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Contents

DIGITAL TAX - PENALTY POINTS, THREE MONTHLY ACCOUNTS AND MORE

So now we have six consultation documents on Making Tax Digital for unincorporated businesses and landlords, running to over 230 pages. It can be hard to get behind the rhetoric and see what this actually means for businesses and their agents.

The biggest surprise is that this is much more than digital tax. Like a bed of Procrustes, digital is being used to lop the tax system to size.

Radical change

Basis periods, overlap relief, and opening and closing year rules are swept away with the possibility of non-annual basis periods.

In a move which could be aimed at Universal Credit claimants, quarterly, or even monthly, tax basis periods are proposed as an optional alternative to annual accounting.

For most represented businesses, the future is likely to become four quarterly updates followed by a year-end reconciliation, with nine months allowed to prepare the final submission, and one month permitted for each quarterly update.

The role of agent

The bulkiest of the consultation papers, "Bringing business tax into the digital age" **https://www.gov.uk/government/consultations/making-tax-digital-bringing-business-tax-into-the-digital-age**, is the most challenging. One part of the challenge is that the consultation focuses on small and mainly unrepresented businesses. The agent's role seems to have been considered almost as an afterthought.

The starting point is digital record keeping. Businesses and landlords with gross income of £10,000 or more will need to keep their basic accounting records digitally. As a minimum, this will mean all cash book transactions (see para 3.11) for businesses using the cash basis of accounting.

The position of spreadsheets is undecided (para 2.12); but it would seem likely, given the need for agents to adjust client records, that clients with agents will need digital book keeping software, rather than spreadsheets.

Implications for agents

Client book keeping software will be connected to HM Revenue & Customs' (HMRC) system, via the client's Business Tax Account. (see p8 fig 1.2). This contrasts sharply with current practice where agents make submission via their own software. Under the new system, according to the HMRC examples, agents would correct figures within the client's

ICAS

software (see p49 fig 6.2).

This has significant implications in terms of processes and access. There will need to be an audit trail of amendments to client data (para 5.46). The level of access and functionality which is assumed in the consultation examples can be envisaged on cloud-based systems; but it is unclear how it will work otherwise. Software access and compatibility are likely to be major issues.

Where clients are digitally excluded, it will be necessary for agents to operate a separate system.

Quarterly updating

Quarterly updates are likely to comprise three-line accounts for businesses who are under the VAT registration threshold. More detailed analysis will be required to support this. The information required for larger businesses is likely to mirror current self assessment requirements. The start date will be delayed for a year (from April 2018) for some smaller businesses – thresholds to be decided.

The consultation document assumes, for its examples, that clients will make quarterly updates themselves: the accountant will only be involved in the year-end submission. Given that most clients have an accountant so that they do not need to make submissions to HMRC themselves, this could leave a very big gap between HMRC's expectations and reality.

Quarterly submissions will be expected to reflect the taxable profit as closely as possible, and will include an adjustment for the personal allowance. Quarterly accruals accounting would be optional; though tax liabilities based on figures without such adjustments would be of limited value – an issue that is acknowledged in the consultations, but not resolved.

The possibility of non-GAAP compliant accounts is raised. Modified rules for closing stock, long-term contract up to one year in length, bad debt provision, and accruals/prepayments are put forward here. It is difficult to see that these would be anything other than of limited advantage. (See "Simplifying tax for unincorporated businesses" **https://www.gov.uk/government/consultations/business-income-tax-simplifying-tax-for-unincorporated-businesses**).

Apportionment and classification of income and expenses

Businesses will be expected to apportion income and expenses between business and private elements, and to separate deductible/non tax deductible expenses in their accounting records. This will be done before making quarterly submissions.

For SME businesses, this potentially pushes what is normally a year-end task carried out by the accountant into one undertaken on a transactional basis by the client.

Clients generally may not feel confident to make this sort of adjustment. It's therefore likely to mean earlier and more real-time engagement for agents: and consequently more expense.

The consultation assumes that 'nudges' within the software will enable businesses to make such decisions, but this does not generally match practitioner experience. Businesses have an agent so they don't need to make cutting-edge decisions and judgment calls.

Cash basis accounting

Cash basis accounting is high in the agenda, but it will not suit all businesses. Smaller businesses (possibly up to twice the VAT threshold) will be able to choose between the cash basis and accruals accounting.

The cash basis comes with interest and loss relief restrictions. Many businesses will need accruals accounting to give a realistic idea of profitability.

A new cash basis for unincorporated landlords is introduced (see "Simplified cash basis for unincorporated property businesses" - **https://www.gov.uk/government/consultations/business-income-tax-simplified-cash-basis-for-unincorporated-property-businesses**). It is suggested that this could apply to property businesses with a turnover under the compulsory VAT registration threshold (£83,000 in 2016/17).

We have here the advantage of giving immediate relief for unpaid rent; balanced against the fact interest relief could be restricted. The trading cash basis limit of £500 would not apply. Mortgages would need to be tied to property used in the business and not exceed the value of the property.

There is a restriction on interest relief on residential property, limiting it to the basic rate of income tax. This is in line with 2015 Budget. For residential lettings a replacement basis would apply to furniture and moveable equipment, with no deduction for initial costs.

There are potential complexities around security deposits: where these are held by the landlord, the cash basis would treat them as income.

Compliance

Compliance powers for the final year-end submission, would replicate those of Self Assessment, but a 'penalty points' system is suggested for missed quarterly submissions. This would potentially convert four points into a financial penalty.

Conclusion

There is a great deal of change wrapped up in the six consultations, with some welcome simplification. The biggest challenge appears to be quarterly updates and digital record keeping.

TAXATION OF DIVIDENDS AND SAVINGS– NEW REGIME

A new regime for taxation of dividends and savings came in on 6 April 2016. How will this affect your clients, the paperwork and their tax bills?

Example 1

John has salary of £8,060, interest of £6,000 and dividend income of £30,000

		PAYE income £	Interest £	Dividends £
Salary		8,060	6,000	30,000
Personal allowance	11,000	8,060	500	2,440
Taxable income		-	5,500	27,560
Taxable:				
At starting rate for savings	0%		5,000	
			500	
PSA (at level for higher rate tax payer)			500	
			===	
Dividend allowance	0%			5,000
				£22,560
				======
At basic rate £21,500 at 7.5%	£1,612.50			21,500
At higher rate 32.5% on £1,060	£344.50			1,060
				£22,560
				=======

Note: If the balance of personal allowance had been allocated against savings income, £2,440 more dividend income would have been taxable.

PSA is £500 as income within the PSA, starting rate for savings and DA all reduce the basic rate band available.

Allowances, rates and bands – key changes

The new system for dividends means:

- Last year's net dividend income is this year's gross – the 10% tax dividend credit disappears
- The new Dividend Allowance (DA) means that the first £5,000 of dividend income is taxed at zero – whatever level of income a taxpayer has
- Dividend income within this £5,000 band still counts as part of a taxpayer's basic or higher rate band – so can push other income into a higher tax bracket
- Tax rates become 7.5% at basic rate; 32.5% at higher rate and 38.1% at additional rate

The new system for savings means:

- For clients with high savings and low non-savings income, the 0% starting rate for savings tax band of £5,000 has greater significance
- The new Personal Savings Allowance (PSA) has three levels: £1,000 for basic rate taxpayers; £500 for higher rate taxpayers; and nil for additional rate taxpayers. Note the cliff-edge effect – small additional amounts of income can mean a £500 fall in the PSA
- The level of PSA available depends on Adjusted Net Income – that is taxable income after deduction of grossed-up gift aid payments and some pension contributions. S64 Income Tax Act 2007 (ITA 2007) – trade losses from general income – are also deducted. Losses, gift aid and pension contributions may therefore increase the PSA available
- Most tax deduction at source ceased at 6 April 2016. But interest on loans from shareholder directors to their own company still require tax deduction at source

A new concept - reallocating the personal allowance

Where a taxpayer has dividend income, savings income of under £6,000 and non-savings income of less than £17,000 (the personal allowance, plus the PSA and the £5,000 0% starting rate for savings), allocating the personal allowance against dividend income may reduce the overall tax liability. See Example 1 above.

