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The Institute of Chartered Accountants in England and Wales
The Institute of Chartered Accountants of Scotland
The Institute of Chartered Accountants in Ireland
The Association of Chartered Certified Accountants
The Chartered Institute of Management Accountants
The Chartered Institute of Public Finance and Accountancy

Statement of Recommended Practice

Accounting by Limited Liability Partnerships

Effective for periods commencing on or after 1 January 2010

31 March 2010

STATEMENT OF RECOMMENDED PRACTICE

ACCOUNTING BY LIMITED LIABILITY PARTNERSHIPS

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PREFACE

Background to the SORP

This Statement of Recommended Practice (SORP) is issued by the Consultative Committee of Accountancy Bodies (CCAB), the members of which are:

The Institute of Chartered Accountants in England and Wales
The Institute of Chartered Accountants of Scotland
The Institute of Chartered Accountants in Ireland
The Association of Chartered Certified Accountants
The Chartered Institute of Management Accountants
The Chartered Institute of Public Finance and Accountancy

The Accounting Standards Board (ASB) has approved the CCAB for the purpose of issuing a recognised SORP for Limited Liability Partnerships (LLPs) incorporated in Great Britain under the Limited Liability Partnerships Act 2000 ('2000 Act'). As part of the process for obtaining this approval, the CCAB agrees to follow the ASB's Code of Practice for bodies recognised for issuing SORPs. The Code of Practice sets out procedures to be followed in the development of SORPs. These procedures do not include a comprehensive review of the proposed SORP by the ASB, but a limited review is performed.

SORPs issued by SORP-making bodies include a statement by the ASB that:

(i) outlines the limited nature of the review that the ASB has undertaken; and

(ii) confirms that the SORP does not appear to contain any fundamental points of principle that are unacceptable in the context of current accounting practice, or to conflict with an accounting standard or the ASB's plans for future standards.

The ASB Statement is included on page 5.

CCAB Steering Group and Working Party

The SORP for LLPs differs from a number of other SORPs in that it does not apply to a specific industry or sector, but to a legal entity.

The process of developing and reviewing the SORP is overseen by a Steering Group. Membership of the Steering Group is drawn both from trades and professions that have member firms that commonly have LLP status, including the accountancy and legal professions and the construction industry, and from amongst users of LLP accounts. The Steering Group deals with strategy and high-level issues, while the Working Party concentrates on technical detail.

Membership of these two groups at 31 March 2010 is set out below.

Steering Group

Andrew Vials (Chairman)	The Institute of Chartered Accountants in England and Wales
Jonathan Beckerlegge	The Association of Chartered Certified Accountants
David Berragan	Barclays plc
Matt Blake	HMRC
George Bull	Construction Industry Council
Ian Dinwiddie	Allen & Overy LLP
Steve Gale	The Institute of Chartered Accountants of Scotland
Peter Graham	The Law Society
Barry Lawson	British Venture Capital Association
Frances Paterson	Construction Industry Council
Peter Saunders	SORP Working Party
Richard Turnor	Association of Partnership Practitioners
David Tyrrall	Department for Business, Innovation and Skills

Working Party

Peter Saunders (Chairman)	Deloitte LLP
Phil Barden	Deloitte LLP
Kathryn Cearns	Herbert Smith LLP
Hannah King	PricewaterhouseCoopers LLP
Yvonne Lang	Smith & Williamson Limited
Janet Marton	KPMG LLP
David Snell	PricewaterhouseCoopers LLP

Review of the SORP

The ASB approved the CCAB for the purposes of issuing a SORP on 2 March 2000. The first edition of the SORP *Accounting by Limited Liability Partnerships* was published on 29 May 2002, and the second edition on 31 March 2006. In keeping with the ASB's Code of Practice, the CCAB reviews the SORP for changes in accounting practice and new developments, and accordingly published an Exposure Draft of a revised SORP for public comment on 29 July 2009. As well as requesting comments on all aspects of the Exposure Draft, certain issues on which the CCAB particularly sought views were also presented, as discussed in the Basis for Conclusions in Appendix 6.

All responses to these questions and regarding other matters were carefully considered during the development of the final version of the revised SORP. The ASB approved the SORP for publication on 18 March 2010 and the third edition of the SORP *Accounting by Limited Liability Partnerships* was published on 31 March 2010

Future editions of the SORP

In keeping with the ASB's Code of Practice, the CCAB will keep the SORP under review for changes in accounting practice and new developments.

Note on legal issues

The SORP discusses a number of legal issues relating to LLPs. Such discussion is included solely to explain the principles adopted in the SORP and should not be relied upon for any other purpose.

STATEMENT BY THE ACCOUNTING STANDARDS BOARD ON THE SORP 'STATEMENT OF RECOMMENDED PRACTICE: ACCOUNTING BY LIMITED LIABILITY PARTNERSHIPS'

The aims of the Accounting Standards Board (the ASB) are to establish and improve standards of financial accounting and reporting, for the benefit of users, preparers, and auditors of financial information. To this end, the ASB issues accounting standards that are primarily applicable to general purpose company financial statements. In particular industries or sectors, further guidance may be required in order to implement accounting standards effectively. This guidance is issued, in the form of Statements of Recommended Practice (SORPs), by bodies recognised for the purpose by the ASB.

The Consultative Committee of Accountancy Bodies (the CCAB) has confirmed that it shares the ASB's aim of advancing and maintaining standards of financial reporting in the public interest and has been recognised by the ASB for the purpose of issuing SORPs. As a condition of recognition, the CCAB has agreed to follow the ASB's code of practice for bodies recognised for issuing SORPs. The code of practice sets out procedures to be followed in the development of SORPs. These procedures do not include a comprehensive review of the proposed SORP by the ASB, but a review of limited scope is performed.

On the basis of its review, the ASB has concluded that the SORP has been developed in accordance with the ASB's code of practice and does not appear to contain any fundamental points of principle that are unacceptable in the context of current accounting practice or to conflict with an accounting standard or the ASB's present plans for future standards.

18 March 2010

STATEMENT OF RECOMMENDED PRACTICE
ACCOUNTING BY LIMITED LIABILITY PARTNERSHIPS

INTRODUCTION

Accounting requirements

1. The detailed accounting requirements relating to Limited Liability Partnerships (LLPs) are currently set out in the following Statutory Instruments:

   - The Limited Liability Partnerships (Accounts and Audit) (Application of Companies Act 2006) Regulations 2008 (SI 2008/1911);

   - The Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912); and

   - The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1913).

   These are collectively referred to in this SORP as the ‘Regulations’. The Regulations apply to accounts for financial years commencing on or after 1 October 2008, replacing the accounting provisions previously contained in the Limited Liability Partnerships Regulations 2001 and the Limited Liability Partnerships Regulations (Northern Ireland) 2004. The Regulations apply, with modifications, the accounting and auditing provisions of the Companies Act 2006 to LLPs. The Regulations apply to the whole of the United Kingdom, reflecting the scope of the Companies Act 2006. Statements of Standard Accounting Practice (SSAPs), Financial Reporting Standards (FRSs), UITF Abstracts and other components of UK Generally Accepted Accounting Practice (GAAP) also apply to any financial statements of LLPs intended to give a true and fair view. They do not apply where the LLP adopts International Financial Reporting Standards (IFRS).

Scope and objectives

2. This statement applies to LLPs incorporated in the United Kingdom under the Limited Liability Partnerships Act 2000, or which were incorporated prior to 1 October 2009 under the Limited Liability Partnerships Act (Northern Ireland) 2002, that report under UK GAAP. It does not seek to set out all of the reporting requirements that apply to LLPs reporting under UK GAAP and it is intended to complement, not replace, accounting standards, which comprise FRSs, SSAPs and UITF Abstracts. This statement should therefore be used in conjunction with the Regulations and accounting standards rather than on a stand-alone basis. In the event of conflict, the Regulations and accounting standards take precedence over this SORP.

3. The recommendations of this SORP are applicable to all LLPs, as defined in paragraph 13, that do not adopt IFRS. (For LLPs that follow the Financial

Reporting Standard for Smaller Entities (FRSSE), see paragraphs 27 - 29 below). The ASB has no authority to frank guidance on IFRS, and interpretations of IFRS are not permitted. Application of the SORP is therefore restricted to LLPs complying with UK GAAP.

Measurement

4. There are a number of standards that are relevant to the measurement of the type of financial liabilities, provisions and other financial instruments dealt with in the SORP. FRS 26 (IAS 39) *Financial Instruments: Measurement* will only be mandatory for those LLPs which prepare accounts in accordance with the fair value accounting rules for financial instruments set out in the Regulations or are otherwise required to follow FRS 26, for example due to debt securities being listed. In this respect paragraph 1B of FRS 26 provides further guidance as to when the fair value accounting rules and thus FRS 26 would apply.

5. On the assumption that FRS 26 is not applied by an LLP, then the relevant measurement standards include:

   (a) For provisions recognised in accordance with FRS 12 *Provisions, Contingent Liabilities and Contingent Assets* that standard itself contains appropriate measurement principles (see paragraph 86 below for those FRS 12 obligations for which the measurement approach in FRS 17 *Retirement Benefits* is appropriate).

   (b) For equity instruments and financial liabilities within the scope of FRS 25 *Financial Instruments: Presentation* then the relevant measurement literature would generally be either (i) FRS 4 *Capital Instruments* for financial liabilities that meet the definition of a capital instrument or (ii) the general provisions of the Companies Act/GAAP for equity instruments and all other liabilities. In this respect, as explained in paragraph 81 below, where such a liability is of uncertain timing or amount, then it is likely that the measurement principles in FRS 12 will be relevant.

   The guidance given in these standards is considered comprehensive enough that no further guidance is necessary in the SORP.

Format and terminology

6. All the material in this Statement is an integral part of the SORP. However, the central principles are printed in bold in order to distinguish them from explanatory paragraphs.

7. For simplicity, the term ‘profits’ has been used rather than ‘profits or losses’ where circumstances allow. Similarly, the term ‘year’ has been used rather than ‘period’.

Definitions

8. The following definitions apply within this SORP.

Allocated profit

9. Profits (after deducting members' remuneration charged as an expense) that have been allocated during the year as a result of the members deciding on a division of profits.[1]

Automatic division of profits

10. An automatic division of profits is one where a member has an entitlement to a share of future profit without the need for any further decision by the members on the division of those profits. Such a pre-agreed automatic division of profits could be in respect either of the entire profits for the year or a portion or fixed amount thereof. If the automatic division does not relate to the entire profits for the year, the fact that the actual amount allocated to the member is contingent on the existence of profits in the first place does not negate the member's unconditional entitlement to those profits nor the LLP's unconditional obligation in respect of those profits.

Designated members

11. Designated members are those members specified as such in the incorporation document or otherwise in accordance with an agreement with the other members, as required under the 2000 Act. Designated members perform certain duties in relation to the legal administration of an LLP that would, for a company, be performed by the secretary or directors. If there would otherwise be no designated members, or only one, all members are deemed to be designated members.

Drawings

12. The payment in cash (or kind) of amounts to members. Drawings may consist of regular monthly payments or *ad hoc* payments; for example, in respect of current year's and/or prior years' remuneration (as defined).

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[1] The decision to divide profits, which gives rise to a liability in respect of allocated profits, must be distinguished from the arrangements for profit sharing. A provision in an agreement between the members which sets out the profit shares of the members does not of itself constitute an agreement for the division of profits. It merely sets out the respective profit shares of the members that will apply to those profits that the members decide to divide among themselves. Accordingly, the default rule that is applied by virtue of Regulation 7(1) of the Limited Liability Partnerships Regulations 2001 (which provides for the members of an LLP to share equally in the capital and profits of an LLP in the absence of agreement to the contrary) does not constitute a default rule as to the automatic division of profits between the members. (As explained further in paragraph 48, where the agreement between the members provides for the automatic division of profits, those divided profits will form part of members' remuneration charged as an expense and will be credited directly to the current accounts of the members without being first shown under the balance sheet heading 'Other reserves'.) Allocated profits are debts due to members which, unless otherwise agreed by the members, rank *pari passu* with ordinary creditors in the event of a winding up. The total amount of profit allocated following a decision to divide may be less (or more) than the amount of profit earned by the LLP in the relevant year.

Limited liability partnership (LLP)

13. A limited liability partnership incorporated in Great Britain under the Limited Liability Partnerships Act 2000.

Loans and other debts due to members

14. Members' interests that are debts of the LLP and are included in balance sheet item J in the accounts formats set out in the Regulations.

Members

15. On incorporation, the members of an LLP are the persons who subscribe their names to the incorporation document. Persons may become or cease to be members in accordance with an agreement between existing members.

Members' agreement

16. Any agreement express or implied between an LLP and its members that determines the mutual rights and duties of the members in their capacity as such and their rights and duties in relation to the LLP. An agreement between the members, to which the LLP is not party - for example, an agreement to guarantee a minimum or specified remuneration for a particular member - does not constitute a members' agreement for the purposes of the SORP.

Members' capital

17. Amounts subscribed or otherwise contributed by members that are classified as capital by the constitutional arrangements of the LLP. Such amounts will require analysis as to whether they are considered equity or debt in accordance with FRS 25 (IAS 32) and UITF Abstract 39 *Members' Shares in Co-operative Entities and Similar Instruments*. Members' capital is a component of 'Members' other interests' or 'Loans and other debts due to members' depending on its classification under FRS 25 and UITF 39.

Members' other interests

18. Members' interests other than debt due to them by the LLP, which constitute equity in the LLP and are included in balance sheet item K in the accounts formats set out in the Regulations. Members' other interests include 'Members' capital' that is classified as equity in accordance with FRS 25 and UITF 39, 'Revaluation reserve' and 'Other reserves'.

19. *Members' participation rights*

All the rights of a member against the LLP that arise under the members' agreement (for example, in respect of amounts subscribed or otherwise contributed, remuneration and profits).

Members' remuneration

20. Any outflow of benefits to a member. It may include or comprise, but is not limited to, one or more of the following elements: salary, interest, bonus, risk premium and allocated share of profits. The form that remuneration takes will be a matter of agreement between the members.

Members' remuneration charged as an expense

21. Remuneration that is payable to a member, which falls to be treated as a charge against profits and not an allocation of profits. The treatment of members' remuneration in the profit and loss account is determined by reference to the nature of the participation rights that give rise to the remuneration. If the members' remuneration gives rise to a liability in accordance with FRS 25 and UITF 39, then it is charged as an expense. Members' remuneration charged as an expense is not restricted to amounts that are payable by the LLP regardless of the existence or extent of profits; it also includes, for example, any profits that are automatically divided between members by virtue of a members' agreement. Members' remuneration charged as an expense may in some exceptional circumstances be a negative amount. A member can also legally be an employee of an LLP - in this case, there will be a contract of employment between the two parties - and such remuneration covered by the employment contract is classified as members' remuneration charged as an expense, including amounts relating to pension obligations.

Post-retirement payments to members

22. Any post-retirement payments, whether in cash, in kind or any other benefits, including annuities and payments for goodwill, payable by the LLP as principal to former members of the LLP, other than where the payments are properly made in return for post-retirement services performed by the recipient for the LLP's benefit. Members who retire by or at the balance sheet date are regarded as former members. Such post-retirement payments include, but are not limited to, amounts payable to, for example, spouses, children and the estates of former members. In this context, former members may include former partners in a predecessor partnership of the LLP, where the LLP assumes responsibility for the post-retirement payments to the former partners.

Puttable instrument

23. The definition of 'puttable instrument' is contained in FRS 25. A puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder (paragraph 11 of FRS 25, as amended in August 2008.) In practice for LLPs, puttable instruments may include certain types of capital or members loans which carry rights for the member (or other holder) to obtain repayment from the LLP.

