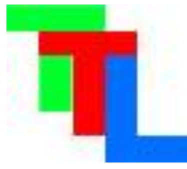

Accounting standards and tax

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Introduction

Tax is often calculated on profits or gains as shown in a set of accounts.

A tax computation for a commercial entity starts with “profit per the accounts”. Some items are not allowed for tax, even though they are properly included in the accounts. Such items include capital expenditure and depreciation, personal expenditure, fines and entertaining customers.

Disallowed items are said to be “added back”. For example, depreciation is not allowed for tax. If a profit and loss account shows £100,000 net profit after deducting £8,000 of depreciation, the net profit for tax purposes is £108,000 (subject to any other adjustments). For some items, it may be possible to claim a capital allowance instead of depreciation.

In many areas, tax law simply accepts the figures as calculated.

The general rule is that, unless there is a specific tax provision to the contrary, tax law accepts the figures produced by accounts that comply with accounting standards. As a consequence, accounting standards can have the effect of being part of tax law.

One troublesome area is when a commercial entity is entitled to record a profit. Consider a simple commercial operation:

(1) a business buys £100 worth of goods to sell for £150
(2) a customer places an order for the goods
(3) the business sends the goods
(4) the business sends an invoice for the goods
(5) the customer pays the invoice.

At what point has the business earned the £50 profit? In law, it is step (3). In accounting, it is step (4). If using the cash basis, it is step (5).

For income tax purposes, an individual may use cash accounting up to a limit. For VAT, any entity (including a company) may use a different system of cash accounting up to a limit.

It could be argued that the profit has not necessarily been earned at step (4) or even (5). The customer may fail to pay for the goods. The business may have to repair or replace the goods, or agree a refund. All of these will reduce the profit. For accounting purposes, these are all treated as subsequent events which are accounted for when they happen.

International accounting standard IFRS 15 makes clear when profit may be shown in the accounts.

True and fair view

The overriding requirement of all accounts is that they must present a **true and fair view.** This one requirement trumps every accounting standard and convention.

This term was first introduced in Companies Act 1947, replacing the previous “true and correct”. The change reflects the fact that accounts can never be “correct” in the sense that a mathematical equation can be. Accounts involve subjective decisions such as the value of property and the expected useful life of a fixed asset. Ten accountants looking at the same figures would produce ten different sets of accounts. Like ten artists painting the same picture, the pictures would be different while the subject was recognisably the same.

For companies, the present “true and fair” requirement is contained in Companies Act 2006 393. The provision is also a requirement of EU law as part of the EEC Fourth Directive on company law passed in 1978. However, “true and fair” applies to all entities, including partnerships and sole traders, and including non-commercial entities such as charities and local authorities.

True means that the accounts are in accordance with the supporting financial records. **Fair** means that they paint a picture which fairly represents the company’s financial position.

Finance Act 1986 s84 contains a provision allowing HMRC to override accounts that are not true and fair, even if they comply with all accounting standards. The only known occasion this provision has been used was in the case *GDF Suez Teesside Ltd (formerly Teesside Power Ltd) v HMRC. [2015] TC 4590.* The company was owed a substantial sum from Enron when it went bust in 2002. In 2006, the company established a subsidiary in Jersey and assigned to it all rights to any dividend from Enron. This subsidiary subsequently received £243 million in dividends which it lent to its parent company as an interest-free loan. The company’s original entitlement was a contingent loan which, under then accounting standard FRS 12, did not have to be included as profit. The subsequent loan from a subsidiary was also not income. Therefore the company did not include any of this dividend as income. HMRC said that it had to be included under the loan relationship rules.

The tribunal held that the accounts did not give a fair representation of profits, even though they complied with accounting standards.

This case also held that, where it was possible to determine two different figures for profit under accounting standards, the business is entitled to choose which one to report.

An understanding of the role of accounting standards is helped by knowing a little of their history.

What led to accounting standards

Accountancy is a new profession, largely recognised only from the end of the 19th century when the development of railways and banks led to ownership of business being separated from its management. This created a requirement for the latter to account to the former.

For decades, accounting standards comprised nothing more than "received wisdom" as recorded in text books or decreed by respected accountants, such as a president of one of the accounting bodies.

An example of this was the case *Lothian Chemical Co Ltd v Rogers [1926].* This held that conversion of plant was capital expenditure. The judge said that it was necessary to consider "ordinary principles of commercial accounting".

