Business Profits Toolkit

2018-19 Self Assessment and Company Tax Returns

Published June 2019

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Introduction

Tax agents and advisers play an important role in helping their clients to get their tax returns correct. This toolkit is aimed at helping and supporting tax agents and advisers by providing guidance on the errors we find commonly occur in relation to business profits for small and medium sized businesses. It may also be helpful to anyone who is completing an Income Tax Self Assessment Tax Return for a sole trader or partnership or a Company Tax Return using UK Generally Accepted Accounting Practice (UK GAAP).

This version of the toolkit was published in June 2019. The risks in this toolkit have been reviewed and updated where necessary for 2018-19 and are applicable for financial years commencing 6 April 2018 for Income Tax Self Assessment Tax Returns and 1 April 2018 for Company Tax Returns. Its use is entirely voluntary.

The content of this toolkit is based on our view of how tax law should be applied. Its application to specific cases will depend on the law at the relevant time and on the precise facts.

For further information on using this toolkit and reasonable care under our penalty system see **Tax Agents toolkits**.

For guidance on matters not dealt with in this toolkit you should refer to our **Business Income Manual (BIM)** and **Company Taxation Manual (CTM)**.

Areas of risk within business profits

This toolkit is based on the use of UK GAAP and is not intended to be used by sole traders and partnerships that use the cash basis for calculating their taxable income or by companies which have adopted International Financial Reporting Standards (IFRS). It covers general areas of risk seen when computing taxable profits. Other toolkits address risks that are more specific to particular areas such as Directors' Loan Accounts and Capital Allowances for Plant and Machinery etc. For a full list of available toolkits please see **Tax Agents toolkits**.

This toolkit does not reflect any differences which may arise from the application of the cash basis which is available from 2013-14 for the simplest sole trader and partnership small businesses. For further information see **BIM70000+**.

In computing taxable profits the general principle is that the starting point is accounts prepared in accordance with generally accepted accounting practice ('GAAP'), and the commercial profits are then adjusted in accordance with the provisions of the Taxes Acts. This means that if there are no relevant tax rules or principles which affect a particular item of income or expenditure, then GAAP will determine the amount of the taxable profit.

Record keeping

Good record keeping is essential. Poorly kept records can result in sales or allowable expenditure being omitted from the accounts or returns and consequently the level of profits or losses may be incorrect.

Business income

It is important that all business income is included in the accounts. This should normally be included on the accrual basis of accounting to ensure that the correct profit or loss is established. Business income can include income that is not immediately obvious, for example scrap sales, contra or barter arrangements etc. To assist in identifying all sources of business income, particularly cash sales, it is recommended that the business activities are considered to identify possible ancillary or miscellaneous business income. Preparation of a cash reconciliation is also recommended.

It is also important to ensure that where the turnover exceeds the prescribed registration thresholds that the business registers for VAT. Where a business is registered for VAT the accounts and returns should normally include sales and purchases net of VAT.

Expenditure

It is important that all business expenditure is included in the accounts. This should normally be included on the accrual basis of accounting to ensure that the correct profit or loss is established. Purchases and expenses should also be reviewed to ensure that any necessary adjustments are made for tax purposes. Only those expenses that are wholly and exclusively incurred for the purposes of the trade or profession and those that are not capital in nature are allowable for tax purposes. In addition there are expenses that are specifically prohibited for tax purposes such as entertaining. Sole traders and partnerships, where all the partners are individuals, can use simplified expenses, flat rate amounts, for certain expenses. Sole traders can elect to calculate their profits for tax purposes by deducting the trading allowance instead of deducting any allowable expenses.

For further information on private and personal expenses for Income Tax Self Assessment see the **Private and Personal Expenditure Toolkit**.

For further information on expenses for directors or employees see the **Expenses and Benefits from Employment Toolkit** and/or the **Directors' Loan Accounts Toolkit**.

For further information on capital or revenue expenditure see the **Capital v Revenue Expenditure Toolkit**.

For further information on simplified expenses see **BIM75000+** and/or **GOV.UK simplified expenses** if you are self-employed. For further information on trading allowances see **BIM86000+** and/or **GOV.UK trading and property allowance** if you're self-employed.

Stock and work in progress

All stock must be identified and included in the accounts at the correct value. If stock is overlooked or incorrectly valued this can result in the incorrect level of profits or losses being included on tax returns.

Work in progress and work in progress arising under construction contracts can be a complex area and care should be taken to consider the correct treatment.

Miscellaneous

There are certain other matters that should be considered when preparing accounts and completing tax returns to ensure the correct level of profit or loss is established. For example where there are events that occur after the balance sheet date up to the date the accounts are authorised for issue, and these events provide evidence of conditions existing at the balance sheet date (adjusting events), then the accounts should be adjusted for these amounts if they are material. See **BIM31040**.

Staff costs that remain unpaid at the date the tax return is submitted or nine months after the end of the accounting period should normally be added back for tax purposes. In the case of directors it should be noted that when amounts are credited to the directors loan account this is normally considered to be ‘paid’ for PAYE purposes. This date should be regarded as the date of the credit and may differ from the date when the remuneration is voted or provided for in the accounts.

Using links within this document

Blue underlined text are links within this document.

Green bold text are hyperlinks to external documents on the internet (access to the internet is necessary to view these).

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Dealing with HMRC if you have additional needs

Giving HMRC feedback on toolkits

HMRC would like to hear about your experience of using the toolkits to help develop and prioritise future changes and improvements. HMRC is also interested in your views of any recent interactions you may have had with the department.