Unallocated profit

24. Profits of the LLP (after deducting members' remuneration charged as an expense) that have been ascertained but which are not yet divided among the members. After the profits have been ascertained, in the absence of any agreement between members to the contrary, the balance on profit and loss account will be unallocated profit and will need to be shown under 'Other reserves' on the balance sheet, pending a decision to divide the profits among the members. It is open to the members of an LLP to agree that all, or a proportion of, the profits of the LLP shall be automatically divided between the members after they have been ascertained; in that event, the LLP will not have an unconditional right to avoid delivering cash or other assets to a member in

respect of those amounts. This is a matter of construction of the members' agreement. Where this is the case, any amounts automatically divided will form part of members' remuneration charged as an expense, i.e. they will be deducted in arriving at retained profit or loss for the financial year available for discretionary division among members. Accordingly, where all the profits are automatically divided, a nil amount will be reported as retained profit or loss for the financial year available for discretionary division among members, and there will be no unallocated profits.[2]

THE CONTENTS OF THE ANNUAL REPORT AND FINANCIAL STATEMENTS

25. The Annual Report should comprise:

- **the financial statements;**
- **a statement of members' responsibilities in relation to the production of financial statements;**
- **a report on the financial statements by a registered auditor, if required by the Regulations; and**
- **a report to the members (the Members' Report).**

26. The financial statements, as defined by the Regulations and accounting standards, should, subject to the exemptions for small and medium-sized entities, comprise:

- **a profit and loss account, consolidated in the case of a group preparing consolidated accounts;**
- **a statement of total recognised gains and losses (STRGL) in accordance with FRS 3 *Reporting Financial Performance*, consolidated in the case of a group preparing consolidated accounts;**
- **a cash flow statement in accordance with FRS 1 *Cash Flow Statements*, consolidated in the case of a group preparing consolidated accounts;**
- **a balance sheet for the LLP and, if it prepares group accounts, a consolidated balance sheet; and**
- **notes to the above financial statements.**

Accounting by smaller LLPs

27. Exemptions from disclosure are likely to apply in cases where an LLP is eligible to apply the FRSSE (interpreted as appropriate for LLPs).

28. As noted in paragraph 2 above, in the event of conflicting requirements, those in the Regulations or accounting standards (including the FRSSE) should take precedence over this SORP. The SORP should not be interpreted as removing or not permitting exemptions for certain smaller entities in legislation or

2 See the legal opinion in Appendix 5.

accounting standards, including those from the need to prepare group accounts or cash flow statements.

29. On other matters the SORP sometimes includes references to specific accounting standards. Those preparing financial statements in accordance with the FRSSE should interpret these as referring to the related requirements that are generally included in the FRSSE (which includes as appendices tables of derivations and simplifications from other accounting standards). In particular, LLPs entitled to use the FRSSE should note that while the main part of the requirements of FRS 25 have not been incorporated into the 2008 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. (See also paragraph 45 below.) The ASB has advised that at this time it does not intend to amend the FRSSE to reflect the August 2008 changes made to FRS 25.

30. The Members' Report should disclose the following information:

- **the principal activities of the LLP and its subsidiary undertakings, indicating any significant changes during the year;**
- **an indication of the existence of any branches[3] outside the UK;**
- **the identity of anyone who was a designated member during the year; and**
- **the policy of the LLP regarding members' drawings and the subscription and repayment of amounts subscribed or otherwise contributed by members (see paragraph 69 below).**

31. The financial statements and related notes cannot on their own describe in full the financial performance of an LLP, nor by definition will they encompass non-financial performance matters that some LLPs will wish to communicate to the users of the Annual Report. Although not a statutory requirement, the Members' Report offers a vehicle for such communication, with the disclosures listed in paragraph 30 above required as a minimum.

[3] As defined by s 1046(3) CA 2006.

THE APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRACTICE TO LIMITED LIABILITY PARTNERSHIPS

MEMBERS' REMUNERATION AND INTERESTS

Analysing members' participation rights

32. **Members' participation rights in the earnings or assets of an LLP should be analysed between those that give rise to, from the LLP's perspective, either a financial liability or equity, in accordance with FRS 25 and UITF Abstract 39. Members' different participation rights should be analysed separately into liability and equity elements. Depending on the terms of the members' agreement, members' participation rights may give rise to equity or liabilities or both.**

33. Under FRS 25 and UITF 39, a critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation of one party to deliver either cash or another financial asset to another party. Critical, therefore, to determining whether the LLP has a financial liability to a member, or alternatively the member holds equity in the LLP, is whether there exists a contractual obligation on the part of the LLP to deliver cash (or other financial assets) to the member - for example, on the member retiring from or otherwise leaving the LLP. Generally, a member's participation right will result in a liability unless either the LLP has an unconditional right to avoid delivering cash or other assets to the member (i.e. the right to any payment or repayment is discretionary on the part of the LLP) or certain conditions are met for puttable instruments and amounts payable on liquidation. Following the amendment to FRS 25 in August 2008 (the 'puttables amendment' – see paragraph 40 below), where the conditions are met for puttable instruments and amounts payable on liquidation, such instruments will be classified partly or wholly as equity even though the LLP does not have an unconditional right to avoid delivering cash or other assets to the member. The amendment to FRS 25 does not require rights which have been classified as members' equity to be reclassified as a financial liability of the LLP in any circumstances. The flowcharts included in Appendix 3 form part of the SORP and are intended to set out the various tests to be applied to members' interests in order to ascertain whether they fall to be treated as liabilities or equity.

34. Participation rights in respect of amounts subscribed or otherwise contributed should be analysed separately from participation rights in respect of remuneration (which may include, inter alia, salary, interest, bonus, risk premium and allocated share of profits), except where the remuneration, or part thereof, is clearly identifiable as a return on amounts subscribed or otherwise contributed. To the extent that remuneration cannot be clearly identified as a return on amounts subscribed it is regarded, for accounting purposes, as separate from the instrument that consists of the amount subscribed and return thereon. For example, profit share payable at the discretion of the LLP would be accounted for as an equity interest, even if the member's capital is treated as a liability. Where remuneration, or part thereof, is clearly identifiable as a return on the amounts subscribed – for example, non-discretionary interest payments –

rather than a return for the services provided by the members, then the amounts subscribed and that part of the remuneration that is clearly identifiable as a return on the amounts subscribed would be analysed together for accounting purposes. This important principle also has particular relevance when considering the impact of the puttables amendment. This is discussed further in paragraph 41 below and more detailed guidance on its application is given in Appendix 2.

35. Non-discretionary amounts becoming due to members in respect of participation rights in the profits of the LLP for the financial year that give rise to liabilities should be presented as an expense within the profit and loss account (within the heading 'Members' remuneration charged as an expense').

36. Amounts becoming due to members in respect of equity participation rights, following a discretionary division of profits, should be debited directly to equity in the year in which the division occurs. Such amounts should not be presented as an expense within the profit and loss account. A discretionary division of profits that takes place after the balance sheet date is a non-adjusting event under FRS 21 *Events after the Balance Sheet Date*.

37. Guidance on how to apply the principles set out above is given in paragraphs 38 to 50 below. Some examples of the practical effects of analysing participation rights separately are given in Appendix 2.

Amounts contributed by members and returns thereon

38. For some LLPs, the terms of the members' agreement may result in all members' participation rights being classified as giving rise to financial liabilities, i.e. not equity participation rights. This may be the case if, for example, all profits are automatically divided between members (see paragraph 48 below), and if individual members have the right to demand payment of amounts subscribed or otherwise contributed to the LLP. The ability of a member to exercise a contractual right may be conditional on a future event; for example, a member may only be able to demand amounts subscribed or otherwise contributed on retirement. Despite the fact that the member's right is conditional on a future event, the LLP does not have an unconditional right to avoid making the payment, so, unless the conditions for puttable instruments are met, a financial liability exists.

39. If the LLP has an unconditional right to refuse repayment to members of amounts subscribed or otherwise contributed by them then, providing there is no obligation to pay a return on those amounts, such amounts will be classed as equity. If the LLP does not have an unconditional right to refuse repayment and the conditions for puttable instruments have not been satisfied, such amounts will be classed as liabilities and included within loans and other debts due to members. However, if the LLP has an unconditional right to refuse repayment of members' capital, but interest is mandatorily payable on members' capital, then because the interest would be a clearly identifiable return on that capital

(see paragraph 34 above) it should be accounted for under paragraph AG.26 of FRS 25. A liability will be recognised on subscription reflecting the present value of minimum non-discretionary outflows. In many cases, this will be the same as the relevant amount of members' capital. Such a liability will not qualify for classification as equity under the puttables amendment because of the contractual obligation to pay interest. Following the principle set out in paragraph 34, any other remuneration (salary, bonus, risk premium and allocated share of profits etc) would fall to be accounted for separately.

Puttable instruments

40. The amendment made to FRS 25 in August 2008 affects the treatment of puttable financial instruments and obligations arising on liquidation. In certain limited circumstances rights of members which have been classified as a liability of the LLP under the original version of FRS 25 will fall to be classified as equity under the amended standard. The amendment to FRS 25 does not require rights which previously fell to be classified as members' equity to be reclassified as a financial liability of the LLP. Reclassification from liability to equity is only possible where members receive an 'equity-like' return in respect of those rights. If the LLP has other instruments that receive a variable return, with the effect that the return to members is substantially restricted or fixed, the criteria for reclassification in respect of those rights will not be met.

41. In considering whether members' participation rights require further analysis under the provisions of the puttables amendment it is first necessary to consider how the principles set out in paragraph 34 are being applied. For example, if all remuneration is being considered separately from capital as there is no clearly identifiable return on the amount subscribed then the remuneration and the capital would also be considered separately for the purposes of the puttables amendment.[4] For LLPs where members provide services, it is unlikely that the amendment will have a significant, if any, impact. Appendix 3 contains two flowcharts and Appendix 2 some additional guidance and a number of examples designed to demonstrate the impact of the puttables amendment in various scenarios.

42. The amendments to FRS 25 are drafted so as to apply to individual classes of financial instrument. Depending on the structure of an LLP, members' interests may consist of one or more classes of financial instrument, which themselves may comprise one or more 'components'. For example, members may invest in the capital of an LLP and may also be required to make loans to the LLP. If those loans are legally a separate financial instrument from the capital, then the LLP will have two classes of instrument with members. Under the amended Standard, reclassification is only possible for the class of instruments that is subordinate to all other instruments. Accordingly, where members' interests include more than one class of instrument, reclassification is only possible for

[4] In such circumstances, the puttables amendment will have no effect, because the remuneration will itself be a separate instrument or contract that has 'total cash flows based substantially on the profit or loss' of the entity and substantially restricts or fixes the return to the holders of capital. Accordingly, the test in paragraph 16B of FRS 25 would seem not to be met.

the class of instrument that is subordinate to all others. For convenience, the flowcharts refer to this most subordinate class of financial instruments as 'members' residual interests'. Frequently, members' residual interests will be members' capital, though this need not necessarily be the case.

43. The amendments are applied differently depending on whether members' residual interests may be put (i.e. redeemed at the option of the member) (i) without the LLP being liquidated or (ii) only on liquidation. In the former case, any reclassification can only be of the entire balance of members' residual interests, i.e. it is not possible to reclassify a component of members' residual interests. Where members' residual interests may be put or redeemed only on liquidation, it is possible to reclassify a component of members' residual interests without reclassifying the entire balance.

44. Where reclassifications arise under the amended requirements, these are mandatory rather than voluntary. Accordingly, all LLPs (other than, for the reasons set out in paragraph 45, those that apply the FRSSE) will need to consider whether they are affected by the amended requirements.

45. The amendments to FRS 25 apply for accounting periods beginning on or after 1 January 2010. Earlier application is permitted only for accounting periods beginning on or after 1 January 2009. At the time of writing, no changes have been made or proposed to the FRSSE. Accordingly, the requirements described in Appendix 3 do not apply to LLPs that have adopted the FRSSE. Such LLPs should continue to comply with the requirements of the FRSSE in respect of liabilities and equity, which are essentially consistent with those of FRS 25 before it was amended in August 2008.

Division of profits

46. Amounts becoming due to members in respect of participation rights in the profits of the LLP for the year that give rise to a liability might include, for example, salary, interest on capital balances and any automatic division of profits, to the extent that the LLP does not have an unconditional right to avoid delivering cash or other assets to a member in respect of such amounts.

47. Where there are no equity participation rights in the profits for the year, it follows that all amounts becoming due to members in respect of those profits will be presented within members' remuneration charged as an expense. In these circumstances, LLPs should refer to the presentational guidance given in paragraph 51 below and the illustrative examples in Appendix 1.

48. Where profits are automatically divided as they arise or are determined, so that the LLP does not have an unconditional right to refuse payment, the amounts arising that are due to members are in the nature of liabilities. They should therefore be treated as an expense in the profit and loss account in the relevant year and, to the extent they remain unpaid at the year end, they should be shown as liabilities in the balance sheet. Conversely, where there is no automatic

division of profits the LLP has an unconditional right[5] to refuse payment of the profits of a particular year unless and until those profits are divided by a decision taken by the members (or a committee of the members to which the authority to divide profits has been delegated); and accordingly, following such a division, those profits are classed as an appropriation of equity rather than as an expense. They are therefore shown as a residual amount available for appropriation in the profit and loss account. Once profits are divided, the amount of the divided profits is treated as an appropriation which is deducted from equity, and, to the extent that any divided profits remain unpaid at the year end, the amount unpaid will be recorded as a liability.

49. It is possible that a combination of these circumstances may arise, for example if 50% of profits are automatically divided, but the remaining profits are only divided at the discretion of the LLP, then the former will be treated as an expense/liability and the latter as an appropriation/equity.

50. Paragraph 3 of the Legal Opinion in Appendix 5 addresses the division of profits and may be helpful in determining whether payments are discretionary.

Members' remuneration: presentation and disclosure

51. The Regulations require the profit and loss account to disclose a total, being 'Profit or loss for the financial year before members' remuneration and profit shares'. The total of 'Members' remuneration charged as an expense', as defined in paragraph 21 above, should be disclosed separately and deducted from this balance. Disclosure on the face of the profit and loss account should be as follows:

Profit or loss for the financial year before members' remuneration and profit shares	**X**
Members' remuneration charged as an expense	**(X)**
Profit or loss for the financial year available for discretionary division among members	**X**

52. The basis on which each element of remuneration (as defined) has been treated in the accounts should be disclosed and explained by note.

53. 'Members' remuneration charged as an expense' is defined in paragraph 21 above. The Regulations require disclosure on the face of the profit and loss account of a sub-total 'Profit or loss for the financial year before members' remuneration and profit shares'. Therefore, after the sub-total required by the Regulations, a line item described as 'Members' remuneration charged as an

5 As it is the members who make decisions on behalf of the LLP, the members have the power to divide the profits of the LLP. However, until the members take a decision to divide the profits, the LLP has an unconditional right to refuse to pay the profits to individual members.

expense’ should be deducted as an additional expense. This includes any related employment costs.

54. The treatment of members’ remuneration in the profit and loss account is summarised in the following table.

<table>
<tr><th>Nature of element of a member’s remuneration:</th><th>Treat as:</th></tr>
<tr><td>Remuneration that is paid under an employment contract</td><td rowspan="3">Expense, described as ‘Members’ remuneration charged as an expense’, and deducted after arriving at ‘Profit for the financial year before members’ remuneration and profit shares’</td></tr>
<tr><td>Other payments, arising from components of members’ participation rights in the profits for the year that give rise to liabilities in accordance with FRS 25 and UITF 39, such as mandatory interest payments</td></tr>
<tr><td>Automatic division of profits</td></tr>
<tr><td>Any share of profits arising from a division of profits that is discretionary on the part of the LLP (i.e. where the decision to divide the profits is taken after the profits have been made).</td><td>Allocation of profit</td></tr>
</table>

Where it is considered that it will assist an understanding of the financial performance of the LLP, members’ remuneration charged as an expense should be further analysed within the notes to the financial statements, for example, between that which is paid under a contract of employment and that which relates to amounts arising from participation rights that give rise to a liability. In the case of a group, members’ remuneration from all entities in the group that are consolidated into the parent LLP’s group accounts should be considered.

Members’ interests: presentation and disclosure

55. ‘Loans and other debts due to members’ (balance sheet item J) and ‘Members’ other interests’ (balance sheet item K) should be disclosed separately on the face of the balance sheet. Balance sheet item J includes ‘Loans and other debts due to members’ and ‘Members’ capital’ in so far as it is classified as a liability. Balance sheet item K includes ‘Members’ capital’, ‘Revaluation reserve’ and ‘Other reserves’, in so far as they are classified as equity, which are also each required to be disclosed separately on the face of the balance sheet.

56. All amounts due to members that are classified as liabilities in accordance with FRS 25 and UITF 39 should be presented within 'Loans and other debts due to members'. This heading will include any unpaid element of 'Members' remuneration charged as an expense' together with any unpaid allocated profits arising from a discretionary division of profits made during the year. It will also include members' capital classified as a liability.

57. Equity should not include members' capital that is classified as a liability in accordance with FRS 25 and UITF 39. For some LLPs, the terms of the members' agreement may result in all 'capital' subscribed by members being presented as financial liabilities. Except where the conditions described in Appendix 3 are met, this will be the case where individual members have the right to demand repayment of such balances (for example, on retirement) and the LLP does not have the unconditional right to refuse such repayment.

58. The face of the balance sheet should show the net assets attributable to members of the LLP (that is, the sum of items B to I). In addition, 'Total members' interests', being the total of items J and K less any amounts due from members in debtors, should be disclosed as a memorandum item on the face of the balance sheet.

