CAPS TECHNICAL BULLETIN

ISSUE No 140
NOVEMBER 2016

MAKING TAX DIGITAL IN TEN - ALL YOU NEED TO KNOW

We had expected an announcement on Making Tax Digital (MTD) in the Chancellor's Autumn Statement, but he was totally silent on the matter. However, we have received confirmation from HMRC that the draft legislation has been delayed by a month until January 2017 to allow them to consider the 1,800 responses they received to the six consultation documents issued in August, with a further consultation to held after the draft legislation is published.

In this issue of Technical Bulletin, we look at the detail of each consultation in turn, and in this article we highlight how the biggest change in tax for twenty years will impact your practice and business.

1. MTD brings in mandatory digital records for business and landlords, with quarterly tax submissions to HM Revenue & Customs (HMRC). New businesses will have to make a first return within four months of start-up.
2. One month will be allowed to make each quarterly update; for smallest business this may just be a three-line account (we don't know the details yet): but it will have to made directly from the accounting software via a digital tax account.
3. Nine months will be permitted for a year-end finalisation – the 'quarter five'. In the consultations, HMRC envisages taxpayers submitting their own quarterly updates and agents making the final year-end update – the fifth return.
4. "Digital records" most likely means 'intelligent' digital accounting software, with the potential for scanned invoices and smart phone apps. These may be standalone or cloud-based.
5. There is a push towards cash accounting for SME businesses, with the cash accounting threshold potentially doubled (which could bring an exit level at four times the VAT threshold).
6. A new cash accounting regime is proposed for landlords – (ie unincorporated property businesses) with no turnover limit. New rules for capital/revenue divide, interest restrictions and no sideways loss relief are also proposed.
7. Third party income data from banks, employers, and potentially DWP, will be sucked into digital tax accounts: discrepancies would need to be challenged with the third party.
8. The timeline: unincorporated landlords and the self-employed with £10,000 or more gross income – start in April 2018; VAT will move onto the new system April 2019; companies by 2020. A 12 month deferral for some SME businesses (threshold to be agreed) is being considered.

ICAS

9. A voluntary "pay as you go" option is mooted – based on forecast tax liability in digital tax account.
10. A new points based penalty system for all late returns across Income Tax, VAT and Corporation Tax is proposed.

ICAS Commentary and other resources

MTD cash accounting - **https://www.icas.com/technical-resources/making-tax-digital-cash-accounting**

MTD: how will it impact your practice? - **https://www.icas.com/technical-resources/making-tax-digital-consultation-how-will-it-impact-your-practice**

MTD fact or fiction - **https://www.icas.com/technical-resources/making-tax-digital-fact-or-fiction**

Making tax digital: Complications and risks - **https://www.icas.com/technical-resources/making-tax-digital-complications-and-risks**

Making Tax Digital: A business burden too far? - **https://www.icas.com/technical-resources/mtd-a-business-burden-too-far**

Making tax digital consultation: How will it impact your practice? - **https://www.icas.com/technical-resources/making-tax-digital-consultation-how-will-it-impact-your-practice**

Making Tax Digital (MTD) - The view from ICAS - **https://www.icas.com/technical-resources/making-tax-digital-mtd-the-view-from-icas**

Crofter meets HMRC four times a year in new digital tax world - **https://www.icas.com/technical-resources/crofter-meets-hmrc-four-times-a-year-in-new-digital-tax-world**

HMRC Consultations

All consultations - **https://www.gov.uk/government/collections/making-tax-digital-consultations**

MAKING TAX DIGITAL – CASH ACCOUNTING

Creating a digital tax administration is proving a key driver of fundamental change. Some of this looks like real simplification, albeit that the transition for existing businesses could be tricky.

The "Simplifying Tax for Unincorporated Businesses" consultation has two key strands (a) extending cash accounting and (b) the reform of basis periods.

Cash accounting

The issues here are how far to extend cash accounting and how to simplify its use. There are separate proposals for a cash basis for landlords (**https://www.gov.uk/government/consultations/business-income-tax-simplified-cash-basis-for-unincorporated-property-businesses**). These will be considered in a later article.

What's on offer?

In terms of making quarterly submissions to HM Revenue & Customs (HMRC), cash accounting could look like a natural fit. The suggestion is to increase the turnover limit for cash accounting – both at entry and exit levels. A number of thresholds are considered, ranging from £100,000, to double the VAT limit (£166,000) or beyond.

This could potentially mean some businesses would remain in cash accounting until turnover reached £332,000 (four times the VAT registration threshold, and double the proposed entry limit).

From a quarterly updates angle, this level of cash accounting, when combined with making tax adjustments in the prime records in real-time, brings the possibility of just four updates a year and no need for a fifth 'year-end' update.

Accounts. Who needs them?

This turns on a fundamental question: who needs accounts? In the HMRC condoc view of life, accounts equals tax bill. If you can work out your tax bill without accounts, dispense with accounts. Now that's all well and good, but it takes a limited and ill-informed view of what a set of accounts is there to do. Accounts are not simply about tax. They're about profitability.

The business adviser's role goes beyond tax. After all, we want the business to exist next year, even to expand, and that requires accurate information for decision making. Can cash accounting provide this?

There is a danger in viewing the proposed changes in tax-only terms. Certainly there is simplification in cash accounting and cash basis submissions to HMRC. It may even mean that a business pays less tax. But looking to the wider picture, how high can we push cash basis turnover limits before we need accruals basis accounts as well in order to support loan applications, business decisions and profit allocation between partners, for example?

Non GAAP compliant accounts

Continuing the same theme, the consultation proposes that business too large for even a revised cash basis, could use non GAAP compliant accounts. This would be achieved by accepting (for tax purposes) accounts prepared on modified rules with no requirement for a year-end stock take and simplified models for long term contracts, bad debts and accruals.

Bad debts could be written off once recovery action had failed (though leaving open the question of what happens if recovery action is not taken). Accruals and work in progress adjustments would not be required where the 'timing adjustment' is under a year.

This is clearly quite fundamental change.

Reforming the capital/income divide

Continuing the same line of simplification the capital/revenue distinction has often proved contentious. The proposed levelling rule here would be to move toward a 'use up in the business' definition.

Cars, as always, would not be included. Property too would be excluded, including any fixtures included in the price. Intangible assets with a life expectancy of over 20 years would be disallowable, as would financial instruments, purchase of a business and any non-depreciating asset.

Appendix C of the consultation paper has draft legislation and an explanatory note on how this could look.

Basis periods reformed

Starting with a clean slate in a digital age, one might not have opted for a system which results in complex opening and closing year rules, where the same profits are potentially assessed more than once.

The consultation considers the position afresh. Could we have non-annual basis periods? Quarterly? Monthly? Abolish overlap relief? There could be a move towards a model more like that for companies, with final returns due nine months after the chosen accounting date, and profits apportioned to tax years.

Managing transition

The consultation has little, if anything, to say about how the transition to a new model might impact existing businesses, beyond "*the government believes that it would be beneficial to businesses for changes to be made in time for the introduction of Making Tax Digital in 2018*".

MTD - CASH ACCOUNTING FOR LANDLORDS

Income from land and property is a specialist area of tax. From rent a room to wayleaves, and sporting rights to holiday homes, it is a broad canvas with its own sub sets of rules.

The starting point for most income from land and buildings is preparation of 'trading' accounts on an accruals basis using GAAP. Specific tax rules then impact the results; bringing, for example, restrictions on loss relief and modifying expenses rules for capital expenditure for furnished holiday lettings.

