



# The Consultative Committee of Accountancy Bodies

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The Association of Chartered Certified Accountants  
The Chartered Institute of Management Accountants  
The Chartered Institute of Public Finance and Accountancy

## REVISED STATEMENT OF RECOMMENDED PRACTICE (SORP) ON ACCOUNTING BY LIMITED LIABILITY PARTNERSHIPS (LLPS)

### An Alert to practising firms from the Consultative Committee of Accountancy Bodies

#### 1. Why am I receiving this Alert?

By the end of March, the CCAB is expected to have issued a revised Statement of Recommended Practice on *Accounting by Limited Liability Partnerships*. This is likely to have a major impact on the accounts of many LLPs; in particular:

- many balances that would previously have been classified as members' capital will now be classified as debt; and
- in some cases, members' profit shares will be treated as a charge to the profit and loss account rather than as appropriations.

This note alerts members to the changes in accounting by LLPs, explains the reasons why they are required and sets out what the CCAB and members can do to manage any potential impact of these changes.

#### 2. Why has the SORP been revised?

FRS 25 (IAS 32) *Financial instruments - Disclosure and presentation* and UITF Abstract No 39 *Members' shares in co-operative entities and similar instruments* came into force for accounting periods beginning on or after 1 January 2005. Implementing these accounting standards raises difficult issues for LLPs, and the CCAB was anxious to ensure that formal guidance was in place for members and their LLP clients.

The SORP requires approval by the Accounting Standards Board (ASB) before it can be issued, and must therefore comply with the ASB's interpretation of accounting standards. The draft SORP is still awaiting approval by the ASB at the time of issue of this Alert.

### **3. What are the key provisions of the SORP?**

*The distinction between debt and equity* Under the SORP, members' participation rights (broadly, the rights of a member against the LLP, including rights relating to amounts subscribed, remuneration and profits) must be analysed between those that are, from the LLP's perspective, either a financial liability or equity, in accordance with FRS 25 and UITF 39. A member's participation right will result in a liability except to the extent that the right to any payment or repayment is discretionary on the part of the LLP. The broad consequence of this is that in many cases members' interests that would previously have been regarded as capital will now be classified as debt due to members (because, for example, the member is entitled to have the capital repaid on ceasing to be a member). LLPs could have no equity capital, at least in accounting terms.

*Profit and loss account implications* The SORP will require the treatment of members' remuneration in the profit and loss account to be based on the same principles as are used for determining debt and equity in the balance sheet: where the LLP has no discretion over the payment of a benefit to a member it should be charged as an expense in the profit and loss account. The broad consequence of this is that members' profit shares will in a number of cases be treated as an expense in the profit and loss account rather than as an equity appropriation. (Previously, only remuneration paid under a contract of employment would have been treated as a charge to profit and loss.) For example, where all the profits are automatically divided without the need for a decision by the members, the members' remuneration will all be charged as an expense

*Post-retirement payments to former members ('annuities')* The SORP will require the liability for non-discretionary post-retirement payments to current and former members to be accrued as the rights to the payments accrue. Such a right will in many cases arise during the period of a member's service to the LLP. Previously, the liability would only have been recognised on the member's retirement.

### **4. Won't this make the financial statements less useful?**

Some may regard these changes as counter-intuitive and unhelpful in the case of an LLP. However, the definition of financial liability in FRS 25 with which LLPs must comply leaves very little, if any, room for interpretation on this issue. In order to make the financial statements clear and perhaps more user friendly, the SORP provides some helpful guidance and also some suggested formats for the balance sheet and profit and loss account which minimise the impact of the changes on the presentation of the financial statements. These were published in the exposure draft, which can be found at <http://www.ccab.org.uk/PDFs/SORPEXposureDraft.pdf>.

### **5. Are small and medium-sized LLPs affected?**

The SORP emphasises that it does not override exemptions for smaller entities in legislation or accounting standards, and in particular that the Financial Reporting Standard for Smaller Entities (FRSSE) takes precedence over the SORP. However, while the main part of the requirements of FRS 25 have not been incorporated into the 2005 version of the FRSSE, the definition of financial liabilities and a requirement to present those separately from equity (paragraph 12.1 of the FRSSE) have been included and these are important for the accounting for members' participation rights.

## **6. Will the new accounting have any practical consequences?**

The CCAB has identified areas where the new accounting may affect LLPs' relations with third parties. These relate to the Financial Services Authority, regarding the capital requirements of regulated LLPs, and the Pension Protection Board, regarding insolvency scores calculated for the Pension Protection Levy.

## **7. What is the position with regard to regulated LLPs?**

Authorised professional firms are not subject to the FSA's capital adequacy requirements, except that they must be able to meet their debts as they fall due, and will therefore be unaffected.

Some other regulated LLPs may need to re-examine the basis on which certain regulatory returns are compiled. While the amount of regulatory capital of an LLP is not determined by the accounting treatment, measurement is based on the accounting. The debt/equity classifications required under FRS 25 may therefore highlight issues regarding the amount of Tier 1 capital available to meet the capital requirements of regulated LLPs.

The FSA is giving urgent consideration to the implications of the SORP and potential ways in which any potential regulatory impact may be mitigated. At the time of issue of this Alert, no final decision has been taken. However, the CCAB welcomes this initiative and believes it is very important to remove any uncertainty for affected LLPs. The CCAB is continuing to work with the FSA to achieve this goal.

## **8. What about the Pension Protection Levy?**

The reclassification of members' capital as debt due to members could have an effect on the risk-based levies to be imposed by the Pension Protection Board. The CCAB is seeking to clarify this with Dun & Bradstreet, the company calculating insolvency scores.

## **9. Are there any potential tax consequences?**

The CCAB believes that there should be no adverse income-tax consequences of applying the SORP, given the tax transparency of LLPs (ie, given that members of an LLP are taxed as if they were partners in a general partnership). The CCAB is nevertheless seeking urgent confirmation from HM Revenue & Customs that the changes set out in the SORP will not alter the way in which members of an LLP are currently taxed; and, in particular, clarification:

- that members' profit shares from an LLP will continue to be treated in the same way as if they were partners; and
- that any balances due to members will continue to be treated as if they comprised an interest in a partnership.

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