accounting regime.
- For medium companies the turnover and balance sheet total thresholds would be raised to £36 million and £18 million respectively (currently £25.9 million and £12.9 million).
- Consider if the method for determining thresholds for company size should be amended where "net turnover" is not a relevant factor for a company or where it might be more appropriate to consider the thresholds on a consolidated or aggregated basis.
- Implement changes to comply with the new largely harmonised small company regime, which will include changes to the mandatory notes to the accounts.
- Consider whether small companies should be permitted to prepare an abbreviated balance sheet and abbreviated profit and loss account for shareholders.
- Review the exclusion of public companies (except for those whose securities are traded on a regulated market) from the small company regime and the medium-sized company regime.
- Explore the opportunities offered by the option to provide greater flexibility in the layout of the profit and loss account and balance sheet.
- Amend the approach in relation to the writing off of goodwill and development costs as required by the Accounting Directive.
- Require that information on subsidiaries included with the consolidated financial statements is only provided as a note to those statements.
- Remove the requirement for micro-entity companies to prepare a Directors Report.
- Seek views on the interaction of the Accounting Directive with the UK's statutory audit framework.
- Seek views on the implications of the revised accounting framework for charitable companies.

Small companies – True and fair

In the UK it is proposed that the 8 notes mandated by the Directive as well as the 5 optional member state notes will be required to be produced in a set of financial statements for a small company. The true and fair view principle however will also apply, so in many cases it is likely that further notes to the accounts will be required to ensure compliance with this provision.

Audit considerations

The Accounting Directive determines which companies are within scope of mandatory audit for financial statements. The Directive introduces changes related to audit in three areas:

- the companies within scope of audit, impacting upon the application of the audit exemption;
- the audit report; and
- group reporting of fees paid for non-audit services.

Audit exemption

The Accounting Directive adopts a new approach to what was previously the exemption from the audit requirement for the accounts of small undertakings. Previously the 4th Company Law Directive contained a Member State derogation allowing the introduction of an audit exemption for some or all small undertakings. Instead the Accounting Directive simply excludes all small undertakings, other than those that are Public Interest Entities, from the audit requirement. It is then a matter for Member States to require an audit as a matter of national law in those cases where they consider it appropriate.

The balance sheet and turnover thresholds for small undertakings have been raised. Given the Government's proposals on the implementation of this change for some undertakings that currently are medium-sized, it would be possible to provide an audit exemption to some or all of the current medium-sized companies qualifying as small under the increased accounting thresholds. However, the Government is not proposing to increase the audit exemption thresholds for the small undertakings as part of the initial implementation of the Accounting Directive. This will mean that the balance sheet and turnover thresholds for the small undertakings will differ for the purposes of the small companies regime for accounting purposes and the small companies audit exemption.

The small companies audit exemption in the Companies Act will therefore need to be amended so that it no longer refers back to the thresholds that apply for small company regime for accounting purposes. Instead the audit exemption framework in the Companies Act will have to explicitly set out the current thresholds so that those thresholds continue to apply for the purpose of audit exemption, while the thresholds that apply for the purpose of the small companies accounting regime are increased.

The Government intends to consider in due course the possible increase in the audit exemption thresholds for small

undertakings. However this will not form part of the initial implementation of the Accounting Directive or of the Audit Directive and Regulation.

Audit report

The Accounting Directive extends the requirements on an opinion in an audit report on the company's management report. Previously, the 4th Company Law Directive only required an opinion on whether the management report was consistent with the financial statements of the same year. The Accounting Directive now goes further and requires auditors to:

(i) Express an opinion on the compliance of the management report with the applicable legal requirements; and
(ii) State whether any material misstatement has been identified by the auditor in light of knowledge and understanding of the audited entity which they have gained during the course of the audit.

The new Audit Directive further amends the framework governing the auditor's opinion and statement so that both of these need now be based only on the work undertaken in the course of the audit. This reduces the regulatory burden that would otherwise arise from the new requirement in the Accounting Directive. To avoid creating an intervening period (following the implementation of the Accounting Directive) in which this amendment does not apply, and in which the resulting regulatory burden is briefly increased, BIS is proposing for the relevant provision in the new Audit Directive to be implemented at the same time as the implementation of the requirement in the Accounting Directive.