Order of set off:

S25(2) ITA 2007 means that the personal allowance can be allocated to minimise the tax liability. S6 ITA 2007 prescribes the order in which income is taxed: so dividend income is taxed as the top slice, with savings income below it and earned income below that. The starting rate for savings is accessed before the PSA (Finance Bill 2016 s4).

Unexpected results

The exact mix of income – earnings/dividends/interest – is important and small differences in the balance will make significant impact on the overall tax liability.

Dividends

The publicity around the new dividend

allowance may lead clients to think that tax bills on dividend income are a thing of the past, but the reality is that tax rates are higher, once the £5,000 allowance is exceeded. The calculations are complex but, comparing 2015/16 with 2016/17 using the dividend amount received (excluding the tax credit), the basic pattern is:

- Dividends up to £5,000 – higher and additional rate taxpayers will have a reduced tax bill on dividend income; while basic rate taxpayers are unaffected
- Dividends over £5,000 but under £21,667 (£25,250 if all at additional rate), basic rate taxpayers pay more, but higher and additional rate taxpayers pay less
- Dividends above these levels mean higher tax bills

Note: The position is more complicated where dividend income brings a taxpayer into a higher tax band.

For Owner Managed companies, the impact of employer's and employee's National Insurance is likely to keep dividends attractive.

Savings

While the majority of taxpayers will see savings income paid without deduction of tax and with no tax liability – as savings income will be covered by the PSA – some categories of taxpayers will be due refunds, or bills.

Basic rate taxpayers with PAYE income of over £16,000 (so the starting rate for savings is inaccessible) and interest of over £1,000 receiving gross interest will be due a bill.

Trust income

The position here can be complex, particularly around mandated income and administration. There are on-going consultations with HM Revenue & Customs (HMRC) in this area, but the situation so far would seem to be that where income is mandated to a beneficiary, there is no requirement for the trustees to deduct additional tax (see **http://www.hmrc.gov.uk/manuals/tsemmanual/tsem3763.htm**). For non-mandated income, trustees may need to account for additional tax, which beneficiaries may be able to re-claim depending on their individual circumstances.

Worked example – 2016/17

Ewan has a salary of £50,000 as a marketing consultant. In addition he receives £12,000 in dividends, for 2016/17. This would be taxed as follows:

	£
Employment income	50,000
Dividend income	12,000
	62,000
Less: Personal Allowance	11,000
Taxable income	£51,000
	======

Tax on earned income less personal allowance (£50,000 – 11,000 = £39,000):

	£
Employment income (£50,000 – 11,000 pa = £39,000 taxable)	
0–£32,000 at basic rate of 20%	6,400
Balance of £7,000 at higher rate of 40%	2,800
Dividends: First £5,000 at 0% covered by dividend allowance	0
Balance at higher rate for dividends, £7,000 at 32.5%	2,275
Tax payable	£11,475
	======

The dividend allowance factsheet gives additional examples - **https://www.gov.uk/government/publications/dividend-allowance-factsheet/dividend-allowance-factsheet**.

Practical points to watch for

There are three key areas to consider here:

1. Coding out
2. Record keeping
3. Unexpected tax bills

Coding out

This particularly affects shareholder directors where there have been high dividends and low salary arrangements in the past. HMRC may include estimated amounts of dividend income in 2016/17 PAYE codes.

HMRC's figures are likely to be based on dividend levels in earlier years, whereas dividend levels in 2016/17 may be significantly lower.

The end of dividend vouchers

The dividend tax credit disappears from 6 April 2016 and Companies will cease to issue 'dividend vouchers': last year's net dividend becomes this year's gross. Instead of the dividend voucher, there will be a statement or 'dividend confirmation' showing the amount of the dividend received.

Digital or paper?

Some companies are going further and moving on-line. This is particularly so where dividends are paid directly into a bank account. Paper dividend vouchers disappear in favour of on-line dividend confirmation statements.

A company making a qualifying distribution is permitted to use digital format provided that the recipient has been informed, has agreed to digital and had not withdrawn this consent. The digital format must be one which can be stored by the recipient, permits a paper copy to be printed, and is in a format designed to 'prevent alteration of the contents'.

There is a risk that some clients may have opted out of paper statements accidentally when mandating payment directly into their bank.

Conclusion

The changes in savings and dividend taxation mean that tax remuneration packages, particularly for owner managed companies, should be reviewed. Clients with high level of savings interest and dividends will need pro-active advice to avoid cliff-edge impacts on personal savings allowance and to ensure that they are aware of possible tax bills.

THE SUSPENSION OF PENALTIES

Penalty suspension is a considerably misunderstood area. But if practitioners can add it to their technical armoury, it has immense potential to salvage situations in which a client has been issued with a penalty for careless inaccuracy.

Inaccurate returns

The starting point is provided by Sch 24 Finance Act 2007 (FA 2007), which imposes a penalty for an inaccuracy on a return or other document.

Quantum of penalty

The penalty rate is based on taxpayer behaviour, and whether or not disclosure of the error was at HM Revenue & Customs' (HMRC) prompting. Once the penalty rate is established, it is applied to the potential lost revenue (PLR) to set the amount of the penalty due.

Potential for suspension

If, however, the penalty is for careless inaccuracy, and it fulfils HMRC criteria, it may be possible to ask for suspension.

This essentially gives a stay of execution for up to 2 years, conditional on the fulfilment of terms imposed by HMRC. Satisfactory compliance results in the penalty being cancelled. Failure to comply, on the other hand, will bring the penalty back into play, and it would then become immediately payable.

How will HMRC decide?

First, the case has to fit the relevant categories.

These cases will not qualify:

- Careless inaccuracy where inaccuracy was deliberate
- Penalty arising due to failure to notify
- VAT or Excise delinquency
- Errors where reasonable care was taken
- Penalty arising from failed use of an avoidance scheme

If the penalty arises because of 'mixed' behaviour, the penalty can be suspended in proportion to the element of careless inaccuracy attaching.

Tool for compliance

HMRC views suspension as an opportunity to remedy the problems which led to the penalty arising in the first place ie as a way to ensure future compliance. Weaknesses in record keeping and systems' faults which can measurably and demonstrably be rectified make ideal candidates.

HMRC uses the mnemonic SMART. The conditions for suspension are:

Specific – relating directly to the circumstances of the taxpayer in question

Measurable – the taxpayer will be able to show that the conditions have been met

Achievable – it is possible for the taxpayer to meet them

Realistic – taking into account the circumstances of the taxpayer

Timebound – there is a statement of when the conditions are to be implemented

Examples

HMRC Compliance Handbook - CH83220 (**https://www.gov.uk/hmrc-internal-manuals/compliance-handbook/ch83220**) provides examples of situations where HMRC might consider suspension.

Here HMRC considers a trader with multiple errors, some deliberate, others careless. Suspension of deliberate errors is ruled out by the legislation. The careless errors in the example include:

1. Private use of motor expenses incorrectly recorded
2. Goods for own use unrecorded
3. Missing turnover
4. An undisclosed capital gain

HMRC considers that conditions could be set for items 1-3, in terms of improved record keeping; but that item 4 could not be considered for suspension as it arose from a one-off sale of assets that will not recur because the taxpayer has no further assets that could be sold.

Suggested conditions are:

For item 1 – a new record-keeping system or a reliable sampling exercise that will allow accurate identification of private use of motor expenses, to be introduced within one month of the date of the notice to suspend the penalty.

For item 2 – continuation of action taxpayer has already taken to record goods for his own use: monitored for the next 12 months.

For item 3 – a modified record-keeping system to accurately record turnover from the omitted source. This to be in place within one month of the date of the notice to suspend the penalty.

The taxpayer must also file all returns on time during the suspension period of 12 months.