Send HMRC your feedback

Client Name:	Period Ended:

Checklist for business profits

		Yes	No	N/A	N/K

Business income

		Yes	No	N/A	N/K
1	Has all business income been included in the accounts?	☐	☐	☐	☐
2	Has income been recognised on the accrual basis of accounting?	☐	☐	☐	☐
3	Have all cash sales been included correctly in turnover?	☐	☐	☐	☐
4	Has any ancillary or miscellaneous income of the business been included appropriately?	☐	☐	☐	☐
5	Have all tips, gratuities or service charges been included as business income if appropriate?	☐	☐	☐	☐
6	Have any goods or services exchanged without payment being received been correctly accounted for?	☐	☐	☐	☐
7	Have any grants or subsidies been identified and correctly accounted for?	☐	☐	☐	☐

Business income continued

8 Have any insurance or compensation receipts received during the period been correctly accounted for?

9 If the turnover exceeds the prescribed threshold has the business registered for VAT?

Expenditure

10 Have only allowable purchases and expenses relevant to the business been deducted?

11 Have all business entertaining expenses been fully identified?

12 Have all purchases been accounted for on the accrual basis of accounting, or using the simplified expenses flat rate amount (sole traders and some partnerships)?

Stock and work in progress

13 Has all stock been identified and accounted for appropriately?

14 Has work in progress been identified and accounted for appropriately?

Stock and work in progress continued

15 Have all construction contracts been identified and any profits or losses correctly accounted for?

☐ ☐ ☐ ☐

Construction Industry Scheme

16 Have subcontractors registered for the Construction Industry Scheme (CIS)?

☐ ☐ ☐ ☐

17 Have all CIS payments and deductions been accounted for?

☐ ☐ ☐ ☐

Miscellaneous

18 Have appropriate adjustments been made to any bad or doubtful debts or impairment losses on trade debtors for tax purposes?

☐ ☐ ☐ ☐

19 If any provisions for liabilities have been made do they meet the required criteria for tax purposes?

☐ ☐ ☐ ☐

20 If contributions have been made by an employer to a registered pension scheme have any necessary adjustments been made?

☐ ☐ ☐ ☐

21 Have any necessary adjustments been made for unpaid staff costs?

☐ ☐ ☐ ☐

Miscellaneous continued

22 Have all events after the end of the reporting period been identified and adjusted where appropriate?

☐ ☐ ☐ ☐

23 Where a prior period adjustment has been made in the accounts have the appropriate adjustments been made for tax purposes?

☐ ☐ ☐ ☐

24 For companies, have any loans to participators released or written off in the period been accounted for correctly?

☐ ☐ ☐ ☐

25 For sole traders and partnerships that used the cash basis of accounting last year, has the appropriate adjustment been made?

☐ ☐ ☐ ☐

26 For sole traders and partnerships with a positive adjustment when leaving the cash basis of accounting, has the appropriate amount of adjustment (minimum one sixth) been returned as adjustment income?

☐ ☐ ☐ ☐

Explanation and mitigation of risks

Business income

1. Has all business income been included in the accounts?

Risk
All income from every source relating to the business should be included in the accounts.

Turnover should include all sales for the period no matter how or when payment is received. It is also important to include income that may not be immediately obvious, for example:

- cash or other sales that may be recorded differently or separately - see Q3
- internet sales
- post-cessation receipts - see **BIM90000**
- VAT refunds - see **BIM40150**
- ancillary income such as scrap sales or commissions - see Q4
- money received but not yet cleared, for example cheques not cleared or presented, or transfers
- income from goods delivered even if the monies have not yet been received - see Q2
- service and construction contracts in progress - see Q14 and Q15.

Mitigation
All sales, including cash and internet sales and post-cessation receipts, VAT refunds, ancillary income, commissions, uncleared or unpresented cheques or transfers should be included in the accounts. Consideration should be given to the date goods have been delivered or services provided to ensure that the related income has been appropriately included in turnover.

It may be helpful to consider the pattern of sales, including any seasonal variations etc. based on your past experience and understanding of the business and any differences in the cash and bank reconciliations. In addition a reconciliation of the identified turnover to the income shown on the VAT Return is recommended.

Explanation
Where the recognition of sales relies on goods being delivered sales should only be recorded if goods have left the warehouse and are excluded from stock. Particular care may need to be taken if stock is retained offsite or in the hands of third parties.

When stock is taken for personal use or transferred to or from a connected business there may be other implications. For example for stock taken the market value should be included as income and for a director of a company employment taxes may also be due. For a sole trader the drawings figure should be appropriately adjusted to reflect the transaction.

For further guidance see **BIM33630**.

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2. Has income been recognised on the accrual basis of accounting?

Risk
All accounts prepared for the purposes of computing taxable profits of a trade or profession should normally be prepared on the accrual basis of accounting except in very limited circumstances. Appropriate year-end adjustments should therefore be made to include all relevant sales in turnover for the accounting period.

The accrual basis of accounting can often be overlooked when ‘cash accounting’ has been used for VAT purposes. Although VAT output tax declarations are usually ascertained from the same accounting records there can be differences between the outputs declared in the VAT Return and the sales that should be declared in the annual accounts.

Mitigation
Establish the end date for the period of the accounts and ensure that the turnover includes all sales on the accrual basis of accounting.

For further information regarding ‘service contracts’, particularly in respect of professional businesses such as accountants, solicitors and surveyors see Q14.

Explanation
The ‘accrual basis’ of accounting recognises income when earned and expenses when incurred, as opposed to the ‘cash basis’ which reports income when received and expenses when paid. The ‘accrual basis’ therefore ensures that the total income and expenses relating to a particular accounting period are included in the accounts, irrespective of whether or not cash was received or paid out during that period.

