ICAEW FINANCIAL REPORTING FACULTY

Information for Better Markets

PRINCIPLES BEFORE STANDARDS

The ICAEW's 'N Series' of Recommendations on Accounting Principles 1942-1969

Edited by Stephen Zeff

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ICAEW foreword

The regulation of financial reporting is one of the key themes pursued by the ICAEW Financial Reporting Faculty through its *Information for Better Markets* thought leadership programme. In considering how best to tackle current problems it can be useful to look back and see what solutions were adopted in the past. This can both open our eyes to different ways of looking at things and help us to understand how we got to where we are now.

Most accountants now active in business life are too young to recall a time when financial reporting was not governed by accounting standards. We now take standards for granted, and many may assume that this is the natural and eternal order of things in the accounting universe.

Yet accounting standards in the UK date from only the 1970s. Until then best practice – within the fairly loose constraints of the company law of that era – was a matter of professional judgement. What codification there was existed principally in textbooks.

Authoritative, but still non-mandatory, guidance began to appear in the 1940s when the ICAEW started issuing its series of 'Recommendations on Accounting Principles'. These Recommendations – often known as the 'N series' because, from 1958, they appeared under the letter 'N' in the ICAEW *Members' Handbook* – continued being issued until 1969.

Individual Recommendations were withdrawn as they were superseded by events or by later Recommendations. This process was accelerated after 1971, when the first accounting standard was issued, and in the 1980s the remaining N series Recommendations were finally withdrawn.

This book reproduces the full, original texts of the ICAEW's Recommendations on Accounting Principles. As well as illustrating the ICAEW's pioneering work on financial reporting, they are of value now:

- as a reminder that it was until comparatively recently still possible to organise financial reporting to a significant extent on the basis of non-mandatory best practice;
- as evidence for researchers who wish to understand the development of financial reporting in the UK from the 1940s to the 1960s. Key issues dealt with in the Recommendations include the content of the profit and loss account and balance sheet, and accounting for depreciation, stocks and work-in-progress, taxation, retirement benefits, foreign currency translation and asset finance; and
- not least, because the ideas developed in some of these Recommendations have helped shape subsequent debate.

We are greatly indebted to the distinguished accounting historian Professor Stephen Zeff for editing the book and writing an introduction. He also kindly gave us permission to reproduce a relevant extract from his 1972 book, *Forging Accounting Principles in Five Countries: A History and an Analysis of Trends*.

We are also pleased to have this opportunity to acknowledge further debts, to:

- Michael Renshall CBE, for permission to publish the transcript of his 2008 interview with Professor Zeff;
- VRL KnowledgeBank, for permission to reproduce the late Professor Baxter's 1953 article, 'Recommendations on Accounting Theory'; and
- Andrew Lennard of the Accounting Standards Board, who drew attention to the Recommendations' continuing relevance and planted the idea that they would be worth reprinting.

September 2009

Editor's introduction

It is a curious fact that the first two programmes for establishing accounting principles undertaken by professional accountancy bodies were not in response to leadership by their members in practice. In 1938-39 in the United States, the American Institute of Accountants, at the urging of a government regulatory agency, the Securities and Exchange Commission (SEC), endowed its Committee on Accounting Procedure (CAP) with authority to issue bulletins setting out proper accounting practice, which became known as 'generally accepted accounting principles'. The government agency sought to tap the expertise of the organised accountancy profession because it did not itself possess the expertise or resources – or the will – to sort out proper from improper accounting practice. The leading partners of the major accounting firms, led by Price, Waterhouse's George O. May, had resisted efforts to standardise accounting practice, as they preferred an inductive approach to divining proper practice. But the SEC was determined to see much less diversity in practice.

In 1941-42 in the United Kingdom, the Institute of Chartered Accountants in England and Wales (ICAEW) established a Taxation and Financial Relations (T&FR) Committee at the urging of members not in practice (ie, those employed in industry and commerce) partly to provide technical support for the Institute's representations to the Chancellor or Board of Inland Revenue on matters regarding taxation.[1] Yet perhaps the T&FR Committee's most significant contribution to the profession became the series of Recommendations on Accounting Principles, which it drafted for consideration by the Parliamentary and Law Committee and eventually by the Institute's Council.[2] In 1958, the Recommendations then in effect became the N series in the *Members' Handbook*. The Recommendations constituted the first programme anywhere in the British Empire by a professional accountancy body for dispensing advice on proper accounting practice for use in company financial statements.[3] Moreover, the T&FR Committee was the first committee ever established by the Institute's Council whose membership included members not in practice.

Another motivation of members not in practice serving on the T&FR Committee may have been to provide sound advice to the Company Law Amendment Committee prior to Parliament's approval of revised companies legislation to modernize the 1929 Companies Act. It is interesting that, at its first meeting, the Committee set up not only a taxation subcommittee but also an accounting principles subcommittee.

Looking back on the formation of the T&FR Committee, the Institute President, W. L. Barrows, said in 1958:

> 'Perhaps the most remarkable feature of the Committee is that it was born in 1942, which by no standards can be regarded as a year of optimism. Most of our thoughts were then concentrated on mere survival and there was little time or encouragement to plan for the future. Moreover, a good many wartime babies proved to be little horrors; consider for example the Finance Act, 1940. Historians may rightly wonder how in that dark period the Institute managed not merely to build for the future but to build so well. The establishment of the Taxation and Financial Relations Committee has enabled the Council to extend enormously the scope of its activities for the good of our profession and those who need the services we provide. It has also brought about a great welding of the two main branches of our membership – those in industry and those in public accountancy.'[4]

[1] See Paul Bircher, *From the Companies Act of 1929 to the Companies Act of 1948: A Study of Change in the Law and Practice of Accounting* (New York: Garland Publishing, 1991), p234. Also consult Masayoshi Noguchi and John Richard Edwards, 'Harmonising Intergroup Relations within a Professional Body: The Case of the ICAEW', *The British Accounting Review*, June 2008, p129.

[2] In 1949, the T&FR Committee was renamed the Taxation and Research Committee, and in 1964 it became the Technical Advisory Committee. The reason given for the latter change was to avoid confusion with the recently established Research Committee. See *The Accountant*, 18 April 1964, p480. The successive Committees and their subcommittees maintained a busy schedule. During their first 16 years, the Committees held a total of one hundred meetings, and the number of subcommittee meetings exceeded 1,000. Much of the ongoing work of the Committees involved matters of taxation. See 'Taxation and Research Committee: Luncheon to Mark One-hundredth Meeting', *The Accountant*, 27 December 1958, p799.

[3] In 1946, both the Institute of Chartered Accountants in Australia and the New Zealand Society of Accountants published reprints or close copies of the early Recommendations for the guidance of their respective members. See Stephen A. Zeff, *Forging Accounting Principles in Australia* (Melbourne: Australian Society of Accountants, 1973), p3, and Stephen A. Zeff, *Forging Accounting Principles in New Zealand* (Wellington: Victoria University Press, 1979), p12.

[4] Taxation and Research Committee: Luncheon to Mark One-hundredth Meeting', loc. cit.

While in the USA it was expected that the SEC would pay close attention to the drafting of the CAP's bulletins and would enforce compliance with those from which it did not seriously dissent, in the UK there was no government department or other agency to secure compliance by companies with the Recommendations. Therefore, the series of Recommendations constituted non-obligatory advice on best practice that directors might or might not carry into their companies' financial statements. Both the companies and their auditors were subject to the overriding constraint in the Companies Act that the financial statements give a 'true and correct view', which was altered to 'true and fair view' in the Companies Act 1947. Yet these terms have never been defined in the courts, and they served as no more than an amorphous desideratum which could embrace a wide range of alternative accounting practices.

Between 1942 and 1969, the ICAEW's Council issued 29 Recommendations on Accounting Principles. The most controversial of the Recommendations were N12 and N15, which dealt with inflation accounting, on which there were tensions borne of disagreement between industrial and practising members within the ICAEW as well as with other accountancy bodies.[5]

In 1969, the ICAEW discontinued the series of Recommendations. They were replaced by Statements of Standard Accounting Practice (SSAPs), which were drafted by the newly created Accounting Standards Steering Committee.[6] SSAPs were promulgated by the ICAEW's Council in concert with the Councils of the other collaborating UK and Irish accountancy bodies.

During the period from the 1940s to the 1960s, one supposes – but one cannot know for sure – that there was less aggressiveness than we see today on the part of company directors to use accounting choice as a means of achieving strategic and tactical aims. In a prologue to the Recommendations, the Council made it clear that they possessed no legal force and that the choice of accounting methods fell within the discretion of company directors. To be sure, some of the contents of the early Recommendations, notably on the preparation of consolidated financial statements, were incorporated into the Companies Act 1947 and thus became legal requirements. For the other Recommendations, only the external auditor was in a position to counsel the directors to comply.

The effectiveness of the series of Recommendations is a matter of dispute. Professors R. J. Chambers and Edward Stamp criticized them for the many optional treatments they permitted.[7] Yet flexibility of choice was necessary if the draft Recommendations were to have any hope of making it through the Parliamentary and Law Committee and the Council, both dominated by elders of the profession. There was then a strong belief, held even more staunchly by leaders of the Scottish accounting profession, that a professional accountancy body should not delimit the scope of auditor judgement in fulfilling the requirements of the Companies Act. Ronald Leach, who, as President of the ICAEW in 1969, bowed to public criticism from Professor Stamp that the Recommendations were too flexible[8] and persuaded the Council to replace them with a new regime of SSAPs, wrote as follows some years later:

> '[The Recommendations] usually took a considerable time to develop since attempts seem to have been made to accommodate a variety of points of view and the resultant compromise was often only a broad guide. These recommendations were in no way mandatory and not much help to the auditor in persuading his client to accept best accounting practice. In fact, there were often alternative approaches, none of which was sufficiently out of line to distort a true and fair view.'[9]

Some assessments of the impact of the Recommendations on practice were more positive. In 1962, the Jenkins Committee, appointed by the Board of Trade to review and report on the provisions and working of the Companies Act 1948, wrote that the Recommendations 'have already done much to ensure that the standards of accounting are reasonably uniform and

[5] For a discussion of the development of these two Recommendations, see Masayoshi Noguchi and John Richard Edwards, 'Accounting Principles, Internal Conflict and the State: The Case of the ICAEW, 1948-1966', *Abacus*, October 2004.

[6] For a history of the work of this new standard-setting body, see Brian A. Rutherford, *Financial Reporting in the UK: A History of the Accounting Standards Committee 1969-1990* (London: Routledge, 2007).

[7] R. J. Chambers, 'Financial Information and the Securities Market', *Abacus*, September 1965, pp15-16, and Edward Stamp, 'The Public Accountant and the Public Interest', *Journal of Business Finance*, Spring 1969, p33.

[8] See Edward Stamp's letter published in *The Times*, dated 11 September 1969, in Edward Stamp and Christopher Marley, *Accounting Principles and the City Code: The Case for Reform* (London: Butterworths, 1970), pp155-159, and Rutherford, op. cit., chap. 1.

[9] Sir Ronald Leach, 'The Birth of British Accounting Standards', in Sir Ronald Leach and Professor Edward Stamp (editors), *British Accounting Standards: The First 10 Years* (Cambridge: Woodhead-Faulkner, 1981), p4.

constantly rising'.[10] Professor John Richard Edwards has written that the Recommendations 'helped to raise the general standard of published accounts'.[11] A. A. Garrett, the long-time secretary of the Society of Incorporated Accountants, wrote, 'The Recommendations have been accepted in the profession and elsewhere as of high authority'.[12]

The most articulate critic of the Recommendations was W. T. Baxter, a Scots CA who was professor of accounting at the London School of Economics. In a famous article, 'Recommendations on Accounting Theory', published in October 1953, he raised a warning flag against any pronouncements from an accountancy body to the extent that they stifle theoretical enquiry:

> 'Recommendations by authority on matters of accounting theory…are likely to weaken the training of accountants; the conversion of the subject into cut-and-dried rules approved by authority and not to be lightly questioned, threatens to reduce the value of accounting as a subject of higher education almost to *nil.* They are likely to narrow the scope for individual thought and judgment; and a group of men who resign the hard problems of their work to others must eventually give up all claim to be a learned profession.'[13]

Which Recommendations might have provoked Professor Baxter to issue his warning? The first eight Recommendations dealt chiefly with disclosure, format, and consistency issues in the financial statements. They stated working rules, usually with little or no attention to alternative treatments. Baxter would have had little complaint about them. But the Recommendations then began to take up valuation and profit determination issues, which struck at the heart of accounting theory. N9, 'Depreciation of fixed assets', after examining several methods of apportioning depreciation, concluded in favour of the straight-line method because it was the most widely used in practice. In a terse paragraph at the end, N9 said that amounts set aside for a possible increase in replacement cost were a matter of 'financial prudence' and should not affect the determination of profit. N10, 'The valuation of stock-in-trade', began by surveying the interpretations to be placed on 'cost' 'and market value', and concluded, without any supporting reasons, that stock-in-trade should be shown at the lower of cost or market. N12 (issued in January 1949), 'Rising price levels in relation to accounts', was a prime example of why Baxter inveighed against professional proclamations of 'right' theory. After a lengthy recitation of the arguments against changing extant accounting practice, the Recommendation concluded that fixed assets should not be written up to replacement cost 'especially in the absence of a measure of stability in the price level', and that any amounts set aside to finance replacements of stock-in-trade or fixed assets at enhanced costs should be taken to reserves and not affect the determination of profit. Yet the impact of changing prices on accounting practice provoked intense controversy, obliging the ICAEW to revisit the subject three years later. Baxter himself had written in 1949 that a strong case has been made for extra provisions based on changes in the general price index.[14] In May 1952, the ICAEW issued N15, 'Accounting in relation to changes in the purchasing power of money'. Like N12 before it, N15 reviewed, always in a sceptical tone, the arguments for changing accepted practice. Although the Council said that it 'cannot emphasise too strongly that the significance of accounts prepared on the basis of historical cost is subject to limitations', it nonetheless concluded that 'the alternatives to historical cost which have so far been suggested appear to have serious defects and their logical application would raise social and economic issues going far beyond the realm of accountancy'. The Council reaffirmed the position in N12.[15] These two Recommendations alone would have been enough to provoke Baxter into railing against *ex cathedra* pronouncements on accounting theory.[16]

[10] *Report of the Company Law Committee*, Presented to Parliament by the President of the Board of Trade by Command of Her Majesty, June 1962, Cmnd. 1749 (London: Her Majesty's Stationery Office, [1962]), para. 334.

[11] John Richard Edwards, *A History of Financial Accounting* (London: Routledge, 1989), p155.

[12] A. A. Garrett, *History of the Society of Incorporated Accountants 1885-1957* (Oxford: University Press, 1961), p237.

[13] W. T. Baxter, 'Recommendations on Accounting Theory', *The Accountant*, 10 October 1953, p410. Baxter has written that his article was 'stimulated by the lectures of Sir Karl Popper'. Preface, William T. Baxter, *Collected Papers on Accounting* (New York: Arno Press, 1978), p18. An updated version of Baxter's article appeared as 'Accounting Standards—Boon or Curse?' *Accounting and Business Research*, Winter 1981.

[14] W. T. Baxter, 'Accountants and the Inflation', *Papers of the Manchester Statistical Society*, February 1949, p19.

[15] In N15, for the first time in the series of Recommendations, it was stated in the text that 'the Council recommends'. In all previous Recommendations, the wording was 'It is therefore recommended that'. One infers that the purpose of referring to the Council as the recommender was to emphasise the authority carried by the Recommendations in the minds of Institute members.

[16] Baxter first expounded his criticism of such pronouncements in a June 1953 article, in which he wrote: '[A professional body] can help us in our present dilemmas by fostering discussion, experiment, and research; for the rest, is not its only wise course to maintain a strict neutrality?' W. T. Baxter, 'Accounting Principles: The Conflict in Current Theory', *The Accountant*, 13 June 1953, p705.

In this volume, we reproduce the 29 Recommendations, which appear for the first time in a complete collection. We also reproduce an extract dealing with the origin and work of the T&FR Committee and the contents and apparent impact of the Recommendations, drawn from the editor's *Forging Accounting Principles in Five Countries: A History and an Analysis of Trends* (Champaign, IL: Stipes Publishing Company, 1972). A third reproduction is of Baxter's article, 'Recommendations on Accounting Theory'. A fourth reproduction is the foreword to the Recommendations written in October 1944 by the ICAEW President, Harold M. Barton. Finally, we publish an interview held in October 2008 with Michael Renshall, who served as the full-time assistant to the Taxation and Research Committee and its successor, the Technical Advisory Committee, from 1960 to 1969, in which he recollects his experiences. In 1969, Renshall became the Institute's first Technical Director and proceeded to service the Accounting Standards Steering Committee. He left the Institute in 1977 to join the accounting firm of Peat, Marwick, Mitchell & Co., in London. From 1986 to 1990, he chaired the Accounting Standards Committee.[17] He retired from KPMG Peat Marwick in 1992.

Stephen Zeff FCA (Honorary)

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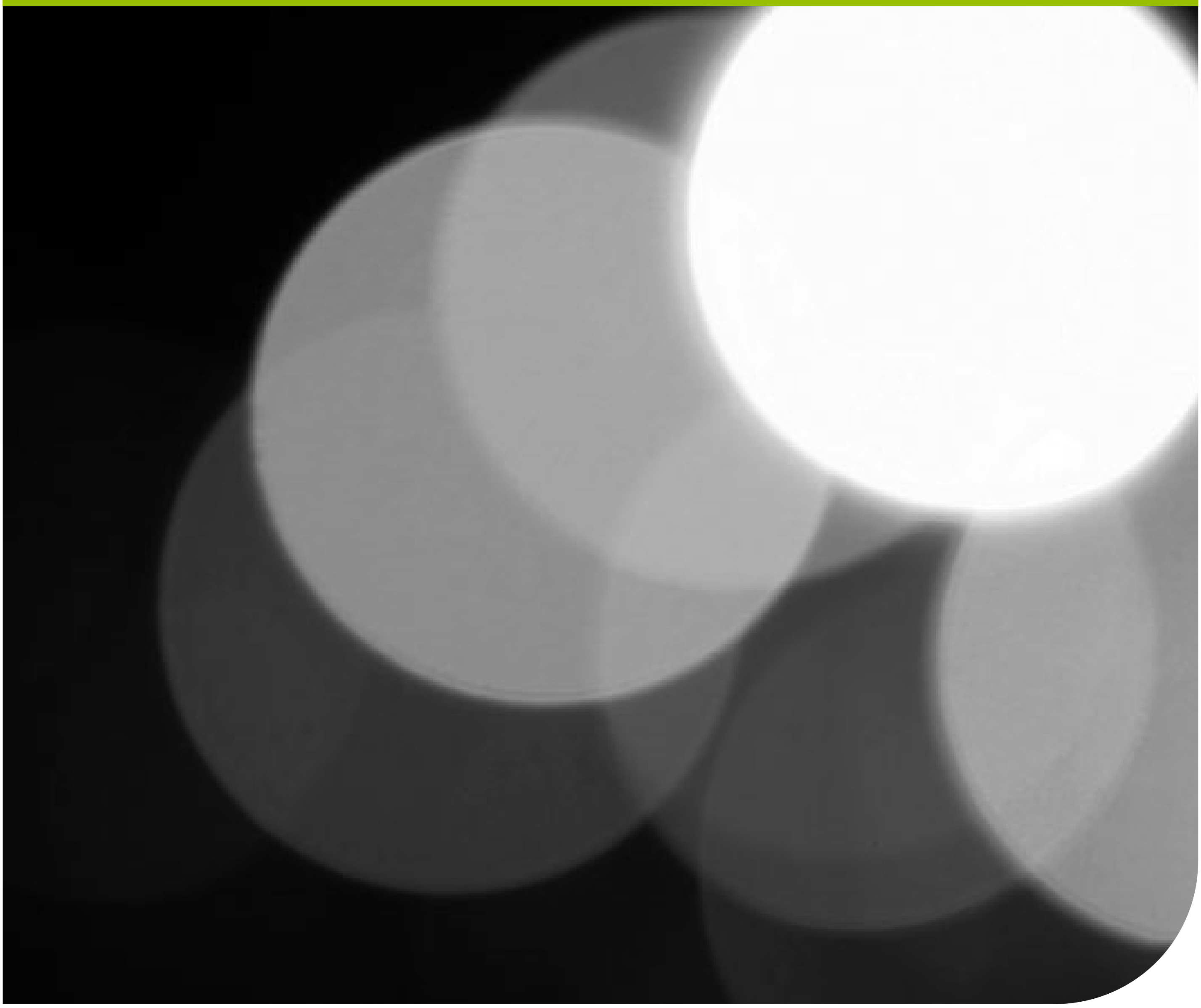
[17] In 1976, the Accounting Standards Steering Committee was renamed the Accounting Standards Committee.

Stephen Zeff, extract from *Forging Accounting Principles in Five Countries: A History and an Analysis of Trends* (1972)

The following extract from Professor Zeff's book (pp 7-23 in the original publication) sets out the background to the Recommendations on Accounting Principles, describes the tortuous process by which they were prepared, and briefly summarises their more important points. It also draws attention to the controversies to which some of them gave rise, notably on inflation accounting.

In reading the extract, it needs to be borne in mind that 'the present' to which it refers is 1972.



Stephen Zeff, extract from *Forging Accounting Principles in Five Countries: A History and an Analysis of Trends* (1972)

Early Years of the T. & F. R. Committee

Origin of the committee. The English Institute's 1941 annual meeting marked a turning point in the Council's attitude toward the technical work in which Institute members were engaged. Historically, the Institute's 45-man Council had stood aloof from its members' accounting and auditing activities, never having published a booklet or guidance statement in the technical field. There was no Institute journal for the publication of technical articles, although *The Accountant* regularly published Institute announcements and reports. The Council had devoted its entire attention to matters of administration, including its role as an examining and disciplinary body.

Increasingly during the 1930s, newly qualified Institute members were taking employment in industrial and commercial concerns. By 1941, more than half the total Institute membership consisted of 'members not in practice'[1] (i.e., all who do not practice as public accountants), while the Council itself had always been composed solely of 'practising' members. It is estimated that less than half of the number of members not in practice, i.e., about 25 percent of the total membership, was employed in industry and commerce. Many members in industry felt that the Institute was doing nothing to serve them, and for this and other reasons, one observer writes, 'the membership was seething with discontent.' An article in *The Economist* echoed this anxiety:

> With a few notable exceptions in both the Institute and the Society, the [member in practice] is reasonably satisfied with things as they are. He has no very intimate contact with the accountants directly employed in industry or other public companies; and next to no contact with cost accountants. But it is precisely these, the accountants directly employed by industry and business and the cost accountants, who are, so to speak, in the front line. It is they who see industry working, and it is upon their work that the accounts are built – if, indeed, they do not do the whole preparation. They have, however, very little voice in the conduct of the accounting profession, which is determined by members of the councils of the two professional bodies. It is quite certain that there are wide differences of opinion [between members in practice and members employed in industry and commerce] in both the Institute and the Society.[2]

At the Institute's 1941 annual meeting several motions were introduced to broaden the membership base of the Council. This agitation for reform led the Council to draft a special report for the 1942 annual meeting which recommended the creation of a 'Taxation and Financial Relations Committee' to be composed of practicing and non-practicing members. It was offered as part of a compromise settlement which also provided that 'membership of the Council should as a general rule be confined to practising members.' This wording seemed to open the possibility, at least, of an exception being made at some time in the future.

The charge given to the new committee, which was favorably received by the Institute membership at the 1942 annual meeting, was made deliberately broad: 'to consider matters affecting taxation and the financial relationship of the business community with the Inland Revenue or other Government Departments.'[3] As a committee dedicated to technical matters and composed in part of non-practicing members it marked a twofold innovation in the Institute's traditional policies. In the past, all Institute committees had been appointed exclusively from the Council membership.

The election of non-practicing members to the Council itself occurred much more gradually, the first such member, F. R. M. de Paula, being chosen in 1943.[4] In the late 1940s, many practicing accountants looked upon chartered accountants in industry as 'having left the profession'.

[1] Of 13,745 total members as of January 1, 1941, 7,387 were non-practicing. Many of these were in the employ of practicing accountants.

[2] 'Accountants and Accounts', *The Economist*, September 26, 1942, p. 392. This article was written a few months after the formation by the Institute's Council of the Taxation and Financial Relations Committee (see below) but before issuance by the Council of the initial Recommendations on Accounting Principles.

[3] 'Report of the Council on the Constitution of the Council,' dated April 1, 1942, p. 2.

[4] By 1948, the number of non-practicing members on the Council increased to two. It became five in 1953 and seven in 1958. The number jumped sharply in 1966 as a result of an amendment to the Institute's bye-laws, and by 1971, 16 of the 65 Council members were not in practice. In 1968-69, Stanley Dixon became the first non-practicing President, and in 1969 Professor Harold C. Edey, of the London School of Economics, became the first full-time academic to sit on the Council.

If by creating the Taxation and Financial Relations Committee (T. & F. R. Committee), the Council believed it had met a grievance by the appointment of 'just one more committee', it seriously misjudged the portent of its deed. An Institute member who was closely associated with the Institute's technical activities for many years later wrote of 'this novel and refreshing machinery' as follows:

> Those who prepared the [Council's] report and those who were present at the annual meeting when it was adopted in 1942 could not have foreseen the dramatic effect it was to have on the status of the Institute and on the relationship between the Council and the general body of members. Although the original agitation was for a change in the constitution of the Council, the results of the establishment of the Taxation and Financial Relations Committee have been infinitely greater than anything which could have been achieved by changing the constitution of the Council.
>
> The establishment of the new committee made possible for the first time the close collaboration of practising and non-practising members of the Institute and this was in itself sufficient to bring a new spirit into the Institute's affairs. This new spirit spread throughout the country, partly because the members of the new committee were drawn from all areas of the district societies of chartered accountants and partly because in each of those areas a regional Taxation and Financial Relations Committee was established to assist the main new committee.[5]

Operation of the committee. The initial membership of the committee was set at 27, of whom eight, including the Vice-Chairman, held commercial and industrial appointments. Five additional members from industry were co-opted onto its subcommittees. In 1944, the membership was increased to 44; it was raised to 48 and then 52 in the 1950s. Non-practicing members from industry and commerce, while never forming a majority of the committee membership, were nonetheless a large and influential component.

At its first meeting, in July, 1942, the committee asked the Council for permission to prepare drafts of pronouncements on accounting principles. A concern for the inadequacy of published accounts was sufficiently strong that it demanded resolution even in the midst of the war with Germany.[6] The committee's request, forwarded through the Parliamentary and Law Committee,[7] was promptly granted by the Council,[8] and thus was born the English Institute's well-known series of guidance statements, 'Recommendations on Accounting Principles', of which 29 were issued between 1942 and 1969.

In addition to addressing itself to accounting principles, the T. & F. R. Committee assumed a heavy burden of preparing frequent memoranda and technical papers on taxation matters in connection with proposed or pending legislation, as well as educational documents on cost and management accounting.

The procedure through which a proposed Recommendation had to pass was cumbersome indeed, owing to the Council's desire that it be exposed to a broad range of comment. The object of a Recommendation was to offer guidance to members on 'best practice.'

The Recommendations, as with all other Institute position statements, were issued only on the authority of the Council. An axiom of the English Institute, in contrast to the policies of The Canadian Institute of Chartered Accountants and the American Institute of Certified Public Accountants, is that only the Council may authorize the issuance of guidance statements to members. While factual surveys, in the form of books, booklets, or short papers, may carry the

[5] Private memorandum to the writer.

[6] There was much dissatisfaction in the late 1930s and early 1940s with accounting practices. Among other things, the *Royal Mail* case had not been forgotten. See, for example, 'Directors and Auditors,' *The Economist*, April 11, 1942, pp. 507-08; 'Company Control for Publicity', *The Economist*, April 25, 1942, pp. 574-75; 'Accountants and Accounts', *The Economist, loc. cit.*, reprinted in *The Accountant*, October 17, 1942, pp. 234-35; also the letters by F. R. M. de Paula in *The Economist*, October 31, 1942, p. 268, and by Russell (later Sir Russell) Kettle in *The Economist*, November 14, 1942, pp. 301-02. Kettle was later appointed to the Cohen Committee on Company Law Amendment. Also of interest is Harry Norris, *Accounting Theory* (London: Sir Isaac Pitman & Sons, Ltd., 1946), Chapter XII.

[7] From its inception to the present, the Taxation and Financial Relations Committee (later known as the Taxation and Research Committee and today as the Technical Advisory Committee) has never been permitted direct access to the Council. In the 1940s the Parliamentary and Law Committee was perhaps the most powerful committee of the Council, and like all other Institute committees save the Taxation and Financial Relations Committee it was composed entirely of Council members. As one Institute member who was a close observer of the Council said, 'The Taxation and Financial Relations Committee was never allowed to grow up.'

[8] See 'The Institute of Chartered Accountants in England and Wales,' a report on a meeting of the Council dated December 2, 1942, *The Accountant*, December 12, 1942, p. 354.

name of an Institute committee, the Council must authorize their publication.[9]

The Council required that a proposed Recommendation meet three conditions prior to being approved for publication:

> First, that the substance of the document be endorsed by an overwhelming majority of the Council.
>
> Second, that the document be reasonably concise in form.
>
> Third, that in the opinion of the Council there is a real need for a declaration on the subject.

The procedural channel through which proposed Recommendations passed may be outlined as follows:

1. Subjects for consideration originated with a Research Program Subcommittee. If a subject were approved by the T. & F. R. Committee, it was submitted to the Parliamentary and Law Committee (the 'P. & L. Committee'), which is a subcommittee of the Council. Final go-ahead on a subject would be given either by the P. & L. Committee or by the Council itself.
2. An approved subject was assigned to one of three subcommittees of the T. & F. R. Committee: General Advisory (which was concerned with accounting principles and related matters), Taxation, and Cost Accounting. Since these subcommittees were rather large, they would appoint a drafting subcommittee for each new subject.
3. The drafting subcommittee held meetings (which could be many) to formulate a draft memorandum. Subcommittee members and a member of the Institute secretariat worked over successful drafts.
4. The General Advisory Subcommittee considered the draft, altered it where necessary (in some instances returning the amended draft to the drafting subcommittee for comments), and circulated the new version to the regional T. & F. R. committees.
5. Each of the (then) 14 District Societies had a T. & F. R. Committee which was independent of the Institute's committee of the same name. All told, some 250 members were involved throughout the country. The secretary of each regional committee obtained the comments of his committee's members on the circulated draft memorandum and forwarded them to the secretary of the Institute's T. & F. R. Committee.
6. The comments from the regions were circulated among the members of the drafting subcommittee, which met to settle a revised draft to be submitted to the General Advisory Subcommittee.
7. The General Advisory Subcommittee considered the revised memorandum, perhaps making amendments that would require a further intervention by the drafting subcommittee, and forwarded the approved draft to the T. & F. R. Committee.
8. The T. & F. R. Committee, intervening for the first time since the approval of the subject, would approve the draft or return it to the General Advisory Subcommittee for directed revisions.
9. Once approved by the T. & F. R. Committee, the draft was sent to 'joint representatives', consisting of T. & F. R. Committee members who had taken an active part in the detailed drafting and key members of the P. & L. Committee. The objective of this intermediate stage was to enable senior members of the P. & L. Committee to raise any major points that were likely to be brought up in a meeting of the full P. & L. Committee.
10. The P. & L. Committee, once it received the draft, had to decide if it should go forth as a Recommendation, a Note, a booklet, or what. Was it sufficiently clear and concise, and did it omit any necessary element? Was it a subject on which a statement is needed? Was its substance acceptable? If legal counsel were needed, the decision would be delayed accordingly. If the draft was not returned to the joint representatives for further discussion, it would be forwarded to the Council with the P. & L. Committee's advice.
11. At the Council level, it was seldom that more than minor amendments were made, owing to the elaborated process of study and amendment through which the draft had already passed. Nonetheless, it was not unknown for the Council to rewrite a draft extensively.
12. When the Council had given authorization, the document was published in the appropriate form.

[9] See *infra*, p. 24, for an exception in the case of the Research Committee. [The extract reproduced here does not extend as far as the material referred to in this note.]

Upon reviewing the foregoing procedure, the Institute's Secretary humorously remarked:

> If anyone were to sit down with the avowed object of devising the slowest method of producing a document I doubt whether he could devise anything better than [this] procedure …[10]

The votes of the Council on Recommendations were never revealed. Dissents and dissenting opinions were not recorded. 'Overwhelming majority' was never formally reduced to a specific numerical count although it was generally understood to mean a two-thirds majority. Furthermore, no notice was given of the subjects on which the Council (or the P. & L. and T. & F. R. Committees) was considering Recommendations. It was not announced if a proposed Recommendation aborted at any point along the prescribed route, including at the Council level. Nothing about any modifications made by the Council was disclosed. In sum, except for the announcement and publication of approved Recommendations, the deliberations of the Council and the two committees were entirely confidential.

It was not known, of course, the extent to which any Recommendation embodied the views of the T. & F. R. Committee. It was entirely possible for a Recommendation not even to originate in the committee: It might have been written by the Council itself.

That the Taxation and Financial Relations Committee was among the busiest committees of the Institute is confirmed by the number of meetings held by the committee and its subcommittees between 1942 and 1952:

1942	18	1948	48
1943	39	1949	57
1944	33	1950	71
1945	24	1951	110
1946	38	1952	113[11]
1947	32		

As its workload increased, the committee required the full-time assistance of an Institute staff member. Accordingly, after being attended on a part-time basis for nine years, in 1951 the committee was assigned a full-time assistant.

Foremost among the stalwarts of the T. & F. R. Committee in its first years were Harold (later Sir Harold) Barton and William (later Sir William) Carrington, who also played a significant role in 1941-42 when the Council was persuaded to create the committee; and F. R. M. de Paula and P. M. Rees, two non-practicing members. Barton was the committee's first Chairman, and de Paula, the first Vice-Chairman, later ascended to the chair.

To many, the title 'Taxation and Financial Relations Committee' had never seemed wholly appropriate to its actual role. In October, 1949, the Council decided to adopt the name, 'Taxation and Research Committee.'[12] This change was not accompanied by an alteration in its charge or in its mode of work.

The committee's early output: Recommendations issued between 1942 and 1952.
The T. & F. R. Committee went right to work, and by December, 1942, the Council had approved its first two Recommendations on Accounting Principles. These dealt with the accounting treatment of tax reserve certificates and of war damage contributions, premiums, and claims. A portion of the second Recommendation was foreshadowed by a circular letter from the Council dated August 20, 1941. This earlier circular, therefore, represented the Council's first attempt at giving official guidance to members.

The first Recommendations were well received by the accountancy press.[13] It is noteworthy that the editor of *The Accountant's Magazine,* a monthly journal edited in Edinburgh, while praising the initiative of the English Institute, chafed somewhat at the Institute's not having consulted its Scottish brethren.[14]

[10] Alan S. MacIver, 'The Work of the Institute', a paper given at the Institute's Summer Course, Christ Church, Oxford, 1954, p. 65.

[11] *Ibid*, p.61.

[12] To some, the word 'research' might have caused anxiety. In his address to the T. & R. Committee at the time of the change in name, the Institute President, Sir Russell Kettle, '…added that he would like to dispel any fear anyone may have that the Council intends the committee to embark on purely academic studies; the practical nature of its research had always been an essential feature of the committee and he hoped it would continue to keep its feet firmly on the ground.' *The Accountant*, November 26, 1949, p. 577.

[13] See, e.g. *The Accountant*, December 12, 1942, p. 352.

[14] *The Accountant's Magazine*, April, 1943, p. 129. At that stage in its history, the *Magazine* was not the official organ of the Scottish accounting profession. Its editor was Professor A. G. Murray, holder of the accountancy chair in the University of Edinburgh.

In March, 1943, the Council issued three more Recommendations, which *The Accountant* acclaimed as 'a very definite milestone in accounting history.'[15] Added the journal:

> On this occasion the subjects tackled (and we use that word advisedly) are of the most fundamental importance while yet being amongst those which have occasioned the most varied discussions in the business and professional world. These subjects are, respectively, the treatment of taxation in the accounts, the treatment in accounts of income-tax deductible from dividends payable and annual charges, and the inclusion in accounts of proposed profit appropriations. It is notorious that the problems dealt with under these headings are those which have caused very great difficulty in the drafting of published accounts, and the absence of authoritative guidance has led to a diversity of treatment and consequent difficulty and doubt in comparing and summarising the results disclosed by different trading undertakings.[16]

In the first of the three Recommendations, the Council said that 'the charge for income tax should be based on the profits earned during the period covered by the accounts,' rather than related to the fiscal year for which the tax was assessed, which ended on April 5th. The second in the brace of Recommendations dealt with a subject that had excited controversy in and out of the accountancy press, including a remark in *The Economist*.[17] The third Recommendation counselled that a provision should be made in the accounts for proposed profit appropriations, including those yet requiring confirmation by the shareholders. In the latter instance, the contingency was to be described.

Later in the same year, the Council turned its attention to the fuller disclosure of reserves and provisions. This Recommendation, the sixth in the series, was hailed by *The Accountant* as 'a very notable landmark in accounting history.'[18] Partly as a result of the infamous *Royal Mail* case of 1931, the first major public embarrassment to be suffered by the British accounting profession, the surreptitious treatment of discretionary reserves had become the object of considerable criticism. In Britain, accountancy was emerging from an age in which deliberate and material understatement of assets and profits was regarded as one of the hallmarks of good financial reporting. *Royal Mail* taught the accounting profession that 'if secret reserves were drawn upon to bolster current earnings, this fact would have to be disclosed in the accounts. If not, the auditors would feel compelled to disclose the matter in their report. But the vexed question as to whether the existence of secret reserves should be disclosed was still left undecided.'[19] The Recommendation on reserves and provisions proposed expanded disclosures concerning their creation and status at the balance-sheet date.

In 1944, Recommendation 7 proposed that consolidated accounts be presented for holding companies and subsidiaries. At the time, the publication of consolidated statements was not common practice. In 1939, the London Stock Exchange had amended its rules to require companies seeking quotations for new securities to issue consolidated balance sheets and profit and loss accounts.[20] Thus the Institute's Recommendation was not without precedent, although it went considerably further than to codify existing practice.

Recommendation 8, also issued in 1944, dealt with the form and content of balance sheets and profit and loss accounts. It was put out at a time when the Cohen Committee on Company Law Amendment was hearing testimony. Much of the contents of the first eight Recommendations eventually found expression in the 1945 Report of the Cohen Committee and in the revised Companies Act itself.[21]

Recommendation 9, in 1945, dealt with depreciation, generally endorsing the straight-line method in most situations.

[15] 'The Institute and Accounting Principles', *The Accountant*, March 20, 1943, p. 145.

[16] *Ibid.*

[17] 'Company and professional accountants have made scarcely any progress towards a standard practice in treating taxation in the company accounts.' 'Profits – A New Series I', *The Economist*, May 23, 1942, p. 720. Between July 4 and October 3, 1942, thirteen letters debating the subject were published in *The Accountant*. See also 'Treatment of Income Tax', *The Economist*, July 25, 1942, p. 115.

[18] 'The Institute on Reserves and Provisions', *The Accountant,* October 30, 1943, p. 205

[19] F. R. M. de Paula, 'Accounting Principles', a paper delivered in 1946 and reprinted in F. R. M. de Paula, *Developments in Accounting* (London: Sir Isaac Pitman & Sons, Ltd., 1948), p. 36.

[20] 'Consolidated Accounts: The Stock Exchange Ruling', *The Accountant*, February 25, 1939, p. 250.

[21] See F.R.M de Paula, *op. cit.*, pp. 37 and 51.

Recommendation 10, on the valuation of stock-in-trade, was regarded by the Chairman of the T. & F. R Committee at the time the Recommendation was issued as 'the most revolutionary of any of the recommendations issued to date by the Council.' He added:

> The basic premises at the root of [this Recommendation] are, firstly, that the true trend of the earnings of a business must not be distorted by the bases adopted from year to year for the valuation of stock-in-trade, and secondly, I submit that questions of financial policy should be kept quite separate and distinct from the basic principles that should govern these valuations.[22]

The Recommendation gave definitions for 'cost' and 'market value', said that stock-in-trade should be stated at the lower of the two, and proposed that the accounting policy adopted by a company be consistently followed. It permitted the use of any of several methods of finding cost.

Following a Recommendation on the accounting treatment of post-war refunds from excess profits taxes, the Institute issued the first of two highly controversial Recommendations on the impact on the accounts of changing price levels.

Recommendation 12, 'Rising Price Levels in Relation to Accounts', reaffirmed the use of historical cost previously espoused in the Recommendations on depreciation and stock-in-trade, and suggested that any amounts set aside for the replacement of assets should not enter into the determination of profits.

This Recommendation, issued in early 1949, provoked a great deal of controversy. Economists and industrialists had been arguing for some time that profits should be reckoned in 'real' terms. The rapacious 'effective rate' of corporate taxation during inflationary periods was a great concern to company directors.

The essence of the difference between the economist's and accountant's approaches to the valuation of assets and concomitant determination of income was set out in a 46-page booklet, *Some Accounting Terms and Concepts*, published in 1951 by the Cambridge University Press. The booklet emerged from deliberations by a committee of distinguished economists and chartered accountants which had been appointed in 1945 by the English Institute and The National Institute of Economic and Social Research.

Accounting for changing price levels, unlike any previous accounting question, evoked books and position statements from most of the other major accountancy bodies. The Institute of Cost and Works Accountants published a 129-page book in 1952 entitled *The Accountancy of Changing Price Levels*, in which it presented an argument for replacement cost and demonstrated how it might be reflected in the accounts. Also in 1952, The Association of Certified and Corporate Accountants published a 149-page book with the title, *Accounting for Inflation*. The Association's book, which also argued for replacement cost, reflected a more academic flavor than the Cost and Works publications.

Furthermore, the Presidents of the Association and The Society of Incorporated Accountants and Auditors spoke out frequently on the need for replacement cost accounting, thus sharpening the challenge to the English Institute's 1949 position.[23]

After reconsidering its earlier position, the Institute's Council issued Recommendation 15, 'Accounting in Relation to Changes in the Purchasing Power of Money', while at the same time announcing its intent to invite the other accountancy bodies to join in 'further study of the subject.' In Recommendation 15, which was issued in May, 1952, the Institute said:

> Unless and until a practical and generally acceptable alternative is available, the Council recommends that the accounting principles set out below should continue to be applied:
>
> (a) historical cost should continue to be the basis on which annual accounts should be prepared and, in consequence, the basis on which profits shown by such accounts are computed ….[24]

[22] *Ibid.*, p. 52.

[23] See, e.g., the 1952 paper by the Society President in which he argues for replacement cost after presenting the views of accountants, economists, lawyers, and businessmen on the computation of profit. C. Percy Barrowcliff, 'Fluctuating Price Levels in Relation to Accounts', *The Sixth International Congress on Accounting, 1952* (no publisher given), pp. 25-72.

[24] 'Accounting in Relation to Changes in the Purchasing Power of Money', Recommendation on Accounting Principles 15, May 30, 1952, para. 30.

While the English Institute sought joint talks on the availability of 'a practical and generally acceptable alternative', there was a belief that the very issuance by the Institute of Recommendation 15 left little for real discussion among the accountancy bodies: The die had been cast. Nonetheless, after the invitation was tendered in July, 1952, two meetings were held with representatives of the Association, the Society, and the Scottish and Irish Institutes in 1952-53, both without fruit. In January, 1954, the English Institute released the following statement:

> During these two meetings nothing has emerged which makes it necessary for the time being for the Council to amend or add to the comprehensive review of the subject which is contained in Recommendation 15.[25]

Three of the other accountancy bodies, however, expressed themselves in separate statements. In January, 1954, the Society issued a guidance statement which said that its Council

> suggests to its members that encouragement should be given, in appropriate cases, to the wider use of new conventions in calculating the profit shown in financial accounts. When accounts are clearly stated to be prepared on this basis, they should be considered an acceptable alternative to those prepared on the basis of 'historical cost.'[26]

In the same month, the Association published a memorandum that not only proposed a compromise solution which, it contended, would not 'involve any basic change in general accounting principles, nor any departure from the traditional framework of accounts', but also alleged that 'the reasoning of Recommendation XV is defective.'[27] In the same issue in which it reprinted the statements of both the Society and the Association, *The Accountant* criticized the two dissenting views from Recommendation 15 and took the Association very severely to task for publicly questioning the propriety of an Institute Recommendation.[28] While *The Accountant* was legally and operationally independent from the English Institute, there were some who viewed the weekly journal as 'the Institute's mouthpiece.'

The Institute of Chartered Accountants of Scotland also issued a statement by its Council on the subject. The Scottish Institute's Council, which except in this instance had prior to 1971 refrained from giving official guidance on accounting matters to its members, did not refer by name to either the English Institute or its Recommendation. Though it cautiously observed that 'until some of [the differences of opinions among accountants] have been resolved on the basis of practical experience it is clearly inappropriate for a professional body to advocate to its members the adoption of any particular method', its rather laissez-faire conclusion 'that there is no reason in principle why an auditor should qualify his report on accounts by reason only of some disclosed departure from the basis of "historical cost"'[29] was criticized by *The Accountant* as too permissive,[30] a complaint also registered against the Society's position.

Of the accountancy bodies that met in 1952-53 with the English Institute, only the Irish Institute declined to take a public position.

The two Recommendations issued between Nos. 12 and 15 dealt with accounting reports for prospectuses and the accounting problems pertaining to the estates of deceased persons. In addition, the T. & R. Committee contributed to the publication of numerous Notes, memoranda, booklets, and books between 1942 and 1952, covering taxation and cost accounting as well as accounting principles and procedures. In some instances, such as the 1949 Note entitled 'Group Accounts in the Form of Consolidated Accounts', where the Council believed a consensus was lacking, publications were put out in the name of the committee.

Technical Activities from 1953 to 1969

Later Recommendations. Between 1953 and 1969, 14 Recommendations were issued, of which four replaced earlier Recommendations. No. 27, 'Treatment of Taxation in Accounts of Companies', which was a revision and expansion of No. 19 on the same general subject, recommended the

[25] *Ibid*. [amended in 1954 to include this statement], para. 34.

[26] 'The Accounting Implications of Changing Money Values', *The Accountant*, January 16, 1954, p. 74.

[27] 'Observations on Recommendation XV of The Institute of Chartered Accountants in England and Wales on Accounting in Relation to Changes in the Purchasing Power of Money', *The Accountants Journal*, January, 1954, pp. 3-5. Quotations taken from pp. 5 and 3, respectively.

[28] 'Quo Vadis?', *The Accountant*, January 16, 1954, pp. 53-54.

[29] 'Accounting in Relation to Changes in the Purchasing Power of Money', *The Accountant's Magazine*, February, 1954, p. 110.

[30] *The Accountant*, January 23, 1954, p. 91.

creation of a deferred taxation account, not to be grouped among the reserves, 'whenever there exist material taxation liabilities which may crystallize at some future date on profits and surpluses already brought into account.' While the Recommendation was not much debated in the journals or the press, tax allocation is still not practiced by a significant number of companies.

No. 24 on investment grants and No. 28 on the accounts of investment trust companies were noteworthy for their differences in treatment from that preferred by the Research and Publications Committee of the Scottish Institute.

In March, 1966, two months after the Government had published a White Paper on investment incentives which proposed a new form of Government subsidy known as 'investment grants', the Council of the English Institute issued an 'interim statement'[31] in which it tentatively recommended that investment grants be subtracted from the cost of the related fixed assets and be taken into income over their useful lives. This was the first such 'interim statement' ever issued by the Council on accounting principles, since all prior guidance statements had been issued only in the form of final Recommendations.

Once the Industrial Development Act, 1966, incorporating the proposal contained in the White Paper, was approved, the Scottish Institute's Research and Publications Committee published a paper in which the majority of the committee believed that the investment grant should be credited to capital reserves.[32]

Although the committee's paper was not issued on the authority of the Scottish Institute's Council (see below on the Scottish Institute), it nonetheless conveyed the view of the Institute's technical committee and would be given due consideration by members of the Scottish Institute.

Six months later, in its Recommendation 24, 'Accounting Treatment of Investment Grants', the English Institute's Council, while restating its view that the investment grant should be taken into income over the useful life of the related fixed assets, softened its disagreement with the Scottish Institute's committee by saying that an immediate transfer of the investment grant to capital reserves 'will not necessarily impair the presentation of a true and fair view' if 'there is adequate disclosure and consistency of treatment.' The preferred view in Recommendation 24 was that the investment grant should be credited either to fixed assets or be established as a deferred credit among the liabilities, but in either case it should be taken into income in proportion to the depreciation on the related fixed assets.[33]

Notwithstanding the Council's concession that the majority conclusion of the Scottish Institute committee would 'not necessarily impair the presentation of a true and fair view', the conflict in preferred treatments of the two Institutes was a source of anguish to many practitioners, especially in firms where some partners were members of the English Institute and others belonged to the Scottish Institute. Although no public statements were issued by the leaders of either Institute on the difference of views, at least a few of the leading members of the English Institute were perturbed at the contrary position taken by its neighbor to the north.

A rather less consequential difference of opinion between the two Institutes arose in regard to investment trusts. In 1968, the English Institute departed from normal procedure to consult the Scottish Institute on certain aspects of a proposed guidance statement on accounting for investment trusts, a subject in which Scottish chartered accountants have long been interested – Edinburgh being a home of investment trusts.

Indeed, the Scottish Institute's Research and Publications Committee was at the time preparing a paper on certain accounting matters involving investment trusts. When representatives of the two Institutes conferred, it became clear that they differed on whether the possible capital gains tax on any future realization of write-ups in the value of investments should be reflected in the accounts. The English Institute thought 'yes', while the Scottish Institute felt that footnote disclosure would be sufficient. Thereupon, the English Institute arranged a meeting with representatives of The Association of Investment Trust Companies – perhaps the first occasion

[31] 'Accounting for Investment Grants: Interim Council Suggestions', *Accountancy*, May, 1966, p. 304.

[32] 'Accounting for Investment Grants', *The Accountant's Magazine*, September 1966, pp. 692-97.

[33] 'The Accounting Treatment of Investment Grants,' Recommendation 24, *Accountancy*, April, 1967, pp. 287-88. Also see 'Points from Published Accounts' in the same issue of *Accountancy*, pp. 260-62, and *Survey of Published Accounts, 1968-1969* (London: The General Trust of The Institute of Chartered Accountants in England and Wales, 1970), pp. 66-69, which shows that 217 companies followed one of the two preferred methods in Recommendation 24 and 31 companies credited the investment grant to some kind of reserve (in some cases a 'revenue reserve'). Of those using the reserve approach, all but 14 were taking the investment grant into income through periodic credits to depreciation.

on which the Institute had consulted a non-accounting body prior to issuing a Recommendation – and invited the Scottish Institute to attend. At the meeting, The Association of Investment Trust Companies agreed with the Scottish Institute on the disputed point, following which the English Institute, holding to its view, issued Recommendation 28 in August, 1968. In the same month, The Association of Investment Trust Companies notified members of its dissent from the English Institute's position that a footnote concerning the possible capital gains tax would not be adequate in all cases to give 'a true and fair view.' Most investment trust companies, it appears, have not followed the English Institute's Recommendation.

The following year, the Scottish Institute's Research and Publications Committee published a paper in which it took issue with the Institute's recommendation that a footnote would not always be sufficient.[34]

Concluding remarks on the Recommendations series. The years 1942 to 1969, at the conclusion of which the program of issuing Recommendations on Accounting Principles was supervened by a new scheme, comprised the formative period in the Institute's endeavor to raise the standards of accounting practice. While hard evidence is not available, informed observers attest to the effectiveness of the Recommendations in upgrading practice. Writes a former senior partner of a large firm and onetime Chairman of the Parliamentary and Law Committee: 'The Recommendations met a remarkable degree of acceptance not only from members of the profession but, what was even more striking, from directors of companies and their advisers. The consequent impact on the standards of accounting in the country was little short of tremendous.'[35] The very process by which the Recommendations were approved did much to assure their acceptance. Prior to going to Council, drafts of proposed Recommendations ordinarily passed through at least two Institute committees and a network of regional committees. Final approval was taken by the Council, itself a large body, only after an overwhelming majority was in agreement.

The key position in the Institute's technical work was the chairmanship of the Parliamentary and Law Committee. The chairman was responsible for steering all technical documents through the committee and, in due course, through the Council. The chairmanship was normally for a three-year term and, one close observer writes, 'constituted an immense task, demanding high standards of ability, endurance, and diplomacy.' It was no coincidence that most of the chairmen later became Presidents of the Institute. Between 1942 and 1969, the chairmen were, in order, Russell (later Sir Russell) Kettle, Thomas B. (later Sir Thomas) Robson, William H. (later Sir William) Lawson, G.F. Saunders, S. John Pears, Henry A. (later Sir Henry) Benson, W.E. Parker, Ronald G. (later Sir Ronald) Leach, Douglas S. Morpeth, and Stanley Kitchen. Two members of the Parliamentary and Law Committee who were particularly active workers but whose other duties prevented their becoming chairmen were Sir Harold Howitt and Sir William Carrington. Chairmen of the Taxation and Financial Relations Committee (twice renamed in later years) between 1942 and the mid-1960s who did not also become chairmen of the Parliamentary and Law Committee and who are not mentioned above were William G. Campbell, W. Guy Densem, Stanley Dixon, Stanley M. Duncan, and W.W. Fea.

A criticism sometimes heard was that the Recommendations should be firmer and more positive and rather less patient with alternative practices. This feeling emerged again in the latter part of 1969, when the controversy over the Institute's approach to accounting principles was aired in the press.

[34] 'Balance Sheets of Investment Trust Companies', *The Accountant's Magazine*, November, 1969, pp. 604-05.

[35] Private memorandum to the writer.

W.T. Baxter, 'Recommendations on Accounting Theory', *The Accountant*, 10 October 1953

The article that follows is Professor Will Baxter's well-known attack on recommendations on accounting theory. The article makes it clear that it is indeed the ICAEW's Recommendations on Accounting Principles that he has in mind. However, it makes it equally clear that he has no objection to such recommendations – 'given due care and caution' in their preparation – provided they do not attempt to pronounce on matters of theory.

The article does not specify which Recommendations have trespassed on theory. But Stephen Zeff's introduction to this volume suggests that the Recommendations on accounting and inflation (N12 and N15) would, on their own, have been sufficient to prompt Professor Baxter's critique.

RECOMMENDATIONS ON ACCOUNTING THEORY

by W.T. BAXTER

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I. The need for a review

At the end of a talk on the present state of accounting theory,[1] I said that societies of accountants should not, in my view, make statements on matters of 'intellectual principle'. There was not time in that talk to set out the pros and cons of the matter in full, and I should like to do so now.

What I had in mind was, of course, the 'recommendations' or 'bulletins' issued by (in particular) The Institute of Chartered Accountants in England and Wales, and the American Institute of Accountants.[2] These recommendations have now been coming out for just over a dozen years, and add up to a considerable volume of print on a wide range of subjects. Their influence on accounting is great and growing. Accordingly, some review of this development seems not out of place. Many accountants – even if they do not share my feeling that the recommendations have already gone too far – may perhaps like to discuss how much further the process of recommending can, with propriety, go. Where is the limit? Are we to look forward to the day when every aspect of accounting has been dealt with? Should our goal be – as high authority has hinted apropos the question of price levels – super-recommendations by a massed assembly representing *all* the professional bodies?

Another reason for airing the matter is this. Many accounting societies have so far made few or no recommendations. Their members may well have some feeling that the omission may seem to betoken a lack of zeal and public spirit. They should recognize that a policy of official silence has in fact much in its favour. However, this most emphatically does not mean that inertia should be lightly excused, or that accounting societies need take no part in furthering knowledge. On the contrary, they should do everything in their power to encourage education, debate and research. For instance, they could give great help by setting up much-needed scholarships (perhaps to be awarded on the results of the professional Intermediate examinations) to enable their brilliant young men to study further.

II. Scope of the review

If our review of the recommendations is to be profitable, we must restrict its scope to what seems the most important question – whether an accounting society is wise to say what is 'right' or 'true' in matters of theory. By 'theory' is meant the attempt to explain, in terms of fundamentals, what accounting is and what it tries to do; accounting is thus assumed to be a branch of knowledge, like law or physics, with basic principles that are worth exploring.[3]

Recommendations can, in fact, deal with many things beside theory. They may instead be concerned with *policy*. A professional body sometimes advises its members to follow a common policy on questions that have little to do with the intellectual content of its members' work. For instance, it may make statements on ethics, fees, registration by the State, and so forth. Such types of advice should be judged by standards quite different from those useful in our present review; if, for example, a body of architects advises its members to charge a uniform fee, we judge that issue in the light of our views on the benefits or otherwise of economic monopoly.

Similarly, our review is not concerned with narrow problems of *technique*. If a recommendation freely admits that such-and-such fundamental principles are taken for granted, and merely seeks the best way to apply them, there is not much cause for serious criticism.

[1] 'Accounting principles: the conflict in current theory', *The Accountant*, June 13th, 1953.

[2] Conveniently enough, both issues are summarized in *Accounting Research* (January 1953) by E.L. Kohler.

[3] In my first article, I used the phrase 'matters of intellectual policy'. This may sound a trifle pompous. Possible alternatives are 'scientific knowledge' or 'scientific laws', but these are apt to suggest work among test-tubes – unless we call accounting one of the social sciences. Again, 'abstract knowledge', 'learning', and 'scholarly research', may sound best suited to the Faculty of Arts. So 'theory' seems the neatest word to cover what we have in mind. But the name is of small importance so long as we all know what is at issue.

It might be thought that the same applies to *definition*, and *uniform* practice. To some extent these can indeed be handled in ways that avoid theory – in which case they, too, fall outside our discussion. But such matters infringe on theory more often than might be supposed; and so we must give a little space to them.

A recommendation can often be looked on either as theory or what we may call *working regulations*. By the latter is meant a framework of rules designed to make an institution run smoothly (e.g. the Football Association's rules of play, or the Companies Act). The test of a good piece of theorizing, surely, is that it makes us think more clearly. The test of a good law is that the institution works well; it is not educational but practical.

Consider, for instance, the problem of how assets should be valued. When a writer on accounting tries to show us the best method of valuation, he probably builds up his case by discussing and judging various theories. When a law says that company accounts must show the values in such-and-such ways, it does not analyse all the theories and then tell us which satisfies logic. The framers of the law must indeed have some theory in mind; but they treat it merely as the basis for a promising experiment – to be scrapped if it fails – and not as a truth to be endorsed and broadcast.[4]

Our views on recommendations may thus depend on whether we look on them as law or research. In many cases their form and tenor suggest that an element of both is intended. Whatever the intentions of their framers, there can be little doubt that they have been accepted by wide audiences as official pronouncements on general theory.

Our review is thus confined to one aspect of the recommendations. Moreover, it will probably keep more closely to the point if it omits from its scope all discussion of whether individual recommendations on theory have in fact been right or wrong. What is said here is thus not meant as criticism of any recommendation's content. Indeed, we may for our present purpose agree that every word in every recommendation has been entirely true; and yet we may think that a policy of making recommendations on theory will, in the long run, be disastrous.

III. Origins of recommendations

I should like to admit frankly that when first an official statement on accounting principles was published, I was enthusiastic about it. My doubts have arisen since, on seeing how the new venture has developed.

Looking back at that statement, one remembers certain features that have unfortunately not usually been copied since. It came out in 1938, and was called *A Statement on Accounting Principles*; it was published by the American Institute, to whose members it was commended in a foreword; but it bore the names of its three distinguished authors – Messrs Sanders, Hatfield and Moore – who had been formed into an independent committee to do this bit of writing (and who were not even members of the Institute). Under such an arrangement, the Institute was plainly doing its duty to foster discussion and yet was itself not taking sides. That kind of procedure goes far to disarm criticism.

Since this first venture, the trend has been for the statements to be drafted by committees much more closely linked with the sponsoring body; and for the latter to back the conclusions in a much firmer way. The American Institute set up for instance its own committee on Accounting Procedure to issue research bulletins. Bulletin No. I explained the aims and methods. It stressed the growth of corporate organization, and therefore the social importance of good accounts; and it noted that there 'has been a demand for a larger degree of uniformity in accounting'. The committee stated that its rules were not intended to have retroactive effect; also they may be subject to exception, but 'the burden of proof is upon the accountant clearly to bring out the exceptional procedure and the circumstances which render it necessary'.

This has perhaps a somewhat mandatory ring. But the American bulletins have in fact used two safeguards that make their tenor less authoritarian: the members of the drafting

[4] Similarly, Parliament is sometimes forced to choose between scientific theories, e.g. public health law assumes that the views of Pasteur and Fleming are right. But the choice is made merely so that hopeful lines of development can be tried without delay, and should not imply that the official seal of approval has been put on any theory. Otherwise legislators would be exceeding their function, and attacking our freedom of thought.