It should be borne in mind that this is a new and developing area of tax. A number of recent Tribunal decisions on suspension of penalties have gone against HMRC, and widened the scope significantly.

Looking to the longer term

In granting suspension, HMRC is looking to the longer term. Its aim is to correct behaviour. Thus is it unlikely to allow suspension in cases where it considers there is no lasting value.

This might be, for instance, for an error in an inheritance tax calculation; or for a one off capital gain; or in the case of a sole trader, for a final period of account.

A number of Tribunal cases have turned on this question.

In **David Testa [2013] UKFTT 151 (TC)**, the taxpayer had failed to include a large termination payment on his tax return. Testa asked for suspension, maintaining that SMART conditions could be applied – namely that he engage a professional adviser for future years' returns. HMRC's argument in refusing was that the error was a one off. Mr Testa's argument however, was upheld by the Tribunal.

Another case upheld quite the opposite view. This was **Anthony Fane [2011] UKFTT 210 (TC)**, in which the Tribunal held that there were no conditions which could be set which would render suspension appropriate.

This was also the line taken in **John Paul Lindsay Cobb [2012] UKFTT 40 (TC)**. Mr Cobb, having been made redundant, made an error on his tax return, and it was held that there would be no future opportunity for him to demonstrate the fulfilment of conditions for suspension.

On the question of one-off errors, the case of **Ian Hall [2016] UKFTT 0412 (TC) TC05166** is interesting. Here the Tribunal decided that HMRC's view was too narrow. The legislation did not envisage suspension being restricted to cases where exactly the same error was repeated.

The decision in **Ian Hall** suggests that HMRC's view set out in its manual at **CH83143** that "*The legislation requires HMRC to be able to identify any future careless inaccuracies that would result from the underlying cause if it is not corrected*" may be too narrow.

Agent input

Agents can perform a valuable role at many points in the suspension process.

They can initiate the process, either by phone, in writing, or as part of the closing negotiations in a compliance check. Indeed, in a compliance check, the idea of a suspended penalty may be a valuable bargaining tool. The level of penalty may prove less contentious if suspended, allowing both parties to save face and reach agreement.

Agents would be well advised to review with their clients what conditions could be suggested, bearing in mind that HMRC is looking for <u>evidence</u> of changed taxpayer behaviour. What steps would it be possible for your client to take?

Procedure

HMRC will review the taxpayer's past compliance history in order to come to its decision to grant suspension. If past compliance suggests that penalty suspension conditions are unlikely to be implemented, HMRC is likely to refuse.

If suspension is agreed, HMRC will issue a notice of suspension under FA2007 sch24, para 14 (2). This will set out the amount of the penalty being suspended, the conditions attaching to the suspension, and the duration of suspension.

Duration

Penalties can be suspended for up to 24 months. Notwithstanding this, HMRC's internal manuals state that suspension should be for no more than the time needed to establish evidence that conditions have been fulfilled: in practical terms, it should allow a complete "return cycle" for the 'problem' tax. A full 24 months is only likely to be used in exceptional circumstances.

Cancelling suspension

Suspension can be cancelled in some circumstances. This would occur where the taxpayer became liable for another penalty during the suspension period.

A range of options

Suspension is just one of a range of options to mitigate behaviour-based penalties. HMRC's decision not to permit suspension may be appealed to the Tribunal, but only where HMRC's decision is flawed. The terms of any suspension may similarly be appealed.

More generally, appeals to the First Tier Tribunal can be against the decision to charge a penalty or about the amount of the penalty. This includes whether the taxpayers behaviour was deliberate, concealed, or disclosure was prompted.

Special reduction (para 11, of Sch 24 FA 2007) can be invoked where there are extenuating circumstances - but not lack of funds, or because a potential loss of revenue from one taxpayer is balanced by a potential over-payment by another.

Taking this route means accepting that the taxpayer was careless. HMRC's decision on Special Reduction can only be challenged at Tribunal if it is wholly unreasonable. Where HMRC has not considered Special Reduction, the Tribunal may give its own decision – which can include reducing or staying the penalty.

Conclusion

Suspension can have benefits all round: clients avoid a fine; agents can use their technical expertise to suggest conditions for suspension; and benefit from improved client records; HMRC avoids the potentially negative PR of a penalty, while securing improved future compliance.

EMPLOYMENT CORNER - PUBLIC SECTOR BODIES AND IMPACT ON "OFF PAYROLL" WORKERS FROM APRIL 2017

In Budget 2016, the Government published a Technical Note which can be found at: **https://www.gov.uk/government/publications/off-payroll-working-in-the-public-sector-reforming-the-intermediaries-legislation**, entitled "Off-payroll working in the Public Sector: reforming the intermediaries legislation". This has been followed by a consultation document of the same name which can be found at: **https://www.gov.uk/government/consultations/off-payroll-working-in-the-public-sector-reform-of-the-intermediaries-legislation**, the response window of which closed on 18 August 2016.

Background

The Government revealed its plans for reform of the intermediaries (IR35) legislation in the Technical Note, and we learned that it proposes to transfer the responsibility to operate IR35 where an individual contractor works for a public sector body .

The public sector is the part of the economy concerned with providing various governmental services. The composition of the public sector varies by country, but in most countries the public sector includes such services as the military, police, infrastructure (public roads, bridges, tunnels, water supply, sewers, electrical grids, telecommunications, etc), public transit, public education, along with health care and those working for the government itself, such as elected officials. The public sector might provide services that a non-payer cannot be excluded from (such as street lighting), services which benefit all of society rather than just the individual who uses the service

To be clear, under the new proposals, the responsibility to operate PAYE and NICs would be that of the public sector body in the absence of an agency. If an agency is providing the worker, the responsibility for operating PAYE and NICs will lie with the agency.

This essentially seems to herald the end of the ill-conceived intermediaries legislation as we know it, in that anyone engaged by a public body (or by an agency to work for a public body) will not be expected to operate PAYE on themselves any more as this will be done elsewhere. This is because there is perceived to be a high level of non-compliance in relation to IR35 generally and when HM Treasury reviewed the statistical information available (ie the number of one-man limited companies compared to the number of people registered as IR35 taxpayers) there was an obvious gap.

The Issue

It seems likely, therefore, that this legislation will start with public sector bodies and agencies, and then roll out to the wider public and to private sector organisations.

Now that the consultation has been issued, a short debate can begin about how fair this legislation is. There is no doubt that the widespread avoidance of IR35 in its current state could not continue... but is this the correct way to fix the problem? Several other "no doubts" accompany this thought:

No doubt: Public sector bodies will need to review their procurement procedures and evaluate their risk in terms of the number of people invoicing through intermediaries who are not engaged through agencies. This could be a huge job, as "off payroll" workers are engaged in almost every department. The likely unintended consequence (if indeed it is an unintended consequence) of the proposals are that Public Sector bodies will simply cease to pay intermediaries and only engage "off payroll" workers through agencies.

No doubt: Finance departments will be reviewing their cash flow and budgets going forward and considering whether they can continue to pay these individuals if the payments are now to be accompanied by an Employer's NIC liability, adding 13.8% to the cost at the drop of a hat. According to HM Treasury, of the 4.5 million self employed workers in the UK, it is estimated that at least a third will be affected.

No doubt: The services undertaken by the "off payroll" workers, which form part of the overall public sector delivery accountability to the taxpayer, will be affected and it is as yet unclear how these services will be maintained if these workers are not re-engaged. Also the internal dynamic of each particular public sector body will likely be affected and if additional duties fall to the existing employed staff, low morale and disengagement is likely to follow.

No doubt: There is likely to be a huge backlash from agencies, who would presumably not wish to have to administer this PAYE and NIC, or bear the secondary NICs liability. However, if they do have to bear it, will they not simply just pass the cost on to the Public Sector body anyway? Hence, the taxpayer will once again bear the brunt of the "off payroll" worker and the person who has set up a limited company purely to avoid employment taxes will be absolved of responsibility, credited with paying PAYE and NICs, and receive welfare benefits and pensions credits for his trouble!