Made cheaper

Overall, there is at least the hint that quarterly submissions on a cash basis will be cheaper than the current self assessment arrangements of accruals accounting and one return as year. But is the hint justified?

For the simplest, smallest cases, accruals accounting as against cash accounting may make minimal impact to the work involved. Four (or more likely, given the timescale, five submissions a year), however is likely to increase costs.

For large businesses, where accruals adjustments would be significant, accruals based accounts may also be necessary (to support lending) and only a small part of the complexity.

Topping and tailing for digital tax

How can an estimated 2.5 million unincorporated 'small property businesses' be brought more easily into quarterly reporting and digital record keeping?

The starting point, according to the consultation, is to make a new form of cash accounting available to all unincorporated property businesses; without an upper turnover limit. This would range from an individual letting out a former home, which they have been unable to sell, to potentially very large, complex property portfolios run by partnerships.

Target taxpayer

HMRC's primary target is presumably individuals with one rental property. On HMRC figures, this covers two thirds of individuals making income tax self assessment returns for property income.

Excluded are companies, trusts, real estate investment trusts, limited liability partnerships and partnerships with a corporate member. Other 'similar, more complex entities' would also be precluded from using the new cash basis.

The starting point

Cash accounting for property income is optional, and will follow the cash accounting for traders rules, with certain exceptions.

The most significant differences are the absence of an upper turnover limit and modified rules for interest, equipment and furnishings. Overseas property could be included: it is yet to be decided if a separate opt in would be available for UK and overseas property owned by the same individual(s).

Interest relief restrictions

The 2015 Budget introduced a restriction of tax relief to basic rate for interest payments on residential property lettings. This would also apply to property income taxed on the new cash basis.

Cash basis for traders has a £500 limit for deduction of interest and finance charges; this would be set aside for property income. Instead, for all properties, interest relief would be restricted to mortgages tied to property assets used in the business; and interest would be disallowed where mortgage values exceed the value of property.

Equipment and furnishing

Furnished holiday lets would be permitted to deduct initial and replacement costs for equipment and furnishings currently eligible for capital allowances.

For other property, rules would mirror the April 2016 replacement furniture allowance, with a deduction for replacements, but nothing for the initial cost.

Jointly held property

There is potential complexity here as the proposal is to let individuals who jointly own property make separate decisions on using cash basis. But, if there is a 'partnership property business' then the business would be expected to decide, and all partners would be expected to use the same basis.

Loss relief

Property income losses are already restricted (under s120 Income Taxes Act 2007), with very limited 'sideways' relief being available.

Cash basis for property income would deny all sideways relief, in line with the cash basis rules for traders. This would leave only carry forward relief.

Deposits, premiums and bad debts

The position for uncollected rent is simplified by giving immediate relief at source; but the situation with deposits potentially becomes complex.

Deposits would be treated as income and taxed on receipt by the landlord, whether they are repayable security deposits or advances of rent. Only on repayment to the tenant, or transfer to a third party tenancy deposit scheme, would they be deducted as an expense.

Lease premiums could be tricky and might be a reason for staying out of cash accounting. Para 3.22 of the consultation states that receipts normally charged to Capital Gains Tax would continue to be excluded from property income. This would include premiums on long leases and property sales.

But premiums paid on long leases would not be allowable expenses (para 3.30). To access the apportionment rules (ITTOIA 2005 chapter 3), accruals accounting would be required.

Transition - moving in and out of cash

Transition could be tricky, with particular care needed to avoid double counting of income and expenses. Capital expenditure too could bring unexpected consequences.

Moving into cash accounting, unrelieved allowable expenditure could be claimed in full (though with AIA available there may be few occasions when this would apply).

Capital expenses which have been written off under cash accounting would need to be brought back into a capital allowance pool at nil value; with the possibility of a balancing allowance on subsequent sale.

And a worrying finale

It is well known that most people browse a book from the back page forwards. Do that with the current consultation and you will start with the impact assessment. Here we read that

"*The simplification provided by the cash basis is expected to make it easier and cheaper for unincorporated property businesses to calculate tax liabilities by no longer having to compute profits in accordance with GAAP, so many property businesses <u>will avoid the need to carry out time-consuming accruals based adjustments at the end of each period</u>.*" (emphasis added).

For further clues, we have consultation question 4:

"*Does the above advice give you enough information to decide whether or not to use the cash basis <u>with/without (please indicate) professional advice</u>? If not, what else would you need to know about the new rules?*"

The punctuation in question 4 is a little ambiguous; but there is a real underlying challenge. Taxpayers are being encouraged to think of the new system as being simpler and cheaper; and that they might be able to make decisions on the suitability of cash accounting, without taking appropriate professional advice.

So what is the role of agents in future?

Changing workload

Anyone with gross rental income of £10,000 or more will need to keep records digitally and make quarterly online submissions to HMRC. It is likely that most taxpayers who use an agent will continue to do so, but the change in workload needs to be factored in.

How ready are your clients to go digital? Are they aware of how the MTD changes will impact them? What are the cost, staffing and software implications? Who will prepare and submit the quarterly updates? In most cases, a fifth year-end submission will also be needed – to be filed within none months of the accounting date. As 31 March/5 April is the usual accounting date for property income, will this mean 31 December becomes the new peak return period for income tax?

MAKING TAX DIGITAL – COMPLIANCE AND ADMINISTRATION

This the most elusive of the consultations on making tax digital. Little concrete detail is given: this is postponed to the realm of 'further consultation'.

The focus is HM Revenue & Customs (HMRC) 'Promote, Prevent, Respond' compliance strategy, aiming to:

- Promote compliance by designing it into the system and processes
- Prevent non-compliance at or near the time of filing, and
- Respond to non-compliance through a well-designed approach

Penalty points

A radical change is the indication of a future 'penalty points' system for late returns.

The exact model is up for discussion: a preferred approach would include one penalty point for each late return, with an unspecified financial penalty on reaching four points. It would take 24 months of full compliance to wipe the slate clean.

VAT default surcharge would go. The new system would apply to all returns for income tax, VAT, Corporation tax; IHT would retain its own system.

Penalty points would apply to late quarterly updates.

There are number of potential anomalies: it is suggested that penalty points should be per default date, rather than per return. So a late VAT return and a late quarterly income tax update due on the same date would register one penalty point: but if due on different dates would attract two points.

Inaccuracy penalties (of schedule 24 FA 2007) would continue, and apply to the year-end submissions.

Right first time

'*MTD will help more customers get their tax affairs right first time.*'(para 2.4). This is a very broad statement.

While 'right first time' is laudable, how is it to be achieved? HMRC's answer is that requiring taxpayers to use accounting software, which has inbuilt prompts; and channelling taxpayers through digital tax accounts, where HMRC can make available targeted information, will reduce errors.

But does this assumption stand up to challenge?

Double entry - Since 1458

Goethe called it "*one of the most beautiful discoveries of the human spirit*": and for well over 500 years, double entry book keeping has been the rock on which business, banking and trading have relied.

Double entry book keeping underpins the integrity of a set of business records, and the tax submissions and accounts prepared from them. Computerisation revolutionises the way book keeping is done, but it doesn't change the nature of debits and credits: the two-way double entry check that maintains precision.

MTS risks conflating two concepts: 'integrity of records' – that is the basic double entry checks that cash, bank and ledger accounts balance; and 'tax analysis' of the records – that all taxable income is included and only tax deductible expenses are claimed.

Integrity of the records depends on discipline, in recording, reconciling and in business behaviour. Tax analysis depends primarily on knowledge.