59. 'Loans and other debts due to members' (balance sheet item J), while in substance liabilities of the LLP, do not form part of the external financing of the LLP. Consequently, these amounts should be shown separately in the analysis of changes in net debt required by FRS 1.

60. Disclosure should be made under 'Members' other interests' and 'Loans and other debts due to members' of the amount brought forward from the previous year, the changes arising in the financial year and the balance carried forward at the end of the year. Disclosure should be in the following format (although additional categories of members' interests or types of movements should be disclosed where this aids clarity or circumstances require it):

	Members' Other Interests [6]				Loans and other debts due to members less any amounts due from members in debtors[7]	Total 2XX1	Total 2XX0
	Members' Capital (Classified as equity)	Revaluation Reserve	Other Reserves	Total			
Amounts due to members					X		
Amounts due from members					(X)		
Balance at [start of the period]	X	X	X	X	X	X	X
Members' remuneration charged as an expense, including employment and retirement benefit costs					X	X	X
Profit / (loss) for the financial year available for discretionary division among members			X	X		X	X
Members' interests after profit/(loss) for the year	X	X	X	X	X	X	X
Other divisions of profits / (losses)			(X)	(X)	X		
Surplus arising on revaluation of fixed assets		X		X		X	X
Introduced by members	X			X	X	X	X
Repayments of capital	(X)			(X)		(X)	(X)
Repayments of debt (including members' capital classified as a liability)					(X)	(X)	(X)
Drawings					(X)	(X)	(X)
Other movements	X	X	X	X	X	X	X
Amounts due to members					X		
Amounts due from members					(X)		
Balance at [end of the period]	X	X	X	X	X	X	X

61. Any unallocated profits should appear under 'Other reserves' (balance sheet item K). Where the LLP makes a loss for the financial year that is

6 Balance sheet item K.

7 Balance sheet item J less any amounts due from members in debtors. 'Loans and other debts due to members' would include any members' capital classified as a liability. The analysis of amounts due to members is required in order to comply with the Regulations.

not allocated to the members, the amount should be deducted from 'Other reserves'.

62. The members of the LLP may agree to allocate to the members a sum different from the amount shown as profit or loss for the financial year available for division among members. Amounts may, for example, be retained in the business as unallocated profits.

63. The notes to the accounts should explain where amounts in 'Loans and other debts due to members' (balance sheet item J) would rank in relation to other creditors who are unsecured in the event of a winding up. Details of any protection afforded to creditors in such an event which is legally enforceable and cannot be revoked at will by the members should be included in a note to the accounts. Where no such protection is afforded in respect of items shown under balance sheet item K, that fact should be disclosed.

64. The capital (whether classified as a liability or equity) of an LLP may be reduced by agreement of the members either by repayment or by the conversion of equity capital into liability capital or other debt.[8] In the absence of agreement to the contrary, unsecured debt due to members will rank equally with debts due to other unsecured creditors in a winding up. For these reasons, some LLPs may, in order to facilitate the obtaining of credit, decide to invest their capital with a degree of permanence by subordinating debt due to members to other creditors in a winding up.

65. The Regulations require disclosure of the amount of loans and other debts due to members falling due after more than one year.

66. The Regulations require separate disclosure of the aggregate amount of money advanced by members by way of loan, the aggregate amount of money owed to members in respect of profits and any other amounts.

67. The amount of debts owing to the LLP by members should be disclosed.

68. Amounts owing to and from members should not be offset in the financial statements, except where they are in respect of the same member and the conditions set out in paragraph 42 of FRS 25 are met. Debits on members' balances (where, for example, drawings were made during the year in anticipation of profits) should be reviewed for recoverability and shown separately in debtors.

Other disclosures

69. LLPs should disclose in the Members' Report the overall policy followed in relation to members' drawings, including an indication of the policy

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8 Neither the Companies Act 2006 nor the Regulations contain any provisions in relation to capital maintenance of an LLP, such as those in the Companies Act for limited liability companies.

applicable where the cash requirements of the business compete with the need to allow cash drawings by members. Such disclosures should include any transfers of members' interests from equity to debt (and vice versa) during the year and up to the date the accounts are approved. The policy under which members contribute or subscribe amounts to the LLP by way of equity or debt and the policy under which their contributions and subscriptions are repayable by the LLP, should also be disclosed.

70. In the case of large and medium-sized LLPs, the Regulations require disclosure of the average number of members in the financial year. This is determined by dividing the aggregate number of members of the LLP for each month or part thereof in the financial year by the number of months in the financial year (rounded to the nearest whole number).

71. In the case of large and medium-sized LLPs, the Regulations also require disclosure of the profit (including remuneration) that is attributable to the member with the largest entitlement to profit (including remuneration) where the amount of the profit of the LLP for the financial year before members' remuneration and profit shares exceeds £200,000. The identity of this member need not be disclosed.

72. When determining the disclosable amount, the LLP should take account of all the relevant factors and disclose the policy by which the amount was arrived at, as the Regulations do not provide specific guidance as to how the disclosable amount should be determined. A consistent policy should be applied. Where the LLP has an unconditional right to avoid paying an amount of remuneration or profit, the policy for determining the disclosable amount should be disclosed and should explain how current year unallocated profits and current year allocations of both current and prior year profits are treated.

73. Where LLPs choose to disclose average members' remuneration, this should be calculated by dividing the 'Profit before members' remuneration and profit shares' by the average number of members (as discussed in paragraph 70 above), these being the two items that are required to be disclosed by the Regulations. If any other figure for average members' remuneration is given, it should be reconciled to the figure calculated in accordance with this paragraph.

Cash flow statement presentation

74. In the cash flow statement of the LLP, in place of the line item 'Equity dividends paid' required by FRS 1, the following should be shown as a minimum:

Transactions with members and former members

Payments to members	**X**	
Contributions by members	**X**	
Post-retirement payments to former members*	**X**	
		X

* See the following section

RETIREMENT BENEFITS

Retirement benefits of employees and members

75. **Retirement benefits provided for employees of the LLP should be accounted for as required by FRS 17 *Retirement Benefits*. This will include retirement benefits payable to members that are based on any salary paid to the member under an employment contract.**

Other post-retirement payments to members: recognition and measurement

76. **LLPs should analyse their contractual or constructive obligations (including any relating to early retirement options) to make payments to members at and after the point of their ceasing to be members of the LLP between:**

(a) **those that give rise to financial liabilities falling within the scope of FRS 25; and**

(b) **those that give rise to liabilities of uncertain timing and amount falling within the scope of FRS 12.**

In the case of a contractual liability to deliver cash or other financial assets, this will give rise to a financial liability under FRS 25 unless outside the scope of that standard (see paragraph 80 below).

In the case of contractual liabilities scoped out of FRS 25 or a constructive obligation of uncertain timing or amount, these will fall within the scope of FRS 12.

In the case of a constructive obligation of certain timing and amount, this will fall to be accounted for as a liability under the general provisions of the Companies Act/GAAP.

77. Payments by an LLP to members after they have retired, often referred to as annuities, can take many different forms. It will be necessary to examine the nature of the contractual or constructive obligations in order to determine the governing accounting standard.

78. Annuity payments may be either ‘pre-determined’ or ‘profit-dependent’.

(a) Pre-determined annuity payments are amounts payable that are fixed at the time of retirement; for example, by reference to historical earnings (such as a percentage of the final year’s profit share) or fixed at an amount, which may be index-linked or linked to a measure independent of the LLP’s future profit. The period for which they are payable may or may not be pre-determined. The payment of the retirement benefit is thus not dependent on the LLP earning profits in the post-retirement period.

(b) Profit-dependent annuity payments are amounts payable to former members that are, in effect, a share of the LLP’s ongoing profits, by way of a preferential first share, profit-points, profit-dependent bonus or some other mechanism. Many different arrangements exist, and there may be no amount payable in a year in which no or insufficient profits are earned.

79. An annuity meets the definition of a financial liability under FRS 25 if there is a contractual obligation for the LLP to deliver cash or a financial asset to a member. An example of an annuity dealt with under FRS 25 might be where a former member is to be paid a fixed annual amount for a fixed term beginning on the first anniversary of his retirement; if he were to die, an amount representing the present value of the future payments would be paid to his estate.

80. Annuities are likely in many cases to be subject to uncertainties. This will be the case, for example, where the member has a choice of retirement dates, the payments are dependent on future profits or there is significant mortality risk. In this respect, an annuity that carries a life-contingent element (i.e. a mortality risk) is outside the scope of FRS 25 because it meets the definition of an insurance contract under FRS 25. Such annuities therefore fall within the scope of FRS 12.

81. It should be noted that uncertainty of timing or amount per se is not the boundary between FRS 25 and 12 since the former envisages situations where financial liabilities within the scope of that standard will be of uncertain timing or amount. Nevertheless, in the case of such a liability within the scope of FRS 25 it is likely that, for measurement purposes, the principles of measurement contained within FRS 12 will still be the most relevant. Accordingly, in most cases, where the liability is of uncertain timing or amount, whether within the scope of FRS 25 or 12, the measurement principles of the latter standard will apply.

82. A liability in respect of an annuity is recognised when a member obtains an actual or constructive right to the annuity, which the LLP has no discretion to withhold.

83. If the rights to an annuity are earned over a period, then costs should be recognised over that period.[9] This accords with FRS 25, as a liability for the annuity arises in the LLP as service is rendered by the member; and with FRS 12, under which the LLP has either an obligation or a constructive obligation to pay the annuity which builds up over time.

84. Often, a member of an LLP will obtain absolute entitlement to an annuity only on reaching a specific milestone, such as reaching a particular age or achieving a specified number of years' service. A member choosing to leave before reaching the milestone will not be entitled to an annuity. On reaching the milestone while remaining a member of the LLP, the member will be entitled to an annuity based on past service. The LLP cannot avoid the liability that is accruing through the service period through its own actions without the agreement of the member (unless it had the right to terminate his or her membership without compensation for the loss of annuity rights, which is unlikely to be the case). In these circumstances, therefore, a liability should be built up over the period of service rather than just recognised at the date on which the milestone is reached.

85. If the liability falls within the scope of FRS 12 the LLP should assess the probability of a future cash outflow using the principles of paragraphs 23 and 24 of that standard. Any liability for post-retirement payments to members earned to date and therefore recognised in the accounts should reflect the latest expectations in respect of:

(a) the likely date of ceasing to be a member; and

(b) the amounts likely to be payable from that date.

86. The value of the liability should be based on the best estimate of the current value of future cash flows. In practice, it will often be appropriate to value the liability on an actuarial basis consistent with the principles of FRS 17 for the measurement of pension liabilities. Where, because of their nature and/or complexity, the arrangements are such that it is appropriate to apply the guidance in FRS 17, then that guidance should be applied in arriving at the measurement of the liability. In the case of profit-dependent payments, it will be necessary for the LLP to make a best estimate of the level of future profits of the LLP. Only in extremely rare cases will no reliable estimate be capable of being made. In these extremely rare cases, if accounting for the liability under FRS 12, then a liability exists that cannot be recognised. This is disclosed as a contingent liability.

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9 This is similar to the approach in FRS 17.

87. The liability should be recalculated annually to take account of changes in membership, eligibility for post-retirement payments, financial estimates and actuarial assumptions.

Post-retirement payments to members: presentation

88. Amounts recognised in respect of current members should be charged to the profit and loss account within 'Members' remuneration charged as an expense'. The recognition of and changes in the liability for post-retirement payments to or in respect of current members and to or in respect of former members should be shown separately. The change in the liability in respect of former members should be expensed in the relevant expense item (that is, not in members' remuneration) in the profit and loss account. The change in the liability in respect of current members should be charged to the profit and loss account within 'Members' remuneration charged as an expense'.

89. The liability for post-retirement payments to or in respect of current members and to or in respect of former members should be shown separately. The liability in respect of former members should be shown in the balance sheet under 'Provisions for liabilities' or 'Creditors', as appropriate, as 'Post-retirement payments to former members'. The liability in respect of current members should be shown separately, if material, as a component of 'Loans and other debts due to members'. In the year in which a member retires, a transfer should be made between the balance in respect of current members and the balance in respect of former members.

90. Where the liability has been discounted (for example, as required by FRS 12 where the effect is material), the unwinding of the discount should be presented next to the interest cost line in the profit and loss account, to the extent that it relates to former members. Where it relates to current members it should be included in 'Members' remuneration charged as an expense'.

91. Additional annuities granted after the date of a member's retirement should be recognised in full in the profit and loss account within operating profit as soon as the award is granted to the former member.

Post-retirement payments to members: disclosure

92. The LLP's accounting policy note should disclose the LLP's policy in respect of post-retirement payments to members.

On transition of a partnership or other undertaking to an LLP

93. Where an LLP makes post-retirement payments to members of a predecessor partnership or other organisation, the extent to which the LLP has an actual or constructive liability for such payments should be considered. Where an actual or constructive liability exists, this should be

recognised in the balance sheet of the LLP. Where there is merely recourse to the LLP in the event of a default of a third party and such default has not occurred and is not probable, this should be disclosed as a contingent liability.

94. It is possible that an LLP which succeeds to the business of a partnership will not assume actual or constructive liability for post-retirement payments payable by the predecessor partnership or partners therein. However, it may, as agent for the members of the LLP, disburse the related cash to the former members.[10] In such circumstances, the payments to the former members represent amounts in respect of their services to the former partnership which the LLP is distributing to the former members as agent of the continuing members and do not represent liabilities of the LLP. Reference to these arrangements is encouraged where this would aid clarity.

TAXATION

95. Where tax (whether current or deferred) to be paid on members' remuneration is a personal liability of the members, it falls within 'Members' interests' on the balance sheet. It should not appear in the profit and loss account.

96. Amounts retained by an LLP in respect of a member's tax liability do not require separate disclosure. In such cases, the LLP is simply acting as agent of the member by settling the liability direct to the tax authorities. Amounts retained for tax should be included in 'Loans and other debts due to members'.

97. Tax withheld from members who subsequently retire from membership should be dealt with as any other balance due to former members.

98. LLPs that are subject to tax on profits arising in jurisdictions where LLPs are taxed as corporate entities should report such taxes in their accounts as required by accounting standards.

99. In the group accounts of an LLP which include entities or organisations that are not partnerships or LLPs, such as companies, the tax liabilities of such entities should be recorded in the profit and loss account under the relevant heading and any related liability carried as a creditor in the balance sheet.

REVENUE RECOGNITION: STOCKS AND LONG-TERM CONTRACTS

100. In respect of stock, the cost of members' time and related overheads should be accounted for in accordance with SSAP 9 *Stocks and long-term contracts*. Contracts should be accounted for in accordance with SSAP 9, FRS 5

[10] Whether such arrangements exist will depend on the terms of the agreement between the predecessor partners and the former member, as varied by any agreements entered into at the time the LLP succeeds to the business of the predecessor partnership.

***Reporting the Substance of Transactions - Application Note G: Revenue Recognition*, and UITF Abstract 40 *Revenue recognition and service contracts*.**

101. When calculating the cost of stock or work in progress in accordance with SSAP 9, the cost of members' time should be considered. The cost of members' time will include only those elements that would be expensed in the profit and loss account, i.e. 'Members' remuneration charged as an expense' as defined in paragraph 21 above. However, regardless of whether the time input by a member is a cost to be included in stock, any overhead related to that time should be included in the cost of stock or work in progress.

BUSINESS COMBINATIONS AND GROUP ACCOUNTS

Entity and group accounts

102. An LLP should follow the rules on the requirement to prepare group accounts (and the exemptions therefrom) and the contents of the group accounts (and on inclusion and exclusion of subsidiaries) set out in FRS 2 *Accounting for Subsidiary Undertakings* and FRS 5, modified where necessary to comply with the Regulations.

Accounting for business combinations

103. The accounting treatment for business combinations which include one or more LLPs should have regard to the substance of the combination. Application of GAAP with respect to mergers and acquisitions should be considered in the context of both the group accounts and the entity accounts of the LLP.

104. When two LLPs combine, there may be only one surviving LLP, or a new LLP may be created or one LLP may become a member of the other. The recommended accounting treatment may therefore apply both to the entity accounts of an LLP and, if relevant, to its group accounts.

105. Consideration will be required to determine whether a particular business combination represents:

- an acquisition;
- a merger; or
- the granting of membership to one or more individuals.

The circumstances of business combinations will vary greatly. Where a business combination is not simply the granting of membership to one or more individuals, it will be treated as either an acquisition or a merger in accordance with FRS 6 *Acquisitions and Mergers*.