No doubt: There will be a backlash from think tanks and representative bodies such as IPSE (**www.ipse.co.uk**) who would wish the current status quo to continue to ensure their survival. Net payments to contractors will be lower due to tax and NICs deductions and some contractors will be unprepared for this eventuality.

And yet, it seems only right and fair that, to hark back to the original IR35 premise - "*but for the existence of the intermediary, the worker would be an employee of the engager*", the engager should be the one administering the payroll.

In summary, after many years of defending the ill-conceived and ill-fated IR35 legislation, in spite of inadequate resources to police it, and with only sporadic compliance by intermediaries, it seems that the Government are finally tackling this tax gap. The revised dividends and travel and subsistence legislation compliments this action. Whether it is the correct solution remains to be seen…but what could realistically take its place?

ENTREPRENEURS' RELIEF – ASSOCIATED DISPOSALS

Had he been alive to read Clause 73 of the 2016 Finance Bill, Oliver Hardy may have said to the parliamentary draftsman "*that's another fine mess you're about to get me into*".

Entrepreneurs' relief is given where an individual makes a material disposal of business assets which include an interest in a partnership or shares in an unquoted trading company, and certain conditions are met.

Usefully, the relief extends to associated disposals where, for example, a partner in a firm owns the premises from which the partnership trades, or the owner of shares in an unquoted trading company owns the property from which it trades. Where the property is disposed of at the same time as a material disposal of business assets, which could be the individual's retiral from a partnership or disposal of all of his shares, then entrepreneurs' relief could extend to the business property which the individual owned personally.

Up until 17 March 2015, it was not necessary for the individual to dispose of much of a partnership interest or many shares to qualify for entrepreneurs' relief on the associated disposal. However, after that date:

- The individual had to make a material disposal of at least a 5% interest in the partnership of which he was a member and that no "partnership purchase arrangements" existed; or
- Make a material disposal of ordinary shares in the company of at least 5% and that no "share purchase arrangements" existed.

The partnership and share purchase arrangements referred to above are arrangements where the individual or a person connected with him was able to acquire any interest in or increase in the partnership or shares in the company.

This could create some odd and surely unintended consequences, such as the situation where a parent wished to transfer his shares in an unquoted trading company to his children, together with the premises from which the company traded but, rather than doing this by way of gift, required an element of consideration. As the children are connected with the parent then there will be share purchase arrangements and the parent would be entitled to entrepreneurs' relief in respect of the material disposal of shares but not on the associated disposal of the property.

Clause 73 of the 2016 Finance Bill proposes changes to correct the anomalies and the notes accompanying the draft clauses state that "*it will still be necessary for the claimant to withdraw from participation in the business by making a material disposal of either an interest in the partnership or shares in the company. However, under the new rules, the necessary material disposal may be to persons connected with the claimant, such as family members. Also, the requirement that the material disposal be of a certain minimum size may not apply if the claimant is disposing of all of his or her interest in the partnership or shareholdings*". These changes are to have effect for disposals after 17 March 2015 and in this case, retrospection is to be welcomed.

A new alternative condition is being introduced which will allow entrepreneurs' relief to be claimed on a disposal associated with the material disposal of the whole of the claimant's interest in a partnership, even though this may be less than 5%. For example, a parent may have been reducing his partnership share over the years and has only a 3% interest. Up until clause 73, provided it is enacted, this individual could not possibly meet the requirement to dispose of at least a 5% interest if any associated disposal was to qualify for entrepreneurs' relief. The alternative test is that, where the claimant has owned 5% or more of an interest in a partnership for 3 years in the 8 years preceding the disposal, and is disposing of his entire remaining partnership interest, entrepreneurs' relief will be available on the associated disposal of, for example, the business premises.

A further change is that the material disposal itself will not be treated as a partnership purchase arrangement and therefore entrepreneurs' relief will be available on the associated disposal of, for example, partnership property by a parent to his children.

Other relaxations are proposed and, in particular, arrangements entered into before both the material and associated disposals, and which are not connected with these disposals, will not be treated as partnership or share purchase arrangements. The Finance Bill notes make the point that this "*...ensures that pre-existing arrangements (unconnected to the material or associated disposal) for succession to a business, or ownership of shares in the event or retirement or death will not prevent a claim to entrepreneurs' relief on an associated disposal*". This may cover, for example, provisions in a partnership agreement or a shareholders agreement which set out what is to happen in the event of an individual retiring from a partnership or company or in the event of his death.

The partnership purchase arrangements definition is also being changed so that, where the associated disposal, takes place before the material disposal, any arrangements connected with the material disposal will not be partnership purchase arrangements and therefore will not prevent entrepreneurs' relief being available on the associated disposal.

These are not areas which we necessarily meet very often, and the easiest course of action when advising a client regarding assets to be held outwith a partnership or company may be, in fact, to advise them to have the property held as a partnership asset or by the company.

The partnership agreement could allow for capital profits to be shared in a different way than income profits. In a company situation, if the individuals are concerned that failure of the company could result in the property being lost then perhaps a simple group structure with a holding company owning the property and the shares in a trading subsidiary would solve this particular issue.

Additionally, such a change should enable 100% business property relief to be available for inheritance tax purposes rather than, at best, 50% relief where an individual owns the asset personally.

HMRC UPDATE

New bank account details for customers who use International Bank Account Number (IBAN)

HM Revenue & Customs (HMRC) has changed all its bank accounts from Citi to Barclays. Anyone who makes payments from abroad using an International Bank Account Number (IBAN) will need to ensure they use the new Bank Identifier Code (BIC) and IBAN when they make a payment. This could be when they make a payment online themselves, or when paying over the counter at a bank. Each type of tax has its own HMRC IBAN and BIC details, and you can find these using this link, **https://www.gov.uk/topic/dealing-with-hmrc/paying-hmrc**. Sometimes the details are quite far down the page, so keep looking! The majority of taxpayers do not use an IBAN and will not be affected, but those who do need to take action to make sure HMRC continues to get their payments.

HMRC changes gateway password rules

Without much publicity. HMRC has changed the number of characters required for accountants and taxpayers to access the Government Gateway, reducing the limit to between 8 and 12 characters, and preventing those attempting to sign in with their longer 15-character password from accessing their account. The Revenue announced the changes on 29 July in a VAT online guidance document, which is no longer available, advising those with long password to enter the first 12 characters, as this will be used as their new HMRC password. Previously, those with longer passwords were able to access HMRC services by typing in the 'long' password because the additional characters were disregarded and the first 12 characters matched the password on record. Now any extra characters typed in the password box will cause a login failure.

Agent Account Managers

HMRC has a small team of Agent Account Managers ("AAMs") whose role is to resolve difficult or persistent issues that agents have encountered when dealing with other departments in HMRC. Before contacting them you should ensure that you have a 64-8 agent authorisation in place for the appropriate head of duty; that you have tried to resolve the issue yourself; and that normal channels have been ineffective and broken down.

To use the service, you will first of all need to register which you can do at: **https://online.hmrc.gov.uk/shortforms/form/AAMReg?dept-name=&sub-dept-name=&location=43&origin=http://www.hmrc.gov.ukhttps://online.hmrc.gov.uk/shortforms/form/AAMReg?dept-name=&sub-dept-name=&location=43&origin=http://www.hmrc.gov.uk**.

You only need to register once, and only one representative needs to register for everyone in the firm to be able use the service. However, if you have more than one branch or office, a representative from each branch will need to register, but then everyone in that branch will be able to use the service. You will receive an automatic acknowledgement to the registered email address.

To submit an issue, you will need your firm's details; the client's details; details of the problem; and details of what you have done to try and resolve it. Issues must be logged online at: **https://online.hmrc.gov.uk/shortforms/form/AAMIssue?dept-name=&sub-dept-name=&location=43&origin=http://www.hmrc.gov.uk**. An AAM will contact you within three days, liaise with the relevant team within HMRC, and keep you advised of progress.