Digitalisation alone doesn't result in 'integrity of records'. Spaghetti in, spaghetti out.

In most cases, integrity of the records will need someone with a command of double entry book keeping.

Will MTD close the tax gap?

October 2015 saw the publication of the official Tax Gap figures for 2015. The 2016 figures must be due off the press shortly, and presumably will show a similar trend.

MTD is designed to reduce the tax gap. (Most recent published figures - **https://www.gov.uk/government/statistics/measuring-tax-gaps**).

In 2015, the tax gap was officially about £34 billion. VAT accounted for 41%; income tax, National Insurance, CGT and Corporation Tax for 38%. Some £16.5 billion, or over 48%, is attributed to 'SME' businesses.

In terms of behaviour, 46.3% (£15.7 billion) is attributed to criminal behaviour – criminal attacks, evasion, and the hidden economy; 8% is 'avoidance', 14.5% 'legal interpretation and 12% non-payments. The remaining 19.2% is failure to take reasonable care (11.5% - £3.9bn) and error (7.7% - £2.6bn).

Criminals don't keep to the rules, so it's hard to see how MTD will impact criminal attacks, evasion, and the hidden economy.

People who will drive an empty waggon out of the UK, to 'prove' that significant quantities of alcohol have been exported, so that they can sell the supposed contents of the lorry in the hidden economy, free of VAT and duty, are hardly likely to pay up under MTD.

Will MTD help with tax analysis?

Given that digitalisation alone won't fix the book keeping, will it help with tax analysis? What is the potential impact of built in software prompts, free webinars and tax tool kits?

HMRC assert that accounting software with prompts and nudges will reduce errors. Does this stand up to analysis?

The impact here is going to depend on the size and structure of the business and the nature of the taxpayer. It may also depend on cost.

Large business

For large businesses, with dedicated accounts staff, it seems unlikely that it will make any difference. There is also the practical problem that point of data input nudges and prompts are likely to be ineffective where tax and accounting treatment differs.

Tackling errors – small and medium sized business

Moving on to smaller businesses, we enter a very diverse market.

For those with agents, the same arguments apply as for larger business. Professional review keeps errors to a minimum. One professionally-reviewed digital submission nine months after the year-end without quarterly updates, looks a winner compared with four (or five) submissions without professional review: but current proposals require quarterly figures for every unincorporated landlord or business with over £10,00 gross income.

Given the cost implications of assisting clients with quarterly updates, or potentially unscrambling self-submissions at the year-end, lack of professional representation could be the stark option for some small businesses.

Small business is messier

The nearer we move to micro-business, the more complex the situation becomes. Life is messy. From 'I'll paint your house if you give me that car', to the sole trader throwing a business toner cartridge into the supermarket shopping trolley with the grocery shopping, it is very unlikely that there will be an appropriate digital 'prompt' because the accounting software won't know.

It can't predict that Uncle Brian bought the brake pads for Joyce's pickup on his credit card, in return for a crate of beer. So the brake pads are a genuine business expense, but there is no expense in cash or via the bank to match.

High volume, low quality data?

At micro-business level, prime-time needs to make money: book keeping comes lower on the list. Spending more time and money on record keeping (which at this level MTD will certainly bring) is not high priority.

There is potentially a choice between a reasonably priced, once a year service from a professional agent, who plugs the gaps in incomplete records; and self-submission, where it is eminently possible to submit digital garbage, where even the usual balances and check of reconciling cash and bank have been overlooked.

It is unlikely that HMRC will have the resources to correct high volume, low quality data where the tax yield from an enquiry would be low, and the client would be unable to pay.

Partnership, estimates and discoveries

There are other proposals for change in the Consultation, though little detail is given. Partnerships; estimated assessments; compliance powers, all these are likely to face changes.

For example, on estimated assessments, HMRC's powers to raise a determination under self assessment would be replicated and applied to year-end declarations.

But as regards timelimits, we are told '*the safeguard that customers should be able to supersede the determination if the customer completes their End of Year declaration within 12 months of the determination*,' will be 'replicated'.

This is only one leg of the current rules: the timelimit is the later of 12 months from the issue of a determination or three years from 31 January self assessment filing date.

But if there is no longer a self assessment filing date, have we reduced the timeframe from 3 years to potentially just 12 months?

Workloads and timeframes

How are these changes going to impact workload, and how is compliance activity likely to impact strategy? If a client self-submits for four quarters, and the accountant needs to re-write the figures at the End of Year submission, have we just flagged to HMRC than the client has incomplete records?

If quarterly submissions are late, then the penalty clock could be ready to strike even before the End of Year update. Who is going to chase interim submissions?

MAKING TAX DIGITAL – INTERFACING WITH HMRC IN REAL-TIME – ALL THE TIME

The consultation on Transforming the tax system through better use of information is unique among the six Making Tax Digital consultations in that it is focussed almost exclusively on HM Revenue & Customs (HMRC) and how it can make taxpayers' lives easier through using information it already holds.

But don't be misled by the title: this heralds fundamental change in how taxpayers, agents and HMRC interact. It ushers in a real-time system with more frequent contact, more review, less data origination, with far reaching implications for workloads, costs and timetables,

No more duplication

HMRC receives information from employers, financial institutions and other government departments about employment income, interest on savings, pensions and benefits. Currently, many self-assessment taxpayers need to re-supply this information to HMRC, in some cases, with few additional details.

With slicker use of data, HMRC aims to put the information it already holds into individual taxpayer's digital tax accounts, so all the taxpayer (or their agent) needs to do is double check and fill in the gaps. The role of agent (and taxpayer) is set to change from preparer to reviewer.

Unnecessary errors

A quick review of tribunal cases for careless error will show penalty charges for innocent errors in reporting information which HMRC already held. For example, the Tribunal recently confirmed a £1,141.87 careless error penalty on the footballer, Nicholas Blackman, when one of his three employment was missed from his self assessment return (**Nicholas Blackman [2016] UKFTT 0465 (TC) TC05218**).

The prime reason HMRC suspected a mistake was that it already held employment information from all three of Mr Blackman's employers!

Real-time change

HMRC is also looking at month by month PAYE reconciliations – aiming to avoid, or reduce, year-end PAYE under and overpayments. The current system of PAYE tax codes was not designed for the modern labour market with multiple employments, fluctuating earnings, and potentially a mix of different income sources, from employment, pensions, property and some freelance earnings.

Real-time adjustment of PAYE tax codes is due to start from April 2017. Explanations of why tax code changes are being made will be given via the taxpayer's digital tax account.

For employers, and more particularly, payroll providers, the other side of the equation is much higher frequency of tax code changes. And while the employee in HMRC's examples, uses HMRC webchat, webinars and a digital tax account to understand the changes, it is not impossible that many employees will simply contact HR or the payroll provider by telephone.

The first question in the consultation is about the frequency of such employer notifications.

Not just for employees

The bulk of the consultation focuses on five 'case studies' – a pensioner and four employees, none of whom have a tax agent. But the implications of HMRC's use of information reaches beyond the P800 employee into the agent-zone of directors and self assessment employees, with potentially very complex tax affairs.

HMRC envisages postal and text alerts to taxpayers in real-time. When HMRC becomes aware of changes that affect a taxpayer's liability, through employer or bank information feeds, the taxpayer will receive an alert to check, or create, a digital tax account in order to find out what is going on.