Acquisition accounting

106. **Acquisition accounting is required when the conditions set out in FRS 6 to use merger accounting are not met.**

107. **Where acquisition accounting is used, the fair value of the purchase consideration used in the calculation of goodwill arising on an acquisition should be assessed carefully. In particular, the profit share promised to the new members in the enlarged LLP should be assessed to determine whether any portion of that remuneration represents consideration for the business acquired, rather than future members' remuneration. For example, if members of the purchased entity were awarded an increased profit share for a limited period of time after the acquisition, falling back to 'normal' remuneration levels thereafter, this could indicate that the short-term excess amounts were part of the purchase consideration.**

108. **Where it is not possible to value the consideration given in accordance with the requirements of FRS 7 *Fair Values in Acquisition Accounting*, the best estimate of its value may be obtained by valuing the entity acquired.**

109. **Where the fair value of stock and work in progress used in acquisition accounting by LLPs cannot be ascertained from market value, consideration should be given to paragraphs 52 - 57 of FRS 7; in which case, the current cost would include the cost of members' time charged as an expense, as discussed in paragraph 101 above.**

Merger accounting

110. **Merger accounting is required when all five of the specific criteria set down in FRS 6 indicate that a merger, rather than an acquisition, has taken place.**

111. When applying the five criteria to combinations involving LLPs, it may not be clear how to apply the guidance on size criteria set out in paragraph 68 of FRS 6. Accordingly, suitable alternatives for establishing relative sizes may need to be considered, such as respective revenues, number of members, profits, employees, relative voting rights, etc. Finally, the nature of the combination should be considered, to determine whether circumstances indicate that the size criterion should be rebutted.

Group reconstructions

112. **The transfer of all or the majority of the assets, liabilities and business of a partnership into an LLP incorporated for that purpose should be dealt with as a group reconstruction, except where the requirements of paragraph 13 of FRS 6 are not met, after taking account of the different legal nature of an LLP. The initial 'opening' balance sheet should follow the accounting policies of the LLP.**

Considerations on transition from an existing partnership

113. Where existing undertakings are transferred into an LLP, the transfer should be accounted for as a group reconstruction, as noted in paragraph 112 above, where the conditions of paragraph 13 of FRS 6 are met.

114. Both start-up businesses and existing undertakings, including partnerships, may choose to incorporate as LLPs. Where there is a transfer of an existing undertaking to an LLP, it will be accounted for as a group reconstruction where the conditions of FRS 6 are met.

115. Single-entity LLPs that are formed by the transfer or incorporation of existing undertakings, including partnerships, which meet the requirements of FRS 6 to use merger accounting for the initial transfer of business, should reflect the transfer at book value at the date of transfer and disclose comparative *pro forma* amounts in the financial statements of the first period after incorporation. Where such comparative amounts are disclosed, they should be stated on the basis of the accounting policies adopted by the LLP. The initial statutory period may or may not be a 12-month period.

116. In some cases there may be a hiatus between the formation of the LLP and the transfer of the existing undertaking. Where this occurs, the principles of merger accounting should be used, and the net assets at book values should be reflected in the accounts at the date of the transfer, and profits should be recognised for the period from the transfer to the end of the accounting period. A *pro forma* profit and loss account, including corresponding amounts, should be given for the whole of the original entity's accounting period spanning the transfer. These issues are considered in Appendix 4.

117. The restatement of comparatives to consistent accounting policies will often result in a difference between the total interests of partners in the predecessor firm shown by its final balance sheet, and the members' interests in the opening balance sheet of the LLP. Such differences should not be dealt with in the financial statements of the LLP.

118. The disclosures required by FRS 6 will be required; for example, those outlined in paragraph 22(e) of the standard.

119. Existing groups that, using merger accounting under a group reconstruction, put a new LLP at the top of the group (whether in order to convert to an LLP or as part of a group reconstruction) should present corresponding amounts in the financial statements of the period of the merger, as required by FRS 6.

PROVISIONS AND OTHER IMPLICATIONS OF FRS 12

120. FRS 12 applies in all respects to LLPs.[11]

121. While the application of FRS 12 is unlikely to present any unusual problems for LLPs, applying it fully may require a significant change in practice for existing partnerships that are incorporated as an LLP. Historically, partnership accounting has focused heavily on what was perceived as equitable between partners and different year groups of partners, since there are often different partners and/or differing profit shares in successive years. By agreement, major liabilities may have been spread over several years, often to match cash flows, rather than being fully provided immediately.

122. When considering FRS 12, an LLP should have regard to all contracts and all relevant circumstances, including side agreements and promises whether or not in writing. An example of a constructive obligation arising would be where post-retirement payments have been offered consistently to previous members at the point of, but not prior to, retirement. Where this is the case, it could be argued that this would build an expectation and, hence, a constructive obligation that all members would be offered this benefit at retirement. If so, then the point of recognition of the liability would be earlier than retirement (see paragraphs 82 et seq. above).

123. The basis of allocation of profits between members is a private matter and will usually be governed by the members' agreement referred to in the LLP legislation. There is no reason why the determination of profits to be allocated to members cannot be based on different accounting policies from those applied to the financial statements of the LLP.

124. If the LLP has entered into any guarantee or indemnity with respect to the borrowings of a member or members personally, the existence of such a guarantee or indemnity where material should either be disclosed as a note to the accounts (where it is unlikely that the guarantee or indemnity would be called) or provided for in the primary statements where there is an actual or constructive liability as defined under FRS 12 and it is probable that the guarantee or indemnity will be called.[12]

125. It is common practice within partnerships for partners to borrow to fund their capital and similar interests in a firm. Such arrangements may involve the firm entering into guarantees, indemnities or undertakings toward the lender concerned. Broadly similar arrangements may occur with regard to members of LLPs and the LLP itself.

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[11] Professional services firms will apply FRS 12 in relation to claims against them and associated insurance reimbursements. Such matters are not specific to LLPs and so are not addressed in this SORP.

[12] LLPs applying the provisions of FRS 26 will need to follow the recognition and measurement rules for financial guarantees set out in that standard.

126. Of itself, the extent to which members' interests have been financed by lenders, who have lent funds to the member or members concerned, is not a matter for disclosure. Similarly, any undertaking that the LLP may give to act as agent for a member, in remitting funds from members' interests to a lender or other third party, need not be disclosed.

127. A provision would be required where, for example, an LLP has undertaken to repay a loan of a member, such that the LLP is under a legal or constructive obligation to ensure that the full liability to the lender is settled, and it is more likely than not that the guarantee will be called upon.[13] Where a provision of this nature has been made in relation to a member who is a related party (see paragraphs 128 - 131 below), further disclosures should be given in accordance with FRS 8 *Related Party Disclosures*.

RELATED PARTIES

128. The provisions of FRS 8, including the definition of related parties, apply to LLPs. An LLP which is under the control of another LLP, partnership, company or other entity will be a related party of that other entity. The fact that some members of an LLP are members of another LLP or another partnership does not in itself make the businesses related parties: the extent of common control and/or influence determines this. Predecessor partnerships of LLPs should be treated as related parties of the LLP.

129. The nature and extent of members' involvement in the management of the LLP should be considered, to determine whether a member is a related party.

130. In the case of smaller LLPs, where all members play a part in the management of the entity, it will frequently be the case that all members are related parties. However, in larger LLPs, it may not be appropriate for all members of an LLP to be considered as related parties. FRS 8 includes directors of companies as related parties by definition and the key management personnel of a reporting entity are also defined as related parties of that entity. Key management personnel of an LLP are those persons having authority and responsibility for planning, directing and controlling the activities of the LLP, directly or indirectly. Designated members are therefore likely to be related parties of the LLP.

131. The controlling party and ultimate controlling party of an LLP, if one exists, should be disclosed in accordance with FRS 8. This includes an individual or entity which has the ability to direct the financial and operating policies of the LLP, although that party may not be entitled to the majority of profits or have invested the majority of capital represented by equity or debt. It will also be necessary to consider the extent to which

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13 The LLP will need to consider the extent to which it has the legal right to offset the aggregate 'capital' and undrawn profits of the member concerned against the outstanding debt.

members are acting in concert in such a way as to be able to exercise control or influence over the LLP.

COMPLIANCE STATEMENT

132. The note to the financial statements which deals with accounting policies should refer to the LLP's compliance with this SORP, or detail areas of non-compliance and any reasons therefor, in accordance with FRS 18 *Accounting Policies*.

EFFECTIVE DATE

133. The revised SORP should be applied for accounting periods beginning on or after 1 January 2010. Earlier application is permitted but, in respect of the amendments made to FRS 25 in August 2008, only for accounting periods beginning on or after 1 January 2009. The previous edition of the SORP (published in 2006) applies to earlier periods.

134. In implementing the provisions of this SORP that relate to FRS 25, LLPs should have regard to paragraphs 96 – 97C of that standard, which deal with certain transitional and comparative issues. Any other changes in accounting policy should be dealt with in the normal way under FRS 18.

APPENDIX 1: EXAMPLES SHOWING THE PRESENTATION OF MEMBERS' INTERESTS AFTER APPLYING FRS 25 AND UITF 39

(The LLP has no retirement benefit arrangements for current members in these examples)

EXHIBIT A - LLP Balance Sheet

PRESENTATION AFTER FRS 25/UITF 39 – LLP WITH NO EQUITY	20X5 £'000	20X4 £'000
Fixed assets		
Tangible fixed assets	9,500	8,200
Current assets		
Amounts recoverable on contracts	8,000	7,500
Trade debtors	17,500	16,000
Amounts due from members	1,500	1,200
Other debtors and prepayments	4,000	3,800
Cash at bank and in hand	6,000	4,500
Current assets	37,000	33,000
Creditors: amounts falling due within one year		
Bank overdraft and loans	3,000	2,800
Other creditors and accruals	6,500	6,000
Current liabilities	9,500	8,800
Net current assets	27,500	24,200
Total assets less current liabilities	37,000	32,400
Creditors: amounts falling due after more than one year		
Bank loans	4,000	3,200
Provisions for liabilities		
Post-retirement payments to former members	4,500	4,800
Other provisions	2,000	1,900
	6,500	6,700
NET ASSETS ATTRIBUTABLE TO MEMBERS	26,500	22,500
REPRESENTED BY:	**20X5 £000**	**20X4 £000**
Loans and other debts due to members within one year		
Members' capital classified as a liability	8,000	6,000
Other amounts	18,500	16,500
	26,500	22,500
TOTAL MEMBERS' INTERESTS		
Amounts due from members	(1,500)	(1,200)
Loans and other debts due to members	26,500	22,500
	25,000	21,300

Note: In this example, members' other interests are nil.

EXHIBIT B - LLP Balance Sheet

PRESENTATION AFTER FRS 25/UITF 39 – LLP WITH SOME EQUITY	20X5 £'000	20X4 £'000
Fixed assets		
Tangible fixed assets	9,500	8,200
Current assets		
Amounts recoverable on contracts	8,000	7,500
Trade debtors	17,500	16,000
Amounts due from members	1,500	1,200
Other debtors and prepayments	4,000	3,800
Cash at bank and in hand	6,000	4,500
Current assets	37,000	33,000
Creditors: amounts falling due within one year		
Bank overdraft and loans	3,000	2,800
Other creditors and accruals	6,500	6,000
Current liabilities	9,500	8,800
Net current assets	27,500	24,200
Total assets less current liabilities	37,000	32,400
Creditors: amounts falling due after more than one year		
Bank loans	4,000	3,200
Provisions for liabilities		
Post-retirement payments to former members	4,500	4,800
Other provisions	2,000	1,900
	6,500	6,700
NET ASSETS ATTRIBUTABLE TO MEMBERS	26,500	22,500

REPRESENTED BY:	**20X5 £000**	**20X4 £000**
Loans and other debts due to members within one year		
Members' capital classified as a liability	5,000	4,000
Other amounts	9,000	8,000
	14,000	12,000
Members' other interests		
Members' capital classified as equity	3,000	2,000
Members' other interests - other reserves classified as equity	9,500	8,500
	26,500	22,500
TOTAL MEMBERS' INTERESTS		
Amounts due from members	(1,500)	(1,200)
Loans and other debts due to members	14,000	12,000
Members' other interests	12,500	10,500
	25,000	21,300

EXHIBIT C - LLP Profit and Loss Account (Format 2)

PRESENTATION AFTER FRS 25/UITF 39 – LLP WITH AUTOMATIC DIVISION OF PROFIT EQUIVALENT TO SALARIED REMUNERATION	**20X5 £'000**	**20X4 £'000**
Turnover	55,500	49,500
Other operating income	2,500	2,000
	58,000	51,500
Other external charges	(8,500)	(7,500)
Staff costs	(21,500)	(18,500)
Depreciation	(2,000)	(2,000)
Other operating expenses	(11,000)	(9,000)
Operating profit	15,000	14,500
Profit on sale of fixed assets	1,000	-
Interest receivable and similar income	1,000	1,000
Interest payable and similar charges	(500)	(750)
Profit for the financial year before members' remuneration and profit shares	16,500	14,750
Profit for the financial year before members' remuneration and profit shares	16,500	14,750
Members' remuneration charged as an expense	(3,000)	(2,500)
Profit for the financial year available for discretionary division among members	13,500	12,250

Note: This example may apply to an LLP which has a members' agreement or other profit sharing arrangement which gives members the equivalent of a salary. It is not intended to suggest that all LLPs should impute notional salaries.

EXHIBIT D - LLP Profit and Loss Account (Format 2)

PRESENTATION AFTER FRS 25/UITF 39 – LLP WITH AUTOMATIC DIVISION OF ALL PROFITS	20X5 £'000	20X4 £'000
Turnover	55,500	49,500
Other operating income	2,500	2,000
	58,000	51,500
Other external charges	(8,500)	(7,500)
Staff costs	(21,500)	(18,500)
Depreciation	(2,000)	(2,000)
Other operating expenses	(11,000)	(9,000)
Operating profit	15,000	14,500
Profit on sale of fixed assets	1,000	-
Interest receivable and similar income	1,000	1,000
Interest payable and similar charges	(500)	(750)
Profit for the financial year before members' remuneration and profit shares	16,500	14,750
Profit for the financial year before members' remuneration and profit shares	16,500	14,750
Members' remuneration charged as an expense	(16,500)	(14,750)
Result for the financial year available for discretionary division among members	-	-

Note: This example may apply to an LLP which has a members' agreement or other profit sharing arrangement which has arrangements which automatically divide the full amount of the earned profit among members.

EXHIBIT E - LLP Profit and Loss Account (Format 2)

PRESENTATION AFTER FRS 25/UITF 39 – LLP WITH NO AUTOMATIC DIVISION OF ANY PROFIT	**20X5 £'000**	**20X4 £'000**
Turnover	55,500	49,500
Other operating income	2,500	2,000
	58,000	51,500
Other external charges	(8,500)	(7,500)
Staff costs	(21,500)	(18,500)
Depreciation	(2,000)	(2,000)
Other operating expenses	(11,000)	(9,000)
Operating profit	15,000	14,500
Profit on sale of fixed assets	1,000	-
Interest receivable and similar income	1,000	1,000
Interest payable and similar charges	(500)	(750)
Profit for the financial year before members' remuneration and profit shares available for discretionary division among members	16,500	14,750

Note: This example may apply to an LLP which has a members' agreement or other profit sharing arrangement which has no element of automatic division of profit and does not give members any rights to a share in the profits until it is divided.

APPENDIX 2:
LIABILITY AND EQUITY ELEMENTS OF MEMBERS' INTERESTS

General

The interests of members in an LLP are typically governed by the LLP's members' agreement. Compared to the memorandum and articles for limited companies, LLPs have considerable flexibility over how that agreement is drafted, and there is wide diversity in practice. The absence of standard arrangements makes it necessary to analyse each members' agreement with care so that members' equity and liability interests are properly reflected in financial statements.

The members' agreement will specify what members are expected to provide to the LLP and what they will receive in return. Depending on the nature of the LLP and what has been agreed, members may or may not provide services or expertise to the LLP; and they may or may not be required to provide cash, or other assets, as members' capital. In return, they may receive equity or liability interests in the LLP or a combination of the two. One purpose of the examples below is to illustrate that there need not be symmetry between the treatment of amounts subscribed as members' capital and the 'returns' arising. For example, a member may be able to demand repayment of capital subscribed (liability, unless the conditions for the puttables amendment are met) but the LLP may have discretion over the division of profits (equity).

It will generally be necessary, when analysing members' interests between equity and liabilities, to distinguish those rights that are only exercisable by the members as a whole from those rights that may be exercised by an individual member against the LLP. For example, where the profits are only divided if the members as a whole (or a committee of the members with the relevant authority) so decide, an individual member will not be entitled to a share of those profits unless and until a decision to divide them is taken; accordingly, the profits will constitute an equity interest so far as the profit and loss account is concerned (and will continue to do so even if a decision by the members to divide the profits is taken during the year in which the profits are earned; although, so far as the balance sheet is concerned, the taking of such a decision will convert the profits into a liability owed by the LLP to its members). By contrast, where the members have agreed to an automatic division of profits, the individual will be entitled to a share of those profits based on his percentage profit share, and accordingly his profit share will fall to be treated as an expense in the profit and loss account (and also as a liability in the balance sheet insofar as the profit remains unpaid at the balance sheet date).