One common misconception is that every agent has their own AAM. That is not the case. AAMs are allocated to issues, not agents, on a "taxi rank" basis, and you may therefore have a number of different AAM looking after different issues for you.

AMMs can't help if you haven't exhausted the usual channels in trying to deal with a problem. They do not deal with complaints, as their role is to resolve issues, not apportion blame. They are also unable to deal with queries in compliance checks, appeals, or technical matters.

The Top 5 issues commonly dealt with by AAMs are:

1. Self Assessment repayments
2. Agent maintainer issues eg 64-8s
3. PAYE repayments
4. Self Assessment correspondence
5. Construction Industry Scheme repayments

Full details about the AAM service can be found at: **https://www.gov.uk/guidance/agent-account-managers-in-hmrc**.

Logging onto the Government Gateway with your clients' credentials

HMRC has issued a warning to agents who log onto the Government Gateway with their clients' credentials. Recent analysis by HMRC shows that about a third of logins using client credentials were made from agents' IP addresses. When this happens, security alerts are triggered within HMRC, which then have to be investigated. These incidents make it harder for HMRC to identify genuine suspicious online behaviour and activity, and reduces the amount of resource available to deal with real fraudulent behaviour. HMRC believes that there are large volumes of hidden agents who not have signed up and registered correctly with them. This also affects the risk model they use for detecting and combatting fraud. To reduce the risk of fraudulent access to clients' details, HMRC may "block" any IP address which has a significant number of multiple client logins while they investigate the reasons for the occurrence. This will cause considerable delay and inconvenience to agents and, to avoid such problems, you should ensure that you use your own credential to transact client business with HMRC.

HMRC has also told us that some agents are not responding in a timely manner to online prompts to update their passwords. This can lead to clients' information potentially being stolen from agent accounts, as it makes it easier for organised criminals to compromise the security protocols. HMRC have found examples of repayment, VISA, mortgage and registration frauds caused by undue delays in changing passwords.

BREXIT – LIKELY IMPACT ON ACCOUNTING AND AUDITING

On 23 June 2016, the people of the UK voted for the UK to leave the EU. Since then there has been much political activity, including the appointment of a new Prime Minister and considerable speculation as to the likely way ahead. Matters relating to accounting and auditing standards will not be top of the UK Government's agenda, but they are important to the accountancy profession: so what are the key questions that need to be answered in these areas?

(i) Will the UK Government be inclined or persuaded to depart from requiring International Financial Reporting Standards (IFRS) to be applied in the preparation of consolidated accounts of listed entities?

(ii) Will there be any changes to the recently established new UK Generally Accepted Accounting Practice (GAAP)?

(iii) Will the EU Audit Directive and Regulations be reviewed and some aspects reversed?

Addressing each area in turn:

(i) As the UK intends to remain a global player, after all it is the fifth largest economy in the world, then one would expect that it would need to require listed entities to comply with global standards in the area of financial reporting. It is therefore highly likely that the IFRS requirement would continue to apply to the consolidated accounts of entities listed on the London Stock Exchange and AIM (AIM rules requirement). Currently this requirement specifically relates to IFRS as adopted by the EU. However, following its exit, the UK may have the ability to specifically adopt IFRS standards as issued by the International Accounting Standards Board (IASB) without them firstly having to be adopted by the EU. If the UK had this ability (depends on the deal negotiated with the EU) then it could of course establish its own adoption mechanism, possibly via the Financial Reporting Council (FRC) if it felt this was necessary. There would appear little scope for setting rules requiring the use of financial reporting standards other than IFRS for such entities. IFRS is now seen as the global benchmark in terms of financial reporting standards and therefore their use, or the use of standards substantively based on the IFRS framework (such as is currently the case with IFRS, as adopted by the EU standards), would appear to be the primary option.

(ii) The FRC has also just completely revamped UK Generally Accepted Accounting Practice (GAAP) with the issue of Financial Reporting Standard (FRS) 100 in late 2012, subsequently followed by the main new standards: FRS 101, FRS 102, and FRS 105.

FRS 102 is largely based on the IFRS for SMEs which has not been adopted by the EU and this is seen as the core standard of the new UK GAAP. Considerable costs have already been incurred by various parties in relation to this change and it is inconceivable that any changes to the standard will result from the UK's exit from the EU. The most likely future changes will arise from (i) the FRC's review of the implementation of the standard and issues arising and (ii) from possible adoption of changes to main IFRS standards eg IFRS 16 'Leases'.

FRS 101 is designed for use by parent and subsidiary undertakings, who are members of a group which applies IFRS as adopted in the EU in its consolidated accounts, in their respective individual entity accounts. Any changes here would be linked to a change in the overall requirement for IFRS for listed groups and, again, is very unlikely.

Although introduced via EU legislation, the UK Government did not need to take up the option to have reduced financial reporting requirements for micro-entities but elected to do so. The subsequent FRS 105 for micro-entities was specifically derived by the FRC from FRS 102 taking account of the reduced legal financial reporting requirements but also offering additional concessions to such entities. Again the requirements are most unlikely to change.

Where there might be greater scope for change would be in relation to the size criteria for companies (which are also indirectly used by other entities). For example, if not bound by having to adhere to EU legislation, and this will ultimately depend on the result of the deal negotiated with the EU, the UK Government could opt to have higher or indeed lower thresholds for determining whether an entity is micro, small or large. Whilst the UK Government would be unlikely to change this in the short-term it is something over which they might have the ability to exercise greater control. The audit exemption criteria are of course also directly linked to this. Another possible area for change would be in relation to the EU requirement which stems from the accounting directive which mandates the maximum number of notes that can be required of a small company (subject of course to the true and fair view test). The UK Government would have the ability to amend this requirement if it was not bound by EU legislation.

(iii) On the audit side, the UK has only just introduced legislation and revisions to audit and ethical standards to implement the 2014 EU Audit legislation (Regulation and Directive). For as long as the UK remains a member of the EU there will be no scope to revise any of this legislation and related provisions. However, depending on the agreement reached with the EU, and also dependent on the views of stakeholders, there may be scope for amending certain aspects of this legislation post exit. By and large the main changes introduced by the recent EU audit legislation apply to Public Interest Entities (PIEs) as defined in the EU legislation. Therefore, most scope for any such changes, subject to the exit deal, would be for requirements which apply to such entities.

FRC CONCLUDES REVIEW OF FRS 101

Following the conclusion of the latest Financial Reporting Council (FRC) annual review of Financial Reporting Standard (FRS) 101 'Reduced Disclosure Framework', the FRC has issued:

(i) 'Amendments to FRS 101 – 2015/16 cycle'; and
(ii) a proposal contained in Financial Reporting Exposure Draft (FRED) 65 'Draft amendments to FRS 101 – Notification of shareholders'.

The amendments to FRS 101 are limited (see below), and predominately provide exemptions from many of the disclosure requirements of International Financial Reporting Standard (IFRS) 15 'Revenue from Contracts with Customers'.

FRS 101 is an optional standard that allows entities within qualifying groups to prepare financial statements in accordance with IFRS, but with reduced disclosures. As part of the consultation on these amendments, stakeholders took the opportunity to provide feedback to the FRC on the existing requirement to notify shareholders before applying the disclosure exemptions in FRS 101.

Respondents felt the cost-effectiveness of this requirement, and the guidance provided to ensure consistent application, could be improved. This feedback has led the FRC to propose, in FRED 65, that notification is no longer required. It is expected that this proposal will be implemented.

Summary of changes to FRS 101

1. Equity method in separate financial statements

   Following changes that implemented the 2013 EU Accounting Directive, company law now permits the use of the equity method in an entity's individual financial statements for entities applying Schedule 1 to the Regulations. This is not the case for entities applying Schedule 2 or Schedule 3 to the Regulations. As a result, no amendments to FRS 101 itself have been deemed necessary in relation to the recent amendment to International Accounting Standard (IAS) 27 'Separate Financial Statements'. However, an additional paragraph (paragraph A2.7E) has been included in Appendix II to FRS 101: 'Note on legal requirements' to discuss this issue, as the requirements are not universal.