Disclosure of non-audit service fees

The Accounting Directive requires some companies to include in the notes to their accounts a statement of the amounts they have paid to their auditor for audit and non-audit services. The Accounting Directive suggests three changes to the scope of this requirement:

(i) Disclosure of non-audit service fees no longer to be required for medium sized companies. BIS does however intend to continue to require disclosure of audit fees by all audited undertakings.
(ii) UK law provides that all public companies and companies in the same group as a public company are required to disclose the fees paid for their audit and non-audit services. BIS is considering whether this blanket requirement should be maintained in respect of the disclosure of non-audit services by most medium sized and small public companies. They are proposing that these companies (excepting those that are banks, insurers or whose securities are traded on a regulated market) should not be required to disclose in the notes to their accounts a statement of the amounts paid to their auditor for non-audit services.
(iii) BIS is also proposing that small and medium sized companies in the same group as a public company should not be required to disclose their non-audit fees on this basis.

The Consultation can be viewed at: **https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/348997/bis-14-1025-implemention-of-eu-accounting-directive-chapters-1-to-9-consultation__2_.pdf**.

PROPOSED SMALL COMPANY FINANCIAL REPORTING CHANGES

In conjunction with the consultation launched by the Department of Business, Innovation and Skills (BIS) on the implementation of the EU Accounting Directive, the Financial Reporting Council (FRC) has issued its proposals for changes to accounting standards for smaller entities to take account of the legal changes being brought about by the Directive. These are intended to apply to accounting periods commencing on or after 1 January 2016 and are summarised as follows:

1. The FRC proposes to issue a new accounting standard for micro-entities (companies with a turnover of not more than £632,000, a balance sheet total of not more than £316,00 and not more than 10 employees). The proposed title for this standard is: *the Financial Reporting Standard for Micro-entities (FRSME)* and its purpose is to simplify the accounting framework for micro-entities as follows:
   (a) Presentation and disclosure requirements as set out in legislation.
   (b) Recognition and measurement requirements based on FRS 102 except for:
      (i) simplification of the requirements for financial instruments, which will be solely based on historical cost or amortised cost;
      (ii) no requirement to account for deferred taxation;
      (iii) no requirement to account for equity-settled share-based payments prior to the issue of the shares;
      (iv) a simplification to accounting for post-employment benefits, that will permit defined benefit plans to be accounted for as defined contribution plans (including

recognition of a liability for contributions payable arising from an agreement to fund a deficit in relation to past service because the micro-entity will no longer be recognising the net asset or liability arising from the defined benefit plan);

(v) no option to capitalise borrowing costs; and

(vi) deletion of sections that are unlikely to be applicable to micro-entities, such as Section 19 Business Combinations and Goodwill (with a cross-reference to FRS 102 if a micro-entity has undertaken a trade and assets acquisition), Section 31 Hyperinflation and most of Section 34 Specialised Activities (the sub-Section Agriculture will be retained).

2. The Financial Reporting Standard for Smaller Entities (FRSSE) will be withdrawn.

3. FRC will introduce a new section into *FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland for small entities*. The underlying accounting by small entities will in future be consistent with the standard for financial reporting used by other unlisted companies, subsidiaries of listed companies and public benefit entities such as charities; however the presentation and disclosure requirements for small entities may be more straightforward. BIS is proposing the small company thresholds for financial reporting purposes be increased to a turnover of not more than £10.2 million and a balance sheet total of not more than £5.1 million for accounting periods commencing on or after 1 January 2016.

The FRC's deadline for comments is 30 November 2014. A future issue of Techncial Bulletin will contain details of all of the finalised changes.

FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING AMENDMENTS TO FRS 102

In Issue 127, we reported that the Financial Reporting Council (FRC) had amended Financial Reporting Standard (FRS) 102 in the following ways:

- To relax the conditions a debt instrument must meet in order to be treated as 'basic' and therefore generally be accounted for at amortised cost; and
- To update the requirements on hedge accounting.

In this article, we take a closer look at what these changes will mean in practice.

FRS 102 contains two sections on financial instruments:-

(i) section 11, basic financial instruments; and

(ii) section 12, other financial instrument issues.

Financial instruments which meet the definition of 'basic' will generally be measured at amortised cost, while all other financial instruments will in the vast majoriy of cases be measured at fair value. When the initial version of FRS 102 was published, it became apparent that a number of fairly common debt instruments, such as certain types of bank loans, would not in fact meet the definition of 'basic', the FRC therefore agreed to re-consider the dividing line between 'basic' and 'other' financial instruments.

The FRC has now decided that the conditions for satisfying the defintion of a 'basic' debt financial instrument should be relaxed so that most of the commonly used debt instruments can be measured at amortised cost, which in most cases is simpler to apply than fair value, and is a more appropriate measurement base given that such instruments are generally held to term.

The revised conditions for basic debt instruments are as follows:

(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).

(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).