Capital and remuneration

The examples set out below, which are provided for guidance only, illustrate both how the principles set out in the SORP should be applied to participation rights following the August 2008 amendment to FRS 25 on puttable instruments, and also, where applicable, how the accounting would have been different prior to that amendment. The matters set out in the following paragraphs are relevant when considering those examples.

Paragraphs 34 and BC20 to BC25 deal with the issue of when to treat remuneration and amounts subscribed (capital) separately for accounting purposes because there is no clearly identifiable return on capital and the substance of the arrangement makes it inappropriate to treat remuneration as a return on capital. This separate analysis will most often apply in situations where the members of the LLP provide services to that LLP (for example, professional services firms). As explained in BC23, in such situations remuneration and profit shares are often payable to members in return for participation in the business as well as representing a financial return on amounts invested by members and the latter element will represent a relatively insignificant proportion of total remuneration.

When considering whether a particular payment to a member is a return on capital subscribed or, for example, a payment in relation to services, an entity should apply paragraph 34 of the SORP. Accordingly:

a) where a member provides both capital and services to an LLP and no element of the return to the member is clearly identifiable as a return on the amount subscribed or otherwise contributed, no part of the return to the member (which may include inter alia salary, bonus, risk premium and allocated share of profits) will be regarded as a return on capital;

b) where a member provides both capital and services to an LLP but an element of the return to the member is clearly identifiable as a return on amounts subscribed or otherwise contributed, only that element will be regarded as a return on capital; and

c) where a member provides no services to an LLP then the whole of the return to the member will be regarded as a return on capital.

Where the members of an LLP provide services to the LLP, and a separate analysis of the accounting for the capital and remuneration is appropriate, it will usually be the case that the puttables amendment does not have any significant impact on the accounting treatment. This is because the remuneration will usually be a separate instrument or contract that has ‘total cash flows based substantially on the profit or loss’ of the entity and substantially restricts or fixes the return to the holders of capital. In such circumstances, the test in paragraph 16B or paragraph 16D of FRS 25 would seem not to be met, and repayable capital would not be eligible for equity treatment under the puttables amendment.

In relation to the consideration of the puttables amendment paragraph AG.14H of FRS 25 is of particular relevance to LLPs whose members provide services. The paragraphs preceding AG.14H explain that only cash flows and contractual terms and conditions relating to the instrument holder as an owner of the entity should be considered. They give the scenario in which certain partners are remunerated for providing a guarantee to the entity as an example of a transaction in a role other than that of an owner, which would be disregarded for the purposes of the puttables amendment. Paragraph AG.14H states:

> ‘Another example is a profit or loss sharing arrangement that allocates profit or loss to the instrument holders on the basis of services rendered or business

generated during the current and previous years. Such arrangements are transactions with instrument holders in their role as non-owners and should not be considered when assessing the features listed in paragraph 16A or paragraph 16C. However, profit or loss sharing arrangements that allocate profit or loss to instrument holders based on the nominal amount of their instruments relative to others in the class represent transactions with the instrument holders in their roles as owners and should be considered when assessing the features listed in paragraph 16A or paragraph 16C.'

Broadly, this means that remuneration for services is a non-owner transaction and disregarded in the puttables analysis but other profit or loss sharing arrangements based on the nominal amount of the relevant instrument are transactions in the holder's role as an owner and do need to be taken into account. Again, following the principles set out above, the provisions of this particular paragraph should be considered only after establishing whether the capital and remuneration are being analysed together for the purposes of the puttables amendment or separately (paragraph 34).

To summarise, based on the analysis above, part or all of the capital subscribed by a member will be accounted for as a liability a) if the LLP is obliged to make payments to the member which are clearly identifiable as a return on that capital (e.g. interest on an annual basis) or b) there are circumstances in which the member can demand repayment of capital (e.g. on retirement) and the conditions set out in the puttables amendment are not met – for LLPs where members provide services, this would be where the remuneration is regarded separately for accounting purposes and so 'substantially restricts or fixes the return to the holders of capital'.

As discussed above, for many LLPs where the members provide services, it is unlikely that the puttables amendment will have a significant impact. However, where there could possibly be an impact and the amendment needs to be considered in more detail, the flow charts in Appendix 3 set out the criteria that will need to be met for an instrument that would otherwise be treated as a liability to be treated as equity under the amendment.

Example 1 - Equity capital and profits

The analysis in this example applies irrespective of whether the members provide services to the LLP.

An LLP has ten members. Under the terms of the members' agreement, each member subscribes £1,000 as initial capital and will receive a 10% share of any profits that are divided. Any decision to divide profits or return capital must be approved by a majority of the members.

All cash outflows to members are at the discretion of the LLP. Accordingly:

- the capital subscribed of £10,000 is presented within equity, and
- divisions of profit are reported as equity appropriations when they occur (whether during or after the end of the period).

Thus, if the LLP made profits of £500,000 before profit sharing, and £300,000 was paid out to members as drawings during the year, the profit reported for the year would be £500,000. The drawings of £300,000 would be included in debtors and the £500,000 of unallocated profits would be included within equity at the year end, assuming that at that point in time, the decision to divide profits had not been made. Once the profits are divided, the amount of drawings in debtors would be offset against the liability then created. This may be contrasted with Example 2 below.

Example 2 - Liability for capital and profits

An LLP has ten members. Members provide services to the LLP. Under the terms of the members' agreement, each member subscribes £100,000 as initial capital and has a 10% share of profits. All profits are divided automatically each year, and a member may demand the return of capital (for example, upon retirement). No element of members' remuneration is clearly identifiable as a return on amounts subscribed or otherwise contributed. Accordingly, no part of the return to the members is regarded as a return on capital.

The LLP has no discretion over cash outflows to members. In addition, the tests in the puttables amendment are not met, because the remuneration is regarded as separate from the capital subscribed for accounting purposes and substantially restricts (to zero) the return to the holders of capital (see the footnote to paragraph 41). Accordingly:

- the capital subscribed of £1,000,000 is presented within liabilities, and

- an expense is charged in the profit and loss account (under the heading 'Members' remuneration charged as an expense') and a further liability recognised equal to the amount of profits available for division. (This profit and loss account treatment is illustrated at Exhibit D in Appendix 1.)

Thus, if the LLP made profits of £500,000 before profit sharing, and £300,000 was paid out to members as drawings during the year, the profit reported for the year would be £nil. Members' remuneration charged as an expense would be £500,000 and the undrawn balance of £200,000 would be included within liabilities at the year end. This may be contrasted with Example 1 above.

Example 3 - Liability for capital, equity for profits

An LLP has ten members. Members provide services to the LLP. Under the terms of the members' agreement, each member subscribes £1,000 as initial capital and has a 10% share of profits. Any decision to divide profits must be approved by a majority of the members, but a member may demand the return of initial capital (for example, upon retirement). No element of members' remuneration is clearly identifiable as a return on amounts subscribed or otherwise contributed. Accordingly, no part of the return to the members is regarded as a return on capital.

The LLP has no discretion over cash outflows to members in respect of capital. In addition, the tests in the puttables amendment are not met, because the remuneration is regarded as separate from the capital subscribed for accounting purposes and fixes the return to the holders of capital at zero (see the footnote to paragraph 41). Accordingly:

- the capital subscribed of £10,000 is presented within liabilities, but

- divisions of profit are reported as appropriations (not an expense) when they occur (whether during or after the end of the period).

Example 4 - Equity for capital, liability for profits

An LLP has ten members. Members provide services to the LLP. Under the terms of the members' agreement, each member subscribes £1,000 as initial capital and has a 10% share of profits. All profits are divided automatically each year, but any decision to return capital must be approved by a majority of the members. No element of members' remuneration is clearly identifiable as a return on amounts subscribed or otherwise contributed. Accordingly, no part of the return to the members is regarded as a return on capital.

The LLP has discretion over the return of initial capital, but no discretion over cash outflows in respect of profits. Accordingly:

- the capital subscribed of £10,000 is presented within equity, but

- an expense is charged in the profit and loss account (under the heading 'Members' remuneration charged as an expense') and a liability recognised equal to the amount of profits.

Example 5 - Liability for capital, split treatment of profits

An LLP has ten members. Members provide services to the LLP. Under the terms of the members' agreement, each member subscribes £1,000 as initial capital and will receive a 10% share of any profits that are divided. A member may demand the return of capital. The membership agreement specifies that 50% of the profits made during a year will be divided automatically. Any decision to divide part or all of the remaining profits must be approved by a majority of the members. No element of members' remuneration is clearly identifiable as a return on amounts subscribed or otherwise contributed. Accordingly, no part of the return to the members is regarded as a return on capital.

The LLP has no discretion over cash outflows to members in respect of capital. In addition, the tests in the puttables amendment are not met, because the remuneration is regarded as separate from the capital subscribed for accounting purposes and fixes the return to the holders of capital at zero (see the footnote to paragraph 41). Accordingly:

- the capital subscribed of £10,000 is presented within liabilities,

- an expense is charged in the profit and loss account (under the heading 'Members' remuneration charged as an expense') and a further liability recognised equal to 50% of the amount of profits available for division, and

- any divisions out of the remaining profits are reported as equity appropriations (not an expense) when they occur (whether during or after the end of the period).

Thus, if the LLP made profits of £500,000 before profit sharing, and £300,000 was paid out to members as drawings during the year, the profit reported for the year would be £250,000. Members' remuneration charged as an expense would be £250,000 (i.e. 50% of available profits) and the additional drawings of £50,000 would be included in debtors. The unallocated balance of £250,000 would be included within equity at the year end, assuming that at that point in time, no further decision to divide profits had been made.

Example 6 - Liability for capital and interest payments, equity for remaining profits

The analysis in this example applies irrespective of whether the members provide services to the LLP.

An LLP has ten members. Under the terms of the members' agreement, each member subscribes £1,000 as initial capital and has a 10% share of any profits that are divided. A member may demand the return of capital (for example, upon retirement), and interest at a market rate of 6% is automatically payable on the capital subscribed. Any decision to divide the balance of profits must be approved by a majority of the members.

The LLP has no discretion over the return of initial capital. In addition, the tests in the puttables amendment are not met, because the payment of interest is a non-discretionary return on the capital. Cash outflows to members in respect of profits after interest, however, are at the discretion of the LLP. Accordingly:

- the capital subscribed of £10,000 is presented within liabilities, and

- interest expense of £600 is charged in the profit and loss account (within the heading 'Members' remuneration charged as an expense'), and a corresponding liability recognised, but

- any other divisions of profit are reported as an equity appropriation when they occur (whether during or after the end of the period).

Example 7 - Discretionary repayment of capital

The analysis in this example applies irrespective of whether the members provide services to the LLP.

An LLP's constitution requires that members subscribe capital to the LLP. Upon retirement, the LLP is required to pass a resolution before any capital is repaid. If no such resolution is passed, the LLP is entitled to retain the capital indefinitely. Any decision to divide profits must be approved by a majority of the members.

In this example, a positive resolution is required to repay capital, and without it the LLP has no obligation to repay the amounts. Accordingly, the capital is presented as equity.

Example 8 - Discretionary repayment of capital and non-discretionary return on capital

The analysis in this example applies irrespective of whether the members provide services to the LLP.

An LLP's constitution requires that members subscribe capital to the LLP. Upon retirement, the LLP is required to pass a resolution before any capital is repaid. If no such resolution is passed, the LLP is entitled to retain the capital indefinitely. Interest at a market rate is automatically payable on all capital subscribed. Any decision to divide the balance of profits must be approved by a majority of the members.

In this example, although a positive resolution is required to repay capital, the LLP is obliged to pay a return on that capital. Accordingly, a liability will be recognised to reflect the present value of the minimum non-discretionary outflows (see paragraph 39 of the SORP). In this case, as the return is at a market rate at the time the capital is subscribed, the entire capital will be classified as a liability. Furthermore, the tests in the puttables amendment are not met, because the payment of interest is a non-discretionary return on the capital.

Example 9 - Discretionary repayment of capital and no identifiable return on capital

An LLP's constitution requires that members subscribe capital to the LLP. Members provide services to the LLP. Upon retirement, the LLP is required to pass a resolution before any capital is repaid. If no such resolution is passed, the LLP is entitled to retain the capital indefinitely. The membership agreement specifies that all profits made during a year will be divided automatically. No element of members' remuneration is clearly identifiable as a return on amounts subscribed or otherwise contributed. Accordingly, no part of the return to the members is regarded as a return on capital and their remuneration is considered separate from the capital for accounting purposes.

In this example, a positive resolution is required to repay capital, and without it the LLP is neither obliged to repay the amounts nor to pay any return on that capital. Accordingly, the capital is presented as equity. An expense is charged in the profit and loss account (under the heading 'Members' remuneration charged as an expense') and a liability recognised equal to the amount of profits.

Example 10 - Minimum level of capital in aggregate

The analysis in this example applies irrespective of whether the members provide services to the LLP.

An LLP's constitution requires members to subscribe capital to the LLP. The LLP is required to repay any retiring member's capital unless the aggregate of the capital would otherwise fall below £1 million. The LLP has no obligation to any member to repay capital if the amount would fall below that threshold.

If the total amount of capital is greater than £1 million then, unless the tests in the puttables amendment are met in relation to members' capital, the excess would be shown as a liability and £1 million would be shown as equity. If the tests in the puttables amendment are met in relation to members' capital, or if the total amount of capital is less than £1 million, the whole amount would be shown as equity.

Example 11 - Liability for capital and profits

An LLP has ten members. Members do not provide services to the LLP. Under the terms of the members' agreement, each member subscribes £1,000,000 as initial capital and has a 10% share of profits. All profits are divided automatically each year, but any decision to return capital must be approved by a majority of the members. Accordingly, because the members do not provide services to the LLP, the whole of the return to the members is regarded as a return on capital. For accounting purposes, therefore, it is not regarded as separate from the capital but needs to be considered when determining the appropriate accounting treatment for that capital.

The LLP has discretion over the return of initial capital, but no discretion over cash outflows in respect of profits. Accordingly, because a non-discretionary return is paid on capital:

- the capital subscribed of £10,000,000 is presented within liabilities (in this example, this equates to the present value of the future non-discretionary outflows for profits), and

- an expense is charged in the profit and loss account (under the heading 'Members' remuneration charged as an expense') and a liability recognised equal to the amount of profits.

Example 12 - Equity capital and profits

An LLP has been set up as an investment vehicle, and has ten members. Members do not provide services to the LLP. The LLP's investments are managed by a third party who is not a member. Under the terms of the members' agreement, each member subscribes £1,000,000. The agreement specifies certain dates on which a member can require the LLP to repurchase his or her interest. On repurchase, the member will receive the £1,000,000 originally subscribed, adjusted for the member's share of any losses or any profits not yet divided. Any decision to divide profits must be approved by a majority of the members. On such a division, the profits are divided equally between all ten members.

The LLP has no discretion over cash outflows in respect of the repurchase of members' interests. However, it considers the tests included in the puttables amendment, and concludes that they are met in relation to the members' initial capital. Accordingly:

- the capital subscribed of £10,000,000 is presented within equity, and

- any divisions of profit are reported as equity appropriations when they occur (whether during or after the end of the period).

Thus, if the LLP made profits of £500,000 before profit sharing, of which £300,000 was paid out to members as drawings during the year, the profit reported for the year would be £500,000. Members' remuneration charged as an expense would be nil and the drawings of £300,000 would be included in debtors. The unallocated balance of £500,000 would be included within equity at the year end, assuming that at that point in time, the decision to divide profits had not been made.

Prior to the puttables amendment, the capital in this example would have been presented as a liability, because the LLP has an obligation to repurchase members' interests. However, the LLP now concludes that all the tests for equity treatment in the puttables amendment are met – for example the total cash flows attributable to the capital over its life are based substantially on the LLP's profit or loss (paragraph 16A (e) of FRS 25).

Example 13 - Equity for capital, split treatment of profits

An LLP has been set up as an investment vehicle, and has ten members. Apart from the one member noted below members do not provide services to the LLP. Under the terms of the members' agreement, each member subscribes £1,000,000. The agreement specifies certain dates on which a member can require the LLP to repurchase his or her interest. On repurchase, the member will receive the £1,000,000 originally subscribed, adjusted for the member's share of any losses or any profits not yet divided. One of the members, Company X, is responsible for managing the LLP's investments. It has been agreed that 5% of the reported profits for each period will be divided automatically to Company X, as compensation for providing these investment management services. Any decision to divide the remaining balance of profits must be approved by a majority of the members. On such a division, the balance of profits is divided equally between all ten members, ie including Company X.