The first serious blow arose from the notorious case *R v Kylsant [1931]* known as the **Royal Mail case**. A shipping company had earned substantial profits from the government during the first world war. Much of this profit was squirrelled away in a secret reserve. Between 1921 and 1925 its trade dropped, but the company continued to pay dividends from its secret reserve, part of which was transferred to the profit and loss account to look like income. In 1928, the company issued a prospectus to sell shares on the basis that it was earning £500,000 a year profit when in reality it made £300,000 loss. Lord Kylsant, the director, and John Moreland, the auditor, were convicted of issuing a false prospectus and imprisoned. The company was liquidated.

The case prompted a review of company accounting. The company's use of reserves was in accordance with general accounting practice at the time, yet the court had found it to be fraudulent.

Even so, the profession did not rush into standard setting. The first authoritative accounting standards were "recommendations" produced by the Institute of Chartered Accountants in England and Wales in 1942 and published in *The Accountant.* These became known as the N regulations. The first two dealt with war damage claims and tax reserve certificates. These regulations were issued until 1969. They have all now been withdrawn. The last extant regulation was N21 on retirement benefits, withdrawn in February 1989.

These recommendations were not binding. They were also issued solely by the Institute of Chartered Accountants in England and Wales. They had not been agreed with the Institutes of Chartered Accountants for Scotland or Ireland, nor with any other accounting body.

It took the collapse of **Rolls-Royce** in 1971 to prompt the profession into a more organised form of issuing standards. The company had capitalised its expenditure on developing the RB 211 engine. In other words, it showed all this spending as something of value. When the engine could not be made to work (a problem now resolved), it could not sell them.

There was concern that a company could be reporting a healthy balance sheet one day and be insolvent the next.

Birth of standards

In 1970 the various bodies of chartered accountants formed the Accounting Standards Committee (ASC). In 1971, they were joined by other accounting bodies.

The ASC produced Statement of Standard Accounting Practices (SSAPs). These were then issued by the accounting bodies rather than the ASC itself. The only form of sanction for non-compliance was an accountant being disciplined by his or her accounting body. There is no known instance of this ever happening. Accountants meekly complied.

As there was, and still is, no obligation for a business's accounts to be prepared by a qualified accountant, an unqualified person could legally prepare accounts and ignore accounting standards. In practice, this tended not to happen.

SSAP 1 was on accounting for associated companies. The more logical start would have been SSAP 2 on accounting policies.

The first SSAPs were short documents. SSAPs 4 and 5, for example, could both be written on a single side of paper.

An SSAP started life as an Exposure Draft (ED). This was published as a little booklet. Accountants and others could comment during the exposure period.

Between 1971 and 1990, 25 SSAPs and 9 revisions were issued. Eight SSAPs remained in force until 2015. They have now all been repealed.

Standards get statutory authority

On 1 August 1990, the ASC was replaced by the more powerful **Accounting Standards Board** (ASB).

ASC adopted all extant SSAPs, and started to issue its own standards as Financial Reporting Standards (FRSs). Some replaced SSAPs. By 2013, ASB had issued 30 FRSs, all of which have now been repealed. It also amended SSAPs and produced other material.

The ASC was a subsidiary of the newly created Financial Reporting Council (FRC). FRC includes not just accounting bodies but the (then named) Department of Trade and Industry, Bank of England, and London Stock Exchange.

The ASC issued FRSs directly, not through accounting bodies. Compliance was required by Companies Act 1985 s267(1). This is now Companies Act 2006 s395. This later Act also included other provisions previously only required by accounting standards.

Like SSAPs, FRSs started life as a Financial Reporting Exposure Draft, which was charmingly abbreviated to FRED.

FRSs tend to be longer documents than SSAPs. An extreme example is FRS 26 on financial instruments which runs to 411 pages. Also, FRSs tend to include more discursive material with detailed analysis, rather than just saying what should and should not be done. By 2015, FRSs had mushroomed to more than 3,000 pages.

A contentious issue was of **universality,** whether accounting standards should apply to all entities, regardless of size, or whether smaller entities should have some requirements removed. The latter view prevailed. A Financial Reporting Standard for Smaller Enterprises (FRSSE, pronounced “frizzy”) was produced as a single book which was revised several times. This remained in force until 1 January 2016 when replaced by FRS 102 section 1A.

