

FL MEMO

EXTRACTS

Accountancy
and
Financial Reporting

2011

UK GAAP



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CHAPTER 1

Accounting rules and conventions

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A. Introduction

- 1 This volume is concerned with accounting practice in the United Kingdom for those entities that have elected not to adopt International Financial Reporting Standards (IFRS). Although reference is frequently made to international standards, this is generally for the purpose of comparing their requirements to those prevailing in the UK.
The accounting principles and conventions currently in force in the UK have developed over many years and from various sources: legislation, accounting standards, and customs practised by professionals. However, as might be expected in a global business world, accounting in the UK cannot but be influenced by worldwide developments and practices as well.
- 2 The Accounting Standards Board, which establishes and issues financial reporting standards in the UK, in October 2010 issued far-reaching proposals that move away from the current UK GAAP reporting regime. These proposals will mark an important change for those entities that at present apply UK Financial Reporting Standards (FRS). Entities will be required to prepare financial statements according to how they slot into a tiered system based on whether they are publicly accountable or not, and (if not) how certain size-based criteria will then apply (see details at ¶252). Larger, publicly accountable enterprises already apply the IFRS regime while so-called small entities can elect to report under FRSSE (see ¶6000). Their position will remain largely unchanged. It is for those enterprises falling in between that the new framework will be relevant.
These proposals are still, at the time this book goes to press, under discussion (the consultation period runs until 30 April 2011) but it is anticipated that once finalised the changes will become effective in respect of accounting periods beginning on or after 1 July 2013.
- 3 The general framework and sources of authority for GAAP currently followed in the UK are discussed from ¶200. The overarching requirement of financial statements is that they give a true and fair view.

B. True and fair view

For over 50 years, company law in the UK has required financial statements to present a true and fair view of the reporting entity's financial position and the results of its operations. However, exactly what constitutes such a view is ultimately a matter of professional judgement – because its interpretation is governed by companies' legislation, accounting standards and generally accepted accounting practice. Moreover, "true and fair" is not a static concept, but one that is subject to changes over time. For instance, an accounting treatment that was considered to render a true and fair view as little as 10 years ago may now no longer do so because of changes in business practice or economic realities during the intervening period.

The **principle** that the financial statements present a true and fair view **applies** to all companies without regard to their size. Small and medium-sized companies (¶6000) can elect to adopt the Financial Reporting Standard for Smaller Entities (FRSSE), which – while it exempts them from the provisions of other accounting standards – still holds them to the requirement of true and fair presentation. Therefore, shorter-form and abbreviated financial statements prepared by these companies are expected to give a true and fair view.

The **Companies Act** states that the accounts cannot be approved by the directors unless they are satisfied that such financial statements "give a true and fair view of the assets, liabilities, financial position and profit or loss" of the company for the financial year.

For this purpose, accounts are required to comply with the provisions in regard to form and content of the balance sheet, the profit and loss account and any other additional information to be provided. The Act also requires companies to comply with prevailing accounting standards. This is generally sufficient to ensure that a true and fair view is given.

However, **in certain circumstances**, strict compliance may result in the unusual (and unexpected) situation in which readers are not given a proper appreciation of a company's financial statements – e.g., if additional information beyond the scope of what may have been required by the regulations (or formerly, under the 1985 Act, by Schedule 4) is necessary to explain an unusual transaction or to highlight a related party transaction (¶5000). In these cases, supplying the additional information will satisfy the true and fair requirement.

On the other hand, in special circumstances the accounting treatment required by the Act might not result in a true and fair view even if additional information is given. In these cases, the company is obliged to **depart from the relevant provisions** to the extent necessary to give a true and fair view and consequently follow an accounting treatment that is not in accord with the Act. Full details of any departure, including the reasons and the effect, must be given in the notes. This situation – where a company deliberately disregards a Companies Act requirement – is known as the **true and fair override**. It may be used only in special circumstances, such as where a company finds itself – in relation to a specific issue – in a situation that other companies facing a similar issue would not find itself. The same logic holds for companies in a particular industry, which may be considering issues that are specific to the industry concerned. For example, securities companies "mark to market" their current asset investments and take the resulting gains to the profit and loss account rather than the revaluation reserve, as the Act otherwise requires. This treatment is regarded as acceptable because, owing to the specific nature of the securities business, it gives a better view of such a company's performance. The point to be borne in mind is that before any company can invoke the true and fair override, it must be able to show special circumstances to justify it.