If the day-to-day business records account for sales on a cash basis, or as sales receipts are banked, an adjustment should normally be made to ensure that sales are accounted for in the appropriate year. The relevant date is normally the date when the goods have been delivered or services provided, rather than the date that the invoice is issued. Consideration of transactions close to the year-end date may help ensure that all sales have been recorded in the correct period.

Differences between the outputs declared in the VAT Returns and the sales disclosed in the accounts may often arise for good reason, for instance sales of capital assets, or the use of cash accounting for VAT purposes. However, it is helpful to carry out a reconciliation to ensure that the reasons for these differences are understood and are not the result of an error in either the VAT Returns or the accounts.

For further guidance see **BIM31080+**.

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3. Have all cash sales been included correctly in turnover?

Risk
Cash sales can be overlooked, in particular where these have not been recorded contemporaneously in the books and records. Care should be taken to ensure all cash sales and cash expenses are properly identified and reflected in the accounts.

There is also a risk where a business receives income in cash and the expenses of the business, wages, or drawings of the proprietor or partners are paid from these monies. If the cash sales are recorded net of these expenses this can result in incorrect turnover and expenses being included in the accounts. All income and expenditure should be included on a ‘gross’ basis and not ‘netted off’.

Mitigation
Ensure that all business income including cash sales is appropriately recorded. A cash reconciliation can help confirm all cash received and expended has been properly accounted for and that the balance equates to cash physically held at the year end. Any significant differences should be investigated to identify the correct accounting treatment.

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4. Has any ancillary or miscellaneous income of the business been included appropriately?

Risk
Ancillary or miscellaneous income the business receives outside its normal activities can be overlooked, such as a builder who receives money from the sale of scrap, lottery commission received by a newsagent or a publican who receives commission from vending machines.

In some circumstances businesses such as garages or publicans may receive loans from suppliers with terms linked to the level of purchases. Where interest on such loans has been reduced or waived or the loans treated as partly or fully repaid as a result of the level of business undertaken, care should be taken to ensure that these transactions are accounted for appropriately.

Where money is received from the loss or disposal of a capital asset this should be treated as a capital receipt for tax purposes.

Mitigation
Consider whether there is any income from ancillary business activities and ensure these amounts are included in the accounts. Any capital receipts should be identified and dealt with appropriately.

Explanation
Invoices and receipts may not be issued for ancillary or miscellaneous income or the income may be received in cash or paid into a different or non-business bank account. The income may also be received at irregular intervals or as a one-off payment. If the money received arises out of the normal activities of the business then the relevant sum should be included within the accounts.

For further guidance see **BIM40051+**.

When ancillary income is received in the form of commission payments for items such as mobile telephone top-up payments, lottery commission etc. the net amount of the commission received should be included as a receipt. The cost of the mobile telephone top-ups or lottery tickets should not be deducted.

For further guidance see **BIM40650+**.

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5. Have all tips, gratuities or service charges been included as business income if appropriate?

Risk
In certain businesses, particularly in service trades, such as restaurants, hairdressers or taxi drivers, it is common to receive tips, gratuities or service charges. Where the business receives these, even where they are subsequently paid out to employees, they will normally constitute income for the business and should be included in sales.

For example, where bills are paid by credit card and include a credit card tip, as the transactions are with the business the full amount should be included in sales. If the tips are subsequently paid out to the employees the amounts paid out are subject to PAYE and NICs and the appropriate deduction is allowed in the accounts.

Mitigation
Establish how tips, gratuities or service charges are received. If they are retained or distributed by the proprietor, partner or business, ensure they are included as business income.

The treatment of tips depends on how they are dealt with by the business. If any payment is received by the business this forms part of their business income and should be included as income for tax purposes.

Explanation
If tips, gratuities or service charges are received direct from the customers by the employees of the business or distributed by a troncmaster, these payments will not normally feature in the accounts of the business either as income or a deduction. In these circumstances, employment taxes should not be applied by the employer but tips should be included in the individual employees' Self Assessment tax returns or on the troncmaster's return as appropriate.

For further information on tips, gratuities and service charges for employers and those responsible for arranging tips and gratuities see **Helpsheet E24**.

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6. Have any goods or services exchanged without payment being received been correctly accounted for?

Risk
Goods and services may sometimes be exchanged without money changing hands, for example a payment in kind. These are often referred to as contra, barter or reciprocal arrangements. These arrangements may be informal in nature, such as reducing the amount owed to a supplier for work completed, or a builder repairing the roof of a golf club in exchange for annual golf fees. Due to the informality of these transactions they may be incorrectly treated as non-business income and may not be accurately reflected in the business records.

Mitigation
Establish whether there are any contra, barter or reciprocal arrangements, for example by considering whether invoices include any netted off amounts. Ensure that the value of the work is accurately included as business income. If there are any related business expenses include a deduction in the accounts for the allowable expenses.

Explanation
All receipts arising from contra, barter or reciprocal arrangements must be valued at the money's worth of the goods and services exchanged. The corresponding expenses should also be brought into account.

If both businesses involved in the transaction are registered for VAT, both should account for VAT on each separate supply made to each other, even if no money changes hands, or only a net amount is paid after setting off one outstanding balance against the other.
For further information see **VAT: part-exchanges, barters and set-offs**.

back to checklist

7. Have any grants or subsidies been identified and correctly accounted for?

Risk
A wide variety of grants or subsidies are available to businesses and can be received in addition to the ordinary business income. It is important to identify these and to establish whether they are capital or revenue receipts to ensure they are recorded and returned correctly.

