ICAEW representation

ICAEW REP 02/06

ACCOUNTING BY LIMITED LIABILITY PARTNERSHIPS

Memorandum of comment submitted in December 2005 by the Institute of Chartered Accountants in England and Wales, in response to the Consultative Committee of Accountancy Bodies' exposure draft of proposed amendments to the Statement of Recommended Practice (SORP) 'Accounting by Limited Liability Partnerships', published on 30 September 2005.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the exposure draft of proposed amendments to the Statement of Recommended Practice (SORP) *Accounting by Limited Liability Partnerships*, published by the Consultative Committee of Accountancy Bodies on 30 September 2005.

WHO WE ARE

2. The Institute of Chartered Accountants in England and Wales (the 'Institute') is the largest accountancy body in Europe, with more than 127,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

MAJOR ISSUES

4. We agree with the CCAB that the SORP requires amendment in order to provide guidance on implementing FRS 25 (IAS 32) *Financial Instruments: Disclosure and Presentation* and *UITF 39 Members' shares in co-operative entities and similar instruments*. These standards pose particular problems for LLPs, and the illustrative balance sheets and profit and loss accounts set out in the draft SORP are useful in suggesting how presentational solutions can be used to reflect the economic substance of the entity in compliance with the standards.

5. However, we believe that the CCAB needs to provide a fuller explanation of the reasoning behind the approach it has adopted in recognising the effects of FRS 25 and UITF 39. The CCAB also needs to clarify whether it has considered the implications of FRS 26 (IAS 39) *Financial instruments: Measurement* in reaching its conclusions. In developing this response, it has become apparent that there are some complex issues arising from the application of FRS 25 to LLPs which are not fully addressed in the draft SORP or its basis for conclusions. Furthermore, divergent and strongly held views exist on some of these issues. At the heart of these issues is the unique nature of the members' interests in an LLP and the possibility for the nature of those interests to change at the discretion of the members. This contrasts with other entities where the capital structure is normally fixed so that there is a clear distinction between debt instruments and equity instrument at any time. Although the literature addresses compound financial instruments that have a debt component and an equity component, it is not easy to understand how

these principles should be applied when the components may be varied over time. These issues are considered further below.

6. One view expressed to the Institute is that it is not appropriate for the CCAB to issue guidance which is effectively an interpretation of IAS 32. Those holding this point of view say that only IFRIC should interpret standards issued by the IASB. However, it is unlikely that IFRIC would be prepared to address issues arising out of a legal structure which is unique to a particular jurisdiction. Indeed, we would not consider this an appropriate use of IFRIC's resources. On the other hand, LLPs and their auditors are in urgent need of guidance on how to apply FRS 25 in these circumstances. We therefore agree that it is appropriate for the SORP to address these issues at the relatively high level proposed, so as to leave room to apply the principles to the wide variety of members' agreements that are found in practice. The SORP is clear that in the event of a conflict with an accounting standard, it is the standard which takes precedence over the SORP.

7. We have, in general, limited our comments to the changes proposed to the SORP. This should not be taken to imply that we concur with all the issues that have not been readdressed.

SPECIFIC QUESTIONS

The distinction between debt and equity

Q1. The draft 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 (IAS 32) 'Financial Instruments: Disclosure and Presentation' and UITF 39 'Members' shares in co-operative entities and similar instruments'. A member's participation right will result in a liability except to the extent that the right to any payment or repayment is discretionary on the part of the LLP. Do you agree with the interpretation of FRS 25 and UITF 39 on which the draft SORP is based?

8. We agree that the proposals in the exposure draft are consistent with FRS 25 and UITF 39 in so far as they relate to the presentation of items in the balance sheet. These requirements will, for many LLPs, result in much of the members' 'capital' being classified as a liability in the balance sheet, for example because the member has a right to repayment on retirement. We do not view this as useful financial reporting but accept that it is necessary for compliance with FRS 25. The presentation examples in the draft SORP are helpful in that they illustrate how information may be provided in a more useful form while still complying with the standards. In practice, the application of the principles in FRS 25 and UITF 39 to the particular facts will require careful consideration as to whether a liability to the members is established.

Profit and loss account implications

Q2. Following the introduction of FRS 25, the draft SORP requires the treatment of members' remuneration in the profit and loss account to be based on the same principles as are used for determining debt and equity in the balance sheet: where the LLP has no discretion over the payment of a benefit to a member it should be charged as an expense in the profit and loss account. Do you agree with this approach?

9. We have a number of concerns about this approach, although we accept that the CCAB has attempted to apply FRS 25 in a way that will leave flexibility for LLPs to present useful financial statements.