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CHAPTER 1

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Bill and hold arrangements

525

Under a bill and hold arrangement, the seller arranges a contract with a customer to supply goods, where although **legal title** is transferred immediately, physical delivery is deferred to a later date. The issue is whether the seller or purchaser should recognise the goods as assets or can the seller recognise the revenue and the right to consideration in the case where the goods have not been delivered to the buyer.

The criteria for **recognition of revenue** under these types of arrangement are considered below.

For the seller to be able to recognise the revenue arising from its **right to consideration** in respect of the bill and hold arrangement, or to continue to recognise the goods as stock, the terms of the contract between the seller and buyer should include all the **following characteristics**:

1. The goods should be complete and ready for delivery to the customer;
2. The seller should have relinquished all significant performance obligations, save safekeeping of the goods;
3. Subject to “Rights of Return”, the seller should have gained the right to consideration, regardless of when the goods are subsequently shipped to the customer;
4. The commercial substance of any “Rights of Return” should be examined;
5. The goods should be separately identifiable from other stock held by the seller; and
6. The bill and hold arrangements should be in accordance with the commercial objectives of the buyer not the seller.

The **accounting treatment** is thus:

- a. The seller should recognise the changes in assets or liabilities, and turnover when the “stock” is recognised as an asset by the buyer.
- b. Where the substance of the transaction indicates that the goods are still an asset of the seller, it should be retained on the seller’s balance sheet; any monies received from the customer (payments on account) should be included within creditors.

Principal benefits and risks The **principal benefits** of bill and hold arrangements for the customer are as follows:

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- the right to obtain the goods when required;
- sole rights to the goods in terms of third parties and the associated cash flows; and
- guaranteed prices.

The **principal risks** relate to slow moving stock and the risk of obsolescence.

Sales with a right of return

526

Under the **terms of the contract** a buyer may be permitted to return goods that they have purchased, with the right to a refund or cancellation of an obligation to pay. The existence of “Rights to Return” goods could affect the seller’s **“right to consideration”** under the contract and the recognition of revenue thereof. The seller’s recognition of its “consideration” and contractual obligation to transfer economic benefits to its customer, in respect of “Rights of Return”, are linked transactions.

As a consequence the **seller’s turnover** should exclude the sales value of estimated returns and only include revenue for items not expected to be returned. Estimates of “returns” should reflect the maximum potential number of returns and other appropriate risks based on historical experience of comparable sales. **Where the risk of returns are significant** and effectively all risks associated with the goods are retained by the seller, no turnover or changes in assets or liabilities should be recognised, until such time as:

- the estimated “returns” can be reliably re-measured; or
- any associated time period for the returns has expired.

Any payments received should be included within creditors as payments in advance.

Estimates of returns should be reviewed at each balance sheet date, taking into account constructive as well as legal obligations.

EXAMPLE Retail operation

A retailer sells leather shoes over the internet to customers, who have the right to return the goods within 21 days, provided they are in a resaleable condition. The retailer can estimate the percentage of returns expected (i.e. 25%) based on experience and recognise the appropriate revenue accordingly (i.e. 75%). For each pair of shoes sold, part of the consideration will be recognised as revenue and the remainder as a provision. Cost of sales recognised on each sale should be adjusted for each item returned with a corresponding adjustment to stock. This accounting treatment is in accordance with FRS 12 "Provisions, contingent liabilities and assets".

Presentation of turnover as principal or as agent

527

A seller acting on its own when contracting with customers for the supply of goods is known as the principal. The seller is an agent where he acts as an intermediary on behalf of a principal in return for a commission.

The **general rule** is that for a seller to account for exchange transactions as a principal, it should have exposure to all **significant benefits and risks** associated with at least one of the following; namely the selling price or in respect of stock (i.e. exposure to risk of damage, slow moving stock). Other indications of principal status are that the seller assumes any credit risk and that the seller retains discretion over the choice of supplier.