2 Disclosure initiative

   This International Accounting Standards Board (IASB) project (which was prompted by an earlier joint ICAS/NZICA project) was intended to clarify existing requirements and give greater guidance, particularly on the application of materiality to disclosures; the levels of aggregation (or disaggregation) permitted; and the order in which notes might be presented. As a result, it did not change disclosure requirements. However, one area where additional guidance was included relates to the systematic manner in which the notes to the financial statements are presented. UK company law contains a requirement about the order in which the notes to the financial statements shall be presented. The amendments to International Accounting Standard (IAS) 1 'Presentation of Financial Statements' paragraphs 113 and 114 do not require entities to present notes to the financial statements in an order that would conflict with this legal requirement. However, some of the examples of how to present notes in a systematic manner are unlikely to comply with company law. Therefore, an additional paragraph (paragraph A2.11A) in Appendix II of FRS 101 has been added to discuss this issue.

3 IFRS 15 Revenue from Contracts with Customers

   The FRC's Corporate Reporting Council (CRC) undertook a comparison of the disclosure requirements of IFRS 15 to the principles set out in paragraph 11 of FRS 101. Consideration was given to the principle of 'relevance' and how it should be applied in the context of disclosure by qualifying entities. It noted that qualifying entities usually have few users of their financial statements, and particularly few users that would be external to the group that the qualifying entity is part of. Any external users are likely to be providers of credit to the qualifying entity. The CRC considered that the interest which a provider of credit has in the financial statements of a qualifying entity is generally likely to be focused on information about the liquidity and solvency of the qualifying entity. This is because that information might be relevant to the ability of the qualifying entity to pay (or repay) any credit advanced. As a result, in relation to the detailed disclosures required by IFRS 15, there would be greater interest in information supporting the statement of financial position, rather than information supporting the income statement. Therefore, significant disclosure exemptions from IFRS 15 have been made available to qualifying entities as shown in Table 1.

Additionally:

(a) there is an exemption from the second sentence of paragraph 110 of IFRS 15 to remove the cross-references to these later paragraphs; and

(b) it should be noted that although paragraph 117 of IFRS 15 (from which a qualifying entity is not exempt) cross-refers to paragraph 119, it is not necessary to comply with paragraph 119 in order to meet the requirements of paragraph 117.

Effective date

The exemptions are available from when the relevant standard is applied. Therefore, there is no need to amend the effective date for these proposed amendments. However, it should be noted that the change in company law to permit the equity method in individual financial statements is effective from 1 January 2016 (or 1 January 2015 if it is applied early), which is the same date as the amendment to IAS 27.

Table 1

IFRS 15 Reference	Disclosure Exemption
113(a),	Revenue recognised from contracts with customers, which the entity shall disclose separately from its other sources of revenue
114 and 115	Disaggregation of Revenue
118	*Certain Contract balances disclosures* An entity shall provide an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period. Explanation shall include qualitative and quantitative information.
119(a) to (c)	*Certain Performance obligation disclosures* An entity shall disclose information about its performance obligations in contracts with customers, including a description of all of the following: (a) when the entity typically satisfies its performance obligations for example, upon shipment, upon delivery, as services are rendered or upon completion of services), including when performance obligations are satisfied in a bill-and-hold arrangement. (b) The significant payment terms (for example, when payment is typically due, whether the contract has a significant financing component, whether the consideration amount is variable and whether the estimate of variable consideration is typically constrained in accordance with paragraphs 56-58 of IFRS 15. (c) The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (ie if the entity is acting as an agent)
120 to 127	(i) Transaction price allocated to the remaining performance obligations (ii) Significant judgements in the application of IFRS 15; and (iii) Certain Disclosures on 'Assets recognised from the costs to obtain or fulfil a contract with a customer
129	Practical Expedients

THE SCOPE OF FINANCIAL REPORTING STANDARD 105 'THE FINANCIAL REPORTING STANDARD APPLICABLE TO THE MICRO-ENTITIES REGIME'

This article highlights:

(i) A recent extension in the scope of the micro-entity regime; and

(ii) That applicable unincorporated entities will be able to apply Financial Reporting Standard (FRS) 105.

(i) **Extension of Scope of Micro-entity Regime**

The scope of the micro-entity regime was recently widened by the UK Government. As well as applicable limited companies it now also applies to applicable Limited Liability Partnerships (LLPs) and qualifying partnerships which satisfy the relevant criteria. Further information on this is available at: **https://frc.org.uk/News-and-Events/FRC-Press/Press/2016/May/FRC-issues-amendments-to-FRS-105-to-bring-limited.aspx**.

(ii) **UK GAAP and Unincorporated Entities**

In many cases the only rules regarding the accounting framework to be applied in the preparation of accounts for unincorporated entities are to be found in tax legislation.

Broadly speaking, the tax rules require that taxable profits are derived from the accounting profit subject to any statutory adjustments required by legislation. As the accounting profit requires to be computed from extant UK Generally Accepted Accounting Principles (GAAP), continuing to use the Financial Reporting Standard for Smaller Entities (FRSSE) etc to prepare the accounts of unincorporated entities will soon no longer be possible to meet this tax requirement as old UK GAAP will no longer exist. Those entities currently applying FRSSE 2015 will need to apply new UK GAAP for accounting periods commencing on or after 1 January 2016.

When they adopt UK GAAP, unincorporated entities, subject to meeting the necessary criteria, will generally have the choice of applying:

- Financial Reporting Standard 105 'The Financial Reporting Standard applicable to the Micro-entities Regime';
- FRS 102 (Taking advantage of the presentation and disclosure requirements of Section 1A); or
- FRS 102 'The Financial Reporting Standard applicable in the UK and Republic of Ireland'.

Table 1

Type of Entity	**Financial Criteria**	**Applicable UK GAAP**
Micro-entity	Turnover not more than £632,000 Balance sheet total not more than £316,000 Not more than 10 employees	FRS 105 (Charities and certain other entities cannot adopt this)
Small	Turnover not more than £10.2 million Balance sheet total not more than £5.1 million Not more than 50 employees	FRS 102 (Including Section 1A) It is currently the view that charities cannot avail themselves of the concessions available – this may also apply to other entities
Others	Entities which do not satisfy any of the above criteria	FRS 102

These standards and any applicable updates can be viewed at: **https://frc.org.uk/Our-Work/Corporate-Governance-Reporting/Accounting-and-Reporting-Policy/New-UK-GAAP.aspx**. It should also be noted that an entity will need to make reference to FRS 103 'Insurance Contracts if it applies FRS 102 and it has either:

(a) insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds; and
(b) financial instruments (other than insurance contracts) that it issues with a discretionary participation feature.

For unincorporated entities, if the size criteria are met, and provided they are not an entity which is specifically prohibited from applying this regime, [(The Small Companies (Micro-entities' Accounts) Regulations 2013 (SI 2013/3008) (and any subsequent amendments) which amended The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409)] then HMRC will accept profits calculated in accordance with FRS 105 (Micro-entity financial reporting standards) as FRS 105 is UK GAAP compliant (subject to any tax adjustments required).

For unincorporated entities which do not meet these criteria then they will need to apply FRS 102. Entities which satisfy the small entity criteria will be able to utilise section 1A of FRS 102 and the associated reduced presentation and disclosure requirements.

Table 1 above summarises the requirements for unincorporated entities.

As noted above, the other applicable criteria should be checked. Also, for those entities applying FRS 102, they will need to also apply the requirements of FRS 103 if they have an insurance contract.

REVISED GUIDANCE FOR ICAS MEMBERS ACTING FOR SCOTTISH CHARITIES

The ICAS Charities Committee has updated its Guidance for ICAS members acting for Scottish charities for periods commencing on, or after, 1 January 2015 and before 1 January 2016. The guidance was last revised in 2011.