Two other bodies were also set up in 1990.

The **Financial Reporting Review Panel (FRRP)** monitored accounts of public companies for compliance with standards. If it finds an unjustified departure, it has the power to seek a court order requiring the accounts to be reissued to comply. FRRP can and does impose fines.

The **Urgent Issues Task Force (UITF)** dealt with issues that suddenly arise and cannot wait several years while an FRS is being agreed. These relates to matters that arise from new technology, new law or other development. UITF issues Abstracts. These are short documents that say how such matters should be shown in the accounts.

UITF abstracts can have significant effect on accounts. The most extreme example was UITF 40 which, like international accounting standard IAS 18, required profit to be recognised sooner than UK standards SSAP 2 and (later) FRS 5 did. In particular, it required profit to be recognised on some work in progress. This had the effect of increasing reported profits and hence tax on profits. A special provision was introduced in Finance Act 2006 Sch 15 to allow such additional tax to be spread over six years.

In addition to accounting standards, there are also **statements of recommended practice (SORPs)** for particular types of entity such as charities, education and the oil industry. These are produced by other bodies, and approved or “franked” by the FRC.

Financial Reporting Standards

In 2004, the government made the **Financial Reporting Council** (FRC) the single independent regulator of accounting standards. On 2 July 2012, it took sole responsibility for issuing accounting standards. At that time, standards were not a coherent code but a collection of documents, written in widely different styles and lengths, dealing with various hot topics. Standards were reactive rather than proactive.

Under statutory instrument SI 2012 No 1741, the FRC said in November 2012 that it had adopted 29 FRSs, 8 SSAPs and 31 UITF Abstracts.

FRC decided to scrap the lot and start again. With effect for accounting periods that start on or after 1 January 2015, all SSAPs, FRSs and UITF abstracts are replaced by financial reporting standard FRS 102 and related standards. Over 3,000 pages of standards were replaced by about 300, written in a consistent style, logically laid out. FRS 102 contained 35 sections, each of which is in effect a mini-standard. Note that SORPS were *not* repealed.

The family of new standards is:

- FRS 100: application of financial reporting requirements. This sets out the framework for determining which standards to use
- FRS 101: reduced disclosure framework. This states how small entities may use international accounting standards without having to comply with all requirements
- FRS 102: accounting standard. This is the main accounting standard for the UK and Irish Republic
- FRS 103: insurance contracts. The particular issues of insurance require a separate standard
- FRS 104: interim financial reporting, published in March 2015. The standard does not require interim reporting, but sets out the standard if an entity chooses to report
- FRS 105: reporting for micro-entities, published in 2016.

The FRC has produced other documents such as impact assessments for FRS 100, 101 and 102; implementation guidance for FRS 103; and guidance on the strategic report.

For accounting periods starting on or after a January 2016 (one year after FRS 102), FRSSE was replaced by a new section 1A of FRS 102.

International standards

SSAPs and FRSs only applied to British accounts. With the globalisation of much business, there is an obvious need for international standards. International standards have therefore been developed.

Developing such standards meant addressing a fundamental difference in approach between the UK and many other countries, particularly on Continental Europe. British accounts generally follow a laissez-faire approach where considerable discretion is allowed to the accountant. The Continent has tended more toward a “cook-book” approach which is more prescriptive and less discretionary. The difference is like that between impressionism and painting by numbers.

The International Accounting Standards Board (IASB) was formed in 1973 by 13 countries. There are now 125 countries that use International Accounting Standards. Its work is supported by the G20, the Financial Stability Board and the World Bank.

The main exception is the **USA** whose Financial Accounting Standards Board (FASB) issues various standards. In 2002, FASB and IASB agreed to co-operate, though progress has been

slow. IFRS 15 on revenue recognition in accounts is the first international standard to be the same as the US equivalent. It took 15 years to reach agreement.

Despite this, the UK played a significant role in the development of international standards. The IASB is based in London. The UK also started to rewrite its own standards to comply with International Accounting Standards.

In 2003, the International Accounting Standard Board changed from issuing International Accounting Standards (IASs) to International Financial Reporting Standards (IFRSs). Both IASs and IFRSs tend to be less detailed than their UK equivalents. In many cases, the IAS or IFRS sets out some bare bones which the FRS fleshes out.