Again, if an Act of Parliament includes definitions, these are not meant as revelations of abstract knowledge but only as tools for making effective the particular set of rules. A judge may even hold that the definitions in one Act do not apply in the context of another Act on a dissimilar subject.

committee are named in recommendations, and any member who disagrees with the majority is entitled to have the fact of his dissent recorded in the document. One American committee has had the courage to say bluntly that an earlier pronouncement by itself now seems wrong.[5]

The Institute of Chartered Accountants in England and Wales announced its first recommendation as follows:

> 'The Council has requested the Taxation and Financial Relations Committee to consider and make recommendations to it on certain aspects of the accounts of companies and it is proposed from time to time to publish approved recommendations for the information of members. It is, of course, a matter for each individual member to consider his responsibility in regard to accounts presented by directors, but it is hoped that the recommendations to be made will be helpful to members in advising directors as to what is regarded as the best practice'[6]

These words are as modest and cautious as anyone could wish. They show how undogmatic the original plan was; and they suggest that the Council did not foresee the eventual scope of the recommendations or the deference with which they would be treated.

IV. The case for recommendations

It would be ungenerous not to set down the good that has been done by the recommendations. Their benefits have obviously been great.

As was pointed out in Section II above, statements by a professional body may take several forms; notably they may either suggest working rules or propound abstract principles. The recommendations have been of most service when they fell into the first group – as, for instance, when they have dealt with the content of company accounts. What we may call extra-parliamentary control – such as the rules of the Stock Exchange and these recommendations – can often be a useful supplement to statutes, particularly at the experimental stage; and the early recommendations did much to prepare the way for e.g. Britain's 1948 Companies Act and, indeed, have in part been absorbed into that Act.

The recommendations may thus serve as private forerunners and reinforcements to the law. Their record in this work has on the whole been excellent – notably in procuring full, frank and consistent accounts. The auditor has special cause to be thankful for them; the task of persuading his clients to comply with high standards in published accounts is sometimes delicate, and the recommendations have greatly strengthened his hand.

Though the recommendations have been less successful in the realm of theory, they have yielded some benefits. As each recommendation appears, undoubtedly it gives rise at first to discussion and interest. Again, many of us used to deplore the fact that our profession's leaders never could spare time to write about their work; whatever the faults of the new system, it does prompt these men to tell us a great deal about what they think and do.

We thus have cause to feel grateful to the drafters of the recommendations; and this review should on no account be construed as an attack on them. Obviously they have devoted a vast amount of time and care to their task, and have been prompted by a high sense of public service. If any harm should in the end come from their work, the fault is not theirs; blame will attach rather to the disciples who have accepted their teaching all too eagerly, and have invested it with an *ex cathedra* quality that could not have been foreseen.

It is not unusual in human affairs for a thing to be started with the best intentions, and yet to develop some aspects that threaten harm. My plea is that we should now review the good and bad alike, and see whether we cannot guide future growth in directions that are wholly good.

The recommendations' benefits are clear and present. Their ill results are hypothetical and will show – if at all – in the future. Moreover, these ill results are suggested by experience in other fields of study; and conceivably accounting differs in nature and difficulty from these. If accounting is unlike other subjects, or is mere child's play, then the arguments that follow are greatly weakened. But I see no reason to think that it is different.

[5] *Accounting Problems Arising from Devaluation of Foreign Currencies*, Research Department, American Institute of Accountants (1949).

[6] *The Accountant*, December 12th, 1942, page 354.

V. The case against recommendations

The case against official recommendations on theory is threefold. First, men do not always become better at research when they don the mantle of authority. Second, if authority takes direct part in the pursuit of truth, it may hinder rather than help. Third – and most important – there are no sure signs by which truth can be recognized.

The first objection need not keep us long; admittedly it is not always a strong factor. To judge from experience in most fields of learning, men tend to do their best research when left to their own devices. There are many exceptions; a large team of chemists may be the quickest means of dealing with a laborious task, and a government committee may be admirable at sifting evidence and assessing opinion. In general, however, thinkers are apt to be hampered by close connection with a team or with a powerful institution. The link may bring a need for diplomacy or compromise; policy may be more urgent than truth. Thus the authorities of the Church could not deal fairly with the ideas of Copernicus and Galileo because these ideas clashed with official pronouncements of the past.

The second objection is much weightier. It is an indirect way of saying that freedom is necessary for progress. Man must be able to think freely, so that the stream of new ideas can flow strongly; and men must be able to discuss and experiment freely, so that these ideas can be criticized and tested with the utmost rigour. If authority intervenes – by joining in the quest itself, or by giving its *imprimatur* to some favourite idea, or by making crude attacks on personal liberty – the chances of progress are lessened. Men cease to think so freely – whether from awe, fear or belief that others can do the job better; and therefore the stream of new ideas dries up. They cease to discuss and experiment so freely; and therefore criticism loses its edge, and ideas are not put to a stern test.

This train of reasoning leads us to the third objection. Under strong criticism, many ideas soon prove false. Others satisfy all immediate tests, yet we ought still to accept them as tentative only, for they, too, are likely to show flaws as the years go by. Even after an idea has survived triumphantly for centuries, some critic may shatter it, or else show it to be capable of improvement. Einstein was able both to generalize Newton’s theory and to correct it for conditions that had not previously been considered. No human being – however distinguished – can certainly foretell which idea will become a casualty. As Bacon tells us: ‘Truth is the daughter, not of Authority, but of Time.’

The root of the matter, surely, is man’s fallibility. Only where we believe a statement to have divine inspiration can we treat it as beyond all doubt.

It may be helpful to ask why learned bodies do not in general issue official solutions to questions puzzling their members. Why, for instance, does the Royal Society not organize a team of Fellows to solve this or that intractable problem of physics? All three objections suggested above are relevant to the answer. The Fellows may perhaps feel that they can work better in isolation. Their training in science has made them sceptical and more apt to test and attack than to defend ideas. They have learnt from the experiences of centuries that their ‘laws’ can never be regarded as final. If the Society gave official approval to theories, its members would probably soon be rent by a schism between an orthodox and a dissenting party; and sooner or later (the chances are) the Society would be proved wrong, and would be forced to utter an embarrassing recantation.

Similarly, official recommendations by an institute of engineers would have to be framed with some care. Assume, for instance, that its members were advised to build bridges in a uniform way, based on the best current knowledge. For a while, standards might well be raised. But research would in time point to better bridges; non-conformist bodies of engineers would be free to build these, while the orthodox would be denied the fruits of advancing science.

Exactly what do we mean by ‘authority’ in this section? A wide sweep should be given to the word; we wish it to include all forces that can give weight to some ideas at the expense of others. Privilege is bad for ideas as for men; only if they can jostle one another in a democratic way is the best likely to reach the top.

Authority may thus rest (at one end of the scale) on prestige only, and (at the other) on power. Occasionally the sheer brilliance of a single scholar can cause his views to be treated with undue deference. A close-knit school of able thinkers may well dominate opinion to an unhealthy point – even if they lack organization and can impose no sanctions. The harm becomes vastly more formidable when the authority controls education, or can mould adult opinion. It reaches its worst when authority has total power. In its extreme forms, we are all agreed that it is evil; and we should continue to think so whether or not the views that it promulgates happen to seem true or false.

Happily, we are here concerned with authority only in its mildest and most benevolent form. Nevertheless, we may wonder whether, in the realm of mental freedom, even a slight degree of control must not lead to harm.

VI. Authority and accounting principles

With our recommendations, the basis of authority is, of course, mainly the prestige of the bodies concerned. But this is of a high order. We all know in what regard and respect such a body is held by the bulk of its members. Moreover, its drafting committee will include many of the profession's best-known men. It gives the recommendations its whole-hearted backing and a good deal of publicity. In consequence, the issue of a new recommendation is treated as a matter of some moment by the accounting press; this attention is fitting, but one could wish that the notices were a shade less passive.

The recommendations must therefore have a considerable influence on the thought of the mature accountant. On the immature mind – that of a young man in training – their impact must be even deeper; for they have been given conspicuous places in his text-books and correspondence courses, and so take a leading part in moulding his views when he is still impressionable and uncritical. Even before the days of recommendations, accounting text-books and courses preferred in general to state facts rather than to explore theories. Their main concern was painstaking description of normal practice; scant space was accorded to the reasoning behind the practice, and next to nothing was said of controversy. This narrow approach has now been rendered even more likely. If an official answer is available to a problem, why should a teacher burden his examination candidates with other views? Further, the body that gives the answers may also set the examination. A young man has thus good cause for minute and respectful study of its statements. And his examination does not often include such searching questions as: 'Discuss Recommendation No. -. Set out the grounds for supposing that its reasoning is *(a)* correct, and then *(b)* fallacious; and give your own views on this point.'

Thus the recommendations tend to rob our young men's education of its power to enrich and stimulate. On such a spare diet, they may perhaps still train well enough to master the problems of today. But their minds will be less fit to solve the new problems of tomorrow; and such fitness is no bad test by which to judge an education.

The authority behind the recommendations has so far been based on prestige alone. But can we be quite certain this will always be so? There is at present not the slightest wish among the societies to take action against any non-conformists in their ranks; and I scarcely imagine that a less liberal trend will appear in the future. But danger may arise in another way – namely, if recommendations are used as evidence in lawsuits.

Consider, for instance, a case that hangs on questions of auditing theory – say, the valuation of stocks and wasting assets when price levels change. Suppose that a company follows the advice of an auditor who sincerely believes a recommendation to be wrong; that the company thereafter runs into financial trouble, and that it sues the auditor for negligence. In such a case, the determining test would probably be the standard of behaviour followed by good professional practice. Hostile counsel would treat the recommendations as powerful evidence, and could make the most damaging use of the auditor's deviation. The defence might have some difficulty in proving that many conscientious but inarticulate accountants still regard the issue as open to argument. A judge or jury might well be swayed decisively by the recommendations and give a verdict against the auditor.[7]

Such cases must inevitably crop up sooner or later. Where an auditor is faced with this risk, the temptation to play safe – by abandoning his independence of judgment – is very great. Yet a pliant attitude in such matters is scarcely compatible with the dignity of his profession.

[7] An analogy is tempting. Suppose that the medical profession's first dislike of antiseptic surgery had crystallized in a hostile recommendation, that one of Lister's patients had died, and that the deceased's relatives had brought a suit for negligence. What would have been the effect on surgery?

VII. Other kinds of recommendations

The preceding section looked at recommendations that are intended as statements of theory, and tried to suggest their dangers. In Section II, however, we saw that some recommendations are not meant as statements of theory, but only as, e.g. working rules – in which case they may be judged by other and less severe tests, and fall outside the scope of this review.

Section II also suggested that there are certain other kinds of recommendations which may seem to avoid theory, but in fact are apt to become entangled with it. Let us consider these briefly:

(a) Definition. If precise and uniform meanings can be given to our terms and figures, then doubtless we shall be able to exchange ideas with more ease and clarity.[8] Also, accounting data will be more consistent.

Standard definitions are, however, not without their drawbacks. If speech is made rigid, it cannot evolve to meet new needs. There may be a clash between the ordinary and the technical use of a word; thus 'reserve' in everyday speech can mean something quite different from its sense in a balance sheet, and its standard use might bewilder rather than enlighten the public.

Further, words are seldom quite neutral in the battle between ideas. With 'goodwill', for instance, the ordinary meaning stands out so strongly that it obtrudes when we are trying to unravel the accounting concept, and probably colours our views. Again, choice of a definition often necessitates a choice between ideas. For example, any definition of 'depreciation' is almost sure to be tendentious.

Thus, an official link between a word and an idea is likely to bias our minds. What is almost as bad, some definitions have an air of finality that checks inquiry, and leaves students with no exciting sense of being explorers in a great and unknown territory.

(b) Standard practice. Uniformity in method and layout has strong arguments in its favour – provided it neither cramps business nor begs ideas.

Perhaps these provisos do not leave much scope for the spread of uniformity. And one remembers the rather sinister fact that standard accounting has been most used in totalitarian states.

If, however, a choice between words or methods clearly is arbitrary and free from any pretence of research, it is not likely to damage future thinking or to cramp our liberty; for example, whether traffic keeps to the left or right of the road is an arbitrary matter, and uniformity yields a gain in convenience, so no one regards a standard rule as an attack on freedom. Therefore, when we are attracted by uniformity, a good test is perhaps this: if a decision between possible terms or practices can be reached by tossing a coin or the random pulling of words from a hat, then uniformity seems unlikely to do harm.

(c) Legal opinions. Counsel's opinions, given at the request of an accounting society and sent out to its members, are not usually classed as 'recommendations'. But to round off our review we should ask ourselves how such statements fit into our reasoning.

The opinions do not seem so dangerous as recommendations on theory, on two grounds.

First, no wise man tries to be expert in everything; outside his own province, he can to some degree accept ideas from others without sapping his mental independence. Second, as we noted in Section II, the law does not pretend to state absolute principles. When a lawyer is trying to find what is 'true' or 'false', he is mainly concerned with the arbitrary – though no doubt exacting – task of interpreting words (especially those in statutes) according to the intentions of the speakers and the rules of his craft.

VIII. Conclusions

If the argument of this article is sound, where does it lead us? Perhaps the recommendations that should be made on recommendations are:

(a) Official statements on accounting cover a number of very different things, which are often hard to separate. They include:

[8] The Royal Society has set up a standing committee to make recommendations on the symbols, signs and abbreviations used in scientific publications.

Guidance on professional behaviour.
Working rules, e.g. company accounts.
Definitions.
Suggestions for uniform accounting.
Legal opinions.
Abstract theory.

None of these is without its pitfalls. However, given due care and caution, the risks seem worth taking – except in the case of theory. Official quests for the abstract are apt to bear little fruit and to run into great hazards.

(b) Recommendations should, if they are concerned with matters other than theory, try to make plain this very proper restriction in scope. For instance, if the drafts of a recommendation suggest a definition of 'current assets', they might expressly disclaim any attempt to elucidate final principles, and describe their rules as being merely based on, e.g. convenience or custom.

(c) The more concerned a statement is with theory, the stronger is the case for not treating it as an official recommendation. A group of distinguished accountants who have debated a subject, and who wish to announce their conclusions, would not have the least trouble in finding a publisher.

(d) The objections to a recommendation become much less marked if it is described as the work of certain named persons. We all know that individuals can err; we all tend to look on institutions as infallible. Therefore recommendations should – following the American example – be signed by the men who approve the final draft.

(e) A dissenting opinion at once adds an extra dimension to a recommendation, and gives it far more worth as an aid to the mind. So great pains should be taken to foster and express minority views.

To conclude. Recommendations by authority on matters of accounting theory may seem in the short run to help the profession. In the end, however, they will probably do much more harm than good. They are likely to yield little fresh knowledge; 'the best test of truth is the power of the thought to get itself accepted in the competition of the market'.[9] They are likely to weaken the training of accountants; the conversion of the subject into cut-and-dried rules, approved by authority and not to be lightly questioned, threatens to reduce the value of accounting as a subject of higher education almost to *nil*. They are likely to narrow the scope for individual thoughts and judgment; and a group of men who resign the hard problems of their work to others must eventually give up all claim to be a learned profession.

[9] Dissenting opinion of Judge Oliver Wendell Holmes in *Abrams v. United States.*

Interview by Stephen Zeff with Michael Renshall, 16 October 2008

Michael Renshall worked at the ICAEW from 1960 to 1977, and during the 1960s dealt with, among other things, the preparation of Recommendations on Accounting Principles. In 1969, he became the ICAEW's first Technical Director.

In the following interview with Stephen Zeff, Michael Renshall recalls the process for preparing and approving the Recommendations, some of the problems with the more controversial ones, the personalities involved, and the events that led to the replacement of the Recommendations by accounting standards. He also points out that the Recommendations were not confined to corporate reporting, and that their preparers in fact did pioneering work on trust accounts.

Interview by Stephen Zeff with Michael Renshall, 16 October 2008

Zeff: Please recount your experience with the Recommendation on investment grants. You said it was the most controversial of the ones with which you were involved.

Renshall: After much discussion and argument and reflection, the Recommendation that emerged was that, instead of deducting the investment grant from the capital asset, which was the simplistic way of doing it and was initially what people wanted to do, the English Institute said that that was too simplistic: the preferred method is to capitalise the asset at the full amount you paid and then set up a reserve for the grant that you received. The political objection to that, taken by the Confederation of British Industry [CBI], was: if you do that, over the years the reserve for investment grants will accumulate and will become huge for major industrial companies, and ultimately it will be the dominant figure in the balance sheet. And the Government will say 'that is ours'. And it will be a gateway to backdoor nationalization. Crudely, that was the argument the CBI presented, and they meant it.

Zeff: It sounds like the argument the CBI made about ten years later with the deferred tax credit.

Renshall: It came back.

Zeff: The same thing.

Renshall: Absolutely right. They simply said that this reserve, when it gets too big, will be claimed by the politicians as the capital of the nation in the companies. It was a bitter dispute. I well remember more than one meeting between English Institute representatives and senior representatives of the CBI to argue about that.

Zeff: Can you recall any interested parties ever meeting with the drafting committee?

Renshall: I can't. Now you are going back to the way these drafts emerged. Over the years, the system changed. When I first joined the Institute in 1960, the system was simple and crude. Basically, technical statements were referred by the Parliamentary and Law Committee, which was the 'technical committee' of the Institute – it also dealt with tax matters and so on. It would say to the Taxation and Research Committee, which was a very junior body, 'We would like a draft Recommendation on [whatever subject they chose]. Please, would you draft one?' And the Taxation and Research Committee, which had representatives from District Societies all around the country, would prepare one and would consult with District Societies around the country. It was a very long, slow process. It would debate the draft, and when they were finally content, they would pass it to the Parliamentary and Law Committee. Then it was out of their hands.

One of your questions to me was, 'Can you recall any document being referred back to the Taxation and Research Committee?' My recollection is, that's not the way it worked. The Parliamentary and Law Committee received a draft, took it over, and changed it as they willed. They didn't refer it back, I think, to the Taxation and Research Committee.

Zeff: Can you recall any instances in which they made really important changes in drafts?

Renshall: Yes, they frequently did. And to explain that I need to recall the way the system worked in those days. The Taxation and Research Committee, I repeat, was a very junior committee. It was not a committee of the Council. It did not report to the Council. Its members were appointed by the Council, but it reported to the Parliamentary and Law Committee. When the Parliamentary and Law Committee received a draft, it simply took it over. And if it wanted to rewrite it, it did. It didn't go back to the Taxation and Research Committee unless they thought that it should, but that was not usual. In those days, the Chairman of the Parliamentary and Law Committee was Henry Benson [in the early 1960s], and Henry Benson had his own mind. And then there was the senior staff of the Institute. When I joined the Institute, they had a Secretary, not then called the Chief Executive. When I joined, it was a man called [Alan S.] MacIver. He was a lawyer. MacIver retired [on 31 October 1962], and, to replace him, two Joint Secretaries were appointed, one called [Frank M.] Wilkinson, a chartered accountant, and one called [C.A.] Evan-Jones, who was an administrator, not a chartered accountant.[1] And they were very different men. Wilkinson was a very bright, very intelligent man, bowed with an unfortunate affliction, but it didn't affect his mind.

[1] For news reports of MacIver's retirement and the appointment of the two Joint Secretaries, see *The Accountant*, 20 October 1962, p. 502, and 3 November 1962, pp. 574-5. From 1946 to 1954, Wilkinson had been Secretary to the Taxation and Research Committee (formerly known as the Taxation and Financial Relations Committee).

Zeff: He seemed to be a fairly rigid thinker.

Renshall: He was. He had very fixed views. He was a very good draftsman. When the Taxation and Research Committee put a paper to the Parliamentary and Law Committee, sooner or later Wilkinson would take it and, in conjunction with the Chairman of the Parliamentary and Law Committee, and at the time I am thinking of it was Benson, would rewrite it. And they wouldn't put it back to the Taxation and Research Committee. So far as I can recall, it was in the hands of the Parliamentary and Law Committee. And when the Parliamentary and Law Committee was content with the shape of it, they would refer it to the Council for the Council's imprimatur.

Zeff: And they would have certain members of the Parliamentary and Law Committee on Council to argue for it.

Renshall: Oh yes, certainly. Obviously, the Chairman of the Parliamentary and Law Committee was always a member of Council, and a number of others. This morning, when I looked back, I reminded myself that the members of the Parliamentary and Law Committee in those days, the early 1960s, were very powerful men. They were men like Sir William Carrington, who was the senior partner of Whinney Murray; Benson; [John] Pears, Sir William Lawton, men like that.

Zeff: This was the heavyweight committee of the Institute, wasn't it?

Renshall: Absolutely. The other major committee was the General Purposes Committee, but that was responsible for the governance of the Institute, fixing the subscriptions, the budget, and so on. But, technically…the name was apt, the Parliamentary and Law Committee. It dealt with the Institute's response to new legislation and the Institute's pronouncements on technical matters. And it **was** a heavyweight committee. And the major firms made sure that they were represented on it. They had voices on it, and they had powerful voices.

Zeff: Do you recall any drafts, such as on investment grants or investment trusts, that might have made it through the Parliamentary and Law Committee without substantial revision?

Renshall: I cannot recall any.

[break]

Renshall: I arrived in 1960, and I don't recall being involved in the Recommendation on stock-in-trade. But the aftermath of that was, again largely driven by Henry Benson, that the Institute decided that, as well as Recommendations on Accounting Principles, it should issue Statements on Auditing. The first Statement on Auditing was the audit of stock-in-trade. The contentious issue in the audit of stock-in-trade was the attendance of auditors at stock-taking. That created enormous repercussions. I well remember there was a prominent member in Manchester who forecast that, if that was promulgated as the standard for auditing practice, it would ruin the profession, because they couldn't find the personnel to attend stock-taking. Henry Benson, you could imagine, took a completely different view.

Zeff: Let me jog your memory. You may recall the Accountants International Study Group which issued a series of pamphlets, bringing together the CICA, the AICPA, and the Scots, the English and the Irish Institutes. Henry Benson founded that.

Renshall: He did.

Zeff: And he wanted the first booklet to be on stock-in-trade. Also, it was to deal with auditing. And he very much wanted this statement to reflect required attendance at stock-taking. And it may have been drafted by you.

Renshall: It was.

Zeff: And because of the precedents of Canadians and Americans having done this for a long time, it was brought into the booklet with the idea that he could then cite it as authority for the Statement on Auditing which shortly followed.

Renshall: That's broadly correct. You need to look at the precise timing. But you're absolutely right. Henry Benson had a bee in his bonnet about what the auditor should do during stock-taking, and he was really the begetter of the Accountants International Study Group, although, interestingly, he never participated himself in it to a significant degree.

Zeff: He dropped out after the first booklet came out.

Renshall: That's right. He was mainly responsible for its establishment, and, yes, he knew how to manage things, and he contrived that the first thing that group should deal with was stock-in-trade, including audit.

Zeff: And you drafted it.

Renshall: I was the draftsman.

Zeff: And shortly afterward, that Statement on Auditing came out, within six or eight months afterward, which reinforces the point you are making about Henry Benson.

Renshall: Oh, yes. Henry Benson was, one knew it at the time – but in retrospect you can see it clearly – an enormous driving force in the English Institute at that time. It was his vision that really re-launched the Recommendations on Accounting Principles. But he also realised that they were weak, they hadn't got any sanctions. And he drove these things along.

Zeff: Why would the CBI have been so concerned about the accounting for investment grants because no one required anyone to follow Recommendations?

Renshall: Here my recollection of the timing is faulty. It may be that when it was only a Recommendation, they were relaxed, because one of the other questions you asked was, did people follow them? In my view, they were influential but they were ineffectual. People followed them if they wanted to. Let me give you an example: inflation accounting. Henry Benson was very concerned that there should be some method of accounting for inflation. He was not inclined to die in a ditch for one particular method, at that time anyway. But he said you should do something, and particularly in relation to the depreciation of fixed assets.

Now, Henry Benson, amongst other things, was the auditor of the company that employed me, Pilkington Brothers, who were in those days one of the major industrial companies of Britain. They were Britain's only major glass manufacturer, because setting up a factory to manufacture flat glass was one of the most expensive industrial projects you could invest in. Steel works and glass were the really expensive ones. He was the auditor of Pilkingtons. Henry took the position that you should make provision for inflation when you were depreciating your fixed assets. That was a fairly elementary position, but not many industrialists really liked it, because it hit your depreciation charge very heavily. My recollection is that, no doubt advised by Henry Benson, Pilkingtons recognised the effect of inflation on their fixed assets by making an additional depreciation charge, which was progressive and unusual at the time. In their treatment they departed from the Recommendation, which advised the additional depreciation should not hit the income account but be taken to reserve. Pilkingtons took the hit. They were a private company at the time, not a listed company, and this may have helped them to take a bold line. Henry Benson as auditor accepted this treatment. That is an example of a senior and powerful member of the Institute accepting a departure from an Institute Recommendation.

Zeff: I have been told that, in firms where there were Scottish CAs and English CAs, there was a disagreement, for example, with respect to investment grants as to whether they would follow the Scottish committee report, which said they should be taken to capital reserves, or the English Institute Recommendation, which said that it should be a credit to a reserve that would go through profit.

Renshall: That's right. The English Institute argued you should amortise the reserve over the useful life of the assets. Yes, there was a difference. It was a bit like Protestantism and Catholicism, depending on which church you belonged to.

Zeff: Did you have reason to believe that was true in some of the larger firms, that the Scottish partners might have acted somewhat differently than the English partners?

Renshall: It's possible. I am not sure.

Zeff: It would be hard for you to know that.

Renshall: Yes, I can't say from my own memory and experience that that's what happened.

Zeff: There was great pride in one's Institute.

Renshall: Oh, yes. Yes, indeed.

Zeff: Could you understand what would have motivated the Scots to say that it should never go through profit, whereas the English said it should go through profit?

Renshall: As an Englishman, I will say – and this will mortally offend my good friend and former partner, David Tweedie – I always suspected they simply did it to be different.

Zeff: That could have been enough of a reason.

Renshall: Yes, but that's an Englishman's view. I had a lot of dealings with the Scottish Institute. They were always forceful people, the Scots. And they had a very forceful Secretary of their Institute in those days, Victor McDougall. McDougall was very independent-minded.

Zeff: He was a barrister.

Renshall: He was a barrister, which explains what I am about to tell you. I can well remember him telling me more than once that the Scots were different. And I said, 'How are they different, Victor? Why are the Scots different?' He said, 'We have a completely different legal system'. Of course they do have a different legal system. He stood on that: 'We are different'.

Zeff: There was also a difference on investment trusts. Of course, Edinburgh was the place where the head offices of many of the trust companies were.

Renshall: That's right. They had a proprietorial interest in investment trusts. That raises some interesting issues. That industry, like all the industries that have any muscle, has a trade association, and it still does: the Association of Investment Trust Companies, which defends the interests of its industry. And when the English Institute began, as they saw it, tinkering with accounting for investment trusts, they rose up in some wrath. I remember a very tense meeting with representatives of the Association of Investment Trust Companies, where they told us in plain terms that they didn't agree with what the English Institute was proposing, and they wouldn't have it. They just put their foot down. Of course, it was not easy for the English Institute then to override these people, because they represented the industry.

Zeff: Can you recall any other interest groups with whom you met on behalf of the English Institute when you were drafting Recommendations?

Renshall: We would need to go through the list of the Recommendations. After the Recommendations on Accounting Principles were consigned to history, and we began producing accounting standards, the Accounting Standards Committee realised that there were industry groups that needed their own accounting standards. And they found that very difficult to deal with because it was so specialist. They set up special machinery to produce Statements of Recommended Practice [SORPs], and these were intended for industry groups. They had learned their lesson by this time, and so the very first thing they did was identify the representatives and invite them to form the groups. Wherever there was a SORP, there was an industry group, and that was given special treatment.

Zeff: That occurred after the Recommendations series, of course. By the way, you mentioned standards, and I have always wondered why the English Institute changed from principles to standards. Why were Recommendations on Accounting Principles succeeded by Statements of Standard Accounting Practice, known as standards? Can you recall the provenance of that change?

Renshall: Yes. There was anxious discussion. The problem was that [Recommendations on] Accounting Principles were often disregarded. People followed them if they chose and disregarded them equally if they chose. And the whole purpose of accounting standards was to establish **one** standard practice, not a recommendation. The term 'principle' might still have been apt, but it was the term 'recommendation' that was really at fault, because to signify things had changed they had to get away from the ineffectual term 'recommendations' – 'This is a good idea, why don't you do it?' – to saying, 'This is the way you should do it, and if you don't, there may be consequences'. That was about as far as they could carry it, and the consequences, you remember, would be that you could depart from an accounting standard, provided you explained and justified it. And then there was a stick behind that, which said, 'And you may be called to account'. And in very rare circumstances, I think some were. That was the way the standards were set up, and that's what distinguished them from Recommendations on Accounting Principles – that it was the hard practice you not quite **must** follow but you **should** follow. But there is an escape hatch if you can justify a different treatment and explain, but you must be ready to come in to Institute head office and explain why. And there is a possibility that your explanation may not be accepted.

Zeff: In Statement of Standard Accounting Practice, standard was an adjective, but it quickly became a noun.

Renshall: Yes.

Zeff: People began talking about 'standard setting', and this term came out of the Accounting Standards Steering Committee, where 'standards' was a noun. The Financial Accounting Standards Board [FASB] in the United States was set up three years later, in 1973. David Solomons, an English Chartered Accountant, who was an important member of the Wheat Committee, which recommended the establishment of the FASB, has told me that the adoption of the term 'standards' in the UK did not influence the use of the term 'standards' in the Wheat Committee's recommendation. The FASB succeeded the Accounting Principles Board.

Renshall: I hadn't realised that. I hadn't really made the connection.

Zeff: And I suppose you were trying to get rid not only of 'recommendations' but also 'principles', which was associated with it.

Renshall: That's right. The English Institute was groping for a word that would indicate that this was a concrete requirement. And I remember we had anxious discussions with the Scottish Institute when we proposed to issue what we called definitive accounting standards. The Scots challenged this and said, 'What do you mean by "Definitive accounting standards"?' I remember McDougall in particular pressed us very hard – '**Definitive** accounting standards; that word worries us'.

Zeff: The Scots always took a view that professional judgement should not be trampled upon by the Institute.

Renshall: Yes, they did, which is a view I respect, in fact. But the difficulty was, in the end, how is that different from *laissez faire?*

Zeff: That's right. I recall my first visit to the UK in 1967. And I was always curious about this term, 'true and fair view' – how it was set, especially in the absence of anything other than the Recommendations. I had lunch with Sir William Carrington and Trevor Macdonald, both of Whinney Murray, leaders, respectively, of the English and Scottish Institutes. And I asked Sir William, 'How do you know when the accounts give a "true and fair view"?' And he looked at me incredulously and said, 'I am an experienced auditor. I can tell by looking at the accounts whether they give a "true and fair view"'.

Renshall: I can 'sniff them'.

Zeff: Exactly, I can 'sniff them'.

Renshall: You will know better than me how 'true and fair view' as a term emerged, as a term of art. It was not used in this country until the 1947 Companies Act. And I believe it was a recommendation of the English Institute in the discussions that preceded that Act, which was remarkably slim, slimmer than many subsequent Acts.

Zeff: The Cohen Committee report.

Renshall: The Cohen Committee report was what it was based on, and I believe I am right in saying that it was the English Institute who suggested there be a legal requirement for accounts to give a 'true and fair view'. But nobody's ever defined it. And it wasn't in our law before.

Zeff: I think that Sir Russell Kettle was the person who was at the helm at that time. Does that sound familiar?

Renshall: Absolutely. That is my understanding.

Zeff: I think he served on the Cohen Committee. At least he gave testimony if he didn't serve.

Renshall: It has been a very useful defence and shield for the British accounting profession ever since, in a strange way.

Zeff: So when you developed the Recommendations, people may have asked, 'Does this approach give a "true and fair view"?' That would be their ultimate criterion.

Renshall: Yes. But what does 'true and fair view' mean? When we entered the European Common Market [in 1973], I was the senior official who went with the English and Scottish delegations to Brussels to discuss the harmonization of company law. The concept of 'true and fair view' was completely unknown in Europe. We were asked to explain it. And we were at something of a loss. What does it mean? I have spent a lot of time since working out what it means. I have attempted definitions, not very brilliant ones. And it isn't an American concept either, is it?

Zeff: We have 'fair presentation', but we always say, 'in conformity with generally accepted accounting principles'. So it's linked, unlike yours. So it's very different.

Renshall: I do not know who devised the term. It may have been Kettle, as you say. But another prominent accountant of the time, who was a very good draftsman – my guess, it's pure guesswork – if there was a single begetter of that phrase, it may well have been Sir Thomas Robson. He was a brilliant draftsman, and many's the time I have seen him in the [Parliamentary and Law Committee], which was deadlocked in discussion and unable to arrive at a solution. He would go sit in the corner and scribble some notes. Then he would produce his paper and put it in front of the Committee and say, 'Try that, Chairman'. And he would have found the right formulation or one which led the way to a solution.

Zeff: Why not have another look at the list of the Recommendations that were issued while you were on the English Institute's staff, and see if there are any besides those two, N24 and N28, of which you have a recollection?

Renshall: 1960 N22, 'Treatment of stock-in-trade'. I note there's a gap of four years before they could produce N23, 'Hire purchase, credit sale and rental transactions'.

Zeff: Of course, that's when it emerged from Council. It could have been bottled up in Parliamentary and Law.

Renshall: That's right. Again, the leasing Recommendation was industry-specific, a powerful industry, the leasing industry. They were consulted. They made sure they were. And so it would take a long time in gestation. Also, between 1960 and 1967, other things were going on. The Parliamentary and Law Committee wasn't only concerned with company law and with accounting principles and standards, whatever you call them. It was also heavily concerned with taxation. In 1965 there was a revolution in our tax system. The Wilson Government came in, and they changed our corporation tax. They also introduced capital gains tax – a complete innovation. The Parliamentary and Law Committee had to deal with all of these things, and there was only a very small staff: me and, at most, two assistants at the time. So all the leg work, drafting, secretarial work had to be done by very few people. And I recall we spent a lot of time in negotiations with the Inland Revenue. The English Institute produced ground-breaking books on capital gains tax and corporation tax, the two great new taxes. They had never issued informational or instructional works like that before. This was the first time we'd ever done it. They weren't written by the Parliamentary and Law Committee, because it was realised you can't write a book in a committee. So they said we must get tax experts to study the legislation, and write the books. We'll attribute them. I think they didn't pay the authors all that much. But they did produce the books, and they achieved a remarkable coup – I take some pride in it because I had a hand in it – we actually published these books on the day the Finance Act, the governing legislation, became law. That was unprecedented at the time. We got ahead of everybody else, and they were best-sellers. The Institute was in dire financial trouble at the time, and these two books alone changed their position. Looking back, they were cheap paperbacks which I think we sold for 50p each. But because we got them out first, and because of the status of them, they sold enormously well. One effect was that attention was diverted for a time from mundane things like accounting principles. [The titles were *Corporation Tax*, 96 pages, and *Taxation of Capital Gains*, 120 pages, both published in 1965.]

Zeff: There was something else major going on at that time, the Jenkins Committee report which led to the Companies Act 1967.

Renshall: Correct.

Zeff: The Parliamentary and Law Committee must have been involved in that, too.

Renshall: Yes, they were.

Zeff: Because Jenkins made some proposals for segment reporting and the disclosure of turnover.

Renshall: Yes. What did Jenkins do? It did many good things. One big change it made was disclosure of turnover, at least for public companies. That was a very contentious issue. But the Institute took the position that it should be disclosed.

Zeff: I presume that your committee would have been busy on the taxation issues, because its name was the Taxation and Research Committee.

Renshall: Oh, yes. They looked very closely at it.

Zeff: But when it came to the Companies Act revision, would that have originated in another committee reporting to the Parliamentary and Law Committee?

Renshall: There was no other committee. It would normally have fallen to the Taxation and Research Committee whose remit included company law and related matters. We would need to go back to the archives to see if the Taxation and Research Committee produced a paper in draft for the Parliamentary and Law Committee. I can't now remember.

Zeff: But it would have gone through Parliamentary and Law.

Renshall: Ultimately, everything connected with accounting practice went through Parliamentary and Law.

Zeff: So, because of these two reasons, either one was a potential bottleneck [in the production of further Recommendations].

Renshall: It was inevitably a slow process.

Zeff: It had to have delayed their work on whatever drafts you were preparing.

Renshall: Yes. There simply weren't the resources.

Zeff: Both of those explain that gap. What about the ones after the gap?

Renshall: I think there were some company scandals about that time, which involved leasing companies and the like.

Zeff: Wasn't Rolls Razor one of them? Was that an issue?

Renshall: Absolutely. It was a big issue. Henry Benson was the Department of Trade inspector into Rolls Razor, which was a great scandal. The inspectors' report into Rolls Razor has never been published, to this day. Anybody interested could probably get it now under the Freedom of Information Act.[2] I remember Henry Benson saying to me once, 'That will never be published'. He said that with absolute assurance.

Zeff: He said everything with absolute assurance.

Renshall: Yes! And it hasn't been published. It was concerned with hire purchase and leasing.

Zeff: That was the scandal you alluded to before? Or were there others?

Renshall: There were one or two others. But that was the primary one. My guess is that Henry Benson probably said to the Parliamentary and Law Committee, 'We'd better look into accounting for leases'. I feel almost certain that that's what happened.

Zeff: Did Rolls Razor shake the Establishment at the Institute?

Renshall: It probably did. What shook the Institute was the involvement of the auditors. When the auditors were in the firing line the Institute became very agitated. I can't remember now who the auditors of Rolls Razor were. It would be easy to find out.

[2] Brian Rutherford obtained access, under the Freedom of Information Act, to an edited version of the report, which he refers to in *Financial Accounting in the UK: A History of the Accounting Standards Committee, 1969-1990* (London, Routledge: 2007). The report was made publicly available at the National Archive with effect from 9 January 2009.

Zeff: So that was a matter that predated GEC-AEI at the end of the 1960s.

Renshall: I'm pretty sure that hire purchase and leasing was either prompted or expedited by Rolls Razor. Investment grants then became a hot issue because it was an extraordinary Government intervention, with huge subsidies for capital investment. And that was exacerbated, it now comes back to me, because there were also considerable tax incentives for capital investment to the extent that it was sometimes said that you could make a profit simply out of making capital investment, because the tax concessions were so generous. Investment grants caused the Department of Trade, which was responsible for administering them, to organise itself in a big way. I remember that I got involved in discussions with the Department of Trade, because the Department of Trade said, 'How do we do this? How do we manage, how do we control, these investment grants?' They came to the English Institute, and the Institute, as usual, produced representative people to advise them. I was the staff man who went along to facilitate things.

Zeff: By then, had your job title changed?

Renshall: I can't remember what my job title then was.

Zeff: What was your job title at the outset?

Renshall: Originally, I think it was something like Assistant Technical Officer. I was not designated Technical Director until 1969.

Zeff: Was Wilkinson [still] on [the staff] by the end of the 1960s?

Renshall: No. The Institute went through trauma over the Joint Secretaryship. As I said MacIver was the Secretary of the Institute when I joined. Shortly afterwards he retired, and they appointed Joint Secretaries: Wilkinson, chartered accountant, and Evan-Jones, administrator. But it was not a happy dual Secretaryship. The two men were very different, and I think they didn't get on, but I was too distant from them to know. I got on well with both of them, in fact. But internally and within the Council there was growing discontent with the Joint Secretaryship. There were factions, some supporting Wilkinson and some supporting Evan-Jones. Finally, there was a showdown, and Wilkinson, who was not in good health anyway, went. Evan-Jones emerged as the Secretary of the Institute. That did change things, because Wilkinson, a chartered accountant and a highly skilled and, I would say, academic man and a good draftsman, took technical documents to himself, but that meant that there was a serious bottleneck. That may have been one of the causes of friction, but I was never privy to the politics. I was very junior, keeping a low profile. Evan-Jones was not a technical man, and he turned to me. And he said, 'Michael, I don't keep a dog and bark myself. You do it'. And so I emerged as the guy who had to handle the technical stuff with pretty limited resources. I did try to get more resources, and I think we did actually accelerate things just a bit, though I don't make any great claims, because you still had to cope with committees.

Zeff: Does this relate at all to the origin of the title Technical Director? I believe you were the first to have it.

Renshall: I was. I was the first Technical Director.

Zeff: Looking at the Recommendations issued at the end of the 1960s, do any ring a bell as having been particularly controversial, having that much of an impact on practice?

Renshall: Overseas currencies [N25 issued in 1968] was a contentious matter, for obvious reasons. How do you convert? When do you convert? At what rate do you convert? Land Commission Act [N26, issued in 1968], I've forgotten. That's gone into history now. It must have introduced some kind of levy on land transactions. It doesn't stand out in my mind. It was ephemeral. Treatment of taxation [N27, issued in 1968] we've talked about, it was major and of course it's ever with us. Investment trust companies [N28, issued in 1968] – I'm not quite sure why it came to the fore like that, or what prompted it.

Trust accounts [N29, issued in 1969] was a revision of N14 [1948], 'Recommendations on the accounts of deceased persons'. It was not contentious in itself and attracted little outside attention, but it sowed important seeds. There are two main classes of trust accounts – private and charitable. Private trusts are generally created by wills, typically the accounts of executors of the estates of deceased persons, and family dispositions. Charitable trusts have a more obvious element of public interest.

Zeff: Whose accounts would be affected by this? Banks, financial institutions?

Renshall: No, executorship accounts are private, where an individual disposes of his assets in his will. Typically he may establish a family trust, but charitable foundations are also endowed in this way. The financial statements of charities represent an important separate class. While the majority are small, there are charities which control significant funds, and the charitable sector as a whole in the UK is substantial. In the nineteenth century the importance of charities was recognised, and there was periodic public concern about their accountability and governance – Gladstone amongst others expressed himself forcefully on the subject.

Zeff: So it really wasn't involved with the attest function at all?

Renshall: Broadly, there was no statutory audit requirement for private trusts, except as provided by the trust deed. Until almost the end of the twentieth century it could be said audits were optional for charities.

Zeff: This was not one of those things that found its way into the annual accounts of publicly traded companies?

Renshall: No. While charities could be corporate bodies, many were unincorporated, and the not for profit concept does not fit comfortably with the concept of publicly traded companies. N29 confined itself to private trusts and excluded charities from its scope. While the financial reporting of charities was loosely regulated by the Charities Act 1960, private trusts were not regulated by statute but rather by custom, practice and case law, so that Recommendations N14 and its successor N29 made an important contribution to the development of practice for the financial statements of private trusts, which had grown in an unorganised way.

There is an obvious relationship between private trusts and charitable trusts. A couple of years ago I was approached as a suitable 'dinosaur' accountant to advise in litigation which included issues about trust accounting in the 1950s – evidently I was considered competent to speak from my own knowledge about prehistoric accounting practices. It prompted me to look into the history of the financial statements of trusts, and I realised then that the Institute of Chartered Accountants had made a major contribution, showing the way to legislators and regulators.

It's worth recalling that until the Charities Act of 1992 the administration and financial reporting of charities in England and Wales had been governed by Charities Acts promulgated in the 1850s. Until 1960 there was no central register of charities, and it may be said that until 1993 financial reporting standards were set out in four short paragraphs of Victorian statute. It was, I suppose, a prime example of 'light touch' regulation. A leading accounting text book of the 1950s dealt with the issue of trust accounts in a short chapter which began dismissively, 'There are no significant problems to worry about in trust accounts'.

Official reports in the 1980s drew attention to defects in the regulation and financial reporting of the charitable sector. I cannot say how much the accountancy profession contributed to this thinking. But action speaks louder than words. In 1981, the ICAEW issued an auditing guideline on charities – I believe the first formal statement by a public body in the UK discussing – albeit through the audit optic – the financial statements of charities. And in 1988 the Accounting Standards Committee issued 'Accounting by Charities', SORP 2, which foreshadowed subsequent regulation by the Charities Commission.

Zeff: It had considerable impact in its own way?

Renshall: Absolutely. The accountancy profession has endured criticism throughout its history, and sometimes with justification, but, in my view, history has not given due credit to the anonymous accountants who independently wrote, in effect, the first rule book for the financial statements of charities in SORP 2. They performed a major public service.

Zeff: The Recommendation on trust accounts was the final one in the series. It is hard, I suppose, to recall whether any of the Recommendations were generally ignored as opposed to being at least to some degree influential.

Renshall: It is impossible to say at this time, because nobody seems to have done any research. It's interesting that, years later, when I was still at the Institute, after accounting standards had been launched, long after accounting principles had been laid to rest – although they still stayed in the book – the Research Committee of the Institute was looking for projects to sponsor.[3]

[3] The Research Committee, which was initially chaired by Sir William Carrington, was set up in 1964.

It was my experience bodies set up like that to sponsor research sometimes have great difficulty in knowing exactly what they want to sponsor and suggesting things that should be researched. In those days, I intend no disrespect, the Institute's Research Committee had some trouble thinking of things that ought to be researched. I remember suggesting that a really useful work would be a survey of the annual accounts of companies to see what their practices are and how far they follow or deviate from accounting standards. There was tremendous resistance to that.

Zeff: It must have seemed like a monitoring of the work of the profession.

Renshall: Oh, yes. Tremendous resistance. I can remember the individuals. I will not name the members – they're still alive – who would die in the ditch to prevent this project. The reason they gave was that this research is likely to disclose many deviations from accounting standards. If those are made known publicly, people will simply imitate them, and you would destroy your whole standardization process. That was the argument against it. In the end, the Research Committee found the courage to conduct the research. I don't know whether they still do it, but for a number of years they did publish annual reviews of published accounts.

Zeff: I think it started in 1969, as early as that.

Renshall: I think it did. It was connected with the establishment of accounting standards, because one of the things that the people who tried to start accounting standards needed to know was what do the companies actually do. I always thought it was a useful project. I thought it was useful information, boring for most, but it was much consulted when it became available.

Zeff: *Survey of Published Accounts.*

Renshall: *Survey of Published Accounts*.[4] And auditors did hate it, because it was always being quoted against them. They'd say, 'What you're supposed to do is this', and the finance director would pull this book down off the shelf and say, 'Ah, well, it says here that ICI (for example) do it differently'.

Zeff: Before we move ahead, there is a mention in the extract I asked you to read from my *Forging Accounting Principles in Five Countries*, that, when the Government White Paper came out proposing investment grants, the Council issued interim guidance on accounting for them even before the Taxation and Research Committee could draft any proposed Recommendation, which was extraordinary.

Renshall: That was unusually prompt and prescient of the Council of the English Institute. There must have been an activist there who said, 'We need to give guidance now'.

Zeff: It must have come straight out of Council.

Renshall: It must have done.

Zeff: That was, I think, the first such initiative off Council's own bat, as far as I can tell.

Renshall: I think that's probably true, because they would normally go through due process: start with a junior committee, put it through the Parliamentary and Law Committee, let it stew for a bit, then give it some further thought. But my memory does not help me with what prompted that. That was unusual diligence.

Zeff: GEC-AEI as a precipitating factor in the late 1960s. This involved, I think, Deloittes and Price Waterhouse.

Renshall: And a profit forecast and the subsequent actual results, and the difference between the two – and how can you explain it?

Zeff: Exactly. And it was somewhat of an embarrassment, and it was written up in the financial press.

Renshall: Oh, yes. There was outrage.

[4] From 1969 to 1976, C. J. Platt, a member of the English Institute's technical staff, prepared the annual volumes. The first volume, for 1968-69, was published in April 1970.

Zeff: And there was another one, which may have broken too late to have had influence on the new standard-setting programme: the Pergamon-Leasco affair.

Renshall: You're quite right. There was a huge furore.

Zeff: Robert Maxwell, I think.

Renshall: It was Robert Maxwell. There were two DTI inspectors. One of them was a lawyer called Staples. And the other was Ronnie Leach. Those two inspectors concluded that Robert Maxwell was a man 'not fit to be a director of a public company'. He never forgave Leach and never gave Peat Marwick any work. He went elsewhere. He had a very colourful history, largely invented by himself. But nobody knows the facts. I never met him, but the truth seems to be that he was a charismatic character who could turn on enormous charm and on the other hand be totally brutal. You know how he came to an end, and again that's a mystery, whether he really fell off his yacht or committed suicide. Nobody knows. After he died, Ronnie Leach, the man who said he was not fit to be a director of a public company, an old man by then, was interviewed by the press. They recalled what he had said, and asked 'What's your view now?' Ronnie Leach replied, 'The only thing I would change is that I would say, 'He was not fit to be director of **any** company!'' Ronnie did see through him.

Zeff: It would be interesting to imagine Robert Maxwell and Henry Benson in the same room.

Renshall: It would. You would have nuclear fission.

Zeff: Two enormous personalities. A new question: the major changes that occurred in 1969 that led to the announcement of the new programme at the end of 1969 that set up the Accounting Standards Steering Committee. There was that article in *The Times* by Edward Stamp, you may recall.

Renshall: Eddie Stamp, I remember him well. I was very fond of Eddie. Yes, I do remember it. It created a great furore.

Zeff: And Sir Ronald Leach, contrary to the traditional behavior of Institute Presidents, responded in *The Times*.

Renshall: Yes, he did.

Zeff: I think it may have shocked quite a few people that the Institute President would actually do that.

Renshall: Yes. I was involved in that response and consulted, because I was close to Ronnie. Ronnie was a man of his time and had a better understanding of the media and the press than his predecessors, and probably a better understanding at that time than Henry Benson, but Henry learned rapidly. And, yes, Ronnie broke with convention. Previously, the attitude was, ignore the press. We don't need them. They're just hyenas, barking at our heels. But Ronnie saw it differently and concluded that you just couldn't ignore them. If you'd just stayed silent and kept your head down, you were going to lose the battle. So he did respond. And also, you may know that Ronnie later became a very good friend of Eddie's.

Zeff: One infers that, when he responded, Sir Ronald Leach might already have been of a mind to change the approach to something like the standard-setting system and felt that perhaps Stamp had given him the ammunition to move in that direction.

Renshall: That's possible. As I say, I was close to Ronnie, knew him well. I can't bear witness to 'Did he have this idea before?' But he was sufficiently flexible to see that something had to be done. And within the Council and his closer advisers, there were people who said, 'We're going to have to change'. And, although Henry Benson was not then in the presidential circle, he was not far outside it – a former President but no longer President. Henry clearly went along with it, because if Henry had not agreed with moving in that direction, it would not have happened. So although Ronnie and Henry had their differences, as you know, on this matter, when Ronnie decided the Council ought to go in the direction of standards, there was no doubt that Henry supported it. Of course, Henry then wanted to go further and have international standards.

Zeff: Three years later, in 1973, Benson formed the International Accounting Standards Committee and became its first Chairman. There seemed to be a little sensitivity in that Benson was trying to get the London Stock Exchange to modify its Listing Agreement by which companies were to show departures from International Accounting Standards, when these companies were also under an obligation to show departures from Statements of Standard Accounting Practice. Does this ring a bell?

Renshall: I don't recall that.

Zeff: And for a while, from about 1974 to about 1978, the Stock Exchange had something like that, and then they dropped it – the reference to International Accounting Standards. I suspect that Benson was trying to suggest that his system was easily as good as Leach's, if not better.

Renshall: There was a well known rivalry between those two great figures. If I knew that the Stock Exchange had that requirement, I had forgotten. I don't think it was much observed or enforced.

Zeff: I thought that one source of the rivalry between the two was that Coopers was growing somewhat by leaps and bounds, while Peat Marwick was an old Establishment firm, along with Price Waterhouse. And Coopers may have been seen as a 'Johnny come lately'.

Renshall: That's probably right. Coopers were, in those days, regarded by some as upstarts. Their business-getting methods were disliked, because they were very aggressive. And, at a more personal level, it is said – I cannot say that I know this as my own knowledge, but I have heard it said more than once by people who do know—that Coopers, and Henry in particular, did offend Ronnie because one of the jewels in [Peats'] crown was that they had been the auditors to all the major British steel companies. Then the steel companies were nationalised [1951]. The individual steel companies disappeared and were no longer audit prizes. But then they were privatised [1953-63], and when they were privatised, Coopers, led by Henry Benson, captured the lion's share. And it is said that Peats, and Ronnie in particular, were personally offended by this, because they regarded those audits as theirs by right. There is no way you can document or prove that, but I have heard it said. It is a fact that Coopers were more successful in capturing those audits, because they were more aggressive, and they used more modern methods of getting business.

Zeff: Going back to the setting up of the Accounting Standards Steering Committee in late 1969, would it be fair to say that there was already an inclination in Council to move in such a direction, thus not requiring a major persuasive effort on the part of the President?

Renshall: That is probably right. The Council accepted Ronnie Leach's proposals. They debated them, but they didn't argue them. His proposals, perhaps to his surprise and certainly to mine – I was assisting him, so I was drafting the papers for him to approve to go to the Council…. I think that both of us held our breath, because it was such a departure from the tradition and convention, as to whether Council would accept them, but they did, without particular demurrer, as I remember.

Zeff: He was the right man at the right time.

Renshall: He was. He had a very charming manner, and he could be very persuasive. Whereas Henry – I might not call Henry charming, but, by gosh, he was persuasive. Ronnie did convince the Council at that time. But I think he would have had problems if Henry hadn't concurred.

Zeff: So Henry was consulted even if he was not a member of Council.

Renshall: Henry was a member of Council. But he would have been consulted in any case. And notwithstanding any rivalry that may have existed between them, Henry backed accounting standards.

End of interview.

Harold Barton foreword (1944)

Harold Barton (later Sir Harold Barton) was the first chairman of the ICAEW's Technical and Financial Relations Committee, which undertook most of the work in drafting the Recommendations on Accounting Principles.

The Recommendations were not at first included in the ICAEW *Members' Handbook*. It was decided that it would be useful to bring them together in a single publication. Accordingly, in 1944 Gee & Co published, at a price of one shilling and six pence, a looseleaf collection of the eight Recommendations already issued by then. This remained the collected format of the Recommendations until they were included in the *Members' Handbook* in 1958.

Harold Barton was President of the ICAEW in 1944–45, and it was in this capacity that he wrote the following foreword to the original looseleaf collection of Recommendations.

Recommendations on Accounting Principles issued by the Institute of Chartered Accountants in England and Wales: Foreword by the President of the Institute

Since the first issue of the Council's Recommendations on 'Accounting Principles' in December, 1942, many requests for their publication in some permanent and convenient form have been received both from the profession and from industry. It has therefore been decided to reproduce the series in a booklet and to this I have been asked to write a Foreword.

Whilst there have been considerable and important developments in recent years in the form of published balance sheets and profit and loss accounts, it has long been felt that, owing to the complexities arising in connection with the accounts of companies, some authoritative guidance to members was desirable on some of the matters that presented a constant source of difficulty. In particular, there was an absence of uniformity in the presentation and grouping of the various items in accounts and doubts had arisen as to what should be regarded as the best practice in applying certain accounting principles for the purpose of presenting clear and informative accounts. The war has produced many new problems for the accountancy profession and many factors, notably increased taxation, have emphasised old problems; despite the difficult conditions under which all are working, the Council decided that the time had come when an authoritative lead was called for.

As stated in the preamble to the series of Recommendations, it is recognised that the form in which accounts are submitted to shareholders is necessarily a matter within the discretion of directors, subject to compliance with the Companies Act: it was considered, however, that directors, as well as the profession, would welcome recommendations based on the wide experience of members of the Institute both in practice and in industry. Experience has shown that the Council was right in taking this view as evidenced by the number of companies which have adopted the Recommendations in whole or in part, and the general approval which they have received. It is also to be remarked that the steps taken by the Council may prove timely at a moment when new company legislation is coming forward for consideration.

The Recommendations are necessarily drawn up in very concise form and cannot pretend to be exhaustive of the various matters dealt with; their main purpose is to put forward general principles as to the best practice, thus setting a standard which will, I hope, be followed by an ever-increasing number of companies. At the same time it must be remembered that accounting development can never be regarded as complete, and there is every reason to encourage flexibility of form to meet new circumstances as they arise.

The booklet has been designed in handy form and on loose-leaf lines so that any further Recommendations can conveniently be included as and when issued and so that, if desired, further leaves may be inserted for annotation purposes.

I welcome the opportunity afforded to me by this Foreword of indicating the circumstances which led the Council to break new ground and also of acknowledging the work of the Taxation and Financial Relations Committee of the Institute, and of its Regional Committees, in initiating the various subjects and preparing all the relative material for the consideration of the Council. I also wish to pay a tribute to the accountants in industry who, as members of these Committees, have taken so active a part in co-operation with practising members in assisting the Council in producing the Recommendations.

Harold M. Barton
President

October, 1944

The Recommendations

The Recommendations on Accounting Principles are reproduced here as originally published with, in three cases (N3, N6 and N16), later addenda. The statements provide valuable evidence of what was regarded as best practice in the UK from the 1940s to the 1960s and of the profession's attempts to deal with novel problems, such as accounting (or, if one followed the Recommendations, by and large not accounting) for inflation. They also provide a reminder of the persistence of many controversial issues in financial reporting. On a number of important questions, we are still arguing over the problems that our grandparents faced.

Dates of issue and withdrawal

Number	Title	Issued	Withdrawn
N1	Tax reserve certificates	12 December 1942	October 1958
N2	War damage contributions, premiums and claims	12 December 1942	1958*
N3	The treatment of taxation in accounts	13 March 1943	October 1958
N4	The treatment in accounts of income tax deductible from dividends payable and annual charges	13 March 1943	October 1958
N5	The inclusion in accounts of proposed profit appropriations	13 March 1943	October 1958
N6	Reserves and provisions	23 October 1943	October 1958
N7	Disclosure of the financial position and results of subsidiary companies in the accounts of holding companies	12 February 1944	1958*
N8	Form of balance sheet and profit and loss account	15 July 1944	October 1958
N9	Depreciation of fixed assets	12 January 1945	January 1980
N10	The valuation of stock-in-trade	15 June 1945	16 November 1960
N11	Excess profits tax post-war refunds	19 July 1946	15 August 1953
N12	Rising price levels in relation to accounts	14 January 1949	May 1974
N13	Accountants' reports for prospectuses: fixed assets and depreciation	11 March 1949	January 1987
N14	The form and contents of accounts of estates of deceased persons and similar trusts	12 August 1949	5 November 1969
N15	Accounting in relation to changes in the purchasing power of money	30 May 1952	May 1974
N16	Accountants' reports for prospectuses: adjustments and other matters	13 November 1953	January 1987
N17	Events occurring after the balance sheet date	13 October 1957	January 1980
N18	Presentation of balance sheet and profit and loss account	October 1958	January 1980
N19	Treatment of income tax in accounts of companies	October 1958	July 1968
N20	Treatment of investments in the balance sheets of trading companies	13 November 1958	January 1980
N21	Retirement benefits	29 February 1960	February 1989
N22	Treatment of stock-in-trade and work in progress in financial accounts	16 November 1960	May 1975
N23	Hire purchase, credit sales and rental transactions	9 December 1964	January 1980
N24	The accounting treatment of investment grants	14 April 1967	July 1974
N25	The accounting treatment of major changes in the sterling parity of overseas currencies	17 February 1968	January 1980
N26	Land Commission Act 1967: accounting implications	11 May 1968	January 1980
N27	Treatment of taxation in accounts of companies	July 1968	January 1980
N28	The accounts of investment trust companies	7 August 1968	January 1983
N29	Trust accounts	5 November 1969	October 1986

* We have been unable to confirm the withdrawal dates for N2 and N7. It appears that it was decided to exclude them, on the basis that they were by then obsolete, when the Recommendations were included for the first time in the ICAEW *Members' Handbook* in 1958. It was at this point, from the system adopted in the organisation of the *Handbook*, that the Recommendations acquired the N prefix to their numbering.

Note on paragraph numbering

One oddity of the original form of publication of the Recommendations is that the paragraph numbering runs continuously through from N1 to N17. Thus, N2 starts with paragraph 9, N3 with paragraph 20, and so on through to N17, which concludes with paragraph 381.

Confusingly, within these statements, the parts that make recommendations are sometimes given separate paragraph numbers, additional to those in the overall numbering. So, in N9, paragraphs 99-106 are also recommendations paragraphs 1-5 (sic). This can make the occasional cross-references between statements difficult to follow. For example, the reference in N12, paragraph 188, to 'recommendation 9', 'paragraph 5' refers to N9, paragraph 106/recommendation paragraph 5.

The above example also reminds us that, for the first 17 statements, the 'N' prefix was not initially used: thus, what appears here as N9 was initially referred to as 'recommendation 9'.

All this changed when the statements were incorporated in the *Members' Handbook* in 1958. At that point they were given the N prefix and the paragraph numbering started afresh with each statement. However, this creates another minor confusion for the modern reader.

On transfer to the *Handbook*, only eight of the first 17 statements appear to have been incorporated. The paragraphs in each of these were now renumbered so that they began afresh for each statement. So N10, for example, instead of starting with paragraph 107, now started with paragraph 1. The two cross-references to pre-1958 statements in post-1958 statements are therefore to paragraph numbers that are not used in this edition. Supplementary references have therefore been added in square brackets.

N1 *Tax reserve certificates*

(Issued 12th December 1942)

1 It is considered that regard should be had to the relevant conditions of issue set forth in the leaflet issued by the Treasury on 22nd December, 1941, namely:

2 (a) Certificates can be used for the payment of income-tax (except under Schedule E), sur-tax, national defence contribution, excess profits tax, and war damage contributions under Part I of the 1941 Act; but this right is limited to such liabilities falling due not less than two months and not more than two years from the date of the certificate; if so used interest is allowed at 1 per cent. per annum free of tax.