Mitigation
Identify whether any payments in respect of grants or subsidies have been received. Review the documentation such as contracts and any correspondence between the relevant parties to establish the split between capital and revenue. Ensure that any revenue income is included in the relevant tax return.

Consider whether any capital element impacts any other figures in the tax return, for example capital allowances.

Explanation
Amounts received towards revenue expenditure, such as staff costs, are normally trading receipts and should be included as income or netted off against the relevant expense. Funding which meets capital expenditure, such as new premises or machinery, is normally treated as a capital receipt.

A capital grant can reduce the qualifying capital expenditure for capital allowance purposes, see **Capital Allowances Manual CA14100**.

The impact of grants towards capital expenditure for capital gains purposes is explained at **Capital Gains Manual CG15288**.

A grant towards research and development (R&D) expenditure can affect any R&D Relief claim (companies only) - see **Corporate Intangible and Research & Development Manual CIRD81670+**.

Some grants may not be for a specific purpose, sometimes called undifferentiated receipts. An undifferentiated receipt should be regarded as revenue; however there is an exception for specific grants paid by Highlands and Islands Enterprise.

For further guidance see **BIM40451+** and **BIM40470**.

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8. Have any insurance or compensation receipts received during the period been correctly accounted for?

Risk
Insurance, compensation or other similar receipts may be received in addition to ordinary business income. Any such amounts should be included in the accounts according to the nature of the receipt as they may be received for a variety of reasons and can include both capital and revenue elements. For example amounts received may be to replace capital assets and also compensation for loss of profits.

Where amounts received include both capital and revenue elements the receipt should be apportioned appropriately. There are several factors which may need to be taken into account when considering how the amount received should be apportioned between capital and revenue for tax purposes.

Mitigation
Establish whether there have been any insurance or compensation receipts. Review all appropriate documentation such as contracts and correspondence between the relevant parties to identify the nature of the receipt and whether it should be apportioned in any way. Ensure the receipt is included in the accounts appropriately.

Where an allocation between capital and revenue is required consider whether this will affect any other figures in the return, for example capital allowances.

For further guidance see **BIM40751** and **BIM40101+**.

Explanation
To establish whether a receipt is capital or revenue it is necessary to identify the reason the payment was made. Amounts received in relation to the permanent loss of fixed capital assets are capital receipts. However if the loss is merely temporary, the receipt will effectively be compensation for a reduction in profits as a result of that temporary loss. In this scenario, the

receipt will be revenue in nature. Receipts for loss or damage to stock, for temporary interference to the trade or compensation for loss of profits are revenue receipts.

For further guidance see **BIM40751.**

Any amount received in respect of a personal matter rather than in a business capacity is unlikely to be chargeable, for example compensation for personal injury (even if the sum is measured by reference to loss of earnings).

For further guidance see **BIM40105**.

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9. If the turnover exceeds the prescribed threshold has the business registered for VAT?

Risk
When the business turnover exceeds the applicable taxable registration threshold it must normally register for VAT and thereafter charge and account for output tax on its standard and reduced-rated supplies.

VAT input tax may also be claimed on appropriate business purchases and expenses.

Mitigation
Review the business turnover and compare it to the current registration threshold. Ensure that where the turnover exceeds the threshold the business is registered for VAT if appropriate. If the turnover is likely to exceed the threshold, when considering, at the end of any month, any taxable supplies either in the previous 12 months or less, or in the next 30 day period alone, ensure that the business has procedures in place to register for VAT at the appropriate time.

For further information on calculating 'taxable turnover' for VAT purposes and when it is possible to apply for exemptions, exceptions or voluntary registration see **VAT Registration**.

For further information on errors that we find commonly occur in relation to VAT output tax see the **VAT Output Tax Toolkit**.

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Expenditure

10. Have only allowable purchases and expenses relevant to the business been deducted?

Risk
Generally purchases and expenses are included in the profit and loss account in accordance with generally accepted accounting practice. For tax purposes only those purchases and expenses that are incurred wholly and exclusively for the trade or profession and not capital in nature are allowable. For example a sole proprietor's personal drawings or purchase of a capital asset such as a motor vehicle for the proprietor's use are not allowable business expenses.

For companies, dividends are not an allowable deduction as such payments are normally a distribution. For accounting purposes preference dividend payments may be treated as interest payable within the profit and loss account. It is important to identify such payments and ensure they are adjusted appropriately for tax purposes.

Mitigation
Consider the purchases and expenses and review them as appropriate to ensure that only such payments that are allowable have been deducted. Where payments that are not allowable for tax purposes have been included ensure these are added back in the tax computation.

A review of certain accounts headings such as travel/motor expenses, repairs and renewals etc. may assist in identifying both non-allowable expenses and capital items.

For further guidance see **BIM42050+**.

Explanation
There are a number of common adjustments that should be made for tax purposes, for example:

- depreciation
- entertaining
- non-business use of assets
- personal expenses
- apportionment of interest on mixed purpose loans to reflect the amount borrowed for non-business purposes.

HMRC has published a number of toolkits on common errors relating to business expenditure as follows:

- **Capital Allowances for Plant and Machinery Toolkit**
- **Capital v Revenue Expenditure Toolkit**
- **Private and Personal Expenditure Toolkit**
- **Directors' Loan Accounts Toolkit**

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11. Have all business entertaining expenses been fully identified?