Where the **seller acts as an agent**, it will not normally be exposed to the benefits and risks attached to the exchange transaction. Agency arrangements exhibit the following transactions:

- the seller has disclosed that it is acting as an agent; and
- the seller plays no further part in the transaction, once the agent has confirmed the customer's order to the principal;
- the seller's commission is pre-determined;
- the agent bears no credit or stock holding risk.

Summary Condition	Accounting treatment Based on substance of transaction
Seller acts as principal	Turnover should be based on gross revenue received or receivable in return for performance of the contract.
Seller acts as agent	Turnover represents the commission or other amounts received or receivable under the terms of the contract. Amounts received or receivable from the customer that are payable to the principal should not be included in the agent's turnover.

Disclosures

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Application Note G does not include a requirement to list specific accounting policies so detailed disclosure should be made of revenue recognition policies adopted. For each principal source of revenue the following disclosures should be given:

- the timing of the revenue recognition;
- accounting treatment of discounts;
- measurement of sources of revenue; and
- methods used to allocate revenue in composite transactions where different revenue recognition policies are used.

EXAMPLE Retail

A retailer sells leather shoes over the internet to customers, who have the right to return the goods within 21 days, provided they are unworn and in resaleable condition. The retailer can estimate the percentage of returns expected (i.e. 25%) based on experience and recognise the appropriate revenue accordingly (i.e. 75%). For each pair of shoes sold part of the consideration will be recognised as revenue and the remainder as a provision. Cost of sales recognised on each sale should be adjusted for each item returned with a corresponding adjustment to stock. This accounting treatment is in accordance with FRS 12 "Provisions, contingent liabilities and assets".

CHAPTER 9

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A. Audit reports on Annual Financial Statements

All companies incorporated under the Companies Act are obliged to produce annual financial statements which, together with the reports of the directors and that of the auditors, must be sent to every member, every debenture holder, and every person who is entitled to receive notice of general meetings. In addition, a copy must be lodged with the Registrar of Companies.

As discussed in the appropriate sections, certain companies are able to claim exemption from the general duty to have their financial statements audited – e.g., dormant companies (see ¶6430) and small companies (see ¶6070) – but this chapter is concerned with entities that are not exempt. While auditors are called upon in the course of their varied engagements to issue many kinds of reports, the majority issued by them are those **addressed to the shareholders** in respect of annual financial statements.

The Act specifies that the accounts should comprise a balance sheet, a profit and loss account and accompanying notes that give a true and fair view (¶12) of the state of affairs of the reporting entity at the end of the financial year and of the profit or loss for the period then ended.

Company law requires the auditors to state explicitly whether, in their opinion, the company's annual accounts have been **prepared in accordance with the Act** and **give a**

true and fair view. In determining whether the financial statements give a true and fair view, the auditor should consider the accounting requirements not only of the Act but also **Financial Reporting Standards** and other pronouncements by the accounting profession – such as UITF abstracts, or industry-specific guidance such as the charities SORP. Where a company fails to comply with any of these, an auditor will have to assess the effect and consider whether the audit opinion on those financial statements should include details of how the company has failed to comply.

5801 In addition, auditors are required to satisfy themselves that proper accounting records have been kept and that the financial statements are in agreement with them. Moreover, they must make certain that any information given in the directors' report is consistent with the books and records of the company.

If any of these requirements are not met, or if the auditors have not been able to obtain all the necessary information and explanations required to enable them to form their opinion, they are obliged to disclose this fact in their report.

With regard to information that is required to be given in the directors' report or elsewhere in the financial statements – e.g., disclosures of directors' emoluments, benefits, loans or transactions required by Schedule 3 of The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (SI 2008/409) and Schedule 5 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410) – if the directors fail to provide this information, the auditors should do so.

5802 In the following paragraphs, the various **essential elements of an auditors' report** are discussed. These are:

- a title identifying the persons to whom the report is addressed;
- an introduction identifying the financial statements referred to;
- a headed section dealing with both directors' and auditors' responsibilities;
- a headed section dealing with the basis of the auditors' opinion (scope paragraph);
- a headed section expressing the auditors' opinion;
- the auditors' name and signature;
- the auditors' address; and
- the date of the report.