Examples

The standard now includes 7 examples of debt instruments and how the new conditions apply to them. Two of the examples are as follows:

Example of a debt instrument qualifying as basic

A fixed interest rate loan with an initial tie-in period which reverts to the bank's standard variable interest rate after the tie-in period.The initial fixed rate is a return permitted by paragraph 11.9(a)(ii). A bank's standard variable interest rate is an observable interest rate and, in accordance with the definition of a variable rate, is a permissible link. In accordance with paragraph 11.9(a)(ii) the variable rate should be a positive rate.

The variation of the interest rate after the tie-in period is non-contingent and since the new rate (ie the bank's standard variable rate) meets the condition of paragraph 11.9(a), paragraph 11.9(aB)(i) is met.

Example of a non-basic debt instrument

Interest on a loan is charged at 10 per cent less 6-month LIBOR over the life of the loan.

The effect of combining a negative variable rate with a positive fixed rate is that the interest on the loan increases as and when the variable rate decreases and vice versa (so called inverse floating interest).

Under paragraph 11.9(a)(iv) the combination of positive or negative fixed rate and positive variable rate is a permitted return. The variable rate (6-month LIBOR) meets the definition of a variable rate, as the rate is a quoted interest rate. However, since the variable rate is negative (minus 6-month LIBOR), the rate is in breach of paragraph 11.9(a)(iv). The instrument is measured at fair value in accordance with Section 12.

Hedge accounting

The FRC decided to amend FRS 102 in relation to hedge accounting to reflect the new hedge accounting requirements recently introduced by the IASB in IFRS 9. The new requirements are designed to:

(a) allow entities to apply hedge accounting when this reflects their economic and risk management strategies;
(b) use concepts and language that are, as far as possible, consistent with those included in IFRS 9; and
(c) Introduce hedge accounting requirements that are as straightforward to apply as possible, without onerous conditions.

The amended FRS 102 allows hedge accounting to be applied for three different types of hedging relationship:

(a) fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that are attributable to a particular risk and could affect profit or loss;
(b) cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction, and could affect profit or loss; and
(c) hedge of a net investment in a foreign operation.

An entity may apply hedge accounting (it should be remembered that hedge accounting is optional) when the following conditions are met:

(a) the hedging relationship consists only of a hedging instrument and a hedged item;
(b) the hedging relationship is consistent with the entity's risk management objectives for undertaking hedges;

(c) there is an economic relationship between the hedged item and the hedging instrument;
(d) the entity has documented the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified; and
(e) the entity has determined and documented causes of hedge ineffectiveness.

A hedged item is defined as follows:

A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation, or a component of any such item, provided the item is reliably measurable.

An instrument may be a hedging instrument provided all of the following conditions are met:

(a) it is a financial instrument measured at fair value through profit or loss;
(b) it is a contract with a party external to the reporting entity (ie external to the group
or individual entity that is being reported on); and
(c) it is not a written option, unless the written option is an offset to or is combined with a purchased option and the effect of the offset or combination is not a net written option.

The Appendix of Section 12 of FRS 102 now includes examples of the accounting entries for each of the three types of hedge accounting. The first of these relates to "Fair value hedge accounting" – and the forward hedging of foreign currency risk of an unrecognised firm commitment. The second example relates to "Cash flow hedge accounting" and the hedge of variability in cash flows in a floating rate loan due to interest rate risk. The third example which is less likey to be of use to smaller entities relates to "Hedge accounting: Net investment in a foreign operation" ie it illustrates the accounting for a net investment hedge in the consolidated financial statements.

The revised version of FRS 102 (August 2014) which includes the above amendments is available from: **https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/FRS-102-The-Financial-Reporting-Standard-appli-(1).pdf**.

THE NEW CHARITIES SORPs – INITIAL MATTERS FOR CONSIDERATION

In issue 127 of Technical Bulletin we highlighted plans for the publication of two new Statements of Recommended Practice (SORP) for charities for periods commencing on or after 1 January 2015. Charities preparing true and fair accounts which meet the small company definition are eligible to apply the Financial Reporting Standard for Smaller Entities (FRSSE) and can use the Charities SORP (FRSSE); all other charities preparing true and fair accounts must apply FRS 102 and the Charities SORP (FRS 102).

As a reminder, a company charity or non-company charity meets the small company definition in a particular 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.

(Although the wording of the Companies Act 2006 has been revised in relation to the above, the substance of the requirements remains the same.)

The qualifying conditions are met by a company in a year in which it satisfies two or more of the following requirements:

- Turnover of not more than £6.5 million
- Total assets of not more than £3.26 million
- Employees of not more than 50

For charities, 'turnover' is interpreted by the charity regulators as 'gross income'.