From 2005, all companies **listed** on the London Stock Exchange must prepare their accounts using international standards. In 2007, this also became a requirement for companies listed on the Alternative Investment Market (AIM). This is an EU requirement under regulation 1606/2002.

However, this requirement has little effect for corporation tax. The only accounts required to conform to international accounting standards are the *consolidated accounts* of the group. Consolidated accounts treat a family of companies as if they were one company. Corporation tax is charged on *individual* companies who may, if they wish, use UK accounting standards.

Stock Exchange rules

Companies listed on the London Stock Exchange must also comply with the exchange's listing rules.

From 2000, these are issued by the UK Listing Authority. Previously it was issued by the Stock Exchange itself, and commonly known as the Yellow Book.

Auditing

Auditing is a passive activity whose nature and purpose is not widely understood. In particular, auditing is not a check on the accounts nor on how well the business is run, or even if the business is being run legally. The word audit comes from the Latin meaning "he hears". A Companies Act 2006 audit report simply gives an opinion on whether the accounts:

- are true and fair, and
- comply with the Companies Act 2006.

Although the audit report is addressed to company shareholders, all they usually receive is text lifted verbatim from an auditing standard. The real concerns of the auditors are given to the directors in a letter of weakness, even though the directors are the very people the auditors should be checking.

A “clean” audit report does not necessarily mean that the company is well-run or free of fraud.

In other areas, an audit may check for other matters, such as compliance with the law or obtaining value for money. The exact terms of the audit engagement are set out in a letter from the auditor.

In June 2016, all auditing standards were replaced or re-adopted by the Financial Reporting Council. They are designated ISA followed by three digits. So, for example, ISA 210 deals with agreeing the terms of the audit engagement. In 2016, an ethical standard of auditing was published.

Choice of standards

Every entity must comply with accounting standards but may choose which set of standards.

For all entities there is the choice of UK standards (such as FRS 102) or international standards.

Smaller entities can choose to use lighter standards, such as FRS 102 section 1A or international standards as relaxed by FRS 101. Micro-entities may use FRS 105 which has even lighter standards.

Even though an entity may be entitled to use a lighter standard, it may choose not to do so. A small entity that believes it will soon become a large one, or where the entity believes it will be sold may wish to comply with full standards.

A micro-entity can choose between five standards:

- FRS 102
- FRS 102 section 1A
- FRS 105
- international accounting standards
- international accounting standards as relaxed by FRS 101.

Both UK and international accounting standards keep changing. IFRS 15 on profit recognition and IFRS 16 on leasing will both have significant impact on accounts. Both of these standards will probably soon be reflected in UK standards. This changing and choice undermines one of the main reasons for having standards in the first place, namely being able to make fair comparisons between different businesses.

It should also be noted that sometimes standards themselves offer a choice. For example, FRS 102 section 12 allows a business to use:

- FRS 102 sections 11 and 12 in full
- IAS 39, or
- IFRS 9.

An entity may change which standards it uses from year to year, though this is not to be encouraged. There are standards that deal with a change in standards (IFRS 1 and FRS 102 section 35). They have the obvious objective that all profit is taxed once and only once, and all costs and expenses are allowed once and only once.

For a simple business such as a sweet shop, the choice of standards is unlikely to make any difference to reported profit. Differences are likely to arise when there are such things as goodwill and financial instruments such as derivatives.

Some of the differences between standards relate to what items are disclosed and how they are reported. These differences have no impact on the tax payable.

Statutory requirement for tax

In practice, it has always been a requirement that the accounts used for tax must comply with accounting standards. Yet it was not until 1993 that tax law explicitly stated that fact. The first explicit example was that foreign exchange had to be accounted using SSAP 20.

A more general provision is Finance Act 1982 s42 which requires trading profits to be calculated on a "true and fair" view from 7 April 1999. This provision is now in Income Tax (Trading and Other Income) Act 2005 s25 for income tax and Corporation Tax Act 2009 s46 for corporation tax.

Finance Act 2002 s103(5) requires trading profits to be calculated in accordance with **generally accepted accounting principles (GAAP)** from 24 July 2002.

GAAP is defined for corporation tax in Finance Act 2004 s50 and for income tax in Income Tax Act 2007 s997. The definitions are the same.