3 (b) They are not transferable (except under the ordinary law on death, bankruptcy, &c.), and consequently cannot be pledged as security.

4 (c) They may be surrendered after two months against a cash payment but no interest is then allowable.

5 (d) The appropriation of the amount represented by the certificate for any of the liabilities referred to in (a) above or the surrender against a cash payment is at the option of the holder.

Recommendation

It is therefore recommended that:

6 (1) The amount of tax reserve certificates held should be shown as a separate item in the balance sheet and grouped with the current assets.

7 (2) The 1 per cent. per annum allowed on the surrender of the certificates in payment of taxation, &c., should be treated as interest and not as a reduction of the taxation charge.

8 *Note.* – It is suggested that accrued interest to the date of the balance sheet should not be taken to credit unless the certificates have been surrendered before the balance sheet has been signed.

N2 *War damage contributions, premiums and claims*

(Issued 12th December 1942)

War damage contributions

9 (a) The War Damage Act, 1941, enacts that contributions under Part I (Properties) shall be treated for all purposes as outgoings of a capital nature.

10 (b) The liability under Part I is referred to as 'the contribution' and is payable by five annual instalments, the first of which was due on 1st July, 1941. The risk period under the Act of 1941 covered by this contribution extended from 3rd September, 1939, to 31st August, 1941.

11 (c) Under the War Damage (Amendment) Act, 1942, the risk period covered by the contribution was extended for all purposes to 31st August, 1942, and thereafter until terminated by an order made by the Treasury and approved by a resolution of the House of Commons.

12 (d) It has been the general practice on the ground of financial prudence to make provision for the full contribution out of available profits of free reserves.

Recommendation

13 Bearing in mind that (i) payment of the contribution adds nothing to the asset values, and (ii) notwithstanding (a) above, it is open to directors to achieve the same result by appropriating profits to a reserve equivalent in amount to the contribution if treated as capital, the general practice referred to in (d) above is recommended. But whatever course is adopted the annual accounts should show the facts in order that they may be before the shareholders when approving accounts.

14 In cases where the full contribution for the cover has been provided to 31st August, 1942, no provision is considered to be necessary in respect of possible contributions for subsequent periods.

War damage premiums

15 The War Damage Act, 1941, enacts that premiums under Part II (Plant, Equipment, &c.) shall similarly be treated as outgoings of a capital nature.

Recommendation

16 For the same reasons as in the case of Part I and particularly as premiums under Part II cover a risk for a definite period under the terms of a policy, it is recommended that, in whatever manner the contribution under Part I may have been treated, the premiums under Part II should be provided out of available profits or free reserves by reference to the period covered.

17 *Note.* - The recommendations made above regarding contributions and premiums may not be appropriate to certain classes of companies, such as statutory companies, property companies and building societies or where property is held for sale.

War damage claims – fixed assets

18 The treatment in published accounts of war damage claims on fixed assets is already fully covered by a circular letter issued to professional firms on behalf of the Council by the Secretary of the Institute dated 20th August, 1941. It has, however, transpired that many industrial accountants are not aware of the Council's recommendations in this connection and accordingly it is considered desirable to include the following extracts from the letter referred to.

19 ‘The Ministry of Information have in a considerable number of cases approved the use of the following alternative forms of wording which have been agreed with groups of accountants, as a note on balance sheets of companies whose assets have suffered from war damage, with a view to the avoidance of qualifications in the auditors’ report:

(a) Owing to the war, adjustments will be required at a future date in respect of certain of the assets included in the above account.

(b) Adjustments are required to certain assets which will be dealt with when the position is fully ascertained.

The Council have had these suggested wordings under consideration, and I am instructed to advise you that whilst in many cases the forms of wording might be appropriate, the Council feel that standard forms of qualifications tend to become restrictive and might not be appropriate in all cases. Every case must be considered on its merits, including the question as to whether the company is a subsidiary where a qualification in an auditors’ report might possibly be unavoidable.

It is understood that the Ministry of Information has no desire to standardise any particular form or forms of words. Its sole concern is to advise whether the accounts as presented contain information which might be useful to the enemy. Every case in which accounts are submitted to the Ministry will be considered with a view to allowing the maximum information compatible with safety to be published. In general, the extent to which particulars of damage can be stated will depend largely on the importance of the particular company to the country’s war effort.’

N3 *The treatment of taxation in accounts*

(Issued 13th March 1943)

20 The incidence of taxation and its effect on profits and on the financial position disclosed by the balance sheet, together with the extent to which the Inland Revenue on the one hand and shareholders on the other have participated in profits, are matters which should be made clear to shareholders.

21 The assessment of liability to national defence contribution and excess profits tax is based on the profits of the accounting period under review. The assessment of liability to income-tax is, however, for the fiscal year ending 5th April and is normally based on the profits of a preceding accounting period. The minimum or legal amount to be provided for taxation is thus the aggregate of taxes assessable on these bases, apportioned, as regards income-tax, according to the period covered by the accounts under review.

22 Income-tax so apportioned takes no account, however, either of the balance of the liability assessable for the current fiscal year, or of the liability which, in normal circumstances, will arise in respect of profits included in the accounts but not assessable until the following fiscal year. Further, unless provision be made year by year for income-tax based on each year's results, the trend of net available profits will not be apparent, and cases will arise where the profits earned in a succeeding period will bear a disproportionate charge for taxation – indeed, they may even be insufficient to meet it.

23 In the case of principal and subsidiary companies (as defined in the Finance (No. 2) Act, 1939) excess profits tax is assessable on the principal company in respect of the net excess profits of the group. The principal company has, however, the option of recovering from any subsidiary the tax charge relative to the excess profits of such subsidiary or of crediting any subsidiary with the tax benefit arising from the deficiencies of such subsidiary. The charge for taxation in the principal company's accounts thus depends upon the exercise (in whole or in part) of the option to allocate excess profits tax over subsidiaries and may not be appropriate to the profits shown in the principal company's own accounts.

Recommendation

It is therefore recommended that:

24 (1) The charge for income-tax should be stated in the accounts, and, subject to war-time or other special circumstances, the charge for national defence contributions or excess profits tax should also be stated.

25 (2) (a) The charge for income-tax should be based on the profits earned during the period covered by the accounts.

26 (b) Where it has been the practice to charge only the minimum or legal liability, then, until full provision has been made for income-tax on all profits up to the date of the balance sheet, it is desirable where possible to make provision, in addition, for or towards the balance of the liability for the current and following fiscal years. This provision should be shown separately in the profit and loss account.

27 (c) Whatever method is adopted, the bases (i) of the charge and (ii) of any supplemental provision made for income-tax should be disclosed.

28 (d) Income-tax on revenue taxed before receipt should be included as part of the taxation charge for the year and the relative income should be brought to credit gross.

29 (3) In the case of principal companies it should be indicated whether the provision for excess profits tax is in respect of the group or whether the sum charged has been arrived at after taking into account amounts allocated over subsidiary companies.

30 (4) Taxation charges may be affected by losses in the current period, deficiencies brought forward or adjustments of taxation in respect of previous periods, the effect of which, if material, should be disclosed. Any provision made in excess of the amount required to cover the estimated future liability on profits earned to date should, if material, be similarly disclosed.

31 (5) Any provision for (or in excess of) the estimated future liability to income-tax in respect of the fiscal year commencing after the date of the balance sheet should not be included with current liabilities but should be grouped with reserves or separately stated as a deferred liability and suitably described.

Addendum

[The following amendment was issued in May 1948 by the Council of the Institute. It arose from the statutory definition of 'provision' in the Companies Act 1947.]

In the opinion of counsel an amount set aside to meet future income-tax is not a liability and accordingly cannot be a 'provision'; it follows that for the purposes of the schedule it is necessarily a reserve. In view of that opinion, recommendation 3 requires amendment in the following respects

(a) The word 'provision' cases to be applicable to amounts set aside to meet future income-tax.

(b) Such amounts should in all cases be grouped with reserves; the alternative of stating them separately as deferred liabilities ceases to be available.

N4 *The treatment in accounts of income tax deductible from dividends payable and annual charges*

(Issued 13th March 1943)

32 The payment of a dividend to shareholders does not affect the amount of tax payable by a company, the assessment being on the amount of profits as adjusted for the purposes of income-tax.

33 On the other hand, income-tax deducted upon payment of debenture and other interest, royalties and similar annual charges is in effect assessed on a company for collection from the payee.

Recommendation

It is therefore recommended that:

34 (1) (a) Whether dividends are described 'less income-tax' or 'free of income-tax' the amounts shown in respect thereof in the accounts should be the net amounts payable.

35 (b) Where a company continues the practice of providing for dividends gross the narrative should indicate that the distributions are subject to income-tax. The taxation charge should be arrived at after taking credit for the tax deductable on payment of the proposed dividends.

36 (2) Annual charges for debenture and other interest, royalties and similar annual payments should be charged gross.

N5 *The inclusion in accounts of proposed profit appropriations*

(Issued 13th March 1943)

37 Although certain appropriations of profits, including dividends recommended by directors are subject to subsequent confirmation by shareholders, the inclusion of all appropriations in the accounts shows the amount which will be required for distribution to the shareholders and completes the accounts for the financial year by showing the results of trading and their application in one account. This course avoids the inclusion in the accounts of the next period of appropriations which were set out in the directors' report for the previous period, and have already been dealt with and disposed of. Also, it facilitates the linking up of the accounts from one period to another, the balance carried forward to the following period being clearly shown in the accounts of each year.

Recommendation

It is therefore recommended that:

38 Provision be made in the books and in the annual accounts for proposed profit appropriations, those subject to confirmation by shareholders being so described. Provision for dividends should be shown as a separate item in the balance sheet.

N6 *Reserves and provisions*

(Issued 23rd October 1943)

39 A true appreciation of the financial position of a company as disclosed by its balance sheet may be rendered difficult or even impossible owing to lack of information as to the extent of undisclosed reserves and to insufficient distinction being made between (a) free reserves retained to strengthen the financial position or to meet unknown contingencies; (b) capital reserves or other reserves not normally regarded as available for distribution as dividend; (c) provisions for known contingencies; and (d) provisions for diminution in value of assets in excess of normal or estimated requirements.

40 The terms 'reserves' and 'provisions' are commonly regarded as interchangeable. Accounts would be more clearly understood if the term 'reserve' were applied only to reserves which are free, and the term 'provision' were confined to amounts set aside for specific requirements.

41 Unless the amounts involved are stated, the trend of profits may be obscured by transferring amounts to or from undisclosed accounts of the nature of free reserves, by charging abnormal provisions or by utilising provisions no longer required.

Recommendation

It is therefore recommended that:

42 (1) The following distinction should be made between reserves which are free and those in the nature of provisions for specific requirements; the latter should preferably be described as 'Provisions':

43 (a) The term 'reserve' should be used to denote amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist as at the date of the balance sheet.

44 (b) The term 'provision' should be used to denote amounts set aside out of profits or other surpluses to meet:

(i) specific requirements the amounts whereof can be estimated closely; and

(ii) specific commitments, know contingencies and diminutions in values of assets existing as at the date of the balance sheet where the amounts involved cannot be determined with substantial accuracy.

45 (2) Reserves, as defined in (1) (a) above, should be disclosed in the balance sheet.

46 The term 'Reserve Fund' should only be used where a reserve is specifically represented by readily realisable and earmarked assets.

47 Where two or more reserves are retentions of distributable profits available for general use in the business and none of them is created in accordance with statutory requirements or in pursuance of any obligation or policy, the subdivision of such reserves under a variety of headings is unnecessary. Capital and other reserves not normally regarded as available for distribution as dividend, should, however, be separated from those of a revenue nature, the latter group to include any undistributed balance, or, by deduction, any adverse balance on profit and loss account.

48 (3) As a general principle 'Provisions' as defined under (1) (b) (ii), should be disclosed in the balance sheet under one or more appropriate headings. Only in circumstances where disclosure of the amount of a particular provision would clearly be detrimental to the interests of a company should it be included under another heading, for example 'Creditors'; the fact that such heading includes 'Provisions' should then be indicated in the narrative.

49 Where practicable, fixed assets in existence at the date of the balance sheet should be shown at cost, and provisions for depreciation and for diminution in values should appear as separate deductions therefrom.

50 (4) Subject as in (3) above in regard to provisions the disclosure of which would be detrimental to the interests of a company, where reserves and provisions are created or increased, the amounts involved, if material, and the sources from which they have been created or increased, should be disclosed in the accounts. In all cases the utilisation of reserves, and of provisions proved to have been redundant, should be disclosed in the accounts.

Addendum

[The following amendment was issued in May 1948 by the Council of the Institute. It arose from the statutory definition of 'provision' in the Companies Act 1947.]

In the opinion of counsel nothing that does not fall within the definition of 'provision' can properly be described as a provision. In view of that opinion the amounts referred to in paragraph (1) (b) (i) of recommendation 6 cannot be described as provisions and the Council has made the following new recommendations:

(a) The word 'provision' should cease to be used to denote amounts set aside to meet specific requirements the amounts whereof can be estimated closely; such amounts should be grouped with creditors since they represent liabilities or accruals.

(b) Amounts set aside to meet deferred repairs the execution of which is a contractual or statutory obligation (e.g. under a dilapidations clause of a lease) should be treated as liabilities if the amounts can be determined with substantial accuracy and as provisions if the amounts cannot be so determined.

(c) Other amounts set aside to meet deferred repairs because they are regarded as charges necessary for the correct computation of profits should be treated as provisions, on the footing that they are closely analogous to amounts provided for renewals (which are specifically required to be treated as provisions) and differ from these in degree rather than in character.

N7 *Disclosure of the financial position and results of subsidiary companies in the accounts of holding companies*

(Issued 12th February 1944)

51 Where a company holds a direct or indirect controlling interest in another company or companies (referred to in this memorandum as 'subsidiary undertakings'), a true appreciation of the financial position and the trend of results of the group as a whole can be made only if the accounts of the holding company as a separate legal entity take into account or are supplemented by information as to the financial position and results of the subsidiary undertakings.

52 The following are three methods of disclosing this supplemental information. Each has its own value and limitations. The first and second methods are suitable only in special cases.

53 *Method* (1): To submit copies of the accounts of each of the subsidiary undertakings.

This method is suitable only where it is desired to focus attention on the financial position and earnings of each component of the group. It is impracticable where the companies are numerous and, in all but the simplest cases, the shareholders of the holding company could not obtain a true view of the group as a whole without considerable explanation of inter-company relations.

54 *Method* (2): To submit statements of the consolidated assets and liabilities and of the aggregate earnings of the subsidiary undertakings as distinct from those of the holding company.

This method is of value where it is desired to show the underlying assets which represent the investment of the holding company in its subsidiary undertakings, or particular groups of them, and also the earnings attributable thereto.

55 *Note.* – As regards methods (1) and (2), if the holding company trades extensively with or through its subsidiary undertakings, the disclosed earnings of the subsidiary undertakings may not by themselves be a true criterion of the real value of the holding company's interests in such undertakings; in such circumstances their value cannot be assessed separately from the group undertaking as a whole.

56 *Method* (3): To submit a consolidated balance sheet and a consolidated profit and loss account of the holding company and of its subsidiary undertakings treated as one group.

This method is the most suitable for general application.

57 It must, however, be remembered that a consolidated balance sheet is not a record of the assets and liabilities of a legal entity and that the liabilities of each company in the group are payable only out of its own assets and not out of the combined assets of the group. Also, there may be special cases where it may be impracticable or inappropriate to include the figures of a particular subsidiary undertaking in the consolidation. This applies especially in the case of subsidiary undertakings operating overseas where, apart from the temporary difficulty of enemy occupation, there may be restrictions on exchange.

58 A consolidated profit and loss account does not suffer to the same extent from these limitations and, subject to any necessary explanations, the aggregate results of the group as a whole can be stated. Such disclosure is important even if for any reason the publication of a complete consolidated balance sheet is impracticable or inappropriate.

Recommendation

59 It is therefore recommended that in the case of every holding company:

(1) With the published accounts, statements should be submitted in the form of a consolidated balance sheet and consolidated profit and loss account or in such other form as will enable the shareholders to obtain a clear view of the financial position and earnings of the group as a whole.

60 (2) Every consolidated statement should indicate:

(a) The nature and measure of control adopted as a basis for the inclusion of subsidiary undertakings.

(b) The reasons for the non-inclusion of any subsidiary undertakings which would normally be included on the basis adopted for the group.

(c) The procedure adopted in cases where the accounts of subsidiary undertakings are not made up to the same date as the accounts of the holding company.

(d) In the case of subsidiary companies operating overseas, if relatively important, the basis taken for the conversion of foreign currencies as affecting assets, liabilities and earnings.

61 (3) The consolidated balance sheet should exclude intercompany items and should show the combined resources of the group and its liabilities and assets, aggregated under suitable headings. It should distinguish between capital reserves not normally regarded as available for distribution and revenue reserves, including those which would be available for distribution as dividend by the holding company if brought into its accounts. It should also show the interests of outside shareholders in the capital and reserves of the subsidiary undertakings and, under a separate heading, the interests of the group in subsidiary undertakings which have not been consolidated.

62 (4) The consolidated profit and loss account, or other information given as to the earnings of the group, should disclose the aggregate results of the group for the period covered by the accounts, after eliminating the effect of inter-company transactions. It should be in such a form that these aggregate results may readily be reconciled with those shown by the profit and loss account of the holding company, in which should be stated separately the aggregate amount included in respect of subsidiary undertakings whose accounts have not been consolidated.

63 The following, *inter alia*, should be separately stated:

(a) The aggregate results of any subsidiary undertakings the balance sheets of which have not been included in the consolidation.

(b) The portion of the aggregate net results attributable to outside shareholders' interests in the subsidiary undertakings.

(c) The portion of the consolidated net results attributable to the holding company's interest which remains in the accounts of consolidated subsidiary undertakings or the amount by which the dividends from such subsidiary undertakings exceed the holding company's share of their earnings for the period.

64 (5) Profits earned and losses incurred by subsidiary undertakings prior to the acquisition by the holding company of the shares to which they are attributable should be viewed as being of a capital nature from the standpoint of the holding company. Such pre-acquisition profits (whether received in dividend or not) should therefore not be brought into account as being available for distribution in dividend by the holding company.

N8 *Form of balance sheet and profit and loss account*

(Issued 15th July 1944)

65 Businesses are so varied in their nature that there must be flexibility in the manner of presenting accounts and a standard form to suit every commercial and industrial undertaking is neither practicable nor desirable. The financial position can, however, be more readily appreciated if the various items in the balance sheet are grouped under appropriate headings and a proper view of the trend of the results can be obtained only if certain principles are consistently applied and if profits or losses of an exceptional nature or relating to previous periods are stated separately in the profit and loss account. In both cases, appreciation is facilitated if the comparative figures of the previous period are also given.

Recommendation

66 It is therefore recommended that, subject to compliance with statutory requirements, the balance sheet and profit and loss account should be presented in conformity with the following general principles:

Balance sheet

67 (1) The use of general headings for a balance sheet, such as 'liabilities' and 'assets', is inappropriate and unnecessary. The various items, whatever may be their sequence or designation, should, however, be grouped as indicated below under appropriate headings. Additional groups may be necessary in certain cases to show the aggregate liabilities and assets subject to exchange or other restrictions, special funds and other special items, such as deferred revenue expenditure. Where any material part of a company's liabilities or assets is in foreign currency, the basis of conversion to sterling should be disclosed.

Share capital

68 (2) In addition to the authorised and issued amounts of the various classes of capital and the redemption date of any redeemable preference capital, the terms of redemption should be stated. Particulars of any option on unissued capital should also be given. If dividends on cumulative preference capital are in arrear, the gross amounts of dividends in arrear or the date up to which the dividends have been paid should be stated.

Reserves

69 (3) The items to be included in this group are amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist as at the date of the balance sheet. Capital and other reserves not normally regarded as available for distribution as dividend should be shown separately from those of a revenue nature, the latter group to include any undistributed balance or, by deduction, any adverse balance on profit and loss account.

70 (4) A sub-total of share capital and reserves should be given to indicate the members' interest in the company.

Debentures, mortgages and long-term liabilities

71 (5) In this group should be included debentures, mortgages and other long-term loans or liabilities. Where practicable, the dates and terms of redemption should be stated.

72 (6) The expression 'long-term' is intended to cover liabilities not due for payment until after the lapse of one year from the date of the balance sheet.

Amounts owing to subsidiary undertakings

73 (7) In addition to the aggregate amount owing to subsidiary companies, the aggregate amount owing to subsidiary companies should be disclosed. Such aggregate amounts may be shown under long-term liabilities, current liabilities, or as a separate group, according to their nature.

Current liabilities and provisions

74 (8) The items in this group should be classified to disclose their nature and amount including, inter alia, (a) trade liabilities, bills payable and accrued charges; (b) bank loans and overdrafts; (c) other short-term loans; (d) interest accrued on debentures and long-term liabilities; (e) provision for current taxation (see Recommendation No. 3); (f) provisions to meet specific commitments or contingencies where the amounts involved cannot be determined with substantial accuracy (see Recommendation No. 6); and (g) provision for proposed dividends.

Commitments for capital expenditure

75 (9) Where commitments of material amount for capital expenditure exist at the date of the balance sheet, these should be indicated in a suitable note.

Contingent liabilities

76 (10) Contingencies on guarantees, bills under discount, partly paid shares and similar items, should be dealt with by note.

Fixed assets

77 (11) In this group should be shown under separate headings fixed assets such as (a) goodwill, patents and trademarks; (b) freehold land and buildings; (c) leaseholds; (d) plant, machinery and equipment; (e) investments acquired and intended to be retained for trade purposes.

78 (12) Where practicable, fixed assets in existence at the date of the balance sheet should be shown at cost, and the aggregate of the provisions for depreciation and for diminution in values up to that date should appear as deductions therefrom.

Shares in amounts owing from subsidiary undertakings

79 (13) In addition to the aggregate amount of shares in, and the aggregate amount owing from, subsidiary companies, which must be stated separately in accordance with the Companies Act, 1929, the aggregate amount owing from sub-subsidiary companies should also be stated. The aggregate amounts owing from subsidiary and sub-subsidiary companies may be shown under fixed assets, current assets, or as a separate group, according to their nature.

80 *Note.* – In the balance sheets of subsidiary and of sub-subsidiary companies the aggregate amount of shares in, and the aggregate amounts owing to and from, the ultimate holding company and its subsidiary undertakings should be stated separately.

Current assets

81 (14) In this group should be included such as assets as are held for realisation in the ordinary course of business. They should be stated separately in appropriate sequence and normally include: (a) stock-in-trade and work-in-progress; (b) trade and other debtors, prepayments and bills receivable; (c) investments held as part of the liquid resources of the company; (d) tax reserve certificates; (e) bank balances and cash.

82 *Note.* – Debts of material amount not due until after the lapse of one year from the date of the balance sheet should be separately grouped and suitably described.

Preliminary and issue expenses, etc.

83 (15) In this group should be particulars and amounts of expenditure such as preliminary expenses, issue expenses and discount on capital issues not written off.

Profit and loss account

84 (16) The profit and loss account should be presented in such a form as to give a clear disclosure of the results of the period and the amount available for appropriation, for which purpose it may conveniently be divided into sections.

85 (17) Such a disclosure implies substantial uniformity in the accounting principles applied as between successive accounting periods; any change of a material nature, such as a variation in the basis of stock valuation or in the method of providing for depreciation or taxation, should be disclosed if its effect distorts the results. The account should disclose any material respects in which it includes extraneous or non-recurrent items or those of an exceptional nature, and should also refer to the omission of any item relative to, or the inclusion of any item not relative to, the results of the period.

86 (18) However much supplemental detail of the trading results may be given, the following items should be stated separately in addition to those required by statute:

(a) Income (gross) from investments in subsidiary undertakings.

Note. – The treatment of income from subsidiary undertakings will depend on the nature of their relations with the holding company and on whether a consolidated profit and loss account is submitted. Where, for any reason, a consolidated profit and loss account is not submitted, income from subsidiary undertakings should be shown separately unless the trading with the holding company is so interlocked that such separate disclosure might create a misleading impression. If a consolidated profit and loss account is submitted, it should disclose, as a minimum, the items referred to below relative to the group as a whole.

(b) Income (gross) from other investments.

(c) Depreciation and amortisation of fixed assets.

(d) Interest charges (gross) on debentures and long-term liabilities.

(e) Credits or charges in respect of provisions, other than those for specific requirements the amounts whereof can be estimated closely. (See Recommendation No. 6.)

(f) National defence contribution or excess profits tax, showing separately, if material, credits or charges in respect of earlier periods.

(g) Credits or charges, if material in amount, which are abnormal in nature or relate to previous periods.

(h) Income-tax and the basis thereof, showing separately, if material, credits or charges in respect of earlier periods. (See Recommendation No. 3.)

(i) Amounts set aside for redemption of share and loan capital.

(j) Reserves made or withdrawn. (See Recommendation No. 6.)

(k) Dividends paid or proposed, showing under a separate heading those which are subject to confirmation by the shareholders.

(l) Balances brought in and carried forward.

Comparative figures

87 (19) Comparative figures of the previous period (prepared on the same basis as those for the period under review) should be given both in the balance sheet and in the profit and loss account.

Disclosure of information

88 (20) If directors of a company desire to disclose in their report information which, but for its inclusion in the report, would be required to be disclosed in the accounts, the relative paragraphs in the report should be clearly distinguished from the remainder of the report and specifically referred to in the accounts.

N9 *Depreciation of fixed assets*

(Issued 12th January 1945)

89 Fixed assets, whatever be their nature or the type of business in which they are employed, have the fundamental characteristic that they are held with the object of earning revenue and not for the purpose of sale in the ordinary course of business. The amount at which they are shown in the balance sheet does not purport to be their realisable value or their replacement value, but is normally an historical record of their cost less amounts provided in respect of depreciation, amortisation or depletion.

90 Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned.

91 The assessment of depreciation involves the consideration of three factors: the cost of the asset, which is known, the probable value realisable on ultimate disposal, which can generally be estimated only within fairly wide limits, and the length of time during which the asset will be commercially useful to the undertaking. In most cases, this last factor is not susceptible of precise calculation. Provisions for depreciation are therefore in most cases matters of estimation, based upon the available experience and knowledge, rather than of accurate determination. They require adjustment from time to time in the light of changes in experience and knowledge, including prolongation of useful life due to exceptional maintenance expenditure, curtailment due to excessive use, or obsolescence not allowed for in the original estimate of the commercially useful life of the asset.

92 There are several methods of apportioning depreciation as between the several financial periods which constitute the anticipated useful life of the asset. Those most commonly employed in industrial and commercial concerns in this country are the straight-line method and the reducing balance method.

93 Subject to any periodic adjustment which may be necessary, the straight-line method (computed by providing each year a fixed proportion of the cost of the asset) spreads the provision equally over the period of anticipated use. It is used almost universally in the United States of America and Canada and to a large extent in this country. Though other methods may be appropriate in the case of some classes of assets, the balance of informed opinion now favours the straight-line method as being the most suitable for general application.

94 The reducing balance method which spreads the provision by annual instalments of diminishing amount computed by taking a fixed percentage of the book value of the assets as reduced by previous provisions, is also largely used in this country. It involves relatively heavy charges in the earlier years of the life of an asset and relatively light charges in the later years. In order to provide depreciation under this method within any given period, the percentage applied needs to be from two to three times that applied under the straight-line method. This is a fact not generally realised, the consequence being that rates of depreciation fixed on this basis may tend to be inadequate.

95 A third method, known as the sinking fund method, which endeavours to take account of anticipated income from funds set aside for depreciation purposes, is not used to any great extent in industrial and commercial concerns, though in public utility undertakings, where special considerations arise, it is frequently met. Under this method, fixed annual instalments are provided and set aside, which with compound interest, will accumulate to the cost of the asset by the end of its useful life. Where the amounts set aside are invested outside the business, the validity of the calculations depends upon the realisation of the anticipated net rate of interest, and each change in tax rates or interest yield involves recalculation. Where the amounts are retained as additional working capital, the effect is to make a growing charge in the periodic accounts for depreciation, because the fixed periodic instalment has to be supplemented in each period by an amount equivalent to interest on past provisions. Experience shows that, with the uncertainties inescapable in industrial and commercial enterprises, it is not prudent to place reliance upon the accrual of additional earnings to the extent required.

96 A fourth method, also not commonly used in industrial and commercial concerns, is the renewals reserve method, under which round sums, not necessarily computed by reference to the useful lives of the assets, and sometimes determined largely by the results of the year's trading, are provided and set aside as general provisions towards meeting the cost of future renewals. This method does not accord with a strict view of depreciation and may distort the annual charges to revenue.

97 The different natures of asset involve consideration in deciding on the method of depreciation appropriate in each case. Unless the methods adopted are applied consistently the usefulness of periodic accounts for the purpose of comparison of one period with another may be vitiated.

98 Whatever be the method adopted, the periodical revision of depreciation rates and the ascertainment of the residue of cost which has not been covered by depreciation provisions made up to any given date are greatly facilitated by, and often impracticable without, the maintenance of fixed asset registers showing the cost of each asset, the provisions for depreciation made thereon and the basis on which these have been calculated.

Recommendation

It is therefore recommended that:

99 1. Provisions for depreciation, amortisation and depletion of fixed assets should be applied on consistent bases from one period to another. If additional provisions prove to be necessary, they should be stated separately in the profit and loss account. Where practicable, fixed assets *in existence at the balance sheet date* should normally be shown in the balance sheet at cost and the aggregate of the provisions for depreciation, amortisation and depletion should appear as deductions therefrom (see Recommendation 8). The extent to which these provisions are being kept liquid will then be ascertainable from the balance sheet as a whole.

2. Such provisions should be computed on the bases mentioned below as being appropriate to the particular class of asset concerned:

100 (a) ***Goodwill and freehold land.***

Depreciation does not arise through use in the business, except in the case of freehold land acquired for purposes such as are referred to in (d) below. Amounts set aside to provide for diminution in value do not constitute a normal charge against revenue and should be shown separately in the profit and loss account.

101 (b) ***Freehold buildings, plant and machinery, tools and equipment, ships, transport vehicles and similar assets which are subject to depreciation by reason of their employment in the business.***

Provision for depreciation should, in general, be computed on the straight-line method. Assets of very short effective life, such as loose tools, jigs and patterns, may, however, frequently be dealt with more satisfactorily by other methods such as re-valuation, which in no case should exceed cost.

102 (c) ***Leaseholds, patents and other assets which become exhausted by the effluxion of time.***

Provision for amortisation should be made on the straight-line basis, including, in the case of leaseholds, allowance for the estimated cost of dilapidations at the end of the lease or useful life of the asset if shorter. If a leasehold redemption policy is effected with an insurance company, the charge of the annual premiums to profit and loss account provides a satisfactory method of amortisation if supplemented in respect of dilapidations.

103 (d) ***Mines, oil wells, quarries and similar assets of a wasting character which are consumed in the form of basic raw material or where the output is sold as such.***

Provision for depreciation and depletion should be made according to the estimated exhaustion of the asset concerned. In the case of an undertaking formed for the purpose of exploiting this particular class of asset, if the practice is to make no provision this should be made clear in the accounts so that shareholders may realise that dividends are, in part, a return of capital.

104 3. Where a method different from that recommended has hitherto been followed and it is not considered practicable or desirable to make a change in the case of assets already in use, it is suggested that the methods recommended should be followed in cases of assets subsequently acquired.

105 4. Details of all fixed assets should be kept (preferably in registers specially maintained) to show the cost of each asset, the provisions made for its depreciation and the basis of the provisions made.

106 5. Amounts set aside out of profits for obsolescence which cannot be foreseen, or for a possible increase in the cost of replacement are matters of financial prudence. Neither can be estimated with any degree of accuracy. They are in the nature of reserves and should be treated as such in the accounts.

N10 *The valuation of stock-in-trade*

(Issued 15th June 1945)

107 No particular basis of valuation is suitable for all types of business but, whatever the basis adopted, it should be applied consistently, and the following considerations should be borne in mind:

108 (A) Stock-in-trade is a current asset held for realisation. In the balance sheet it is, therefore, usually shown at the lower of cost or market value.

109 (B) Profit or loss on trading is the difference between the amount for which goods are sold and their cost, including the cost of selling and delivery. The ultimate profit or loss on unsold goods is dependent upon prices ruling at the date of their disposal, but it is essential that provision should be made to cover anticipated losses.

110 (C) Inconsistency in method may have a very material effect on the valuation of a business based on earning capacity though not necessarily of importance in itself at any balance sheet date.

The following interpretations are placed on the terms 'cost' and 'market value':

(a) 'Cost'

111 The elements making up cost are (i) the purchase price of goods, stores and, in the case of processed stock, materials used in manufacture; (ii) direct expenditure incurred in bringing stock-in-trade to its existing condition and location; and (iii) indirect or overhead expenditure incidental to the class of stock-in-trade concerned.

112 Whereas the cost of (i) and (ii) can be ascertained with substantial accuracy, (iii) – indirect or overhead expenditure – can only be a matter of calculation. If (iii) is expressed as a percentage of actual production, the amount added to the stock valuation will fluctuate from one period to another according to the volume produced. To avoid distortion of revenue results, in some cases indirect or overhead expenditure is eliminated as an element of cost when valuing stock-in-trade or, alternatively, only that part which represents fixed annual charges is excluded. In other cases, an amount is included which is based on the normal production of the unit concerned.

The following are bases usually adopted in practice for calculating cost:

113 (1) ***'Unit' cost***

Upon this basis, each article, batch or parcel is valued at its individual cost.

In certain cases, such as bulk stocks, this method is not always capable of application and records, including the allocation of expenses, may become unduly complicated. Further, it may not be practicable to apply the method to partly processed stocks or finished products where the individual units lose their identity.

114 (2) ***'First in, first out'***

This basis assumes that goods sold or consumed were those which had been longest on hand and that the quantity held in stock represents the latest purchases.

It has the effect of valuing unsold stock in a reasonably close relation to replacement price. In certain manufacturing or producing businesses, however, it is difficult to apply accurately through the various stages of manufacture or production.

115 (3) ***'Average' cost***

This basis entails averaging the book value of stock at the commencement of a period with the cost of goods added during the period after deducting consumption at the average price, the periodical rests for calculating the average being as frequent as possible having regard to the nature of the business.

It has the effect of smoothing out distortion of results arising from excessive, and often fortuitous, fluctuations in purchase price and production costs and is particularly suitable to manufacturing businesses where several processes are involved.

116 The bases referred to above are founded on the principle that 'cost' is an historical fact. In some cases, however, their application is unsuitable or impracticable owing to the nature of the business and stock-in-trade is taken at a cost estimated by one of the following methods:

(4) ***'Standard' cost***

117 This basis entails valuing stock at a pre-determined or budgeted cost per unit. It is coming more into use, particularly in manufacturing or processing industries where several operations are involved or where goods are produced on mass production lines.

(5) ***'Adjusted selling price'***

118 On this basis, an estimated cost is obtained by pricing stock at current selling prices and deducting an amount equivalent to the normal profit margin and the estimated cost of disposal.

119 Other methods of stock valuation are the 'base stock' method, which retains permanently certain basic stock at a fixed price not exceeding its original cost, and that known as 'last in, first out' which is based on the principle that profit or loss trading is the difference between the price at which goods are sold and their replacement cost. There is, however, only limited application of either of these methods in this country.

(b) 'Market value'

120 The expression 'market value' is commonly interpreted as either:

(i) the price at which it is estimated that the stock can be realised either in its existing condition or as incorporated in the product normally sold after allowing for all expenditure to be incurred before disposal; or

(ii) the cost of replacing the stock at the accounting date.

121 In considering the merits of these alternative methods, regard must be had to the purpose for which stock-in-trade is held, namely, to sell either in its existing condition or as incorporated in a manufactured product. The fact that at the time of valuation the goods could have been acquired at a sum less than their cost only indicates that the expected profit is less than it might have been had it been possible to acquire them at the accounting date – a possibility which often does not exist in view of the quantity held and of the fact that in many cases purchases have to be made for later delivery; the circumstance has not caused a trading loss but only indicates that the ultimate results under other conditions might have been better.

122 On the other hand, if at the time of the valuation it is clear that selling prices will not cover cost and expenses yet to be incurred before the goods are disposed of, provision is necessary to meet the anticipated loss.

123 When estimating the amount of the provision required to cover excess of cost over market value, the method employed may be either (i) to consider each article in stock separately, (ii) to group articles in categories having regard to their similarity or interchangeability or, (iii) to consider the aggregate cost of the total stock-in-trade in relation to its aggregate market value.

Recommendation

It is therefore recommended that:

124 (1) The basis of valuation for stock-in-trade should normally be the lower of cost or market value, calculated as in (2) and (3) below.

125 In certain businesses, such as tea or rubber producing companies and some mining companies, there is a general custom to value stocks of products at the price subsequently realised less only selling costs; if this basis is adopted, the fact should be clearly indicated in the accounts.

126 In the case of long-term contracts, the value placed on work-in-progress should have regard to the terms and duration of the contracts. If, after providing for all known contingencies, credit is taken for part of the ultimate profit, this fact should be indicated.

127 (2) Cost should be calculated on such a basis as will show a fair view of the trend of results of the particular type of business concerned. Indirect or overhead expenditure, if included as part of the cost of partly processed or finished products, should be restricted to such expenditure as has been incurred in bringing the stock-in-trade to its existing condition and location.

128 Stocks of by-products, the cost of which is unascertainable, should be valued at current selling price (or contracted sale price where applicable) after deducting expenses to be incurred before disposal. The cost of the main product should be reduced accordingly.

129 (3) Market value should be calculated by reference to the price at which it is estimated that the stock-in-trade can be realised, either in its existing condition or as incorporated in the product normally sold, after allowing for expenditure to be incurred before disposal. In estimating this price, regard should be had to abnormal and obsolete stocks, the trend of the market and the prospects of disposal.

130 If the value of stock-in-trade is calculated by reference to replacement cost, it should be described in the balance sheet as being 'at the lower of cost or replacement value', but in no case should it exceed market value as described above.

131 (4) For the purpose of estimating the amount of the provision required to reduce stock-in-trade below cost, it may properly be valued on the basis of the lower of its aggregate cost or of its aggregate market value. On the other hand, a more prudent and equally proper course is to take each item of stock (or each category group) and value it on the basis of the lower of its own cost or market value.

132 (5) Where goods have been purchased forward and are not covered by forward sales, provision should be made for the excess, if any, of the purchase price over the market value and should be shown as such in the accounts.

133 *Note.* – Where goods have been sold forward and are not covered by stocks and forward purchases, provision should be made for the excess, if any, of the anticipated cost over sales value.

134 (6) Whatever basis is adopted for ascertaining cost or calculating market value, it should be such as will not distort the view of the real trend of trading results and should be applied consistently regardless of the amount of profits available or losses sustained. Any reduction in stock values which exceeds the provisions embodied in the above recommendations is a reserve and should be shown as such in the accounts.

N11 *Excess profits tax post-war refunds*

(Issued 19th July 1946)

Material Provisions of Finance (No. 2) Act, 1945

135 The undertakings to be given under Section 40 of the Finance (No. 2) Act, 1945, include, amongst others, undertakings that:

(a) 'the net amount of the refund will be used in developing or re-equipping the trade or business and, until so used, will be so dealt with as to remain available for use, when required, in developing or re-equipping the trade or business'.

(b) '... any part of the said net amount which is not so used shall not be directly or indirectly distributed by way of dividend or cash bonus or capitalised for the purpose of issuing bonus shares or debentures or releasing any liability for uncalled share capital or applied, whether by way of remuneration, drawings, loans or otherwise, for the benefit of partners, shareholders or proprietors'.

136 Section 47 authorises the Commissioners, subject to specified conditions, to give credit for the net amount of the refund (after deducting income-tax at the standard rate for 1946-47) against excess profits tax liabilities. Any amount so credited is to

> 'be deemed to have been paid to the Commissioners and repaid by them and the said undertakings and authorities shall, with the necessary modifications, have effect accordingly'.

137 Section 42 (3) states:

'It shall be the duty of the advisory panel, in such cases and at such times as they think fit, to inquire how the net amount of any post-war refund has been dealt with, and, if, in the opinion of the panel, any part of the said net amount has, under the last preceding section, become due to the Crown, to report to the Treasury accordingly, and no sum shall be so recoverable unless the panel have so reported in respect thereof'.

138 Section 50 (4) states:

'Where any expenditure has been incurred, on or after the first day of April, 1945, in developing or re-equipping a trade or business, any sum used in or towards the recouping of that expenditure shall be deemed for the purposes of this Part of this Act to have been used in developing or re-equipping that trade or business and any undertakings given under this Part of this Act shall have effect accordingly.'

Observations thereon

139 (a) Prior to the enactment of the Act it was recognised accounting practice in a vast majority of undertakings to ignore post-war refunds on the grounds that the right thereto was nebulous and the relative conditions were unknown. The passing of the Act has changed this situation.

140 (b) Official guidance is not at present available as to the meaning and scope of the expression 'developing or re-equipping' used in the sections quoted above, nor as to certain other important matters arising in connection with the regulations. The recommendations which are set out below may, therefore, need modification in the light of experience. It is, however, considered that, in view of the importance of this matter to a great variety of businesses, the Council should indicate now, rather than await the results of experience, the provisional views which it has formed as to the appropriate accountancy treatment of certain aspects of the refund. The notes set out below are designed to deal with the case of the single trading company and no endeavour has been made to comment upon the circumstances peculiar to partnerships, individual traders and groups of companies, the case of assignees of the refunds, and other special cases.

141 (c) Special attention is drawn to the stipulation that the refund shall be so dealt with as to remain available for use for the particular purposes specified in the Act. It is to be noted that inasmuch as credits which are set off against liabilities under Section 47 are to be deemed to have been received from the Commissioners, the same obligation rests upon the taxpayer in this connection as if he has actually received these refunds in cash.

142 (d) As the net refund must be so dealt with as to remain available for the specified purposes, it may be thought that the only appropriate way of doing this is to open a separate bank account into which the refund would be paid and from which the only permissible payments would be those for the purchase of specific investments for account of the refund and those clearly identified as falling within the scope of the section.

143 Whilst this procedure would have great merit in a large number of cases in assisting those responsible to demonstrate that the moneys are kept available until used for purposes covered by the section, it is thought that, had Parliament intended such a course to be followed in every case, it would have included a specific provision to that effect in the Act, and would also have included provisions for the payment into such an account of amounts equivalent to the sums deemed to have been received though actually applied in reduction of liabilities. Where an undertaking has ample liquid resources it can readily keep available for use when required an amount equal to the refund; in such a case there seems no reason why, as long as this is done, the refund should not be merged in the general financial resources of the business.

Recommendation

It is therefore recommended that:

144 (1) Where the amounts involved are material it should no longer be regarded as good accounting practice to ignore the right of a business to post-war refunds of excess profits tax.

145 (2) If, at the time of the completion of the accounts, the amount of the refund recoverable is not known with substantial accuracy and no amount has been received or deemed to be received on account thereof, no credit should be taken for the refund in the accounts. If, however the estimated amount of the total refund is material, a suitable note should be made on the balance sheet, giving such indication as may be practicable of the magnitude of the sum involved.

146 (3) Where, before the completion of the accounts, the amount of the refund has been ascertained either for the whole period or up to a particular date, or a payment has been received or deemed to have been received, the amount ascertained, received or deemed to have been received, as the case may be, should be credited to a specific reserve or suspense account shown separately in the balance sheet under an appropriate name, such as 'Excess Profits Tax Post-war Refund Suspense Account'. Except in cases where the credit represents substantially the whole of the anticipated refund in respect of tax liabilities to the date of the balance sheet, the narrative used should indicate the basis of calculation used and, as far as practicable, should indicate the further net sums which are expected to be received but have not been taken up in the accounts. Alternatively, an appropriate note on the balance sheet should explain the position.

147 As an alternative procedure where no money has been received or deemed to have been received, an appropriate note mentioning the sum concerned and the basis of its calculation should be entered on the balance sheet.

148 (4) Where, before the completion of the accounts, the amount of the refund has been ascertained either for the whole period or up to a particular date and is credited in the accounts as explained above, any part of the refund which has not been received or deemed to have been received in cash should, if material in relation to the other assets, be shown separately as an asset in the balance sheet under an appropriate description such as 'Amount Recoverable in respect of E.P.T Post-war Refund'.

149 (5) The question whether such an asset, or the cash representing it when received or deemed to be received, should be treated as a current asset or otherwise should be determined according to the facts of the case. The circumstances of businesses differ greatly. At the one extreme is the business whose refund is clearly a current asset in that it is wholly required to discharge current liabilities existing at the date of the balance sheet for expenditures on developing or re-equipping, or to replace funds already used for that purpose. At the other, is the business whose liabilities do not include any liability for developing or re-equipping

and whose refund consequently is not available to meet any liabilities outstanding at the date of the balance sheet or to refund expenditures incurred since 1st April, 1945; in some cases there may, indeed, be little prospect of using the refunds to any substantial extent for several years. In such a case the assets representing the refund, if material, would be better separated from the current assets and grouped under some separate heading in the balance sheet. Between these extremes is a diversity of cases which would seem to call for treatment according to their circumstances, the important point being not to mis-state the net current asset position of the business.

150 (6) The question whether cash received or deemed to be received in respect of the refund should be paid into a special bank account or merged in the other financial resources should be decided by reference to whether a separate account is necessary in order to keep the appropriate amount available for the purposes for which the refund is intended to be used. Where there is any shortage of liquid resources it may be especially desirable to use such an account so as to obviate the danger of infringing the undertakings to keep the refund available for the prescribed purposes.

151 (7) A detailed record should be kept of all expenditures which are claimed to represent applications of the refund. This should be kept available so as to show what these are and how they have been treated in the books of the business, in the event of the uses to which the refund is put being challenged at any time by the advisory panel.

152 (8) For the time being the specific reserve or suspense account arising from the refund, should only be charged with repayments to the Commissioners (including constructive repayments arising because of the occurrence of E.P.T. deficiencies after the periods to which the refund relates) and expenditure on developing or re-equipping which, if the refund were not available for the purpose, would be written off to profit and loss account.

153 The extent to which the balance on the specific reserve or suspense account has been applied for the prescribed purposes should be indicated in the balance sheet by the insertion of appropriate words in the narrative relative to the balances or in a note thereon.

154 This recommendation may need further consideration when official guidance is available as to (i) the meaning of the expression ‘developing or re-equipping’; (ii) the intentions of Parliament with respect to the period within which moneys must be utilised or repaid to the Commissioners; and (iii) the intentions as to the ultimate destination of balances on the specific reserve or suspense accounts arising from the refund.

155 (9) Expenditure on the acquisition of capital and other assets should be dealt with in accordance with the normal accountancy procedure and should not be charged against the reserve or suspense account. Depreciation and amortisation thereof should also be charged against profit and loss account in accordance with the normal accountancy practice of the business.

Addendum

(Note: An announcement to the following effect was published by the Council in the ‘Accountant’, 14th December, 1946.)

156 The attention of members of the Institute is drawn to the announcement dated 8th November, 1946, by the Excess Profits Tax Refunds Advisory Panel (reprinted overleaf). The recommendations of the Council on excess profits tax post-war refunds should be read with and regarded as subject to the Advisory Panel’s announcement, in particular with respect to the modification which is necessary as to the treatment of expenditure on developing or re-equipping which, if the refund were not available for the purpose, would be written off to profit and loss account (see paragraph 152 above).

Announcement, 8th November, 1946

by the

EXCESS PROFITS TAX REFUNDS ADVISORY PANEL

157 (1) The Excess Profits Tax Refunds Advisory Panel appointed by the Treasury under Section 42 of the Finance (No. 2) Act, 1945, makes the following announcement as to the principles to which it will work in carrying out the duties laid upon it by the Act.

Terms of making over

158 (2) Where the refund is to be made over to a person or company other than the person or company to whom a refund is due, the Panel is called upon to approve the terms under which it is made over before payment can be made. (The undertakings, etc., do not, however, require the approval of the Panel where the refund is made over by the principal company of a group to an Excess Profits Tax Subsidiary – see Sixth Schedule, Part II, paragraph 4 of the Act.)

159 (3) The Panel will approve cases in which the refund is made over unconditionally or as a loan for use in the original trade or business or for use in a trade or business carried on or to be carried on by a relative of the taxpayer (relative being defined as in the last paragraph of Section 39 (2) of the Act) provided that in the loan cases the loan is fixed for a period of at least five years and the interest, if any is charged, is reasonable.

160 (4) Where the refund is made over for use in a trade or business in which the taxpayer or a relative of his has or is to have a substantial interest the Panel will approve cases where it is made over unconditionally or subject to the conditions mentioned in the previous paragraph as a loan and where the interest in the business is 20 per cent. apart from 'any interest acquired by or for him in consideration of the making over'. In other words the Panel will regard the expression 'substantial' in Section 39 (2) (c) of the Act as satisfied by a 20 per cent. interest.

161 (5) The Panel will not approve cases in which the refund is made over for a cash or equivalent consideration.

Use of refunds – development and re-equipment

162 (6) The fundamental principle behind the payment of refunds is that they shall be used to develop or re-equip a specified trade or business.

163 (7) The receipt of a refund will normally give rise to an increase in the net worth of the business concerned, that is the capital and reserves of the business as represented by the excess of the assets of the business over its liabilities. The Panel will expect this increase in net worth to be shown and maintained separately on the Balance Sheet of the business as a capital reserve. Where a refund is received as a loan there will be no such increase in net worth, but the Panel will expect the loan to be maintained and shown separately on the Balance Sheet.

Development

164 (8) In general 'development' will be clearly identifiable where the refund has been used to expand the capital employed in the business as represented by the fixed assets and working capital of the business. The reduction of a bank overdraft or the discharge of other liabilities will be regarded as such an expansion of capital.

165 (9) The Panel will be prepared to regard as development, expenditure out of the refund on special advertising, research and other similar expenditure aimed at improving the business provided that it is capitalised and treated as a capital asset against reserves. Expenditure of this nature charged to profit and loss will not be regarded by the Panel as development.

Re-equipment

166 (10) The Panel will regard as re-equipment of a trade or business any expenditure on assets where the effect is to obtain more for less efficient buildings, plant, machinery, equipment, etc.

167 (11) To the extent that relief from taxation falls short of the expenditure, rehabilitation expenses as defined by the Finance Act, 1946 (broadly speaking, expenditure on the removal of A.R.P.

installations, the return of evacuated businesses and the re-adaptation of buildings, plant, machinery, etc., for peacetime production) may be charged against the refund. The Panel will not, however, regard as so chargeable expenditure on deferred repairs.

Improper use of refunds

168 (12) Section 40 (1) (b) of the Finance (No. 2) Act, 1945, lays it down that any part of the net refund which is not used for development or re-equipment of a business 'shall not be directly or indirectly distributed by way of dividend or cash bonus or capitalised for the purpose of issuing bonus shares or debentures or releasing any liability for uncalled share capital or applied, whether by way of remuneration, drawing, loans or otherwise, for the benefit of partners, shareholders, or proprietors'. As has already been stated, the receipt of a refund will normally give rise to an increase in the net worth of the business concerned. The normal test to be applied by the Panel in determining whether or not any part of a refund has been directly or indirectly distributed for the benefit of the partners, shareholders or proprietors will be the movement of the net worth of the business, due regard being paid to the normal level of the provision for depreciation and to the course of profits and their disposal.

169 (13) Any distribution of free or capital reserve will in the view of the Panel constitute a *prima facie* case for enquiry in order that the Panel may satisfy itself that the refund is not being indirectly applied in a manner contrary to the undertakings given under the Act. In any case in which the distribution of profits in respect of the year or period concerned for the benefit of partners, shareholders or proprietors exceeds the amount of the profits for that year or period, the Advisory Panel would feel obliged to satisfy itself that the undertakings given in respect of the refund were not being infringed.

170 (14) It will also be clear that the question of the distribution of existing reserves is linked with the disposal of the current earnings of any business which has received a refund. The Chancellor of the Exchequer has already made it clear that any increase in current earnings which results from the benefits conferred by the use of a refund may be freely dealt with in the same way as earnings generally (Hansard, 22nd July, 1946, Columns 294-295).

Miscellaneous

171 (15) Section 40 of the Act requires that, until the refund has been used for developing or re-equipping a business, it is to be 'so dealt with as to remain available for use, when required, in developing or re-equipping the trade or business'. As long as any part of a refund remains unused, the Panel will be assisted in carrying out its duties if any such unused part is separately distinguished among the assets of the business. The Panel will regard investment in Government or other marketable securities as complying with the requirement that a refund should remain available for use.

172 (16) The work of the Panel will be facilitated if reports of Directors to their shareholders or the Accounts indicate how a refund has been used.

173 (17) The Panel calls attention to the provisions of Section 47 of the Finance (No. 2) Act, 1945, which provides that, subject to specified conditions, the Commissioners of Inland Revenue may give credit for the net amount of any Excess Profits Tax refund (after deduction of Income Tax at the standard rate for the year 1946-47) against Excess Profits Tax liabilities. Any such credits are to be deemed to have been paid to the Commissioners and repaid by them and the undertakings and authorities in respect of the refund are, with the necessary modifications, to have effect accordingly.

174 (18) Finally, the Advisory Panel draws attention to the provision of Section 50 (4) of the Act, under which any part of the refund used in or towards the recoupment of expenditure in developing or re-equipping a business which has been incurred on or after the first day of April, 1945, is to be regarded as expenditure on development or re-equipment for the purpose of satisfying the undertaking given in respect of the refund.

Treasury Chambers,
Great George Street, S.W.1.
8th November, 1946

P. L. SMITH
(Secretary)

Copies of this announcement can be obtained free of charge from the Secretary, Excess Profits Tax Refunds Advisory Panel, Treasury Chambers, Great George Street, London, S.W.1.

N12 *Rising price levels in relation to accounts*

(Issued 14th January 1949)

The Council of the Institute of Chartered Accountants in England and Wales makes the following statement and further recommendations to its members on certain aspects of the accounts of companies engaged in industrial and commercial enterprises. Whilst it is recognised that the form in which accounts are submitted to shareholders is (subject to compliance with the Companies Act) a matter within the discretion of directors, it is hoped that the statement and recommendations will be helpful to members whose advice may be sought by clients.

175 In periods when rises in price levels are marked, businesses tend to become undercapitalised and the problems thereby created have been increasingly emphasised in recent months in annual reports, chairmen's speeches, the financial press and elsewhere. As stocks of materials are converted into goods and sold and as fixed assets wear out or become obsolete, substantially greater amounts have to be invested in the assets which replace them than were invested in the purchase of those displaced; other working capital requirements likewise increase.

176 In some businesses the immediate effects of a rise in price levels are more apparent than in others. Those where rapid stock replacement occurs feel the results quickly, and those whose plant and equipment call for immediate or early replacement feel the effect more rapidly than those for which replacement is a long-term problem. But in nearly all businesses the undercapitalisation will be felt sooner or later if the rise in prices is maintained.

177 The maintenance of the capacity of the business to cope with the physical volume of goods or services previously handled depends to a large extent upon the correction of this undercapitalisation. This can be done either by obtaining new capital from outside sources or by retaining in the business moneys which would otherwise be free for distribution; or by a combination of these methods.

178 The raising of new capital from outside sources necessarily implies a surrender by the proprietors of a proportion of their equity in the business or the introduction of prior ranking capital. Some fear that the adoption of this method may involve the drastic pruning of the capital structure, as happened in the case of some companies in the decade which preceded the last war; but the alternative of retaining resources in the business has its difficulties also.

179 The basis and scale of taxation in force in Great Britain are such that the extent to which profits can be retained in businesses for the purpose of adjusting the undercapitalisation is seriously restricted. The difference between the original monetary cost of stocks sold and the amount realised on the sale in the ordinary course of business is brought into account for taxation purposes; moreover, the allowances for taxation purposes in respect of the fixed assets are restricted to an amount equal to their original monetary cost. Profits are subjected not only to income-tax at 9s. in the £, but also to profits tax in the case of corporate bodies and sur-tax in the case of individuals and partnerships. The amounts which might otherwise accrue in the course of trading and become available for meeting increased costs of replacement are thus gravely diminished.

180 The combined effect of the rise in price levels and the oppressive burden of taxation has led a number of business men and their advisors to question the validity of the methods of profit ascertainment hitherto generally followed by industrial and commercial undertakings. They do not challenge the generally accepted accounting principle that the profit of a period can be ascertained only after providing, by way of charges against revenue, adequate sums for remedying any impairment of the capital of a business which may have occurred in the ordinary course of trading in that period. Opinions differ, however, as to whether capital for this purpose means (a) the money contributed by the proprietors, including profits left by them in the business for financing it, or (b) the power of that sum of money to purchase a particular volume of goods or equipment. Some business men have adopted the latter conception and accordingly maintain the proposition that profit can be stated correctly only if it is ascertained after treating as revenue charges sums sufficient to provide the increased funds necessary for replacing the stocks consumed or sold and for providing an appropriate proportion of the prospective enhanced cost of replacing the fixed assets used up in carrying on the business.

181 This proposition is at variance with the accounting practice hitherto generally followed of treating as charges to revenue the actual monetary cost of the stocks consumed or sold and depreciation provisions representing the appropriate proportion of the amounts carried in the books for fixed assets (usually their historical cost). Those who maintain the view hitherto accepted, point out that logical application of the method advocated by those who desire a change would require them in ascertaining profit not only to make charges against revenue on new bases in respect of stocks and fixed assets, but also to provide for the diminished purchasing power of cash and other liquid assets to be used in the business. They put forward the criticism that it would be illogical, in ascertaining profit, to treat as a necessary charge the cost of maintaining the purchasing power of money provided by the issue of fixed preference or loan capital, whilst ignoring the corresponding diminution in the obligation, expressed in terms of purchasing power, to the holders of that capital. They emphasise that if the new conception were adopted the holders of preference shares might be deprived of dividends without acquiring any capital benefit. Moreover, they point out, as regards goods consumed or sold, that those who desire the change have not yet been able to devise a satisfactory method, suitable for general use, of applying the principle advocated and, as regards fixed assets, that, owing to improved processes of manufacture, plant which becomes worn out or obsolete is not invariably replaced. Further, they claim that not only is the suggested change wrong in principle, but also that it strikes at the root of sound and objective accounting because of the practical difficulties of assessing the amounts which would be treated as charges to revenue if the new conception were adopted.

182 Some suggest that apart from the taxation consequences, which are inescapable in the present state of the law, the problem should be met by arranging, so far as fixed assets are concerned, that the amounts (generally their depreciated historical cost) at which they are carried in the books should be written-up to the amounts which it is estimated might have to be paid if they were to be replaced at the present time by identical assets in a comparable state of depreciation. They also suggest that depreciation should thereafter be calculated upon the written-up figures, but there is not unanimity among them as to whether the future annual instalments of depreciation should be calculated so as (a) to amortise over the residue of the effective life of each asset the whole of the gross replacement cost (i.e. the amount which would have to be paid at the present time to acquire similar assets in a new condition) less the provisions for depreciation already made, or (b) only to provide annually one year's proportion of the gross replacement cost based upon the total life of the asset, ignoring the fact that provisions for earlier years were calculated upon smaller capital sums. In the absence of a sufficient fall in prices, the adoption of the latter method would fail to secure the provision of the funds required by the eventual replacement date, but, on the other hand, might be regarded as providing a fair charge against the revenue of each year on the new basis; it would need to be supplemented out of profits or otherwise in order to provide the necessary funds.

183 Apart from the question of depreciation, the writing-up of the fixed assets itself involves practical difficulties, including, *inter alia*, those which arise because relative stability of prices on a new level has not yet been attained, the invalidation of comparisons with figures of previous periods and, in many cases, the lack of data on which satisfactory revaluations could be achieved.

184 In certain European countries assets have been written-up by the use of price indices, with governmental encouragement in the shape of additional taxation allowances; in Great Britain no such benefit is available and the extra sums provided for depreciation, as in the case of other sums provided to meet increased replacement costs, would be treated as disallowable charges for taxation purposes.

185 The foregoing matters have been the subject of much discussion among business men and their advisers in Great Britain and North America. There is no generally accepted conclusion in either territory as to the way in which the problems should be solved. It is, however, clear that in Great Britain the effects of the rise in prices when combined with the effects of the basis and scale of taxation cannot, unless profits are sufficient, be met by changes in accounting practice; Parliament alone has the power to mitigate these consequences by changes in the tax law.

186 The majority of businesses maintain their past practices for the ascertainment of profits and set aside out of those profits such additional sums as are found practicable towards meeting the enhanced costs of replacement. The setting aside of profits for this purpose is viewed by their directors as a major requirement when deciding upon the amounts which they can prudently recommend for distribution in dividends. Some boards of directors are so impressed with the importance of emphasising to their shareholders the implications of the matter that they set aside the sums concerned on the basis of a programme designed to provide by instalments, over the period during which the assets are in effective use, the funds which it is expected will be needed

for their replacement. The financial effects of such a plan are identical with those of schemes involving a drastic change in the basis of profit ascertainment as outlined in earlier paragraphs, the material difference being that the extra amounts set aside are treated as appropriations of profits instead of as charges made before profits are ascertained.

