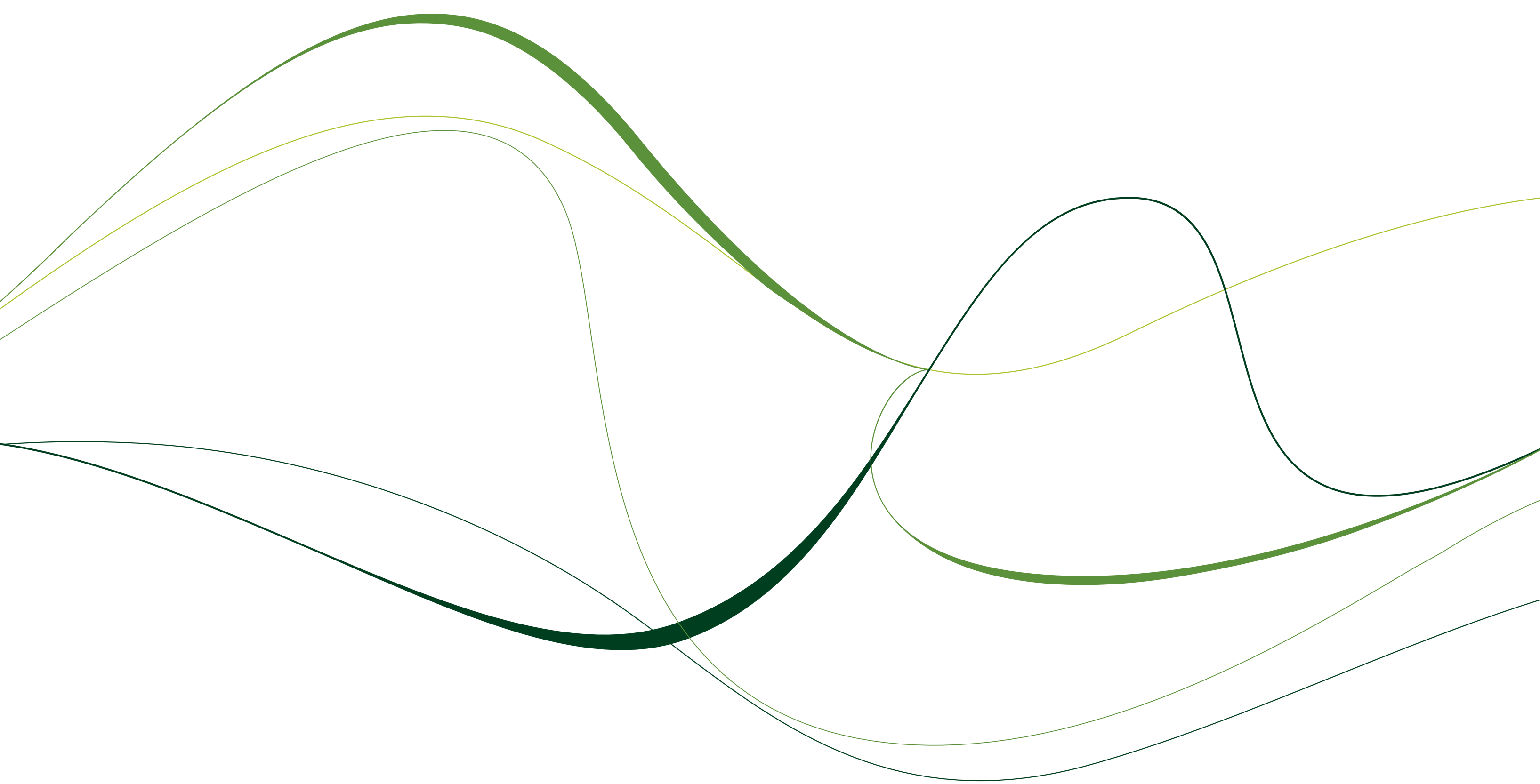
HMRC Top Five **Investigation** Hot spots



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Steve Collings outlines the areas typically targeted by HMRC accountants in financial statements

During the course of a tax investigation inspectors may query the accounting treatment of certain points in the financial statement. In certain cases, the inspector will refer the matter(s) to the revenue accountants who will then interpret the relevant accounting standards.

Where HMRC accountants disagree with an accounting treatment, they will then provide details of the relevant standards or legislation. Revenue accountants also inform tax inspectors whether, in their opinion, financial statements comply with UK GAAP.

- **During tax investigations certain points in the financial statement may be queried**
- **HMRC accountants will assess the statements to ensure they are compliant**
- **There are certain problem areas they are trained to look out for**
- **These hot spots include bad debt provisions, related parties, revenue recognition and directors' bonuses**

Accounting policies

Under FRS 18 and FRSSE, entities are required to adopt accounting policies that are most appropriate to its particular circumstances. Under FRS 18 provisions, where management deem a policy no longer applicable to their circumstances, they are required to change the policy and apply this change retrospectively to the previous year's financial statements.

Problems can arise when a transaction is not covered by an accounting standard or FRSSE. Where FRSSE is concerned, then the mainstream accounting standards should be consulted. Where no specific UK standard covers an accounting issue, then IFRS or US GAAP should be referred to in order to determine best practice.

Problem areas

HMRC accountants have a list of 'hot spots' which they consider to be the most problematic areas in financial statements which are discussed below.

Bad debt provisions

Specific bad debt provisions are generally allowable for tax purposes, whereas general bad debt provisions are not. Significant bad debts which are written off are often challenged by HMRC and they often require an explanation of how management deemed the debt to be bad. It is recommended to have some documentary evidence of large bad debts which are written off, such as correspondence from a liquidator.