Savings income

The Personal Savings Allowance is expected to mean that 95% of savers have no income tax liability on savings income. However, for the 5% who still have tax to pay, with the end of tax deduction at source on most forms of interest, there could be an unexpectedly large tax bill.

So HMRC is aiming to use bank data on savings to amend tax codes for individuals with taxable savings – starting from October 2016. This is not going to be universal, and as HMRC will be using the previous year's income figures, it may not be entirely accurate.

Looking to April 2018, HMRC wants to be updating PAYE codes for interest more frequently.

Rental and self employed income below £10,000

From 2018, taxpayers who are not required to keep digital records and make quarterly submissions to HMRC will be able to 'opt out' of self assessment by using a personal digital tax account to interact with HMRC. Taxpayers would need to check that their digital tax account record was accurate and complete at least annually.

End of the tax return

For employees with rental or self employed income of £10,000 or more, there will be prompts each quarter to upload the additional details from their digital records. Tax which is not collected under PAYE (for example because it would exceed the maximum deduction allowed), may be paid as you go by direct debit, or at the year end. The in-year liability will be estimated within the digital tax account. The year-end procedure will involve confirming that the information in the digital tax account is complete and correct: this will replace the annual SA tax return.

Data - accuracy and security

With all this information flow of personal data, there will be 'robust matching to the correct customer'. Taxpayers will be allowed to 'query' information held by HMRC: the default is that third party supplied information is correct.

Privacy issues come to the fore with jointly held assets; with HMRC assuming a 50:50 split. Banks and other third parties, will be supplying more detailed information to HMRC and more frequently. Data security and data protection will be paramount.

Correcting information – third party assessment or self assessment?

Where a taxpayer thinks that information held by HMRC is incorrect, the default will be for the taxpayer to contact the third party provider and arrange for the third party to correct the error. This is a far cry from the principle of self assessment.

The recent case of **Robert King ([2016] UKFTT 409 (TC) TC05163)** reported this June, suggests a very different interpretation – that an individual's self assessment is just that. Individual partners were allowed to use their own calculation for their share of partnership income on their personal tax return, even when this differed from that shown on the partnership return.

MAKING TAX DIGITAL – BRINGING BUSINESS TAX INTO THE DIGITAL AGE

This is a mammoth document, running to 78 pages and 44 questions. It would be hard to overstate the depth of change. We have mandatory accounting software and quarterly updates to HM Revenue & Customs (HMRC). Basis periods are revolutionised. Overlap relief goes out. It is the most radical change in twenty years. It comes on a very tight timescale.

Simple and cost saving?

Unincorporated businesses and landlords join MTD from April 2018. There is possibly 12 months' delay for the smallest businesses, and exemption for gross incomes under £10,000. VAT joins MTD from April 2019 and companies from April 2020. It's a challenging schedule.

The foreword to the document sets the tone:

'*This reform does not mean 'four tax returns a year'. In fact, it will eliminate the burdensome annual return and simplify tax for businesses.*'

In this context, digital tax means digital accounting. It is hard to see where MTD will save businesses money, but digitalisation and cloud accounting might. The guide, "How to create your firm's cloud proposition" looks at how this might work. (**www.cloudproposition.co.uk**)

The annual tax return disappears, to be replaced by four quarterly 'updates' and a year-end submission or declaration.

Results for agents

All this has very significant implications for agent workload, resourcing and firm structure. Agents have an opportunity to improve profitability, but there is also a significant risk of being left behind in a rapidly changing market.

Agents: Preparers or reviewers?

The focus of the consultation is on bringing record keeping into real-time, and incorporating tax adjustments (such as for apportionment and disallowable expenses) into the accounting records.

Businesses will use apps and software packages to enter data, and 'get it right first time' due to prompts, nudges and the overall constraint of digital accounting.

The role of the professional adviser changes to reviewer, rather than preparer. Digital accounts will be pre-populated with third party data, from banks, DWP and employers. Partnership profit shares may even be streamed in from the partnership digital tax account.

With adjustments made at the point of data entry, quarterly and year-end submissions become a "check and change" routine.

This is the ideal. And for straightforward SME businesses which operate on cloud - or large firms - the transition may be relatively straightforward.

Results for business

Businesses with a turnover above £1.5 million, probably need regular management accounts. With in-house staff and external professional advisers, the MTD transition may be within reach.

From £1.5m down to the VAT registration threshold, we have a diverse range of business using a combination of accounting package, stand-alone, bespoke and cloud, as well as spreadsheets and paper records.

There is a significant distance for these businesses to travel before they have MTD compliant digital records. Within this group, there are many business sectors where quarterly figures would appear to be of very limited value, or simply an additional and unwelcome expense – both in terms of time and money.

For the non-VAT registered business and individual, the changes required are likely to be even more extensive. A change in lifestyle and attitudes would be needed in many cases.

Help from HMRC

HMRC webchat, virtual assistants, messaging, webinars and tax toolkits take stage front positions. The new policy is 'one to many' communication rather than the one to one of telephone and face to face.

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 a very big gap between HMRC's expectations and reality.

Quarterly submission 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 such figures would be of limited value – an issue that is acknowledged in the consultations, but not resolved.

Digital records

The position of spreadsheets is undecided. It would seem likely that digital book keeping software, rather than spreadsheets, will the norm.

HMRC is keen to see prompts and nudges within the book keeping package, with a view to error reduction; and the data must feed directly into the business digital tax account from the accounting software – which spreadsheets alone will not do.

Digital records and agents

Client book keeping software will be connected to HMRC's system, via the client's Business Tax Account. (see p8 fig 1.2). This contrast 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 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.

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

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. This does not generally match practitioner experience. Businesses have an agent so they don't need to make cutting-edge decisions and judgment calls.

Start thinking now

This is a long consultation paper, but it is worth reviewing.

The gaps are as important as the text itself. Look at the impact assessment, from p67 onwards. This indicates savings to business of £250 million and increased tax revenue mounting to £625 million by 2020-21.

The impact of all these changes is likely to vary greatly between different businesses and accounting practices.

MTD – PAY AS YOU GO

Voluntary pay as you go will be an option for landlords and the self-employed who fall within the new quarterly reporting regime. The aim is for PAYG to cover income tax, National Insurance and capital gains tax from the start of April 2018. It would be extended to VAT from April 2019.

There is a further extension planned, which would see companies in the scheme by 2020.

What's new

Statutory payment dates remain. We already have payments on account, and budget payment plans, so what is new here?

Under voluntary PAYG, payments will be made digitally, and need not be regular or planned. They will normally be allocated to tax liabilities on a first in first out basis. One option is for taxpayers to be prompted to make a payment at the time quarterly updates are made.

Alternatively, ad hoc payments are envisaged as an option.

Overpayments

The aim is for voluntary payments to be based on the information in quarterly updates. This could result in overpayments, for instance if early quarters show profits that are reduced by events in later quarters, such as bad debts, or purchase of machinery or equipment.

The system therefore needs to be capable of refunding amounts voluntarily paid. This functionality will be built in, but it is unclear exactly how it will work.

Payments on account

Payments on account could continue, as under current rules, or be replaced by mandatory payments based on quarterly updates.

HM Revenue & Customs (HMRC) is looking at an option for taxpayers to choose to hold refunds in their digital tax accounts as 'voluntary credits', rather than receive a refund via the bank.

Adding VAT

From April 2019, the intention is for VAT to be included. Amounts due to HMRC would still be taken from amounts paid voluntarily via the digital tax account. This potentially could cause confusion if amounts set aside by the taxpayer for, say, an income tax liability, were used to cover a current VAT bill.