187 Owing to the inherent difficulty of determining in advance the prices which may have to be paid in the future for the replacement of assets, it is impracticable to forecast with any precision the additional reserves which will be required. This fact alone is likely to necessitate modification of any plan whereby the actual sums required to effect replacements are provided by instalments over a period of years, either by way of supplementing depreciation charges or by setting up in lieu of depreciation a provision for renewals based on estimated replacement costs. Moreover, the gap between historical and replacement costs might be too big to be bridged in these ways.

188 The matters mentioned in the foregoing paragraphs have been under close examination by the Council and the advice given in the Council's recommendations 9 and 10, issued in 1945, has been re-examined. In recommendation 10 the Council emphasised that profit or loss on trading is the difference between the amount for which goods are sold and their historical cost including expenses of sale and delivery; it recommended that for accounting purposes the basis of valuation for stock-in-trade should normally be the historical cost (or, if lower, the market value as defined in the recommendation). In recommendation 9 the Council expressed a similar view with respect to fixed assets when it emphasised that depreciation provisions should be based on cost and stated in paragraph 5 that: 'Amounts set aside out of profits for ... a possible increase in the cost of replacement are matters of financial prudence (and cannot) be estimated with any degree of accuracy. They are in the nature of reserves and should be treated as such in the accounts.' The advice thus given on replacement costs was subsequently endorsed from the legal standpoint by counsel whose opinion was taken by the Institute upon the implications of the Companies Act (see paragraph 92 of the Institute booklet – published in May, 1948 – on the Companies Act, 1947).

189 The Council sees no need to modify the advice which it has already given, but amplifies this advice in the recommendations set out below. It wishes, however, to draw attention to the fact that the funds which can be accumulated by businesses through charging sums against revenue in absorption of the historical cost of goods sold and assets consumed must, if the enhanced levels of prices are maintained, be inadequate to meet the cost of replacing goods and assets which were purchased at substantially lower levels. It is necessary also to recognise that rising prices, coupled with the present basis and scale of taxation, seriously impair the ability of industry and commerce to maintain their volume of trade or services at pre-war levels and make necessary the taking of steps to strengthen their financial resources for this purpose.

190 It is, therefore, of the greatest importance that directors should be advised to consider, in relation to the circumstances of their company, the effects of the rise in price levels and the relative merits of (a) relying upon the company's ability to raise new capital as and when it may be required for the purpose of meeting enhancements in replacement costs, and (b) the desirability of setting aside and accumulating out of profits such sums for this purpose as may be practicable. In many cases this consideration may be a matter of major importance in determining the amount of profits which, from the standpoint of financial prudence, should be regarded as available for dividend. It should be borne in mind that if carried to extremes the retention of profits might involve the severe curtailment or even cessation of dividends and the imposition of undue burdens upon existing shareholders, including preference shareholders, for the benefit of future holders of the equity shares.

191 The desirability of informing shareholders, as to the effects of the rise in price levels on their own company's affairs and as to the steps taken or contemplated to meet them, is a matter for consideration by directors. Where an amount set aside out of profits is determined in accordance with a programme designed to provide the necessary funds by instalments over the period during which the assets are in effective use, the information given should indicate the facts.

Recommendations

The following further recommendations are now made in amplification of recommendations 9 and 10.

192 (1) Any amount set aside to finance replacements (whether of fixed or current assets) at enhanced costs should not be treated as a provision which must be made before profit for the year can be ascertained, but as a transfer to reserve. If such a transfer to reserve is shown

in the profit and loss account as a deduction in arriving at the balance for the year, that balance should be described appropriately.

193 (2) In order to emphasise that as a matter of prudence the amount set aside is, for the time being, regarded by the directors as not available for distribution, it should normally be treated as a specific capital reserve for increased cost of replacement of assets.

194 (3) For balance sheet purposes fixed assets should not, in general, be written-up on the basis of estimated replacement costs, especially in the absence of a measure of stability in the price level.

N13 *Accountants' reports for prospectuses: fixed assets and depreciation*

(Issued 11th March 1949)

The Council of the Institute of Chartered Accountants in England and Wales makes the following recommendations to its members on certain aspects of the reports required to be given by accountants for the purpose of inclusion in prospectuses, offers for sale and similar documents. Whilst it is recognised that the form in which such reports are submitted to directors or promoters is (subject to compliance with the Companies Act, 1948, and the regulations of the Stock Exchanges where applicable) a matter within the discretion of the accountants concerned, it is hoped that these recommendations will be helpful to members as to what may be regarded as the best practice.

195 The report by a company's auditors, which is required for prospectus purposes under the Fourth Schedule to the Companies Act, 1948, must deal with:

(a) the profits or losses in respect of each of the five financial years immediately preceding the issue of the prospectus; and

(b) the assets and liabilities at the last date to which the accounts were made up.

Similar reports by accountants are required in respect of any business which is to be acquired out of the proceeds of an issue. In practice the reports generally deal with profits or losses over a period of ten years in order to comply with Stock Exchange regulations.

196 Such reports must either indicate by way of note any adjustments as respects the figures of profits or losses or assets and liabilities dealt with by the report which appear necessary to the persons making the report, or must make those adjustments and indicate that adjustments have been made. Among the matters which may require adjustment are the treatment of fixed assets and the depreciation thereof.

197 The amounts at which fixed assets stand in the books normally depend on the price levels at the time of acquisition and the depreciation policy adopted since that time; they are not usually intended to indicate the current values of the assets. Frequently, however, a company obtains from an expert a valuation of fixed assets for inclusion in a prospectus. Under existing conditions such a valuation may be greatly in excess of the amounts at which the assets stand in the books. In some cases the valuation figures may be adopted for the purposes of the company's books, but in others they may be used for prospectus purposes only without being incorporated in the books.

198 Where the valuation is incorporated in the books, depreciation will in future necessarily be calculated on the valuation figures, resulting in future earnings being charged with sums which might be considerably in excess of those charged in the accounts during the period covered by the report. Consequently, a report dealing with assets and liabilities on the basis of the valuation taken into the books would mislead intending investors, if the figures stated in the report for past profits or losses were arrived at after providing for depreciation on amounts considerably less than the valuation without any indication being in the report of the effect of the valuation on future depreciation provisions. Similar considerations arise in the case of a business acquired, or to be acquired, on the basis of a valuation of fixed assets greatly in excess of the amounts carried for such assets in the books of that business at the time of acquisition.

199 Where, on the other hand, the valuation is used by the directors in the prospectus for the purpose of indicating the assets cover for the issue, but the valuation is not incorporated in the books, then depreciation provisions will be calculated in future on the book amounts, which may be substantially less than the valuation. In this case, subsequent profits will be ascertained correctly by reference to depreciation charges based upon the book amounts, but the assets cover indicated by the directors will not normally be maintained unless, out of profits earned during the effective life of the assets which are subject to depreciation, reserves are set aside at least equal to the excess of the valuation of those assets over their book amounts. The same need for reserves arises in the case of a holding company where a valuation of the fixed assets of subsidiaries is used by the directors in the prospectus, but is not incorporated in the books of the subsidiaries. In these cases the creation of the whole or part of the necessary reserves may be

obligatory under the terms of the prospectus if the issue is one of redeemable preference shares or debentures; but, whatever may be the terms of the issue, intending investors may be misled in regard to the assets covering their subscriptions unless the necessity for retaining profits, up to the amount of the excess, is recognised fully by the directors in their representations in the prospectus as to the profits which they anticipate will be available for future dividends. The context in which the accountants' report appears may thus have a material effect on the conclusions which the intending investor will draw from the prospectus as a whole.

200 Special considerations arise where the cost to a holding company of shares in its subsidiaries is in excess of the amounts at which the underlying net assets are carried in the books of the subsidiaries. In some cases the profits of the group may not be stated fairly unless they are arrived at after charging depreciation on that part, if any, of the excess which relates to fixed assets. Circumstances of companies differ greatly and each case has to be considered on the facts. Among the matters requiring consideration is the extent to which the excess is attributable to such assets as goodwill or freehold land, which are not generally regarded as subject to depreciation, or to depreciating assets such as leaseholds, buildings, plant and machinery; the allocation of the excess between the several types of asset will affect the depreciation, if any, which should be provided and, consequently, the profits.

201 Another important aspect is that of taxation. If the allowances for taxation purposes are materially different from the corresponding provisions made for depreciation, the net profits after deducting depreciation provisions may give a misleading indication of the profits for taxation purposes and consequently of the net amount available for distribution. A similar position may arise where a material part of the assets comprises depreciating assets on which no allowance is obtainable for taxation purposes. Further, where in future the depreciation provisions will be calculated on a valuation which is not applicable for taxation purposes, the written-down amount for taxation purposes (representing the total maximum amount available for future taxation allowances) may be substantially less than the valuation; where this is so, provisions for depreciation in future will be greater than the allowances for taxation purposes. In circumstances such as the foregoing, the excess of the depreciation provisions is not the whole amount involved; to set aside the full depreciation provisions required, the company will have to earn not merely the excess over the taxation allowances but such an amount of taxable profit as after deduction of income-tax and profits-tax will leave a net sum equal to the excess.

202 The foregoing paragraphs and the recommendations that follow relate to circumstances in which it may frequently be necessary to make adjustments in respect of fixed assets and depreciation, but it must be borne in mind that the circumstances of one company may differ greatly from those of another. It is necessary to take into account the relevant facts of each case before deciding what, if any, adjustments should be made and what matters should be referred to specifically in the accountants' report.

Recommendations

It is therefore recommended that the following principles should normally be applied by members of the Institute who may be called upon to report for prospectus purposes:

203 (1) If material to the presentation of the figures, the amounts charged for depreciation in the years under review should be stated in the report.

204 (2) Where there has been a change (whether of rates or by reason of a valuation) in the basis of depreciation during the period covered by the report, the effect of the change should be indicated in the report if the effect is material and cannot be dealt with appropriately in the adjustments made in arriving at the figures shown in the report.

205 (3) Where allowances obtained for taxation purposes differ materially from the corresponding charges made for depreciation in arriving at the profits or losses shown in the report:

(a) If the difference is material in relation to the profits or losses shown, the report should indicate the fact and should state the amount of the difference (or give the relevant amounts) for the last year covered by the report or for such other period as may be appropriate;

(b) If the allowances obtained are substantially greater than the amounts charged, it is a matter for consideration whether adjustments should be made so as to substitute the amounts of the allowances for the depreciation charged.

206 (4) Where the amounts chargeable in future for depreciation are materially in excess of the allowances obtainable for taxation purposes (for example, because the assets include assets on which no allowance for taxation is obtainable, or because of a writing-up of assets on a revaluation, or because of the acquisition of a business on terms that the purchase price of depreciating assets is materially in excess of the amount on which allowances for taxation purposes are available to the purchaser):

(a) The report should indicate the extent of the excess of the depreciation chargeable over the taxation allowances obtainable for the year immediately subsequent to the period covered by the report;

(b) The report should also indicate that owing to the disallowance for taxation purposes of this excess, the sum required to cover it is the gross amount which after deduction of income-tax and profits-tax will leave a net amount equal to the excess.

207 (5) Where a valuation of fixed assets is adopted for the purposes of the books and accounts:

(a) It is not normally appropriate or practicable, in a report dealing with a period during which there have been material changes in price levels, to make consequential adjustments in the depreciation provisions for past years;

(b) The report should, however, indicate the approximate future annual provision computed on the basis of the valuation and should give a comparison thereof with the actual provision made in arriving at the profit or loss shown in the report for the last year covered thereby.

208 (6) Where a valuation of fixed assets is used by the directors in the prospectus in order to indicate the assets cover for the issue, but the valuation is not adopted for the purposes of the books and accounts:

(a) The report should not include figures based on, or a reference to, a valuation in excess of the amounts standing in the books;

(b) Before consenting (under Section 40, Companies Act, 1948) to the inclusion of their report in the prospectus, the accountants should either:

(i) Ascertain from the directors that the directors' estimates of future profits available for dividend, as shown in the prospectus, have been arrived at after appropriate deductions have been made for the profits which it will be necessary to retain as reserves (including profits set aside for the redemption of preference shares or debentures) in order to maintain the assets cover indicated in the prospectus; or

(ii) If such deductions have not been made, satisfy themselves that the disclosure is sufficient to show how far the directors have taken this factor into account.

209 (7) In the case of a holding company effect should be given to the foregoing recommendations where either:

(a) The cost of its shares in subsidiaries is materially in excess of the amount at which the underlying net assets are carried in their books and a material part of the excess relates to fixed assets which are subject to depreciation; or

(b) There is used in the prospectus a valuation of the fixed assets of the subsidiaries which is materially in excess of the amount at which such assets are carried in their books or (in a case where the valuation has been adopted by the subsidiaries for the purposes of their books and accounts) were so carried immediately prior to their adoption of the valuation.

210 (8) In the foregoing recommendations references to 'allowances for taxation purposes' should normally be interpreted as the annual allowances (other than initial allowances, balancing allowances and similar items) obtained for income-tax purposes for the fiscal years of which the financial years are the basis years. In some cases, however, it may be more appropriate to apply the allowances for profits-tax purposes. The circumstances of companies differ greatly and each case should be examined on its merits. In order to obtain a fair basis of comparison it may, for example, be necessary in some cases to take into account, whether by way of spreading or otherwise, initial and balancing allowances and charges, particularly in respect of assets which have a short effective life or where the aggregate depreciation charges over a long period are being compared with the corresponding aggregate taxation allowances.

N14 *The form and contents of accounts of estates of deceased persons and similar trusts*

(Issued 12th August 1949)

The Council of the Institute of Chartered Accountants in England and Wales makes the following recommendations to members of the Institute in respect of the accounts of certain types of trust. Whilst it is recognised that the form in which accounts are submitted is, subject to the observance of any legal considerations affecting the accounts, a matter within the discretion of the trustees, it is hoped that these recommendations as to what is regarded as the best practice will be helpful to members who act as trustees, or whose advice or assistance may be sought by trustees.

211 The purposes for which trust accounts are prepared are in essence the same as those for which other accounts are prepared. These purposes are to record the transactions of persons entrusted with administration or management and to convey to interested parties information relating to those transactions and the position achieved thereby. In the case of executorship and similar trust accounts the interested parties will normally be the trustees, the persons entitled to life-interests and the ultimate beneficiaries. Information from the accounts may also be required for taxation and other purposes.

212 In addition to being accountable for money and other assets coming into their hands, trustees are responsible for the administration of the trust estate. The extent of their responsibility will therefore not be apparent unless the periodical accounts show both aspects. To show both aspects involves the recording of all the assets and liabilities of the estate, so that a balance sheet will show the position of the estate as a whole and not merely the position regarding those assets which have come into the hands of the trustees. In many cases it also involves the distinguishing of realised estate from unrealised estate.

213 There is a fundamental distinction in executorship and similar trust accounts between transactions on 'income' account and those on 'capital' account. Unless this distinction is made clear in the periodical accounts they will not reveal the respective positions of life-tenants and remaindermen, whose interests may be conflicting. To make the distinction clear, it is necessary to prepare separate capital accounts and income accounts and to distinguish in the balance sheet between capital and income items.

214 Beneficiaries are frequently persons with little knowledge of accounting but with considerable interest in the trust estate or its income. The importance of simplicity and clarity in trust accounts cannot therefore be over-emphasised. The position shown by the balance sheet, the income account and the estate capital account will not readily be apparent if they are overloaded or obscured by detailed information. Details can conveniently be shown in schedules and subsidiary accounts, cross-referenced to the main accounts. In this way it is possible for trustees and beneficiaries to appreciate the general position of the estate as disclosed by the main accounts, whilst at the same time the totals included in those accounts are supported by full details for those who may be interested in particular items. The trustees may consider it desirable, in the interests of all parties, that they should sign the periodical accounts and that beneficiaries should formally signify agreement with their personal accounts. The adoption of this course is greatly facilitated by simplicity in the presentation of the accounts.

215 Legal considerations, including questions such as equitable apportionment between capital and income, affect the accounts of trustees. It is therefore necessary for the trustees to have regard to all relevant statute and case law and also to the terms of the will or other trust instrument, which may expressly exclude the operation of legal rules which would otherwise apply. This recommendation does not purport to deal with the legal aspects of such matters; these may need consideration by the trustees' legal advisers.

216 It may become necessary for trustees to satisfy the requirements of a court of law. In such cases the requirements of the court will depend upon the nature of the proceedings. Normally, the first concern of the court is in relation to the accountability of the trustees and the court may therefore require the trustees' transactions to be examined in conjunction with the appropriate vouchers. This recommendation does not deal with the form in which accounts may be required

by the court; but if the books and records are kept on the principles recommended below they should provide the information to enable the trustees to satisfy the court's requirements where it becomes necessary to do so at any time.

217 Accountants are frequently called upon to prepare accounts for trustees. In such cases the accountants may deem it necessary to submit with the accounts, which are the responsibility of the trustees, a report explaining the principles adopted in their presentation and drawing attention to particular factors, problems or outstanding matters. This recommendation does not deal with the form of such reports, although it may facilitate their preparation. Nor does the recommendation deal with the form of report required where accountants are called upon to audit accounts prepared by or for trustees.

218 The recommendations below relate to the accounts of the estates of deceased persons and similar trusts. It will be understood that references to legacy and succession duties are not relevant in the case of estates affected by the abolition of these duties by the Finance Act, 1949. In view of the considerable diversity of purposes for which and circumstances in which trusts are created, the recommendations may not apply fully throughout the entire field of trust accounts; but it is considered that in all trusts the fundamental principles do not differ in substance from those now recommended. It may be desirable to emphasise that trusts are so varied in their nature that there must be flexibility in the manner of presenting accounts. A standard form to suit every trust is neither practicable nor desirable.

Recommendations

It is therefore recommended that the following principles should normally be applied by members of the Institute in connection with the books and the preparation of accounts of estates of deceased persons and, with modification of detail or expression, the accounts of similar trusts.

General principles

219 (1) The books should contain all the information from which, in the light of the trust documents and legal considerations, periodical statements of account can be prepared. They should give all the material that may be required at future dates (possibly long deferred) for any review of the transactions of the trustees. The only satisfactory way of achieving this is to keep the books on ordinary double-entry principles, the entries being detailed fully and supplemented where appropriate by subsidiary records such as an investment register.

220 (2) The periodical accounts prepared from such books should show not only the position at the accounting date, but also full information explaining the administration of both capital and income during the period from the commencement of the trust or since the last account. In addition to recording all transactions for the period under review, it may be desirable in certain cases to summarise the capital transactions from the inception of the trust to the date of the accounts.

221 (3) Income and capital transactions should be segregated clearly. This may often be facilitated by the use of separate columns in cash books and ledgers.

222 (4) Periodical accounts should normally consist of:

(a) Balance sheet of the whole of the trust estate, including separate trusts arising out of the will or other trust instrument.

(b) Estate capital account, summarising the transactions on capital account since the date of death or the last account, with separate accounts on a similar basis for any special funds.

(c) Income account, with separate accounts for any special funds.

(d) Schedules and subsidiary accounts explaining in greater detail the major items appearing in the balance sheet, capital accounts and income accounts.

223 (5) The balance sheet, the estate capital account and the income account should be presented in the simplest manner possible, all detail being relegated to the schedules and subsidiary accounts.

224 *Note*. – It may be useful to include with the accounts an epitome of relevant provisions of the will or other trust instrument.

225 (6) The date to which accounts are made up should be decided according to the circumstances and will not necessarily be the anniversary of the creation of the trust. As a general rule, having regard to the taxation liabilities of the trust and of the beneficiaries, it may be convenient for accounts to correspond with fiscal years; but in some cases it may be necessary for accounts to be made up to the anniversary of the date of death if the rules of law relating to equitable apportionments are applicable or if there are other special circumstances. The nature of the assets of the trust, the dates on which income is receivable, the due dates of annuities, are all factors that may affect the selection of the most convenient accounting date.

Balance sheet

Grouping

226 (7) The various items in the balance sheet should be grouped under appropriate headings, so that significant totals are readily apparent.

Distinction between capital and income

227 (8) Items relating to capital should be distinguished from those relating to income, either by appropriate grouping to show the aggregate of each or by the use of separate capital and income columns.

Comparative figures

228 (9) Comparative figures should be included if they serve a useful purpose. Normally, however, the supporting schedules (in particular the investment schedules and the capital cash summary account recommended later) will be more informative than a comparison of total figures with those on the previous accounting date.

Estate capital account

229 (10) The capital account in the balance sheet should show the balance of the estate capital, so far as it has been ascertained, after deducting distributions which have been made. In some cases it may be sufficient to show the net figure but in others it will be desirable to show both the gross figure and the distributions to date.

230 (11) Where the value of a material part of the estate has not been agreed for estate duty purposes the position should be explained by note.

Liabilities

231 (12) Liabilities on capital account should include unpaid legacies, outstanding death duties that have been ascertained, unpaid debts owing by the deceased and, so far as they relate to capital, administration expenses accrued due.

232 (13) Balances due to life-tenants should be distinguished from other liabilities on income account.

233 (14) All accruing liabilities on income account will normally have been brought into account (see paragraph (50)). Any material amounts not so brought in (for example, interest accruing on unascertained death duties) should be recorded by note.

234 (15) A note should be made in respect of any known liabilities of which the amounts cannot be determined with substantial accuracy; for example, death duties in dispute or not yet calculable.

235 (16) Contingent liabilities, such as contingent legacies and liabilities that may arise under guarantees given by the deceased, should also be recorded by note.

Assets

236 (17) Realised and unrealised estate should normally be distinguished. This is particularly important if questions of equitable apportionment arise under the rules laid down by the court from time to time in decided cases. The distinction between realised and unrealised estate may cease to be necessary after all questions of equitable apportionment have been dealt with, even where investments of the testator are retained by the trustees or appropriated to settled or other special funds. The distinction should, however, be maintained so long as any of the unrealised investments are of a kind which the trustees, though authorised to retain, would not have been authorised to purchase.

237 (18) Subject to (19) below, assets should be stated at the valuations adopted for estate duty purposes, or at cost to the estate. They should not be adjusted to values shown in the residuary account for legacy duty purposes, or to market values calculated for the purpose mentioned in (21) below. Where, however, special circumstances arise, such as a partial division of the estate in specie, the assets as a whole may be revalued and the accounts may then continue on those valuation figures.

238 (19) The valuations adopted for estate duty purposes will subsequently be reduced in the accounts where a proportion of income received after the date of death is treated as a realisation of capital (see paragraph (48)). Where statutory apportionments are excluded by the trust instrument, so that the whole of the income received is credited to income account, it may nevertheless be necessary to adjust both the asset account and the estate capital account, especially if the proportion of income relating to the period up to the date of death is material; such an adjustment would always be required where, for estate duty purposes, accrued interest receivable had been added to the amount of a mortgage, or the full amount of dividend had been added to shares quoted ex-dividend.

239 (20) The nominal amounts of investments should not be used as values for accounting purposes. They should, however, be noted in the supporting schedules (see paragraph 63 (a)).

240 (21) Quoted and unquoted investments should be segregated and the aggregate market value of the quoted investments stated by note. The details in relation to each investment should appear in the schedules supporting the balance sheet totals.

241 (22) It may be desirable to make a further classification of investments showing a separate group total for each class; for example, properties, trustee stocks, other stocks, mortgages.

242 (23) The composition of cash and bank balances as between capital, income and special funds should be shown. If the grouping adopted for the balance sheet as between capital, income and special funds makes it necessary, one bank balance will have to be divided so that the appropriate amounts appear under their proper headings in the balance sheet.

243 (24) A note should be made in respect of any known assets of which the amounts cannot be determined with substantial accuracy; for example, reversions and claims for damages.

Special funds

244 (25) Where special funds arise by reason of the existence of separate trusts or settled funds within the main administration, the capital and liabilities of such special funds should be stated under separate headings and the corresponding assets should also be stated separately.

Estate capital account

245 (26) The estate capital account should explain in appropriate detail the capital account balance shown in the balance sheet.

Assets and liabilities at date of death

246 (27) For the first accounting period the capital account should show the assets and liabilities at the figures included for estate duty purposes, a balance being struck to show the net estate as declared for duty and sub-divided, if necessary, to show:

(a) property liable to duty;

(b) property not liable until falling into possession;

(c) property exempt from duty.

247 (28) Changes arising from corrective affidavits in subsequent accounting periods should be brought into account in those periods.

Estate duty

248 (29) Where appropriate the capital account should show the total on which estate duty is payable, the rate of duty and the amount paid; also, the information relating to estate duty should include matters such as the lower rate of duty applicable to agricultural property, marginal relief and a reference to any property which is aggregable for duty purposes though not forming part of the estate for which the trustees are accountable.

249 (30) In some cases the agreement of valuations for estate duty purposes may be a protracted matter extending over several years; for example, where the estate includes unquoted shares, shares in controlled companies, business goodwill or unusual complications. Where such a position arises the fact of the estate duty being provisional should be stated with an indication, where appropriate and practicable, whether the outstanding amount involved may be material.

250 (31) Any other material matters affecting the estate duty should also be stated in the capital account.

Trustees' transactions

251 (32) The capital account should record, suitably classified and in adequate detail, the transactions of the trustees showing the extent to which the estate has been increased (for example, by surpluses on realisations) and decreased by the payment of estate and succession duties, administration expenses, legacies and by appropriations to special funds, deficiencies on realisations, or otherwise.

Apportionments

252 (33) The provisions of the trust instrument as affecting statutory and equitable apportionments should be observed.

253 (34) Normally the capital account is not affected by the receipt of income of which a proportion relates to the period up to the date of death (see paragraph (48)). Where, however, statutory apportionments are excluded by the trust instrument it may be necessary to make an adjustment to both the capital account and the relevant asset account (see paragraph (19)).

254 (35) Where it has been necessary to make an equitable apportionment any amount credited to capital should be stated separately.

255 (36) Where there have been payments of succession duty or legacy duty, an indication should be given of whether the whole has been charged to capital or whether some part has been apportioned to income.

Outstanding liabilities

256 (37) All outstanding liabilities of material amount affecting the capital account should normally be provided for. (Liabilities not provided for should be noted on the balance sheet, as stated in paragraphs (15) and (16)).

Comparative figures

257 (38) Comparative figures for the preceding period will not normally serve a useful purpose in the capital account.

Cumulative totals

258 (39) Cumulative totals from the commencement of the trust should be included where it is of advantage to do so.

Special funds

259 (40) Special funds, dealt with separately in the balance sheet, should have their separate capital accounts.

Income account

260 (41) The income account should be presented in such a form as to give a clear disclosure of the transactions of the period and the amount available for division.

261 (42) All items involving considerable detail, such as investment income, should be included in total only, with appropriate reference to supporting schedules.

262 (43) The selection of a suitable accounting date (see paragraph (6)) should be regarded as an important factor in the presentation of the income account; for example, where the question of annuities and the income from which they are paid arises.

Income

263 (44) The income account should normally include all income received within the period of the account.

264 (45) The trustees are not normally required to account for income until it has been received, so that the account should not include income which though due at the accounting date has not been received. Where however a material item of income, due and normally received within the accounting period, has not been received, it may be desirable, in order to avoid distortion, to include the amount due with a corresponding debtor item in the balance sheet, provided it has since been received; if this is not done the account should indicate by note the item which has not been so included.

265 (46) Items such as rents collected but still in the hands of agents should be regarded for accounting purposes as having been received by them on behalf of the trustees and therefore brought into the income account with a corresponding item of debtors in the balance sheet.

266 (47) Items should be grouped in appropriate classification; for example, interest on government securities, dividends, interest on mortgages, rents, business profits, credits from realised capital on equitable apportionments.

267 (48) Where income is received which relates to a period partly before and partly after the date of death, the income account should be credited only with the proportion which has accrued since that date, unless there are contrary instructions in the trust instrument. The balance should be treated as a realisation of capital and credited to the relevant asset account. This principle applies whether an apportionment was included specifically in the valuation for estate duty purposes or was deemed to be included in the valuation of investments at the date of death.

268 (49) Dividends, interest and other income received under deduction of tax should normally be stated at the gross amount (see paragraph (52)).

Expenditure

269 (50) The income account should include all amounts payable in respect of the accounting period, including amounts accrued up to the accounting date but not then due for payment. This accrual basis should normally be applied to all items, including annuities, chargeable to the income account.

270 (51) Items of expenditure should be grouped in appropriate classification; for example, annuities, interest on estate and succession duties, interest on bank overdraft, transfers to capital as a result of equitable apportionments, income-tax, administration expenses, succession duty (if any) apportioned to income and any legacy duties chargeable to income (indicating whether any part of the legacy duty on the residuary account, representing duty on income falling into the residuary estate, has been charged to income).

Income-tax

271 (52) The charge for income-tax should normally represent the full charge falling on the estate income, namely, tax under direct assessments *plus* tax deducted at source less tax recovered under repayment claims by the trustees and tax deducted from payments. This necessitates the inclusion of interest, annuities and similar items at the gross amount (whether or not tax was deducted by the trustees) and the inclusion of income at the gross amount (whether or not received less tax). Such treatment, besides showing the true incidence of income-tax on the trust income, facilitates comparisons with income and expenditure of other periods.

272 (53) If the income-tax details are considerable it is desirable to show them in a separate schedule.

273 (54) Where the income-tax charge arrived at in accordance with (52) above does not represent income-tax at the standard rate on the estate income, the position should be explained by note or narrative and if necessary in the schedule. This position may arise, for example, where trustees pay income-tax under direct assessments after deduction of life-tenants' personal allowances, or where foreign income or other complications arise.

274 (55) In some cases it may not be practicable to follow the normal procedure referred to in (52) above; for example, where there are special difficulties arising from annuities free of income-tax and sur-tax. In such cases the income account should indicate clearly the treatment adopted.

Balance of income

275 (56) The income account should show the balance available after meeting expenditure chargeable against income and the manner in which the balance has been applied by the trustees; for example, amounts divided amongst the beneficiaries and transfers to accumulations accounts, indicating the bases of division in cases such as those where adjustment is required for interest on advances of capital to beneficiaries.

Comparative figures

276 (57) Comparative figures of income and of expenditure for the preceding accounting period should be stated if appropriate.

Schedules and subsidiary accounts

277 (58) Whenever possible, detail should be relegated to schedules and subsidiary accounts, leaving only the significant totals in the main accounts.

278 (59) Appropriate cross-references should be given both in the main and the subsidiary documents.

Investments

279 (60) Unless investments are so few that they can be detailed conveniently in the main accounts, a separate schedule should be prepared.

280 (61) The schedule should be so drawn as to enable totals in the main accounts to be identified readily. The grouping of the items in the schedule should therefore correspond with the grouping adopted in the balance sheet and it may be necessary to have more than one schedule.

281 (62) Special funds dealt with separately in the balance sheet or income account should in any case have their separate schedules.

282 (63) The following information should be given in the investment schedules(s), either in detail or by appropriate summaries, by the use of separate columns or otherwise:

(a) Description and nominal amounts of investments, with estate duty value in the case of the testator's investments (see paragraph (18)) and cost or other book amounts of the trustees' investments; also, in the case of all quoted investments, the market value on the accounting date.

(b) In the case of mortgages, details of the amount, security, rate of interest and due date thereof, with particulars of any arrears of interest.

(c) The gross amount, the income-tax deducted and the net amount of interest and dividends.

(d) The periods in respect of which income has been received and the rates of dividend, with any appropriate comments.

(e) Purchases and sales of investments during the period and any surpluses or deficits arising on realisation.

(f) Statutory apportionments of dividends between capital and income, shown item by item. (Equitable apportionments do not usually fall to be dealt with item by item. Any entries in the capital and income accounts for these apportionments should be explained by narration or by reference to a separate schedule if appropriate.)

(g) In the case of real estate and leasehold estate, the estate duty value or cost or other book amount where available, with such details as tenure held, property expenses suitably analysed, rents received and particulars of any arrears.

Accounts with beneficiaries

283 (64) Accounts with beneficiaries should normally be presented. This is particularly important where the details are involved; for example, where there are periodical payments on account of income, accumulations accounts, maintenance accounts, or other special complications.

Capital cash summary account

284 (65) A capital cash summary account, containing in summarised form all significant information regarding the receipts and payments on capital account during the period covered by the accounts, should be presented where it is desirable to do so. The information shown by such a summary account will not normally be apparent in the estate capital account, which includes transactions other than receipts and payments. The summary account therefore provides a link between the capital cash shown in the balance sheet and that shown in the previous balance sheet.

Other schedules

285 (66) Examples of other matters for which separate schedules should be prepared, where the detail involved makes it desirable, are the following:

(a) Debts due by the deceased, giving suitable particulars where the amounts paid differ from probate figures.

(b) Debts due to the deceased, giving suitable particulars where the amounts received differ from probate figures.

(c) Executorship or administration expenses on both income and capital accounts.

(d) Pecuniary and specific legacies, showing the rates and amounts of legacy duty, the legacies paid or satisfied and whether the estate or the legatees were liable for the duty.

N15 *Accounting in relation to changes in the purchasing power of money*

(Issued 30th May 1952)

In amplification of its recommendation 12 on RISING PRICE LEVELS IN RELATION TO ACCOUNTS*, the Council of The Institute of Chartered Accountants in England and Wales makes the following statement to members of the Institute. This statement is designed to present in conjunction with recommendation 12 a brief description of the limitations on the significance of accounts prepared on the generally accepted basis known as historical cost, to examine the main suggestions so far made for new principles designed to overcome those limitations, and to make recommendations as to the procedure which should be followed in preparing annual accounts unless and until a generally acceptable alternative to the historical cost basis of accounting is available. The whole subject of accounting in relation to changes in the purchasing power of money is of such importance that the Council proposes, after the International Congress on Accounting in June 1952, to invite other professional bodies to join with it in further study of the subject. Pending the outcome of such further study, it is hoped that this statement will be helpful to members whose advice may be sought by clients, or who have responsibilities as directors or officers of companies.*

Accounting based on historical cost

286 The primary purpose of the annual accounts of a business is to present information to the proprietors, showing how their funds have been utilised and the profits derived from such use. It has long been accepted in accounting practice that a balance sheet prepared for this purpose is as an historical record and not a statement of current worth. Stated briefly its function is to show in monetary terms the capital, reserves and liabilities of a business at the date as at which it is prepared and the manner in which the total moneys representing them have been distributed over the several types of assets. Similarly a profit and loss account is an historical record. It shows as the profit and loss the difference between the revenue for the period covered by the account and the expenditure chargeable in that period, including charges for the amortisation of capital expenditure. Revenue and expenditure are brought into the account at their recorded monetary amounts. This basis of accounting is frequently described as the historical cost basis and in this statement the expression ‘monetary profits’ is used to denote profits so computed.

287 An important feature of the historical cost basis of preparing annual accounts is that it reduces to a minimum the extent to which the accounts can be affected by the personal opinions of those responsible for them. For example, the cost of a fixed asset is known so that in calculating depreciation provisions based on that cost the only respects in which estimates enter into the matter are in relation to the probable useful life of the asset and its realisable value, if any, at the end of its life. Depreciation provisions computed on this basis are intended, by making charges against revenue over the useful life of an asset, to amortise the capital expenditure incurred in acquiring it. For this purpose, estimates of current value or of replacement cost do not arise. Again, there are limits within which estimates and opinions can properly operate in relation to stock-in-trade, provided the bases of calculation are sound in principle and used consistently.

288 The significance of accounts prepared on the basis of historical cost is, however, subject to limitations, not the least of which is that the monetary unit in which accounts are prepared is not a stable unit of measurement. During a period of rising prices a decrease occurs in the purchasing power of cash and bank balances and assets such as bad debts and investments carrying fixed rates of interest or dividend, but this decrease is not treated as a reduction of business profits; nor are business profits shown as being increased by the benefit derived from the fall in the burden, expressed in terms of purchasing power, of loans and other liabilities incurred before the rise in prices but payable in currency of diminished purchasing power. Moreover, the monetary cost at which stock-in-trade is charged against revenue is not sufficient, during a period of rising prices, to meet the cost of replacing the same quantity of stock; and similarly depreciation charges based on the monetary cost of fixed assets will not provide the amount required to meet the cost of replacement of those assets at higher prices if and when they need to be replaced.

289 Monetary profits do not therefore necessarily reflect an increase or decrease in wealth in terms of purchasing power; and in times of material change in prices this limitation upon the significance of monetary profits may be very important. It would be a major development in the building up of a coherent and logical structure of accounting principles if the limitations of accounts based on historical cost could be eliminated or reduced by the adoption of new principles, capable of practical application to all kinds of businesses in a manner which would be independent of personal opinion to a degree comparable with the existing principles based on historical cost.

The main suggestions for new accounting principles

290 The main suggestions which have so far been made for new accounting principles to overcome the limitations of the historical cost basis, may be considered in the following four broad categories:

The replacement cost method of dealing with fixed assets.

The writing-up of fixed assets.

The current value method of dealing with stock-in-trade and depreciation of fixed assets.

The index method of adjusting accounts to reflect changes in the purchasing power of money.

The replacement cost method of dealing with fixed assets

291 The object of the replacement cost method of dealing with fixed assets is to make charges to profit and loss account to provide the amount needed to meet the cost of replacement. Under this method, therefore, provisions for replacement would be charged, instead of depreciation charges designed to amortise the cost of fixed assets over their useful life. The method was followed more extensively in the past than it is today, particularly though not exclusively by public utility undertakings.

292 Considerable uncertainty attaches to the calculations required by the replacement cost method. Unless an asset is to be replaced within a very short period, the replacement cost cannot be estimated with any accuracy and the method therefore leaves wide scope for extremes of personal opinion in determining each year the charge to be made in computing profits. Moreover improved methods of production and new inventions often render existing plant obsolete with the result that when it is replaced the new equipment is of a different character from the old.

293 In conditions where prices continue to rise, the uncertainty of the method is emphasised because the estimated replacement cost of assets increases year by year. If each year's charge has been calculated on the basis of one year's proportion of the replacement cost estimated at the time of making the calculation, then the aggregate of the amounts so provided will not be sufficient to meet the actual cost of replacement. If in order to meet this difficulty the calculation each year is made on a cumulative basis so as to make up the deficiency in past provisions, the effect would be to place undue burdens upon particular years. On the other hand if the deficiency were not so made good, the amounts shown as profits would not have been arrived at after providing for the replacement of fixed assets. In the latter event, the effect of applying the method would be to show as profits each year amounts which are neither monetary profits nor profits after providing fully for the replacement of fixed assets; the more persistent the rise in prices the less significance the profits computed in this way would have, because each further rise in prices would increase the deficiency in the past provisions.

294 In addition to the foregoing difficulties of calculation and treatment, the method involves other considerations which become apparent when replacement occurs. At that point two courses are open, namely either (a) to bring into the balance sheet the cost of the new asset, thus maintaining in the balance sheet the cost of the fixed assets in current use; or (b) to charge the cost of the new asset against the accumulated replacement provisions. If the first course is followed the cost of the asset replaced will be charged against the accumulated replacement provisions; but if prices have been rising these provisions will exceed the amount charged against them and this excess will be treated as a reserve, thus being recognised in the balance sheet as part of the proprietorship interest. This involves the inconsistency that the profits of each year during which the provisions are accumulated will be ascertained after deducting amounts which it is known must in due course be recognised as reserves and could become available for distribution to proprietors. Such a reserve would not be disclosed in the balance sheet if the second course were followed (namely the charging of the cost of the new asset against the accumulated replacement provisions), because the balance sheet would not show the cost of

existing assets; instead it would continue to include the cost of the asset which has been replaced and if this procedure were followed on each successive replacement the amount standing in the balance sheet would be the original cost of an asset which may have been replaced many times.

295 Another consideration arises in a period of falling prices when replacement would cost less than historical cost. If each year's charge is calculated on the basis of one year's proportion of the replacement cost estimated at the time of making the calculation, then the aggregate of the amounts so provided will fall short of the amount required to amortise the cost of the existing assets. It cannot be assumed that there will be reserves against which to charge the deficiency and it would therefore seem that the charge must be to the profit and loss account. The effect of such a charge would be to adjust the aggregate depreciation charges to what they would have been under the historical cost method. The replacement cost method is therefore not capable of application in a period of falling prices, unless an additional charge is made in order to provide for the full amortisation of capital expenditure actually incurred.

The writing-up of fixed assets

296 In some countries businesses have been permitted for taxation purposes to write-up fixed assets in accordance with a legally established index and thereafter to charge depreciation on the written-up amounts.

297 The writing up of fixed assets has the effect of treating the business as ceasing and starting afresh on a new basis as from the date of writing-up; and this is why it is in practice considered to be appropriate and desirable in certain special circumstances, such as where a subsidiary is acquired and the assets are written-up to reflect the cost to the acquiring company, or where subscriptions for new capital are invited on the basis of a current valuation of the assets. Apart from such special purposes, the writing-up of assets appears to be suitable only for the readjustment of all balance sheets by government action as part of a process of stabilising a currency.

298 If fixed assets are written up, the subsequent charges for depreciation will be the amounts required to amortise the written-up amounts of the assets over their remaining life. The figures shown as profits for years subsequent to the writing-up will therefore be arrived at after charging depreciation on amounts which are neither the historical cost nor the estimated replacement cost of the fixed assets. If the writing-up were not based on a legally established or generally accepted index there would be wide scope for the factor of personal opinion in so computing depreciation charges. The method also involves an inconsistency similar to that arising under the replacement cost method. At the time of writing-up, the excess of the written-up amount over the historical cost of the assets concerned would be treated in the balance sheet as a capital reserve; later, when the written-up amount has been fully amortised by subsequent depreciation charges, the reserve could become available for distribution to the proprietors although it will never have appeared as profit in the profit and loss account.

The current value method of dealing with depreciation and stock-in-trade

299 The object of the current value method of dealing with depreciation and stock-in-trade is to express charges for consumption of assets in current values and not in terms of the monetary cost of the assets consumed.

300 Charges for depreciation of fixed assets would not be regarded as the spreading of historical cost or as provisions for future replacement. They would be regarded as a measurement of asset consumption during the year, calculated by applying the depreciation rates to the estimated current value of the fixed assets instead of to their historical cost. Broadly the effect would be that the charges in any particular year for depreciation of fixed assets would be adjusted to approximately what they would have been if the assets had been purchased at prices ruling in that year instead of when they were in fact purchased. Some advocates of this basis of ascertaining profits suggest that the method by which the current value of fixed assets is estimated should be that best suited to the particular type of business; for example valuation by the company's engineering staff, or current insurance values, or price indices according to the year of purchase. Such a proposal serves to emphasise the dependence of the method upon personal opinion.

301 In a period of rising prices when current values are greater than historical cost, the depreciation charges calculated on current values would exceed depreciation calculated on historical cost and the method requires this excess to be shown in the balance sheet as a capital reserve. This would involve the inconsistency that an amount which is treated as a deduction in computing profits is recognised in the balance sheet as forming part of the interest of the proprietors and could even

become available for distribution to them in the event of the reserve being regarded as no longer of a capital nature. In a period of falling prices when current values are less than historical cost, the method would not be capable of application unless an additional charge were made to provide for the full amortisation of capital expenditure actually incurred.

302 As already indicated, the current value method does not purport to be a means of providing for the replacement of fixed assets. If therefore prices continue to rise and it were desired to accumulate the full amount required to replace fixed assets, it would be necessary to set aside additional sums over and above the depreciation charges calculated on current values. These additional sums would be treated in the profit and loss account as transfers to reserve. The total reserve shown in the balance sheet under the current value method would then be the same as that which can be achieved under existing accounting principles; but whereas under existing principles the creation of that reserve would be shown in the profit and loss account as having been made out of profits, under the current value method part of the amount taken to reserve would be treated, as stated in the preceding paragraph, as a charge in arriving at profits.

303 The current value method also requires charges for consumption of stock-in-trade to have regard to current values rather than to historical cost. Some advocates of the method suggest that the manner of charging consumption in current values should be left open for consideration in the special circumstances of each case but that certain methods of valuing stock-in-trade, namely LIFO (last in, first out), NIFO (next in, first out) base stock and variants of these should be recognised as means of achieving the desired end and that whatever method is adopted should be indicated in the accounts.

304 In a period of rising prices the effect of charging consumption of stock-in-trade on the basis of current values would be that the difference between the cost of an article and the higher amount for which it could be replaced at the time of its sale would not form part of the profit on the transaction. In a period of falling prices when stock-in-trade could be replaced at less than its historical cost, the current value method could not be applied unless an additional charge were made to cover the excess of the historical cost over the current value. Whether prices are rising or falling, however, the difference between the cost of an article and its current value may often result to a much greater extent from market fluctuations in the prices of particular goods than from any general trend in the purchasing power of money. Such market fluctuations are an ordinary business hazard affecting profit or loss and their incidence on a particular business may be dependent to a considerable extent upon judgement in buying and on management generally, whereas under the current value method the effect of these fluctuations would be excluded in computing profits.

The index method of adjusting accounts to reflect changes in the purchasing power of money

305 The object of the index method of adjusting accounts is to eliminate from profits the effect of fluctuations in the purchasing power of money.

306 The method is not strictly a proposal for a change from accounting based on historical cost; it is more in the nature of a proposal for adjusting accounts which have been prepared on the basis of historical cost. The ascertainment of profits involves bringing together in one account monetary amounts for transactions which have taken place not only at various times during the period covered by the account but also at various times in other periods, for example, stock-in-trade at the commencement of the period and fixed assets acquired many years earlier. The theory of the index method is that if there has been a change in the purchasing power of money between the time when a transaction was entered into and the date as on which the accounts are prepared, the currency in which the transaction took place was a currency different from that now in use and must be converted into the new currency. For the conversion process an index of purchasing power would be used.

307 The technique of applying the index method need not present insuperable difficulties if a satisfactory index were available, although there could be considerable complications in respect of businesses with complex capital structures. An important practical consideration would be that in order to enable the index method to be applied as part of normal accounting procedure, it would be essential for the index to be available in an up-to-date form month by month; otherwise it would not be available for use as and when required by a particular business for the rapid production of the annual accounts at the normal accounting date. It would seem from the theory underlying the index method that it must apply not merely to transactions effected in earlier years, such as the purchase of fixed assets or stock-in-trade held at the beginning of the accounting period, but also to transactions during the accounting period if during that period there have been material changes in the purchasing power of money.

308 Unless all items were converted into the 'new currency' and not merely selected items such as depreciation of fixed assets and consumption of stock-in-trade, the account would not, in a period of rising prices, reflect the loss in purchasing power arising from the holding of assets such as investments, debtors and bank balances or the gain arising on liabilities of fixed monetary amount. In businesses where such items are material in relation to fixed assets and stock-in-trade it would be inconsistent to ignore such losses and gains and to take into account only those arising on particular types of assets. To do so would not enable the effects of the diminution in the purchasing power of money to be measured so that they can be eliminated in ascertaining profits or losses. Similar considerations arise in a period of falling prices.

309 Application of the theory underlying the index method would require an index which represents changes in the purchasing power of money and not indices of changes in the prices of particular articles. If an index of purchasing power were not used, it would be necessary to use different indices for various items in the accounts of any one business; this procedure would be a means of applying the current value method to stock-in-trade and depreciation but it would not measure the effect of changes in the general purchasing power of money which is the object of the index method. The view might be taken that the use of an accurate index of changes in general purchasing power is not important and that any reasonable index could enable the effects of such changes to be measured with sufficient accuracy, provided the same index were used by all businesses. On the other hand, prices do not move uniformly for all articles and commodities, so that the application of a general index to a particular business could well be inappropriate. Moreover the effect on a particular business of changes in the purchasing power of money may be offset by the benefits derived from technical improvements. The whole theory of the index method therefore needs further examination before it could be accepted as a valid method of adjusting accounts prepared on the basis of historical cost.

310 If it were established that the theory of a general purchasing power of money is valid and a satisfactory index could be prepared, there would remain the important question of the purpose for which the index method is to be applied. If it were used merely as a means of measuring the effects on the affairs of a business of changes in the purchasing power of money, for the purpose of giving this information in statements supplementary to accounts prepared on the basis of historical cost, it might give information which would be of interest to the management and proprietors. If however the index method were accepted as a means of introducing a new conception of profit, it would carry implications which extend far beyond accounting matters.

Economic and social issues

311 The adoption of any new conception of profit, whether based on the replacement cost method, the writing-up of fixed assets, the current value method, or the index method, would raise much wider questions than the computation of business profits. A conception based on the index method would raise the whole question of the effect of changes in the purchasing power of money on rights expressed in monetary terms. Important economic and social issues would then need consideration and some of these would also arise if a conception of profit based on any of the other three methods were adopted. The following are some of the questions which would need consideration:

(a) Whether there should be legal recognition of changes in the purchasing power of money so as to adjust legal rights which have been expressed in terms of money; for example investments in government and other stocks and shares, rents under leases, pensions, insurance policies, debentures and other liabilities, rights under service agreements and profit sharing schemes to incomes which are dependent on or vary with profits, and the relative rights of life tenants and remaindermen.

(b) The determination of prices of goods and services, particularly the question whether a new conception of profit would make it necessary for prices to be raised in order to enable a business to pay a fair return to investors, or indeed to make a profit at all; in other words whether the effect would be to cause a further fall in the purchasing power of money and thereby aggravate the problem.

(c) The relative position for taxation purposes of different kinds of businesses and of persons having money incomes, including employees and pensioners of businesses. In the United Kingdom the basis and scale of taxation seriously restrict the extent to which monetary profits may be retained in businesses to meet the increased capital requirements imposed by diminution in the purchasing power of money. A new conception of business profits designed to alleviate this situation would raise the question of what is the proper taxable income of other classes of taxpayer; in a period of rising prices it would relieve businesses of a large amount of taxation and would therefore raise the further question of how the burden of that relief is to be distributed over other taxpayers.

(d) The effect on the raising of capital for business undertakings if such capital is to be raised on the basis that before dividends can be paid the purchasing power of the capital employed in the business must be maintained, as distinct from the existing position under which it is a matter of policy for directors to consider to what extent monetary profits are to be regarded as available for distribution and to what extent it is desirable to retain profits to meet the future requirements of the business.

(e) The position in the event of the purchasing power of money being increased by falling prices, particularly if the effect of a new conception of profit were to be that the contributed capital would cease to be intact.

(f) The position of persons who have acquired investments on the basis of annual accounts or prospectus statements prepared in accordance with existing accounting principles, if the adoption of a new conception of profit would result in dividends, including those on preference capital, whether or not cumulative, being reduced or passed.

These issues affect not merely every business but also every individual and they involve major considerations of general monetary and social policy which go far beyond the question whether one accounting method of computing business profits is more free from limitations than another.

Conclusions and recommendations

312 The Council cannot emphasise too strongly that the significance of accounts prepared on the basis of historical cost is subject to limitations, not the least of which is that the monetary unit in which the accounts are prepared is not a stable unit of measurement. In consequence the results shown by accounts prepared on the basis of historical cost are not a measure of increase or decrease in wealth in terms of purchasing power; nor do the results necessarily represent the amount which can prudently be regarded as available for distribution, having regard to the financial requirements of the business. Similarly the results shown by such accounts are not necessarily suitable for purposes such as price fixing, wage negotiations and taxation, unless in using them for these purposes due regard is paid to the amount of profit which has been retained in the business for its maintenance.

313 On the other hand the alternatives to historical cost which have so far been suggested appear to have serious defects and their logical application would raise social and economic issues going far beyond the realm of accountancy. The Council is therefore unable to regard any of the suggestions so far made as being acceptable alternatives to the existing accounting principles based on historical cost.

Recommendations

314 Unless and until a practicable and generally acceptable alternative is available, the Council recommends that the accounting principles set out below should continue to be applied:

(a) Historical cost should continue to be the basis on which annual accounts should be prepared and, in consequence, the basis on which profits shown by such accounts are computed.

(b) Any amount set aside out of profits in recognition of the effects which changes in the purchasing power of money have had on the affairs of the business (including any amount to finance the increase in the cost of replacements, whether of fixed or current assets) should be treated as a transfer to reserve and not as a charge in arriving at profits. If such a transfer is shown in the profit and loss account as a deduction in arriving at the balance for the year, that balance should be described appropriately, since it is not the whole of the profits.

(c) In order to emphasise that as a matter of prudence the amount so set aside is, for the time being, regarded by directors as not available for distribution, it should normally be treated as a capital reserve.

(d) For balance sheet purposes fixed assets should not (except in special circumstances, such as those referred to in paragraph 297) be written-up, especially in the absence of monetary stability.

315 The Council also recommends to members who are directors or officers of companies or who are asked by clients for advice, that they should stress the limitations on the significance of profits computed on the basis of historical cost in periods of material changes in the purchasing power of money; and that they should draw attention to the desirability of:

(a) Setting amounts aside from profits to reserve in recognition of the effects which changes in the purchasing power of money have had upon the affairs of the business, particularly their effect on the amount of profit which, as a matter of policy, can prudently be regarded as available for distribution.

(b) Showing in the directors' report or otherwise the effects which changes in the purchasing power of money have had on the affairs of the business, including in particular the financial requirements for its maintenance and the directors' policy for meeting those requirements, either by setting aside to reserve or by raising new capital.

(c) Experimenting with methods of measuring the effects of changes in the purchasing power of money on profits and on financial requirements. If the results of such experiments are published as part of the documents accompanying the annual accounts, the basis used for the calculations and the significance of the figures in relation to the business concerned should be stated clearly.

N16 *Accountants' reports for prospectuses: adjustments and other matters*

(Issued 13th November 1953)

The Council of the Institute of Chartered Accountants in England and Wales makes the following further recommendations to members of the Institute on certain aspects of the reports required to be given by accountants for the purpose of inclusion in prospectuses, offers for sale and similar documents. Whilst it is recognised that the firm in which such reports are made is (subject to compliance with the Companies Act, 1948, and the regulations of the stock exchanges where applicable) a matter within the discretion of the accountants concerned, it is hoped that these further recommendations will be helpful to members as to what may be regarded as the best practice.

Adjustments generally

316 In the preparation of accountants' reports for the purpose of inclusion in prospectuses (which, where appropriate, should be read as including offers for sale and similar documents) it may be necessary to make various adjustments, in addition to giving consideration to the special matters dealt with in recommendation 13 on ACCOUNTANTS' REPORTS FOR PROSPECTUSES: FIXED ASSETS AND DEPRECIATION. The reports required under the Third, Fourth and Fifth Schedules to the Companies Act, 1948, must either indicate by way of note any adjustments as respects the figures of profits or losses or assets and liabilities dealt with by the report which appear necessary to the persons making the report, or must make those adjustments and indicate that adjustments have been made. There is no statutory guidance as to the nature of the adjustments to be made; the accountants making the report must form their own judgement. Where required by Section 41 (1) of the Act, a signed statement, setting out the adjustments and giving the reasons therefor, must be attached to or endorsed on the copy of the prospectus delivered to the registrar of companies.

317 The accountants' report is necessarily confined to past results and does not purport to deal with future prospects. The intending investor is concerned with the future and he will regard the accountants' report, showing the trend of past results, as being submitted to assist him in forming his own assessment of the prospects. It may therefore be necessary, in order that the trend of past profits may be fairly presented having regard to the purposes of the prospectus, either to make appropriate comments thereon or to adjust the figures.

318 The circumstances in which adjustments to the figures of profits or losses are usually required fall generally under the following headings:

(a) Where there are material facts which should have been taken into account in preparing the profit and loss accounts for the various years covered by the report if those facts had been known at the time when the accounts were prepared.

(b) Where there have been material sources of revenue or categories of expenditure which are expected not to recur.

(c) Where during the period covered by the report there has been a material change in the accounting principles applied or where accepted accounting principles have not been applied.

In considering whether an adjustment is required it is essential to bear in mind that the accountants' duty is to report on past profits or losses and not to attempt to forecast results in future conditions.

319 Adjustments or comments may also be necessary in relation to the statement of assets and liabilities shown in the accountants' report. In particular it will be necessary to consider to what extent it is relevant to include notes which appeared on the last balance sheet and to consider the appropriate treatment of matters such as the market value of investments, the accumulated amount of profits tax non-distribution relief, and reserves for future income-tax. The accountants' report deals with the assets and liabilities as on the last balance sheet date; but the reporting accountants may have knowledge of events subsequent to that date which may have a material bearing on the conclusions which the intending investor may draw from the prospectus and in such cases the accountants will need to consider their report in the light of that knowledge.

Period covered by the report

320 Apart from the question of adjustments, the period to be covered by the report requires consideration having regard to the importance of presenting a fair view of the trend of results. At present the Stock Exchange, London, requires the report on profits or losses to cover a period of at least ten years instead of the statutory minimum of five years specified in the Companies Act, 1948. A period of ten years ending in 1954 or earlier will include part of the 1939-1945 war period, when conditions were exceptional.

Taxation

321 The treatment of taxation in the accountants' report raises some difficulties, particularly at the time of the issue of this recommendation, as reports will normally cover periods during which the excess profits tax at varying rates (or the alternative national defence contribution) was in force for part of the time, followed by the profits tax at rapidly changing rates with its complication of non-distribution relief and, for 1952 and 1953, the excess profits levy. Until recently the most usual method of treating taxation has been to use three columns showing:

(i) Profits before charging United Kingdom taxation.

(ii) Excess profits tax (or national defence contribution) and profits tax.

(iii) Profits before deducting income-tax (column (i) less column (ii)).

but in recent years some accountants have omitted column (iii). More recently, particularly since the Finance Act, 1952, introduced the further complications of the excess profits levy, some accountants have shown only column (i).

322 For prospectus purposes accountants are required to report 'upon' or 'with respect to' the profits and are authorised to make such adjustments as appear to them to be necessary. The Council therefore takes the view that the accountants are free to deal with excess profits tax, national defence contribution, profits tax and excess profits levy in whatever manner they think appropriate to the case and that in the absence of exceptional circumstances it is sufficient to show in a single column the profits before charging United Kingdom taxation, notwithstanding legal cases in which the courts may have interpreted the word 'profits' in other contexts. It is, however, necessary that the report shall fairly indicate the basis on which the profits are stated and shall be in such a form that a person reading the prospectuses can ascertain the trend of profits during the period covered by the report, so that he can consider the past results in forming his own view of the profits which may become available for interest or dividend in future years.

323 The excess profits tax was charged under legislation which is no longer in operation and which differed greatly from the new excess profits levy; and the profits tax borne in past years may bear no relation to the current position regarding 'distributions' or to the current rates of profits tax. A report which shows profits before charging United Kingdom taxation will therefore normally be more informative and less likely to be misunderstood than one which states for each year the amounts of excess profits tax or national defence contribution and of profits tax. In each case, however, it will be for the accountants to decide on the appropriate treatment of taxation having regard to all the circumstances. It will also be necessary for the accountants to consider whether there are material amounts of expenditure for which no allowance is obtained for taxation purposes and which therefore absorb earnings of the relative gross amount.

324 The question of profits tax non-distribution relief has been considered in detail in the Council's NOTES ON THE TREATMENT OF PROFITS TAX IN ACCOUNTS. The conclusions there reached are as follows and the Council takes the same view in relation to the accountant's report dealing with the assets and liabilities at the last date to which the accounts of the company were made up:

'(a) In normal circumstances any attempt to estimate the amount of the profits tax liability which might be incurred on a hypothetical future distribution cannot produce any result of sufficient accuracy to be of value or significance.

'(b) Even if it were possible to compute a significant figure, it is not normally necessary in law to refer in a balance sheet to the existence of an accumulated amount of non-distribution relief, because the existence of such an amount does not constitute either a liability or a contingent liability at the balance sheet date and any possible liability which may be incurred in the future as a result of future distributions is not an element which in law required consideration when determining whether a balance sheet gives a true and fair view of the state of affairs of the company as on the balance sheet date.

‘(c) Nevertheless the Council considers that it may be helpful to shareholders to remind them that if any of the reserves were distributed a part thereof would normally have to be paid away in profits tax instead of being paid to the shareholders. The Council therefore considers that there is much to commend the practice, now being adopted by some companies, of making the balance sheet as informative as possible by including an appropriate reference to the existence of an accumulated amount of non-distribution relief. It is a matter for consideration, in the circumstances of each case, whether the suggested reference should specify the accumulated amount of non-distribution relief or should be made in general terms only:

(i) If the accumulated amount is stated, care must be taken to ensure that it will not be misleading, having regard to the relationship between that amount and the amount of reserves shown in the balance sheet.

(ii) If the reference is made in general terms only, the following is an example of wording which may be suitable:

"The company has been given profits tax non-distribution relief and accordingly a profits tax charge would normally be incurred in the event of a distribution to shareholders out of reserves, including the balance on profit and loss account." (If Section 31, Finance Act, 1951, applies, the wording would need variation to cover also a reduction or repayment of capital, or a capitalisation of reserves.)

‘(d) Apart from the general position dealt with in (a), (b) and (c) above there may be exceptional circumstances, for example where a liquidation is contemplated, which require special treatment in order to indicate as clearly as possible the significance of the non-distribution relief in the exceptional circumstances.’

Presentation

325 Persons reading the report will more readily understand the significance of the figures if they are stated as simply as possible with a clear indication of the basis on which they have been computed. An indication of the adjustments which have been made, or of the matters to which it is considered necessary to direct attention, can usually be given conveniently in the form of explanatory notes or narrative following a tabulation of the figures.