The main driver for the publication of the new SORPs is the Financial Reporting Council's proposed forthcoming withdrawal of existing UK accounting standards and their replacement with a new suite of accounting standards, including core standard, Financial Reporting Standard (FRS 102). However, the forthcoming implementation of a new EU Accounting Directive also made the publication of two separate SORPs expedient.

The Directive will significantly reduce the mandatory disclosure requirements of small companies (excluding non-profit making companies) for accounting periods commencing on or after 1 January 2016 although the accounts of such entities will still be required to show a true and fair view. At the same time it is proposed that the financial reporting qualifying conditions for small companies will be raised (Turnover from £6.5 million to £10.2 million and Balance Sheet total from £3.26 million to £5.1 million). This in part is expected to necessitate the withdrawal of the FRSSE 2015 and its replacement with new guidance for small companies to be contained in a FRS 102-based

framework with reduced disclosures.

The withdrawal of the FRSSE in itself for periods commencing on or after 1 January 2016 would lead to the withdrawal of the SORP (FRSSE) as it would have no underlying standard to support it and the Office of the Scottish Charity Regulator (OSCR) and the Charity Commission would need to consider what, if anything, may replace it.

Although the Directive does not apply directly to charitable companies and non-company charities it will influence the future of charity accounting as the FRC plans for all entities which meet the new small company definition to be eligible to use the FRS 102 reduced disclosure framework. This is likely to be a factor in the charity regulators' deliberations on whether or not to replace the SORP (FRSSE) with material based on the FRS 102 reduced disclosure framework or to require all charities preparing true and fair accounts to comply with the full version of the SORP (FRS 102).

Both versions of the SORP are available on the SORP microsite at: **www.charitysorp.org**.

The Charities SORP (FRS 102)

While there are many differences between the Charities SORP (FRS 102) and the Charities SORP (2005), the main difference between old and new is in the application of the fair value approach under the SORP (FRS 102) in relation to the recording of some transactions and balances, although historic cost accounting remains a feature in some instances, for example, fixed assets can continue to be measured at historic cost. Some of the other changes introduced by the SORP (FRS 102) are:

- In the Statement of Financial Activities (SoFA), income and expenditure classifications have been amended to reduce the number of line items.
- In the SoFA, gains and losses in investment assets must be treated as part of the income or expenditure of the charity and therefore go 'above the line'.
- In the SoFA, comparative figures for each column must be presented. However, these more detailed comparatives may be included within the notes rather than in the main statement.
- In the SoFA, or in the notes to the accounts, material items must be separately disclosed where this is necessary to give a 'true and fair'. This requirement is similar to the old UK GAAP requirements on exceptional items.
- A statement of cash flows must be prepared.
- In the notes to the accounts, support costs, including costs classified as governance costs, must be disclosed separately. Governance costs are no longer reported as a separate line item within the SoFA.
- In the notes, charities must disclose the total amount of all employee benefits received by key management personnel in relation to their services to the charity.
- In the notes, charities must either disclose the fact that there were no employees who received remuneration in excess of £60,000 or disclose the number of employees remunerated above £60,000 in bands of £10,000.
- Income, including legacies, must be recognised when receipt is 'probable' rather than 'certain'.
- Charities may adopt a new portfolio approach to the recognition of legacies.
- Donated goods for resale or distribution must be recognised at fair value on receipt unless it is impractical to do so.
- Holiday pay must be accrued in relation to any outstanding annual leave entitlement at the year-end.
- Two broad financial instrument categories are introduced - 'basic' and 'other', accompanied by requirements for each category on recognition, measurement and disclosure. The other financial instruments category picks up all financial instruments which fall outside the definition of basic, in essence complex financial instruments.
- Charities which do not recognise their share of a defined benefit pension scheme deficit must recognise the net present value of agreed deficit contributions.
- Charities engaged in restructuring must comply with new tailored guidance on accounting for acquisitions and mergers.

The Charities SORP (FRSSE)

Applying the SORP (FRSSE) should in theory limit the extent of any changes required to a charity's accounts. However, this will depend on the circumstances of each individual charity. Also, the limited shelf-life of the SORP (FRSSE) and its likely replacement with FRS 102 - based requirements and guidance for accounting periods commencing on or after 1 January 2016, means that adopting the SORP (FRSSE) would lead to two years of upheaval rather than one.

Charities applying the FRSSE will need to understand when to apply 'current practice' and when it is appropriate to apply 'accepted practice'. 'Current practice' in this context means compliance with new UK GAAP ie FRS 102 and 'accepted practice' means compliance with old UK GAAP. Referencing two different accounting frameworks adds complexity and if time had allowed, OSCR and the Charity Commission may well have consulted on prohibiting the use of the FRSSE by charities.