Risk
There is a statutory provision that expressly disallows costs incurred in respect of business entertaining and gifts. Such expenses may not be separately identified in the financial accounts drawn up under generally accepted accountancy practice. Appropriate add-backs should therefore be made in the tax computations.

Mitigation
Analysis should be carried out on general heads of expenditure that are likely to be affected by the risk, such as 'Advertising, 'Promotional and Marketing', 'Travel', 'Sponsorship' and 'Cost of Sales'.

Any amounts that are business entertaining or gifts should be added back in the tax computations, with apportionments considered where appropriate. Particular attention should be given to potential exemptions from the statutory disallowance, or where specific fiscal limits are applicable.

For further information see **BIM45065** and **BIM45070**.

Explanation
There is a specific statutory disallowance where costs are incurred in providing entertainment or gifts in the course of trading activity.

It should be noted that this specific statutory disallowance is separate to and additional to the general prohibitions in respect of expenses not incurred wholly and exclusively for the purposes of the trade, or capital expenditure.

'Entertainment' is defined by statute as 'hospitality of any kind'. A useful practical test when identifying whether costs are business entertaining or gifts is to consider whether a full and sufficient 'quid pro quo' (something of equivalent value given in return) is given by the recipient. This may take the form of services given, rather than cash or goods. So long as a trader can demonstrate that hospitality is given as part of a contractual arrangement in which services of an equivalent value are provided, then you should not treat the hospitality as business entertainment.

For further guidance see **BIM45000+**.

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12. Have all purchases been accounted for on the accrual basis of accounting, or using the simplified expenses flat rate amount (sole traders and some partnerships)?

Risk
All accounts prepared for the purposes of computing taxable profits of a trade or profession should be prepared on the accrual basis of accounting except in very limited circumstances. Appropriate year-end adjustments should therefore be made to include all purchases and expenses relevant to the accounting period.

All purchases and expenses relevant to the accounting period should normally be included, even when the payment has not yet been made or where it has not yet cleared the business bank account.

Purchases should be included in the accounts when goods are received or a service is provided, regardless of whether or not invoices have been received before the year end.

Sole traders and some partnerships can use flat rate amounts for certain expenses.
Sole traders can elect to calculate their profits for tax purposes by deducting the trading allowance instead of deducting any allowable expenses. However, if a person makes an election for the trading allowance to apply, and carries on more than one trade, the election will apply to each trade.

Mitigation
Establish the end date for the period of the accounts and ensure that the deductions for purchases are accounted for on the accrual basis and expenses are accounted for on the accrual basis or using the flat rate amount.

Explanation
The 'accrual basis' of accounting reports expenses when they are incurred and income when it is earned, as opposed to the 'cash basis' which reports expenses when they are paid and income when it is received. The 'accrual basis' therefore ensures that the total expenses and income relating to a particular accounting period are included in the accounts, irrespective of whether or not cash was received or paid out during that period.

If the day-to-day business records account for purchases and expenses as purchases and expenses are paid, an adjustment should normally be made to ensure that purchases and expenses are accounted for in the appropriate year. The relevant date is normally the date when the goods have been received or the services provided, rather than the date that the invoice is issued. Consideration of transactions near the year end date may also help to ensure that all purchases and expenses have been recorded in the correct period.

For further guidance see **BIM31080+**.

Sole traders and some partnerships can use simplified expenses, flat rate allowances or adjustments, rather than apportioning actual expenditure for

- Expenditure on motor vehicles (see **BIM75005**)
- Use of home for business purposes (see **BIM75010**)
- Private use of business premises (see **BIM75015**).

For further information on trading allowance see **BIM86000+** and/or **GOV.UK trading and property allowance** if you're self-employed.

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Stock and work in progress

13. Has all stock been identified and correctly valued?

Risk
Stock, including materials, goods in the process of production (work in progress) and items held for sale, should be valued at the lower of cost and net realisable value of each item or groups of similar items. Some businesses may overlook the existence of certain stock, carry out the valuation imprecisely or base it on unrealistic assumptions.

Mitigation
Ensure all stock, including materials, goods in the process of production (work in progress) and items held for sale have been identified and included in the accounts at the lower of cost or net realisable value - see explanation.

For further guidance see **BIM33000+**.

For further information on work in progress and construction contracts see Q14 and Q15.

Explanation
Stock includes raw materials and consumables, such as production materials, and any items treated as work in progress.

Stock should be valued at the lower of cost and estimated selling price less costs to complete and sell, considering each item (or group of items) separately. Generally 'cost' means the total historical cost of bringing the relevant stock to its present location and condition, e.g. inclusive of transport, handling costs etc. The 'last in first out' basis (LIFO) is not acceptable for tax purposes.

If it is not anticipated that the carrying amount of the stock is fully recoverable, the stock value should be impaired and measured at its selling price less costs to complete and sell.

Companies are required by S386 (4) Companies Act 2006 to retain statements of stock held at the year end and details of any stocktaking undertaken to arrive at these figures.

For further guidance see **BIM33120**.

Where stock is taken for personal use or transferred to or from a connected business, market value should normally be used.

For further guidance see **BIM33630**.

When a business ceases to trade the valuation of stock depends on particular circumstances.

For further guidance see **BIM33470+**.

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14. Has work in progress been identified and accounted for appropriately?

Risk
Accounting records for work in progress may initially include three types of uncompleted items, 'manufactured products', 'contracts for services' and 'construction contracts'. The tax treatment of these items follows the accounting treatment, which is broadly as follows:

- 'Manufactured products' should be valued at the lower of cost and estimated selling price less costs to complete and sell - see Q13

- ‘Contracts for services’ and ’construction contracts’ should be accounted for by reference to the stage of completion of the contract at the end of the reporting period. This area can be complex and it is important that such contracts are correctly identified and accounted for - see explanation and Q15.