Context

326 The context in which the accountants’ report appears may have a material effect on the conclusions which the intending investor will draw from the prospectus as a whole. Under the Companies Act, 1948, a prospectus containing a report by accountants must not be issued unless the accountants have given and not withdrawn their consent to the issue thereof with their report in the form and context in which it is included; and a statement that they have so given and not withdrawn their consent must appear in the prospectus.

Stock exchange requirements

327 In addition to the statutory requirements under the Companies Act, there are also requirements of the stock exchanges. In particular, attention is drawn to the following requirements of the Share and Loan Department of the Stock Exchange, London:

(a) *Memorandum regarding certificates of profits for purposes of prospectuses, offers for sale and advertised statements.* This memorandum was issued on 3rd November, 1948, and published in *The Accountant* on 13th November, 1948; it was also reproduced at page 60 in the Institute’s annual report for 1948. The memorandum relates to the ‘written statement signed by the auditors or accountants setting out the adjustments made in the report on the profits and giving the reasons therefor’ which is required to be submitted to the Share and Loan Department and to be available for inspection by the public for not less than fourteen days at a place in the City of London.

(b) *Announcement regarding pre-acquisition profits.* This announcement was reported in *The Accountant* of 4th June, 1949, as follows:

‘In cases where application is made for the quotation of securities of holding companies the department will require to be satisfied that in arriving at any estimate contained or to be contained in any prospectus, offer for sale or public advertisement of the profits of or any dividends to be paid in respect of the first financial year of the holding company due account has been taken of the fact that "pre-acquisition profits" will not be available for distribution’.

(c) *Stock-in-trade.* It is the practice of the Share and Loan Department to ask the question, 'Have the reporting accountants satisfied themselves that stock-in-trade and work in progress (if any) have been properly taken and valued throughout the period covered by this report?' A simple affirmative answer to that question would amount to the assumption by the reporting accountants of a wider responsibility than they can normally take, particularly if they have not been the auditors of the company for the whole of the period; but if the reporting accountants have satisfied themselves in regard to the matters dealt with in paragraphs 336 and 337 they should be able to give the requisite confirmation to the Share and Loan Department.

Special circumstances

328 In considering the recommendations made below it must be borne in mind that the circumstances of one business may differ greatly from those of another. Moreover there are some circumstances, particularly where the report involves subsidiaries or branches operating in the United Kingdom or overseas, for which it would be inappropriate to attempt to make any recommendations of general application. In all cases it is necessary to take into account the relevant facts before deciding what, if any, adjustments should be made and what matters should be referred to specifically in the accountants' report.

Recommendations

329 It is therefore recommended that the following principles, which should be read in conjunction with those dealt with in recommendation 13 ACCOUNTANTS' REPORTS FOR PROSPECTUSES: FIXED ASSETS AND DEPRECIATION, should normally be applied by members of the Institute who may be called upon to report for prospectus purposes; **but it must be emphasised that the reporting accountants should bear in mind the purpose for which their report is to be used and exercise their own judgement on whether the observations and adjustments mentioned below would be appropriate in the circumstances of a particular case.**

Profits or losses

Presentation

330 The figures relating to profits or losses should be set out in the report in columnar form, accompanied by appropriate definition of the bases on which the figures have been computed. A figure of 'average profits' should not be stated.

Taxation

331 The report should show for each year the profits (as defined in the report) before charging any United Kingdom taxation on profits. In the absence of exceptional circumstances, the report need not include figures showing excess profits tax, national defence contribution, profits tax, or excess profits levy.

332 If in any particular case the accountants should consider that there are exceptional circumstances which make it desirable to show the amounts of excess profits tax, national defence contribution, profits tax and excess profits levy, it will be for the accountants to decide whether also to show for each year the profits after deducting those taxes.

333 Where there are material items of expenditure which are chargeable in arriving at profits but are not allowable for taxation purposes, the report should indicate the amount of such expenditure for the last year covered by the report or for such other period as may be appropriate; and should also indicate that the sum required to cover such expenditure is the gross amount which after deduction of taxation will leave a net amount equal to the expenditure which is not allowed. (In relation to depreciation of fixed assets this matter is referred to more specifically in recommendation 13.)

Adjustments generally

334 The reporting accountants should make such adjustments to the profits or losses as shown by the accounts as they consider appropriate and the report should state that this has been done. If the amount involved in any adjustment is of special importance in relation to the results disclosed, the nature of the adjustment should be stated. The accountants should consider whether the amount involved in any such adjustment should also be stated.

Adjustments based on new information

335 In some cases it may be necessary to consider whether adjustments should be made where there are facts which should have been taken into account in preparing the profit and loss accounts for the various years covered by the report if those facts had been known at the time when the accounts were prepared. These adjustments may often consist of a reallocation, between one year and another, of items such as provisions. Where the correct credit or charge for each year concerned can be ascertained with reasonable accuracy at the date of the report, a reallocation may be appropriate if the amounts are material. In particular:

(a) *Contract prices.* Where material amounts of income were provisional in that they were derived from government or other contracts which were subject to cost investigations, or which for other reasons were known at the time of making up the accounts to be liable to subsequent price adjustments, consideration should be given to the question of whether estimates should be adjusted, having regard to the most recent information.

(b) *Deferred repairs.* Owing to conditions arising out of the war many businesses have had to defer necessary expenditure on maintenance of their equipment. Where claims have been made for allowances for deferred repairs for excess profits tax purposes, or provisions therefor have been made in the accounts, these should be regarded as prima facie evidence of the existence of deferred maintenance at the relevant dates. The accountants should, where necessary, make adjustments to correct under- or over-provisions at previous balance sheet dates.

(c) *Bad or doubtful debts.* Adjustments should not normally be made, in the light of subsequent events, to provisions which were considered to be reasonably necessary in respect of bad or doubtful debts having regard to information available when the accounts of any year were made up. Exceptional cases do arise however where the amounts involved are very material and in such cases it is necessary to consider whether adjustments should be made.

Stock-in-trade and work in progress

336 The method of valuing stock-in-trade (whether of raw materials, partly finished or finished stocks) should be reviewed and tested in relation to the fair presentation of the trend of profits. Where it is established that the amount included in the accounts at any particular year end should have been materially different a reallocation should be made. Where during the period covered by the report there has been a material change in the basis on which stock-in-trade was valued and it is not practicable to make an adjustment, because the relevant figures are not ascertainable, there should be an appropriate reservation in the report. The taxation implications of any matters arising on stock-in-trade also require consideration.

337 In some businesses, for example constructional engineers or public works contractors engaged on large contracts on which work may be in progress over a lengthy period, some profit element may have been included in the valuation of work in progress. In other businesses no profit element may have been included until the period in which the contract has been completed. The basis on which the valuation has been made should be examined from the standpoint of seeing how far the practice which has prevailed is consistent with that in force at the time of the report and of deciding whether it would be appropriate to make adjustments so as to apportion the profit over the period of the performance of the contract.

'Non-recurring' expenditure

338 It may be undesirable to make an adjustment merely because in the period covered by the report there were items of revenue expenditure which it is believed will not recur in the future. In many businesses special expenditure of one kind or another may be incurred from time to time and it will often be inappropriate to eliminate the particular items which arose in the period covered by the report.

Repayment of loans

339 Where a loan of fixed amount is to be repaid out of the proceeds of the issue, or has been repaid out of the proceeds of an issue during the period covered by the report, an adjustment to eliminate or amend the interest charged in each year may be appropriate. If a material adjustment has been made the fact should be stated in the report. In the absence of special circumstances it is inappropriate to make an adjustment for interest where a bank overdraft is to be repaid or reduced out of the proceeds of the issue. Where interest charges on loans or overdrafts are of material amount and no adjustment is made, the report should state the facts and, if several years are affected, this may conveniently be done by showing the relevant interest charges in a separate column in the report.

Changes in sources of income

340 Where in the period covered by the report there were material changes in the nature of the business or the sources of income, or there have been exceptional receipts, the circumstances of each case will require consideration in deciding whether any adjustment should be made, but regard should be had to the following general principles:

(a) Where another business has been acquired by means of an issue of share or loan capital it may be appropriate to make an adjustment to include the profits of the acquired business in respect of the years prior to acquisition; and for this purpose a suitable method may be to show in a separate column the profits which have been so included. (Where a business is to be acquired out of the proceeds of the new issue, a report on the profits of that business must be given in accordance with paragraph 20 of the Fourth Schedule to the Companies Act, 1948.)

(b) Where however another business has been acquired out of existing resources, the profits of such business for the years prior to the acquisition should not in general be included, for the reason, amongst others, that for those years the profits of the acquiring business already include profits derived from the use of the resources which were later used to acquire the further business. Similar considerations apply where the acquired business had sustained losses prior to acquisition; but there may be circumstances which require different treatment or appropriate comment in the accountants' report, for example where the further business has a record of material losses and it was acquired towards the end of the period covered by the report.

(c) Where a distinct and material section of the business has been discontinued or sold, it would normally be appropriate to show separately, or to make an adjustment to exclude, the profits attributable to that section of the business where ascertainable. Consideration should however be given to the effect of such adjustments on the trend of results shown by the adjusted profits. If losses have been sustained in the discontinued or sold section of the business and an adjustment is made to exclude those losses, the report should indicate that such an adjustment has been made and state the amounts of the losses so excluded. If no adjustment is made to exclude losses and the discontinuance or sale of the section has had a material effect on the trend of results in the later years, the accountants should refer to the matter in their report.

(d) Considerations similar to those mentioned in (a), (b) and (c) above apply in the case of groups of companies where subsidiaries are acquired or disposed of.

Expenditure not borne in the past

341 There will be cases where items of expenditure to be incurred in the future have not been borne in the past, or have in the past been materially different in amount. In particular, the charge in future for directors' emoluments may differ materially from that in the past. In view of the length of the period covered by the report and the changes which have occurred in the purchasing power of money, it is usually inappropriate to adjust the past profits or losses. The report should however indicate the facts, for example by way of comparison of the emoluments for the last year covered by the report with what those emoluments would have been under the arrangements in force at the time of making the report.

342 If the amounts involved are material, management remuneration not covered by directors' emoluments should be dealt with in the manner indicated in the preceding paragraph.

Capital expenditure

343 Where an item which has been charged in the accounts has been disallowed for taxation purposes as being capital expenditure, it should not necessarily be adjusted. Moreover no adjustment should be made to write back, as being capital, expenditure which has been charged in the accounts and allowed for taxation purposes, even though some items may be of a kind which might have been regarded as of a capital nature if a different accounting practice had been followed. Where an adjustment is made, it is necessary to consider whether it has a significant effect on the provisions for depreciation.

Expenditure carried forward

344 Where a material amount of development or similar expenditure is carried forward on the grounds that it is abnormal and has a continuing value to the business, the nature of the expenditure and the manner in which such expenditure has been dealt with in the past or is proposed to be dealt with in the future, together with the reasons for carrying it forward, should

be investigated. The treatment in the report will necessarily depend on the circumstances of each case. If necessary, adjustments should be made so as to charge the expenditure against the revenue of the appropriate period. If expenditure is carried forward the report should indicate the nature and amount of the expenditure carried forward at the close of the period covered by the report and, in some cases, should also indicate the period over which it is to be written-off in future years. Adjustment is not usually required for amounts which represent normal annual expenditure on designs and prototypes of the following year's products of companies whose usual practice is to carry forward such expenditure as a charge against the revenue of the following year.

345 Conversely, the accountants should consider whether the trend of results has been affected materially by charging against profits expenditure of abnormal amount which could properly have been carried forward to a period following that in which it was incurred.

Items not passed through the profit and loss account

346 Adjustments should be made in respect of any items which affect the profit and loss account but have not been dealt with through that account.

Accounting principles applied

347 Where in the period covered by the report there has been a material change in the accounting principles applied, or the method of computing profits or losses has in any material respects not been in accordance with accepted accounting principles, the profits or losses should, if practicable, be adjusted so that they are computed in accordance with consistent and accepted principles or, if this cannot be done, the matter should be explained in the report.

Period covered by the report

348 The reporting accountants should consider whether a report covering the minimum period required by law, or by a stock exchange, presents a fair view of the trend of results having regard to any exceptional circumstances during that period. It may be necessary to extend the period or make appropriate comments.

Other considerations

349 The reporting accountants may have knowledge of events subsequent to the end of the last year covered by their report, or of other special circumstances not dealt with in the foregoing recommendations, which in their opinion have had or may have a material bearing on the statement of past profits or losses, or on the context in which that statement appears. In such circumstances the accountants should consider whether the facts should be stated in their report or whether this is rendered unnecessary by the manner in which the matter has been dealt with elsewhere in the prospectus.

Assets and liabilities

Presentation

350 The statement of assets and liabilities should be so arranged that the liabilities are deducted from the assets, ending with the proprietorship interest.

Future income-tax

351 The report should make clear whether an amount has been set aside for future income-tax and, if so, should specify the amount and the basis on which it has been computed.

Profits tax non-distribution relief

352 The report should include an appropriate reference to the existence of an accumulated amount of non-distribution relief. It is a matter for consideration, in the circumstances of each case, whether the reference should specify the accumulated amount or should be made in general terms only:

(a) If the accumulated amount is stated, care must be taken to ensure that it will not be misleading, having regard to the relationship between that amount and the amount of reserves.

(b) If the reference is made in general terms only, the following is an example of wording which may be suitable:

'The company has been given profits tax non-distribution relief and accordingly a profits tax charge would normally be incurred in the event of a distribution to shareholders out of reserves, including the balance on profit and loss account.' (If Section 31, Finance Act, 1951, applies, the wording would need variation to cover also a reduction or repayment of capital, or a capitalisation of reserves.)

Investments

353 Where quoted investments are held the report should state the market value on the balance sheet date; and if the amount standing in the books is greater than the market value on that date, the statement of assets and liabilities should include the market value instead of the book amount.

Balance sheet notes

354 The report should incorporate all notes (such as those relating to market values, commitments, rates of exchange or arrears of dividends on cumulative preference shares) which appeared on the last balance sheet, so far as the notes are material to a proper appreciation of the position at the balance sheet date.

Proceeds of the issue

355 The accountants' report deals with the assets and liabilities at the last balance sheet date and should therefore not include any addition in respect of the expected proceeds of the issue. This can appropriately be dealt with elsewhere in the prospectus.

Other considerations

356 The reporting accountants may have knowledge of material events subsequent to the last balance sheet date, for example where there has been a material fall in the market value of investments or of stock-in-trade. In such cases and where the reporting accountants have knowledge of any other special circumstances, not dealt with in the foregoing recommendations, which in their opinion have had or may have a material bearing on the statement of assets and liabilities, they should consider whether the facts should be stated in their report or whether this is rendered unnecessary by the manner in which the matter has been dealt with elsewhere in the prospectus.

Subsidiaries, branches and overseas business

357 Where the report involves subsidiaries or branches or overseas businesses, the circumstances are not usually such as to be suitable for the application of any general recommendations. For example, where subsidiaries or branches have different accounting dates it may not be practicable or appropriate to apportion the figures of profits or losses so as to obtain aggregates for a common period and the appropriate treatment will be a matter for the accountants to decide in the circumstances of each case. Similarly, where a material part of the profits is derived from overseas branches or companies it will be for the accountants to decide whether it is desirable to show separately the amount of such profits, or of the overseas taxation thereon, or of both, and the manner of indicating the position where there are material exchange restrictions on the transfer of overseas profits. All these matters and many others which arise in relation to groups and overseas businesses require consideration of the circumstances in each case to ensure that the report will not be misunderstood. In all cases where a matter is material the report should state clearly what has been done.

358 The accounts of some subsidiaries or branches may have been audited by accountants other than those who are reporting for prospectus purposes and it is then necessary for the reporting accountants to consider in the circumstances of each particular case whether they should examine the books and records of the subsidiaries or branches concerned, for which purpose it may be necessary to employ overseas agents. The reporting accountants should consider the desirability of communicating with the other auditors to ascertain whether they wish to draw attention to any matters which may be relevant to the report required for prospectus purposes.

Consent to the inclusion of the report

359 Before consenting (under Section 40, Companies Act, 1948) to the inclusion of their report in the prospectus, the reporting accountants should have regard particularly to:

(a) The manner in which the directors, in their statement of estimated current and future profits, deal with figures shown in the accountants' report and with matters to which attention has been drawn in that report.

Note. – The Share and Loan Department of the Stock Exchange, London, requires the company to furnish the department with an outline of the facts on which the estimate of profits is founded.

(b) Material facts of which they have knowledge in relation to the directors' estimates.

(c) Whether the directors, in any statement of 'value' of ordinary shares in terms of net assets, have paid due regard to the restriction imposed by the existence of an accumulated amount of non-distribution relief.

(d) The manner in which any special circumstances have been dealt with in the prospectus, where the accountants have decided that no reference thereto is necessary in their report. (See paragraphs 349 and 356.)

360 In cases where their report deals with assets and liabilities of a company or business acquired or to be acquired, the reporting accountants should ascertain from the directors that the directors' estimates of future profits available for dividend, as shown in the prospectus, have been arrived at after appropriate deductions have been made in respect of pre-acquisition profits which will not be available to the acquiring company for distribution as dividend.

Addendum

The Council of The Institute of Chartered Accountants in England and Wales issues to members of the Institute the following statement in connection with matters arising on investigations for prospectus purposes.

16th February, 1957

Preservation of records

361 Accountants' reports for prospectus purposes involve the investigation of accounts covering a long period, normally at least ten years. Where the records of the business in respect of the whole of the period have not been preserved such an investigation can be hindered and the reporting accountants may find it necessary to include reservations in their report.

362 Such reservations may reflect adversely upon the reliability of the figures given in the report. Moreover they may be embarrassing to the company's auditors where they were entirely satisfied, at the time when their audits were conducted, in regard to figures which cannot be verified during the investigation because the records are no longer available.

363 The Council therefore wishes to emphasise to members of the Institute the desirability of advising that important records should be retained for a long period, particularly where a business is such that there is a possibility that at some future date it may be necessary for a prospectus or similar document to be issued.

364 The need to retain important records applies particularly to stock inventories, including not only the fair copy summaries but also the rough stock sheets made out at the time when a physical count was taken in the works or storehouse. In this connection special attention is drawn to paragraphs 327(c) and 336 of recommendation 16. If records have been destroyed the question asked by the Stock Exchange (paragraph 327 (c)) cannot be answered satisfactorily nor can the procedure recommended in paragraph 336 be carried out satisfactorily.

N17 *Events occurring after the balance sheet date*

(Issued 18th October 1957)

While it is generally recognized that the fundamental purpose of annual accounts is to show a true and fair view of the state of affairs as on the balance sheet date and of the profit or loss for the year then ended, questions sometimes arise as to the extent to which events occurring after the balance sheet date should be taken into account in preparing those accounts. The Council of The Institute of Chartered Accountants in England and Wales makes the following recommendation to members of the Institute on this matter. The form and contents of accounts submitted to shareholders are (subject to compliance with the Companies Act) matters within the discretion of directors, but it is hoped that this recommendation will be helpful to members in advising, in appropriate cases, as to what is regarded as the best practice.

Events which should be dealt with in accounts

365 In British practice, rendered obligatory by the Eighth Schedule to the Companies Act 1948, certain events which take place after the balance sheet date, such as dividend proposals and other appropriations of profits, are shown in the accounts to assist the shareholders in making informed decisions, for example on dividend policy.

366 Accounts must often include estimated figures, for example of liabilities of uncertain amount, while for some assets, usually current assets, it is necessary to arrive at an opinion as to their realisable value in the ordinary course of business. Such estimates and opinions relate to conditions as on the balance sheet date but events occurring after that date may assist in the assessment of the position as it existed on that date. The following paragraphs deal with the more usual items.

Liabilities

367 Where a liability, or a contingent liability, existed on the balance sheet date it cannot be ignored in the accounts merely because the amount was unknown or uncertain on that date. An estimate is normally needed and for this purpose guidance may be obtained from developments which have taken place since the balance sheet date.

368 Where there have been changes in taxation since the balance sheet date, which affect the amounts to be set aside for taxation on the basis of the profits up to that date, it will be necessary to take the new taxation position into account if significant figures are to be shown in respect of the charge for profits tax and the amount set aside for income tax.

369 Except as a guide in making such estimates, events occurring after the balance sheet date are not relevant to the statement of liabilities. The discharge of an existing liability or the creation of a new liability does not enter into the true and fair presentation of the position as it existed on the date of the balance sheet.

Fixed assets

370 In general the balance sheet statement of fixed assets as on the balance sheet date will remain unaffected by events occurring after that date. The disposal or destruction of assets or the acquisition of new assets are not relevant to the position as it then existed. They are later happenings which fall to be dealt with in the next period together with their related matters such as the receipt of sale proceeds, the collection of insurance claims, or the financing of new acquisitions.

371 Subsequent events may however be of assistance in deciding the amount to be included in the balance sheet where the amount was in doubt on the balance sheet date, for example, where an asset has been acquired and the purchase consideration had still to be ascertained at that date although it became settled later.

Debtors

372 Some of the debts owing to a business on the balance sheet date may have to be estimated because the amounts thereof had not been agreed on that date. Guidance may be obtained from developments after the balance sheet date. The more usual problem in relation to debtors is that of deciding the extent to which the amounts owing by them should be regarded as realisable.

Normal accounting practice is to estimate, by reference to all the available information, including that relating to events occurring after the balance sheet date, the extent to which it may be necessary to recognise that on the balance sheet date the debts had a realisable value in the ordinary course of business less than the amount at which they were carried in the books and to make provision accordingly.

Stock-in-trade

373 Stock-in-trade is held for realisation in the ordinary course of business and is therefore normally upheld in the balance sheet at the lower of cost or market value. Hence an estimate of market value is required as on the balance sheet date, in order to decide whether a deduction should be made from the cost of stock because on the balance sheet date it had a market value lower than cost. Normal accounting practice is to make this estimate by reference to all the available information, including changes in selling prices since the balance sheet date, so far as the information is of assistance in determining the market value of the stock in the ordinary course of business on the balance sheet date.

374 In certain types of business, such as tea and rubber producing companies and some mining companies, it is normal practice to bring stock into the balance sheet at the price subsequently realised less the selling costs. This procedure has the advantage in businesses of this kind that the produce of the year is related to the eventual proceeds of disposal. The fact that the procedure involves a confusion of dates (in that it brings into account profit which had not been realised on the balance sheet date) is offset by the fact that it results in a more understandable presentation of the affairs of this particular type of business so long as the accounts indicate clearly the basis adopted.

Investments

375 Investments held as current assets are normally viewed as being capable of realisation on the balance sheet date. Subsequent changes in market value are therefore not normally relevant for balance sheet purposes.

Foreign exchange

376 Where rates of exchange have altered after the balance sheet date the alterations would normally be disregarded unless the rates of exchange on the balance sheet date were not realistic and the amounts affected are material.

Events which may need to be disclosed otherwise than in accounts

377 An event occurring after the balance sheet date may sometimes affect materially the solvency of the undertaking, or otherwise be of great importance to shareholders, although the event is not relevant to a fair view of the position as on the balance sheet date or of the result for the year then ended. Examples of such events are the disposal of a substantial part of the undertaking or a profit or loss, whether of a capital or revenue nature, having a significant effect on the financial resources of the business.

378 Such events are changes from the facts as they existed on the balance sheet date and to give effect to them in the accounts would be to attempt to present a state of affairs as on some unspecified later date. The function of a balance sheet is to set out the position as on a particular date, whereas the business to which it relates is normally in a constant state of movement. This limitation of the function of the balance sheet cannot be overcome by attempting to use different dates for different items, nor by endeavouring to show in accounts for a period the effects of events which occur after the close of that period. An attempt to do so would not only disregard the purpose of the balance sheet but would be impracticable, involving, as it would, a last minute re-examination of every item in the balance sheet in order to ensure that all material changes were effected.

379 As events of the character referred to in paragraph 377 do not relate to the period ending on the balance sheet date they ought not normally to be reflected in the accounts for that period. Because of their great importance however they may need to be brought to the notice of the shareholders in some other way. Unless this is done shareholders may be prevented from making informed decisions on matters with which they are concerned. Sometimes the information will have been communicated to the shareholders before the issue of the annual accounts; in other cases a suitable reference will be made in the directors' report or chairman's statement accompanying the accounts. The method of communicating such information and the decision as to when it should be done are matters for the directors.

Recommendation

380 Events which, at the time of preparing annual accounts, are known to have occurred after the balance sheet date, should not normally be taken into account in preparing accounts unless:

(a) they assist in forming an opinion as to the amount properly attributable, in the conditions existing on the balance sheet date, to any item the amount of which was subject to uncertainty on that date; or

(b) they arise from legislation affecting items in the accounts, for example changes in taxation, or are required by law to be shown in the accounts, for example appropriations and proposed appropriations of profit.

381 The foregoing recommendation concerns the extent to which events occurring after the balance sheet date need to be dealt with in the accounts for the period ended on that date but events which are properly excluded from those accounts may, nevertheless, be of such importance that they need to be disclosed to shareholders through some other medium.

N18 *Presentation of balance sheet and profit and loss account*

(Issued October 1958)

The Council of The Institute of Chartered Accountants in England and Wales makes the following Recommendation to members in replacement of Recommendations 4, 5, 6 and 8. The Recommendation relates to the accounts of companies engaged in industrial and commercial enterprises. Whilst it is recognised that the form in which accounts are submitted to shareholders is (subject to compliance with the Companies Act) a matter within the discretion of directors, it is hoped that this Recommendation will be helpful to members in advising, in appropriate cases, as to what is regarded as the best practice.

1 Businesses are so varied in their nature that there must be flexibility in the manner of presenting accounts. A standard form to suit every industrial and commercial undertaking is neither practicable nor desirable. This is recognised in the Companies Act 1948 which, while containing extensive requirements as to matters to be disclosed in the accounts, does not prescribe any standard method of giving the true and fair view required by Section 149. The detailed requirements of the Act are not incorporated in this Recommendation and therefore it does not deal with many matters referred to in the Recommendations which it replaces, those matters now being covered by the Act.

2 Special considerations arising on consolidated and other group accounts (including profit and loss accounts framed as consolidated profit and loss accounts) are not dealt with in this Recommendation, nor are the special exceptions permitted under the provisions of the Companies Act 1948 in respect of the accounts of banking, insurance, shipping and other special classes of companies.

Balance Sheet

3 The function of a balance sheet is to give a true and fair view of the state of affairs of the company as on a particular date. A true and fair view implies appropriate classification and grouping of the items and therefore the balance sheet needs to show in summary form the amounts of the share capital, reserves and liabilities as on the balance sheet date and the amounts of the assets representing them, together with sufficient information to indicate the general nature of the items.

4 A true and fair view also implies the consistent application of generally accepted principles. Assets are normally shown at cost less amounts charged against revenue to amortise expenditure over the effective lives of the assets or to provide for diminution in their value. A balance sheet is therefore mainly an historical document which does not purport to show the realisable value of assets such as goodwill, land, buildings, plant and machinery; nor does it normally purport to show the realisable value of assets such as stock-in-trade. Thus a balance sheet is not a statement of the net worth of the undertaking and this is normally so even where there has been a revaluation of assets and the balance sheet amounts are based on the revaluation instead of on cost.

Recommendations

It is recommended that, subject to compliance with statutory requirements, the balance sheet should be presented in conformity with the following general principles:

Headings for groups of items

5 The terms used in paragraphs 2, 3 and 4 of the Eighth Schedule to the Companies Act 1948 such as issued share capital, reserves, liabilities, fixed assets and current assets, are normally appropriate headings for summaries and classifications. Other headings should be used if it is considered that they will be better for the purpose of presenting a true and fair view of the state of affairs of the company. The use of general main headings such as ‘liabilities’ and ‘assets’ is unnecessary.

Redeemable preference shares

6 In addition to the earliest date on which the company has power to redeem redeemable preference shares, other material facts relating to redemption of those shares should be indicated; examples are the latest date on which redemption may take place and any premium payable on redemption.

Reserve fund

7 The description 'reserve fund' should not be applied to a reserve unless it is represented by specifically earmarked investments (or other assets) realisable as and when required at not less than the amount of the 'reserve fund'. Exceptions arise from the statutory requirement to describe a 'capital redemption reserve fund' as such and from any provision of the memorandum or articles of association, or other instrument constituting or regulating a company, requiring a reserve to be described as a 'fund'.

Capital reserves

8 The expression 'capital reserves' should be used to describe reserves which for statutory reasons or because of the provisions of the memorandum or articles of a company or for other legal reasons are not free for distribution through the profit and loss account.

9 The expression 'capital reserves' may also be applied to other reserves which, although legally distributable, are regarded by the directors as not available for distribution at the date of the balance sheet. Such a reserve shown as a capital reserve in one balance sheet may, owing to a change of circumstances, properly be shown in the next balance sheet as a revenue reserve.

Sub-division of revenue reserves (including unappropriated profits)

10 Where revenue reserves are retentions of distributable profits available for general use in the business and none of them is created in accordance with statutory requirements or in pursuance of any obligation or policy, the sub-division of such reserves under a variety of headings is unnecessary.

Additions to and withdrawals from reserves

11 All profits and losses of a revenue nature should normally be reflected in the profit and loss account. Additions to or utilisations of revenue reserves and the application of capital reserves to the relief of charges on revenue should therefore normally be passed through that account. They should be dealt with either as items entering into the ascertainment of the result shown for the year or as adjustments of the unappropriated balance from the accounts of the current and prior years as may be appropriate. This does not however prevent wholly exceptional items of material amount which do not relate to the accounting period from being taken direct to reserves if a true and fair view will be better presented in that way.

12 If the inclusion in the profit and loss account of capital losses and of realised capital profits (so far as these may lawfully be included) will facilitate the presentation of a true and fair view of the results of the transactions of the year they should be passed through the account.

13 Where movements in reserves are not shown in the profit and loss account and are of material amount they should be disclosed in the balance sheet or in notes on the accounts. Such items may include movements on capital reserves not dealt with as mentioned above, transfers between reserves, transfers from reserves to share capital account and applications of reserves in writing-off items such as preliminary and issue expenses.

Sub-total of share and capital and reserves

14 A sub-total of share capital and reserves, including any credit balance carried forward on profit and loss account, should be shown and any description should be factual, such as 'share capital and reserves'. Descriptions such as net worth, which lend themselves to being misunderstood as tending to suggest that a balance sheet purports to be a statement of values, or to show the value of the undertaking, should be avoided.

Adverse balance on profit and loss account

15 Available reserves should be appropriated to extinguish an adverse balance on profit and loss account. Where this practice is not adopted, the adverse balance should be grouped with and be a deduction in arriving at the sub-total of share capital and reserves. Preferably such deduction should be made first from revenue reserves; if these are insufficient then from the aggregate of revenue and capital reserves. If both are insufficient the adverse balance should be deducted from the aggregate of share capital and reserves.

Amounts set aside for future income tax

16 Amounts set aside for future income tax, whether described as reserves or not, should be shown separately and should preferably not be aggregated with reserves. Income tax assessable for any income tax year commencing after the balance sheet date should not be grouped with liabilities.

Provisions

17 Where the replacement of fixed assets is dealt with by making provision for renewals and charging the cost of replacement against the provision so made, the accumulated amount of provision for renewals, so far as not used, should be shown separately. Such a provision should not be shown as a deduction from the assets.

18 Where depreciation is provided on fixed assets, an amount set aside in recognition of the increased cost expected to be incurred in replacing fixed assets, as compared with the amount at which they are carried in the books, is not a 'provision'; it is a reserve and should be shown as such.

19 On a proper grouping of the balance sheet some provisions may not be suitable for aggregation with other provisions, for example where some provisions are current liabilities and others are not. The statutory requirement (paragraph 6 of the Eighth Schedule) to give an 'aggregate' should not be treated as a restriction operating against the presentation of a true and fair view.

Reasonableness of provisions

20 Paragraph 27 (2) of the Eighth Schedule provides that where any amount written off or retained by way of providing for depreciation, renewals, or diminution in value of assets (not being an amount written off in relation to fixed assets before 1st July 1948) or retained by way of providing for any known liability, is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated as a reserve and not as a provision. Directors should be advised that an opinion expressed in accordance with paragraph 27 (2) should be based on a consideration of all relevant information and have regard to recognised accounting principles.

Grouping of liabilities and proposed dividends

21 Current liabilities and proposed dividends should normally be shown in one group classified under appropriate descriptions and will include *inter alia*:

(a) trade liabilities, bills payable, accrued charges

(b) short-term loans

(c) bank loans and overdrafts

(d) current taxation

(e) provision for any current liability of which the amount cannot be determined with substantial accuracy

(f) proposed dividends (less income tax).

22 In respect of all liabilities other than current liabilities, a specific description such as debenture stock, mortgages, or unsecured notes, should be given. The dates and material conditions of redemption or conversion should be indicated.

Secured liabilities

23 Paragraph 9 of the Eighth Schedule provides that where any liability is secured otherwise than by operation of law on any assets of the company, the fact that the liability is so secured shall be stated. In complying with this paragraph the word 'secured' should not be used without amplification if there is evidence from the documents that the charge on the assets is for an amount less than the liability.

Bank overdrafts

24 To comply with paragraph 8 (1) (d) of the Eighth Schedule the aggregate amount of bank loans and overdrafts must be shown under a separate heading. Where there are debit and credit bank balances with no legal right of set-off the full amounts of bank loans and overdrafts and of bank balances should be shown.

Contingent liabilities

25 Where some contingent liabilities are not suitable for aggregation with others the amount or estimated amount of each contingent liability or group of contingent liabilities should be shown if practicable.

Future capital expenditure

26 In a statement of the aggregate amount or estimated amount of contracts for capital expenditure, given to comply with paragraph 11 (6) of the Eighth Schedule, the description of 'contracts for capital expenditure' is appropriate and, as a description of this item, is preferable to 'commitments for capital expenditure' which may have a wider significance.

27 Where a company has entered into contracts for only part of the work on a project of capital expenditure a matter which directors might be recommended to consider is whether, in addition to stating the amount of contracts outstanding, further information might usefully be given indicating the estimated total expenditure involved in the project they have approved.

Other forward contracts

28 The existence of uncompleted or forward contracts for the purchase and sale of goods or services in the ordinary course of business is not generally referred to in the balance sheet, but consideration should be given to the possibility of losses arising from positions on forward contracts and the necessity for providing for such losses.

Assets

29 Paragraph 4 (2) of the Eighth Schedule requires that fixed assets shall be distinguished from current assets. The division of assets into either 'fixed' or 'current' is not always practicable and could be misleading. (This is sometimes the case with interests in subsidiaries.) Where neither 'fixed' nor 'current' is a true and fair description, the assets should not be described as either but the nature of the assets should be stated clearly.

30 Where an asset is classified as neither fixed nor current the method of arriving at and stating the amount of a fixed asset, set out in paragraph 4 (3) and (except in the case of interests in subsidiaries) paragraph 5 of the Eighth Schedule, should be applied.

Fixed assets

31 The fundamental characteristic of fixed assets is that they are held with the object of earning revenue, directly or indirectly, and not for the purpose of sale in the ordinary course of business. They will normally include such assets as:

(a) goodwill, patents and trademarks

(b) freehold land and buildings

(c) leaseholds

(d) plant, machinery and equipment

(e) investments intended to be held continuously by the business.

Interests in subsidiaries

32 Interests in subsidiaries, which may consist of shares in subsidiaries and amounts owing by subsidiaries in respect of debentures or otherwise, should generally be shown as one group in the balance sheet of the holding company. It may however be desirable to group with current assets the aggregate of the temporary advances and/or the amounts due on current accounts which are regularly paid, provided it is possible to segregate the whole of such amounts from other indebtedness of the subsidiaries to the holding company.

33 A holding company's indebtedness to its subsidiaries should normally be grouped with liabilities but should be stated separately. Such indebtedness may however be shown as a deduction from interests in subsidiaries in appropriate circumstances, for example where the subsidiaries lend their surplus funds to the holding company.

Fellow subsidiaries

34 Shares held by a subsidiary in a fellow subsidiary should be shown separately.

Associated companies

35 Where interests in associated companies are material they should be stated separately under the general heading of “Trade Investments” or under a heading of their own.

Current assets

36 Items classified as current assets should include:

(a) stock-in-trade and work in progress

(b) trade and other debtors, bills receivable and prepayments (other than those on capital expenditure or of a long-term nature)

(c) quoted and other readily realisable investments (other than trade investments, investments in subsidiaries and other investments intended to be held continuously even though they may happen to be quoted or are otherwise readily realisable)

(d) tax reserve certificates

(e) bank balances and cash.

Overseas assets

37 If there are material amounts of assets in overseas countries where restrictions on remittances are in force this fact should be disclosed and there should be given such other information, if any, as may be needed to give a true and fair view.

Profit and loss account

38 The general aim of a profit and loss account should be to show a true and fair view of the profit or loss of the year, before and after taxation, based on the consistent application of recognised accounting principles. The account should be presented in a form which affords as clearly and readily as circumstances permit a comparison with the results of previous years.

39 There are differing opinions as to what should be included in the amount shown as the profit or loss of a year. Some consider that it should take into account, subject to separate disclosure of material items in certain circumstances, all profits or losses arising or ascertained within the year, including those items which are the result of activities of the year and others which are the consequence, ascertained within the year, of transactions of earlier years. Others hold that the amount shown as the profit of the year should be restricted to the results of the operations of the year and that all other items should be excluded from the profit or loss of the year as being adjustments of earlier years and should be shown in the profit and loss account.

40 Each of these opinions has arguments in its favour and it cannot be said that either of them is generally accepted to the exclusion of the other. Provided that the account is prepared in conformity with either of these opinions and is the result of the consistent application of recognised accounting principles it can properly be said to be true and fair. If a change is made in the accounting principles applied and the effect is material, that fact and its consequences would need to be disclosed.

Recommendations

It is recommended that, subject to compliance with statutory requirements, the profit and loss account should be presented in conformity with the following general principles:

Profit or loss of the year

41 Where the turnover is not disclosed the profit and loss account should commence with the trading surplus or deficit of the year computed after charging depreciation and all other trading expenses. Depreciation and other items which have been charged or brought to credit in arriving at the trading surplus or deficit, but which are disclosed to comply with the Companies Act 1948 or because the directors consider that they should be disclosed, should be shown by notes on the account or by an unextended inset or in a ‘box’ immediately after the trading surplus or deficit of the year.

42 Other income and non-trading expenditure of the year should then be shown. If the balance on the account at this stage shows a profit it may be described as 'profit before taxation' and against this amount there should be charged the taxation based on this profit. The balance arrived at is the 'profit after taxation'.

43 Items of an exceptional or non-recurrent nature should be dealt with in such a way as to show in the particular circumstances a true and fair view of the result of the year. Such items, other than tax adjustments of earlier years, may be dealt with as follows:

(a) where the items arise from the trading operations of the company, they may be dealt with in arriving at the trading surplus or deficit and disclosed separately by one of the methods recommended in paragraph 41

(b) they may be shown separately in the section of the account which includes other income and non-trading expenditure of the year

(c) they may be shown separately after the 'profit after taxation'

(d) they may in appropriate circumstances be omitted from the profit and loss account and taken direct to reserve (see paragraph 11).

44 Where exceptional or non-recurrent items have been taken into account before arriving at 'profit before taxation', any tax charges or reliefs arising because of the items should be included with the tax charge on such profit.

45 Where exceptional or non-recurrent items are not taken into account before arriving at 'profit before taxation', the effect of these items on the amount shown in respect of tax should be considered; where appropriate the relevant tax charges or reliefs should be shown as separate adjustments to the respective items.

46 Whether brought into the account with the tax charge of the year or shown after 'profit after taxation' any adjustment of the tax charge of previous years should be separately disclosed, if material.

Depreciation of fixed assets

47 The requirement in paragraph 14 (2) of the Eighth Schedule should be applied to each class of fixed asset and not to fixed assets as a whole; this requirement is that, if depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the profit and loss account must state the method by which it is provided for or the fact that it is not provided for, as the case may be.

Annual payments

48 Debenture, loan and note interest, royalties and other annual charges payable under deduction of income tax should be charged gross in the profit and loss account.

Income from investments

49 Dividends, interest and other income should be brought to credit gross and should therefore include income tax suffered by deduction, or deemed for income tax purposes to have been suffered by deduction, on such income. The relative amount of income tax should be included as part of the charge for income tax for the year.

Income from subsidiaries

50 Although paragraph 12 (1) (g) of the Eighth Schedule requires the amount of income from investments to be shown, paragraph 15 (2) (a) excludes income from investments in subsidiaries from this requirement. Income (gross) from subsidiaries may, with appropriate narrative, properly be included in the trading surplus of the holding company and need not be shown separately in the profit and loss account of that company unless it is necessary to do so in order to present a true and fair view.

Subvention payments

51 A subvention payment (Section 20 of the Finance Act 1953) made by a holding company to a subsidiary can for accounting purposes be regarded as the converse of the receipt of a dividend from a subsidiary. Therefore:

(a) where a holding company has given or received a subvention payment it need not be shown separately in the profit and loss account of the holding company provided that the income from investments in subsidiaries is included in the trading result and there is appropriate description of that result

(b) a subvention payment should normally be shown separately in the profit and loss account of a subsidiary which has received or given a subvention from or to the holding company or a fellow subsidiary. This disclosure may however properly be omitted where trading results have been affected materially by an arbitrary course of dealing in respect of inter-company transactions.

Dividends paid or proposed

52 Paragraph 12 (1) (h) of the Eighth Schedule requires that the aggregate amount of the dividends paid or proposed shall be shown in the profit and loss account. In addition to this statutory requirement, the dividends on each class of shares should be shown, distinguishing between dividends already paid and dividends recommended. The rates (per cent or per share) at which dividends have been declared or are proposed should preferably be stated. It may be helpful to shareholders to state the dates of payment of the dividends.

53 The amounts shown in respect of dividends paid or payable should be the net amounts, whether they are declared as 'subject to income tax', 'less income tax' or 'free of income tax'.

Comparative figures

Recommendations

54 It is recommended that the following principles should be applied in complying with paragraphs 11 (11) and 14 (5) of the Eighth Schedule, which require the corresponding amounts for the immediately preceding year to be shown for all items in the balance sheet and profit and loss account:

55 Where an item, which is required to be stated, appears in a note on the accounts or in a document annexed thereto the corresponding amount for the immediately preceding year should be shown.

56 Where the accounts do not include an item corresponding to an item which appeared in the accounts for the immediately preceding year the amount for that earlier year should nevertheless be shown; except that where the item appeared in a note on or document annexed to the accounts for the immediately preceding year it may not be necessary to repeat the item unless its omission could cause the comparison of the two years' accounts to be misleading.

57 If items in the accounts have been re-grouped, sub-divided or otherwise rearranged as compared with the accounts for the immediately preceding year then the items for that earlier year should be similarly re-arranged for the purpose of showing the comparative figures.

58 Where a change in the basis of accounting affects materially the comparability of the profit and loss account of the year with that of the preceding year appropriate information should be included in the accounts by way of note or otherwise. This information should explain the nature of the change and should indicate either the extent to which the account of the preceding year would have been affected had the revised basis been in use in that year, or, as may be appropriate, the extent to which the account of the current year would have been affected had no change been made.

Notes on the accounts

Recommendations

It is recommended that the following principles should be applied where the Companies Act permits information to be given by note or in a statement annexed:

59 Where a note relates to an item in the accounts there should be a reference against that item to the note.

60 Where information is given in the directors' report instead of in the accounts (see Section 163 of the Companies Act) the relative paragraphs in the directors' report should be clearly identifiable and specifically referred to in the accounts.

61 A copy of the chairman's statement, even if it accompanies the accounts, is not an appropriate document in which to give information which should be given in the accounts.

N19 *Treatment of income tax in accounts of companies*

(Issued October 1958)

The main accounting problems arising from the present basis of assessment to income tax are dealt with in the following Recommendation, which the Council of the Institute of Chartered Accountants in England and Wales hopes will be helpful to members. This Recommendation replaces Recommendation 1 issued in December 1942 and Recommendations 3 and 4 which were issued in March 1943, amplified in April 1947 by a statement dealing with initial allowances and amended by paragraph 80 of the booklet on the Companies Act 1948. This Recommendation also deals with investment allowances on which the Council issued a statement in November 1954.

Although this recommendation deals primarily with income tax there are appropriate references to profits tax in Sections III, IV and V.

I. Requirements of the Companies Act 1948

1 In relation to the treatment of tax in accounts of companies the specific requirements of the Companies Act 1948 are:

(a) to state by way of note on the balance sheet (or in a statement or report annexed) if not otherwise shown, the basis on which the amount, if any, set aside for United Kingdom income tax is computed (paragraph 11 (10) Eighth Schedule)

(b) to show in the profit and loss account the amount of the charge for United Kingdom income tax and other United Kingdom taxation on profits, including, where practicable, as United Kingdom income tax any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income tax and distinguishing where practical between income tax and other taxation (paragraph 12 (1) (c), Eighth Schedule)

(c) to state in the profit and loss account by way of note, if not otherwise shown, the basis on which the charge for United Kingdom income tax is computed (paragraph 14 (3), Eighth Schedule).

II. Basis of the charge and of amounts provided and set aside for income tax

General considerations

2 The accounting year of very few companies ends on 5th April and thus the accounting periods of the majority of companies fall partly within one income tax year and partly within another. Before the more general adoption of the practice of basing the charge for income tax on the profits earned during the period covered by the accounts, as recommended by the Council in 1943, the common (though not universal) practice was to calculate the income tax charge in the profit and loss account by apportioning between accounting periods, on a time basis, the tax assessed for the two income tax years falling partly within the accounting year. Such a calculation produced a charge which was not, except in the opening or closing years of a business, based in any way on the profits of the accounting year for which the calculation was made. Another result was that no amount was included in the balance sheet for income tax other than the amount provided for income tax due for payment at the date of the balance sheet and any amount accruing, but not due for payment at that date, in respect of the income tax year in which the balance sheet date fell.

3 For a continuing business the foregoing procedure came to be regarded as unsatisfactory. A calculation on an apportionment basis may be all that is strictly necessary, since it results in a company including in its balance sheet the minimum amount which must be provided in respect of income tax and in charging the minimum amount of income tax against its accumulated profits to date. On the other hand, although income tax is based on profits, the amount included

in the balance sheet specifically for income tax under this procedure does not cover all income tax based, or to be based, on profits to date; also, the profit and loss account shows a charge for income tax which is not based on the profit shown in that account. There is therefore not necessarily any relationship between the income tax charge and the profit. If the charge is based on a period when profit was lower, it will not indicate the full tax burden to which the current profit will later give rise. If the charge is based on a period when profit was higher, it will represent a burden in excess of that relevant to the current profit; indeed the profit may be insufficient to cover the charge.

4 In recent years it has become general practice to remedy the unsatisfactory features of the apportionment method by charging in the profit and loss account the estimated amount of income tax which will be based on the profit of the year and by maintaining amounts provided or specifically set aside for current income tax liabilities and those subsequently arising based on profits to date.

5 The treatment described in the preceding paragraph, if adopted by a new business, may create difficulties because the law requires a transition in the early years of a business from the 'actual' basis of assessment to the 'preceding year' basis and thus requires the profit of one of the early years to be used as the basis of assessment for more than one year. As a result amounts required to be set aside to cover the income tax liabilities which will be computed by reference to the profits of the early years of a business will be out of proportion to the profits of those years. In such circumstances it may be desirable in each year to charge one year's income tax based on the profit of that year and also to set aside an additional amount until the company has set aside sufficient to cover all income tax based, or to be based, on profits to date.

6 A similar difficulty may arise if any established company which has hitherto adopted the apportionment method wishes to change to the method described in paragraph 4. Such a company may have existing reserves, including unappropriated profits, from which it can transfer an amount to meet the assessments to income tax based on profits of earlier years. If the existing reserves are insufficient then it will be desirable to set aside an additional amount in each year until there is sufficient to cover all income tax based on profits to date.

Amount to be shown as income tax liability

7 There is no universally accepted method for calculating the amount to be shown in the balance sheet as the liability for income tax. In accordance with paragraphs 2 and 3 above the minimum amount which a company must provide in respect of income tax is any income tax due for payment at the date of the balance sheet and any amount accruing, but not due for payment at that date, in respect of the income tax year in which the balance sheet date falls. Such accruing amount would be calculated on the basis of a day-to-day accrual of the income tax assessed for the income tax year in which the accounting year ends. There is no legal requirement for a company to include any greater amount as a liability for income tax at the balance sheet date; nevertheless there are in certain circumstances practical objections if a company treats as a charge in its profit and loss account only income tax accruing on a day-to-day basis to the balance sheet date. For example, if the balance sheet date is 31st January the full liability for the current income tax year would require to be provided (if unpaid) but many would regard it as unrealistic to carry forward, as a prepayment, tax in respect of two months. Again, if the balance sheet date is 31st December, many regard it as unrealistic to provide only three-fourths of the current income tax year's liability since on the day after the balance sheet date, namely 1st January, the whole of the income tax liability in respect of the current income tax year would become payable.

8 These and other considerations have led to a practice commonly followed of including as a liability the whole amount of the income tax payable in respect of the income tax year in which the accounting year ends. On the other hand some companies which base the income tax charge in their profit and loss accounts on the profit of their accounting year but whose accounting year ends in the early months of the income tax year nevertheless consider it more appropriate to include as a liability only the proportion of the income tax liability for the current tax year accrued to the accounting date.

Future income tax (other than tax deferred by capital allowances)

9 There is also no universally accepted practice in describing and setting out amounts specifically set aside for future income tax. An amount set aside to meet future income tax is not, at the date of the balance sheet, a liability and accordingly cannot be a 'provision' as defined in the sense in which that word is used in the Companies Act. Some companies therefore treat these amounts as specific reserves and group them with reserves in their balance sheets; an increasing number

of others show them separately under descriptions such as 'Amounts set aside for future income tax' without attaching the description of reserve or aggregating them with their reserves. The latter procedure has manifest practical advantages, especially that of separating reserves which are within the free disposition of the company from amounts which will normally be payable at some future date unless the company ceases business or incurs losses.

10 Further, there is no universally accepted practice for determining the amount to be shown as future income tax. Apart from any amount set aside (as a separate item) in accordance with paragraph 31 below (which deals with tax deferred by capital allowances) the maximum amount which can fairly be stated to be set aside specifically for future income tax is the estimated income tax which will be payable under assessments based on profits to date, but excluding any amounts properly grouped with current liabilities.

Conclusion on foregoing paragraphs

11 These differences of practice are inevitable while income tax assessments have to be computed on a preceding year basis and are payable on fixed dates prior to the end of the income tax year. The Council is of the opinion that in all the circumstances the best solution of this difficult problem is to follow the procedure recommended in paragraphs 12 to 15 below.

Recommendations

12 While the apportionment method referred to in paragraph 2 above is not incorrect, the following method of dealing with income tax in the profit and loss account is recommended in preference to it:

(a) the charge for income tax should be based on the profit of the year and should be so described

(b) any material adjustment in respect of amounts charged in previous years should be shown separately

(c) new companies should preferably set aside from profits an additional amount, to be shown separately, for or towards the balance of the tax payable for the current and following income tax years until all income tax based on profits to date has been set aside

(d) companies whose practice has been to charge only the accrued proportion of the current year's assessment should preferably set aside from current or accumulated profits an additional amount, which should be shown as a separate item, for or towards the balance of the tax payable for the current and following income tax years until the full amount to cover all income tax based on profits to date has been set aside.

13 The balance sheet should show by note or otherwise the basis on which the amounts included for income tax have been computed; if the full amount of income tax which is expected to be payable by reference to all profits to date is not set aside that fact should be made clear.

14 Amounts set aside for future income tax (apart from amounts set aside because depreciation and capital allowances differ) should consist only of:

(a) any amount set aside in respect of the estimated tax payable for the income tax year commencing after the balance sheet date, and

(b) the proportion of the current year's income tax for the period from the balance sheet date to the following 5th April, if the amount included under current liabilities is calculated by the day-to-day accrual method described in paragraph 7.

15 Amounts set aside for future income tax, whether described as reserves or not, should be shown separately and should preferably not be aggregated with reserves. Income tax assessable for any income tax year commencing after the balance sheet date should not be grouped with liabilities.

Income taxed at source and under Schedule A

16 The fact that some income of a company may be received after deduction of United Kingdom income tax (for example, investment income, ground rents, royalties, or rent from which Schedule A tax has been deducted) arises merely from the statutory procedure for the collection of income tax and ought not to affect the manner in which information is presented in the accounts. This applies to dividends described as 'free of tax' or as 'without deduction of income tax' as well as to other income taxed at source. Income tax so deducted, or deemed for tax purposes to have been deducted, forms part of the taxation charge to be shown in the profit and loss account.

Recommendations

17 Dividends, interest and other income should be brought to credit gross and should therefore include income tax suffered by deduction, or deemed for income tax purposes to have been suffered by deduction, on such income. The relative amount of income tax should be included as part of the charge for income tax for the year.

18 Income tax assessed under Schedule A and not recovered by deduction from rent paid forms part of the income tax charge of the paying company and should be included in the charge for income tax.

Annual charges

19 Income tax deducted by a company when making a payment of debenture, loan or note interest, royalties and other annual charges, is in effect assessed on the company as a means of collection from the payee. The expense of such annual charges to the company is the gross amount, whatever the division of the payment between the payee and the Inland Revenue.

Recommendation

20 Debenture, loan and note interest, royalties and other annual charges payable under deduction of income tax should be charged gross in the profit and loss account.

Dividends payable

21 Apart from special features relating to overseas trade corporations, the payment of a dividend, whether declared as 'subject to income tax', 'less income tax' or 'free of income tax', does not affect the amount of income tax payable by a company. The company is assessed on its profits as adjusted for income tax purposes irrespective of dividends declared and is not accountable to the Inland Revenue for the tax deducted, or deemed to have been deducted, therefrom.

Recommendation

22 The amounts shown in the accounts in respect of dividends paid or payable should be the net amounts, whether they are declared as 'subject to income tax', 'less income tax' or 'free of income tax'.

Claims for relief under Section 341, Income Tax Act 1952, in respect of trading losses

23 When a trading loss (as adjusted for tax purposes) has been incurred a claim may be made under Section 341 and in practice relief may be obtained either by way of repayment or by reduction or cancellation of an income tax liability. The taxpayer has the choice of making a claim under this section or of obtaining relief for the loss in some other manner. The relief under Section 341 may be given either against income tax paid or due in respect of some other source of income, or against the liability assessed for the year in which the loss was incurred on profits earned in the same trade, or by repayment of tax suffered by deduction at source from income such as dividends and interest. If the trading loss is smaller than the total taxable income (including the profit assessed for that year in respect of the same trade) less any charges, the relief can be obtained in that fiscal year for tax on the full amount of the loss; if the trading loss exceeds the total taxable income less charges, the immediate relief is limited to tax on this amount and the balance of the loss is normally carried forward.

24 If a trading loss has been incurred the relief which will be received under Section 341 is in some cases dealt with in the profit and loss account for the same year; in other cases it is not dealt with until the year in which the claim is settled. In the latter event no credit is taken in the accounts for the year in which the loss was incurred for the claim which the company has the right to make. This right exists whether or not it is intended to exercise it but at the date when the accounts are presented the claim may be a matter of intention only and the intention may be reversed because of a subsequent change in the standard rate of income tax or for some other reason.

Recommendation

25 A company which bases its charge for income tax on the profit of the year should adopt the procedure described below when it incurs a trading loss entitling the company to relief under Section 341:

(a) *If income tax relief under Section 341 is dealt with in the accounts for the year in which the trading loss is incurred:*

   (i) where the relief obtainable under Section 341 is less than the tax on income from other sources the charge for income tax should be shown after taking relief into account and should be described as income tax based on the profit of the year

   (ii) where the relief obtainable under Section 341 exceeds the tax on income from other sources the excess should be shown as income tax recoverable

   (iii) the amount of income tax recoverable should be treated in the balance sheet by set-off, either as a deduction from current liabilities for tax or from amounts set aside for future tax as may be appropriate, or as an asset reduced where appropriate by current liabilities for tax or by amounts set aside for future tax.

(b) *If the income tax relief under Section 341 is not dealt with in the accounts for the year in which the trading loss is incurred:*

   (i) in the accounts for the year in which the trading loss is incurred an indication should be given, if the amount is material, that no credit has been taken for the potential income tax recovery under Section 341.

   (ii) when the relief is brought into the profit and loss account in a subsequent year it should be disclosed separately as an adjustment relating to a previous year.

III. Relation of charges for income tax and profits tax to profits

26 The treatment of income tax in the manner recommended in paragraph 12 (combined with the fact that for profits tax the latest chargeable accounting period ends on the accounting date) will not necessarily ensure that an adequate amount is set aside for tax payable in the future on profits to date or that the profit and loss account shows a tax charge which is appropriate in relation to the profit of the year. The reason for this is that there may be material differences between the treatment of items for accounting purposes and their treatment for tax purposes; in particular, the amounts charged for depreciation in accordance with Recommendation 9 may differ from the capital allowances for tax purposes and this difference may involve substantial deferment of tax liability.

27 There are various reasons why capital allowances differ from depreciation charges and therefore affect the relation of the tax charge to the profit of the year. These reasons include the claiming of initial allowances, which have the effect of reducing future annual allowances; the incidence of balancing charges and balancing allowances; the fact that there are usually differences between the rates of and methods of calculating annual allowances as compared with those used for calculating depreciation; the granting of investment allowances, which give relief in addition to normal capital allowances; and the fact that there are some assets for which depreciation or amortisation is provided but which do not attract capital allowances (for example, commercial buildings and leases) and some for which the capital allowances are based on a smaller amount than the depreciation provisions (for example, industrial buildings and assets which have been written up on a revaluation).

28 The foregoing and other matters are considered in more detail in the following paragraphs. It is desirable to bear in mind that, with the exception of circumstances where special considerations arise, the object of capital allowances (other than investment allowances) is basically the same as that of depreciation provisions, namely to write-off the cost of an asset, less its residual value, over its useful life. Material differences between the way in which this is achieved in the accounts and the way in which it is dealt with for tax purposes therefore need to be considered to determine whether an adequate amount has been set aside for tax and whether the tax charge in the profit and loss account is appropriate in relation to the profit of the year.

Tax deferred by capital allowances

29 The result of obtaining initial allowances is to defer to subsequent years a part of the tax which would otherwise be payable on the profit of the year. The Council issued a statement on the subject in 1947 and a practice subsequently developed of setting aside and spreading over a period of years the temporary tax benefit resulting from initial allowances. Under this practice capital allowances including initial allowances are compared with the capital allowances which would have been granted if no initial allowances had been granted either for the year under review or for preceding years. This comparison discloses the amount on which tax has been deferred by initial allowances; and tax on this amount is set aside to meet, when payable, the tax so deferred.

30 Some companies have extended the principle underlying the foregoing practice in order to take into account the fact that temporary tax benefits (and therefore deferment of tax liability) may result from capital allowances (other than investment allowances) taken as a whole and not merely when initial allowances are obtained. This extension, which is simpler to operate than the procedure confined to initial allowances, is achieved by maintaining the total set aside for tax deferred by capital allowances at an amount equal to income tax and profits tax on the excess of:

(a) the net amount at which the relevant fixed assets are stated in the balance sheet (excluding any part which does not attract capital allowances because of a revaluation of assets or other reason) over

(b) the amount to which they have been written down for capital allowance purposes by allowances which have been effectively used in computing amounts charged or set aside for income tax.

If there is no such excess then no amount requires to be set aside.

Recommendations

31 If material, the amount of tax deferred by capital allowances should preferably be set aside and shown in the balance sheet, with appropriate description, as a separate item which may be grouped with 'future tax'. An amount so set aside should represent tax at current rates on the excess of –

(a) the net amount at which the relevant fixed assets are stated in the balance sheet over

(b) the written-down value of those assets for capital allowance purposes.

In making this calculation the net amount at (a) should where applicable be adjusted to eliminate any part of the amount which does not attract capital allowances because of a revaluation of assets or other reason; and the written-down value at (b) should where applicable be increased by an amount equal to any capital allowances which have not been effectively used in computing amounts charged or set aside for income tax.

NOTE: The question of assets which do not attract capital allowances, or which attract capital allowances based on a smaller amount than that on which the depreciation provisions are based, is dealt with later in paragraphs 41 and 42.

32 Where the practice recommended in the preceding paragraph is adopted:

(a) the amount to be dealt with in the profit and loss account each year (to increase or reduce the amount set aside) will be the difference between the amount of tax deferred by capital allowances at the end of the accounting period and the amount so deferred at the beginning of the period. This increase or decrease for the year may properly be taken into account in arriving at the tax charge of the year and if the effect is material the description of the basis of the tax charge should indicate the course followed and, if necessary, the amount involved

(b) if a change in rates of tax affects materially an amount already set aside for tax deferred by capital allowances the fact that there is a special adjustment to the amount set aside should be disclosed.

33 When an established company sets aside for the first time an amount computed as in paragraph 32 (a) there should also be set aside, from accumulated profits or if necessary from current profits, an additional amount, which should be disclosed, for or towards tax deferred by capital allowances in previous years.

34 Where the practice of setting amounts aside for tax deferred by capital allowances is not adopted:

(a) there should be indicated the extent, if material, to which depreciation will require to be provided in the future without relief from tax, and

(b) the effect of capital allowances which have materially distorted or even extinguished the tax charge should be indicated.