10. As noted in paragraph 4 above, complex issues arise concerning how to apply FRS 25 to the particular circumstances of an LLP. This is particularly true of whether the members' profit shares should be shown as an appropriation or as an expense. The draft SORP (paragraph 23B) takes the view that this will depend on whether the payment is non-discretionary. In particular, it notes that a profit share payable at the discretion of the LLP would be accounted for as an equity appropriation even if the members' capital is treated as a liability. It is arguable that this approach is not consistent with paragraph 36 of FRS 25 which 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. Nevertheless, we recognise the practical difficulties that would arise from applying this requirement when part of the members' capital is shown as a liability and part of it is shown as equity, coupled with the possibility that this analysis may change on a day to day basis. Therefore, on balance, we regard the guidance in the draft SORP as a pragmatic solution to a difficult problem. The SORP should, however, explain the rationale more fully than is currently done in BC11 to BC15 and confirm that this is not inconsistent with paragraph 36 of FRS 25.

11. We are concerned by the implications of treating members' remuneration, including profit shares, over which the LLP has no discretion as to payment, as a charge in the profit and loss account. It is difficult to see how reporting nil profits in a business that is in fact profitable is either helpful to users or supportive of high-quality financial reporting. We do, however, reluctantly accept that this accounting is required for compliance with FRS 25, at least in some cases depending on the terms of the members' agreement.

12. The amount of 'Members' remuneration charged as an expense' will include both amounts paid under an employment contract and other payments arising from components of members' participation rights that give rise to liabilities. The distinction between these two components is important and an analysis of the total into the two components should therefore be required by the SORP. This will to some extent continue the useful distinction adopted in the 2002 SORP between salaried and unsalaried remuneration. This had the benefit of certainty and clarity, which in turn helped to provide consistency and comparability in reporting.

13. The disclosure required by paragraph 24 of the draft SORP is very helpful in providing a sub-total that is a meaningful measure of the profitability of the LLP, even if the 'bottom line' is nil or some other arbitrary number required to comply with FRS 25.

14. In developing this response, the Institute is aware of concerns expressed about the line taken in the exposure draft with regard to automatic division of profits. Arguably, automatic division does not create the same obligation on the LLP to make payment as does, for example, a salary obligation, and the two will confer different enforcement rights on the member. There is a view that if automatic division is, in effect, dependent on the agreement of the members, it is not correct to expense it as proposed in the exposure draft. However, we believe that the existence of such an agreement does change the substance of the arrangements such that the profits of the LLP become 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. Indeed, if such agreements had no substance, there would be little point in entering into them from a commercial perspective. An LLP that does not like the accounting consequences of such an agreement is under no obligation to enter into one and presumably would not do so unless there were good commercial reasons that outweighed this disadvantage.

Balance sheet implications

Q3. Do you agree that the draft SORP properly reflects the requirements of FRS 25 in relation to balance sheet items?

15. We agree subject to our comments in response to question 1 above.

Post-retirement payments to former members ('Annuities')

Q4. Following the issue of FRS 25 and its definitions of liabilities, the draft SORP requires the liability for non-discretionary post-retirement payments to current and former members to be accrued as the rights to the payments accrue. Such a right will in many cases arise during the period of a member's service to the LLP. Do you agree with the SORP's approach to:

(a) applying the recognition criteria of FRS 12 to the liability arising in respect of annuities; and

(b) referring to the guidance in FRS 17 when measuring that liability (where appropriate) but not applying the principles of FRS 17 in determining how its components should be dealt with in the profit and loss account and the STRGL?

16. We agree that the liability should be dealt with under FRS 12. The argument in the Basis for Conclusions might be said to rely over-heavily on a legalistic

interpretation of FRS 17 as applying only to employees. However, we agree that members are sufficiently different from employees for the approach taken in the exposure draft to accord with the substance of annuity arrangements.

17. A better explanation is required of why the liability arises at the point when the member becomes entitled to a non-discretionary future payment, rather than over the period of service. This could be achieved by transferring some of the useful material in paragraph BC17 to paragraph 43B.

18. In particular, we are concerned that the reference to the 'vesting' of annuity rights in paragraph 43B may be misunderstood. A common feature of annuity rights of members of LLPs is that they become an absolute entitlement only when the member attains a particular age. If the member chooses to leave before that age, he or she will have no entitlement to an annuity. On the other hand, on attaining that age while still a member of the LLP, the member will only be entitled to an annuity based on past service. It appears clear to us that in the scenario a liability should be built up over the period of service rather than provided at the date when the specified age is attained. 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 practice). We believe that the SORP should deal with this point explicitly to avoid any divergence of practice.

19. We note that paragraph 58 has not changed substantively. However, we suggest that the final sentence is little more than an exhortation to take liabilities off the balance sheet, and should be removed.

Merger accounting on initial transition of an existing undertaking

. *Q5. When an existing undertaking is transferred to a single-entity LLP formed for this purpose, the draft SORP requires the LLP to present the net asset book values at the date of the transfer, and to recognise profits only from that date. It also encourages disclosure of the 12-month profit and loss and comparatives as 'pro forma' numbers. Do you agree with this approach?*

20. We agree. This proposal appears to be intended to bring the treatment of LLPs into line with that usually adopted by companies.

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