The Guidance has been updated to:

- Reflect changes to the accounting framework for Scottish charities, for periods commencing on or after 1 January 2015, brought about by the implementation of Financial Reporting Standard 102 and two new Charities Statements of Recommended Practice (SORPs).
- Provide commentary on the accounting framework for Scottish charities following the withdrawal of the Financial Reporting Standard for Smaller Entities (FRSSE) for periods commencing on or after 1 January 2016.
- Highlight changes to standards for auditors applicable to the audit of accounts for periods commencing on or after 17 June 2016.
- Set out changes to the Office of the Scottish Charity Regulator's (OSCR's) monitoring regime introduced on 1 April 2016.

The Guidance is available on the ICAS website at: **https://www.icas.com/__data/assets/pdf_file/0009/253692/guidance-for-ICAS-members-Scottish-Charities-Aug-2016.pdf.**

New UK GAAP and the new Charities SORPs

Following the changes to UK GAAP from 1 January 2015, including the implementation of FRS 102 and the retention of the old UK GAAP-based FRSSE, the Charity Commission for England and Wales and OSCR published two new Charities SORPs: the Charities SORP (FRS 102); and the Charities SORP (FRSSE).

The FRSSE remains in place for accounting periods commencing on or after 1 January 2015 but has been withdrawn for periods commencing on or after 1 January 2016.

FRS 102 and the Charities SORP (FRS 102) apply to Scottish charities preparing "true and fair" accounts which are ineligible to apply the FRSSE and the Charities SORP (FRSSE) or have chosen not to.

For future accounting periods, all charities preparing "true and fair" accounts will be required to follow FRS 102.

Statement of cash flows

Charities applying the Charities SORP (FRS 102) must prepare a statement of cash flows for accounting periods commencing on or after 1 January 2015 and before 1 January 2016. A statement of cash flows exemption will become available to Scottish charities with a gross income of £500,000 or less under the Charities SORP (FRS 102) for accounting periods commencing on or after 1 January 2016.

Charities applying the FRSSE and the Charities SORP (FRSSE) do not need to prepare a cash flow statement.

Charities SORP (FRS 102) and Update Bulletin 1

The amendments made to the Charities SORP (FRS 102) by Update Bulletin 1 come into force for periods commencing on or after 1 January 2016. Scottish charities are prohibited from adopting the changes early by the Charities Accounts (Scotland) Amendment Regulations 2016 (SSI 76). It is these regulations which prevent charities eligible to apply the FRSSE but choosing to apply FRS 102 from taking advantage of the statement of cash flows exemption for periods commencing on or after 1 January 2015 but before 1 January 2016.

Looking ahead to changes to the accounting framework

Following the withdrawal of the FRSSE for periods commencing on or after 1 January 2016, ICAS is of the view that all charities preparing "true and fair" accounts will have to apply FRS 102 in full and will not be able to take advantage of any of the concessions available to other small entities afforded by Section 1A of FRS 102.

Section 1A provides presentation and disclosure concessions although the recognition and measurement requirements of FRS 102 must be applied in full. FRS 102 and the Charities SORP do not explicitly address the applicability of Section 1A to charities making it necessary to consider in more detail what Scottish charities will need to do to comply with Scottish charity law.

Scottish charity law requires "true and fair" accounts to comply with the Charities SORP. A charity adopting the provisions of Section 1A is unlikely to be able to comply with the Charities SORP (FRS 102) and therefore prepare accounts which give a "true and fair" view. Therefore, it is the view of ICAS that for periods commencing on or after 1 January 2016, Scottish Charities must comply in full with FRS 102 and the Charities SORP (FRS 102).

Charities are explicitly ineligible to qualify as micro-entities and therefore cannot apply FRS 105: the FRS applicable to micro-entities.

Ethical Standards for Auditors and auditing standards

The Financial Reporting Council (FRC) has revised both its Ethical Standards for Auditors and International Standards on Auditing (UK and Ireland). The revised standards apply to audits of accounts for periods commencing on or after 17 June 2016. From this date, auditing standards are referred to as ISAs (UK).

The FRC is expected to update Practice Note 11: the audit of Charities in the UK and the illustrative auditor's reports for charities in its Compendium of Illustrative Auditor's Reports to reflect the requirements of the revised ISAs (UK).

Changes to OSCR's monitoring regime

On the 1 April 2016, following engagement with the Scottish charity sector and other stakeholders, OSCR introduced a revised monitoring regime, encompassing the following changes:

- A new Targeted Regulation framework designed to ensure that OSCR's proactive and reactive activities prioritise the protection of beneficiaries and charitable assets and the integrity of charitable status.
- A new annual return form with new questions reflecting the more targeted approach to regulation established by the new risk framework.
- A new notifiable events reporting arrangement for charity trustees to report details of any events at their own charity which have a significant impact on the charity or its assets and beneficiaries. There is no legal requirement to report a notifiable event but failure to do so may trigger a regulatory response from OSCR for non-compliance with trustees' duties in section 66 of the Charities and the Trustee Investment (Scotland) Act 2005.

In addition, OSCR is now publishing, on its website, the annual reports and accounts of charities with income in excess of £25,000 and of all Scottish Charitable Incorporated Organisations (SCIOs). As an alternative, a charity can provide OSCR with a link to its report and accounts on its own website.

ACCOUNTING AND AUDITING QUERY – DIRECTORS' LOANS

Query: *I am a partner in a small CA firm and I am about to undertake a training session for my accounting and auditing staff in relation to applying Financial Reporting Standard (FRS) 102 'The Financial Reporting Standard applicable in the United Kingdom and Republic of Ireland'. One area that I would like clarification on is in relation to accounting for directors' loans. A number of our firm's private company clients have loans of this nature. I have done some research on this topic but find it rather confusing as to how such loans should be treated.*

Answer: FRS 102 applies to applicable entities for accounting periods commencing on or after 1 January 2015.

As you indicate, it is commonplace for a company to provide loans to its directors and vice versa. Such loans are normally within the scope of section 11 of FRS 102 ie 'Basic Financial Instruments'. This is the case if the loan satisfies the specific conditions contained in paragraph 11.9 of FRS 102. If the loan does not satisfy these conditions, then it will probably need to be treated as per the requirements of section 12 of FRS 102 ie at fair value (this is anticipated to be in very rare circumstances).

Extract from FRS 102 – Paragraph 11.9

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

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

(i) a fixed amount;

(ii) a positive fixed rate or a positive variable rate; or*

(iii) [not used]

(iv) a combination of a positive or a negative fixed rate and a positive variable rate (eg LIBOR plus 200 basis points or LIBOR less 50 basis points, but not 500 basis points less LIBOR. A variable rate for this purpose is a rate which varies over time and is linked to a single observable interest rate or to a single relevant observable index of general price inflation of the currency in which the instrument is denominated, provided such links are not leveraged.)

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

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

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

(1) a change of a contractual variable rate;

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

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

(ii) the new rate is a market rate of

interest and satisfies condition (a).

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

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

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

(i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or
(ii) the holder or issuer against changes in levies applied by a central bank or arising from changes in relevant taxation or law. The inclusion of contractual terms that, as a result of the early termination, require the issuer to compensate the holder for the early termination does not, in itself, constitute a breach of this condition.

(d) [Not used]

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

Overall Summary

As noted most directors' loans will qualify as basic debt instruments. As such when a financial asset or financial liability is recognised initially, an entity will measure this at the transaction price (including transaction costs) except:

(i) if the initial measurement of financial assets and liabilities that are measured at fair value through profit or loss (unlikely to impact on directors' loans);
(ii) the arrangement constitutes, in effect, a financing transaction (see fixed term loans below).

Furthermore, consideration needs to be given as to whether a sum lent by a director to a company in which he is a shareholder is in fact a loan as opposed to a capital contribution. If there are no documented terms and the director is insistent that the loan is for the long-term then this would give weight to the argument that the amount given by the director to the company is more akin to a capital contribution than a loan.