Mitigation
Establish whether the business has any uncompleted items that could be considered work in progress. Ensure that the work in progress is correctly categorised and that the correct accounting treatment is applied.

Explanation
Work in progress may include:

- raw materials and components purchased for incorporation into products for sale
- products and services in intermediate stages of completion
- costs which are specifically attributable to units of production, for example direct labour, direct expenses and sub-contracted work
- production overheads and other overheads, if any, attributable in the particular circumstances of the business to bringing the product or service to its present location and condition.

‘Contracts for services’ cover uncompleted services, including professional services supplied by lawyers, accountants, architects etc. where the uncompleted services are not represented by any significant physical asset capable of sale.

‘Construction contracts’ are contracts specifically negotiated for the construction of an asset (or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use).

Contracts for services and construction contracts should be accounted for using the percentage of completion method (where the outcome of the contract can be estimated reliably) - see Q15. In order to calculate the appropriate allocation of profit it will be necessary to consider the substance of each contract, the nature of the contractual relationship with the customer and the right to consideration as contract activity progresses. Adjustments should be made to reflect the stage of completion of the work, anticipated recovery rates and likely cash flow.

For further guidance on valuing work in progress see **BIM33115+**.

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15. Have all construction contracts been identified and any profits or losses correctly accounted for?

Risk
Construction contracts are accounted for differently from stock and work in progress and therefore it is important that all construction contracts are identified. These contracts may not be easily identifiable and include contracts where the substantial activity to complete the contract spans two accounting periods. See explanation below.

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs are recognised as income and expenses by reference to the stage of completion of the contract at the end of the reporting period. The stage of completion should be determined using a method that measures most reliably the work performed.

When it is probable that total contract costs will exceed total contract revenue, a provision is included for the expected loss. Profits and losses recognised in accordance with GAAP are recognised for tax purposes.

Mitigation
Consider whether any contracts that span more than one accounting period should be accounted for as construction contracts.

Review all construction contracts, identify the turnover and profit or estimated loss attributable and ensure these are included appropriately. The methodology used may include allocation by reference to time, costs, labour hours or other appropriate criteria.

Appropriate calculations may be made by reference to a valuation of the work carried out to date. Alternatively, there may be specific points during a contract at which the value and cost of individual elements of work done can be identified.

Explanation
Construction contracts are contracts specifically negotiated for the construction of an asset (or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use).

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs are recognised as income and expenses by reference to the stage of completion of the contract at the end of the reporting period.

When it is probable that total contract costs will exceed total contract revenue, a provision is included for the expected loss. Profits and losses recognised in accordance with GAAP are recognised for tax purposes.

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Construction Industry Scheme

16. Have subcontractors registered for the Construction Industry Scheme (CIS)?

Risk
If an individual works for a contractor and is self-employed, a partner in a partnership or the owner of a limited company they should register for the CIS. Once registered a contractor will deduct 20% from any payments made for tax and National Insurance.

Mitigation
If an individual does not register for CIS or gives the wrong business name and the contractor is unable to verify them then a contractor must take 30% instead.

Explanation
Sole traders who already have a unique taxpayer reference number (UTR) can register for CIS online by logging in with their Government Gateway ID. Sole traders without a UTR can register for Self Assessment and register for CIS at the same time. Other businesses can fill in the online form for limited companies or the online form for partnerships.

For further guidance on registering online see **what you must do as a CIS subcontractor**.

Gross payment status can also be applied for so that deductions are not made in advance. For further guidance on how to get gross payment status see **what you must do as a CIS subcontractor**.

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17. Have all CIS payments and deductions been accounted for?

Risk
Sole traders and partners need to include the gross amount shown on their invoices as Business Income on their Self Assessment tax return. This is the full amount, rather than the

amount liable to deduction, or the amount payable. Actual amounts earned during the tax year should be recorded not estimates.

Sole traders and partners should show the deductions taken from their payments received from contractors in the section under the heading CIS deductions and tax taken off.

Limited companies should declare all their business income in their Corporation Tax Return. Limited companies should claim CIS deductions back through their company's monthly PAYE scheme, not through their Corporation Tax Return and may get a penalty if they try to do so.

Mitigation
When a contractor pays a subcontractor they must provide them with a payment and deduction statement (PDS) within 14 days of the end of each tax month for example for the tax month 6 May to 5 June, a contractor must provide the statement by 19 June. This statement will show the gross amount and any deductions they have made. If all the statements needed from a contractor have not been received copies should be requested.

A blank copy of a Payment and deduction certificate can be found **here**.

Explanation
For sole traders and partners, on receipt of their Self Assessment tax return, HMRC will work out how much tax and National Insurance is due and take off any deductions made by contractors. If tax is due it will need to be paid by 31 January following the end of the tax year. If a tax refund is due HMRC will pay the money back.

Limited companies can claim back CIS deductions through their company's monthly payroll scheme by sending their monthly Full Payment Submission (FPS) as usual to HMRC and sending an Employment Payment Summary (EPS) including the total CIS deductions for the year to date. HMRC will take the CIS deductions off what is owed in PAYE tax and National Insurance. Form CIS132 can be used by the company to record how the deductions have been set off.

A copy of Form CIS132 can be found **here**.

HMRC will pay back any deductions the company has not been able to claim back from its PAYE bill after the end of the tax year. Limited company subcontractors can use the CIS Repayment online claim form.