OSCR and the Charity Commission have issued three helpsheets (available on the SORP microsite) to assist charities and their advisors understand the changes. Helpsheet 3 will be helpful in

understanding the differences between the two versions of the SORP.

The SORP (FRSSE) sets out the required approach to the selection of accounting policies in module 3. First, charities using the FRSSE must refer to the FRSSE and the relevant modules in the SORP, thus emphasising that the FRSSE is the main underlying standard. However, there are three important caveats to this:

1. Current practice must be followed as set out in the SORP "to reflect the special factors prevailing or transactions undertaken in the charity sector." Each module of the SORP specifies when current practice must be followed and when there is flexibility.
2. For existing transactions where current practice is not mandated and which are not specifically dealt with in the FRSSE, charities may retain their existing accounting policies provided those policies reflect accepted practice and include the relevant disclosures in the FRSSE SORP.
3. For new transactions not specifically dealt with in the SORP or the FRSSE, charities are required to have regard to current practice but are not compelled to comply with current practice.

Charities which are eligible to use the FRSSE but choose to apply FRS 102 will be required to prepare a statement of cash flows. The equivalent exemption from preparing a cash flow statement under old UK GAAP does not exist under FRS 102.

The key message is that all charities preparing true and fair accounts must review all their accounting policies in preparation for applying the new Charities SORPs. This applies equally to charities applying the SORP (FRSSE) and the SORP (FRS 102).

Transitional matters

As the new SORPs apply to accounting periods beginning on, or after, 1 January 2015, charities with year ends up to and including 31 December 2015 must prepare comparatives on the same basis for the prior year ends falling on or before 31 December 2014. To achieve this, opening reserves at 1 January 2014 must also be established. For charities where transactions, assets and liabilities have been re-measured due to changes in accounting policy, additional information will need to be collected in respect of previous years.

Charities applying FRS 102 should also be aware of and comply with Section 35 of FRS 102 entitled 'Transition to this FRS'.

ACCOUNTING AND AUDITING QUERIES

A focus on FRS 102

This issue's Accounting and Auditing Queries look ahead to accounting periods commencing on or after 1 January 2015: the date Financial Reporting Standard (FRS) 102 will replace existing UK GAAP for unlisted entities not applying the Financial Reporting Standard for Smaller Entities (FRSSE).

The FRSSE has been updated for periods commencing on or after 1 January 2015 to reflect consequential amendments arising from the implementation of FRS 102, including some very limited changes to accounting requirements. Therefore, the FRSSE (2015) is largely based on what will become 'old UK GAAP' while FRS 102 is derived from International Financial Reporting Standards (IFRS), specifically IFRS for Small and Medium Enterprises (SMEs).

The implementation of FRS 102 has led to the updating of industry-based Statements of Recommended Practice (SORPs), including the Charities SORP of which there are now two versions: the Charities SORP (FRS 102) and the Charities SORP (FRSSE) (see 'The new Charities SORPs: initial matters for consideration' article on page 19). The new Charities SORPs do not provide a one-stop shop for accounting requirements and charities and their advisors should also refer to the relevant underlying standard. Our third accounting and auditing query considers how charities should account for defined benefit pension liabilities under FRS 102 and under the FRSSE (2015).

How do the 'Proposed small company financial reporting changes', covered by another article on page 16, fit in? Further changes to the small company financial reporting regime are expected to apply to accounting periods commencing on or after 1 January 2016 and have not yet been finalised. Therefore, these developments are not covered by our Accounting and Auditing Queries this time.

Query: *Unsurprisingly, FRS 102 adopts terminology which will be more familiar to listed groups required to apply EU-adopted IFRS in the preparation of their group accounts. However, I am not convinced my company clients will welcome the use of terms such as 'statement of comprehensive income' and 'statement of financial position' and other terms used to describe primary statements in their annual accounts. Therefore, would it be possible for such clients to continue to use more familiar terms such as 'profit and loss account' and 'balance sheet' instead of their IFRS equivalents?*

Answer: Section 3 of FRS 102 (paragraph 3.22) states that "*An entity may use titles for financial statements other than those used in this FRS as long as they are not misleading.*" Therefore, it is still possible to use other terms for primary statements provided that these are not seen as being misleading. It is generally accepted that the use of more

traditional primary statement headings such as "balance sheet" will satisfy this requirement, provided that the respective primary statements include all of the elements that are required to be included by FRS 102 and that the respective title properly reflects the content of each statement.