Investment allowances

35 Investment allowances are essentially a tax relief and not a reduction in the capital cost of the assets to which they relate. It would therefore be inappropriate for the tax relief on investment allowances to be deducted from the cost of the assets instead of being deducted from the taxation charge. The effect of deducting the relief from the cost of the assets shown in the balance sheet would be to overstate the taxation charge in the profit and loss account, the amount of the overstatement being in effect what would otherwise have to be provided as depreciation over the life of the assets.

36 The desirability or otherwise of transferring to reserve the tax relief on investment allowances is a matter of financial policy.

37 Unlike initial allowances, investment allowances give relief additional to the ordinary capital allowances and it is therefore appropriate to treat the tax relief on investment allowances as a reduction of the tax charge in the profit and loss account; similarly tax arising on the withdrawal of an investment allowance requires to be treated as an addition to the tax charge. The 'spreading' procedure already referred to, of setting aside an amount in respect of tax deferred by capital allowances, is not appropriate in relation to investment allowances.

38 Nevertheless there is no immediate certainty that an investment allowance will not be withdrawn. Under the provisions of the Second Schedule to the Finance Act 1954 the possibility of withdrawal must always exist for a period of three years (or in certain circumstances five years) from the date on which the expenditure was incurred. The making of any reference in the balance sheet to the possibility of withdrawal of investment allowances of material amount is a matter for determination in the circumstances of each case. Where (as will normally be the case with plant and machinery, buildings and similar industrial assets) there is no intention of disposing of the assets within the period specified in the Act then the withdrawal provisions will not need to be taken into account for balance sheet purposes.

39 Where an asset has been disposed of within the specified period in circumstances which do not require the investment allowance to be withdrawn, the provisions of the Second Schedule are such that the allowance may nevertheless be withdrawn at a later date as a result of circumstances over which the vendor has no control. If there has been such a disposal it is therefore necessary to consider whether there is a contingent liability for subsequent withdrawal of the investment allowance, if the amount is material.

Recommendation

40 The tax relief on investment allowances should not be deducted from the cost of the assets; it should be treated as a reduction of the tax charge in the profit and loss account. The extent to which the income tax and profits tax charges are affected should be stated if the tax relief, or the tax arising on the withdrawal of investment allowances, is material.

Depreciation to be provided out of taxed profits

41 Paragraphs 29 to 34 deal with the question of tax which will have to be borne in future but is at present deferred by capital allowances. Another matter for consideration is the position where depreciation must be provided out of taxed profits because there are assets which, though requiring provisions for depreciation or amortisation in the accounts, either -

(a) do not attract capital allowances, or

(b) attract capital allowances based on a smaller amount, for example where there has been a revaluation of assets or where an industrial building is purchased for an amount in excess of that on which capital allowances (based on cost of construction) will be obtained.

Recommendation

42 Where depreciation or amortisation is provided to a material extent on assets which do not attract capital allowances, or which attract capital allowances based on a smaller amount than that used for calculating the provisions, the position should be disclosed clearly in the accounts and there should be indicated the extent, if material, to which the depreciation or amortisation will have to be provided in the future without relief from tax.

NOTE: The information required by the foregoing recommendation may, where applicable, be combined with that required under paragraph 34 (a).

Other special factors and items of an exceptional or non-recurrent nature

43 The tax charge may be distorted in relation to profits by factors such as relief for past losses, the carrying forward of losses in preference to claiming relief under Section 341 of the Income Tax Act 1952, the allowance for tax purposes in one year of expenditure charged against provisions made in previous years, and the treatment for tax purposes on a 'renewals' basis of assets on which depreciation is provided in the accounts. In the same way tax chargeable on future profits may be substantially reduced or even eliminated for some years by reason of expenditure, such as pension fund lump-sum payments, available for carry forward against future assessments to tax.

44 The result of the year covered by the accounts may take account of items of an exceptional or non-recurrent nature which have to be disclosed to comply with paragraph 14 (6) of the Eighth Schedule. If such items have been taken into account in computing the profit of the year upon which the tax charge for the year is based, tax charges or tax reliefs relative thereto will be incorporated in the total tax charge for the year. In some cases exceptional or non-recurrent items of a material amount may not have been taken into account in the profit and loss account before arriving at the 'profit before taxation'; in order to show the tax which is appropriate to the amount shown as profit of the year it is desirable in such cases to show as separate adjustments to the items of profit or loss concerned the relevant tax charges or tax reliefs.

45 A provision for expenditure to be met in the future and not allowed for tax purposes in the year in which the provision is made (such as instalments payable to a pension fund in respect of back service) is sometimes computed after taking into account potential tax saving.

Recommendations

46 The net effect of special factors which have materially distorted, whether upwards or downwards, or even extinguished the tax charge should be indicated.

47 If any reference is made in accounts to the potential tax saving expected from items which may reduce substantially or even eliminate tax chargeable on future profits it should be made clear that the potential tax saving is dependent upon future profits against which such items can be utilised.

48 Where exceptional or non-recurrent items are not taken into account before arriving at 'profit before taxation' the effect of these items on the amount shown in respect of tax should be considered; where appropriate the relevant tax charges or reliefs should be shown as separate adjustments to the respective items.

49 If a provision for expenditure to be met in the future is computed after taking into account potential tax saving the fact that it is so computed should be made clear.

IV. Subsidiaries controlled and trading overseas

50 Where a holding company has overseas subsidiaries which are not regarded as controlled in the United Kingdom for tax purposes and do not trade in the United Kingdom, the consolidated accounts of the group may include profits retained overseas by those subsidiaries which could not be transferred to the holding company without incurring charges to tax additional to those provided in the accounts. This position arises because United Kingdom income tax and profits tax (after appropriate double tax relief) only become chargeable on the declaration of a dividend by such subsidiaries. A similar position also arises where there are local distribution or remittance taxes which are payable before the profits can be transferred to the United Kingdom.

51 Where these circumstances apply it is necessary to give in the consolidated accounts some indication of the limitation which tax imposes upon the availability to the parent company of the overseas profits and reserves brought into the consolidated accounts.

52 Although it may be possible to state the aggregate of the profits retained overseas by the subsidiaries the significance of the aggregate will normally be invalidated if the profits have suffered overseas taxation giving rise to double tax relief and a misleading impression may be given of the net tax involved upon remittance of the profits. Similarly it may not be possible to state the amount of the tax involved. It is therefore necessary to consider how attention should be drawn to the fact that on distribution the retained profits would be subject in some cases to overseas distribution taxes and to United Kingdom income tax and profits tax.

Recommendation

53 When consolidated accounts include profits and reserves of subsidiaries controlled and trading overseas which on distribution as dividends to the holding company would be subject to:

(a) overseas distribution taxes (if any), and

(b) United Kingdom income tax and profits tax (after appropriate double tax relief)

then such observations as may be appropriate should be given by way of note or otherwise in regard to the tax position if the tax resulting from distribution would be material. Similarly information should be given regarding the charge for tax on the profit of the year where a material amount of profit has not been subjected to United Kingdom tax. The tax charge of the year should be suitably described.

V. Overseas trade corporations

54 By the provisions of the Finance Act 1957 the trading income arising to an overseas trade corporation is normally excluded from the charge to United Kingdom income tax and profits tax. Income which is not regarded as trading income (in the Act termed 'investment income') remains subject to United Kingdom income tax and profits tax in the normal way.

55 As legislation permitting certain companies to qualify as overseas trade corporations was enacted for the first time in 1957 there has as yet been little opportunity to develop any generally accepted practice in regard to the treatment of income tax in accounts of such corporations; it is therefore too early to attempt to formulate recommendations covering all the points which may arise in practice. The matters referred to in the two following paragraphs will however require consideration when the accounts of an overseas trade corporation are being prepared.

56 The charge for United Kingdom tax (subject to double tax relief) in the accounts of an overseas trade corporation will be computed by reference to the 'investment income' and the 'distributions' of trading income and not by reference to the total income of the year. The tax arising on 'distributions' is assessable for the fiscal year in which the 'distributions' are due, but if 'distributions' are provided for in the accounts the relative tax will need to be classified in those accounts as a current liability notwithstanding that the 'distributions' may be due in a subsequent fiscal year.

57 The accounts of overseas trade corporations and of certain former overseas trade corporations will normally contain, as part of the retained profits, exempt trading income which at the date of the accounts has been excluded from the charge to United Kingdom income tax. The consolidated accounts of a group with one or more overseas trade corporations may also include retained profits which have likewise been exempted from United Kingdom income tax. It will be necessary to draw attention to the possibility that United Kingdom income tax (subject to double tax relief) may arise on such retained profits in the future; the method of doing this and the procedure for dealing with this tax when it arises therefore need consideration.

VI. Surtax

58 Where a company to which Section 245 of the Income Tax Act 1952 applies has not distributed a 'reasonable part' of its actual income for the year the special commissioners may direct that the income shall be apportioned among the members and charged to surtax at the rates appropriate to those members. The assessments are made on the members in the name of the company and unless the individual members themselves elect to meet the liability it must be borne by the

company. For trading companies the determination of what is a 'reasonable part' of the company's income is (subject to appeal) a matter largely within the discretion of the special commissioners, but for investment companies within the section the making of a direction in respect of the whole of the investment income of the company is automatic. If a 'clearance' under Section 252 has not been obtained in respect of past years there is the possibility that the Inland Revenue may decide to make a direction for any or all of the previous six years.

Recommendation

59 It is not normally necessary for the accounts of trading companies to refer to the contingent liability for surtax which exists where such a company is one to which Section 245 of the Income Tax Act 1952 applies, unless it appears probable that the Inland Revenue intend to make a 'direction'. Where the company is known to be an investment company to which Section 245 applies a note referring to the existence of the contingent liability for surtax is normally necessary.

VII. Tax reserve certificates

60 The holder of tax reserve certificates has the option, after holding them for at least two months, of obtaining repayment without interest or of applying them with interest in payment of taxes in respect of which they are acceptable; at the time of the issue of this Recommendation these taxes are income tax, surtax, profits tax and land tax. The certificates are not transferable and the Treasury will not, except under Court order, recognise any charge affecting their ownership.

61 The interest on tax reserve certificates is exempt from income tax, surtax and profits tax but it may not be used otherwise than in payment of taxes, since the only circumstance in which interest is credited is when certificates are applied in payment of taxes amounting to the sum of the certificates surrendered and the interest thereon. Nevertheless the interest represents interest on the money invested in tax reserve certificates (the purchase of which is optional) and not a reduction of tax liabilities. After being held for a period of two years the certificates cease to attract further interest.

Recommendations

62 The amount of tax reserve certificates held should be shown as a separate item in the balance sheet and grouped with current assets.

63 The interest allowed on tax reserve certificates when used for the payment of taxes should be treated as interest and not as a reduction of the tax charge.

64 If credit is taken for interest accrued to the date of the balance sheet it should be confined to interest on certificates which have since been applied in payment of taxes.

N20 *Treatment of investments in the balance sheets of trading companies*

(Issued 13th November 1958)

The Council of the Institute of Chartered Accountants in England and Wales makes the following Recommendation to its members on the treatment of investments in the balance sheets of trading companies. Whilst it is recognised that the form in which accounts are submitted to shareholders is (subject to compliance with the Companies Act) a matter within the discretion of directors, it is hoped that this Recommendation will be helpful to members in advising, in appropriate cases, as to what is regarded as the best practice.

Introduction

1 This Recommendation relates only to assets which are normally found in a balance sheet of a trading company under the heading 'Investments', including in particular stocks, shares and similar securities but not including such assets as rights in real property. It does not necessarily apply in the special circumstances of:

(a) banks, assurance companies and other companies exempted from certain requirements of the Eighth Schedule to the Companies Act 1948

(b) investment trust companies

(c) companies which deal in shares and similar investments.

General considerations

2 Paragraph 4 (1) of the Eighth Schedule to the Companies Act 1948 requires that the assets of a company shall be classified under headings appropriate to the company's business and paragraph 4 (2) requires that 'fixed assets shall be distinguished from current assets'. These requirements are however subject to the overriding requirement of Section 149 of the Act that 'every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year'.

3 Fixed assets have the fundamental characteristic that they are held with the object of earning revenue, directly or indirectly, and not for the purpose of sale. Trade investments and investments in subsidiaries are therefore properly classified as fixed assets of a company and so also are other investments which are intended to be held continuously.

4 Investments which are fixed assets have characteristics which distinguish them from other fixed assets and therefore they may be grouped under a separate balance sheet heading. The requirements of the Eighth Schedule in regard to stating the methods used to arrive at the amount of fixed assets apply to investments so grouped.

5 Readily realisable investments which represent funds available but not immediately required for use in the business are properly classified as current assets. To show such investments otherwise than as current assets would distort the view of the current asset position.

6 Investments are normally stated in the balance sheet at cost, subject to any necessary provision for diminution in value. In deciding whether such provision is necessary:

(a) where investments are held as fixed assets the material consideration will be their long-term value to the business rather than their current market value. A provision will normally be necessary if there has been a material diminution in value of an apparently permanent nature even though a loss has not been realised at the balance sheet date

(b) where investments are held as current assets the material consideration will be their current market value. If at the balance sheet date the market value of quoted investments is below the amount at which they are stated in the balance sheet, the disclosure of that value (in compliance with paragraph 11 (8) of the Eighth Schedule) will indicate the diminution in value; but in the absence of special circumstances it would not be satisfactory merely to give such an indication by means of a note, because an overstatement of the total current assets (and in turn the reserves) will not be avoided unless a provision is made for the diminution in value.

7 There are two methods of estimating the amount of the provision for diminution in value of investments:

(a) by comparing the cost of each investment with its value and providing for the full diminution in value of those investments which have diminished in value without taking into account any appreciation in value of other investments

(b) by comparing the aggregate cost of the investments held or of appropriate groups of them with the respective aggregate values.

The adoption of the first method is clearly the more conservative and almost invariably has the result of stating the aggregate of an investment portfolio at less than market value. If the method adopted is not consistently followed from one year to another a note on the accounts of the later year may be necessary to indicate that there has been a change in the method of estimating the provision.

Interests in subsidiaries

8 Paragraph 15 (2) of the Eighth Schedule provides that 'the aggregate amount of assets consisting of shares in, or amounts owing (whether on account of a loan or otherwise) from, the company's subsidiaries, distinguishing shares from indebtedness, shall be set out in the balance sheet separately from all the other assets of the company'. A practice which is commonly adopted to meet this requirement is to group together, under one suitable heading such as 'interests in subsidiaries', the separate totals of shares in subsidiaries and either:

(a) the aggregate amount of indebtedness of subsidiaries, whether on loan accounts or otherwise, or

(b) the separate aggregates of –

  (i) the long-term loans and advances to subsidiaries whether secured or otherwise

  (ii) other amounts owing by subsidiaries such as short-term advances and current accounts.

9 It may however be considered that in order to show a true and fair view the amounts owing from subsidiaries on current account and short-term advances should be grouped with current assets. For the purpose of such grouping it is essential to include only amounts which can properly be described as current assets, namely, current accounts which are regularly paid and temporary advances to be repaid shortly; in practice it will often be found that part of the amount described as owing on current account could in fact be more properly described as being a long-term advance and would therefore be unsuitable for grouping with current assets. If all amounts which may properly be described as current assets were eliminated from the aggregate of interests in subsidiaries, the residue (consisting of shares, debentures and other long-term loans and advances) would fall to be classified as fixed assets. Where it is the practice of the holding company to take into account dividends proposed to be paid by subsidiaries it will not be appropriate to include such dividends under current assets unless they are intended to be paid in cash or discharged through a genuine current account.

10 The provisions of the Eighth Schedule in relation to interests in subsidiaries would appear to permit either:

(a) one aggregate (with appropriate sub-division such as that indicated in paragraph 8 above) to be stated in the balance sheet under a suitable heading shown as an intermediate group between fixed and current assets, or

(b) two aggregates (with appropriate sub-division) to be stated in the balance sheet, one grouped with fixed assets and the other grouped with current assets

according to which method appears to satisfy the overriding requirement of Section 149 to show a true and fair view. Method (a), whereby all interests in subsidiaries are grouped together, is usually to be preferred. It is rarely possible to make the complete segregation of the current asset element which is essential for method (b).

11 Paragraph 15 (2) of the Eighth Schedule provides that the aggregate amount of indebtedness (whether on account of a loan or otherwise) to the company's subsidiaries shall be set out in the balance sheet separately from all its other liabilities. Whether this aggregate should be shown as a deduction from interests in subsidiaries instead of being grouped with liabilities is a question for careful consideration in the circumstances of the case, having regard to the overriding requirement to show a true and fair view. If the indebtedness is not in fact likely to be discharged by payment, for example where a subsidiary has lent surplus funds to the holding company, it may be appropriate to deduct the indebtedness from interests in subsidiaries.

12 Normally there will be no difficulty in establishing the cost of interests in subsidiaries when the investments have been acquired from third parties. Where however the consideration to a third party for the acquisition of an interest in a subsidiary is the issue of fully-paid shares in the holding company, the cost of the interest thus acquired is the value properly attributable to the shares of the holding company issued in exchange; this is not necessarily their nominal value.

13 If a subsidiary declares dividends in excess of its profits earned subsequent to the date as from which it was acquired as a subsidiary by the holding company, any such dividends received by the holding company need to be apportioned between capital and revenue; the net amount apportioned to capital is a deduction from the cost of the investment in the subsidiary, as such amount represents in effect a recovery of part of the purchase price.

14 Whichever of the methods set out in paragraph 10 is adopted there is no requirement in the Eighth Schedule for interests in subsidiaries to be shown on the basis normally required for fixed assets, that is to say, a disclosed aggregate of cost or valuation less a disclosed aggregate of depreciation; nor does the Schedule require the profit and loss account to show either the amount of any provision made for diminution in value, or as the case may be, that no such provision has been made. These exceptions from the normal requirements relating to fixed assets are specified in paragraph 15 (2) of the Eighth Schedule.

15 On the other hand, paragraph 4 (3) of the Eighth Schedule provides that the method or methods used in arriving at the amount of the fixed assets under each heading shall be stated; there is no exception from this requirement in the case of fixed assets consisting of interests in subsidiaries. It is therefore necessary to state the method or methods used, whether the whole or any part of the aggregate of the interests in subsidiaries is grouped with fixed assets or whether it is shown in an intermediate group between fixed and current assets.

16 Where provision has been made for diminution in value of interests in subsidiaries the amount need not be disclosed but the fact that such provision has been made must be stated in the balance sheet. 'Provision' for diminution in value does not include amounts which are required to be treated as reserves because they are in excess of what is reasonably necessary for the purpose and were not written off in relation to interests in subsidiaries before 1st July 1948.

17 The amount at which interests in subsidiaries stand in the balance sheet is not normally a current valuation. Provision is made for any material diminution in value of a permanent character (see paragraph 6) but unrealised appreciation is not brought into account except in special circumstances, such as on revaluation of all the assets of a company or group.

Investments by a subsidiary in fellow subsidiaries

18 Paragraph 16 of the Eighth Schedule requires indebtedness with fellow subsidiaries to be shown separately. This requirement does not extend to shares held by a subsidiary in a fellow subsidiary. It will however normally be desirable for such shares to be shown separately, notwithstanding that the Eighth Schedule appears to permit of their being included under 'trade investments' of which the aggregate only be shown.

Trade investments

19 Trade investments comprise broadly:

(a) investments acquired and held primarily in order to protect the company's goodwill, or to facilitate or further its own existing business, rather than for income or appreciation in value

(b) investments representing a substantial but not a controlling interest in another company or undertaking, particularly where the company has the right to appoint its own representatives to take part in the management. Such holdings are often referred to as 'Investments in associated companies'.

NOTE: Investments in subsidiaries often fall within the above definition but they have been dealt with separately since they are required by the provisions of paragraph 15 (2) of the Eighth Schedule to be set out in the balance sheet separately from all other assets of the company. Similarly, investments held by a subsidiary either in its holding company (which must have been acquired before 1st July 1948) or in its fellow subsidiaries often fall within the above definition of trade investments.

20 Where investments or other interests in associated companies (see paragraph 19 (b)) are material it will normally facilitate the showing of a true and fair view if such interests are shown as a separate group under the general heading of 'trade investments'. In certain circumstances loans and advances to and other indebtedness of an associated company will properly be shown under the general heading of 'trade investments'.

21 Trade investments are properly classified as fixed assets of a company and therefore the method used to arrive at the amount at which they are shown in the balance sheet must be stated in order to comply with paragraph 4 (3) of the Eighth Schedule. This applies even though such investments are shown in the balance sheet under a separate intermediate group heading. In addition, if the market value (or in the case of investments not having a market value, the value as estimated by the directors) of the trade investments is not shown either as the amount of the investments or by way of note, sub-paragraph 5 (1) of the Eighth Schedule applies; this sub-paragraph requires such investments to be shown in the balance sheet at their aggregate cost (or, if they stand in the company's books at a valuation, the amount of the valuation) with a separate deduction to show the amount provided or written off since the date of acquisition or valuation, as the case may be, for diminution in value.

22 For the purpose of providing for diminution, if any, in value of trade investments, the value to the holder of a trade investment is not necessarily either its market value or its realisable value. Consideration of the relation of the trade investments to the business as a going concern is necessary, for which purpose enhanced goodwill and trading facilities may also need to be taken into account.

23 Where trade investments include an investment in a company which earns or has earned very substantial profits and accumulated large reserves, the amounts distributed by it in dividend being relatively insignificant, the long-term value of the trade investments may be greatly in excess of the amount at which they are stated in the balance sheet. This excess would not be apparent from the balance sheet and would not normally be reflected elsewhere in the accounts because (unlike a subsidiary) the retained income would not be apparent from consolidated or group accounts. Some explanation may therefore be needed in these exceptional circumstances to enable the accounts to show a fair view.

Other investments – quoted

24 Quoted investments are defined by paragraph 28 of the Eighth Schedule as investments as respects which there has been granted a quotation or permission to deal on a recognised stock exchange, or any stock exchange of repute outside Great Britain.

25 Quoted investments (other than trade investments and investments in subsidiaries or fellow subsidiaries which may happen to be quoted) will in the absence of special circumstances represent funds available but not immediately required in the business and will be properly classified as current assets.

26 Compliance with the requirements of paragraph 8 (3) of the Eighth Schedule entails the sub-division, where necessary, of the heading showing the amount of the quoted investments (other than trade investments and investments in subsidiaries or fellow subsidiaries which may happen to be quoted) to distinguish the investments as respects which there has and those as respects which there has not been granted a quotation or permission to deal on a recognised stock exchange. A recognised stock exchange is defined by Section 455 of the Companies Act as any body of persons which is for the time being a recognised stock exchange for the purpose of the Prevention of Fraud (Investments) Act 1939. No stock exchange outside Great Britain is recognised for this purpose, but the requirement of the Eighth Schedule is of less practical importance than it was when the Companies Act was passed, as The Stock Exchange, London, has since granted permission to deal in most securities quoted on stock exchanges of repute abroad.

27 Where the market value of quoted investments (other than trade investments and interests in subsidiaries or fellow subsidiaries) differs from the amount at which such investments are stated in the balance sheet, paragraph 11 (8) of the Eighth Schedule requires the aggregate market value to be shown. In respect of quoted investments, market value is normally calculated by reference to a stock exchange quotation. If the quotation used is taken from an overseas stock exchange and the currency of the country in which the shares are quoted is unstable or subject to close exchange control it will be necessary, if the matter is material, to deal with the position by note. If the market value of investments is taken as being higher than their stock exchange value, the stock exchange value of any such investments must also be shown to comply with paragraph 11 (8) of the Eighth Schedule.

28 When calculating the market value of a quoted investment by reference to the stock exchange quotation:

(a) it is normal to use the middle market price (the mean of the two quotations shown in the Stock Exchange Official List). If any other basis is adopted it may be desirable to give an indication of the precise basis used

(b) if there has not been a recent marking the quotation may be unreliable as a guide to market value. If there has been no marking for a long time there may be no quotation. In either case it is advisable to ask a stockbroker to obtain a quotation from the market

(c) where accrued interest and dividends are included in the accounts, for example under debtors, no adjustment to the market price is required if that price is ex div, but if the price is cum div an adjustment would be necessary to exclude the net accrued interest or dividend.

29 Having regard to the short period and the purpose for which treasury bills are normally held, they are properly classified as current assets and entered in the balance sheet either 'at cost' or 'less rebate' (that is to say at their face value discounted at the market rate, this being their realisable value at the date of the balance sheet).

Other investments – unquoted

30 An unquoted investment is defined negatively in paragraph 28 of the Eighth Schedule as an investment as respects which there has NOT been granted a quotation or permission to deal on a recognised stock exchange or any stock exchange of repute outside Great Britain. Unquoted investments in a company's balance sheet will therefore normally comprise such items as:

(a) shares or other securities of private companies

(b) unquoted securities of public companies.

There are certain other investments within the general category of unquoted investments which differ from the more normal types mentioned above and therefore require to be treated according to the circumstances. Examples of such investments include mortgages and those which produce a surplus on maturity instead of an annual income, such as sinking fund policies and reversions. In certain circumstances loans to individuals or companies may be investments. The more important of these special types of unquoted investments are dealt with briefly in the next six paragraphs. Where special types of unquoted investments are material in amount it is a matter for consideration whether the description 'unquoted investments' without amplification is appropriate.

31 Where unquoted investments are current assets they will normally be stated in the balance sheet at cost or, if on a reasonable estimate current value is considered to be less than cost, then at that current value. To provide for diminution in value of such investments not only conforms to best accounting practice but is particularly desirable because the requirement set out in paragraph 11 (8) of the Eighth Schedule to state the aggregate market value of quoted investments (other than interests in subsidiaries and trade investments) where it differs from the balance sheet amounts of the investments, does not apply to unquoted investments. For the same reason, paragraph 11 (7) of the Eighth Schedule has particular relevance to unquoted investments which are current assets; this sub-paragraph requires the directors to state if in their opinion any of the current assets have not a value, on realisation in the ordinary course of the company's business, at least equal to the amount at which they are stated.

32 Where a company holds unquoted shares of companies which do not provide for depreciation or diminution in the value of such of their assets as diminish in value (such as certain mining companies) the investment itself will become a wasting asset since the assets underlying it are decreasing in value. The dividends received from the investment may include in effect a partial return of capital. It is necessary to consider whether provision should be made for the diminution in the value of such an investment.

33 There are certain types of investment which are normally held until maturity. One such investment is a sinking fund policy on which (except in the early years) there is an annual increase in value in addition to the premiums paid. This increase (analogous to the interest which would be earned by placing the amounts of the premiums on deposit at interest) is the increase in the surrender value for the year less the premiums paid during the year. Such a policy can readily be realised at its surrender value at any time. For these reasons the annual increment may be taken into account each year on the ground that it is inappropriate to wait until maturity and then treat the whole excess over premiums paid as an appreciation in value arising entirely on maturity.

34 Normally such policies will be stated in the balance sheet at surrender value. In the early years however, when cost is higher than surrender value, they need not be stated at lower than cost unless early realisation is intended; where they are stated at cost the surrender value will be shown by note.

35 Some companies, which hold a sinking fund policy for the purpose of replacing an asset which diminishes in value, adopt a practice whereby they write off the annual premiums as a charge to profit and loss account. They maintain the asset at cost in the balance sheet and state by way of note that a sinking fund policy is held and the amount of its surrender value.

36 The classification of mortgages depends upon the purpose for which they are acquired and held. Where a mortgage is intended to be held on a long-term basis it may be classified as a fixed asset in which case the normal rules regarding the balance sheet treatment and valuation of fixed assets will apply. If however the mortgage is readily realisable and merely represents funds not immediately required in the business it will be grouped with current assets and, unless there are exceptional circumstances, valued on the same basis as other debts.

Recommendations

37 It is recommended that the following principles should normally be applied in connection with the treatment of investments in the balance sheets of trading companies whose normal business does not involve either dealing in investments or the holding of investments other than in subsidiaries.

Classification

Fixed assets

38 Investments which it is intended to hold continuously, for example trade investments and interests in subsidiaries should be classified as fixed assets.

39 Investments which are fixed assets may be distinguished from other fixed assets of the company by showing them under a separate heading. Where investments are so shown the requirements of paragraph 4 (3) and (except in the case of interests in subsidiaries) paragraph 5 of the Eighth Schedule in regard to fixed assets will apply as if the investments were shown under fixed assets.

40 Shares held by a subsidiary in a fellow subsidiary should be shown separately.

41 Where interests in associated companies are material they should be stated separately under the general heading of ‘Trade investments’ or under a heading of their own.

Current assets

42 Quoted and other readily realisable investments (other than trade investments, investments in subsidiaries and fellow subsidiaries, and other investments intended to be held continuously, even though they may happen to be quoted or are otherwise readily realisable) should be classified as current assets; to do otherwise would distort the view of the current asset position.

Special considerations applicable to holding companies

43 Interests in subsidiaries, which may consist of shares in subsidiaries and amounts owing by subsidiaries in respect of debentures or otherwise, should generally be shown as one group in the balance sheet of the holding company. It may however be desirable to group with current assets the aggregate of the temporary advances and/or the amounts due on current accounts which are regularly paid, provided it is possible to segregate the whole of such amounts from other indebtedness of the subsidiaries to the holding company.

44 A holding company's indebtedness to its subsidiaries should normally be grouped with liabilities but should be stated separately. Such indebtedness may however be shown as a deduction from interests in subsidiaries in appropriate circumstances, for example where the subsidiaries lend their surplus funds to the holding company.

Valuation

Diminution in value

45 Provision should be made for the diminution in the value of investments:

(a) where the market value at the date of the balance sheet of investments which are current assets is lower than cost

(b) where the value to the business of investments which are fixed assets appears to have decreased permanently below cost.

46 Provision for diminution in value, calculated by one or the other of the methods referred to in paragraph 7, should not exceed the amount required to reduce cost to market value at the date of the balance sheet in the case of investments which are current assets or to long-term value in the case of investments which are fixed assets.

Appreciation in value

47 Exceptional circumstances may arise in which an undertaking, wherein an important trade investment is held, has retained and accumulated profits on such a scale that the income which reaches the investor company and the amount at which the investment is carried in the accounts are a wholly inadequate reflection of the value of the investment, although this fact is not apparent from the trade investments item in the balance sheet or from the accounts as a whole. In such circumstances consideration should be given to the question whether the relative importance of the matter is such that without some explanation in the accounts they would fail to show a fair view.

Interests in subsidiaries

48 The requirements of paragraph 4 (3) of the Eighth Schedule to state the method or methods used to arrive at the amounts at which fixed assets are stated in the balance sheet should be complied with in respect of interests in subsidiaries. This applies whether such interests are grouped with fixed assets or shown as a separate group; it does not apply to any part of such interests grouped with current assets.

Sinking fund policies

49 Where a sinking fund policy is shown in the balance sheet otherwise than at surrender value the surrender value should be shown by note.

Treasury bills

50 Treasury bills should be shown as current assets and should be stated at cost or at their face value discounted at the market rate.

N21 *Retirement benefits*

(Issued 29th February 1960)

The Council of The Institute of Chartered Accountants in England and Wales makes the following Recommendation to its members on the accounts of schemes for retirement benefits for employees and on the treatment, in the accounts of employers, of their obligations for retirement benefits. It is hoped that this Recommendation will be helpful to members in advising, in appropriate cases, as to what is regarded as the best practice. The Recommendation does not take into account any relevant consequences there may be as a result of the National Insurance Act 1959 which is not yet in force.

1 There is great diversity in the nature and bases of computation of retirement benefits for employees and in the methods by which the funds to pay them are provided. No attempt is made in this Recommendation to review this complex subject in detail nor to make recommendations covering all the diverse arrangements which exist.

2 Paragraphs 6 to 28 are concerned primarily with the main principles applicable to the accounts of a 'pension fund' by which is meant a retirement benefits scheme where the main purpose is to provide pensions for employees on their retirement, the contributions of the employer and the contributions (if any) of the employees being paid to trustees on whom rests the responsibility for investing the funds in order to provide the benefits as and when they become payable.

3 Under such a pension fund it is not usually possible to calculate with certainty the contributions required in order to provide the benefits which will become payable according to the rules. The uncertainties arise from various causes: for example it is not possible to predict future interest rates nor is it possible to know what proportion of the members of the fund will reach retirement age or how long they will survive thereafter; in additional some pension funds provide for benefits to be based on salaries at or near to retirement instead of being related to salaries actually paid during each year of service. The uncertainties require to be examined periodically by means of an actuarial valuation to assess the state of the fund.

4 Actuarial valuations are not required where the whole of the benefits is secured through the payment of premiums to an insurance company or where the scheme is of the provident fund type under which the contributions relative to each employee are invested to accumulate at interest until death or retirement, when the amount then accumulated is paid as a lump sum or used to purchase an annuity. The circumstances of the particular case will determine the extent to which this Recommendation is applicable to the accounts required for a fully insured pension fund or for a scheme of the provident fund type.

5 Paragraphs 29 to 34 concern the accounts of the employer and deal with the main principles applicable to the treatment of the employer's obligations for payment of retirement benefits, having regard to the nature of the arrangements under which those obligations arise.

Accounts of pension funds

6 The object of a pension fund is not primarily to produce income by the employment of capital but to maintain a total fund sufficient to enable the benefits to be paid as and when they fall due. In consequence the accounts are subject to some important considerations which distinguish them from the accounts of other trusts and those of a trading company. In particular:

(a) the distinction between 'capital' and 'revenue' does not normally arise

(b) the accounting treatment of investments is governed by the fact that they may either be retained in order to augment the fund by the income therefrom or be realised for the purpose of paying benefits, the choice depending upon the circumstances of the particular fund at a particular time

(c) the accounts can give a true and fair view of the movements in the assets of the fund during the year of account and of the disposition of the funds at its close (that is to say a record of stewardship) but where the benefits are not fully insured the account cannot give a true and fair view of the state of the affairs of the pension fund unless they are accompanied by appropriate actuarial information, since the ability of the fund to meet the benefits can be assessed only by actuarial valuation; the uncertainties involved in such a valuation may vary widely according to the nature of the fund and the manner in which the benefits are to be computed.

7 Without appropriate actuarial information the accounts will not show the interested parties (the trustees, the members and the employer) whether the existing fund together with future contributions and investment income can be expected to be sufficient to pay the benefits as and when they arise or whether there is expected to be a deficiency which will require to be made good or which may reduce benefits, or a surplus which might be applied to the reduction of future contributions or to the improvement of benefits.

8 If an actuarial valuation were made each year as on the accounting date then the accounts could be read in conjunction with that valuation. In this country however an annual valuation is not normally regarded as necessary; nor is it always practicable for the valuation as on a particular accounting date to be available by the time when it is desired to issue the accounts made up to that date. The normal practice is to have valuations made at five-yearly or other suitable intervals and to issue the annual accounts accompanied by appropriate actuarial information based on the latest available valuation.

9 An actuarial valuation comprises estimates of the present capitalised value of (a) the benefits to be paid to those who are members of the fund at the date of the valuation and (b) the sums which are expected to be provided to meet those benefits by the investments and by further contributions. By comparing (a) with (b) the actuary is able to arrive at a 'surplus' or 'deficiency', on which he can then report with any observations it may be necessary for him to make regarding the adequacy of the contribution rates. In making his valuation the actuary has to make assumptions regarding the rate of interest to be earned, the salary progression of members of the fund where it is relevant to the basis on which benefits or contributions are computed, the withdrawal of members before reaching retirement age, and the expectation of life of the members in relation to death benefits and the duration of retirement benefits. The actuary must decide upon the rate of interest to use in calculating, for the purpose of his valuation, the present value of future contributions and of the benefits resulting from both past and future service; and he must also decide the basis on which to value the existing investments.

10 The value which the actuary places on the investments will not necessarily be the same as the amount at which they are stated in the accounts as on the accounting date to which the valuation relates. The accounts are a factual record in which the investments need to be stated at amounts which will give a true and fair account of the stewardship of the funds up to the accounting date, whereas the actuarial valuation is an assessment of the ability of the fund to meet its future obligations. Such an assessment is necessarily based not only on the existing net assets but also on many assumptions about future events and in deciding what value to place on the investments the actuary will have regard to his assumptions on matters such as the rate of interest to be earned and whether the incidence of benefit payments is likely to make it necessary to realise existing investments.

11 In making an actuarial valuation the rate of interest used is a crucial factor. In deciding upon the rate the actuary is influenced by the known income from the existing assets and by the rate of interest which he expects the fund will earn on any new investments. The actual income from existing assets is not affected by a rise in interest rates and a corresponding fall in the market value of investments; but such a change will have the effect of increasing the rate of interest expected on new investments. The effect of such a change in relation to the actuarial valuation of any particular pension fund will depend upon matters such as whether the fund is expanding or declining and the length of the terms of redeemable investments compared with those of the liabilities.

Recommendations

12 The following recommendations are made as an indication of the main principles applicable to the accounts of pension funds, **but they must always be considered in relation to the circumstances and rules of the particular fund**.

Form of accounts

13 The accounts of a pension fund should normally consist of a balance sheet showing the amount of the accumulated fund and the net assets representing it, with appropriate actuarial information regarding the ability of the fund to meet its obligations. In the balance sheet or in supporting statements there should be suitable detail including in particular:

(a) the amount of the fund at the beginning of the accounting period

(b) the contributions, investment income and other amounts, such as net profits on investments, by which the fund was increased during the period

(c) the benefit payments, refunds on withdrawal, expenses and other amounts, such as net losses on investments, by which the fund was reduced during the period

(d) the amount of the fund at the end of the period.

14 The term 'Revenue Account' is usually inappropriate for any part of the accounts of a pension fund. To attempt to distinguish in the accounts between 'capital' and 'revenue' is normally inappropriate since the object is not to maintain an income-producing capital fund but to maintain a total fund sufficient to enable retirement benefits to be paid as and when they fall due. The distinction may however have to be made where a minimum rate of interest has been guaranteed or where benefits are directly related to the income earned on the accumulated funds.

Accounting treatment of investments

15 Practices in stating investments in stocks and shares and similar securities differ, but whatever may be the practice adopted it should be followed consistently. The bases most commonly used are:

(a) at cost less provision to reduce to market value; the amount of the provision should be disclosed and if the provision is calculated by method (a) in paragraph 17 the aggregate market value should be shown by note

(b) at cost less provision to the extent (if any) considered necessary for diminution in value, the amount of any such provision being disclosed and the amount of the aggregate market value being shown by note together with an explanation of why it is considered unnecessary to make a full provision to reduce cost to market value (for example, where some investments are in government stocks having a redemption date and the view is taken that there is no likelihood of a sale of those investments before the redemption date); such explanation should be so presented that attention is drawn to it in relation to the amount of the accumulated fund and in relation to the investments, for example by a note to which specific reference is made against the accumulated fund and against the investments

(c) at aggregate market value on the accounting date, whether above or below cost, the difference between the aggregate market value and the aggregate cost being dealt with as indicated in paragraph 23; this basis should not be used unless the investments are readily marketable.

16 *'Cost'* should be the actual cost of the investments held at the accounting date. Where sales or conversions have taken place the profits or losses thereon should be taken up in the accounts so that the investments currently held are stated at their cost, not the cost of the investments they have replaced.

NOTE: Where it is the practice to deal with income on a redemption yield basis, by adjusting the investment income for the period by the appropriate proportion of the discount or premium at which the investments were bought, this involves for balance sheet purposes the inclusion of the investments at cost increased or, as the case may be, reduced by the proportion to date of the amount by which redemption value exceeds or falls short of cost. With appropriate description this treatment may be regarded as 'cost' for the purpose of the bases referred to in paragraph 15.

17 '*Market value*' on the accounting date should be the market value of quoted investments and the estimated current realisable value of unquoted investments. A provision made under (a) of paragraph 15 may be computed either:

(a) by comparing the cost of each investment with its market value and providing the full diminution in value of those investments which have diminished in value without taking into account any appreciation in value of other investments; or

(b) by comparing the aggregate cost of the investments held or of appropriate groups of them with their respective aggregate values.

18 As stated in paragraph 14 it is normally inappropriate to attempt to distinguish between 'capital' and 'revenue'. Accordingly the purchase and sale prices of investments should not normally be adjusted for income accrued; similarly, income from investments should not normally be adjusted

by reference to the amounts accrued at the beginning and end of the accounting period. These adjustments may however need to be made where a minimum rate of interest has been guaranteed or where benefits are directly related to the income earned on the accumulated funds.

19 Where a pension fund which is not a fully insured scheme holds investments consisting of endowment assurance or deferred annuity policies they should normally be stated in the accounts on one of the following bases:

(a) at cost (that is to say, premiums paid on policies currently held) less provision for any loss which it is expected will be incurred through surrender of any policies in exchange for amounts lower than cost

(b) at surrender value, the difference between cost and surrender value being reflected in the amount of the fund.

20 Other investments, such as freehold and leasehold properties, should normally be stated in the accounts at cost less provisions for depreciation, amortisation and diminution in value.

21 The descriptions used in the accounts for the various types of investments should make clear the bases on which they are stated; the effect of any change of basis should be indicated if material.

22 Realised profits on investments should be added to the accumulated fund or shown in a separate reserve account. Realised losses and provisions for expected losses, diminution in value, depreciation and amortisation should be deducted from the accumulated fund or, where applicable, the reserve account.

23 Where the investments are stated in the accounts on the basis referred to in (c) of paragraph 15 (market value, whether above or below cost) the accounting treatment referred to in paragraph 22 may be applied to the unrealised appreciation or depreciation of the investments held on the balance sheet date. It may however be convenient to keep this unrealised difference between cost and market value distinct from the remainder of the accumulated fund. In that event the difference should be shown (with appropriate description and disclosing the change in market value during the period) as a separate addition to or deduction from the accumulated fund, realised profits and losses (meaning the surplus or deficiency of proceeds compared with cost) being taken up as such in the accounts and eliminated from the unrealised difference as and when investments are sold.

Ability to meet obligations

24 The accounts of a pension fund should be accompanied by sufficient actuarial information to show whether the fund is likely to be able to meet, as they fall due, the obligations to existing members and beneficiaries if future contributions are made on a specified basis and the expected accretions from investment are achieved; such information should indicate, where applicable, any special contributions which may be necessary to ensure the adequacy of the fund. If the actuarial information is given otherwise than by note on or appendix to the accounts (for example, if it is given in or with an accompanying report by the trustees) the accounts should indicate where the information is given.

25 The actuarial information referred to in the preceding paragraph may be given either by means of the actuary's report or in a statement in terms agreed with the actuary. A concise statement by way of note on or appendix to the accounts will normally be the appropriate method; such a note should relate specifically to the position disclosed by the latest available actuarial valuation, indicating the date as on which it was made and any action taken thereon. The note should indicate the period which elapses between valuations.

26 Developments since the last valuation may make it necessary to ascertain from the actuary whether the position disclosed by that valuation has changed to such an extent that it would be misleading, without further comment, to base on that valuation the actuarial information given with the accounts. Examples of such developments are a substantial fall in the value of investments or in the yield therefrom, a material change in the nature of the membership of the fund, a significant degree of inflation affecting a fund based on salaries at or near to retirement date, or a failure to comply with the rules of the fund or the recommendations of the actuary.

27 If it appears that the assumptions which underlie the actuarial information given with the accounts may be nullified (for example, an indication by the employer of his intention to discontinue his contributions or to close the fund, or inability of the employer to meet his obligation under a guarantee to maintain the solvency of the fund or its rate of accumulation) the appropriate factual information should be furnished with the accounts so that a true and fair view may be given.

28 If the requisite actuarial information cannot be given, for example because an actuarial valuation is due but not yet available or because there has not yet been an actuarial valuation of a recently established fund, the facts should be stated.

Accounts of the employer

29 The full extent of an employer's contractual obligations for payment of retirement benefits to employees needs to be reflected in the employer's accounts. For this purpose it is not sufficient merely to charge against revenue the normal payments made during the period by way of premiums to insurance companies or contributions to a retirement benefits scheme. It is necessary to consider all aspects of the employer's contractual obligations including any guarantees given by the employer and commitments in relation to back service. It is therefore essential to examine the terms of the trust deed or other contract under which the obligations arise and to consider also the latest available actuarial information regarding the adequacy of the funds of any retirement benefits scheme.

30 The fact that benefits are provided by the payment of premiums to an insurance company will not relieve the employer of all further responsibility unless the benefits are fully insured. For example, if an employer is under contractual obligation to pay retirement benefits based on salaries at or near to the date of retirement the only method by which such benefits can be insured is under policies on which premiums are adjusted periodically in the light of salaries then being paid; any increase in premium resulting from such a review necessarily includes a back service element the amount of which can become material as retirement date approaches.

31 The recommendations made below are intended as an indication of the main principles applicable to the accounts of any employer who has responsibilities for employees' retirement benefits. Where the employer is a company the recommendations are not concerned with the statutory obligation to disclose the aggregate amount of directors' or past directors' pensions and to include contributions to pension schemes in the aggregate amount of directors' emoluments; nor are the recommendations concerned with the provisions of the Income Tax Acts which determine the admissibility of contributions as deductions in computing profits or in certain cases the treatment of contributions or accruing benefits as emoluments of directors and others.

Recommendations

32 In the preparation of the accounts of an employer who is under contractual obligation to provide or contribute towards retirement benefits for employees, due considerations should be given to all aspects of that obligation in addition to the normal charge against revenue in respect of insurance premiums or contributions to a scheme. In particular:

(a) where the employer has given a guarantee (for example, to maintain the solvency of the scheme or to ensure a minimum rate of interest on or rate of accumulation of the funds) there should be an appropriate note on the accounts if the amount is or may become material in relation to the accounts of the employer; in view of the effects of inflation special consideration of this matter is necessary where benefits are based on salaries at or near to retirement date

(b) where there is an obligation to provide retirement benefits which are not covered by contributions to a retirement benefits scheme (for example benefits to which employees will be entitled under individual service agreements or their general terms of employment or by way of supplement to insured benefits) provision should be made therefor if the amount is material; if provision is not so made the position should be stated by note.

33 Where an employer has made or is under obligation to make, either in respect of back service or to make good a deficiency, a special contribution (whether by single payment or by a series of annual payments) the amount of which is material in relation to the accounts of the employer:

(a) where the special contribution has been paid in full during the year the amount should be disclosed and if any part of it is being carried forward for charging against future revenue this should be made clear in the accounts for that year and in the accounts of subsequent years in which any balance is carried forward

(b) where the whole or part of the special contribution has not been paid the full amount should be disclosed in the first accounts issued after the need for the special contribution became known and the liability for the unpaid amount should be provided for in those accounts and in the accounts of subsequent years until discharged; if provision is not so made the position should be stated by note, notwithstanding that the employer may have the right to discontinue his contributions or to close the fund

(c) if the amount provided in respect of the special contribution has been reduced by the potential saving of tax this fact should be made clear.

34 Where it is the policy of an employer to pay retirement benefits to employees or their dependants although under no contractual obligation to do so, this expense can be dealt with either by charging against current revenue the retirement benefits payable or by setting aside amounts against which to charge retirement benefits as they become payable in the future. Whichever method is adopted should be used consistently. If the method used is to set amounts aside it is desirable that these should be computed on a consistent basis by making each year an estimate of the benefits which are likely to become payable in the future as a result of service during that year. (The recommendation in paragraph 32 (b) would however apply where a retiring allowance, though made voluntarily, has been granted in such a way that its continuance constitutes a contractual obligation.)

N22 *Treatment of stock-in-trade and work in progress in financial accounts*

(Issued 16th November 1960)

The Council of The Institute of Chartered Accountants in England and Wales makes the following Recommendation to members of the Institute on the treatment of stock-in-trade and work in progress in the financial accounts of industrial and commercial enterprises. The Recommendation replaces Recommendation 10 and it is hoped that it will be helpful to members in advising, in appropriate cases, as to the best practice.

1 In the financial accounts of industrial and commercial undertakings few matters require more careful consideration than the amount to be attributed to stock-in-trade and work in progress. Circumstances vary so widely that no one basis of arriving at the amount is suitable for all types of business nor even for all undertakings within a particular trade or industry. Unless the basis adopted is appropriate to the circumstances of the particular undertaking and used consistently from period to period, the accounts will not give a true and fair view either of the state of affairs of the undertaking as on the balance sheet date or of the trend of its trading results from period to period. The need to give a true and fair view is the overriding consideration applicable in all circumstances.

2 In order to arrive at the amount to be carried forward, as on the balance sheet date, for stock-in-trade and work in progress it is necessary to ascertain (from stocktaking at the end of the period or from stock records maintained and verified during the period) the quantities on hand and to make a proper calculation of the amount. It cannot be emphasised too strongly that all stocks belonging to the business should be taken into account, whatever their location or nature. This Recommendation does not deal with the methods of ascertaining the quantities on hand but is confined to an examination of the factors to be considered when computing the amount. The word 'stock' is used hereafter to embrace stock-in-trade and work in progress.

NORMAL BASIS

3 The basis normally used for the determination of the amount to be carried forward for stock is its cost less any part thereof which properly needs to be written off at the balance sheet date. It is in computing cost and the amount, if any, to be written off that practical difficulties arise.

Cost

Elements of cost

4 The elements making up the cost of stock are:

(a) direct expenditure on the purchase of goods bought for resale, and of materials and components used in the manufacture of finished goods

(b) other direct expenditure which can be identified specifically as having been incurred in acquiring the stock or bringing it to its existing condition and location; examples are direct labour, transport, processing and packaging

(c) such part, if any, of the overhead expenditure as is properly carried forward in the circumstances of the business instead of being charged against the revenue of the period in which it was incurred.

Treatment of overhead expenditure

5 Before deciding upon the method by which to compute 'cost' it is necessary to consider to what extent, if at all, the inclusion of overhead expenditure is appropriate to the particular business.

6 Overhead expenditure may be divided into (a) production expenses such as factory rent, rates, depreciation, insurance and supervision, and other indirect expenses of acquiring and producing

stock; (b) administration expenses not attributable directly to the acquisition or production of stock or the bringing of it to a saleable condition and location; (c) selling expenses; (d) finance charges. Another classification (which can be applied also to each of the foregoing divisions) is to distinguish between 'fixed overheads', that is to say standing charges such as rent and rates which accrue and expire wholly or largely on a time basis, and 'variable overheads', which vary in a greater or lesser degree with the level of activity of the undertaking or of the department concerned but are not so closely associated with production or the volume of production as to be classed as direct expenditure.

7 Opinions differ on the extent to which overhead expenditure should be included in computing the cost of stock, though it is generally agreed that it cannot properly include selling and finance and other expenses which do not relate to the brining of stock to its condition and location. The following are some practices which reflect the differing views on this matter:

(a) in some businesses no overhead expenditure is included as an element in determining the cost of stock which is to be carried forward

(b) in others only the 'marginal' cost of unsold stock is included, that is to say that part of the cost of production of the period which has been incurred only because the stock remaining on hand was acquired or produced; all other expenses, including depreciation, are dealt with as revenue charges of the period for which they are incurred, the ground being that they arise irrespective of the quantity of stock which remains on hand at the end of the period and therefore are not an element in its cost

(c) in other businesses an appropriate proportion of the overhead expenditure relevant to the period of production is included on the ground that for the purpose of financial accounting any expense, whatever its characteristics, which is related even though indirectly to the acquisition or production of goods ought to be included in the cost of those goods and ought not to be charged against revenue until they are sold; an 'appropriate proportion' is determined by reference to a normal level of activity.

8 These differing views about the inclusion of overhead expenditure may be very important in their effect upon the amounts carried forward for stock and upon the profits disclosed in the accounts. No one method of dealing with overhead expenditure is suitable for all businesses. The method selected by the management needs to be clearly defined and must have regard to the nature and circumstances of the business so as to ensure that the trend of the trading results will be shown fairly. Once the method has been selected it needs to be used consistently from period to period regardless of the amount of profits available or losses sustained. A change of method is appropriate only if there is a change in the relevant circumstances of the business. If material, the effect of a change of method would need to be disclosed in the accounts.

9 In selecting a method of dealing with overhead expenditure the following are among the considerations which arise:

(a) ***The nature of the business***

In deciding whether to include a proportion of the overheads as expenditure on stock and also in deciding which elements of expense may properly be included for that purpose, it is necessary to have regard to the nature and the stage of development of the business, particularly factors such as the length of the production period, the probability of fluctuations in the level of production or the volume of sales, the risk of selling campaigns by competitors at reduced prices and the extent to which production is undertaken only to a customer's order or 'for stock' in expectation of sales. At one extreme a business may operate at widely differing levels of production and produce goods in quantity in a highly competitive and sensitive market; at the other extreme, a business may be engaged on a long-term single project contract such as building a ship, a bridge, a road or a heavy engineering installation.

(b) ***The levels of production and sales***

Where the levels of production and sales are relatively stable and production and sales are kept in balance the inclusion of overhead expenditure in the amount attributed to stock may have little impact upon the incidence of profits as between the accounts of one period and those of another. Where however the levels are subject to material fluctuation and are not kept in balance it may be decided to exclude these expenses from stock on the ground that as they would be incurred whatever the levels of production or sales their inclusion in stock has the effect of relieving the profit and loss account in the period when they are incurred of expenses which it should fairly bear and of charging these expenses in a later period to which they do not properly relate.

(c) ***Interruption or other exceptional curtailment of production***

If overhead expenditure is included in the amount attributed to stock an adjustment will be necessary in the event of disruption in production by events such as a strike, a fire, an abnormal falling off in orders, or temporary difficulties in obtaining materials, with the result that the volume of production is abnormally or unexpectedly low. In such circumstances the amount included in respect of overhead expenditure ought not to exceed an appropriate proportion on the basis of normal activity (see paragraph 7 (c)), the excess being treated as a charge against revenue in the period in which the expenditure was incurred. If the overhead expenditure is not related in this way to the normal, instead of the actual, level of production the effect may be to carry forward an excessive part of the expenditure of the period in which the disruption occurred. The profit and loss account of that period would thereby be relieved of charges which it ought to include and it would fail to reflect the adverse effects of the disruption during that period.

(d) ***The risks of realisation at a loss***

In businesses which are highly competitive or have a sensitive market for their products, overhead expenditure may properly be omitted in order to avoid carrying forward expenditure which may prove irrecoverable. Examples are businesses dealing in fashion goods or those of a speciality character where the public taste may change quickly with the result that stocks can be realised only at a loss; businesses whose competitors may launch selling campaigns at short notice to get rid of stocks at reduced prices, sometimes at no more than the cost of the material and direct manufacturing expenditure; and businesses where new methods of production or improved designs may render existing stocks obsolete.

(e) ***Maturing stocks***

In businesses which mature large stocks over long periods (for example, whisky, wine, timber) it is usual to exclude fixed overheads in order to avoid carrying forward large and increasing amounts of time-expired expenditure the recovery of which in the ultimate selling price is uncertain.

(f) ***Long-term contracts***

In businesses which undertake contracts extending over a period of years the normal tendency is to include overhead expenditure in work in progress except where it is considered to be irrecoverable. If overheads are not included in work in progress on such contracts the accounts for the early years may indicate losses, followed by unduly large profits in the years when the contracts are completed. This would be a wholly unrealistic presentation in relation to a contract showing a normal profit. The distinction between businesses of this type and those referred to in (e) above is that in a business with firm contracts the prices are normally known or can be calculated whereas in a business with maturing stocks the ultimate price at which unsold stocks will be realised in the ordinary course of business is unknown and uncertain.

(g) ***The extent of the variation in fixed or standing charges***

The less the fixed or standing charges vary in amount with variations in the volume of output, and the more they accrue on a purely time basis, the greater is the justification for their exclusion.

10 After weighing all relevant considerations it is necessary to decide whether and if so to what extent overhead expenditure should be included. In this connection members are reminded of the Council publication entitled NOTES ON THE ALLOCATION OF EXPENSE.[1]

Methods of computation of cost

11 Apart from the variations which occur in calculating the amount to be attributed to each of the elements of cost there are various methods of computing cost. In a small business one method only will normally be used but in a large composite business carrying on a variety of activities different methods may be used for different activities; once selected however the methods should be applied consistently to those activities from period to period. The following are the principal methods:

[1] See R2 [Not reproduced here].

(a) ***'Unit' cost***

The total cost of stock is computed by aggregating the individual costs of each article, batch, parcel or other unit. The method is not always capable of application, either because the individual units lose their identity (notably where stocks are bulked or pass through a number of processes) or because it would involve undue expense or complexity to keep individual records of cost particularly where these necessitate allocations of expense.

(b) ***'First in, first out'***

Cost is computed on the assumption that goods sold or consumed are those which have been longest on hand and that those remaining in stock represent the latest purchases or production.

(c) ***'Average' cost***

Cost is computed by averaging the amount at which stock is brought forward at the beginning of a period with the cost of stock acquired during the period; consumption in the period is then deducted at the average cost thus ascertained. The periodical rests for calculating the average are as frequent as the circumstances and nature of the business require and permit. In times of rising price levels this method tends to give a lower amount than the cost of unsold stock ascertained on a 'first in, first out' basis and in times of falling prices a higher amount.

(d) ***'Standard' cost***

A predetermined or budgeted cost per unit is used. The method is particularly convenient where goods pass through a number of processes or are manufactured on mass production lines; but it will not result in a fair approximation to actual cost unless there is a regular review of the standards with appropriate adjustment and revision where necessary.

(e) ***'Adjusted selling price'***

This method is used widely in retail businesses. The cost of stock is estimated by calculating it in the first instance at selling prices and then deducting an amount equal to the normal margin of gross profit on such stocks. It should be appreciated that where the selling prices have been reduced the calculation will bring out cost only if appropriate allowance for price reductions is included in fixing the margin to be deducted; if no such allowance is made it may bring out amounts which approximate to replacement price as defined in paragraph 18. The calculations under this method may be made for individual items or groups of items or by departments.

Reduction to net realisable value

12 When the cost of the stock has been determined it is then necessary to establish whether any portion of the outlay on stock is irrecoverable; to that extent a provision for the loss needs to be made. This calculation may be made either (i) by considering each article separately or (ii) by grouping articles in categories having regard to their similarity or inter-changeability or (iii) by considering the aggregate cost of the total stock in relation to its aggregate net realisable value. The third method involves setting foreseeable losses against expected but unrealised profits and would not normally be used in businesses which carry stocks which are large in relation to turnover.

13 The irrecoverable portion of the cost of the stock is the excess of its cost, as computed by the method of cost ascertainment which is deemed appropriate for the business, over the net realisable value of the stock. 'Net realisable value' means the amount which it is estimated, as on the balance sheet date, will be realised from disposal of the stock in the ordinary course of business, either in its existing condition or as incorporated in the product normally sold, after allowing for all expenditure to be incurred on or before disposal.

14 'Net realisable value' is estimated by taking account of all available information, including changes in selling prices since the balance sheet date, so far as the information is of assistance in determining, as on the balance sheet date, the net realisable value of the stock in the ordinary course of business. This involves consideration of the prospects of disposal, having regard to the quantity and condition of the stock in relation to the expected demand (particular attention being given to obsolete or excessive stock) and to the expected effect, if any, on selling prices of any change which has taken place in buying prices of materials or goods.

15 In some circumstances the replacement price of stock (as defined in paragraph 18) may be considered to be the best available guide to its net realisable value.

Reduction to replacement price

16 In many businesses it is important to have regard to the price at which stock can be replaced if such price is less than cost. The considerations which lead to the use of replacement price include the following:

(a) ***Uncertainty as to net realisable value***

Where the volume of stock carried is large in relation to turnover or there is a long period between the purchase of raw material and its conversion into and disposal as finished goods, selling prices current at the balance sheet date for the volume of orders then available may afford an unreliable guide to the prospective net realisable value of the stock as a whole. Replacement price may be considered to be the best available guide for this purpose.

(b) ***Selling prices based on current replacement prices***

In some businesses where selling prices are based on or reflect current replacement prices it may be considered that the trading results of a subsequent period will be prejudiced if they are burdened with any amount for stock which exceeds its replacement price; where this view is taken it is regarded as important in reporting the results of the activities of a period, as compared with those of its successor or predecessor, that the period in which a reduction in buying prices occurs should bear the diminution in profit rather than the period of disposal whose realisations will be adversely affected by the events of the previous period.

(c) ***Recognition of uneconomic buying or production***

Skill in buying or efficiency in production are most important matters in many businesses; the inclusion of stock in the accounts on a replacement price basis (where lower than net realisable value and cost) may be considered to reflect inefficiency in these respects on the ground that it involves the writing down of stock by an amount which represents approximately the result of misjudged buying or inefficient production.

17 Where the replacement price basis is adopted the stock is stated at the lowest of (a) cost, (b) net realisable value, (c) replacement price, with the effect that the profit and loss account is charged with any reductions necessitated by an excess of (a) over (b) or (c) as the case may be.

18 'Replacement price' for this purpose means an estimate of the amount for which, in the ordinary course of business, the stock could have been acquired or produced either at the balance sheet date or during the latest period up to and including that date. In a manufacturing business this estimate would be based on the replacement price of the raw material content plus other costs of the undertaking which are relevant to the condition of the stock on the balance sheet date. In all cases the prices used should be a fair reflection of the ordinary course of business; a depression which has passed before the accounts are completed would generally be disregarded.