These statutory changes made no difference in practice, as businesses had been following accounting standards for more than 100 years.

Some examples

In 1989 two individuals in partnership leased three narrow boats to hire out on a short-term basis. One lease, taken as illustrative of all the **leases**, had an initial lease period of 24 months. There was an initial payment of £14,500, followed by 17 monthly payments of £2,080 and five months with no payments. The secondary lease period was for another 21 years at £5 a year.

For the first year's trading, the partnership claimed tax relief for the payments actually made, namely £14,500 plus some of the £2,080 payments. HMRC held, and the Court of Appeal agreed, that this was not correct. Under statement of standard accounting practice SSAP 21, the payments had to be spread evenly over the 24 months, as a result of which a lower figure could be claimed for the first year.

This case is *Threlfall v Jones [1993].* It also established that a partnership is as bound by accounting standards as a company. (SSAP 21 has now been replaced by FRS 102 section 20. The tax liability is the same.)

A similar principle arose in the case *Johnston v Britannia Airways Ltd [1994]* but where the taxpayer benefited. Aeroplanes require a major overhaul every 17,000 hours, which is about three to four years of use. The company claimed tax relief for **setting aside** a sum in years 1 and 2 towards the cost of the overhaul of year 3, relying on the matching principle of SSAP 2. Inland Revenue objected on the grounds that the company had not incurred any expenditure in years 1 and 2. The High Court found for the company.

Tax relief in these circumstances would not now be allowed because of FRS 12 issued in 1998, and now itself replaced by FRS 102. What remains of interest is the statement of the court that Inland Revenue (now HMRC) could not insist on one interpretation of an accounting standard when there was another interpretation that benefited the taxpayer.

A slightly different view was taken with regard to **best practice.** A supplier of processed meat made a provision for £850,000 expected bad debt from a customer. By the time the accounts were finalised, the debt had been paid, and the sum was written back in the following year's accounts. HMRC argued that it should have been written back in the same year. The Special Commissioners (predecessor to tax tribunal) found that either was permissible under accounting standards, but best practice favoured HMRC's view. *Meat Traders Ltd v Cushing [1997].*

A **misunderstanding** of an accounting standard means that the accounts do not comply with GAAP. An investment company moved from SSAP 20 to FRS 23 (both now repealed). The company also changed its functional currency to US dollars. HMRC argued, and the tribunal agreed, that this change was not permitted under para 11(a) of FRS 23. This is a clear example of HMRC regarding an accounting standard as tax law. The tribunal noted that sometimes more than one interpretation may be given to a standard, but this was not such a case. *Ball UK Holdings Ltd [2017] TC 5920.*

Some practical consequences

There are many differences in terminology and disclosure requirements between UK and international accounting standards. There are also differences in calculating deferred tax. These differences do not affect the amount of tax payable.

HMRC has produced guidance on the tax consequence of moving to new accounting standards. It can be accessed on HMRC's website at https://www.gov.uk/government/publications/accounting-standards-the-uk-tax-implications-of-new-uk-gaap.

The main areas where UK and international accounting standard differ are given below.

Borrowing costs must be capitalised under international accounting standard. Under FRS 102, an entity has a choice between capitalising and expensing directly attributable borrowing costs.

Under international accounting standard, the interest eligible for capitalisation is the actual costs incurred in borrowings less any interest earned on reinvestment of funds not used. Under FRS 102, interest eligible for capitalisation is limited to costs incurred on borrowings for expenditure to date.

For **research and development,** development costs must be capitalised under international accounting standard. Under FRS 102 an entity may choose whether to capitalise or expense such costs. (For tax purposes, it should also be noted that there are generous tax reliefs for research and development.)

Goodwill is the area of greatest disagreement between UK and international accounting standards. Under international accounting standard, goodwill must have an *indefinite* life and not be amortised. Under FRS 102, the opposite applies. Goodwill must be systematically amortised over its useful life, with a presumption that is five years or less.

Three new international accounting standards are likely to have a major impact on accounts:

- IFRS 9 (amended) on financial instruments
- IFRS 15 on recognising revenue from customer contracts
- IFRS 16 on leases.

The first two apply for accounting periods that start from 1 January 2018; the third from 1 January 2019. These changes are likely to be reflected in UK standards, but probably not until 2021 at the earliest.

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