The LLP has no discretion over cash outflows to Company X. In order to assess whether the capital should be presented as equity or liability, the LLP considers, as one of the tests, whether the profits payable to Company X represent remuneration for services provided. The LLP judges that the non–discretionary amounts payable to Company X each year are purely for Company X's investment management services to the LLP and of an amount that is equivalent to what would have been payable to a non-member for such services. It also considers the other tests in the puttables amendment and concludes that they are met in relation to the members' initial capital. Accordingly:

- the capital subscribed of £10,000,000 is presented within equity,
- an expense is charged in the profit and loss account (under the heading 'Members' remuneration charged as an expense') and a further liability recognised equal to the amount of profits (5%) automatically payable to Company X each year, and
- any further divisions of profit are reported as equity appropriations when they occur (whether during or after the end of the period).

Thus, if the LLP made profits of £500,000 before profit sharing, of which £25,000 (5%) was divided automatically to Company X, and a further £300,000 was paid out to members as drawings during the year, the profit reported for the year would be £475,000. Members' remuneration charged as an expense would be £25,000 (i.e. 5% of available profits) and the additional drawings of £300,000 would be included in debtors. The unallocated balance of £475,000 would be included within equity at the year end, assuming that at that point in time, the decision to divide profits had not been made.

Prior to the puttables amendment, the capital in this example would have been presented as a liability, because the LLP has an obligation to repurchase members' interests. However, the LLP now concludes that all the tests for equity treatment in the puttables amendment are met – for example the non discretionary payments to Company X are purely for its investment management services and the total cash flows attributable to the capital over its life are based substantially on the LLP's profit or loss (paragraph 16A (e) of FRS 25).

Example 14 - Equity capital and profits (limited life)

An LLP has been set up as an investment vehicle, and has ten members. Members do not provide services to the LLP. The LLP's investments are managed by a third party who is not a member. Under the terms of the members' agreement, each member subscribes £1,000,000. No member can require the LLP to repurchase his or her interest, but the LLP has been set up with a limited life of ten years, at which point it will be liquidated. On liquidation, each member will receive a pro rata share (i.e. 10%) of the LLP's net assets.

During the LLP's life, any decision to divide profits must be approved by a majority of the members. On such a division, the profits are divided equally between all ten members.

The LLP has no discretion over cash outflows on liquidation in respect of the members' interests in its net assets. However, it considers the tests included in the puttables amendment, and concludes that they are met in relation to the members' initial capital. Accordingly:

- the capital subscribed of £10,000,000 is presented within equity, and
- any divisions of profit are reported as equity appropriations when they occur (whether during or after the end of the period).

Prior to the puttables amendment, the capital in this example would have been presented as a liability, because the LLP has a limited life and an obligation to deliver a pro rata share of its net assets on liquidation.

Example 15 – Split treatment of capital and profits (limited life)

An LLP has been set up as an investment vehicle, and has ten members. Members do not provide services to the LLP. The LLP's investments are managed by a third party who is not a member. Under the terms of the members' agreement, each member subscribes £1,000,000. No member can require the LLP to repurchase his or her interest, but the LLP has been set up with a limited life of ten years, at which point it will be liquidated. On liquidation, each member will receive a pro rata share (i.e. 10%) of the LLP's net assets.

During the LLP's life, interest at a rate of 1% is automatically payable on the capital subscribed. Any decision to divide the balance of profits must be approved by a majority of the members. On such a division, the profits are divided equally between all ten members.

The LLP has no discretion over cash outflows on liquidation in respect of the members' interests in its net assets. Nor does it have discretion over cash outflows in respect of interest payable on members' interests. However, it considers the tests included in the puttables amendment, and concludes that they are met in relation to the members' initial capital. Accordingly:

- that component of the capital subscribed that corresponds to the interest payable is presented within liabilities (this will be the present value of the future interest payments – i.e. the present value of ten annual payments of £100,000),

- the remaining balance of the capital subscribed is presented within equity,

- each year, an expense is charged in the profit and loss account (under the heading 'Members' remuneration charged as an expense') and a liability recognised equal to the unwinding of the discount on the liability component, and

- any further divisions of profit are reported as equity appropriations when they occur (whether during or after the end of the period).

Prior to the puttables amendment, the capital in this example would have been presented entirely as a liability, because the LLP has a limited life and an obligation to deliver a pro rata share of its net assets on liquidation.

APPENDIX 3:
FLOWCHARTS FOR ANALYSING PUTTABLE INSTRUMENTS FOR LLPS (THIS APPENDIX FORMS PART OF THE SORP)

The flowcharts below are intended to assist LLPs in applying the revised requirements of FRS 25, as amended in August 2008, in respect of puttable financial instruments and obligations arising on liquidation.

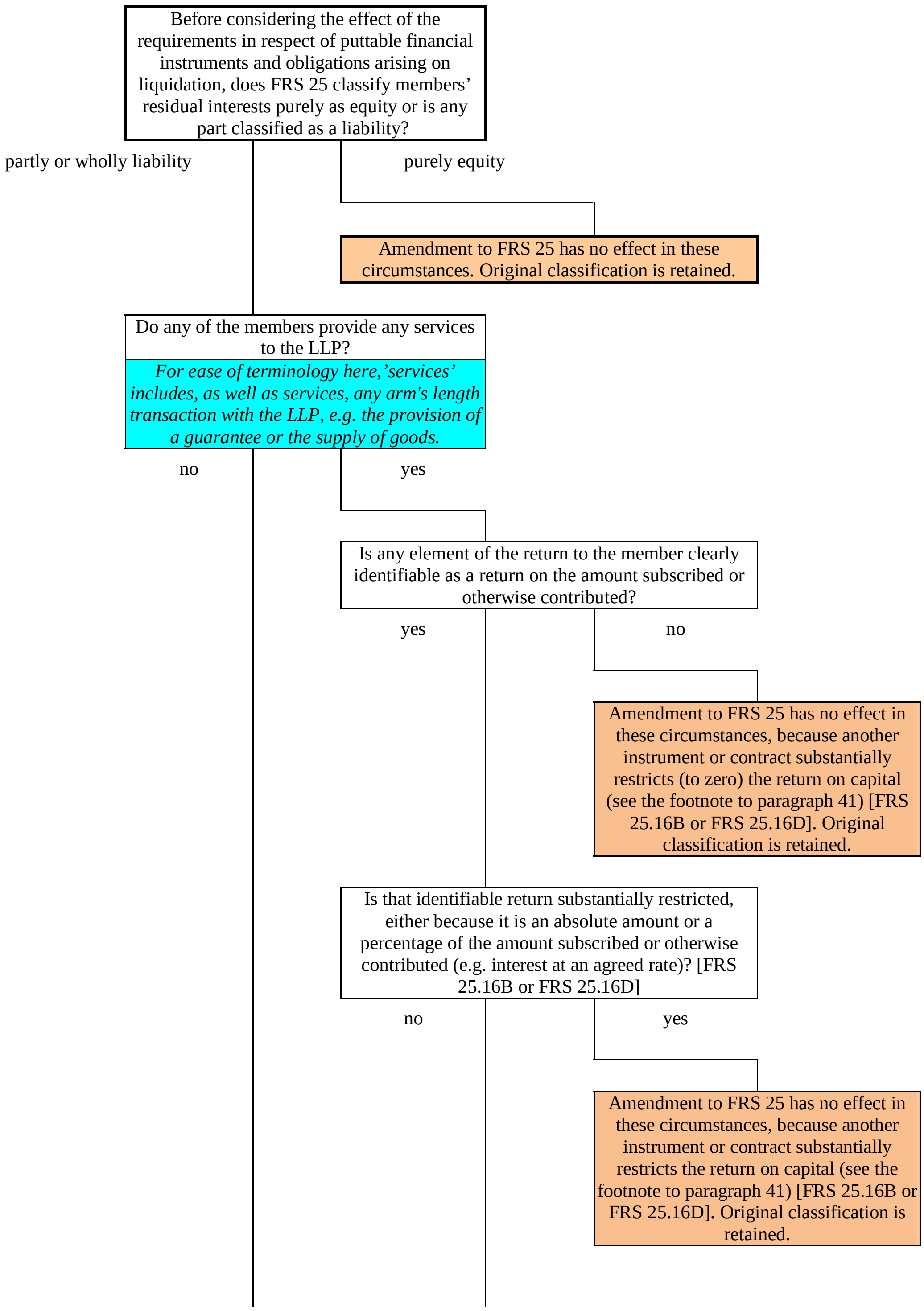
These flowcharts should be read in conjunction with the SORP and are not intended to be a substitute for applying the detailed requirements as set out in the amended standard. The flowcharts are not intended to cover every possible arrangement and judgement will need to be applied in assessing whether the requirements of the standard have been met.

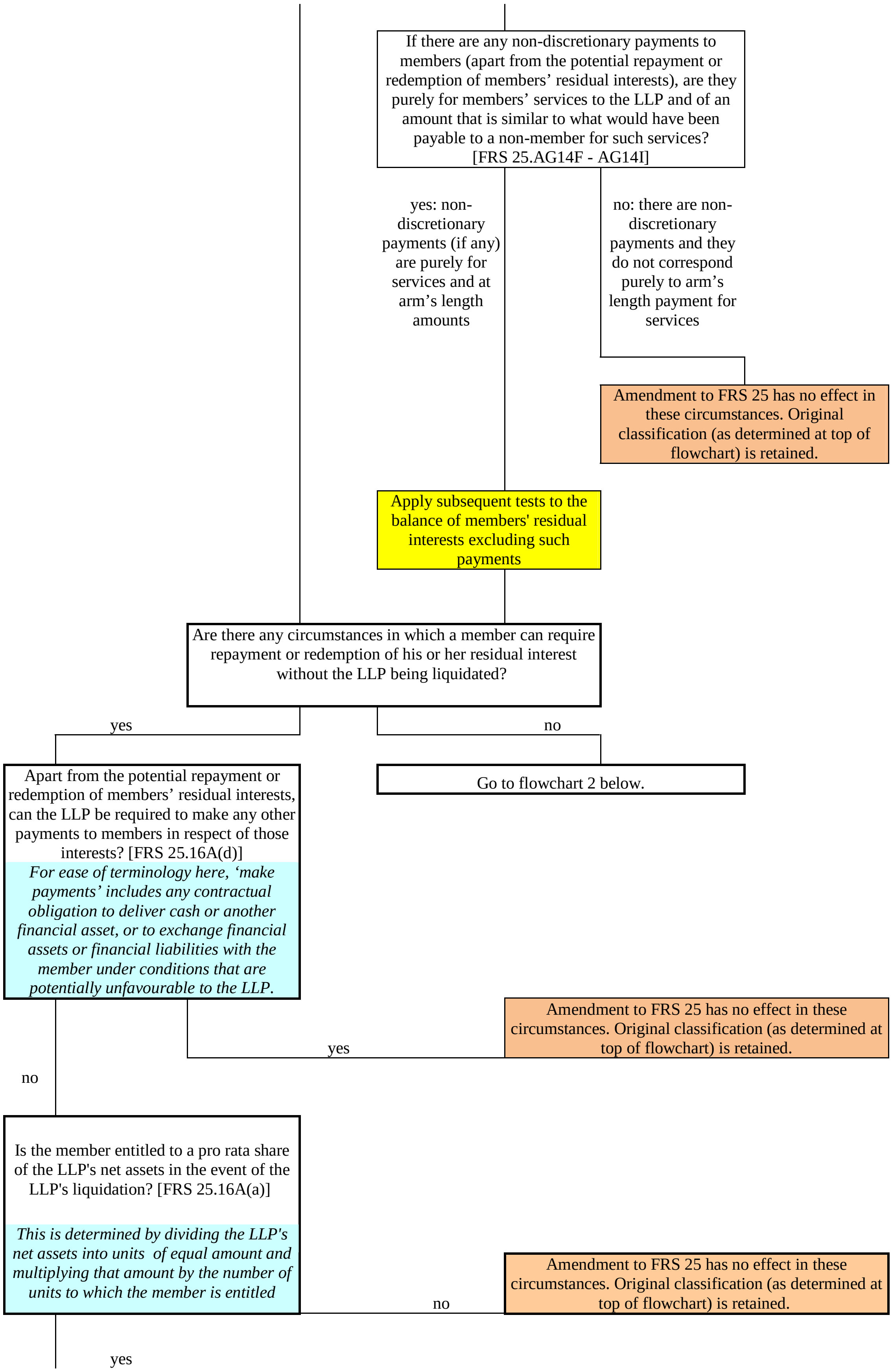
Depending on the structure of an LLP, members' interests may consist of one or more classes of financial instrument, which themselves may comprise one or more ‘components’. For example, members may invest in the capital of an LLP and may also be required to make loans to the LLP. If those loans are legally a separate financial instrument from the capital, then the LLP will have two classes of instrument with members. Under the amended Standard, reclassification is only possible for the class of instruments that is subordinate to all other instruments. Accordingly, where members' interests include more than one class of instrument, reclassification is only possible for the class of instrument that is subordinate to all others. For convenience, the flowcharts refer to this most subordinate class of financial instruments as "members' residual interests". Frequently, members' residual interests will be members' capital, though this need not necessarily be the case.

Note: It may be helpful to read the guidance at the start of Appendix 2 before seeking to apply the flowcharts. In addition, some of the questions in the flowcharts below may be more straightforward to answer than others. Before addressing the more difficult questions, it may be advisable to check whether the responses to the more straightforward questions are such as to confirm that the amendment to FRS 25 will have no impact.

Flowchart 1: Repayment or redemption of members' residual interests without liquidation of the LLP (puttable financial instruments and obligations arising on liquidation)

NB: All LLPs should begin at the start of this flowchart. An LLP will only proceed to Flowchart 2 if it is directed there from Flowchart 1.




If there are any non-discretionary payments to members (apart from the potential repayment or redemption of members’ residual interests), are they purely for members’ services to the LLP and of an amount that is similar to what would have been payable to a non-member for such services? [FRS 25.AG14F - AG14I]
yes: non-discretionary payments (if any) are purely for services and at arm’s length amounts
no: there are non-discretionary payments and they do not correspond purely to arm’s length payment for services
Amendment to FRS 25 has no effect in these circumstances. Original classification (as determined at top of flowchart) is retained.
Apply subsequent tests to the balance of members' residual interests excluding such payments
Are there any circumstances in which a member can require repayment or redemption of his or her residual interest without the LLP being liquidated?
yes
no
Apart from the potential repayment or redemption of members’ residual interests, can the LLP be required to make any other payments to members in respect of those interests? [FRS 25.16A(d)]
For ease of terminology here, ‘make payments’ includes any contractual obligation to deliver cash or another financial asset, or to exchange financial assets or financial liabilities with the member under conditions that are potentially unfavourable to the LLP.
Go to flowchart 2 below.
Amendment to FRS 25 has no effect in these circumstances. Original classification (as determined at top of flowchart) is retained.
yes
no
Is the member entitled to a pro rata share of the LLP's net assets in the event of the LLP's liquidation? [FRS 25.16A(a)]
This is determined by dividing the LLP's net assets into units of equal amount and multiplying that amount by the number of units to which the member is entitled
no
Amendment to FRS 25 has no effect in these circumstances. Original classification (as determined at top of flowchart) is retained.
yes

Is the member's residual interest in the class of instruments that is subordinate to all other instruments? [FRS 25.16A(b)]

This requires that the member's residual interest has no priority over other claims to the assets of the LLP on liquidation, and does not need to be converted into another instrument in order to be in the most subordinate class.

no

Amendment to FRS 25 has no effect in these circumstances. Original classification (as determined at top of flowchart) is retained.

yes

Do all financial instruments in the most subordinate class have identical features? [FRS 25.16A(c)]

This requires, for example, that the formula or method used to calculate the repurchase or redemption price is the same for all instruments in that class, so that two members with the same number of units would receive the same amount.

no

Amendment to FRS 25 has no effect in these circumstances. Original classification (as determined at top of flowchart) is retained.

yes

Are the total expected cash flows to the member over the period of membership based substantially on the profit or loss, the change in the recognised net assets, or the change in fair value of the recognised and unrecognised net assets of the LLP over that period (excluding effects of the member's residual interest)? [FRS 25.16A(e)]

no

Amendment to FRS 25 has no effect in these circumstances. Original classification (as determined at top of flowchart) is retained.