19 In the same way as it is necessary (as pointed out in paragraph 10) to decide whether and if so to what extent overhead expenditure should be included in calculating cost, it is necessary in each business to determine whether replacement price shall be taken into account in computing the amount carried forward for stock. The basis selected by the management should be clearly defined and applied consistently from period to period regardless of the amount of profits available or the losses sustained, so as to enable the accounts to show a true and fair view of the trading results and the financial position. If the basis is changed, the effect on the accounts would need to be disclosed if material.

SPECIAL BASES USED IN SOME BUSINESSES

Stocks at selling prices

20 In some types of businesses, such as tea and rubber producing companies and some mining companies, it is recognised practice to bring stocks of products into account at the prices realised subsequent to the balance sheet date, less only selling costs. By this means the whole of the profit is shown in the period in which the crop is reaped or the minerals won. This basis has come to be accepted as customary in the industries concerned.

21 In manufacturing businesses which carry stocks of by-products the separate cost of which is not ascertainable these stocks are normally included at current selling price (or contract sale price where applicable) less any expenses to be incurred before disposal; the cost of the main product is reduced accordingly.

Long-term contracts

22 In businesses which involve the acceptance and completion of long-term contracts it is often appropriate to spread over the period of the contracts, on a properly determined basis, the profits which are expected to be earned when the contracts are completed. This procedure takes up in each period during the performance of the contract a reasonable amount as representing the contribution of that period towards the eventual profit; it thus recognises to a prudent extent the value of the work done in each period and restricts the distortion which would result from bringing in the whole of the profit in the period of completion. The principles which determine whether an element of profit is to be included are:

(a) profit should not be included until it is reasonably clear from the state of the work that a profit will ultimately be earned; it is therefore inappropriate to include any profit element where at the balance sheet date the contract has been in progress for a comparatively short time or to include an amount in excess of the profit element properly attributable to the work actually done

(b) provision should be made for foreseeable losses and allowance should be made as far as practicable for penalties, guarantees and other contingencies

(c) a clear basis for including a profit element should be established and adhered to consistently.

'Base stock'

23 In some businesses the minimum quantity of raw materials or other goods, without which they cannot operate their plant or conduct their operations, is treated as being a fixed asset which is under constant renewal by charges to revenue; that part of their stock (the base stock) is therefore carried forward not at its cost at the date of the accounts but at the cost of the original quantity of stock with which the business commenced operation. In old established businesses the amount will be based on prices paid for stocks acquired many years previously and many times replaced.

'Last in, first out'

24 The 'last in, first out' basis, which is in use in some overseas countries, assumes that the stocks sold or consumed in any period are those which were most recently acquired or made and therefore that the stocks whose cost is to be carried forward are those which were acquired, or made, earliest. The result is to charge consumption at prices approximating to current replacement prices and to carry forward stocks held at the close of the period at prices at which goods were purchased, or made, in earlier periods. When prices are falling this basis may result in showing the stock at an amount in excess of current prices in which event provision is made for the excess. During periods of rising prices, except in those instances where the physical movement of goods corresponds with the assumption that 'last in' is 'first out', the effect is to state the stock at less than its cost. The amount carried forward for stock may represent prices at which goods were acquired or produced several years earlier.

DESCRIPTION IN THE ANNUAL ACCOUNTS

25 In most businesses the amounts carried forward for stock from one period to another are material in their effect upon the presentation of the trading results and financial position. The differences which exist among the methods which are recognised as proper for the computation of those amounts are also so important that, unless an indication is given of the way in which the amounts are computed, the significance of the results and of the financial position shown by the accounts may be obscured. The following are illustrations of how such as indication might be given concisely where the circumstances make this appropriate:

(a) ***Normal basis***

'at cost'

'at the lower of cost and net realisable value'

'at the lowest of cost, net realisable value and replacement price'

'at cost less provision to reduce to net realisable value (or 'to the lower of net realisable value and replacement price')

The expression 'market value' does not indicate whether it implies net realisable value or replacement price and is therefore not regarded as an appropriate description. Such terms as 'at or under cost' or 'as valued by the company's officials' are also not regarded as suitable.

(b) ***Special bases***

If one of the special bases mentioned in paragraphs 20 to 24 is used an appropriate description would be required.

26 Whether a concise indication on the lines of the illustrations given above will be adequate for an appreciation of the significance of the accounts will depend upon the circumstances of the undertaking. The use of the word 'cost' may be inadequate unless it is accompanied by an explanation of the extent to which overhead expenditure is included at cost; in that event the explanation might be as follows:

'Cost is confined to materials, direct wages and direct expenses, no addition having been made for overhead expenditure'

'Cost includes an appropriate proportion of variable overhead expenditure but excludes fixed overhead expenditure'

'Cost includes an appropriate proportion of all production and administrative overhead expenditure'

27 In some businesses the complex nature of the stock and the use of different bases and methods of computation for determining the amounts of the various sections of the stock, particularly in a large composite undertaking or a holding company with subsidiaries of different types, may mean that no concise indication is feasible. In such circumstances it is however important that those to whom the accounts are submitted should have a specific assurance that the amount included for stock has been determined for the whole of the stock at the balance sheet date on bases and by methods of computation which are considered appropriate in the circumstances of the business and have been applied consistently.

28 The effect of any change of basis or method of computation should be disclosed if the effect of the change is material.

Recommendations

Having regard to the foregoing considerations, it is recommended that the following principles be applied by every industrial and commercial enterprise.

29 Appropriate amounts for all stock-in-trade (including raw materials and partly finished or finished stocks) and all work in progress, wherever situated and whatever their nature, should be included in the financial accounts and should be computed in accordance with the recommendations below. There is no justification for the omission of stock nor for stating stock at an amount which is higher or lower than the amount so computed; to use a higher amount would be to overstate profits (or understate losses) of the period and reduce the profits (or increase the losses) of the next period, whilst to use a lower amount would be to create a reserve which should be so described and disclosed and should not be treated as a charge against revenue.

30 A profit should not be anticipated unless this is justified by the special bases used in some businesses but provision should be made to the full extent of expected losses.

31 The amount carried forward for stock and work in progress should be computed on a basis which, having regard to the nature and circumstances of the business, will enable the accounts to show a true and fair view of the trading results and the financial position. In most businesses the basis should be the cost of the stock held, less any part thereof which properly needs to be written off at the balance sheet date.

32 The circumstances of each business should determine the basis which is appropriate and the method of computation which should be adopted in determining cost and part thereof, if any, which should be written off. In most businesses the choice lies between writing off any excess of cost over either (a) the net realisable value of the stock or (b) the lower of net realisable value and replacement price, these terms having the meanings attributed to them below. In some businesses it may be appropriate to use special bases, including some which depart from the rule that profit should not be anticipated.

33 The basis adopted and the methods of computation should be used consistently from period to period. A change of basis or method should not normally be made unless the circumstances have changed in such a way that its continued use would prevent the accounts from showing a true and fair view of the position and results. When a change is made the effect, if material, should be disclosed as an exceptional item in the profit and loss account or by way of note.

34 The following are the meanings attributed to 'cost', 'net realisable value' and 'replacement price' in this Recommendation:

(a) 'cost' means all expenditure incurred directly in the purchase or manufacture of the stock and the bringing of it to its existing condition and location, together with such part, if any, of the overhead expenditure as is appropriately carried forward in the circumstances of the business instead of being charged against the revenue of the period in which it was incurred

(b) 'net realisable value' means the amount which it is estimated, as on the balance sheet date, will be realised from disposal of the stock in the ordinary course of business, either in its existing condition or as incorporated in the product normally sold, after allowing for all expenditure to be incurred on or before disposal

(c) ''replacement price' means an estimate of the amount for which in the ordinary course of business the stock could have been acquired or produced either at the balance sheet date or in the latest period up to and including that date. In a manufacturing business this estimate would be based on the replacement price of the raw material content plus other costs of the undertaking which are relevant to the condition of the stock on the balance sheet date

35 The comparison between cost and net realisable value or replacement price may be made by considering each article separately, or by grouping articles in categories having regard to their similarity or interchangeability, or by considering the aggregate cost of the total stock in relation to its aggregate net realisable value or, as the case may be, aggregate replacement price. The aggregate method involves setting foreseeable losses against unrealised profits on stock and may not be suitable for businesses which carry stocks which are large in relation to turnover.

36 Where the amount carried forward for stock is material in relation to either the trading results or the financial position, the accounts should indicate concisely the manner in which the amount has been computed. If this is not practicable the accounts should contain a note to the effect that a concise statement of the bases and methods used is not practicable but that the amount has been determined for the whole of the stock at the balance sheet date on bases and by methods of computation which are considered appropriate in the circumstances of the business and have been used consistently. The use of the term 'market value' should be discontinued.

37 Goods purchased forward do not form part of the stock-in-trade or work in progress on the balance sheet date but where they are not covered by forward sales provision should be made in the accounts for the excess, if any, of the purchase price over the net realisable value (or over replacement price, where lower than net realisable value, if stock is stated at the lowest of cost, net realisable value, and replacement price). Similarly, where goods have been sold forward and are not covered by stock and forward purchases, provision should be made in the accounts for the excess, if any, of the expected cost over their net realisable value. Such provisions should not be deducted from the amount at which stock is stated.

NOTE. See N16, paragraphs 46 to 49 [paragraphs 361-364 in this edition], regarding the preservation of stock records.

N23 *Hire purchase, credit sale and rental transactions*

(Issued 9th December 1964)

The Council of The Institute of Chartered Accountants in England and Wales makes the following Recommendation to members on the financial accounts of undertakings granting credit facilities for or by way of hire purchase, credit sale and rental transactions.

These transactions take many forms and the Recommendation which follows deals only with those in most general use. Accounting treatment will depend in each case on the nature of the business transacted and the terms of the relevant agreements. The Recommendation indicates the principles involved and makes recommendations which it is hoped will be helpful to members when advising as to best practice.

The accounting regulations made under the provisions of the Protection of Depositors Act 1963 are not dealt with in this Recommendation, which is concerned only with accounting principles.

Introduction

1 In the context of this Recommendation hire purchase and credit sale transactions are assumed to have as their purpose the sale of goods on extended credit terms, and rental transactions to relate only to hire. Collectively they are described as instalment credit transactions.

2 (a) ***Hire purchase.*** Goods are supplied on hire to customers until on the fulfilment of certain conditions (normally the payment of an agreed number of instalments) the customer becomes entitled to exercise an option to purchase. Until this option is exercised the goods remain the property of the supplier.

(b) ***Credit sale.*** This involves a contract of sale with payment by instalments. Ownership of the goods passes on delivery by the supplier and a binding debt is created which cannot be avoided by returning the goods.

(c) ***Rental.*** The customer enters into a hire agreement for goods, normally for a fixed minimum period with rights of renewal. The agreement does not provide the hirer with an option to purchase; the goods remain the property of the supplier, who may undertake to keep them in working order, and they are returned to him on termination of the agreement.

3 In all instalment credit transactions finance has to be provided to meet the cost of the goods during the currency of each agreement; the sum involved diminishes as instalments are received.

4 When a dealer (that is a trader supplying goods) is unable, or does not wish, to provide the necessary finance himself, it can be obtained from specialist companies, referred to as hire purchase finance companies or simply as finance companies.

PART I – HIRE PURCHASE FINANCE COMPANIES

Operations

5 The operations of hire purchase finance companies extend over a wide variety of financial transactions but their main activities are generally within the following classifications:

(a) ***The financing of sales on hire purchase terms.*** This normally involves the purchase of goods from dealers and letting those goods on hire, with option to purchase, to customers. The customers may be introduced to the hire purchase finance company by the dealer or may approach the finance company direct; in either case the parties to the contract are the same, namely the hire purchase finance company and the hirer, and the goods in question are the legal property of the finance company until the hirer fulfils the agreement and exercises his option to purchase. The dealer is not normally a party to the agreement although he may support it either by a guarantee of the hirer's obligations or a repurchase undertaking under which he agrees to buy back the goods from the finance company in the event of default by the hirer.

(b) ***The purchase from dealers or from other finance companies of contractual rights under instalment credit agreements with third parties.*** This may be done in respect of single agreements or batches; in the latter case it is normally called 'block discounting'. Procedures for discounting agreements vary but there is generally a master agreement setting out the terms and conditions. In general the seller of the contractual rights is appointed the agent of the hire purchase finance company to collect the instalments and the payer is not usually notified that the seller's rights under the agreement have been assigned. In a minority of cases this equitable assignment is converted into a legal assignment by notice being given to the payer who is then directed to pay his instalments to the finance company. In the great majority of cases the vendor guarantees the agreements which have been discounted.

Revenue and expenditure

6 The finance company's principal source of gross profit arises from the difference between the amount of money which it originally expends in the purchase of goods (in the case of 5 (a)) or the purchase of contractual rights (in the case of 5 (b)) and the total sum which it receives by instalments. A further source of profit is purchase option fees which become payable at the conclusion of agreements when hirers exercise their option to purchase, but these are not normally brought into account until received.

7 The charges made by finance companies are designed to produce a surplus after meeting the costs of arranging, administering and financing agreements. Since these costs do not accrue evenly over the life of an agreement (for reasons discussed below), the basis adopted for allocating income from finance charges is of prime importance in determining the profits attributable to each accounting period. For example, if the whole of the income from finance charges were brought into account in the first accounting period of a three-year agreement a substantial profit for that year in respect of the agreement would be disclosed, but in subsequent periods there would be no further income from the agreement against which to charge continuing expenses. Moreover, such treatment would ignore the practice of allowing to customers rebates of finance charges for early settlement. A contrary result would be disclosed if income from finance charges were not brought into account until payment of the last instalment. The imprudence of the former treatment and the extreme caution of the latter, together with the material profit distortions to which they give rise, render both these methods inconsistent with the presentation of a true and fair view.

8 The expenses involved in handling instalment credit transactions may be classified broadly as follows:

(a) ***Initial expenses.*** These involve such items as credit status investigations, introductory commissions and preparing and handling the necessary documents. They are partly fixed (for example, administrative expenses not related to the amount financed or the term of the agreement) and partly variable (for example, introductory commissions related to the amount financed).

(b) ***Administration and collection costs.*** The costs of collecting and dealing with instalments vary with the quality of the business accepted, the manner in which instalments are paid, and the number rather than the amount of individual instalments.

(c) ***Cost of money***. The cost of financing a hire purchase agreement is related to the average sum outstanding over the life of the agreement, and, subject to variations in interest rates, is higher in the early life of an agreement, since the cost of finance diminishes as the amount outstanding is reduced.

(d) ***Bad debts,*** including legal costs and repossession costs not recovered.

9 On the basis of matching income with expenditure, it would be reasonable to spread income from finance charges (assuming equal instalments paid regularly on due dates) over the life of an agreement to absorb expenses as follows:

(a) ***Initial expenses.*** Sufficient income to cover the estimated initial expenses would be brought into account in the period in which they are incurred.

(b) ***Administration and collection costs.*** Sufficient income to cover these would be apportioned in equal instalments over the life of the agreement.

(c) ***Cost of money.*** Income sufficient to cover this item would be apportioned over the life of the agreement *pro rata* to the declining balance outstanding.

Having covered the costs in (a), (b) and (c) above any resultant surplus would be spread over the life of the agreement *pro rata* to the declining balance outstanding (a finance company's profit being regarded in effect as derived from interest received on sums financed). Out of the total surplus resulting in any accounting period, there would require to be made any provision which may be considered necessary for irrecoverable amounts (including any in respect of instalments not yet due).

10 At any accounting date an amount of deferred income (also referred to as unearned income, or income yet to mature) would be carried forward to future periods: it must be sufficient to cover the administration, collection and finance costs to be incurred in relation to instalments not yet due, and to provide a surplus at least sufficient to cover bad debts arising in subsequent periods.

11 The adoption of the theoretical basis described would present considerable problems in practice, involving the continuous analysis and allocation of expenses under each agreement and detailed interest computations. Whilst perhaps practicable for finance companies handling a small number of agreements, the calculations required render it impracticable in the circumstances of companies handling a considerable volume of agreements involving different terms and periods. For practical reasons, therefore, more readily manageable, though necessarily less accurate, methods are normally adopted for computing the allocation of income from finance charges to accounting periods.

Apportionment of income to accounting periods

Actuarial method

12 The actuarial method is based on the view that the major expense of hire purchase finance is the cost of money. Income from finance charges is therefore allocated over the lives of agreements in proportion to the reducing balances outstanding. Actuarial or specially prepared interest tables are used to apportion income to different accounting periods. The principal advantages and disadvantages are in essence the same as those discussed below under the 'sum of the digits' method.

Sum of the digits method (sometimes called 'the rule of 78')

13 This method produces, by another means, an approximation to results produced by the actuarial method, (though it should be recognised that the longer the agreement and the higher the rate of interest involved the greater will be the divergence from actuarial accuracy). Income from finance charges is distributed over the lives of agreements arithmetically in proportion to the reducing balances outstanding. The argument may be stated thus: if the amount of income attributable to the last instalment under an agreement repayable in equal instalments is £x, then the amount of income attributable to the penultimate instalment will be £2x (the balance then outstanding being twice that outstanding at the time of payment of the last instalment); that attributable to the antepenultimate instalment £3x, and so on. In an agreement involving twelve equal monthly instalments the total income from finance charges would be £x+£2x+£3x ... +£12x=£78x. The first repayment under such an agreement would be computed to contain 12/78 of the total income from finance charges, the second instalment 11/78, the last instalment 1/78 (hence 'rule of 78').

14 An advantage claimed for the actuarial and sum of the digits methods is that they relate income approximately to the normal incidence of expenses, which as noted are substantially heavier at the start of an agreement's life than at its close. On the other hand the methods fail to differentiate between transactions with proportionately moderate and proportionately heavy initial expenses. Their suitability in any particular case thus depends on the nature of the transaction. They also ignore the fact that collection cost do not reduce with each instalment and that additional expenses both for costs of money and debt collections are incurred when hirers fail to pay instalments promptly when they fall due. Furthermore, they do not allow for any possible subsequent increase in cost of money to service debts already on the books.

Equal instalment or straight line method

15 Under this method income from finance charges is treated as accruing evenly over the life of each agreement, no attempt being made to relate revenue directly to the expenses incurred in earning it. In favour of this method it is said that by reason of its conservative nature it makes some provision against the many unforeseeable factors and risks inherent in hire purchase finance, particularly debts for which a specific provision does not appear necessary at the accounting date

but which subsequently become bad or doubtful; and also against any subsequent increase in cost of money to service debts already on the books of the finance company. It is however open to the objection that since, as noted, expenses do not accrue evenly over the life of an agreement the effect on the financial accounts may be to disclose a low profit (or in some circumstances even a loss) in the early life of an agreement and a high profit in the later stages. Where the volume of business transacted is not subject to sharp fluctuations, the profit or loss shown by the equal instalment method for any accounting period is unlikely to differ materially from that which would be shown by applying the actuarial or sum of the digits methods, and in these circumstances the equal instalment method can be regarded as acceptable.

Modifications

16 In so far as the above methods depart from the theoretical basis described in paragraphs 9 and 10, modifications are often introduced so as to bring them closer to this basis. For example, immediate credit is sometimes taken for the amount of income appropriate to the initial expenses, the balance of finance charges being spread by one of the above methods over the life of the agreement.

Direct or arbitrary percentage method

17 The method is sometimes adopted of carrying forward as deferred income at the end of each accounting period a percentage of the outstanding balances on instalment credit accounts. At its crudest, the same percentage is applied from year to year in an arbitrary manner which takes no account of variations in the composition and nature of the accounts outstanding. The results are apt to be inaccurate and unreliable. If however the percentage of outstanding balances to be carried forward as income yet to mature is computed on the basis of a representative current sample of the agreements concerned then the result obtained would approximate to that produced by one or other of the methods noted above. In practice the sample taken is frequently not wide enough to be sufficiently representative of the whole and in this event the method has little to recommend it other than simplicity. The practice of carrying forward the same percentage each year, or a percentage which has been selected without exhaustive examination and testing, cannot be regarded as satisfactory.

Batching

18 The system of accounting and the volume of agreements current may be such that it is impracticable to seek to apply the computations considered above to each agreement individually. In such circumstances it is customary to batch agreements for treatment in total, each batch being grouped in appropriate categories according to the calendar months (or other suitable periods) in which they were entered into, the rates of hire purchase charges and the unexpired periods over which they are to run (six, twelve, eighteen months and so on). Thus for each month totals are obtained relating to agreements with like terms and the necessary computations are then applied to the batch totals.

Recommendations

19 In the accounts of hire purchase finance companies the basis adopted for computing income yet to mature under instalment credit agreements should be appropriate to the type of business carried on, should be applied consistently from year to year, and should neither anticipate nor unduly defer income. It should be such that variations in the composition of agreements outstanding, both as to their nature and terms, will be taken into consideration in the computation.

20 The actuarial or sum of the digits methods are the most suitable theoretical bases for computing income yet to mature. The equal instalment (or straight line) method can give acceptable results where the volume of business is not subject to sharp fluctuations. The direct percentage method should be used only when based on sufficiently large representative and current samples. The methods of computation adopted should include such modifications as are judged necessary, having regard to the nature and circumstances of the business, to enable the accounts to show a true and fair view of the trading results and the financial position.

21 The amount carried forward as deferred or unearned income should not in any case be less than any rebates which would be allowable if all agreements were discharged and settled on the day immediately following the balance sheet date.

Provision for bad debts

22 In considering the provision required for bad debts it is not sufficient to have regard only to overdue accounts, since indications that an agreement will not be fully discharged may appear before repayments fall into arrear. A customer of previous good standing may have called a meeting of his creditors, for instance, or the title to the goods concerned may be disputed by a third party, or it may become known that a dealer has been involved in fraudulent agreements. In these circumstances due consideration should be given to the likely effect on the outstanding debt without waiting for arrears to arise.

23 There are two main methods of determining the provision for bad debts. One involves the individual assessment of accounts; the other involves the application of percentages, based on experience, to the totals of balances outstanding.

Individual assessment method

24 This involves close examination of all overdue and suspect accounts. Where only one instalment is in arrear potential default is not necessarily indicated, but where more than one instalment is in arrear the account may be regarded as dubious. In assessing the amount to be set aside where a debt is judged to be bad, due account is taken of the likely net receipts on disposal of repossessed goods, of the likelihood of any further payment being obtained from the customer, of any available recourse to dealers (whose own credit standing, in the light of other possible attributable defaults, requires examination) and of any relevant guarantees (which also require assessment on their own merits). Account is also taken of any legal expenses accrued on accounts judged bad or doubtful, and of any additional costs likely to be incurred in repossession or enforcement. Similar consideration is given to accounts which are not overdue but in connection with which information is available indicating the possibility of loss.

Percentage method

25 Where individual assessment of debts is regarded as not practicable the alternative is to adopt the percentage method. To be satisfactory, this should be (a) based on recent experience and current information, brought under frequent and regular review; and (b) applied to suitably analysed totals of each main category of outstandings. This involves classifying customers' accounts according to the types of merchandise on hire, the degree of risk (i.e. finance company's own risk, dealers' risk and so on) and the value of the supporting security. Accounts are then further analysed by reference to their current condition (for example, according to the number of instalments in arrear, whether merchandise has been repossessed and not sold, whether merchandise has been repossessed and sold, whether special difficulties are involved, and so on).

26 Sometimes an arbitrary percentage of the amounts financed under instalment agreements outstanding, fixed say by reference to bad debt experience of previous years, is used to compute the provision for bad debts. A modification of this method is to apply to accounts in arrear percentages which increase on a sliding scale according to the number of instalments overdue.

27 The application of percentages to balances outstanding has the advantage of simplicity. However, unless care is taken to examine up to date representative samples of accounts in the light of current bad debt experience, this method will fail to reflect material changes in the nature or terms of business transacted, or other circumstances likely to affect bad debts, and must be regarded an unreliable.

Recommendation

28 Whenever practicable the provision for bad debts should preferably be assessed by reference to individual accounts. Where this is not practicable, percentages based on current experience and drawn from representative samples of adequate proportions may be applied to suitably analysed account totals. Specific provision should be made to cover all accounts considered bad or doubtful at the balance sheet date, and the amount set aside for income yet to mature should include an adequate general provision against further bad debts that experience has shown may arise in respect of balances considered good at the balance sheet date.

Treatment and description in accounts

29 Although in law a hire purchase agreement is no more than a contract of hire carrying an option to purchase, the intention to purchase is normally presumed and for accounting purposes it is the generally accepted practice to show hirers in the accounts of hire purchase finance companies as debtors for the total sums financed.

30 The amount set aside in respect of income yet to mature in the accounts of finance companies is a significant item. It may be disclosed in the balance sheet either as a deduction from the total amount of instalments outstanding, or under a separate heading on the liabilities side. The former treatment however has the advantage of recognising the fact that at the date of the balance sheet the present value of the instalments outstanding is less than the gross amount receivable (having regard to finance and collection costs, provision for which is included in the amount set aside for income yet to mature).

31 The Eighth Schedule to the Companies Act 1948 requires the accounts of companies to disclose the amount of interest on the company's debentures and other fixed loans. A substantial part of the funds of most hire purchase finance companies is obtained from public deposits, bank and other short-term advances, and the total amount of interest paid is an informative figure.

Recommendations

32 Amounts financed under instalment credit transactions should be shown separately in the balance sheet and suitably described.

33 Income yet to mature should be shown separately in the balance sheet as a deduction from the assets to which it specifically relates.

34 The accounts should contain a statement of the basis or bases adopted in computing the amount shown as income yet to mature. In the event of the basis being changed for any reason regard should be had to paragraph 14 (6) (b) of the Eighth Schedule to the Companies Act 1948 and any material effect on the profit and loss account for the current year should be disclosed, together with a note of the amount by which the preceding year's profit would have been affected if the same basis had been applied.

35 The total charge for interest payable should be disclosed and adequately described in the profit and loss account; the aggregate of bank interest, interest to depositors and other interest on short-term indebtedness should be distinguished from interest on debentures and other fixed loans.

PART II – DEALERS

36 The treatment of instalment credit transactions in dealers' accounts depends on the nature of the agreements and the legal relationship existing between the parties. Agreements may be financed by the dealer himself, or alternatively the dealer may assign his contractual rights to a finance company, as described above (paragraph 5 (b)).

Agreements financed by dealers

Hire purchase and credit sale agreements

37 Where a dealer disposes of goods to customers by way of hire purchase or credit sale agreements which he himself finances and to which he remains a principal party, his profit on due completion of the contracts is derived from (a) his trading profit arising from the cash sale price of the goods and (b) any added finance charges. Out of the aggregate of these he has to meet his normal selling and administration expenses, and the additional costs of financing and administering agreements.

38 As noted in connection with hire purchase finance companies, agreements which extend over more than one accounting period give rise to the problem of apportioning profits, and a basis must be selected on which to compute the amount to be carried forward at the end of each accounting period in respect of trading profit and finance charges not yet earned.

39 These methods adopted in practice vary according to the nature of the business and the form of agreement. Some methods deal separately with trading profits and finance charges, using different bases of apportionment. So far as finance charges are concerned, under both hire purchase and credit sale agreements it is normal to carry forward a proportion relating to instalments not yet due on one of the bases described in paragraphs 12 to 17.

40 In the case of hire purchase agreements sale does not take place until the hirer exercises his option to purchase, and the goods concerned remain legally the property of the vendor until that time. Accordingly the amount set aside for trading profit not yet earned is sometimes computed by reference to the gross trading profit percentage appropriate to the cash price of the goods in question. On the other hand, particularly where the amounts involved are immaterial, credit is sometimes taken immediately for the whole of the trading profit on hire purchase transactions, subject only to provision for future financing and collection costs and bad debts. Various intermediate methods are also in common use.

41 In the case of credit sale agreements credit is normally taken for the whole of the trading profit on the cash price of the goods in the period in which the agreements are entered into, since by definition sale has been completed, though instalments may remain outstanding.

42 Certain types of hire purchase and credit sale agreements may include an undertaking by the dealer to provide free maintenance of the goods concerned over a stated period. The costs of providing such service must be met out of the relevant revenue, and in these circumstances the amount carried forward normally includes an appropriate allowance for such costs.

Recommendations

43 Where material there should be disclosed separately in a dealer's balance sheet, suitably described, the total amounts outstanding (after provisions for bad debts), (a) under hire purchase agreements and (b) under credit sale agreements; in each case there should be shown as a deduction the total carried forward in respect of trading profit, collection and finance charges relating to future periods.

44 (a) (i) Where dealers finance their own hire purchase transactions with customers there should be carried forward in their accounts, computed on a basis consistently applied and appropriate to the nature of the business, an amount in respect of trading profit and finance charges not yet earned.

(ii) The amount carried forward in respect of trading profit not yet earned should consist of the proportion of trading profit estimated to relate to instalments receivable in future accounting periods, being not less than the percentage of net trading profit nor more than the percentage of gross trading profit appropriate to the goods in question.

(iii) The amount carried forward in respect of finance charges not yet earned should be the proportion of the charges relating to instalments receivable in future accounting periods. The most suitable bases for computing income yet to mature are the actuarial or sum of the digits methods, or such modifications thereof as may be necessary, having regard to the nature and circumstances of each business, to enable the accounts to show a true and fair view. The equal instalment (or straight line method) can give acceptable results where the volume of business is not subject to sharp fluctuations.

(iv) The total amount carried forward in respect of trading profit and finance charges not yet earned should not be less than the greater of (a) the estimated cost of free maintenance, finance and collection charges relating to future periods; or (b) any rebates which would be allowed if all agreements were discharged and all obligations settled on the day immediately following the balance sheet date.

(b) As regards sales by dealers under credit sale agreements, it is proper to take credit immediately for the trading profit on the cash price of the goods concerned provided that adequate provision is made for future free maintenance and finance and collection costs relating to balances not yet due.

(c) Specific provision should be made for all accounts considered bad or doubtful at the balance sheet date and the amount carried forward as income yet to mature should include an adequate general provision against further bad debts that experience has shown may arise in respect of balances considered good at the balance sheet date.

45 In the event of a change in the basis of computing amounts carried forward in respect of trading profit and finance charges not yet earned the effect, if material, should be adequately disclosed.

Rental agreements

46 Goods out on rental are normally treated in the accounts of dealers (here taken to include undertakings specialising in rental business) as fixed assets and are written down to their estimated residual value over the period of their revenue-producing lives.

47 Rentals are normally payable at regular intervals in advance, and credit is taken in the dealer's accounts for rentals received and receivable after adjusting for any portion relating to subsequent accounting periods. Where rental payments have fallen into arrear additional provisions may require to be made against non-recovery of debts and costs of repossession of goods.

Recommendations

48 (a) Goods out on rental, if material, should be shown separately in the balance sheet, preferably grouped with fixed assets.

(b) The basis of arriving at the amount at which they are stated should be indicated.

(c) Provision should be made for depreciation over their estimated revenue-producing lives, computed on an appropriate basis applied consistently from year to year.

(d) Adequate provision should be made for bad debts and, where applicable, estimated costs of repossession.

Agreements financed by finance companies

49 It is common for dealers to enter into arrangements with hire purchase finance companies to provide finance for instalment credit agreements. The normal arrangements are described in paragraph 5. The legal effects of finance agreements between dealers and finance houses are sometimes complex, and are dealt with here only in so far as they affect dealers' accounts.

50 It will have been noted from paragraph 5 that the dealer may (a) sell goods to a finance company which in turn enters into hire purchase or credit sale agreements with customers, or (b) enter into hire purchase or credit sale agreements with customers and sell his rights under such agreements to a finance company. Under (a) customers may pay instalments direct to the finance company (direct collection) or to the dealer who then accounts to the finance company (agency collection). Under (b) the dealer normally collects but in a minority of cases a legal assignment of rights is executed and the customer pays direct to the finance company.

51 Where the dealer is not a party to contracts with his customers, but sells direct to a finance company, immediate credit is normally taken in his accounts for sales and provision is made for losses expected to arise under any guarantees given.

52 Where dealers sell contractual rights under hire purchase or credit sale agreements by means of a block-discounting transaction, part or all of these rights become immediately converted into cash and to that extent (but after making provision in respect of any indemnities or guarantees given by the dealer) there is an accelerated realisation of profit which would otherwise have been deferred and brought to credit during the period of the agreements concerned.

53 If the dealer collects instalments and accounts for them to the finance company under an agency collection agreement provision will require to be made for the cost of providing this service, in so far as it is not covered by any collection commission.

Indemnities and guarantees

54 Agreements with finance companies frequently include recourse clauses by which the dealer undertakes to indemnify or guarantee the contracting finance company against loss or to repurchase goods in the event of default by the customer. The existence and terms of such clauses may have material implications as regards provision for liabilities, and financing agreements should be carefully studied to determine their financial consequences.

55 Block-discounting agreements normally provide that the finance company should retain against possible defaults a specified proportion – perhaps 25 per cent – of the collection value of the agreements discounted. The sum retained is recovered by the dealer as the discounted agreements are discharged. Block-discounting agreements sometimes require the dealer to accept bills drawn on him by the finance company as collateral security. The bills would be presented only in the event of default by the dealer – normally they are returned and cancelled as agreements are discharged.

56 Under agency collection agreements, the existence of a recourse clause entails a careful examination of customers' balances in order to make adequate provision for bad debts. Where instalments are collected by the finance company the dealer has no record of customers' accounts; although the finance company should normally give the dealer early notification of any default he will not necessarily be in a position to assess all outstanding accounts as regards bad debts, and in these circumstances contingent liabilities will exist.

Recommendations

57 Where a dealer has entered into outside financing arrangements regard should be had to the terms of the agreements concerned and effect given to their financial consequences in the dealers' accounts so as to present a true and fair view. The basis adopted should be applied consistently from year to year.

58 Where a dealer is not a party to instalment credit agreements and is not responsible for the collection of instalments, sale to a finance company may properly be treated as an outright sale. Where the dealer has guaranteed payment of the amounts due under the contract between the finance company and the customer, or has undertaken to repurchase the goods in the event of default by the customer, adequate provision should be made for claims expected to arise under such arrangements, based on such information as may be available. The existence of a contingent liability should be stated by way of note, and where practicable the amount, or estimated amount, disclosed.

59 Where a dealer is not a party to instalment credit agreements or has sold such agreements to a finance company they are not his assets and should not be shown as such in his balance sheet. Where the finance company withholds part of the purchase consideration, this should be shown as a debt less the unearned profit applicable thereto and less any bad debts provision considered necessary.

60 Where the dealer is responsible under guarantee for collection of debts on behalf of a finance company adequate provision should be made against both future collection costs and bad debts. The amount of unpaid instalments guaranteed (less provision for bad debts already made) should be disclosed.

N24 *The accounting treatment of investment grants*

(Issued 14th April 1967)

The Council of the Institute of Chartered Accountants in England and Wales makes the following Recommendation to members on the accounting treatment of investment grants payable under the Industrial Development Act 1966. The Recommendation is confined to the treatment of investment grants in financial accounts. It does not deal with their treatment for the purpose of cost comparisons or other internal accounting statements.

1 Investment grants are paid by the Board of Trade towards approved capital expenditure incurred in providing new machinery or plant for use in a qualifying industrial process by a person carrying on a business in Great Britain. The grants may become repayable in certain circumstances.

2 Investment grants are cash reimbursements of part of the cost of specific assets. In this sense they reduce the effective cost of such assets to the purchaser, since the amount of an undertaking's resources committed to fixed assets is reduced by the amount of grant received.

3 This view accords with the fact that annual tax allowances are computed by reference to the cost of assets after deduction of grants. This does not imply that grants should be regarded as an alternative form of capital allowance, since their receipt is not related to or in any way dependent on the profits or taxation liabilities of a business.

4 It is consistent with the view taken above to show assets in respect of which investment grants have been or will be paid in the balance sheet at their net cost after deduction of grant, and to compute the annual charge for depreciation accordingly.

5 Alternatively, it may be preferred, for reasons of financial policy or comparability, to show fixed assets in the balance sheet at gross cost (before deduction of grant) and to credit the grants to a suitably described account disclosed in the balance sheet separately from share capital and reserves. If this treatment is adopted, it is appropriate to bring into revenue annually as a separate item a proportion of the balance of the investment grant account on a basis consistent with the rate at which the depreciation charge is computed.

6 The accounting treatments described in the two previous paragraphs, both of which produce the same net effect on the profit and loss account, regard investment grants as an alleviation of expenditure which is ultimately chargeable to revenue and therefore as a form of deferred credit which should be reflected in the profit and loss account over the estimated useful lives, as computed for depreciation purposes, of the assets to which the grants relate.

7 A case can be made for dealing with investment grants in other ways than those described above. For example, the view may be taken that the grants represent not so much an alleviation of expenditure as a permanent contribution to the resources of the undertaking; accordingly that they should be dealt with as an immediate accretion to reserves, despite the restriction which they impose on the subsequent tax relief by way of capital allowances. Provided there is adequate disclosure and consistency of treatment such other methods will not necessarily impair the presentation of a true and fair view. But the Council considers on balance that one or other of the two methods described in paragraphs 4 and 5 above is to be preferred and recommends accordingly as follows.

Recommendations

8 Investment grants should be treated as a form of deferred credit which should be reflected in the profit and loss account over the estimated useful lives, as computed for depreciation purposes, of the assets to which the grants relate. Either of the following treatments is appropriate:

(a) grants should be applied in reduction of the purchase price of the assets to which they relate, with a consequential reduction in the amounts charged to revenue by way of depreciation of the assets or writing off the relevant expenditure. If the amount of the grants is material, the description of the amount at which the assets are shown in the balance sheet should make it clear that the grants have been deducted; or

(b) assets should be shown in the balance sheet at cost before deduction of grant and the grants shown in the liabilities section, separate from capital and reserves, as a deferred credit pending transfer to profit and loss account at a rate consistent with that at which the relevant depreciation charge is computed.

9 Grants should be brought into account in the accounting period in which the corresponding asset is entered in the books. Any material amount of grant brought into account in the accounting period should be disclosed.

10 The accounting treatment adopted should be clearly disclosed and should be followed consistently.

N25 *The accounting treatment of major changes in the sterling parity of overseas currencies*

(Issued 17th February 1968)

The Council of the Institute of Chartered Accountants in England and Wales makes the following Recommendation for the guidance of members called on to advise or decide on suitable accounting treatment where the financial accounts of United Kingdom trading companies are affected by major changes in the value of overseas currencies expressed in terms of sterling.

The Recommendation deals with general principles and does not attempt to study in detail the great variety of individual problems which may be encountered in practice; each case must be examined in the light of its special circumstances to determine how the effect of a change in sterling parities should be best dealt with so as to present a fair view.

'Sterling' is used throughout to mean United Kingdom money. Other moneys are referred to as 'overseas currencies' or 'currency', notwithstanding that they may be legal currency of a part of the sterling area (the 'Scheduled Territories').

Normal exchange fluctuations distinguished from major changes in currency parities

1 For United Kingdom companies engaged in substantial overseas trade, or owning substantial overseas trading branches or subsidiaries, the normal fluctuation of exchange rates, whether the rates are pegged or floating, may give rise to differences on exchange whenever one currency has to be converted for accounting purposes into another. Such gains and losses on exchange are a normal feature of overseas operations and do not in themselves usually present any special problems. In general, where there has been no substantial shift in parities, exchange differences on direct trading with foreign customers or suppliers are dealt with in the profit and loss account in arriving at the profit or loss for the period. Where the accounts of overseas branches or subsidiaries have to be converted into sterling for inclusion in the parent's or group accounts the normal accounting conventions for conversion are straightforward and are used consistently from year to year. (The Appendix to this Recommendation contains a note on the conversion conventions usually adopted.)

2 Where, however, exchange rates are subjected to a sudden, significant and evidently permanent adjustment outside the run of normal exchange fluctuations, such as happened when on 18th November 1967 sterling was devalued in terms of the United Stated dollar from $2.80 to $2.40, United Kingdom companies may encounter special accounting problems. In these circumstances exceptional exchange gains or losses attributable to the abnormal change in parities may arise as regards both direct trading transactions and the accounts of overseas branches and subsidiaries. It then becomes necessary to determine the amount of exceptional loss or gain involved, and how it should be dealt with in the accounts.

3 In broad theory, the loss or gain attributable to a change in parities could be most directly arrived at by converting overseas assets and liabilities at the date the rate changes into sterling first at the old rate and then at the new: the difference between the sterling equivalents, after taking account of any forward transaction in overseas currencies, including any forward purchases and sales of goods, is the exceptional gain or loss attributable to the shift in parities. In the case of overseas branches and subsidiaries (as described in paragraphs 14 and 15 below) the exceptional gain or loss is in practice generally computed by means of adjustments applied to their assets less liabilities at the balance sheet date. The gain or loss so computed, if material, should be segregated from 'normal' exchange gains or losses (which, as noted, are generally dealt with in the profit and loss account in arriving at the profit or loss for the period), and separately disclosed either (a) as an exceptional item entering into the computation of the profit or loss for the period; or (b) as an exceptional item shown separately after 'profit after taxation'. When the latter treatment is adopted account has to be taken of any consequential effect on the tax charge and disclosure made of such adjustments as are necessary. Where a company or group has extensive

interests overseas and fluctuations in sterling equivalents of overseas assets and liabilities are a recurrent feature, the treatment in (a) above may be preferable unless the amount involved is exceptionally large; in other instances the treatment in (b) may be more appropriate. An alternative to the treatment in (b) is for the exceptional gain or loss (so far as it may be regarded as being of other than a revenue nature – for instance, as arising on the re-statement of currency fixed assets at the new rates) to be dealt with by a direct transfer to or from reserve, if this would facilitate the presentation of a true and fair view. (For recommendations as to the treatment of exceptional items in accounts see Recommendation 18, PRESENTATION OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNT, paragraphs 43 to 45, and 11 to 12.)

4 The identification and treatment of exceptional gains and losses attributable to major changes in exchange parities are dealt with below in two parts; first, in the context of overseas transactions of United Kingdom companies not involving overseas branches or subsidiaries and, second, in the context of the conversion into sterling of the accounts of overseas branches and subsidiaries.

Overseas transactions of United Kingdom companies not involving branches or subsidiaries

5 For companies with overseas assets and liabilities other than those attributable to overseas branches and subsidiaries, a major change in currency parities will give rise to a sterling gain or loss on exchange in respect of those of their overseas assets or liabilities affected at the date currency rates change.

6 In these circumstances the general rule is that overseas assets and liabilities, both current and long term, at the date the parities change should be converted into sterling at the new rate of exchange and the resultant exceptional losses or gains on exchange, if material, presented in the accounts so as to show a fair view of the effects of the alteration in exchange parities.

7 Exceptional gains or losses on exchange attributable to changes in parities and relating to overseas assets and liabilities of a normal trading nature are normally dealt with in the profit and loss account, and separately disclosed as an exceptional item if material. Due account is taken of any consequential effect on liability to tax.

8 There may be exceptions to the general rule to the extent that any part of the gain or loss may properly be taken into account in arriving at the amount at which items to which it relates are to be stated in the balance sheet. For instance, that part of an exceptional loss on exchange attributable to goods unsold on the balance sheet date may be treated as an increment in cost provided net realisable value in sterling is estimated to be in excess of cost so computed; this treatment is preferable if sterling selling prices of the items on hand have been increased to compensate for the change in parities.

9 Similarly, exceptional losses or gains attributable to liabilities outstanding at the relevant date for purchases of fixed assets from overseas are normally dealt with by adjustment of the cost in sterling of the relevant asset account.

10 The amount attributed in the balance sheet to work in progress on long-term contracts involving overseas customers or suppliers will require review in the light of altered exchange parities so that provision can be made in the normal way for any foreseeable loss arising therefrom.

11 Exceptional gains or losses which may be regarded as not of a revenue nature, such as those relating to long-term loans granted or received may be shown in the profit and loss account or dealt with by direct transfer to or from reserve according to which method will better present a true and fair view, as suggested in paragraph 3 above. Where there are both gains and losses of other than a revenue nature, they are set-off in the first instance.

United Kingdom companies with overseas branches or subsidiaries

12 The object of converting the accounts of United Kingdom companies' overseas branches or subsidiaries into sterling is to enable them to be incorporated into the home company's or group accounts at a sterling equivalent which fairly expresses their state of affairs and results. Normally the two main methods of converting other currencies for this purpose, as outlined in the Appendix to this Statement, are the 'closing rate' and 'historic rate' methods.

13 Where a major revision of exchange parities has taken place during the financial period it is necessary to determine whether the effect on the sterling equivalent of overseas branches' or

subsidiaries' accounts gives rise to an exceptional difference on exchange. In theory, as noted above, the gain or loss attributable to a change in parities could be directly arrived at by converting the accounts of overseas branches or subsidiaries at the dates the rates changed into sterling at the old and new rates and measuring the difference.

14 In practice the exceptional gain or loss attributable to the change in parities is normally calculated by adjustment of net assets in the opening or closing balance sheets; for instance, by taking net assets at the last accounting date before the change and adjusting them by reference to the profit earned or loss incurred in the period up to the date of change: the difference between the resultant amount converted at the old and new rates of exchange is the exceptional gain or loss. This achieves the same result as converting net assets at the date the rates changed. Since the 'historic rate' method of conversion uses the average rate of exchange for the year to convert profits or losses (before charging depreciation) it automatically takes account of the effect of any change in parities, but the 'closing rate' method does not, and in that case to determine the exceptional difference on exchange it is normally appropriate to apportion profits or losses to the date the parities changed and to convert results up to that date at the old rate and after that date at the closing rate. In making this calculation results should be apportioned as nearly as possible on an actual basis so as to take due account of seasonal or other fluctuations in trade. Turnover should be apportioned and converted in the same way so as not to present a misleading view of trading and results.

15 Under the 'closing rate' method assets and liabilities at the balance sheet date are converted at the rate of exchange then ruling, so that the effect on them of any major change of parities is automatically recognised. Under the 'historic rate' method, however, fixed assets and long-term loans and liabilities are normally stated at their original sterling equivalents. A major change in parities calls in question these amounts. Bearing in mind that proper provision must be made for depreciation of fixed assets and repayment of long-term liabilities it would be unrealistic not to recognise that a change in parities implies an adjustment in the sterling equivalents of fixed assets and long-term loans. In these circumstances it may be desirable either to adjust their sterling amounts by reference to the balance sheet rate of exchange, or to carry out a valuation of fixed assets; if the 'historic rate' method of conversion is to be followed, the latter amounts would continue to be used for future conversion purposes in place of original sterling equivalents. Whichever basis of conversion is used fixed assets appearing 'at cost' in terms of overseas currencies may normally continue to be so described after conversion into sterling, since the position will be made sufficiently clear by disclosure of the basis on which foreign currencies have been converted into sterling as required by paragraph 11 (a) of Schedule 2 to the Companies Act 1967. In this connection it should also be kept in mind that where the market value of land held as fixed assets is materially different from the book amount at the end of the year, section 16 of the Companies Act 1967 requires the directors to indicate in their report the difference as precisely as is practicable where in their opinion the difference is of such significance that members' attention should be drawn thereto.

Effect of major changes in currency parities after the end of a financial period but before the accounts of that period are completed

16 The general rule set out in Recommendation 17 paragraph 16 (a)[1] is that post balance sheet events should not be dealt with in the accounts unless they assist in forming an opinion as to the amount properly attributable, in the conditions existing on the balance sheet date, to any item the amount of which was subject to uncertainty on that date. Where rates of exchange have altered after the balance sheet date the alterations would normally be disregarded unless the rates of exchange on the balance sheet date were not realistic and the amounts affected are material, though the implications of a change of parities which is properly excluded from the accounts may nevertheless be of such importance that it may need to be disclosed by the directors through some other medium.

17 Where group accounts are being prepared at a date subsequent to a major currency revaluation, but include the accounts of any overseas subsidiaries made up to a date before revaluation, it is appropriate to apply the post-revaluation exchange rate to such subsidiaries' accounts, having regard to the fact that they are intended to give as fair an estimate as possible of the position at the group balance sheet date.

[1] [Paragraph 380(a) in this edition.]

Recommendations

18 (a) An exceptional gain or loss attributable to a major permanent change in currency parities should normally be brought into account in the accounting period in which the change occurs.

(b) The exceptional gain or loss attributable to a major change in currency parities is the difference between the sterling equivalents, converted at the old and new rates of exchange, of overseas assets less liabilities at the date on which the rates changed, after taking due account of any relevant forward transactions. Where the 'historic rate' method of conversion is employed it should be considered whether the sterling equivalent of fixed assets should be adjusted to recognise the change in parities. Profits or losses of overseas branches and subsidiaries for the period before the date the rates changed should be converted at the rate of exchange applicable to that period, and profits or losses for the period after the change at the revised rate. Where 'closing rate' method is employed profits of the period remitted before the rates changed should be converted at the actual sterling amount realised (see paragraphs 3, 6, 8, 9, 14 and 15 above).

(c) The gain or loss so computed, if material, should be segregated from 'normal' exchange gains or losses and disclosed as an exceptional item. It may be shown separately:

(i) as an item entering into the computation of the profit or loss for the period; *or*

(ii) below 'profit after taxation'. In this case the effect on the amount shown in respect of tax should be considered, and where appropriate any relevant tax charge or relief should be shown as a separate adjustment.

(iii) in so far as the loss or gain is regarded as being not of a revenue nature it may be dealt with by direct transfer to or from reserve if this would facilitate the presentation of a true and fair view. (See also Recommendation 18, PRESENTATION OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNT, paragraphs 43 to 45, and 11 and 12.)

(d) To comply with paragraph 11 (9) of Schedule 2 to the Companies Act 1967, the basis on which overseas currencies have been converted into sterling must be disclosed where the amount of assets or liabilities affected is material. The basis on which the results of overseas branches or subsidiaries have been converted into sterling will also need to be disclosed where it is material to the presentation of a true and fair view in the accounts of the home company or the group.

(e) The effect of any post-balance sheet change in parities should not normally be dealt with in the accounts except to the extent that the accounts of an overseas subsidiary drawn up to a date before the parities changed have to be incorporated in group accounts drawn up to a date after the rates changed.

Appendix

NOTE ON THE CONVERSION OF OVERSEAS BRANCH AND SUBSIDIARY ACCOUNTS INTO STERLING FOR THE PURPOSE OF THE FINANCIAL ACCOUNTS OF UNITED KINGDOM COMPANIES

1 The fundamental uncertainties involved in exchange operations make it impossible to lay down hard and fast rules for conversion into sterling of the accounts of overseas branches and subsidiaries, and emphasise the need for each case to be judged on its merits in the light of particular circumstances.

2 Where there have not been exceptional changes in exchange parities two main methods are however normally accepted for converting overseas branch and subsidiary accounts into sterling for the purposes of the financial accounts of United Kingdom companies. For convenience they are termed here the 'closing rate' (sometimes also called the 'balance sheet date') and the 'historic rate' methods. Both methods are described in broad outline below though no attempt is made to discuss the variations in detail often found in practice.

'Closing rate' method

3 Under the 'closing rate' method, all items in the overseas branch or subsidiary accounts are converted at the rate ruling on the balance sheet date, subject to special considerations relating to the following items.

4 *Stocks* acquired locally are stated at closing rate, but stocks bought out of sterling funds, or shipped from other foreign branches or subsidiaries in the group are stated at actual sterling cost or sterling equivalent of the currency with which it was purchased, after elimination of profits attributable to transfers within the group. The normal rules for reducing stocks to net realisable value if this is less than cost apply.

5 *Profit or loss for the year* is converted at the closing rate of exchange except for remittances during the year, which are converted at the actual rate.

'Historic rate' method

6 The 'historic rate' method of converting accounts regards overseas branches or subsidiaries from an accounting point of view as adjuncts of the parent, and their activities are measured in terms of sterling, which in normal circumstances is regarded as remaining constant while foreign currencies fluctuate.

7 *Fixed and other non-current assets* are converted into sterling at the rates of exchange ruling when they were acquired or constructed, or at actual sterling cost.

8 *Depreciation of fixed assets* is converted at the rate or rates used when the relevant assets were acquired.

9 *Cash, debtors and other current assets* (excluding stocks) are converted at the rate of exchange ruling on the balance sheet date ('closing rate').

10 *Stocks* are converted at the rates ruling at the time when they were acquired or produced, or at actual sterling cost if purchased out of sterling funds. This procedure is consistent with 'historic rate' principles, but in practice, even where the 'historic rate' method is used, it is often found expedient to convert stocks at the closing rate used for other current assets. The normal procedures for determining whether any part of the cost of stock is irrecoverable are applied (see Recommendation 22).

11 *Current liabilities* are converted at the closing rate.

12 *Long-term liabilities and share capital stated in overseas currency* are converted at the rates ruling when they were incurred or issued, or at actual sterling cost.

13 *Profit and loss account.* Depreciation, as noted, is converted at the exchange rates ruling when the relevant fixed assets were acquired. Consequently, depreciation is added back to the profit or loss for the period under review before conversion into currency. Conversion is then effected at the average rate for the period: a weighted average is applied where profits (or losses) do not accrue evenly throughout the period.

‘Closing rate’ and ‘historic rate’ methods compared

14 In normal circumstances both the ‘historic rate’ and ‘closing rate’ methods are widely used and equally acceptable in practice. The ‘historic rate’ method is the more traditional. It measures overseas operations from the standpoint of a stable and unchanging home currency, and was evolved in the context of overseas branches and subsidiaries largely financed and stocked from the United Kingdom. The ‘closing rate’ method, which has been increasingly adopted in recent years, recognises overseas branches and subsidiaries as viable units existing apart from their parent, and by no means necessarily relying on their parent for finance or stocks. It expresses overseas operations in current and realistic sterling amounts, and has the practical advantage over the ‘historic rate’ method of simplicity of operation. The method of conversion to be selected is however a matter for judgement in the light of the facts of individual cases. The ‘historic rate’ method, may, for instance, sometimes be preferred where an overseas currency has a history of instability in relation to sterling and the circumstances are such that it is judged appropriate to continue to state fixed assets on the basis of their original sterling equivalents.

N26 *Land Commission Act 1967: accounting implications*

(Issued 11th May 1968)

The Council of the Institute of Chartered Accountants in England and Wales makes the following Recommendation on the accounting treatment of betterment levy arising under the Land Commission Act 1967. The Recommendation is mainly concerned with the accounts of companies but similar considerations will apply to the accounts of individuals and partnerships. No regard has been had to any special considerations which may apply in the case of trust accounts.

The Recommendation is concerned with accounting treatment and therefore does not deal with the calculation of betterment levy or the detailed provisions of the Act. It attempts to give an outline only of the events which may lead to a liability to levy and of the relationship of the levy to income tax, corporation tax and capital gains tax. As it is considered that no new taxation aspects are involved, the only change being the basis on which tax may be chargeable, the recommendations exclude reference to tax.

Betterment levy generally

1 The imposition of betterment levy arises under Part III and the attendant Schedules of the Land Commission Act 1967. Most of the provisions of the Act came into force on 6th April 1967.

2 An outline of the circumstances in which betterment levy may become payable is given in the following paragraphs. This is intended only to give broad principles and regard should be had to the detailed provisions of the Act.

3 Betterment levy is charged only on development value of land including buildings, not on increases in current use value, and arises only on the occurrence of an act or event which realises or is deemed to realise development value and on the person who realises or is deemed to realise that value. Development value is the value of land, additional to its value for current use, which is derived from the right to carry out material development as defined by the Act. Current use value is the value calculated on the assumption that planning permission would not be given for a project of material development.

4 Betterment levy may become payable on the occurrence of any of the following acts or events:

(a) a sale of a freehold or assignment of a leasehold interest (Case A);

(b) the granting of a lease out of a freehold or an existing leasehold interest (Case B);

(c) the commencement of a project of material development (e.g. putting up a building) (Case C);

(d) the receipt of compensation either where development is forbidden or where an existing use of land is discontinued (Case D);

(e) the grant, release or modification of an easement or the release or modification of a restrictive right (Case E);

(f) certain miscellaneous events not otherwise included (Case F).

5 Case C (Material development) differs from the other cases in that a charge to levy can arise without there being a related receipt.

6 In all other cases, however, there will be the receipt of a capital sum or of periodical amounts, or a combination of both, and the amount of levy payable will be related to the amounts received or receivable. For accounting purposes it may be necessary to distinguish between capital sums and future periodical receipts, and to distinguish between the part of the levy attributable to each.

7 It will also be necessary to consider separately the accounting treatment appropriate for:

(a) businesses where property is held as a *capital asset*. These will comprise businesses of all kinds holding property for use in the business or for the purpose of investment;

(b) businesses where property is held as *trading stock*. These will comprise mainly dealers in or developers of property.

Relation of betterment levy to tax

(a) Property held as a capital asset

8 Because of the relationship between betterment levy on the one hand and taxation on certain premiums and on capital gains on the other hand, tax consequences will ensue in addition to any liability to levy in the case of most events concerning property held as a capital asset and will require appropriate treatment in the accounts. The taxation consequences are summarized in the following table:

Case	*Betterment levy*	*Taxation on chargeable gains (corporation or capital gains tax) (Note 1)*
A	Liability on development value realised.	Liability normally restricted to the increase in current use value.
B	Liability on development value realised by the receipt of a premium and/or future rent.	Liability will normally extend only to the increase in current use value as realised by the receipt of a premium. (Note 2.)
C	Liability on development value deemed to be realised on change of use.	None. (Note 3.)
D	Similar to Case A above.	
E, F	Similar to Case B above.	

NOTES

1. In the case of persons other than companies disposing of capital assets within twelve months of acquisition, such a disposal may give rise to a liability under Case VII of Schedule D (short-term gains) as well as to betterment levy. In this event, the amount of the levy is allowable as a deduction in arriving at the gain assessable under Case VII.
2. In the case of premiums chargeable under Case VIII of Schedule D, that part of the betterment levy which relates to the premium is eligible for tax relief.
3. Tax liabilities arising on a future disposal will usually be effectively diminished as a result of the earlier assessment to levy under Case C.

(b) Property held as trading stock

9 In the case of property dealing businesses, where property is treated as trading stock, the complications of the interaction of tax and betterment levy do not arise since the levy will rank simply as an allowable expense under Case I of Schedule D.

Recommendations

It is recommended that levy paid or payable should be dealt with in the accounts as follows.

Property held as a capital asset

10 (a) *Development of freehold or leasehold property* (Case C). Since betterment levy payable under this Case is in effect a payment for the right to develop the property, the amount of levy should be added to the cost of the property. For the purposes of depreciation, the levy should be regarded as forming part of the cost of the land. Similarly, betterment levy should be included, so far as applicable, in any estimate of future capital expenditure stated by way of note or in a statement or report annexed.

(b) *Sale of freehold interest or assignment of leasehold interest* (Case A). The levy being charged by reference to the proceeds of sale or assignment, the amount of levy should be regarded as diminishing the amount of those proceeds and will accordingly diminish the surplus or augment the deficit arising on disposal.

(c) *Creation of a leasehold interest* (Case B). The amount of levy payable will be attributable either to the premium received on the grant of the lease, or to the present value of the future rents reserved by the lease, or partly to the one and partly to the other.

(i) So far as the levy is attributable to the receipt of a premium, it should be regarded as diminishing the amount of that premium and charged to the account to which the premium is credited.

(ii) So far as the levy is attributable to the capital value of future rents reserved by the lease, the amount payable should, in the first instance, be capitalised and added to the amount at which the property is carried in the books, and should thereafter be written off to revenue by way of charge against the rents receivable. It follows that, whether or not depreciation would otherwise be provided for in the accounts in respect of the property concerned, the amount of betterment levy capitalised must be written off over the period during which the rents reserved by the lease are to be received.

(d) *Compensation, easements and other miscellaneous events* (Cases D, E and F). These Cases can normally be treated in the same way as a sale (as under Case A) or, where periodical payments are to be received, as a grant of a lease (as under Case B).

Revaluations of property held as a capital asset

11 (a) If a revaluation of property is incorporated in the accounts, giving rise to an unrealised surplus, and the revalued book amount is attributable to any material extent to an assumed change of use in the property concerned, the possibility that betterment levy would become payable on commencing development or on sale of the property at its revalued book amount should be made clear. The estimated amount of this contingent liability should either be set aside out of the revaluation surplus and credited to a provision for deferred betterment or be shown by way of note. If the amount cannot reasonably be estimated this fact should be stated.

(b) If such a revaluation is referred to in a note on the accounts (without writing up the book amount of the property), the note should include a reference to the possibility of betterment levy becoming payable if the property were disposed of at its revaluation price, or developed on the basis underlying its revaluation. The note should disclose the estimated amount of this contingent liability or should state, if it is the case, that the amount cannot reasonably be estimated.

Property held as trading stock

12 (a) *Levy payable under Case C – development.* Since levy in this case is a cost of being allowed to carry out the development, it should be treated in the accounts as increasing that cost, charged to the profit and loss account and be reflected, if cost is the relevant basis, in the amount at which stock is brought into the accounts. In determining whether net realisable value has to be substituted for cost in arriving at the amount at which stock is brought into account and, if so, the amount of net realisable value, it will be necessary to take into account the estimated amount of any future betterment levy payable on a sale. In this connection attention is drawn to the special rules that apply under Schedule 5 to the Act to purchases between 23rd September 1965 and 5th April 1967 inclusive, whereby the purchaser of property, having possibly paid a price which includes development value, may normally only be permitted to deduct a smaller amount than cost in arriving at the amount on which levy is payable.