Paying for the partnership

Consideration is being given to allowing partnerships to make voluntary tax payments on behalf of the individual partners.

More widely, consideration is being given to the possibility of permitting 'third party' voluntary payments - such as by one member of a couple on behalf of the other.

Incentives to use PAYG and possibility of earlier repayment

HMRC is looking at possible incentives to encourage PAYG. These could include interest on in-hand balances to streamline repayments. The possibility of earlier or more frequent Research and Development tax credit is suggested.

Complex area

Tax bills can be confusing. The concepts behind payments on account are not always clear to the self-employed. Budgeting for tax bills can be difficult, especially for start-up businesses.

There is the potential for voluntary PAYG to positively impact the situation here, but it needs practical insight. Despite the welcome possibility of earlier certainty about tax liabilities, the complexity of the system, coupled with the uncertainties of business, mean that there may be few for whom this becomes a reality.

Danger zone

It is likely that for the majority, an accurate estimate of the income tax and class 4 NIC liability will only be available after the year-end update.

This has very significant impact for the design of the system. Mandatory payments based on quarterly updates could produce a new world with alarming and unrealistic fluctuations in tax liability – with very significant cash flow implications.

Keeping liquidity

A payment cycle which treats tax as a normal 'running cost' of the business, and one to be included in the usual commercial payment cycle is to be welcomed. It would help to avoid the potentially destabilising, initial tax bill for the self employed start up: the big bang with a slow fuse.

Balanced against this is the possibility of unrealistic voluntary payments potentially damaging business liquidity.

The heading of the consultation is 'voluntary pay as you go', but by paragraph 3.4, the phrase 'if payments on account were mandatorily based on the quarterly updates submitted so far', means we enter a very different world.

Confusion or simplification

VAT is government money collected by business. Income tax, and other direct taxes, are payments out of the business owner's profit. There is no hint in the consultation of ever adding in employers' PAYE contributions to this mix.

But is this 'spaghetti mix' of saving for tax going to make it easier for businesses to plan their payments?

TRAVEL AND SUBSISTENCE RULES - WE DISCUSS THE CHANGES AND WHY YOU NEED TO SPEAK TO YOUR CLIENTS ABOUT THEM

New legislation (Part 2, Chapter 7 Income Tax (Earnings and Pensions) Act 2003, section 44(1) Social Security (Categorisation of Earners) Regulations 1978 (SI 1978 No 1689), Regulations 1(2) and 2, Schedule 1, Part 1, paragraph 2 and Schedule 3, paragraph 2) and guidance (**https://www.gov.uk/government/publications/employment-intermediaries-personal-services-and-supervision-direction-or-control/employment-intermediaries-personal-services-and-supervision-direction-or-control**) on the travel and subsistence (T&S) restrictions came into force on 6 April 2016 and the 2016 Finance Act confirms a number of important amendments from the last Budget and Autumn Statement.

The changes affect contractors operating through intermediaries (like umbrella companies, Managed Service Companies and Personal Service Companies) and who are subject to the "*supervision, direction or control*" (SDC), or the right of SDC, of another person. An 'employment intermediary' is defined as "*a person, other than the worker or the client who carries on a business … of supplying labour.*"

The change has been introduced due to HM Revenue & Customs (HMRC) perception of unfair advantage relating to contractors who can claim tax relief on T&S connected to what is essentially ordinary commuting, while employees cannot.

The worrying thing about this is the vast number of agencies, intermediaries and contractors who may not think this legislation applies to them. If you have a contractor client operating through a personal service limited company, you should be talking to them about how this change affects them.

Agency workers

T&S restrictions could apply where there is a "*tripartite relationship between a worker, an agency and a client, and where more than one intermediary is involved.*" Restrictions on T&S will apply by default if any worker is deemed to be personally providing services. Sending a substitute worker or not specifying which worker is personally providing a service will not get them out of the restrictions.

Supervision, direction and control (SDC)

HMRC has toughened up its stance on whether SDC exists in the relationship between the parties. "*HMRC don't consider signed waivers and generic statements that the manner in which the worker personally provides the services is not subject to (or the right of) SDC as satisfactory evidence.*" T&S restrictions will apply if HMRC is not satisfied that SDC is absent from the relationship. Clear and unambiguous tests need to be established by HMRC to assist employers in proving the absence of SDC - otherwise it is likely that tribunal cases will follow. We already know that the question of employment status is a grey area and this could end up the same way unless HMRC provides something useful.

SDC concerns itself with how the role is carried out and the responsibilities of the job according to three tests:

Supervision - Someone oversees the work being done and ensures work is carried out to the required standard.

Direction - Someone provides instructions, guidance or advice as to how to execute the job.

Control - Someone dictates what work a person does and how they should go about doing it, including moving someone from one job to another.

If just one of the three tests applies to the contractor, then travel and subsistence relief is denied. Contractors will, therefore, only be able to continue claiming T&S tax relief if they can show that they work independently and in the absence of any SDC.

Contractors working through agencies will automatically be considered to be under SDC (Section 44 (2) ITEPA 2003), which of course means that they are also deemed to be IR35 workers due to the existence of what is essentially an employment relationship, but for the existence of the intermediary.

What must Agencies now do?

The agency must provide quarterly reports to HMRC containing details of payments to any workers placed with clients where no PAYE has been operated.

Where no such payments have been made, the agency must continue to submit nil reports until a period of four consecutive nil returns have been submitted.

No HMRC reports are due if the following apply:

- UK employer
- Supplies workers to provide their services to end clients and nobody else is involved (such as intermediaries)
- PAYE is deducted from the payments made to the workers

When making a report the intermediary is required to provide their full name, address and postcode and details of the engagement and payments made which will include:

- Workers' full name, address and postcode
- National Insurance number
- Date of birth and gender

The report will also request a reason as to why PAYE was not operated. Reasons could include:

- Self employed
- Partnership
- Limited liability partnership
- Limited company including personal services companies
- Non-UK engagement
- Another party operated PAYE on the worker's payments.

The Employment Intermediaries Coordination Unit (EICU)

EICU is a specialist unit which helps agencies and similar labour-supply businesses comply with the rules. The EICU can be contacted on 03000 555995.

HMRC will apply automatic penalties to employment intermediaries who fail to submit a report each quarter from August 2016.

Penalties and appeals

The amount of the penalty is based on the number of offences in a 12-month period:

- £250 will be charged for the first offence
- £500 for the second offence
- £1,000 for the third and later offences
- A maximum of £3,000 per quarter

Daily penalties for persistent offenders

Where there is a continued failure to send reports, or where reports are frequently sent in late, penalties of up to £600 per day that the report is late (more than 30 days), may be charged.

There is a right of appeal and details will be included within the penalty notice. All appeals and cancellations will be handled by the HMRC EICU.

CONSUMER CREDIT – WHAT DO FIRM'S NEED TO KNOW?

I It has now been over two years since the Financial Conduct Authority (FCA) took over the regulation of consumer credit. This article aims to provide you with a quick update on what to look out for in your practice.

Who regulates?

Similar to investment business, if your firm only conducts consumer credit activities which are incidental to other professional services conducted for your clients, you do not require to obtain a Financial Conduct Authority (FCA) authorisation, as long as you are eligible to fall within the DPB (Consumer Credit) regime of ICAS or another accountancy body. The eligibility of firms is discussed further below. If you are conducting more mainstream consumer credit-related activities, which are not incidental, then you will require FCA authorisation.