yes

Does the LLP have any other financial instruments or contracts that have:
(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets, or the change in fair value of the recognised and unrecognised net assets of the LLP over the period of membership (excluding effects of that instrument or contract), and
(b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders?
[FRS 25.16B]

yes

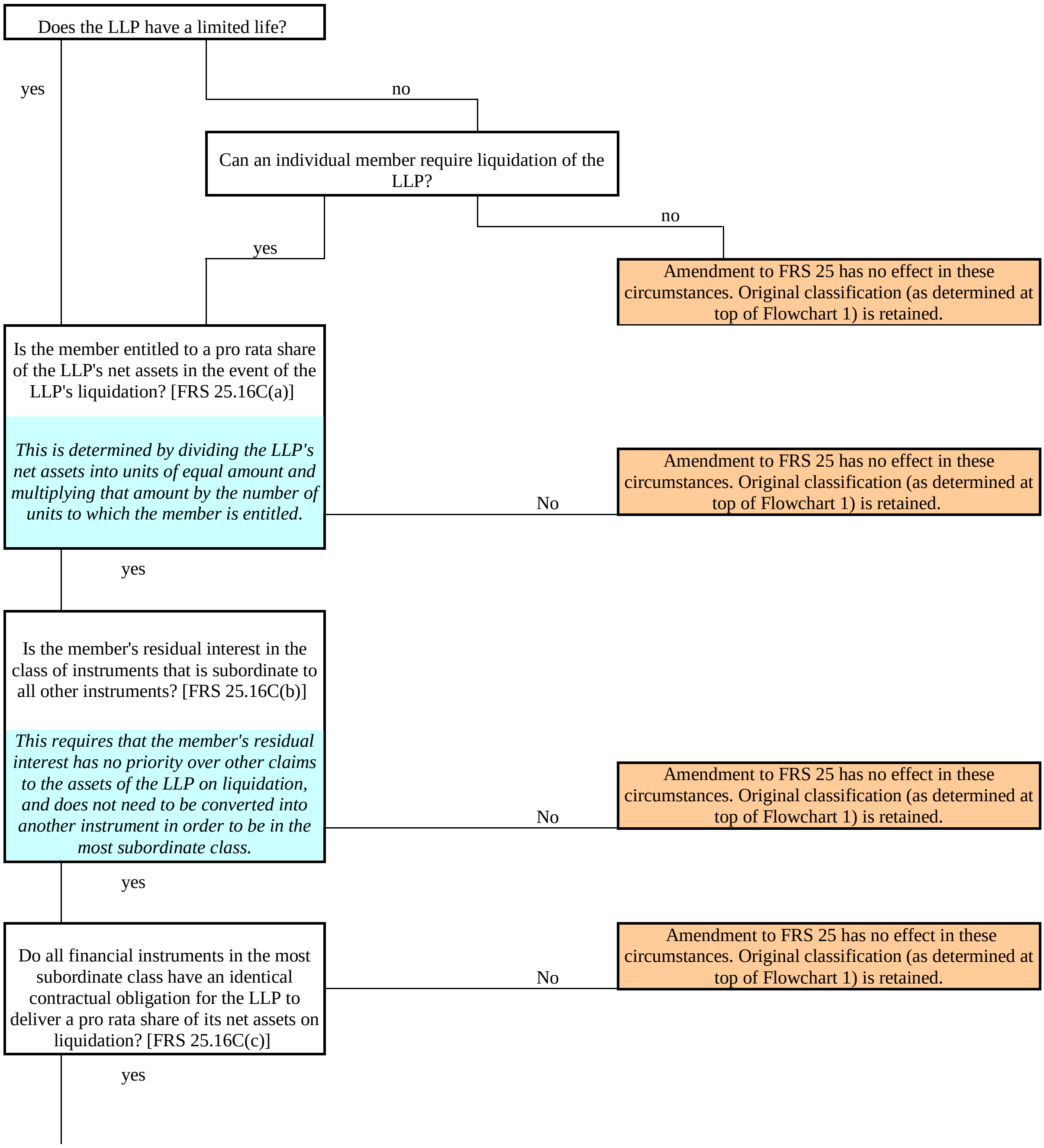
Amendment to FRS 25 has no effect in these circumstances. Original classification (as determined at top of flowchart) is retained.

no

Member's residual interest is classified as equity.

Flowchart 2: Repayment or redemption of members' residual interests on liquidation of the LLP (puttable financial instruments and obligations arising on liquidation)

NB: All LLPs should begin at the start of Flowchart 1. An LLP will only proceed to Flowchart 2 if it is directed there from Flowchart 1.



Does the LLP have any other financial instruments or contracts that have:
(a) total cash flows based substantially on the profit or loss, the change in the recognised net assets, or the change in fair value of the recognised and unrecognised net assets of the LLP over the period of membership (excluding effects of that instrument or contract), and
(b) the effect of substantially restricting or fixing the residual return to the instrument holders?
[FRS 25.16D]

Yes

Amendment to FRS 25 has no effect in these circumstances. Original classification (as determined at top of Flowchart 1) is retained.

no

Any component of member's residual interest that can be repaid only on liquidation is classified as equity.

APPENDIX 4:
MERGER ACCOUNTING ON INITIAL TRANSITION OF AN EXISTING UNDERTAKING TO A SINGLE-ENTITY LLP FORMED FOR THE PURPOSE

Introduction

1. This note explains how the SORP applies FRS 6 in certain special circumstances that arise when merger accounting is adopted on initial transition of an existing undertaking to a single-entity LLP formed for the purpose.

2. Paragraph 115 of the SORP states that a single-entity LLP formed by the transfer or incorporation of existing undertakings should present corresponding *pro forma* amounts.

3. Paragraph 116 of the SORP deals with a situation that is common in LLP incorporations, where the undertaking is transferred to the LLP part way though an accounting period and the LLP is not itself a parent undertaking. Paragraph 116 states that where there is a hiatus between formation of the LLP and the transfer, the net assets at book values should be reflected in the accounts at the date of the transfer, and profits should be recognised for the period from the transfer to the end of the accounting period. This is the commonly adopted practice.

4. Paragraph 116 also suggests that a *pro forma* profit and loss account, including corresponding amounts, should be given for the whole of the original entity's accounting period spanning the transfer.

Illustrative scenario and analysis

5. Entity A establishes an LLP on 1 April and transfers its trade and assets to the LLP on 1 July in exchange for an equity member's stake in the LLP. The LLP has a 31 December year end and prepares entity-only accounts. Assuming that the LLP meets the conditions for merger-accounting the transfer of the trade and assets under FRS 6 as a group reconstruction, there are potentially two alternative ways of presenting its results:

   (a) Bring in the net asset book values at the date of the transfer of trade and assets and only recognise profits arising in the LLP from the date of incorporation - 1 April, which will, in effect, only include transactions from 1 July - 31 December, since the LLP had no trade before the date of transfer.

   (b) Bring in the net asset book values at 1 January and recognise profits for the 12 month period 1 January - 31 December, to be consistent and comparable with entity A's reporting period.

6. FRS 6 is written in terms of consolidated accounts, where a subsidiary is acquired by a parent company. However, paragraphs 4 and 15 of FRS 6 state that the standard also applies to other arrangements that achieve similar results, which includes the scenario outlined above. Hence, although the rules for merger accounting in Schedule 6 to the Large and Medium-sized Companies

and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) only apply to group accounts, technically under FRS 6 they also apply to the transfer of trade and assets in entity-only accounts. Thus the merger accounting principles of reflecting the transfer at book value set out in paragraph 16 of FRS 6 should be applied to the entity-only accounts of the LLP in the scenario.

7. From a statutory viewpoint, the accounting period being reported on is for the nine months to 31 December and therefore profits and losses relating to the period before that should not be recognised in the LLP's first statutory accounts.

8. In addition, for companies combining with a trade and assets, common practice is to adopt option (a) and only bring in profits from the date of the transfer of trade. One rationale for this is that Schedule 1 paragraph 13(a) of SI 2008/410 only permits profits realised at the balance sheet date to be included in the profit and loss account. For companies, the pre-transfer profits are not profits, and certainly not realised profits, of the company and therefore should not be included in the entity profit and loss account.

9. On that basis the CCAB sees no reason for the accounting in LLP entity accounts to be any different. Schedule 1 paragraph 13(a) of SI 2008/410 also applies to LLPs under the Regulations, even though the concept of realised and unrealised profits is not relevant for LLPs.

10. However, paragraph 17 of FRS 6 states that the results of all the combining entities should be brought into the financial statements of the combined entity from the beginning of the financial year in which the combination occurred. This implies that (b) is the more appropriate presentation, assuming that the 'financial year' is the accounting period of the underlying business.

11. Furthermore, on the basis that Schedule 1 paragraph 13(a) of SI 2008/410 is irrelevant to LLPs and that paragraphs 16 - 19 of FRS 6 should be complied with, then the commonsense approach would be to present the results for the 12 months to 31 December, with 12-month comparatives - i.e. option (b) above. This is one of the common approaches in consolidated accounts in the equivalent group scenario.

Recommended practice

12. In view of the above considerations, the SORP recommends that LLPs should present alternative (a) as the statutory profit and loss set out in paragraph 5 above. The SORP also suggests disclosure of the 12-month profit and loss (i.e. option (b)) and comparatives as *pro forma* numbers. This approach is in line with the general requirement of FRS 6 to present such transactions as group reconstructions. It clarifies the original intention of the SORP, that merger accounting would be generally expected regardless of the date of transfer of the business. LLPs in their first accounting period may choose to use a three column profit and loss account format, or include the statutory profit and loss account in the form of alternative (a) as set out in paragraph 5 above as a separate statement for legal reasons, but give prominence to the non-statutory version.

APPENDIX 5: LEGAL OPINION

In June 2001, before the issue of FRS 25 and UITF 39, the Consultative Committee of Accountancy Bodies consulted Robin Potts QC on certain matters relating to the profits of a limited liability partnership, and received the following advice.

1. The profits of a limited liability partnership (LLP) are only converted into a debt due to its members when the members have agreed to divide the profits among themselves. The division of profits is a matter of the internal management of the LLP, as it is in the case of a company and a partnership (*Stevens v South Devon Railway Company [1851] 9 Hare 313* and *21 LJ Ch 816* and *Burland v Earle [1902] AC 83*).

2. The Limited Liability Partnership Regulations do not provide for an LLP (unlike a company) to include in its balance sheet the balance on its profit and loss account under the separate heading of 'Profit and loss account'. Accordingly, after the profits have been ascertained and in the absence of any agreement between the members to the contrary, the balance on profit and loss account would need to be included under the balance sheet heading 'Other reserves' pending an agreement to divide the profits among the members. The heading of 'Other reserves' is wide enough to encompass the balance on profit and loss account.

3. It is open to the members of an LLP to agree that the profits of the LLP shall be automatically divided between the members after they have been ascertained. Whether or not an agreement between the members has this effect is a matter of construction. The division of profits must be distinguished from the arrangements for profit sharing. A provision in an agreement between the members which sets out the profit shares of the members does not of itself constitute an agreement for the division of profits. It merely sets out the respective profit shares of the members which will apply to profits after the members have decided to divide them among themselves. Accordingly the default rule which is applied by virtue of Regulation 7 (1) of the Limited Liability Partnerships Regulations 2001 (which provides for the members of an LLP to share equally in the capital and profits of an LLP in the absence of agreement to the contrary) does not constitute a default rule as to the automatic division of profits between the members.

4. If the members agree to the automatic division of profits, then albeit that there is a scintilla of time between the ascertainment of the profits and their division among the members and notwithstanding that the balance sheet is contemporaneous with the profit and loss account, it would be acceptable to credit the profits directly to the current accounts of the members without first including the profits under the balance sheet heading 'Other reserves'.

5. An LLP could only have a revaluation reserve if there was no agreement between the members for the automatic division of profit. This is because the old common law rules regarding distributions would apply to LLPs and under these rules a revaluation reserve was distributable.

6. Whether a contribution made by the members to an LLP constituted capital or debt was a matter of construction of the intention of the members. For a contribution to constitute capital it must clearly be designated as capital. Otherwise the presumption will be that it constitutes debt.

7. Where the members make a contribution of capital to an LLP, they can subsequently convert the capital into debt by agreement. What constitutes an agreement between the members and in particular what majority is required to convert capital into debt is a matter of construction of the agreement between the members.

8. On an insolvency of an LLP amounts credited to capital and reserves in its books immediately prior to the commencement of the winding up would disappear and would not constitute debt which could be proved for in the winding up.

Robin Potts, QC
27 June 2001

Note: The above opinion was given prior to the introduction of FRS 25 and UITF 39. In paragraphs 6 and 7, the opinion deals with the distinction between capital and debt. In FRS 25 and UITF 39 the equivalent accounting distinction is between equity and financial liability. Although the test for distinguishing between the two is somewhat different, the references in the above opinion to the fact that it is the division of profits, automatic or otherwise, that converts profits into debt, are nevertheless consistent with the general principles of the amended SORP and specifically those in paragraph 24.

APPENDIX 6: BASIS FOR CONCLUSIONS

INTRODUCTION

BC1. This Basis for Conclusions summarises the Consultative Committee of Accountancy Bodies' considerations in reaching its conclusions on revising the Statement of Recommended Practice (SORP) *Accounting by Limited Liability Partnerships* in both 2006 and 2010. The Basis for Conclusions has been updated to reflect the deliberations for both revisions.

BC2. The first edition of the SORP was published on 29 May 2002 ('SORP 2002'). In accordance with the ASB's Code of Practice, the CCAB reviews the SORP annually for changes in accounting practice and new developments. UK GAAP advanced in a number of areas to the point where the CCAB concluded that a revision of the SORP was desirable in 2005. In September 2005 the CCAB published its proposals in an exposure draft of a revised SORP ('ED SORP 2005'), with a comment deadline of 31 December 2005. The CCAB received 12 letters of comment on the exposure draft.

BC3. Set out below is an analysis of the main changes proposed in ED SORP 2005, together with the conclusions reached in the light of comments received and in discussions with the ASB's Financial Sector and Other Special Industries Committee (FSOSIC). A revised SORP was published in March 2006 ('SORP 2006'). The subsequent, albeit less wide ranging, changes made to SORP 2006 as a result of the amendment to FRS 25 in 2008 (the puttables amendment) are also referred to in the text below where appropriate and, in particular, in BC15–19. The amended SORP was issued in March 2010 (SORP 2010).

The distinction between debt and equity

BC4. ED SORP 2005 proposed that members' participation rights in the assets of an LLP should be analysed between those that are, from the LLP's perspective, either a financial liability or equity, in accordance with FRS 25 (IAS 32) *Financial Instruments: Disclosure and Presentation* and UITF Abstract 39 *Members' Shares in Co-operative Entities and Similar Instruments*. The accounting implications of this requirement, as set out in the SORP, are considered in paragraphs BC5 - BC11 below. The majority of respondents to ED SORP 2005 who considered this issue agreed that a revision of the SORP was required and that the proposals were consistent with the standards.

BC5. SORP 2002 distinguished between debt due to members and 'Members' interests other than debt due to them by the LLP, which constitute equity in the LLP'. 'Members' capital' is a subset of 'Members' other interests', comprising 'amounts subscribed or otherwise contributed by members for longer-term retention in the business'. The term 'Members' capital' is used in the relevant legislation. This distinction was considered no longer appropriate in the light of FRS 25 and UITF 39, but applying these standards to LLPs is not straightforward. The constitutions and capital structures of LLPs can vary significantly. Amounts subscribed or contributed by members as 'capital' of an LLP may be withdrawn or converted to debt by agreement between the members. Accordingly, whether or not an instrument is debt or equity will depend entirely on the specific terms of the members' agreement.

BC6. The basis for the accounting required in the SORP is that the members' agreement, in dealing with the financial arrangements between an LLP and its members (for example, in respect of amounts subscribed or otherwise contributed and remuneration (discussed in paragraphs BC20 et seq. below)), will give rise to rights against the LLP. Such members' rights against the LLP are referred to for the purpose of this analysis as 'participation rights'. Participation rights may meet the definition in FRS 25 of a financial instrument: that is, 'a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity'. Participation rights that are financial instruments will be within the scope of FRS 25 and, by extension, UITF 39.

BC7. Under FRS 25 and UITF 39, prior to any consideration of the amendment made to FRS 25 in August 2008 dealing with puttable instruments ('the puttables amendment'), members' shares would be equity only 'if the entity has an unconditional right to refuse redemption of the members' shares' (paragraph 7 of UITF 39). The implication of this for LLPs is that, subject to consideration of the impact of the puttables amendment, members' interests will always be debts of the LLP unless the LLP has an unconditional right to refuse to pay the related amount. (There are also implications for the profit and loss account, including remuneration and profit shares, discussed in paragraphs BC20 et seq. below.) There may be instances, therefore, where members will have no interests classified as equity in the LLP.