Provisions

Under FRS 12, FRSSE and IFRS, a provision can only be recognised in the financial statements if it meets three specific criteria:

- **There is a legal or constructive obligation**
- **An outflow of economic benefits will be required to discharge the obligation**
- **The amount of the obligation can be measured reliably**

Where those three criteria are not met, then no provision is made and a contingent liability is recognised. If the three criteria are met then HMRC have a problem with excessive provisions being made, for example a provision for £10,000 in respect of a legal case being brought against the company, whereas realistically the amount required to settle is actually £5,000.

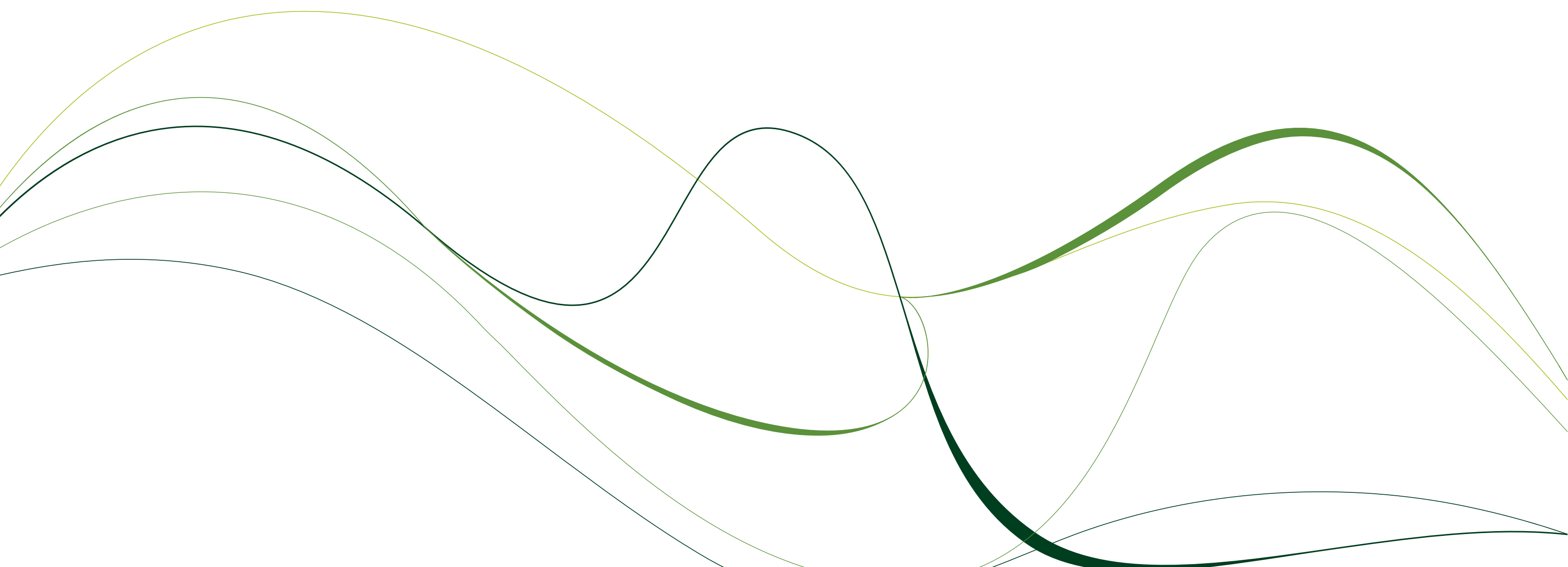
Related parties

Related-party transactions are a 'hot spot' for tax inspectors and revenue accountants. Under current tax legislation, where companies are 'associated' for tax purposes, then the lower and upper profit limits are scaled down proportionately depending on the number of associated companies during the accounting period. The related party note can often reveal details of any associated companies which have not been taken into consideration when dealing with the tax computation and is a simple mistake to make, but could be quite costly.

Revenue recognition

When UITF 40 was issued in 2005 it caused outcry within the profession. The introduction of this task force abstract resulted in accelerated revenue having to be recognised, despite the fact that the work had not been invoiced which in turn resulted in higher tax liabilities. Under the concept of UITF 40, an entity is required to recognise revenue when a critical event (a milestone) passes. The critical event is where the entity receives a right to consideration. Large work-in-progress balances held at the year-end may trigger an enquiry to see if the provisions in UITF 40 have been correctly applied.

Deferred revenue is often queried by HMRC. This usually occurs where an entity invoices for services (for example support services) and these services span two accounting periods. An entity can only recognise revenue in the accounting period which it relates so it is worth ensuring that the accounting policy for deferred revenue is sufficiently disclosed within the notes to the financial statements.



Directors' bonuses

It is common for companies to pay the directors a bonus depending on the profits yielded at the end of the year using a predetermined formula. In almost every case, the financial statements of an entity will not be finalised until sometime after the year end and this is where problems can sometimes occur.

Under FRS 12 (and as discussed above), a provision can only be made in the financial statements if an obligation exists at the balance sheet date. If the bonus has been declared after the balance sheet date, then a provision should not be recognised. This also applies to dividends declared after the balance sheet date. FRS 12 provisions are often cited by revenue accountants when challenging bonus provisions.

However, where an entity has always paid profit-related bonuses to the directors, then FRS 12 provisions are satisfied because the directors will 'expect' a bonus and it is this expectation which creates a constructive obligation at the balance sheet date and thus it is reasonable to recognise a provision.

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