The traditional statement headings are included in the accounting regulations issued under the Companies Act 2006 and these remain unchanged. This supports the continued use of traditional titles by companies applying FRS 102. Company law also permits a degree of flexibility in the production of primary statements if this is necessary to better reflect, for example, the financial performance and financial position of an entity.

Charitable companies produce a Statement of Finance Activities (SoFA) instead of a profit and loss account and Statement of Total Recognised Gains and Losses and will continue to produce a SoFA instead of a statement of comprehensive income as required by FRS 102. The new Charities SORP (FRS 102) includes an updated format which has been amended, in part, to meet the requirements of new UK GAAP.

Query: *I have a company client which currently uses the revaluation model in FRS 15 'Tangible fixed assets' for land and buildings where it has ownership. It has however been complaining about the cost of obtaining external professional valuations which are required every five years. On the move to FRS 102 is it possible to adopt a historic cost approach to the carrying amount of land and buildings?*

Answer: Yes. Section 35 (transition to this FRS) of FRS 102 permits revalued property to be recognised at deemed cost at the date of transition. Entities are permitted to use the latest valuation under FRS 15 to establish deemed cost. However, if the date of the latest valuation does not coincide with the date of transition to FRS 102, deemed cost should include any depreciation incurred between the two dates.

FRS 102 is silent on how a revaluation reserve arising under old UK GAAP should be treated. One possible approach is that the revaluation reserve should be retained to comply with the requirements of the Companies Act 2006, specifically the alternative accounting rules which will need to be complied with on an on-going basis. The disclosure requirements pertaining to the alternative accounting rules are as follows:

- The revalued amounts for the land and buildings (which will be their deemed costs on the date of transition), the year the land and buildings were last revalued and the basis of the valuation.
- The historic cost equivalents for the revalued land and buildings.
- The amount of the revaluation reserve and any transfers from that reserve to realised reserves during the reporting period.

The disclosure requirements under the alternative accounting rules are set out in schedule 1 of Statutory Instrument 2008/410, paragraphs 34, 35 and 52.

Query: *I have a client which has adopted a policy of not amortising goodwill on the grounds that the goodwill is deemed to have an indefinite life. Impairment reviews are undertaken each year. Under FRS 102, will my client have to change its accounting policy?*

Answer: Under FRS 102 (section 19) goodwill is considered to have a finite useful life and must be amortised on a systematic basis over the period of its useful life. If an entity is unable to arrive at a reliable estimate of the useful life of the goodwill, then its expected life must not exceed five years. This means that from the date of transition to FRS 102 goodwill must be assigned a useful life. However, it should be noted that it is currently proposed by the Financial Reporting Council (FRC) to increase this five year period to ten years as permitted by the EU Accounting Directive and we would expect this proposal to be adopted.

Your client must disclose the useful life of the goodwill and if this exceeds five years (ten, if the FRC change is made), an explanation of the reasons for this should be given.

Query: *Our firm has a number of charity clients of different sizes which are members of multi-employer defined benefit pension schemes. Our largest charity clients will be required to implement FRS 102 for accounting periods commencing on or after 1 January 2015 but we also have a number of smaller charity clients which will have the option of applying the FRSSE (2015) at that time.*

How should charities account for any liabilities arising where the pension scheme is in deficit under both FRS 102 and the FRSSE for accounting periods commencing on or after 1 January 2015?

Answer:

The two approaches under FRS 102

Under FRS 102, two approaches are possible, depending on the individual circumstances of the charity.

(i) Sufficient information is available

If sufficient information is available to meet the recognition and measurement criteria for 'post-employment: defined benefit plans' as per section 28 of FRS 102, the charity must recognise its net defined benefit liability and the net change in that liability during the period. The net defined benefit liability is arrived at by deducting the present value of its obligations from the fair value of its share of pension scheme assets. This approach will be familiar to charities which currently recognise their share of a pension scheme deficit under FRS 17.

It is worth highlighting that some charities which have not previously recognised their share of a scheme deficit may have to do so under FRS 102. Under FRS 17, there is no

requirement for an entity to account for its share of a scheme deficit unless it is able to identify its share of the underlying assets on a consistent and reasonable basis. However, under FRS 102, this accounting policy option is only available in the absence of sufficient information. Judgement on this matter will come into play for those charities not currently recognising their share of a scheme's net deficit. Such charities will need to consider whether sufficient information is available even if they previously considered that information not to be consistent and reasonable.