5803 The coming into force of the **Companies Act 2006** and strong support for a shorter audit report by institutional investors, preparer organisations, public sector bodies and some auditing firms following the Auditing Practices Board's 2007 Discussion Paper "The Auditor's Report: A time for change?" resulted in the revision of ISA 700 in 2009.

In December 2010, the APB issued Bulletin 2010/2 "Compendium of Illustrative Auditor's Reports on United Kingdom Private Sector Financial Statements for periods ended on or after 15 December 2010." This bulletin was in turn revised in February 2011 to reflect an auditor's responsibility to report on reading all financial and non-financial information in the annual report and to identify any material inconsistencies. This additional responsibility is for financial periods ending on or after 23 March 2011. (See ¶5809)

The examples of audit reports given in this chapter are taken from the most recently revised ISA 700, unless otherwise explained.

1. Title

5804 ISA 700 (Revised) states that the auditors' report should have an appropriate title and that it may be appropriate to use the term "Independent Auditor" to distinguish the auditors' report from reports that might be issued by others.

2. Addressee

5805 The auditors' report should be appropriately addressed. The Companies Act 2006 requires the auditor to report to the company's members because the audit is undertaken on their

behalf. Auditors' reports are therefore typically addressed to either the members or shareholders of the company.

EXAMPLE Sample Title and Address
INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF A LIMITED

3. Identification of financial statements

The **auditors' report** should identify the financial statements that have been audited, including the date of and period covered by the financial statements.

Usually, the financial statements of larger companies contain other financial information (e.g., in the directors' report or the chairman's statement). Auditors have no responsibility for such information beyond being satisfied that it is not inconsistent with the financial statements or otherwise misleading. It is therefore necessary that they **clearly identify** the parts of the financial statements to which their opinion does refer.

EXAMPLE We have audited the annual financial statements of [*name of entity*] for the year ended [*date*], which comprise the profit and loss account, the balance sheet, the cash flow statement, the statement of total recognised gains and losses, and the related notes 1 to 22. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

Auditors' reports of entities that do not publish their financial statements on a web site – or publish them in 'PDF' format – may continue to refer to the financial statements by means of page numbers.

EXAMPLE We have audited the annual financial statements of [*name of entity*] for the year ended [*date*] which comprise the profit and loss account, the balance sheet, the cash flow statement, the statement of total recognised gains and losses, and the related notes set out on pages 28 to 48. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

It is becoming increasingly common for this introductory paragraph to include wording specifically designed to limit the parties to whom the auditor acknowledges responsibility or duty of care. This development has not taken place under the aegis of the APB but rather as a decision by some members of the profession.

EXAMPLE **Sample of wording to limit the parties to whom auditors acknowledge responsibility:**

This report is made solely to the company's members, as a body, in accordance with Sections 495 and 496 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

MEMO POINTS If the company is a quoted company, this disclaimer should also include a reference to Section 497 of the Companies Act 2006: "This report is made solely to the company's members, as a body, in accordance with Sections 495, 496 and 497 of the Companies Act 2006".

CHAPTER 6

Partnerships

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B. Limited Liability Partnerships

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Limited Liability Partnerships (LLP) **are defined** as a separate legal entity that combines the benefit of the protection of limited liability for its members, with the flexibility to organise internal structures along the lines of traditional partnerships.

An LLP **should not be confused** with limited partnerships under which at least one partner must have unlimited liability. The liability of the partners in an LLP is limited to the capital they have contributed to the partnership.

The **regulatory requirements** in terms of the filing and audit of financial statements for LLP’s are more stringent than for limited partnerships (but similar to limited companies), due to the limited liability of the members. Examples include the professions with member firms (e.g. accountancy or legal). Appropriate **legal and tax advice** should be sought by entities thinking of adopting this type of structure.

The **regulatory framework** is set out in the table in the introduction (¶7602). Regulations issued under the new Companies Act will be phased in over the next 18 months.