We will now look at specific types of directors' loans:

Directors' Loans that are Repayable on Demand

On occasion there are formal written agreements in place but more often than not, such loans are made on an informal basis. Where there is no documentation of the agreed terms it is probably the case that such loans will require to be treated as basic debt financial instruments which are repayable on demand and accounted for accordingly. For a loan from a company to a director that is repayable on demand this will be shown as a current asset and for a loan from a director to a company that is repayable on demand this will be shown as a current liability. One would normally expect such loans to be recognised and subsequently measured at the transaction amount (including transaction costs) i.e. the amount that was loaned by either party.

Fixed Term Loans

Without appropriate documentation it will harder to prove that a loan is not repayable on demand. Therefore, consideration should be given to formally documenting loans where the intention is that the loan is not repayable on demand. If the conditions of a loan are documented, then it is an easy task to determine whether it is repayable on demand or rather is a fixed term loan. Fixed term loans are most probably basic debt financial instruments. Of course, every such loan would need to be considered on its own merits and the conditions applicable in paragraph 11.9 of FRS 102 considered (see above).

Another common feature of directors' loans is that even although there may be a written contract, many do not mention a rate of interest and are therefore deemed to be interest free. Furthermore, at least some such loans where the interest rate is stated will be at an interest rate which is less than the prevailing market rate. Such transactions need to be accounted for as financing transactions where they are not repayable on demand and where the interest rate is not set at the market rate. (If repayable on demand, then the present value of a financial asset or financial liability that is repayable on demand is equal to the undiscounted cash amount payable reflecting the lender's right to demand immediate repayment.) Where a loan is deemed to be a financing transaction, the initial loan recognised will be less than the amount loaned. In terms of the accounting entries, this therefore means that there will be a debit or credit measurement difference. FRS 102 is silent on how such differences should be treated. As per the Financial Reporting

Council's (FRC) Staff Education Note 16 'Financing Transactions', if the loan is from the director to the company then the difference will be a credit and in many cases will be treated as a capital contribution. If the loan is from the company to the director, then the debit difference will generally be treated as a distribution to the owner. The accounting treatment will of course depend on whether the loan was made in the director's capacity as a shareholder or for another reason. See Example 1.

When a director without ownership interest makes a loan to the entity, the director's motives have to be identified, as the director would not normally directly benefit from making a loan on these terms. The appropriate accounting for the measurement difference will be dependent on the individual circumstances of each transaction.

If the loan was from the company to the director in his capacity as a shareholder, then the difference at the outset, assuming the same figures above, would be treated as a distribution to the owner i.e. a reduction of the company's equity. A distribution recorded in the financial statements in accordance with FRS 102 may not, however, be a distribution as a matter of law. The legal requirements on distributable profits are addressed in the ICAS/ICAEW Distributable Profits guidance which is available at: **https://www.icas.com/technical-resources/updated-tech-0210-guidance-on-realised-and-distributable-profits-under-the-companies-act-2006** (Please note this remains draft at the time of writing). The presumption that the loan has been made in the director's capacity as a shareholder can be rebutted if there is evidence to the contrary eg if loans between the entity and other third parties without an ownership interest in the entity (eg employees) are made on the same or similar terms. If an interest-free loan is made between an entity and a director who has no direct ownership interest in the entity, the terms of the loan and the reasons for making need to be assessed carefully eg an entity may offer interest-free loans to all employees, including its directors, as an additional employee benefit to purchase a season travel ticket. In this situation the entity accounts for the measurement difference as an employee benefit cost in accordance with Section 28 Employee Benefits of FRS 102.

Example 1

A director provides a 3 year interest-free loan of £10,000 to a company owned by the director. The loan is considered to be provided by the director in his/her capacity as a shareholder. The market rate of interest is 4.5%. Calculating the net present value at year 0 of £10,000 due in year 3 years' time, equates to £8,763. The difference of £1,237 represents an additional investment by the owner which is recorded by the company as a capital contribution.

Year	**0**	**1**	**2**	**3**
Discount Factor		=1/(1-0.045)	$=1/(1-0.045)^2$	$=1/(1-0.045)^3$
	1	0.9569	0.9157	0.8763

Nb: Tables are also widely available which provide this type of information.

Interest at end of Year 1=10,000*0.045*0.9569 = 431
Interest at end of Year 2=10,000*0.045*0.9157=412
Interest at end of Year 3=10,000*0.045*0.8763=394

Journal Entries

At Year 0		
Dr Bank	£10,000	
Cr Loan repayable to owner/director		£8,763
Cr Capital contribution (equity)		£1,237
At End of Year 1		
Dr Interest Payable	431	
Cr Loan Repayable to owner/director		431
At End of Year 2		
Dr Interest Payable	412	
Cr Loan Repayable to owner/director		412
At End of Year 3		
Dr Interest Payable	394	
Cr Loan Repayable		394
Dr Loan Repayable to owner/director	10,000	
Cr Bank		10,000

At the end of year 3 consideration would then need to be given as to whether to leave the capital contribution as is, or more likely to write off to the profit and loss account reserve as the loan has now been repaid.

Subsequent measurement

Basic financial assets and financial liabilities are generally measured at amortised cost using the effective interest method (paragraph 11.14(a) of FRS 102). This requirement applies regardless of whether the financial asset or financial liability results from an arrangement that constitutes a financing transaction or not. The effective interest rate is determined in accordance with the requirements of paragraphs 11.16 to 11.20 of FRS 102. Assuming that the original effective interest rate, as determined at the time of the initial recognition of the loan, is a fixed rate of interest, the rate is not updated for subsequent changes to the market rate of interest.

FRS 105 – Different Requirements

The above analysis explains the situation under FRS 102. FRS 105 which applies to micro-entities (see separate article for detail on applicable scope) requires a more simplistic treatment of such loans. This can be found at section 9 of FRS 105. As per paragraph 9.5 of FRS 105, loans are initially recognised at cost, which is the transaction price ie the amount borrowed or loaned. Any related transaction costs are required to be added to the cost of a loan which is a financial asset or deducted from the cost of a loan which is a financial liability, unless they are not material in which case they are recognised immediately as an expense in profit or loss.

Subsequently, loans are measured as follows:

(a) the transaction price;
(b) plus, in the case of a loan which is a financial asset, or minus in the case of a loan which is a financial liability, transaction costs not yet recognised in profit or loss;
(c) plus the cumulative interest income or expense recognised in profit or loss to date;
(d) minus all repayments of principal and all interest payments or receipts to date;
(e) minus, in the case of a loan which is a financial asset, any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

Example 2

A micro-entity with an accounting year end of 31 December receives a loan of £10,000 on 1 January 2016. The micro-entity pays loan arrangement fees of £500. The contractual interest rate is five per cent payable annually in arrears on 31 December. The loan is repayable after two years.

The micro-entity determines that the loan arrangement fees (transaction costs) are material and on 1 January 2016 recognises the loan at its transaction price of £10,000 less the transaction costs of £500. The transactions costs of £500 are recognised in the profit and loss account on a straight-line basis over two years, ie £250 each year.

The carrying value of the loan is as follows:

Year	Carrying Amount at 1 Jan £	Interest at 5% £	Transaction costs in profit or loss £	Cash payments £	Carrying amount at 31 Dec £
2016	9,500 (10,000 -500)	500	250	500	9,750
2017	9,750	500	250	10,500	0

Allocation of interest income or expense

Total interest income or expense is the difference between the initial transaction price and the total amount of the subsequent contractual receipts or payments, excluding transaction costs. For loans this normally needs to be allocated over the term of the loan at a constant rate on the financial asset's or financial liability's carrying amount, excluding transaction costs not yet recognised in profit or loss. The applicable rate will normally be the contractual rate of interest and may be a variable or a fixed rate.

Additionally, transaction costs not immediately recognised in profit or loss are required to be recognised in profit or loss on a straight-line basis over the term of the loan. See Example 2 above.

TECHNICAL BULLETIN

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