(ii) Sufficient information is not available

If sufficient information is not available to require a charity to recognise a net defined benefit liability, then the charity should account for the scheme as if it were a defined contribution scheme: an approach also possible under FRS 17. However, a charity in this position will now need to recognise any liabilities arising from an agreement with the pension scheme trustees to fund a deficit. Under existing UK GAAP, recognition of such a liability is a grey area but the required accounting treatment under FRS 102 will be clear.

Under such an agreement, the charity must recognise a liability for the contributions payable to the extent they relate to the deficit in the balance sheet and the resulting expense in the Statement of Financial Activities (SoFA).

If the liability is not expected to be wholly settled within 12 months after the end of the reporting period, then the liability must be measured at its present value. The unwinding of the discount must be recognised as a finance cost in the SoFA in the period in which it arises.

The Financial Reporting Council (FRC) has issued an exposure draft (Financial Reporting Exposure Draft (FRED) 55) with proposed amendments to section 28 which make it clear that if an entity recognises a net defined benefit liability, it must not recognise any additional liabilities in respect of an agreement to fund a deficit. This is due to the two different approaches being different methods of measuring the same thing.

However, the two different approaches may give rise to two different measurements. A briefing prepared by Spence and Partners on accounting for multi-employer pension schemes highlights the reasons for this:

"*A funding plan established to eliminate the deficit in a pension scheme [calculates] the scheme's liabilities using a 'prudent' set of assumptions as required by pensions legislation, it would be from these contributions that the …present value of the deficit would be calculated.*

…. [in] accounting for the scheme as a defined benefit plan, an actuary will use financial assumptions which reflect a more current market assessment……..

It is likely to be more beneficial for organisations to account for the pension scheme provision as a defined benefit plan instead as this may potentially reduce the liability figure… due to the different assumptions used….."

The full version of this briefing is available at: **www.spenceandpartners.co.uk/archives/guide-to-help-charities-prepare-for-accounting-changes-under-frs102**/.

Comparison of FRS 17 and Section 28 of FRS 102

While there are similarities between FRS 17 'Retirement benefits' and section 28 of FRS 102 on 'Employees' benefits', any charity applying FRS 102 should review in detail the requirements under section 28 of FRS 102 and compare these requirements with module 17 of the Charities SORP (FRS 102) to ensure that section 28 of FRS 102 is enough to comply with all requirements appropriate to its circumstances. The Charities SORP also includes additional material on the fund accounting aspects of retirement benefits.

Impact on financial sustainability

Any charity (including those applying the FRSSE) with significant pension liabilities should be considering at the board level the impact of recognising such pension liabilities on the financial sustainability of the charity, and whether continued membership of the pension scheme is sustainable. Where a charity's balance sheet is taking a major hit for the first time, it will be crucial to explain and share the outcome of the Board's deliberations with its financial supporters, whether they are the grant-givers, banks or other lenders, or commissioners, so as to reduce the possibility of their support being withdrawn as a direct consequence of recognition of such liabilities.

Charities should also be mindful to comply with disclosure requirements around going concern, and auditors and independent examiners will need to consider the implications for their reports of any going concern issues arising from pension scheme liabilities.

The FRSSE (2015)

Under the FRSSE (2015), charities which participate in multi-employer defined benefit schemes may need to make some very finely balanced judgements so that they comply with all relevant requirements.

Those charities which currently recognise their share of the net deficit under the FRSSE (2008) should continue to do so. In addition, consideration should be given to the material in section 17 of the Charities SORP (FRSSE), for example on fund accounting and the treatment of defined benefit schemes and disclosures relating

to defined benefit schemes.

For charities which do not currently recognise their share of the net deficit under the FRSSE (2008) on the grounds that their share could not be determined on a consistent and reasonable basis, then they can continue to apply this policy.

For those charities which continue to account for a multi-employer scheme as a defined contribution scheme, the Charities SORP (FRSSE) sets out the following guidance.

"…. *[a charity] may retain its existing accounting policy when accounting for an agreement to make contributions to fund a deficit in the scheme provided the policy reflects accepted practice. Again, if the charity does not have an existing accounting policy for such agreements it should refer to FRS 102 when developing its accounting policy.*"

'Accepted practice' is defined as compliance with the old UK GAAP. Under the old UK GAAP, whether a charity taking a defined contribution approach should then recognise liabilities arising from an agreement to fund a scheme deficit is a grey area: the Charities SORP (FRSSE) provides no clarification on this point.

Charities in this position which currently recognise such liabilities in their balance sheet should continue to do so, as charities should first have regard to their own existing accounting policies.