MEMO POINTS The Consultative Committee of Accountancy Bodies (CCAB) has issued a revised Statement of Recommended Practice (SORP) for Limited Liability Partnerships (LLPs), incorporating amendments to FRS 25 “Financial instruments: Presentation”. The changes concern the treatment of “puttable” instruments and obligations arising on liquidation. The new SORP applies to accounting periods beginning on or after 1 January 2010.

The **purpose** of the LLP SORP is to complement and not replace the reporting requirements under the accounting standards, UITF Abstracts and LLP Regulations. Where **conflicts arise**, the LLP Regulations and accounting standards take precedence. There is no strict legal requirement to comply with the SORP, although non-compliance must be disclosed in accordance with FRS 18 “Accounting Policies”.

An LLP entitled to the **exemptions available** to small companies may prepare its financial statements in accordance with the FRSE.

7631

1. Legal framework

An LLP is a legal entity created under the Limited Liability Partnership Act 2000, and is more similar to a limited company than a partnership. A new or existing firm of two or more persons can incorporate as an LLP, which can own assets and enter into contracts in its own name. **Contractual claims** against third parties will be against the LLP and not against the members themselves. An LLP must register at Companies House.

7632

MEMO POINTS 1. The following regulations have been issued regarding the **accountancy provisions** of the Companies Act 2006, applicable to LLP’s; namely:

- The Limited Liability Partnerships (Accounts and audit) (Application of the Companies Act 2006) Regulations 2008 (SI 2008/1911);
- The Large and Medium-sized Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912);
- The Small Limited Liability Partnerships (Accounts) Regulations 2008 (SI 2008/1912).

These regulations came into force on 1 October 2008.

2. The Department for Business Innovation and Skills has published a final version of the LLP (Application of the Companies Act 2006) Regulations 2009, designed to implement the remaining provisions of the CA 2006. These regulations cover a range of matters, including LLP names and trading disclosures, annual returns, accounts audit, company reorganisation and fraudulent trading. The amendments covering overseas LLPs have not been included. These regulations apply from 1 October 2009. More information on these topics can be found in Company Law Memo.

3. The requirements of the Companies Act 2006 and subsequent regulations do not cover, in relation to LLPs, narrative reporting and summary (interim) financial statements.

Exemptions

1. The Companies Act exemptions **available to small and medium-sized companies** are also available to small and medium-sized LLPs.

2. The **thresholds** for qualifying as a small or medium-sized LLPs are the same as for small and medium-sized companies.

3. An LLP can file **abbreviated accounts** with the Registrar of Companies (where the LLP is not audit exempt).

4. A **small LLP** can prepare accounts for its members using the disclosure exemptions contained in the Companies Act.

5. The exemption from preparing consolidated accounts is also available to **small and medium-sized groups** headed by an LLP.

7634
SORP (21)

“Designated members”

An LLP **must have at least two** “designated members” who should be named on the incorporation document when the company is formed. Where all members are “designated” members this must also be stated.

7635

“Designated members” and other members have the same rights and responsibilities towards the LLP, **but in addition** have the following responsibilities:

- the appointment of auditors when applicable;
- signing the accounts on behalf of the members;
- filing accounts with the Registrar;

- notifying the Registrar of changes in membership, name of LLP or address of registered office;
- preparation, approval and delivery of the annual return to the Registrar; and
- representing the LLP in the event of dissolution or a winding up.

“Designated members” take on the legal administration of the LLP that in a limited company would be dealt with by the Company Secretary or directors.

Where directors **change their status** from “non-designated” to “designated” and vice versa, this should be reported to the Registrar. Changes in membership such as appointments or terminations must also be notified to the Registrar within 14 days.

Audit requirements

7636

LLP's **are subject to** the same audit requirements as private limited companies. A small LLP will qualify for exemption from audit if the annual turnover does not exceed the small company thresholds.

Auditors are appointed annually and only by a designated member.

The **first auditor appointed** by the LLP must be in place before the end of the financial year for which they have been appointed. **In subsequent years**, the auditor must be re-appointed or a new appointment made within two months of the approval of the preceding years financial statements.