However, a quirk of the legislation requires each firm to hold the same status of authorisation for consumer credit and investment business. This means that if a firm is FCA authorised for investment business, the firm must also extend the authorisation with FCA to cover consumer credit and vice-versa, unless the activities are conducted in separate legal entities.

What is the ICAS DPB regime?

ICAS has in place a DPB (Consumer Credit) regime to ensure that we can regulate our firms conducting incidental consumer credit activities, rather than these firms having to be regulated by the FCA.

Our DPB (Consumer Credit) Handbook (**https://www.icas.com/__data/assets/pdf_file/0005/236264/Designated-Professional-Body-Consumer-Credit-Handbook.pdf**) (effective from 1 April 2016) sets out the key consumer credit regulations that DPB (Consumer Credit) firms need to comply with. These firms are monitored against the handbook requirements as part of the Practice Monitoring visit. The handbook is a tenth of the size of the full FCA Handbook that FCA authorised firms require to comply with!

The Handbook sets out which firms are eligible to be ICAS DPB (Consumer Credit) firms. In a nutshell, if 50% or more of the voting rights in the firm are held by ICAS Chartered Accountants you can automatically avail of the DPB regime, without the need for **an application or fee**.

If your firm does not meet this requirement, it can still become eligible by applying, and paying, for either a DPB (Investment Business) Licence or audit registration with ICAS. Firms regulated by ICAS for insolvency or anti-money laundering are also eligible.

Who is a consumer client?

A credit-related activity is only regulated if it is provided to a "consumer client", who is defined in legislation as:

- an individual that is a natural person;
- a partnership consisting of 2 or 3 persons of which at least 1 partner is an individual; or
- an unincorporated body that does not consist entirely of bodies corporate and that is not a partnership.

If the credit-related activity is not provided to a "consumer client", then it is not regulated. Watch out for debt administration though where the definition of consumer client is different (please see the handbook).

What are consumer credit activities?

Our Guidance on Consumer Credit Activities (**https://www.icas.com/__data/assets/pdf_file/0007/238813/Guidance-on-Credit-Related-Regulated-Activities-final.pdf**) should help you identify regulated activities. Here are the most typical examples:

Fee payment by instalment ("entering a regulated credit agreement")

Allowing clients to pay fees by instalment is potentially exempt if correctly structured. Instalment credit agreements entered into after 18 March 2015 where the debt is settled in 12 instalments or less in a 12-month period, with no interest or charges (except default/late payment charges) are exempt and are not regulated credit agreements. To use the exemption there must be a written agreement, e.g. an engagement letter or standard terms entered into with clients after 18 March 2015. Our example wording is:

"*We offer you the facility to pay your professional fees by [monthly][quarterly] instalments. We do not charge any interest or charges [except for default charges]. As these terms have been agreed after 18 March 2015 this instalment agreement is not a regulated credit agreement.*"

Any instalment agreements entered into before 18 March 2015 are more limited. These are exempt credit agreements where there are 4 payments or less in a 12 month period, with no interest or charges (except for default charges). All other instalment arrangements are regulated, and require to be conducted by a DPB (Consumer Credit) firm, under the requirements of the DPB Handbook.

Referring clients to a lender/finance company ("credit broking")

Where your firm refers consumer clients to a lender/finance company for either assistance with payment of fees, or for other personal loans, this is the regulated activity of credit broking, regardless of whether the underlying loan is exempt. Such activities can only be carried out by a DPB (Consumer Credit) firm, complying with the Handbook requirements.

Providing debt advice ('debt counselling')

Debt counselling is providing advice to a consumer client about the liquidation of a debt due under a specific regulated credit or consumer hire agreement. To be classed as debt counselling, the advice must relate to a particular debt and it must be more than simply providing information. The advice provided must steer or influence the client into a specific course of action. If you simply advise clients to speak to their creditors it is likely to be generic, as not offering a solution, and as such would not be considered debt counselling. However, if you then go on to advise which creditors to pay and prioritise that debt, you could be providing debt counselling.

Advice of this type can only be carried out by a DPB (Consumer Credit) firm applying the Handbook requirements. DPB (Consumer Credit) firms cannot provide Debt Management Plans, which is restricted to FCA authorised firms.

New debt counselling guidance is about to be launched in the consumer credit section of our website which will signpost the key areas to look out for.

What are the handbook requirements?

Part 4 of the Handbook sets out how DPB (Consumer Credit) firms should conduct credit-related regulated activities to consumer clients.

One requirement is that a DPB (Consumer Credit) firm informs consumer clients of the firm's status under the Act. Part 4 also covers areas such as engagement with the consumer client, competence, record keeping, complaints resolution, accounting for commission and the best interests of the client.

Schedule 4 of the Handbook provides suggested paragraphs for engagement letters, covering terms of engagement and complaints resolution. There is no requirement for a DPB (Consumer Credit) firm to include a legend on its letterhead, however Schedule 4 provides a specimen legend if required.

Whilst most of our firms are not conducting many, if any, credit-related activities it is a technical area and easy to stray into unintentionally or to get wrong. We would advise you to familiarise yourself with the Handbook and with the free advice and support available on the consumer credit (**https://www.icas.com/regulation/consumer-credit**) section of our website.

AUDIT EXEMPTION: A PRACTICAL GUIDE FOR SCOTTISH CHARITIES

Most Scottish charities will be below the audit threshold in terms of size. Some charities which are below the audit threshold will receive an audit because their constitution requires one or due to trustee or donor preference. ICAS members acting for charities in this position should encourage the trustees to review on a regular basis whether an audit is the required or is the most appropriate form of scrutiny for the charity. Where donor preference is the only reason for undertaking an audit, charity trustees should be encouraged to engage with donors to establish whether an audit is really necessary to meet their needs.

Only accountancy firms which are registered to undertake audit work can audit a charity. All Scottish charities not receiving an audit will require an independent examination.

This article is part of a series of articles for Technical Bulletin on audit thresholds relevant to periods commencing on or after 1 January 2016, although there have been no recent changes to the audit threshold for Scottish charities.

Company and non-company charities

The Charities Accounts (Scotland) Regulations 2006 (as amended) (the 2006 accounting regulations (as amended)) state that a charity must be subject to audit by a registered auditor if in any financial year:

- it has gross income of £500,000 or more; or
- the aggregate value of its assets (before deduction of liabilities) at the end of the financial year exceeds £3,260,000; or
- it is required to do so by the constitution of the charity, any other enactment, or on the instruction of its trustees.

For charitable companies the audit threshold set out in the 2006 accounting regulations (as amended) will trigger an audit as the income condition and asset condition is stricter under charity law than under company law.

Receipts and payments accounts: non-company charities only

Charities eligible to prepare receipts and payments accounts may need an audit if the constitution of the charity, another enactment, or the trustees or donors require one. Receipts and payments accounts are not required to give a true and fair view therefore the auditor will be required to give an opinion on whether the accounts properly present the receipts and payments of the charity for the financial year and the assets and liabilities of the charity reported in the statement of balances.

Requirements for charitable companies

The audit arrangements for charitable companies were complicated following the removal of special provisions relating to charities from company law by the Companies Act 2006. This change has allowed an interpretation of the law whereby a charitable company, which is below the audit threshold in the Companies Act 2006 but is being audited, can opt for an audit solely under Scottish charity law. ICAS takes the view that it is good practice for entities to be audited under all applicable legislation therefore we strongly recommend that charitable companies being audited are audited under both company law and Scottish charity law.