Key Research Undertaken by ICAS on SME Funding

ICAS is currently engaged in a research project, with independent researchers from Kingston University, to investigate whether the use of an accountant influences the success rate of SME (Small and Medium Sized Entities) funding applications. As part of the research project, a survey will be issued to selected ICAS members in practice. ICAS and the researchers would be extremely grateful if you could spare the time to complete the survey, the results of which will be used to inform the policy debate on SME funding. Any queries should be addressed to: **research@icas.org.uk**.

For other charities which have not been recognising such liabilities in their reported accounts, it is now necessary to consider the requirements in section 28 of FRS 102 in respect of the recognition of liabilities arising from an agreement with the trustees of a pension scheme to fund such a deficit. However, a requirement to consider the material is not the same as a requirement to comply with its content, and the FRSSE (2015) makes that clear. It therefore appears that such charities will continue to have a choice of treatment.

It would be easy to get tied up in knots at this point, as a charity which has chosen not to recognise liabilities relating to an agreement in the past and has instead disclosed them as contingent liabilities could support their non-recognition under the FRSSE (2015) on the grounds that it should first have regard to its own existing accounting policies.

Accounting periods commencing on or after 1 January 2016

It is worth highlighting that accounting requirements for small entities are expected to be revised for periods commencing on or after 1 January 2016 to align with the recognition and measurement requirements of FRS 102 (but with reduced disclosure requirements). This means that any relief from the non-recognition of liabilities arising from a funding agreement is most likely to be short-lived.

There will clearly be challenges for accountancy advisors acting for charities where the course of action under the FRS 102 or the FRSSE (2015) requires finely balanced judgements. With the new SORPs being so recently published, some of the more detailed issues around their implementation have yet to be fully aired.

MONEY LAUNDERING UPDATE

Accountancy Service Providers and AML supervision

HM Revenue & Customs (HMRC) have released guidance reminding Accountancy Service Providers (ASPs) of their obligations under the Anti-Money Laundering Regulations 2007. An ASP is anyone who, as a firm or sole practitioner, provides accountancy services, fills the role of statutory auditor, or provides tax advice to others.

Firms of qualified chartered accountants are supervised by their relevant professional bodies and so do not need to register with HMRC. HMRC have also provided a useful tax adviser guidance flowchart which outlines the requirements from an Anti-Money Laundering perspective. More information can be obtained at: **www.hmrc.gov.uk/mlr/account-prov.htm**.

Sanctions update

The Joint Money Laundering Steering Group's latest sanctions update is out and can be viewed at: **www.imlpo.com/news/sanctions_update/**.

MONEY LAUNDERING QUERY

Query: *Our firm has been doing all of its know your client/customer due diligence checks manually for a number of years now. A colleague at another firm has made us aware of some computerised checking programmes that may significantly reduce the level of work that is required. We were given the details of a number of providers who appear to offer a "start to finish" compliance solution that for example does checks through credit reference agencies, the voters roll and Companies House. Does this sort of offering satisfy the Anti-Money Laundering (AML) requirements of us as chartered accountants?*

Answer: This sort of compliance solution is becoming more and more commonly found in the marketplace as technology moves forward. A number of providers are now offering solutions which check sanctions information, and whether or not an individual is a politically exposed person, as well as performing identity verification and the necessary client due diligence. The key to whether or not such a programme ticks all of the compliance boxes will hinge on a few different aspects.

Firstly, the data on which the compliance programme relies must come from at least two different sources. If, for example, the entire data checking and referencing was done via Companies House data and nothing else, this would give some cause for concern as it is unlikely that this as a source would address all of the AML risk aspects of clients. In these circumstances, you would probably need to do some extra checking of your own, which does defeat the object of using such a programme.

Secondly, the compliance programme needs to carry features that allow easy edition of client's data, as and when the client's circumstances change. Your "know your client" (KYC) information must be updated regularly, because this aspect of your client information should be "living" in the sense that it should be amended as and when changes occur that may affect the client and money laundering risk associated with it.

Finally, this sort of programme needs to offer a degree of flexibility. A product that is set-up on a tick-box basis is far less likely to capture the nuances associated with a specific client than one that has sections allowing free-form notes to be recorded. This is particularly relevant when it comes to KYC.

A recent internet search uncovered several providers of these types of services, all offering different types of service at different prices (some by subscription, based on a monthly fee; others charge per check performed). Our advice, if you are considering going down this route, would be to do your research thoroughly before committing to a particular provider, especially with regard to whether the programme can capture more nuanced aspects of client profiles, and enables regular update in order to maintain up-to-date client information and data.

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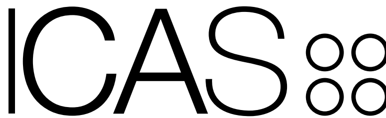

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