For further guidance on how to claim a refund for limited companies see **Construction Industry Scheme repayment claims for limited companies**.

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Miscellaneous

18. Have appropriate adjustments been made to any bad or doubtful debts or impairment losses on trade debtors for tax purposes?

Risk
Any provision for bad or doubtful debts or impairment losses on trade debtors should be computed in accordance with generally accepted accounting practice. For tax purposes any general provision is not allowable.

For further guidance see **BIM42701**.

Any provision for bad or doubtful debts or impairment should reflect events arising after the balance sheet date, but only where those events provide additional evidence relating to conditions that existed at that date. However a provision or impairment should not be made if it arises from new circumstances occurring after the balance sheet date.

Mitigation
Consider any provisions made for bad or doubtful debts or impairment losses on trade debtors. Ensure that any general provisions are added back in the tax computation.

For further guidance see **BIM42700+**.

Explanation
If a debtor is frequently slow with payment, and there are no grounds to believe their financial position has changed, then the length of time a debt has been outstanding is not on its own sufficient reason for a bad or doubtful debt provision or an impairment to be made.

However a provision will not be an allowable impairment loss if it is not based on objective evidence that, as a result of some event or events, future cash flows from the debt or debts will be reduced. It is not sufficient to base the provision on a prediction that something will happen in the future.

For further guidance see **Corporate Finance Manual (CFM) CFM33220**.

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19. If any provisions for liabilities have been made do they meet the required criteria for tax purposes?

Risk
A provision will only be allowable for tax purposes if all of the following criteria are met:

- there is a present legal or constructive obligation as a result of a past event
- it is probable that a transfer of economic benefit will be required to settle the obligation
- a reliable estimate can be made of the obligation
- it is in respect of allowable revenue expenditure.

Mitigation
Ensure any provisions made meet the criteria specified above. Review any existing provisions brought forward from earlier periods at each balance sheet date and ensure any provisions no longer required to take into account current circumstances are written back to the profit and loss account.

Explanation
A 'past event' is one that has already occurred prior to the year-end such that there is no realistic alternative but to settle the obligation created by the event. There must be a direct causal link between the past event and the present obligation.

A 'legal obligation' is one that could be enforced by law and which is outside the control of the directors. A 'constructive obligation' is one where a valid expectation has been created that the obligation will be discharged by way of an established pattern or past practice, published policies or a specific current statement. If the obligation could be avoided by future actions, such as changing the method of operation, then no present liability should be recognised.

The amount recognised as a provision should be the best estimate of the expenditure required to settle the obligation at the balance sheet date. If the provision is large and it is anticipated that it will not be settled for some time, the amount provided should be discounted to its present value. If any reimbursement of the expenditure is anticipated with virtual certainty, this should be recognised by creating an appropriate asset.

Provisions for liabilities exclude trade creditors, accruals, adjustments to carrying values of assets such as stock provisions, bad debts and depreciation, losses on construction contracts, provisions relating to leases (unless onerous) and pensions costs, which are dealt with elsewhere in the accounts.

Provisions should not normally be made in respect of executory contracts (where one or more of the parties have not as yet performed their duties as set out in the contract) except if the unavoidable costs in completing the contract exceed the value of the benefits to be received and so the contract is therefore onerous.

For further guidance see **BIM46510+**.

Examples of allowable provisions can be seen at **BIM46545**.

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20. If contributions have been made by an employer to a registered pension scheme have any necessary adjustments been made?

Risk
The treatment of employer's contributions to a registered pension scheme differs from the normal rules for deducting the expenses of a trade or profession.

The timing of the deduction for a contribution does not necessarily follow its accounting treatment. Relief for a contribution is given for the accounting period in which it is paid and not in the period(s) it is recognised in the accounts. This may be subject to spreading rules. See explanation below.

Mitigation
Establish the relevant contributions paid in the current period. Ensure only the contributions paid in the period are allowed as a deduction for tax purposes.

For further guidance see **BIM46005+**.

Explanation
In certain circumstances, where contributions paid are substantially greater than those paid in the previous period, relief may be required to be spread forward into future periods. This is a complex area.

For further guidance see **BIM46010**.

For full guidance on spreading pension payments to registered schemes see **Pensions Tax Manual (PTM) PTM043400**.

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21. Have any necessary adjustments been made for unpaid staff costs?

Risk
Wages, salaries, bonuses etc. that remain unpaid nine months after the end of the accounting period for which they were accrued are not normally allowable for tax purposes. However if the recipient is a director of a company or has been a director at any time during the year the treatment may be different. See explanation below.

Where the Income Tax Self Assessment Tax return or Company Tax return is submitted prior to the nine month point the appropriate amount should be added back prior to the date of submission. If the wages, salaries, bonuses etc. are subsequently paid out after the return is submitted but prior to the nine month point the return can then be amended.

Mitigation
Ensure that all wages, salaries, bonuses etc. included in the accounts have been paid within nine months of the end of the accounting period. In particular review bonuses, contingency payments, those within creditors and provisions for liabilities and payments due towards the end of the period.

Where any such costs remain unpaid nine months after the end of the accounting period or, if earlier, the date the Income Tax Self Assessment Tax return or Company Tax return is submitted, ensure any necessary adjustments are made for tax purposes before submission of the return.

For further guidance see **BIM47140**.

Explanation
Legislation for individuals and partnerships (**S36 Income Tax (Trading and Other Income) Act 2005**) and for companies (**S1288 and S1289 Corporation Tax Act 2009**) states that emoluments which are not paid within nine months after the end of the period of account shall not be deducted for tax purposes for that period. They should be deducted instead in computing the profits for the period of account in which they are paid.