BC8. Following the above analysis, the SORP requires members' participation rights in the assets of an LLP to 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. For the purpose of this analysis, the SORP requires participation rights in respect of amounts subscribed or otherwise contributed and remuneration (which may include salary, interest, bonus, risk premium and allocated share of profits) to be analysed separately, except where the remuneration is clearly identifiable as a return on amounts subscribed or otherwise contributed - for example, non-discretionary interest payments (see paragraph 39 of the SORP). As set out in the SORP, this means that, for example, a profit share payable at the discretion of the LLP would be accounted for as an equity appropriation even if the member's capital is treated as a liability because the LLP cannot refuse repayment of that capital (and the tests for equity treatment in the puttables amendment are not met). This reflects the reality that in many cases members' remuneration is based on participation in the activity of the business rather than providing a return on the capital invested (see paragraph BC23 below). Unless the tests for equity treatment in the puttables amendment are met, a member's participation rights will result in a liability of the LLP, except to the extent that the right to any payment or repayment is discretionary on the part of the LLP. This will depend on the construction of the members' agreement and, in respect of profits earned, the policy and mechanism for the LLP to divide profits.

BC9. ED SORP 2005 suggested *pro forma* balance sheets for use by LLPs, based on examples in FRS 25. This format was intended to allow LLPs to designate balances with members correctly as debt or equity, but also encourages presentation in a manner that provides useful information regarding the members' net interests in the LLP at the balance sheet date. Respondents to ED SORP 2005 welcomed this presentation, which was retained in SORP 2006.

BC10. The classification of capital and other members' interests in an LLP is not straightforward and will differ from one LLP to another. The CCAB believes it is likely, however, that many 'traditional' LLPs will need to classify capital as a liability. This issue has been complicated further following the amendment to FRS 25 in August 2008 (see BC15 to BC19 below).

BC11. Applying the principles of FRS 25 and UITF 39, a critical issue is whether or not the LLP retains discretion to withhold some or all of the profits to members, irrespective of whether it intends to, and invariably does, allocate all the profits to members. The CCAB accepts that any amounts that the LLP has no discretion to withhold should be classified as liabilities, unless the tests for equity treatment in the puttables amendment are met. It is possible, therefore, that undistributed profits may be shown as liabilities in an LLP balance sheet, where the members' agreement provides for profits to be automatically divided.

BC12. Although some respondents to ED SORP 2005 expressed concern at the outcomes set out in paragraphs BC10 and BC11, the CCAB concluded that they followed inevitably from applying FRS 25 and UITF 39 to LLPs.

BC13. There was some concern that the distinction drawn in ED SORP 2005 between debt and equity is spurious, because members of the LLP control the LLP and can therefore control whether or not the LLP has discretion to make payments to members. According to this view, members' interests would always be equity interests. However, this ignores the fact that, unlike a partnership, an LLP is a legal entity separated from its members by a 'corporate veil'. It is therefore correct to impute discretion to the LLP, even though this can be countermanded by the members.

BC14. Some respondents to ED SORP 2005 felt that the SORP should deal with FRS 26 *Financial Instruments: Measurement*. Given that FRS 26 is not mandatory in many cases and that the standard itself contains a significant amount of implementation guidance, the CCAB concluded that the SORP should not deal with this standard in any detail. However, paragraphs 4 and 5 have been included to provide guidance on which accounting standard is relevant when considering how to measure the type of financial liabilities, provisions and other financial instruments dealt with in the SORP.

BC15. One of the more difficult aspects of applying UK GAAP to LLPs is accounting for the interests of members in the profit or loss of the LLP and of the members' interests in the assets and liabilities of the entity. For the purposes of the guidance provided by the SORP, these interests are described as 'participation rights'. The analysis of members' interests in the assets and liabilities of a LLP needs to be reassessed as a result of the revisions to FRS 25 effective for accounting periods commencing on or after 1 January 2010. The amendment was made following a similar amendment to the equivalent International Financial Reporting Standard which arose following comments that certain types of entity may, under the previous version, have no equity shown in their balance sheet. The result of applying the amendment to LLPs may mean that certain members' interests which would otherwise have been classified as liabilities will now be classified as equity, particularly in situations where members do not provide services to the LLP. This may affect LLPs which would otherwise not have any equity interests in their balance sheets and may also result in other LLPs showing a greater level of equity than would otherwise have been the case. However, the criteria for reclassification are detailed and complex. In practice, the CCAB concluded that it would be likely that many LLPs will not be affected by the amendment.

BC16. The exposure draft of a revised SORP published on 29 July 2009 ('ED SORP 2009') contained further guidance on the application of the amended FRS 25 in the context of classification of members' interests as debt or equity, together with a flowchart and examples to illustrate some, but not all, possible scenarios.

BC17. The number of responses to ED SORP 2009 was small. A theme of some of the responses was that the guidance in the SORP was highly technical, and was for some considered difficult to interpret and use in a practical sense. The CCAB has a great deal of sympathy with this view, but was ultimately constrained by the highly technical and complex underlying amendment to FRS 25 which is itself not simple to understand or apply in practice. However, the role of the SORP is to apply that standard to UK LLPs and a degree of technical analysis is inevitable. The two most substantive responses focused on the same issue: a potential inconsistency between the principles in the SORP on members' participation rights, in particular paragraph 34, and the approach to analysing the members' interests in an LLP as financial instruments.

BC18. A member of an LLP can interact with the LLP in a number of capacities, and throughout the development of the SORP there has been a consistent principle that those different capacities (for example, service provider, investor, lender) should, where appropriate, be viewed separately and the accounting for any resulting transactions should follow the capacity in which the member acts. Respondents to ED SORP 2009 felt that some of the material on puttable financial instruments, particularly in some of the examples in Appendix 2, contradicted this principle and had sought to treat, for example, a members' agreement as a single financial instrument. The CCAB debated these responses and agreed that this underlying principle should still apply, i.e. participation rights in respect of amounts subscribed or otherwise contributed should be analysed separately from participation rights in respect of remuneration except where the remuneration, or part thereof, is clearly identifiable as a return on amounts subscribed or otherwise contributed.

BC19. The final SORP published on 31 March 2010 ('SORP 2010') therefore makes it much clearer that the interests of a member in an LLP are likely in many cases to be viewed as more than one 'instrument'. This is particularly likely in, for example, professional services LLPs where members are not simply investors or funders of the business, but also work in the business and provide services. Accordingly, SORP 2010 requires the remuneration to members in respect of services provided to be viewed separately from the remuneration in respect of capital or funding provided except where the remuneration, or part thereof, is clearly identifiable as a return on amounts subscribed or otherwise contributed. This approach is in many respects simpler and avoids a number of potentially complex accounting issues such as compound instrument accounting for amounts subscribed. It will in many cases (particularly for professional services LLPs) lead to there being no change in the designation of capital from liability to equity as a result of the puttables amendment. Given that the main change from ED SORP 2009 is to align more closely the examples and flowcharts with the principles set out in the body of the ED and that the expected result of SORP 2010 would be less change in some cases than previously expected, the Steering Group concluded it was not necessary to submit the revised SORP to a further exposure period.

Profit and loss account implications

BC20. ED SORP 2005 recommended that the treatment of the members' remuneration element in the profit and loss account should be based on the same principles as are used for determining debt and equity in the balance sheet. This means that participation rights in respect of amounts subscribed or otherwise contributed should be analysed separately from participation rights in respect of remuneration except where the remuneration is clearly identifiable as a return on amounts subscribed or otherwise contributed. Members' remuneration is 'any outflow of benefits to a member', and may include or comprise, inter alia, salary, interest, bonus, risk premium and allocated share of profits. This principle set out in ED SORP 2005 would mean that remuneration comprising a profit share payable at the discretion of the LLP should be accounted for as an equity appropriation even if the member's capital is treated as a liability. Respondents to ED SORP 2005 broadly agreed with this approach as a practical solution to a difficult problem, in line with the analysis set out below.

BC21. Some respondents to ED SORP 2005 felt there should be a closer link between the balance sheet classification of the capital instrument (debt or equity) and the way in which members' remuneration is dealt with in the profit and loss account. This is akin in the corporate situation to the linkage of a debt instrument with interest in the profit and loss account and an equity instrument with dividend payments. In addition some respondents to ED SORP 2005 felt that members' participation rights had certain features of compound instruments.

BC22. However, it is extremely difficult to apply to an LLP the provisions in FRS 25 on compound financial instruments (paragraphs 28 - 32) and 'interests, dividends, losses and gains' (paragraphs 35 - 36). The relationship between capital introduced and remuneration in an LLP is very different to that in a company, where there would normally be a clearly identifiable relationship between return on the investment and the investment itself. At one extreme, for example, there may be LLPs that have no members' capital, being entirely funded from external sources, in which case the profit and loss account treatment of remuneration must be assessed in isolation from any balance sheet amount.

BC23. In this respect, paragraph 36 of FRS 25 states that the classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss. However, while it may be possible to consider that the remuneration and profit shares of members amount to ‘interest, dividends, losses and gains’ as a result of the amounts invested by members in an LLP, in many or most cases this does not reflect the substance of the arrangements in LLPs. Remuneration and profit shares are often payable to members in return for participation in the business, as well as representing a financial return on amounts invested by members. In many LLPs, the latter will represent a relatively insignificant proportion of the total remuneration.

BC24. Because, in many cases, members’ remuneration constitutes a share of profits based on participation in the activity of the business, and given the difficulty of identifying the specific capital to which participation rights might attach, the CCAB considers that to treat all shares of profit in an LLP as some form of return on a financial instrument, even where the share of profit is a financial liability of the LLP once divided, would result in misleading and inappropriate accounting presentation. Accordingly, the CCAB decided to retain the principle that participation rights in respect of amounts subscribed or otherwise contributed should be analysed separately from participation rights in respect of remuneration, except where an element of the remuneration is clearly identifiable as a return of capital (see paragraph 39). As a result of comments received on ED SORP 2009, this principle has continued to be applied subsequently to the puttables amendment to FRS 25.

BC25. With regard to compound instrument accounting, while members’ participation rights might include both equity and liability elements, and thus be thought of as ‘compound instruments’ under FRS 25, it will often be impossible to ascribe these rights to identifiable elements of members’ capital, which itself will vary over time.

BC26. A minority of respondents to ED SORP 2005 expressed concern at the line taken in the ED with regard to automatic division of profits. The view was expressed that automatic division is, in effect, dependent on the agreement of the members, and so it is not correct to charge it as an expense. However, the CCAB continues to believe that an agreement for automatic division of profits does have the substance of establishing profits of the LLP as debts due to the members as they accrue. Although the members could agree among themselves to terminate the agreement, the accounting must be on the basis of the agreement that is in fact in force at the time which would be binding on the parties unless and until terminated or varied.

BC27. The position whereby a LLP had no agreement for the automatic division of profits, but had divided some of the profits during the accounting year was considered. Some views had been expressed that since at the time the accounts were drawn up the LLP had already divided the profit, it was therefore no longer discretionary and should be accounted for in the same way as an automatic division of profit. The CCAB is of the view that this is not the correct position. The position is no different in principle from that of a limited company declaring an interim dividend on ordinary shares. Accordingly, the CCAB considers that the discretionary division of profit during the year that is not clearly identifiable as a return on capital should be accounted for as an appropriation of profit in the year in which it occurs - in line with the treatment of an interim dividend paid by the company on its ordinary shares.

BC28. Appendix 1 to the SORP sets out example balance sheets and profit and loss accounts for an LLP, showing the changes that will result from applying the principles in the SORP. Appendix 2 provides illustrations of how the principles set out in the SORP would be applied to some simple LLP membership arrangements. These examples have been updated to reflect FRS 25 and the subsequent puttables amendment.

BC29. Some respondents to ED SORP 2005 suggested that FRS 20 *Share-based Payment* is applicable to members' remuneration because any share of profits a member receives is at least in part consideration for services rendered to the LLP. While the SORP cannot cover all remuneration arrangements, and it may be that in some circumstances FRS 20 is relevant, the CCAB concluded that typically members' remuneration arrangements would be outside the scope of FRS 20. The standard defines a share-based payment as 'a transaction in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options), or acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price of an entity's shares or other equity instruments of the entity'. The CCAB believes that what the member receives in exchange for any services given, i.e. typically a share of one year's profits, does not meet the definition of an equity instrument, which is 'a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities'. In this respect, an equity instrument is representative of the total value of the entity (for example, the price of an equity share in a corporate entity is representative of both the value of the existing assets and also of future cash flows). Accordingly, the CCAB believes that a share of one year's profits does not meet the definition of an equity instrument because it reflects only one year's earnings rather than a share in the overall value of the entity.

Post-retirement payments to members ('Annuities')

BC30. SORP 2002 required the present value of the best estimate of the expected liability for or in respect of payment to a former member to be provided in the accounts at the date of the member's retirement, in accordance with FRS 12 *Provisions, Contingent Liabilities and Contingent Assets*. (Such post-retirement payments are often described as 'annuities'.)

BC31. The introduction of FRS 25 has led to developments in the thinking behind the treatment of annuities by LLPs. The previous treatment, of recognising a liability only on the retirement of the member, was consistent with the principle of not reflecting transactions with members in the profit and loss account (except in the limited instance of salaried remuneration). However, FRS 25 has brought members' remuneration within the scope of the profit and loss account, and it would be inconsistent to treat annuities differently. Furthermore, an annuity to which a member has a contractual entitlement is a contractual obligation to deliver cash or another financial asset to another entity, and so meets the definition of a financial liability under FRS 25, although if it contains a life-contingent element it is scoped out of FRS 25 and would fall to be accounted for under FRS 12, as would annuities in respect of which the LLP only has a constructive obligation. Whichever is the relevant standard, the obligation in respect of the annuity should be accounted for at the time the member becomes entitled to a future payment that the LLP has no discretion to withhold (in line with the distinction between discretionary and non-discretionary participation rights, discussed in paragraphs BC7 et seq. above). As regards an unconditional annuity right, the granting thereof is the obligating event and it will normally be correct to recognise a liability at the time of such grant. As regards a conditional annuity obligation (for example, conditional on continuing future service), this should be accrued as the rights to that annuity accrue (whereas SORP 2002 required the liability to be crystallised at the time of the member's retirement).

BC32. As noted in the above paragraph, there may be cases in which the LLP considers that the right to an annuity meets the definition of a financial instrument under FRS 25. Note that a life-contingent annuity is likely to be an insurance contract and outside the scope of FRS 25 (see paragraph 4(d) of FRS 25 and Appendix C paragraph 24(d) of FRS 26. In this respect, the SORP deals in paragraphs 76 to 81 with the relationship and boundaries between FRS 12 and FRS 25. These explain that the technical boundary is one of scoping but point out that, whether in FRS 12 or 25, where the liability is of uncertain timing or amount, the measurement principles are likely to be the same.

BC33. FRS 17 explicitly defines retirement benefits as 'consideration given by an employer in exchange for services rendered by employees …'. It is thus designed to deal with employer-employee relationships and how the costs of a pension liability for a defined benefit scheme should be reflected in an entity's accounts. However, the relationship between an LLP and a member is not generally an employer-employee relationship, and it therefore requires a distinct accounting treatment. Furthermore, the amount of post-retirement annuity payable is not likely to be based on a proportion of final 'salary' that is 'earned' over time, but, in the case of profit-dependent annuities at least, is normally measured in relation to events and profits arising after the retirement date. For these reasons, the CCAB believes that these types of arrangement of post-retirement payments paid by LLPs to former members fall outside the scope of FRS 17.

BC34. However, measurement of the liability raises a number of issues. Although the CCAB is of the view that FRS 17 is not the governing standard, where, because of their nature and/or complexity, the arrangements are such that it is appropriate to apply the guidance in FRS 17, then that guidance should be applied in arriving at the measurement of the liability. In order to arrive at the best estimate of the expected liability (i.e. just for measurement purposes), the

CCAB believes that it will often be necessary to adopt actuarial principles and techniques.

BC35. However, where a member of an LLP is also an employee and receives retirement benefits under his or her employment contract, then FRS 17 will be applied in full, as reflected in the SORP.

Merger accounting on initial transition of an existing undertaking

BC36. Appendix 4 to the SORP explains the reasoning behind the treatment the SORP adopts for applying FRS 6 *Acquisitions and Mergers* in certain special circumstances that arise when merger accounting is adopted on initial transition of an existing undertaking to a single-entity LLP formed for the purpose. Commentators on ED SORP 2005 generally welcomed this approach.

Revenue recognition

BC37. Paragraph 65A of ED SORP 2005, which stated that revenue on service contracts should be recognised in accordance with UITF Abstract 40 *Revenue recognition and service contracts*, was deleted, on the ground that it was not specific to LLPs.

Losses

BC38. Certain commentators on ED SORP 2005 requested guidance on the accounting treatment of losses. This was felt to be impracticable, as the treatment will vary depending on the precise provisions of the members' agreement.