We do not believe that it is appropriate for a charity to include an audit exemption statement on its balance sheet claiming exemption from audit under company law to then receive an audit under charity law. This gives the misleading impression that an audit under charity law is less rigorous. Therefore, engagement letters and auditor's reports for charitable companies should refer to the Charities and Trustee Investment (Scotland) Act 2005, the Charities Accounts (Scotland) Regulations 2006 (as amended) and the Companies Act 2006. However, if a decision is taken to audit a charitable company solely under charity law, the audit firm should check with its professional indemnity insurance provider to discuss any implications for its insurance cover.

Entitlement to audit exemption: group situation

If the charity is a component of a group then both the group and the individual audit exemption conditions must be met in relation to charity law and company law, where applicable. In group situations it may be necessary to seek specialist assistance. Under the 2006 accounting regulations (as amended), where a parent charity is required to prepare groups accounts ie the gross income of the group (after consolidation adjustments) is £500,000 or more those accounts must be audited.

For more information on the financial reporting framework for Scottish Charities, read our latest 'Guidance for ICAS members acting for Scottish charities' available on **www.icas.com**.

Look out for an article on the audit exemption for charities in England and Wales in the next edition of Technical Bulletin.

NEW AUDIT EXEMPTION RULES FOR GROUPS

Background

The EU Accounting Directive, effective for accounting periods commencing on or after 1 January 2016 and introduced in the UK primarily by Statutory Instrument 2015/980, has led to an increase in the audit exemption threshold for small companies and groups.

In issue 137 of Technical Bulletin, we considered how the revised qualifying conditions relate to small companies. In this issue, we consider how the revised qualifying conditions relate to group companies.

Group company revised qualifying conditions

A parent company qualifies as a small company in relation to a financial year only if the group it heads qualifies as a small group. To qualify as small in relation to the parent's first financial year, the qualifying conditions must be met in that year.

A group qualifies as small in relation to a subsequent financial year of the parent company if the qualifying conditions are met in that year. In relation to a subsequent financial year of the parent company, where on the parent company's balance sheet date the group meets or ceases to meet the qualifying conditions, that affects the group's qualification as a small group only if it occurs in two consecutive financial years.

The qualifying conditions are met by a group in a year in which it satisfies two or more of the requirements in Table 1 below.

Net means after any set-offs and consolidation adjustments made to eliminate group transactions. Gross means without those set-offs and other adjustments.

A group may satisfy any of the individual conditions using either the net or the gross figure, or a combination of both. Gross figures are calculated by the simple addition of the amounts appearing in each company's accounts. Net figures are those after consolidation adjustments, such as the elimination of intra-group sales and balances. A group may qualify on the basis of either the net or gross figures, and they can be mixed and matched to achieve exemption from audit, if so desired.

Table 1

	New Threshold	**Previous Threshold**
Turnover	Not more than £10.2 million net (£12.2m gross)	Not more than £6.5 million net (£7.8m gross)
Balance Sheet Total[1]	Not more than £5.1 million net (£6.1m gross)	Not more than £3.26 million (£3.9m gross)
Number of Employees[2]	Not more than 50	Not more than 50

[1] Balance sheet total means the sum of all the amounts shown as assets in the balance sheet (ie fixed assets plus current assets) without any deduction for liabilities.

[2] Number of employees is calculated by summing the number of persons employed under contracts of service by the company in each month (whether throughout the month or not), dividing by the number of months in the financial year.

First time application

On first application of the new increased audit exemption thresholds, in the simplest terms, an eligible group will qualify as small, and hence be eligible for audit exemption, if it satisfies the revised qualifying conditions in its current financial year and its previous financial year.

A group is ineligible if any of its members is:

(a) a traded company;

(b) a body corporate (other than a company) whose shares are admitted to trading on a regulated market in an EEA State;

(c) a person (other than a small company) who has permission under [Part 4A] of the Financial Services and Markets Act 2000 (c 8) to carry on a regulated activity;

(d) an e-money issuer;

(e) a small company that is an authorised insurance company, a banking company, a MiFID investment firm or a UCITS management company; or

(f) a person who carries on insurance market activity.

Subsidiary exemption

A company is exempt from the audit requirements in the Companies Act 2006 Act for a financial year if:

(a) it is itself a subsidiary undertaking; and

(b) its parent undertaking is established under the law of an EEA State.

Exemption is conditional upon compliance with **all** the following conditions:

(a) all members of the company must agree to the exemption in respect of the financial year in question;

(b) the parent undertaking must give a guarantee under section 479C (see below) in respect of that year;

(c) the company must be included in the consolidated accounts drawn up for that year or to an earlier date in that year by the parent undertaking in accordance with:

  (i) the provisions of Directive 2013/34/EU of the European Parliament and of the Council on the annual financial statements, consolidated statements and related reports of certain types of undertakings; or
  (ii) international accounting standards.

(d) the parent undertaking must disclose in the notes to the consolidated accounts that the company is exempt from the requirements of the Act relating to the audit of individual accounts under section 479A; and

(e) the directors of the company must deliver to the registrar on or before the date that they file the accounts for that year:

  (i) a written notice of the agreement referred to in (a):
  (ii) the statement referred to in section 479C(1) of the Companies Act 2006;
  (iii) a copy of the consolidated accounts referred to in (c);
  (iv) a copy of the auditor's report on those accounts; and
  (v) a copy of the consolidated annual report drawn up by the parent undertaking.

A company is not entitled to the exemption conferred by section 479A if it was at any time within the financial year in question:

(a) a traded company as defined in section 474(1);

(b) a company that:

  (i) is an authorised insurance company, a banking company, an e-money issuer, a MiFID investment firm or a UCITS management company; or
  (ii) carries on insurance market activity; or

(c) a special register body as defined in section 117(1) of the Trade Union and Labour Relations (Consolidation) Act 1992 (c 52) or an employers' association as defined in section 122 of that Act or Article 4 of the Industrial Relations (Northern Ireland) Order 1992 (SI 1992/807) (NI 5).

Parent company guarantee

The parent guarantee referred to earlier is a guarantee given by a parent undertaking under section 479C whereby the directors of the subsidiary company deliver to the registrar a statement by the parent undertaking that it guarantees the subsidiary company under this section.

This statement must be authenticated by the parent undertaking and must specify:

(a) the name of the parent;

(b) if the parent is incorporated in the United Kingdom, its registered number (if any);

(c) if the parent is incorporated outside the United Kingdom and registered in the country in which it is incorporated, details of where it is registered and its registration number;

(d) the name and registered number of the subsidiary being guaranteed;

(e) the date of the statement; and

(f) he financial year to which the guarantee relates.

Any guarantee given under this section means that the parent guarantees all the subsidiary's outstanding liabilities at the end of the financial year subject to the guarantee, until they are satisfied in full, and is enforceable against the parent by any person to whom the subsidiary is liable in respect of those liabilities.

Examples – group companies

Let us consider some examples of how the new qualifying conditions affect group results:

Example 1a Group A (financial year end 31/12/16)

	2016 £	2015 £
Group turnover	19,000,000	20,500,000
Group balance sheet total	11,900,000	12,700,000
Number of employees in group	67	65

NB: The above figures are assumed as gross for the purposes of this example.

In the above example, group A breaches all three of the revised qualifying conditions in both 2015 and 2016. Therefore, the small group exemption would not be available and an audit would be required.

Examples – group companies (Cont'd)

Example 1b Group B (financial year end 31/12/16)

	2016 £	2015 £
Group turnover	12,200,000	9,800,000
Group balance sheet total	6,500,000	4,800,000
Number of employees in group	45	40

NB: Once again, the above figures are assumed as gross for the purposes of this example.