The rules regarding receipt of earnings are set out within **S17** and **S18 Income Tax (Earnings and Pensions) Act 2003**. It should be noted that there are specific rules relating to directors.

If the employee is or was a director of a company at any time during the year and the earnings are from employment with the company (whether or not as director), earnings are treated as received at whichever is the earliest of:

- the time when sums on account of the earnings are credited to the directors loan account
- if the amount of the earnings for a period is determined by the end of the period, the time when the period ends
- if the amount of the earnings for a period is not determined until after the period has ended, the time when the amount is determined.

For further guidance see **BIM47130+**.

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22. Have all events after the end of the reporting period been identified and adjusted where appropriate?

Risk
Where there are events that occur after the balance sheet date up to the date the accounts are authorised for issue and these events provide evidence of conditions at the balance sheet date (adjusting events) then the accounts should be adjusted for these amounts if they are material. See **BIM31040**.

If events after the end of the reporting period are not appropriately taken into account or other events which are not related to conditions at the balance sheet date (non-adjusting events) are taken into account inappropriately, profits can be incorrectly stated.

Mitigation
Review material events between the balance sheet date and the date when the accounts are authorised for issue. Ensure that only those events which provide further evidence of conditions existing at the balance sheet date (adjusting events) are adjusted in the accounts. Ensure the accounts are dated when approved.

Explanation
Adjusting events are those that provide evidence of conditions that existed at the balance sheet date and will give rise to an adjustment in the accounts. Non-adjusting events are in respect of conditions that did not exist at the balance sheet date and therefore do not result in changes to the accounts.

Examples of adjusting events include:

- the settlement of a court case that confirms the entity had a present obligation at the balance sheet date (see provisions risk, at Q19)
- information giving evidence of the impairment of the stock or inventory valuation, for instance the subsequent sale at lower value
- the determination of profit sharing or bonus payments, but only where a legal or constructive obligation exists prior to the balance sheet date (see provisions risk, at Q19)
- the discovery of fraud or errors that show that the accounts or financial statements are incorrect.

Examples of non-adjusting events include:

- a decline in the market value of investments (provided the decline related to circumstances which arose after the balance sheet date)
- announcing a plan to dispose of a part of the business or to restructure the business
- subsequent fire damage
- subsequent changes in foreign exchange rates
- subsequent litigation in respect of events occurring after the balance sheet date.

For further guidance see **BIM31040**.

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23. Where a prior period adjustment has been made in the accounts have the appropriate adjustments been made for tax purposes?

Risk
Changes to accounting policies or the correction of material prior period errors discovered in the accounts will result in the accounts figures being restated by a prior period adjustment (PPA), which, depending on the nature of the adjustment, may have tax consequences.

Mitigation
For tax purposes where the PPA is as a result of the change from one valid basis to another then any adjustment is treated as a receipt or an expense on the first day of the accounting period for companies (or the last day of the period of account for Income Tax purposes) when the new accounting policy is implemented.

When an invalid basis is changed to a valid basis the opening and closing adjustment for the year of change should be on the same basis. This is because the tax is assessed and charged annually on the profits of the year, and is not based on the profits of any other year. As a result profit may fall out of account or be included twice.

Explanation
PPAs are material adjustments that arise from changes to accounting policies or from the correction of material prior period errors.

A change in accounting policy could be a change in how an item is recognised in the accounts. A material prior period error is an omission from or misstatement in prior period(s) accounts which arises from the failure to use or misuse of reliable information, which was available when those original prior period accounts were authorised for issue.

For further guidance see **BIM34000+**.

For further guidance on the treatment of loan relationships where there has been a change of accounting policy see **CFM33140**.

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24. For companies, have any loans to participators released or written off in the period been accounted for correctly?

Risk
Where any loan made by a close company to its participators that is or could be chargeable under S455 Corporation Tax Act 2010 is released or written off fully or in part during the accounting period and do not form part of the participator's remuneration package the amount released or written off is not an allowable deduction.

However, where the participator is a director or employee of the company and the loan released or written off forms part of their remuneration package these amounts are liable for employment taxes and will normally be an allowable deduction.

Mitigation
Identify any released or written off loans made to participators during the accounting period. Ensure no deduction is claimed unless the released or written off loan forms part of their remuneration package, if so ensure that relevant employment taxes are applied.

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25. For sole traders and partnerships that used cash basis last year, has the appropriate adjustment been made?

Risk
Business income is not correctly taxed; business expenses are not relieved correctly.

Mitigation
Calculate the adjustment if using GAAP (accrual) basis this year and cash basis was used last year. A negative adjustment is added to expenses this year. A positive adjustment (adjustment income) is normally taxed over 6 years, starting this year. Keep a record of the adjustment income, the minimum amount (one sixth of the adjustment income), and the amount returned as adjustment income this year.

Explanation
A transitional adjustment must be calculated in a specified way when changing from cash basis to GAAP (accrual) basis of accounting. For guidance see **BIM70070+**.

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26. For sole traders and partnerships with a positive adjustment leaving cash basis, has the appropriate amount of the adjustment (minimum one sixth) been returned as adjustment income?

Risk
The adjustment income is not returned correctly.

Mitigation
Normally a positive adjustment calculated when changing from cash basis to GAAP (accrual) basis of accounting is taxed over 6 years starting with the first year after leaving the cash basis. Include the minimum amount (one sixth of the positive adjustment) or a greater amount as adjustment income each year until the full amount of the positive adjustment has been returned.

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