In the above example, Group B meets 2 out of 3 of the revised qualifying conditions in 2016 and all three in 2015. Therefore, the small group exemption would be available and an audit would not be required.

IMPORTANCE OF CASH FLOW STATEMENTS HIGHLIGHTED

The recent outcome of the Financial Reporting Council's (FRC) disciplinary case relating to two professional accountants with responsibility for treasury functions of Connaught plc has highlighted the importance of the cashflow statement. The cash flow statement is of course a primary statement in a set of financial statements except where an exemption is available.

The case related to the incorrect accounting of a £4 million short-term loan in Connaught's 2010 interim financial statements. The short-term loan was made by the CEO of Connaught shortly before its 28 February half-year end, and substantially repaid between 15 March and 29 April 2010. The £4 million was not accounted for as a loan, but rather as credit to the supplier rebate account which formed part of the overall 'Trade and other payables' balance contained in the balance sheet of the Interim Financial Statements. The amount received from the director should have been classified as a loan within 'Borrowings' in the consolidated interim balance sheet and within 'Net debt' in the 'Analysis of net debt'.

This incorrect posting had a direct knock-on effect on how the transaction was reflected in the company's cash flow statement. The interim financial statements were materially misleading in that cash flows from operating activities were overstated by £4 million and net cash generated from financing activities was understated by £4 million. This materially increased Connaught's cash conversion rate. But for the loan, the Group would have fallen somewhere between 6 and 11% short of their 70% cash conversion target. This ratio was one of a number of key measures used by analysts and one upon which investors rely – and a figure that was especially important to Connaught at the beginning of 2010. In addition, the loan was not disclosed to the Audit Committee or the auditors; neither was it disclosed as a related party transaction, as it should have been.

Although the root cause of this issue was an incorrect posting of a transaction to the nominal ledger, this case also highlights the importance of the cash flow statement and that where required, care should be taken to ensure that the information within it is properly presented.

ACCOUNTING AND AUDITING QUERIES

Query: *I am a Financial Controller in a large private manufacturing company and I am preparing the company's first financial statements under Financial Reporting Standard (FRS) 102 for the year to 30 September 2016. I am currently trying to decide on the correct disclosure, on transition to FRS 102, for the significant costs incurred during a legal dispute which were presented as an exceptional item in the comparative year. On reading the standard, unlike the former applicable standard (FRS 3 'Reporting Financial Performance), I cannot see any reference to exceptional items.*

In the prior year, the operating profit was split on the face of the Profit & Loss Account, as per FRS 3, to show the amount of operating profit attributable before and after the exceptional item. Therefore, for consistency and clarity, it would have been helpful to show a similar presentation in the comparative column this year, but I am unsure whether this would be acceptable under FRS 102. Please can you confirm if the concept of exceptional items is considered in FRS 102 as there does not appear to be anywhere appropriate to allocate this on transitioning to the new UK GAAP?

Answer: FRS 102 does not make any reference to exceptional items therefore it would be advisable not to use this term. Nevertheless, that term has been commonly used in relation to old UK GAAP financial statements and some preparers may prefer to continue with this approach. If so, then the notes to the financial statements would need to include a definition of the term because it is not defined in FRS 102.

Paragraph 5.9A of FRS 102 requires separate disclosure of the nature and amount of any material items of profit or loss. Materiality could be determined by reference to an item's size or nature, or a combination of both. This is likely to become the norm under FRS 102 and the term "exceptional items" will disappear in due course. Disclosure of such information should be made on the face of the statement of comprehensive income (or, if presented, the income statement) by means of additional line items or headings if such presentation is deemed relevant to understanding the entity's financial performance. [FRS 102 para 5.9]. Otherwise, such items should be disclosed in the notes.

It should also be noted that the former approach under FRS 3 of including certain categories of exceptional item after operating profit no longer applies when applying FRS 102. These former categories were commonly known as 'non-operating exceptional items' ie:

- Profits and losses on the sale or termination of an operation;
- Costs of a fundamental reorganisation or restructuring that have a material effect on the nature and focus of the company's operations; and
- Profits or losses on the disposal of fixed assets.

FRS 102 adopts a different approach and, although separate disclosure or presentation of material items is required, if 'operating profit' is presented, it must include all items that are operating in nature. The end result is that items that were formerly presented after operating profit under FRS 3 will now be shown before operating profit under FRS 102. Likewise, Comparative amounts are restated accordingly."

Query: *I am the auditor of a small private non-charitable company. The company is currently preparing a set of abbreviated accounts and I am unclear as to whether there remains a need for a special audit report on such accounts and if so, whether this report should still refer to Bulletin 2008/4, 'The special auditor's report on abbreviated accounts in the United Kingdom' issued by the old Auditing Practices Board (APB), given that this has been withdrawn. Can you confirm whether this bulletin should still be referred to?*

Additionally, it is my understanding that abbreviated accounts cannot be prepared for accounting periods beginning on or after 1 January 2016, so for periods beginning before that date, provided that the September 2015 version of Financial Reporting Standard (FRS) 102 is not adopted early, am I correct in thinking that the company can still therefore prepare abbreviated accounts for the purposes of filing with Companies House?

Answer: The Financial Reporting Council (FRC) consulted on the withdrawal of Bulletin 2008/4 to take effect as of the date that the revised International Standards on Auditing (UK) become effective, that is for accounting periods commencing on or after 17 June 2016. You should therefore continue to prepare a special auditor's report and refer to the bulletin when your client is preparing abbreviated accounts.

On your second point, small companies that decide to early apply FRS 102 or FRS 102 including Section 1A – small entities (as introduced by Statutory Instrument 2015/980) no longer have the option to file abbreviated accounts at Companies House. The earliest applicable period to which early adoption can be applied is for accounting periods commencing on or after 1 January 2015.

The option to file abbreviated accounts is removed from the date at which a small company adopts the new legislative regime which becomes mandatory for accounting periods commencing on or after 1 January 2016. Therefore, small companies which are still using the

Financial Reporting Standard for Smaller Entities (FRSSE) which is acceptable for accounting periods commencing before 1 January 2016 will be entitled to file abbreviated accounts, while those early adopting FRS102, as discussed above, must comply with the new filing arrangements.

Medium sized companies will still be able to file medium-sized abbreviated accounts for accounting periods beginning before 1 January 2016.

Query: *I am the auditor of a medium sized private company. I wonder if you could help me with a query relating to unaudited comparatives? This is the first year that our client will be audited and we would like to put a note in the independent auditor's report relating to the prior year stock being unaudited. Can you provide any guidance as to whether such a statement is permitted and if so, how it should be presented?*

Answer: There is some guidance available in paragraph 14 of International Standard on Auditing (ISA) (UK) 710: Comparative information on suggested disclosures within the independent auditor's report where prior year figures have not been audited: **https://frc.org.uk/Our-Work/Publications/APB/ISA-710-Comparative-information-corresponding-figu.pdf**.

The guidance suggests the inclusion of an 'Other Matter' paragraph in the auditor's report stating that the corresponding figures are unaudited. However, this statement does not remove the requirement for the auditor to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

It is also best practice to include the word 'Unaudited' above the comparative figures in the accounts to make it clear that the prior year figures have not been subject to audit.

CAPS TECHNICAL BULLETIN

ICAS

CA House 21 Haymarket Yards Edinburgh EH12 5BH
practicesupport@icas.com +44 (0) 0131 347 0249 icas.com