(b) *Levy payable under all other Cases.* It will usually be found that levy will be chargeable by reference to proceeds receivable which are credited to the profit and loss account. The levy payable in these circumstances should be charged to the profit and loss account. However, in some instances, part of any Case B levy may relate to ground rents retained by the dealer and in these cases that part of the levy should be regarded as part of the cost of those retained ground rents.

Disclosure of levy in accounts

13 The amount of levy payable need not be separately disclosed unless there are exceptional circumstances which render it necessary for the presentation of a true and fair view.

N27 *Treatment of taxation in accounts of companies*

(Issued July 1968)

The Council of the Institute of Chartered Accountants in England and Wales makes the following Recommendation to members on the treatment of taxation in the accounts of companies. It replaces Recommendation N19 – TREATMENT OF INCOME TAX IN ACCOUNTS OF COMPANIES and the Council's interim booklet – NOTES ON THE TREATMENT OF TAXATION IN COMPANY ACCOUNTS AFTER THE FINANCE ACT 1965. The Recommendation does not deal with the special problems of particular types of company (for example, investment trusts) nor with special accounting problems affecting members of groups of companies. Subject to this, the Recommendation seeks to deal with the majority of situations which may confront companies and their advisers in connection with the accounting treatment of corporation tax and income tax.

I. Requirements of the Companies Act 1967

1 The specific requirements of Schedule 2 to the Companies Act 1967 regarding the treatment of taxation in the accounts of companies are as follows:

The profit and loss account

(a) To show:

(i) 'the amount of the charge to revenue for United Kingdom corporation tax and, if that amount would have been greater but for relief from double taxation, the amount which it would have been but for such relief, the amount of the charge for United Kingdom income tax and the amount of the charge for taxation imposed outside the United Kingdom of profits, income and (so far as charged to revenue) capital gains' (paragraph 12 (1) (c))

(ii) 'the aggregate amount (before deduction of income tax) of the dividends paid and proposed' (paragraph 12 (1) (h)).

(b) To state by way of note, if not otherwise shown:

(i) 'the basis on which the charge for United Kingdom corporation tax and United Kingdom income tax is computed' (paragraph 14 (3))

(ii) 'any special circumstances which affect liability in respect of taxation of profits, income or capital gains for the financial year or liability in respect of taxation of profits, income or capital gains for succeeding financial years' (paragraph 14 (3A)).

The balance sheet

(a) To state by way of note, or in a statement or report annexed, if not otherwise shown:

(i) 'If a sum set aside for the purpose of its being used to prevent undue fluctuations in charges for taxation has been used during the financial year for another purpose, the amount thereof and the fact that it has been so used' (paragraph 11 (8A))

(ii) 'The basis on which the amount, if any, set aside for United Kingdom corporation tax is computed' (paragraph 11 (10))

(b) 'If an amount is set aside for the purpose of its being used to prevent undue fluctuations in charges for taxation, it shall be stated' (paragraph 7A)

(c) To show under a separate heading 'the aggregate amount (before deduction of income tax) which is recommended for distribution by way of dividend' (paragraph 8 (1) (e)).

2 Apart from these specific requirements, the accounting treatment of taxation must be consistent with the disclosure by the accounts of a true and fair view of the profit or loss for the accounting period and of the state of affairs at the end thereof. In the case of quoted companies, it is also necessary to take account of the requirements of the relevant Stock Exchange regarding the disclosure of matters affecting taxation, as for example, close company status.

II. General taxation considerations

Dividends

3 A company is subject to corporation tax on its profits, including chargeable gains, and bears the gross cost of the dividends it pays. The principle of deduction at source applies to dividends when paid, the company being required to account to the Revenue for the income tax deducted, either by direct payment or by set-off against any income tax which the company itself has suffered on dividends received from other United Kingdom companies. Such dividends constitute 'franked investment income' in the hands of the receiving company and are not subject to corporation tax.

Distributions other than dividends

4 The considerations set out in the previous paragraph regarding dividends apply also to a number of other transactions, termed 'distributions' (as defined in Schedule 11 to the Finance Act 1965), by which a company may benefit its shareholders. Distributions are not allowed as deductions in computing the paying company's income for corporation tax purposes, nor do they rank as charges on income. Income tax on distributions must be accounted for to the Revenue by the company which makes them in accordance with the procedure described in the previous paragraph, and they constitute franked investment income in the hands of a United Kingdom company which receives them. For convenience, the term 'dividends' is used throughout this document, but similar considerations apply, unless otherwise stated, in the case of other 'distributions'. Some special situations are considered in paragraphs 67 and 68 below.

Annual payments

5 The gross amount of yearly interest, annuities and other annual payments (not being distributions) normally ranks as a deduction in computing the corporation tax liability for the period in which it is paid. In the hands of the receiving company income of this nature is assessable to corporation tax. As with dividends, the principle of deduction of income tax at source applies: companies are required to account to the Revenue for income tax deducted from payments made and are entitled to set off the income tax suffered on income of this class received. If such income tax suffered exceeds that deducted from payments made, the excess is set off against the appropriate corporation tax liability, if any, and the balance repaid. Accordingly, no charge for income tax suffered by deduction from income of this nature falls on the profit and loss account.

Income tax

6 It follows from the considerations in paragraphs 3 and 4 above that, although the franked investment income which a company receives suffers income tax by deduction at source, the income tax may be set off against that which the company deducts from dividends paid in the same or subsequent fiscal years. Provided that the available franked investment income does not exceed the gross amount of dividends paid in the same fiscal year, no charge for income tax falls on the company. The converse situation where a company has 'a surplus of franked investment income', that is, where its franked investment income exceeds the dividends paid in the same fiscal year, is not usually found in trading companies and is considered in the Appendix.

III. The profit and loss account

Corporation tax

7 The charge for corporation tax should be based on the profits shown by the accounts. The charge would usually be expected to be in appropriate relationship to the profit (excluding franked investment income and group income). This relationship will, however, be distorted if, in computing the income assessable to tax, the profits shown by the accounts have to be adjusted by:

(a) adding back expenses not allowable for tax in this or any subsequent period, such as depreciation of non-industrial buildings or excess remuneration of the directors of a close company; or

(b) excluding income not taxable such as interest on tax reserve certificates; or

(c) the difference between depreciation charged in the accounts and capital allowances computed for tax purposes; or

(d) the difference arising as a result of allocating items to different periods for accounting and taxation purposes as, for example, provisions and accrued charges on income which do not rank for taxation relief until the expenditure provided for is actually incurred or the charge actually paid.

8 The adjustments referred to in paragraphs 7 (a) and (b) may be material, and even if they are not of an abnormal nature, they may then be considered to fall within the requirements of paragraph 14 (3A) of Schedule 2 to the Companies Act 1967 to disclose any special circumstances which affect the taxation liability.

9 The allocation of items to different periods for accounting and taxation purposes referred to in paragraphs 7 (c) and (d) will usually result in the taxation charge based on the taxable profit of the year not being in appropriate relation to the profit shown by the accounts. The extent of the distortion may vary from year to year and may not always be material. Nevertheless, such distortions should be avoided by providing for taxation on the accounting profit without regard to items allocated to other periods for taxation purposes. The difference between the corporation tax on the accounting profit and corporation tax on the taxable profit should be dealt with through the deferred taxation account (see section V below). There is normally no need to disclose separately in the profit and loss account the amount transferred to or from the deferred taxation account.

10 The rate of corporation tax is fixed retrospectively so that at the time accounts are completed the actual rate may not be known for the whole or part of the accounting period.

Recommendations

11 (a) The corporation tax charge should be based on the accounting profit without regard to the fact that some items are allocated to other periods for taxation purposes.

(b) If material items are altogether disallowed or excluded for taxation purposes, any consequent distortion of the corporation tax charged should be explained by note.

(c) The charge for corporation tax should be described as 'corporation tax on the profits of the year' (or other period), in order to comply with paragraph 14 (3) of Schedule 2 to the Companies Act 1967, which requires the disclosure of the basis on which the charge for corporation tax is computed.

(d) If the rate of corporation tax is not known for the whole or part of the period covered by the accounts, the latest known rate should be used and disclosed.

Overseas taxation

12 A credit for overseas taxation is allowed against corporation tax on profits which would otherwise be doubly taxed.

Recommendation

13 Compliance with paragraph 12 (1) (c) of Schedule 2 to the Companies Act 1967 will be ensured by disclosing the following:

(a) the amount of United Kingdom corporation tax,

from which should be deducted

(b) the relief for overseas taxation,

leaving

(c) the amount of United Kingdom corporation tax after relief for overseas taxation,

to which should be added

(d) the amount of overseas taxation, both relieved and unrelieved.

(See Appendix paragraph 3 (d) for disclosure of income tax borne by the company.)

Trading losses

14 The method selected for the relief of a trading loss may affect the corporation tax charge for the year in which the loss is incurred and also that for subsequent years. The provisions of paragraph 14 (3A) of Schedule 2 to the Companies Act 1967 are relevant to the accounting treatment of such relief, which constitutes a 'special circumstance' requiring disclosure.

Recommendations

15 (a) If a loss is set against other income of the same accounting period, corporation tax should be provided on the net income.

(b) If a loss is set against the profits of the preceding accounting period, the corporation tax recoverable should, if material, be disclosed separately.

(c) If a loss is available to be set off against the profits of succeeding accounting periods, the existence of the loss, if material, should be indicated by way of a note. It should be made clear that any tax relief is dependent on there being future profits of sufficient amount.

(d) If the corporation tax charged for a particular accounting period has been eliminated or materially reduced by losses brought forward, the amount of the relief should be indicated.

Dividends payable

16 A company bears the gross cost of dividends, paying the net amount to its shareholders and accounting to the Inland Revenue for the income tax thereon as described in paragraph 3 above.

Recommendation

17 Dividends paid or proposed should be shown gross in the profit and loss account; the net amounts and the income tax appropriate thereto may be shown inset, if desired.

Franked investment income

18 The special nature of franked investment income is set out in paragraphs 3 and 6 above. In many companies the amount of such income will be of little or no significance.

Recommendation

19 Franked investment income should be included in the profit and loss account gross of income tax and, where it is material, such gross amount should be disclosed. Except in the special circumstances indicated in paragraph 23 below, the amount should not be grossed up by the underlying corporation tax borne by the company paying the dividend.

20 A company which has franked investment income in excess of dividends paid or payable bears income tax as well as corporation tax. Few trading companies are likely to find themselves in this position and the special problems which arise are considered in the Appendix.

Group income

21 If companies are related in the manner described in section 48 (3) of the Finance Act 1965, they may elect, subject to the provisions of the Act, to pay and receive dividends passing between them without deduction of income tax. Such income is referred to as 'group income'. It does not constitute franked investment income but is not liable to corporation tax. To the extent that it is derived from subsidiary companies it will normally be eliminated from the consolidated profit and loss account, but it may form a significant part of a company's profit or, if it arises from associated (consortium) companies, of the consolidated profit.

Recommendation

22 Where 'group income' is material, the amount should be disclosed in the recipient company's profit and loss account or by way of note. Except as indicated in paragraph 23 below, the amount should not be grossed up by the underlying corporation tax borne by the company paying the dividend.

Dividends from jointly-owned companies

23 Although dividends received from another United Kingdom resident company are invariably franked investment income or group income, the nature of the investment may, in some instances, be such as to justify the assimilation of such dividends, in the context of taxation, to

trading profit. This involves bringing the dividends in question into the profit and loss account grossed up by the corporation tax borne by the company paying them. The corporation tax so added to the dividends would then be added also to the tax which is charged in the profit and loss account in respect of the recipient company's own profits, showing it separately if the amount is material. It is important that the accounts should make it clear that this basis has been adopted. This treatment is appropriate only where the shareholding in the company concerned (not being a subsidiary) represents a substantial participation in a trading enterprise which is, in effect, a partnership, consortium, or joint venture with other companies or persons. It should not be adopted unless substantially the whole of the profits of the jointly-owned company are distributed annually as dividend, and unless the dividends brought into account by the recipient company are in respect of a period concurrent, or nearly concurrent, with its own accounting period. Where the incidence of corporation tax on the jointly-owned company is materially affected by, for example, losses brought forward, or franked investment income received, care should be exercised lest the grossing-up of the dividends should have a misleading effect.

Summary (profit and loss account)

24 In the absence of any charge in the accounts for income tax, the profit and loss account will disclose:

(a) profit before taxation (which may include franked investment income gross of income tax and also group income)

(b) the charge for corporation tax and overseas taxation (if any)

(c) profit after taxation

(d) gross dividends paid and proposed.

IV. The balance sheet

25 Corporation tax assessable on the profits of an accounting period, but unpaid at the end thereof, is not a reserve and should not be grouped with reserves; it is a liability at the date of the balance sheet and should be shown as such. If its amount cannot be determined with substantial accuracy, it should appear as a provision.

26 Depending on the date to which a company makes up its accounts, there may be accrued corporation tax liabilities at the balance sheet date for two accounting periods. That for the later period may not become due for payment in extreme cases for almost twenty-one months.

Recommendations

27 (a) The liability for corporation tax on the profits of the period covered by the accounts should be disclosed either as an item of current liabilities or as a separate liability with the due date for payment shown. Corporation tax for earlier periods not yet paid should normally be shown as such under current liabilities.

(b) Corporation tax recoverable should be included in the balance sheet either as a current asset or as a deduction from any liability to corporation tax.

Income tax

28 As the income tax account is in the nature of a current account with the Inland Revenue, any amounts due to or from the Inland Revenue are respectively normal items of creditors or debtors. In the case of amounts due from the Inland Revenue, it is necessary to consider whether settlement is to be made by cash or by set off against a corporation tax liability.

Recommendation

29 Income tax for which the company must account to the Inland Revenue, or which is repayable to the company, may be included with creditors or debtors respectively and in normal circumstances need not be disclosed separately. Income tax which can only be recovered by deduction from a corporation tax liability should be deducted from the relevant amount.

Proposed dividends in the case of companies with franked investment income

30 The Companies Act 1967 provides that proposed dividends shall be shown gross in the balance sheet. If income tax suffered by deduction from franked investment income is available to set against the income tax liability which will arise when the dividend becomes due and payable, this may appropriately be shown, if material, as a deduction from the gross amount of the dividend.

Recommendation

31 Income tax deducted from franked investment income which is available for set off against the income tax liability arising when a proposed dividend becomes due and payable should, if material, be shown in the balance sheet as a deduction from the gross amount of the dividend or, if not material, it may be carried forward as an addition to debtors.

V. The deferred taxation account

32 As mentioned in paragraph 9 above, the corporation tax charge in the profit and loss account should be based on the accounting profit without regard to items allocated to other periods for taxation purposes. In the balance sheet, the liability for corporation tax will represent the amount actually assessable in respect of the accounting period. The difference between the charge and the liability, if material, should be passed through the deferred taxation account, although in order to avoid undue complexity, its use is normally restricted to those items which cause major differences between accounting profit and assessable profit. The purpose for which the account will most frequently be used is to adjust for the differences between capital allowances given for tax purposes and depreciation charged against profit in respect of the same assets, and this will usually ensure that a credit balance is maintained on the account. Other credits to the account will result from following the recommendations set out in section VI below regarding capital surpluses not immediately taxed. The presumption is that amounts included in the balance at the credit of the deferred taxation account will be required at some future date or dates to meet taxation liabilities relating to profits or surpluses already brought into account, or resulting from the acceleration of tax relief in relation to the corresponding charges against profit. The balance should therefore be regarded not as a reserve but as a deferred liability. The fact that as elements of this liability mature they are replaced by new deferments does not alter the character of the balance.

Recommendation

33 (a) A deferred taxation account should be established and maintained at current rates of taxation whenever there exist material taxation liabilities which may crystallize at some future date on profits and surpluses already brought into account.

(b) As regards assets on which capital allowances cumulatively exceed the charges for depreciation in the accounts, the deferred taxation account should provide for tax on the excess of:

  (i) the net amount at which the relevant assets are stated in the balance sheet over

  (ii) the written down value of those assets for taxation purposes. (See paragraphs 48 and 49 below dealing with cases where assets have been revalued.)

(c) A credit balance on the deferred taxation account should not be treated in the balance sheet as a reserve or grouped with reserves. It should be separately stated, but may be grouped with any liabilities or provisions which fall outside the heading of 'current liabilities'.

Treatment of debits to the deferred taxation account

34 Examples of circumstances in which debit entries arise in the deferred taxation account are as follows:

(a) where an expense has accrued (for example, annual interest) but corporation tax relief is not given until the payment is made, which may be in a subsequent year

(b) where a provision is made (for example, for deferred repairs or unspecified doubtful debts) but corporation tax relief is not given until the expense or loss is incurred

(c) where an expense is incurred and paid but the tax allowance is spread forward (for example, lump sum back service contributions to a pension fund).

35 A debit balance on the deferred taxation account can only be realized if there are adequate future profits. Accordingly, it should not be carried forward unless its realization out of profits in the next succeeding period is reasonably certain.

Recommendation

36 If a debit balance arises on the deferred taxation account it should be written off to the profit and loss account, unless its recovery against the profits of the next succeeding period is reasonably certain. Where the amount so written off is material it should be disclosed in similar manner to the existence of tax losses carried forward, as recommended in paragraph 15 (c) above.

Changes in the rate of corporation tax

37 The deferred taxation account is intended to provide for a future liability at future rates of tax, but as those rates are unknown this object can never be achieved with certainty or precision. Nevertheless, as changes in the rate of corporation tax takes place, it should be recognised that the basis on which past provision has been made has become out of date, and the balance of the account should be adjusted accordingly.

Recommendation

38 When a change in the rate of corporation tax has taken place, the entire balance of the deferred taxation account (and any amount of future tax or tax relief shown by way of note) should be correspondingly adjusted. To the extent that the adjustment relates to entries made in previous years, the amount, if material, should be disclosed.

Trading losses carried forward and the deferred taxation account

39 The effect of trading losses on deferred taxation requires consideration. On the one hand, trading losses will operate to reduce a future liability to the extent that such losses can be set off against income subsequently arising from the same trade. On the other hand, the deferred taxation account represents a possible future liability to tax but may include provisions for tax on income against which a trading loss can be set as well as that against which it cannot be set. It may also include future liabilities on tax on capital gains.

Recommendations

40 (a) When a trading loss has been incurred, and is to be carried forward, a transfer should be made from the deferred taxation account to the credit of the profit and loss account of an amount equal to the notional tax relief attributable to the loss, but not exceeding that part of the balance of the deferred taxation account which represents tax on income from the same trade. If account is taken in this manner of the whole of a loss, the need for the note recommended in paragraph 15 (c) above will be obviated. If only part of the loss is so treated, any amount given in the note should be appropriately reduced.

(b) When a transfer has been made under (a) above, then as and when a trading profit is subsequently earned against which the loss can be set for assessment purposes, a transfer should be made from the profit and loss account to the credit of the deferred taxation account of an amount equal to the actual tax relief resulting from the loss, but not exceeding the amount previously transferred in accordance with (a). In indicating the relief obtained, as recommended in paragraph 15 (d) above, it should be borne in mind that a part or the whole of the loss relief will have been credited to the profit and loss account under (a) above in an earlier year.

VI. Realisations and revaluations of assets

Surpluses on capital assets

41 A capital surplus may either be realised (as when an asset is sold) or unrealised (as when a revaluation takes place and the assets are stated in the accounts at a higher figure than before). The special considerations which arise in the latter circumstances are dealt with in paragraphs 46 to 59 below and include those which arise when the book value of investments is adjusted annually to market value.

Realised capital surpluses

42 If a capital surplus which gives rise to a chargeable gain, is realised it is necessary to provide for the corporation tax thereon.

Recommendations

43 (a) The corporation tax on a chargeable gain should be charged to the account to which the surplus itself is credited.

(b) If trading losses are set off against chargeable gains and the amounts are material, the appropriate accounts should be so adjusted as to show the true incidence of the tax on the chargeable gain and the relief for the loss.

Surpluses on business assets replaced

44 Where a chargeable gain arises on the disposal of business assets and the proceeds are used to acquire new assets of the same class, an election may be made to treat their cost for corporation tax purposes as reduced by the amount of the chargeable gain. If only part of the proceeds is so used, the relief is restricted accordingly. The effect is to postpone settlement of the tax liability until there is a chargeable gain arising on the disposal of the assets without replacement. It is desirable to provide in the accounts for this liability, even though its settlement is postponed, out of the surplus arising on the sale of the original assets.

Recommendation

45 If a surplus arises on a disposal of a business asset and an election is made so that the cost of the replacement asset is reduced for tax purposes by the amount of the chargeable gain, corporation tax on the gain should be charged against the surplus and credited to the deferred taxation account at the time of the replacement.

Unrealised capital surpluses

46 If a capital surplus arises from a revaluation incorporated in the accounts, the surplus is normally credited to reserve. When the revalued assets are eventually disposed of there may be a liability to corporation tax, and to the extent that the chargeable gain is a reflection of the surplus created by the revaluation, the tax should be regarded primarily as a charge against the reserve to which the surplus was taken. Alternatively, part of the surplus may be appropriated specifically for this purpose and only the net amount taken to reserve. In any event the existence of the contingent liability needs to be recognised and its amount disclosed.

Recommendation

47 When assets are written up in the accounts on a revaluation, the corporation tax on any chargeable gain which would arise on a sale of the assets at the date of the balance sheet at the amount of the revaluation should be either:

(a) charged against the surplus on revaluation and credited to deferred taxation account; or

(b) stated in a note on the accounts and continue to be so stated – the note should make it clear that no provision has been made out of the surplus for this potential liability.

There may be circumstances, such as where the early disposal of the asset concerned is in contemplation, in which the former treatment is the more appropriate.

48 If a capital surplus arises from a revaluation of assets which attract capital allowances, a balancing charge may arise on disposal, as well as (or instead of) a chargeable gain.

Recommendation

49 When assets which attract capital allowances are written up in the accounts on a revaluation, there should be charged against the surplus on revaluation, and credited to the deferred taxation account (in addition to tax on any chargeable gain) the tax on any balancing charge which

would arise on a sale of the assets at the amount of the revaluation. If the recommendation in paragraph 33 (b) above has been followed, this provision should be reduced by any amount already effectively provided thereunder for tax on the difference between the pre-existing book values and the tax written down values of the assets concerned.

50 An asset which has been written up in the past may either be sold or subsequently revalued at a figure below the written up amount. This most frequently occurs in the case of investments stated in the accounts on the basis of market values at the date of each balance sheet.

Recommendation

51 Where corporation tax has been provided in the past on a capital surplus in accordance with paragraph 47 (a) above and a realised or unrealised capital deficit later arises on the same asset, a transfer should be made from the deferred taxation account and credited against the deficit. The amount transferred should be the lesser of (a) the tax provided out of the original surplus, and (b) tax on an amount equal to the subsequent deficit.

Market values stated by way of note

52 Where, as in the case of investments, a note of market value is given, and this exceeds the book value, the absence of any reference to the potential liability to corporation tax may be misleading.

Recommendations

53 (a) Where the market value of an asset is disclosed by way of note, this should include an estimate of any corporation tax which would arise if the asset were disposed of at the value noted.

(b) If because of practical difficulties such an estimate is not made, the note of market value should include reference to the fact that had the asset been realised at the value noted, a liability to tax on any chargeable gain would have arisen.

Estimation of potential chargeable gains

54 An item stated in the balance sheet at a revaluation, or an amount given by way of note as market value, may relate to a number of separate assets, for example, investments. If the realisation of any of them at the value included in the stated total would result in an allowable loss, the claim for tax relief might depend on the date when other assets, producing chargeable gains, were realised.

Recommendation

55 In applying the foregoing recommendations to an aggregation of a number of separate assets, the tax should be estimated on the basis that any allowable losses arising on some of the constituent items are offset against chargeable gains arising on others as on a simultaneous disposal.

56 In the case of assets (other than quoted securities) acquired before 6th April 1965, special difficulties arise in estimating the potential chargeable gain. Market value at 6th April 1965 is one of the bases available for the computation, but it may be that this basis is not used, either because it is likely to prove disadvantageous, or because the value at that date is arguable and there is no means of establishing a value acceptable to the Inland Revenue in advance of the actual disposal. The alternative basis normally available, time apportionment, will then be considered and it is here that difficulties of estimation arise.

57 Where the time apportionment basis is applied, a potential chargeable gain can be arrived at by assuming a notional disposal at the balance sheet date, but with each year that passes a higher chargeable gain will be produced by substituting the later notional disposal date. Eventually a ‘ceiling’ may be reached by reference to market value at 6th April 1965, if that value can be arrived at with sufficient exactitude.

Recommendation

58 In the case of a revalued asset acquired before 6th April 1965, where the time apportionment basis is appropriate for estimating the potential chargeable gain, the amount to be provided or stated by way of note should be the maximum potential tax liability capable of arising from a disposal at the stated value at any future time, however long deferred. Alternatively, tax should be provided

initially on the assumption that the asset is disposed of at the stated value at the date of the first balance sheet in which the revaluation appears, and additional provisions made annually on the basis of an assumed disposal at the stated value at the date of each subsequent balance sheet.

59 The estimation of potential chargeable gains may prove to be burdensome, for example where a large number of investments is concerned. Nevertheless, it is considered, in order that the accounts may show a true and fair view, that every effort should be made, in accordance with the considerations set out in paragraphs 54 to 58 above, to give at least a fair approximation of the potential liability involved, however remote in time the prospect of incurring it may be considered.

Deficits on capital assets

60 A capital deficit may be either realised, as when an asset is sold, or unrealised, as when on revaluation an asset is stated in the accounts at a lower figure than hitherto.

Realised capital deficits

61 Although an allowable loss which cannot be relieved in the year in which it arises is available for set off against future chargeable gains, it is not desirable to include in the balance sheet as an asset the corporation tax which may ultimately be relieved, because its recoupment is dependent on adequate chargeable gains arising in the future.

Recommendations

62 (a) If an allowable loss is available for set off against chargeable gains in future accounting periods, the existence of the loss, if material, should be indicated by way of a note. It should be made clear that any tax relief is dependent upon there being chargeable gains of sufficient amount in the future.

(b) If the corporation tax on chargeable gains for a particular accounting period has been eliminated or materially reduced by allowable losses brought forward, the amount of the relief should be indicated.

63 An allowable loss may become available for carry forward at a time when the deferred taxation account contains a provision for tax on potential chargeable gains. This is a situation similar to that described in paragraph 39 above in relation to trading losses, and procedures parallel to those recommended in paragraph 40 become appropriate.

Recommendation

64 (a) If the deferred taxation account contains a provision for potential corporation tax on an unrealised capital surplus on certain assets, and on the disposal of other assets an allowable loss arises which can only be carried forward, a transfer should be made from the deferred taxation account to the credit of the account to which is charged the capital deficit on the disposal giving rise to the allowable loss. The amount transferred will represent tax relief for the allowable loss, but should not exceed the provision for tax on potential chargeable gains contained in the deferred taxation account.

(b) If, subsequently, an actual chargeable gain arises (other than one for which tax was originally provided in the deferred taxation account), and the allowable loss brought forward is set against it, it will be necessary to reverse the transfer made earlier in accordance with (a) above, appropriately limited if only part of the loss brought forward is used.

(c) One effect of applying the foregoing procedures will be to eliminate the need for, or to modify, the information which paragraph 62 above recommends should be given.

Unrealised capital deficits

65 A capital deficit may arise when an asset is stated in the balance sheet at a revaluation or be implied by a note of market value (as in the case of investment) which is below the amount at which the asset is stated. As no allowable loss for corporation tax purposes can arise until the revalued asset is realised, no credit for relief should be taken, at least until realisation occurs, when the considerations in paragraphs 61 and 62 above become relevant.

Recommendations

66 Except as indicated in paragraph 55 above, no credit should be taken for any tax relief implied by the existence of an unrealised capital deficit.

VII. Distributions other than dividends

67 Reference is made in paragraph 4 above to distributions other than dividends. Examples of such distributions are bonus issues of debentures or redeemable preference shares, premiums paid on redemption of shares and, in certain circumstances, distributions of assets *in specie*. As in the case of dividends, the company making such a distribution is required to account for the income tax relevant thereto. Where possible, income tax will be deducted from the amount due, and only the net amount will be paid to the shareholders. Otherwise, the distribution will be 'grossed up', and the company will be required to account for tax on this amount. In either event, the tax should be dealt with, in the accounts of the company making such a distribution, in the same manner as the distribution itself so that the gross, or grossed up, amount of the distribution will be charged to reserves or, as the case may be, to the profit and loss account.

68 Distributions received are 'franked investment income', although those of the kind mentioned in paragraph 67 above are normally treated as capital transactions in the recipient company's books. The treatment in the accounts of the recipient company will follow that recommended in paragraph 19 above, except that the gross amount will usually be credited to a reserve, or perhaps to an asset account, and not to the profit and loss account.

VIII. Close companies

Disclosure of status

69 Because of the special corporation tax and income tax provisions affecting close companies, information as to the company's status should be disclosed in accordance with the following paragraph.

Recommendations

70 (a) The status of a company whether 'close' or otherwise should be disclosed by way of note.

(b) If the status of the company is open to doubt or has changed during the accounting period, this should be stated, together with a note of the basis on which the tax provision has been made.

Special taxation considerations

71 If the company is a close company, it is necessary to consider the incidence of income tax upon a possible shortfall, under section 77 of the Finance Act 1965, unless the distributions paid or proposed or the requirements of the company's business are clearly such that no shortfall exists. The shortfall cannot normally be ascertained at the time when the accounts are prepared. Its existence or amount will depend on whether or not distributions for the accounting period are paid within eighteen months thereafter (twelve months as respects accounting periods ending before 20th March 1967), and such dividends may be additional to those proposed in the accounts. It is, therefore, not appropriate to provide for the income tax on a possible shortfall in the accounts of the period to which it ultimately relates, but the existence of the contingent liability should be referred to in an appropriate note. If income tax is payable in respect of a shortfall, it follows from the above that it must relate to a previous accounting period, and accordingly the amount thereof should, if material, be disclosed.

Recommendation

72 A note on the lines of one of the following paragraphs, as appropriate to the circumstances, should appear on the accounts:

(a) *If it is clear there is no material shortfall*

'The company is a close company. No **material* shortfall can arise and no provision for income tax under section 77 of the Finance Act 1965 is necessary.'

(b) *In other circumstances*

'The company is a close company and is therefore potentially liable to income tax on any shortfall of distributions below the required standard. It has not yet been established that the *d*ividends paid and proposed and other distributions* for the period satisfy this standard.'

* *Delete any words that are inapplicable.*

It may be relevant, according to the circumstances, to state, in addition, what the maximum amount of such an assessment would be.

Where a note on the lines of (b) above has appeared on, or would have been relevant to, the accounts of a previous period, there should be disclosed:

(i) the amount of any income tax paid or known to be payable in respect of a shortfall of that period; or,

(ii) the fact that an assessment will not be made in respect of that period; or,

(iii) the fact that the matter has not yet been determined.

Loans to participators

73 In certain circumstances a close company which makes a loan or advances money (otherwise than in the ordinary course of its business which includes the lending of money) to an individual who is a participator (or to his associate) is assessable to income tax on the grossed up equivalent of the loan, the tax being repayable when the loan is repaid. Income tax on such loans is thus comparable in class with the loans themselves.

Recommendation

74 Income tax on a loan to a participator should be grouped in the balance sheet with the loan to which it relates. If the loan is one the disclosure of which is required by section 197 of the Companies Act 1948, the income tax relating thereto should also be disclosed.

Disallowable remuneration, etc.

75 In the case of close companies any disallowance for corporation tax purposes of items such as directors' remuneration in excess of the permitted standard, interest paid to participators, etc., will create a distortion in the relationship between the profits shown by the accounts and the tax charge. In conformity with the principle enunciated in paragraph 8 above, this distortion should be the subject of an appropriate note.

Recommendation

76 If the special rules relating to close companies result in the disallowance for corporation tax purposes of material items of expense and so distort the relationship between the profits shown by the accounts and the tax charge, the position should be explained in a note.

IX. Transitional matters

Reliefs from taxation

77 A company may obtain relief from income tax under the 'one year surplus' or 'three year surplus' provisions and from corporation tax (and possibly income tax) under the provisions of section 87 of the Finance Act 1965 relating to the cessation of certain sources of income.

78 For years up to and including 1972–73, section 84 of the Finance Act 1965 provides for progressively diminishing payments out of public funds ('overspill' relief) to compensate companies for the fact that overseas taxation can no longer be set off against income tax.

Recommendation

79 Relief in accordance with paragraphs 77 and 78 should, if material, be disclosed as exceptional credits and described appropriately.

Appendix

THE TREATMENT OF INCOME TAX WHERE A COMPANY HAS A SURPLUS OF FRANKED INVESTMENT INCOME IN AN ACCOUNTING YEAR

1 If a company has 'a surplus of franked investment income' the treatment of the income tax suffered on the excess requires consideration. Although income tax on a surplus of franked investment income may be used to offset income tax on dividends which may be paid out of future profits, the declaration of future dividends to make this set-off possible should not normally be assumed. The income tax on the surplus franked investment income should therefore be written off. An exception may be made where it can be foreseen with reasonable certainty that in the next succeeding accounting period the dividends will exceed the franked investment income to an extent which will enable the surplus to be utilised.

2 A surplus of franked investment income is arrived at by reference to fiscal years. An accounting period usually includes parts of two fiscal years and, moreover, the accounts may provide for a dividend which will not be paid until after the commencement of a third. For taxation purposes, a surplus of franked investment income is carried forward from one fiscal year for set off against dividends paid in another but it cannot be carried back. The charge (or absence of charge) for income tax in the accounts cannot therefore be arrived at by reference only to the respective totals of franked investment income and dividends included in those accounts but must take account of the incidence of those items as between different fiscal years.

Recommendations

3 (a) In arriving at the amount of income tax to be written off at an accounting date in respect of a surplus of franked investment income, regard should be had to the incidence of the relevant items as between different fiscal years.

(b) A proposed dividend should, for this purpose, be regarded as reducing or extinguishing a surplus of franked investment income at the accounting date, notwithstanding that the dividend is not to be paid until after the commencement of a new fiscal year.

(c) Except as indicated in paragraph (b) above, income tax on a surplus of franked investment income should not normally be carried forward in the accounts in anticipation of its being used to offset tax on future distributions, but should be written off to the profit and loss account, unless its set-off against the excess distributions of the next succeeding period is reasonably certain.

(d) The amount written off should be disclosed in one of the following ways:

(i) The income tax written off on surplus franked investment income is shown as an element of the total taxation charge. The resulting balance of the profit and loss account may then be described as profit after taxation but its amount cannot be determined before the proposed dividends and it does not therefore represent the divisible profit.

(ii) A balance of the profit and loss account is struck after charging the tax on profits, namely corporation tax and overseas taxation, if any, but before charging the income tax written off on a surplus of franked investment income. This balance is described as 'profit after corporation tax (and overseas taxation)'. It cannot truly be described as 'profit after taxation' because of the charge for income tax still to be made. The income tax is then written off in the same section as the dividends as it is dependent on their amount. This method is based on the view that company profits do not attract income tax and that, both for computing the dividend cover and maintaining comparability of profits, it is the figure after corporation tax but before income tax which is significant.

(e) If income tax written off but available for set off against distributions in future years is material, the gross equivalent (i.e., the surplus franked investment income) should be given by way of note. It should be made clear that the tax thereon is available only against future dividends.

(f) If there is a surplus of franked investment income by reason of the receipt of a distribution of a capital nature (see paragraph 68 above), the income tax on the surplus should be written off against the reserve to which the gross or grossed up distribution has been credited.

(g) If income tax on dividends paid or proposed in any year is wholly or partially discharged by income tax written off in previous years, the amount so utilised should be credited to the profit and loss account (or, as the case may be, to the reserve mentioned in (f) above).

4 Income tax borne on a surplus of investment income may be reclaimed under Section 62, Finance Act 1965, in respect of trading losses, charges on income, etc., which have not been relieved against corporation tax. The charge for income tax in the profit and loss account may thus be reduced or extinguished by such a claim made or intended to be made, or it may be found that income tax charged in the accounts of a previous period is recoverable by this means.

5 A Section 62 claim absorbs equal amounts of both trading losses and surplus franked investment income otherwise available for carry forward. The amounts to be noted under paragraph 15 (c) of the main document and 3 (e) of this appendix will, therefore, both be reduced accordingly.

6 Where in a subsequent fiscal year the company makes distributions in excess of its franked investment income, the whole or part of the trading loss is reinstated as a loss brought forward for corporation tax purposes. This will require disclosure in the manner recommended in paragraph 15 (c) or (d) of the main document, as appropriate.

Recommendation

7 The charge for income tax in the profit and loss account may be reduced by any claim made or intended to be made under Section 62, Finance Act 1965, provided both the franked investment income and the loss, expense, etc., relevant to the claim are included in the same financial period. Where the income or the loss, etc., relates to some other period, the relief, if material, should be disclosed separately in the profit and loss account.

N28 *The accounts of investment trust companies*

(Issued 7th August 1968)

The Council of the Institute of Chartered Accountants in England and Wales issues the following recommendations on the treatment of investments in the accounts of investment trust companies. It is hoped that they will be helpful to members in deciding, and in advising in appropriate cases, as to what is regarded as best practice. The recommendations do not apply to companies dealing in investments.

References to 'capital gains tax' in paragraphs 8 to 16 of this Recommendation are to corporation tax on chargeable gains, the rate of which in the case of investment trust companies approved under Section 37 of the Finance Act 1965 is limited to the rate of capital gains tax payable by an individual.

Unless otherwise stated references are to Schedule 2 to the Companies Act 1967, being the form of Schedule 8 to the Companies Act 1948 as amended by Schedule 1 to the Companies Act 1967.

1 The treatment of investments in the balance sheets of investment trust companies varies considerably; the methods at present adopted may be conveniently grouped under the following headings:

(a) cost, each holding being treated as a separate asset

(b) cost less all net surpluses on investments realised; this treatment implies the concept that the whole portfolio is one asset

(c) market value (including the value as estimated by the directors in the case of investments for which there are no quotations), any resulting net surplus or deficiency being transferred to or from reserves.

2 Investments held by investment trust companies have the nature of fixed assets and it is appropriate for them to be stated at cost. Likewise if the investments have been revalued at some past date it is appropriate to state those investments at that valuation with subsequent purchases at cost.

3 Where the shares comprising one holding have been acquired over a long period the use of cost (or valuation at a past date) as a basis may, however, have little significance. Such a basis will have even less significance where profits on realisation have been deducted from the cost of the remainder of the portfolio or where an unspecified amount has been written off cost in arriving at the amounts stated in the balance sheet.

4 Under paragraph 11 (8) of Schedule 2 there must be stated, by way of note or in a statement or report annexed if not otherwise shown, the aggregate market value of quoted investments.

5 Market value at a particular date has the advantage that it is capable of reasonably precise definition (although it is not necessarily the value at which the investment could be realised) and is more relevant for use when calculating the asset value per share and measuring income yield. Investments may therefore appropriately be stated in the accounts of investment trust companies at market value as an alternative to their being stated at cost or revaluation with their market value stated merely as a note.

6 Paragraph 5A of Schedule 2 requires certain information to be given in respect of unquoted investments consisting of equity share capital, if the value as estimated by the directors is not shown elsewhere. For this purpose the definition of equity share capital is that in subsection 154 (5) of the Companies Act 1948. The value may be shown either by stating the investments in the accounts at the value or by way of note.

7 If investments are stated in the balance sheet at market value and this is greater than cost, it will be necessary, subject to the taxation considerations relating to capital gains set out in paragraph 14 below, to credit the difference to reserve. On the other hand, if the value is less than cost, the resultant deficit should be shown as a deduction from the issued share capital and reserves. Subject to any other treatment arising out of taxation considerations (see paragraph 14 below) the distinction between realised and unrealised appreciation appears to be of insufficient significance to justify separate disclosure in the balance sheet.

8 If a capital surplus arises from a revaluation incorporated in the accounts (either at current market values or otherwise) the surplus will normally be dealt with in the accounts by credit to a reserve. When the investments are eventually disposed of there may be a liability to capital gains tax, and to the extent that the chargeable gain is a reflection of the surplus created by the revaluation, the tax should be regarded primarily as a charge against the reserve to which the surplus was taken. Alternatively, part of the surplus may be appropriated specifically for this purpose before it is taken to reserve. In any event the existence of the potential liability needs to be recognised.

9 The estimation of notional chargeable gains may prove to be burdensome where a large number of investments is concerned. Nevertheless, it is considered that the effort should be made to arrive at, at least a fair approximation of the potential liability involved, however remote in time the prospect of incurring it may be considered, in order that the accounts should show a true and fair view. In comparing two companies in apparently similar financial positions, it would be a material factor to be taken into consideration if one of them had a substantial potential liability to tax on chargeable gains while the other had little or none. Even if the company is approved as an 'investment trust' under Section 37 of the Finance Act 1965, thus enabling an ordinary shareholder to reduce his own liability to capital gains tax by reference to that suffered by the company, the factor may be material to the consideration of the company's own position.

Recommendations

Balance sheet

10 Investments held by investment trust companies should be regarded as fixed assets. They should preferably be stated in the balance sheet at either:

(a) cost (or revaluation at a past date) with a note of the market value; or

(b) market value (including the value as estimated by the directors in the case of unquoted investments).

11 For the purpose of calculating the market value of quoted investments it is appropriate to take middle market price, but in any event the basis used should be defined.

12 Paragraph 8 (3) of Schedule 2 requires that quoted investments shall distinguish between those quoted on a recognised stock exchange and those quoted elsewhere. Furthermore, the investments must be stated in a way that enables the accounts to show a true and fair view. In this context, notwithstanding that many overseas quoted investments are also quoted on United Kingdom stock exchanges, the distinction for the purposes of paragraph 8 (3) of Schedule 2 should be made according to the location of the principal market for the shares.

13 If a capital surplus is realised which gives rise to a chargeable gain, the capital gains tax thereon should be charged to the account to which the surplus itself is credited.

14 When investments are written up in the accounts on a revaluation (at current market value or otherwise), an estimate should be made of the tax on any chargeable gain which would have arisen on a simultaneous sale of the assets at the amount at which they are stated. The estimated amount of this potential liability should be either (a) charged against the surplus on revaluation and credited to a deferred taxation account or (b) shown by way of note and continue to be so shown. There may be circumstances in which the former treatment is the more appropriate. If the latter treatment is adopted, it should be made clear that no provision has been made in the accounts for such potential liability.

15 Where investments are stated in the balance sheet at cost, with a note of market value, the note should include an estimate of any capital gains tax which would have arisen if all the investments had been disposed of simultaneously at the values noted.

16 There should be a note on the accounts stating whether or not the company is approved as an 'investment trust' under Section 37 of the Finance Act 1965. If it is so approved it would be appropriate for the note to mention, in connection with any entry or note made in accordance with paragraphs 14 or 15 above, that the holders of ordinary shares at the appropriate time after the realisation of gains by the company would be personally entitled to relief from capital gains tax on the subsequent disposal of their shares (see Section 67, Finance Act 1965).

17 With effect from 7th April 1965 the premium on investment currency has not been recoverable on that part of any sale proceeds which must be surrendered to the Bank of England (currently 25 per cent) at the official rate of exchange. Any revaluation of such investments, whether written into the balance sheet or stated by way of note, should take account of the whole of the premium, and this basis should be stated. The potential loss on realisation represented by the fraction of the premium which is liable to surrender is for accounting purposes similar in nature to capital gains tax arising on a disposal, and procedures in line with those recommended in paragraphs 14 and 15 above should be followed, with necessary adaptations in wording. The estimate of capital gains tax for the purpose of paragraphs 14 and 15 above should then be based on the net value of the investments concerned, after deducting the part of the currency premium which is liable to surrender.

Revenue account

18 In order to present a true and fair view and to comply with the requirements of Schedule 2 the following items should be shown separately in the revenue accounts:

(a) income from (i) quoted investments and (ii) unquoted investments including, in the case of income from overseas investments, the amount before overseas withholding taxes but after all overseas indirect taxes. The amount of franked investment income comprised in the total, gross of income tax, should be disclosed by way of note or otherwise;

(b) interest received from sources other than investments, e.g. bank deposit interest;

(c) other income, e.g. underwriting commission (where the company is obliged to take up shares, through the issue being undersubscribed, it is normal for the commission received to be deducted from the cost of the shares);

(d) expenses of management distinguishing between directors' emoluments and other expenses;

(e) interest payable (i) on short-term loans and to bankers, and (ii) on long-term loans and on debentures;

(f) taxation based on revenue brought into account, stating:

  (i) the amount of United Kingdom corporation tax,

  from which should be deducted:

  (ii) the relief for overseas taxation

  leaving:

  (iii) the amount of United Kingdom corporation tax after overseas taxation relief,

  to which should be added:

  (iv) the amount of overseas taxation

  and

  (v) income tax on any surplus of franked investment income, as reduced by any relief for management expenses, charges on income, etc.

N29 *Trust accounts*

(Issued 5th November 1969)

CONTENTS

The Council of the Institute of Chartered Accountants in England and Wales makes the following recommendations to members regarding the accounts of deceased persons' estates and the more general types of trusts (excluding special trusts such as pension funds and unit trusts). These recommendations supersede Recommendation 14: THE FORM AND CONTENTS OF ACCOUNTS OF ESTATES OF DECEASED PERSONS AND SIMILAR TRUSTS*, issued in 1949. Whilst it is recognised that, subject to the observance of any relevant legal considerations, the form in which accounts are prepared is a matter within the discretion of the trustees, it is hoped that these recommendations as to what is regarded as best practice will be helpful to members who either act as trustees themselves or whose advice or assistance is sought by trustees.*

Introduction

1 The main object of trust accounts is to demonstrate that the trust funds, including the income thereof, have been applied in accordance with the provisions of the trust instrument. They should also convey to beneficiaries and other interested parties, as well as to the trustees, information about the transactions and the current state of affairs of the trust. Trust accounts may also be useful for taxation and other purposes.

2 Special considerations, which are not necessarily dealt with in the following paragraphs, obtain in the case of trusts under the Settled Land Act 1925 and those for which prescribed forms of account exist (e.g. certain charities).

3 Trust accounts differ from ordinary commercial accounts in a number of ways because of different underlying circumstances. For instance there are many trusts where income is separately accounted for, thus lessening the need for production of annual accounts, and, in the case of established trusts, where changes of investments are infrequent and the income is mandated to a single life tenant, the interval between accounting dates may be several years and the accounts might deal only with capital transactions. Accounts dealing with all or selected aspects of the trust will be required in the following circumstances:

(a) where there is a distribution or other significant change in the trust fund or in the rights in it

(b) in the case of the estate of a deceased person which is settled for any period, when the initial administration of the estate has been completed, i.e. when the final estate duty figures have been settled, testamentary expenses paid, and the investments assembled into a fairly permanent portfolio

(c) at selected intervals, to show changes in capital accounts, even when there are no other matters to be dealt with.

If accounts are prepared less frequently than annually, particular care will be necessary to ensure that the underlying records are kept up to date and that the investments come under regular review by the trustees.

4 The following taxes have been repealed, or were operative for one year only:

special charge, imposed by the Finance Act 1968, by reference to investment income for the year to 5th April 1968

special contribution, imposed by the Finance Act 1948, by reference to investment income for the year to 5th April 1948

legacy and succession duties, repealed by the Finance Act 1949 as respects deaths occurring on or after 30th July 1949.

Inasmuch as these taxes were chargeable to capital and, where separate funds are involved, perhaps disproportionately to those funds, their incidence may still be relevant in trust accounts. In paragraph 57 guidance is offered as to the treatment of special charge; the same general principles would have applied to special contribution and legacy and succession duties, but these are not dealt with in detail.

5 In addition to being accountable for money and other assets actually coming into their hands, trustees are responsible for the administration of the trust. The extent of their responsibility and the way it has been discharged will, therefore, not be apparent unless the periodical accounts deal with both these aspects. This will involve the recording of all assets and liabilities of the trust, including for example, interests in expectancy and foreign estate. The balance sheet will then show the position of the trust as a whole and not merely those assets which have come into the hands of the trustees.

6 There is a fundamental distinction in trust accounts between income and capital. Often there are interests in income and interests in capital which conflict and the drawing of this distinction is essential to show the relative positions of those concerned.

7 Various special aspects of the administration of trusts make it necessary to consider how to deal with:

(a) the three ranges of investments ('narrower', 'wider' and 'special') if the Trustee Investments Act 1961 is applied

(b) investments acquired by the trustees from a testator or settler which, but for special powers to postpone sale or to retain, would be unauthorised

(c) assets which have not yet come into the trustees' hands

(d) accumulations of income, and investments made therefrom

(e) special legal considerations such as statutory and equitable apportionments, deeds of family arrangement, court orders

(f) the linking of taxes (e.g., estate duty, capital gains tax, betterment levy) with the particular funds out of which they are payable.

8 Some trustees, and many beneficiaries, may know little about accounting. Trust accounts should, therefore, be as simple and clear as is consistent with the showing of sufficient detail for a proper understanding of the transactions. These requirements can be fulfilled by using schedules and subsidiary accounts for many matters of detail, cross-referencing them to the main accounts. It is desirable that trustees should sign the accounts and that beneficiaries should formally signify agreement with their personal accounts; clarity and simplicity of presentation, by making the accounts more easily understood, will help adoption of this procedure.

9 The accounts and their underlying records may have to be examined because of a dispute (e.g., between trustees and beneficiaries) or, in the case of a discretionary settlement, to calculate estate duty on the death of a beneficiary. In addition to emphasising the need for clarity and adequate detail, these possibilities indicate that accounts, vouchers and records generally should be kept for a longer period than if they were commercial documents.

10 Trust accounts are the responsibility of the trustees. An accountant preparing accounts for trustees should submit with them a report reciting any instructions given to him and stating the principles adopted in presentation and any special factors, problems or outstanding matters. These recommendations do not deal with the form of either such reports or audit reports. However, the accountant should make it clear whether or not he has audited the accounts.

11 It will usually facilitate a clear understanding of the accounts if a short history is attached showing the incidents which led up to the position displayed by the accounts, the names of the trustees and a brief explanation of the devolution of the funds. If the trust instrument(s) is complex, such explanation may be restricted to present interests in income and such indication of succeeding interests as is feasible within the compass of a short note.

12 For quoted investments, a stockbroker's valuation of the portfolio may accompany the accounts and this valuation, together with the accounts, should ideally give sufficient information to enable the capital gains tax implications of investment policy to be considered.

13 The recommendations below may not apply fully throughout the entire field of trust accounts but it is considered that the fundamental principles should not differ in substance from those now recommended. It must, however, be emphasised that trusts are so varied in their nature that there should be flexibility in the manner of presenting accounts and that a standard form is neither practicable nor desirable.

14 The following paragraphs contain references to statutory and equitable apportionments, and to the operation of the Trustee Investments Act 1961. Nowadays, many wills and settlements specifically exclude the former, and, by incorporating their own wide investment powers, override those in the Act.

Recommendations

15 It is therefore recommended that the following principles should normally be applied in connection with the records and the preparation of accounts of trusts.

General principles

16 Trustees should maintain records from which, in the light of the trust instrument(s) and legal considerations, periodical statements of account can be prepared. The records and/or the trust accounts should preserve all the information that may be required at future dates (possibly long deferred) for any review of the trustees' transactions and for capital gains tax purposes. Although traditionally it has been recommended that this should be achieved by keeping books on complete double-entry principles, less formal methods are now acceptable provided that those principles govern the preparation of the trust accounts. Similar considerations apply to the presentation of the accounts.

17 There should be prepared and kept with the trust documents a short history of the trust and a summary of the relevant provisions of the will or other trust instrument(s). However, the original terms should be consulted where necessary. Other information which might be suitably recorded and kept readily available and up to date would include the trustees' names and addresses, and the names and addresses of present and future beneficiaries, their dates of birth (especially where the attainment of a specified age is relevant to the will or settlement), the dates of their marriages (where this is likewise relevant), and their relationship to the testator or settler. It may be appropriate to set out some or all of the above information in a statement attached to the accounts.

18 The date to which accounts are made up should be decided according to the circumstances and will not necessarily be the anniversary of the creation of the trust. Having regard to the taxation liabilities of the trust and of the beneficiaries, it may frequently be convenient for accounting periods to correspond with fiscal years; but in some cases it may be necessary for accounts to be made up to the anniversary of the trust's creation if the rules of law relating to equitable apportionments are applicable or if there are other special circumstances. The nature of the trust assets, the dates on which income is receivable, the due dates of annuities, are all factors that may affect the selection of the most convenient accounting date.

19 Income and capital transactions should be segregated clearly. This may be assisted by the use of separate columns in accounting records.

20 Periodical accounts should normally consist of:

(a) balance sheet of the whole of the trust estate

(b) capital account, summarising capital transactions either from the commencement of the trust or since the last account

(c) income account, where appropriate

(d) schedules and subsidiary accounts explaining in greater detail the major items appearing in the balance sheet, capital account and income account, showing separately the figures for any special funds.

21 The balance sheet, capital account and income account should be presented as simply as possible, all details being relegated to the schedules and subsidiary accounts.

Balance sheet

22 The various items in the balance sheet should be grouped under appropriate headings, so that significant totals are readily apparent. Presentation becomes even more important when the Trustee Investments Act 1961 has been applied and the capital account and the assets represented by it have been divided into narrower-, wider-, and special-range parts.

23 Where there are differing interests in the same trust the accounts will consist of two or more self-balancing sections, and can be made more understandable if the balance sheet layout is designed with this in mind. For instance, if there are few liabilities, it will probably be better to deduct them from the assets than to show them on the liabilities side. In this way the liabilities would be confined to the various funds and beneficiaries' current account balances, and the net assets by which they are represented, would appear by sections immediately opposite them. This form of presentation is not always possible, but whenever it is, it should be adopted.

Distinction between capital and income

24 Capital items should be clearly segregated from income balances, either by appropriate grouping, or possibly by the use of separate columns.

Comparative figures

25 Comparative figures should be included if they serve a useful purpose. Normally, however, the supporting schedules will be more informative than any comparison of total figures with those on the previous accounting date.

Capital account

26 Generally the capital account in the balance sheet will show the balance of the capital funds held, so far as they have been ascertained. If the Trustee Investments Act 1961 has been applied, the division of the fund into two or three parts should be shown, but in that case it is important to show the total of the capital account and not merely the amounts of its parts. Where distributions

of capital have been made to beneficiaries it is permissible, and sometimes necessary (e.g., where advancement has taken place), to show the original available for distribution and the amount of the distributions to date.

27 Where the valuation of a significant part of the fund has not been agreed for probate or stamp duty purposes, the capital account should be amplified by way of note to that effect. This would also apply where the value of the assets is known to differ materially from their balance sheet amount.

Liabilities

28 Where appropriate, liabilities on capital account (e.g., estate duty, capital gains tax, unpaid legacies) should be distinguished from those in income account, which themselves should be analysed so as to segregate balances due to beneficiaries from other liabilities.

29 Accruing liabilities on capital account are normally provided for but in special or difficult circumstances may alternatively be recorded by way of note. An example would be where the Trustee Investments Act 1961 has been applied and it is not known from which part of the fund a liability will be paid. (For treatment of accruals on income account see paragraph 67.)

30 It is normally preferable to deal by way of note with:

(a) known liabilities whose amount cannot be determined with substantial accuracy

(b) contingent liabilities including:

guarantees given by a deceased

potential capital gains tax on an unrealised but recorded appreciation of the trust's investments

estate duty on an *inter vivos* settlement should the settlor die within seven years of the endowment

estate duty in a discretionary settlement in the event of the death of a beneficiary

estate duty on the death of a life tenant (subject to the exemption under the 'surviving spouse' rule)

(c) contingent legacies.

Where it is desirable to indicate the financial effect to the beneficiaries, an amount should be set aside to meet the possible liability covered by the note, or should be dealt with in the covering report.

Tax on capital gains

31 In normal cases it will be possible to quantify any outstanding liability in respect of tax on capital gains. In these cases it should be treated as a creditor and charged against the surplus which has been added to capital.

32 Where allowable losses have been established, the cumulative total available to be carried forward should be noted.

33 If payment of capital gains tax is postponed under the provisions of the Finance Act 1965, Schedule 10, paragraph 4, provision should be made for the whole of the tax, and a note added explaining the period over which the instalments are payable.

34 If it is known that there will be a future deemed disposal for capital gains tax purposes under the Finance Act 1965, section 25 (e.g., 15-year period) this should be stated in a note.

Betterment levy

35 The recommendations on accounting principles set out in the Members' Handbook, Recommendation N26 (LAND COMMISSION ACT 1967: ACCOUNTING IMPLICATIONS), should be followed, in so far as they are deemed applicable to trust accounts, with the following exceptions:

(a) whereas it would be prudent accounting if levy attributable to the capital value of future rents reserved by a lease should be written off to income account by way of charge against the rents receivable over the period of the lease, as recommended in paragraph 10 (c) (ii) of N26, this should not be done in trust accounts without the benefit of legal advice (particularly in the case where the life tenant is not impeachable for waste)

(b) whereas paragraph 13 of N26 states that levy payable need not be separately disclosed other than in exceptional circumstances, in the case of trusts the accounts or schedules attached thereto should include some details regarding levy paid or payable.

36 In respect of trusts or deceased persons' estates holding any interest in land, it will often be necessary to make appropriate enquiries as to whether any transaction has taken place which may be a chargeable act or event under the Act. If the result of such enquiries indicates that a chargeable act or event has or may have taken place and any levy chargeable has not been assessed by the Commission or the Commission has not given assurance that no levy is payable, an appropriate note to indicate the possible liability should be appended to the accounts.

37 If the levy has been assessed but not paid at the balance sheet date or if payment is to be postponed or paid by instalments, provision should be made for the liability or possible liability in the accounts with appropriate comments.

Assets

38 In normal circumstances investments will appear in the balance sheet under a few broad classifications with the detail appearing in schedules attached. Where, however, there are few investments, no changes having taken place during the year, it would be permissible to detail them in the balance sheet. The total market value of the quoted investments should always appear on the face of the balance sheet as well as in the schedules.

39 Where the trustees have applied the Trustee Investments Act 1961 they should have earmarked specific investments to each part of the fund. It is most important that this allocation should be strictly maintained at all times and that the total of the investments of each part of the fund should appear, either in the balance sheet or in the investment schedules.

40 Where the trustees of a deceased person's estate have power to postpone the sale of unauthorised investments, such holdings may need to be distinguished in the accounts so that points of equitable apportionment or investment policy can be understood.

41 The circumstances in which an asset is acquired by a trust will determine the value at which it is brought into the trust books. If it devolves on the trustees as part of a deceased person's estate, the probate value (normally the market value at the date of death) will be adopted. If it is a gift from a living settlor, the market value at the date of the gift will likewise become the book value. If the asset is purchased at arm's length by the trustees, cost will be the basis adopted.

42 On the eventual disposal of an asset, its cost or its market value at the date of acquisition, as appropriate, will generally become relevant for the purpose of computing capital gains tax. It will be convenient if the cost or market value appearing in the accounts is made to agree with that which will govern the capital gains tax position on disposal. Where small realisations of investments (e.g., sales of fractional shares and rights to new shares) have taken place and where the proceeds are less than 5 per cent of the value of the investments, the proceeds would be deducted from the cost or market value. It is not suggested, however, that assets acquired before 6th April 1965 should be restated at their market value at that date, unless there is some circumstance or occurrence such as a part-disposal which renders it obligatory to adopt that value for capital gains tax purposes subsequently.

43 The other significant departures from the general principle set out in paragraphs 41 and 42 would be:

(a) where, because of a provision in the trust instrument, the accounts would be difficult to understand or inappropriate if capital gains tax base values were adopted

(b) where investments are held in unit or investment trusts and those trusts' net capital gains are apportioned among the investors. In those cases the amounts so apportioned are to be treated for capital gains tax purposes as representing additions to the cost of the holdings concerned. A memorandum should be kept of these amounts but it would normally be preferable to ignore them for book-keeping purposes unless they become significant, when they would probably be dealt with in accounts by way of note.

44 The assets of a trust may become subject to estate duty or capital gains tax, or both, while remaining within the ownership of the trustees, e.g., on the cesser of a life interest, or at intervals of 15 years from the creation of the trust. On the happening of such an event, the current values agreed for duty or tax purposes should be adopted in the accounts. In this way not only will the duty or tax borne be shown to bear a proper relationship to the assets involved, but the base for subsequent capital gains tax liabilities will normally be established in the books.

45 There may be revaluation of trust assets for reasons unconnected with taxation, e.g., in order to effect a division of the trust funds for the purpose of applying the Trustee Investments Act 1961, or of carrying out some provision of the trust instrument. If such a revaluation is adopted in the accounts, consideration should be given to the impact of capital gains tax should the assets be disposed of at their new book amounts. If a material liability to tax would result, at least the position should be disclosed in a note on the accounts. It may, however, be preferable to create a provision for the potential capital gains tax liability out of the surplus on revaluation. In the event of a partial distribution of capital to one or more beneficiaries, the potential capital gains tax liability must be taken into account in order to preserve the interests of all beneficiaries. In such circumstances a provision should be set up and, if any of the investments are realised to make the partial distribution, the tax arising should be set against the provision.

46 Stockbrokers' valuations may be attached to trust accounts, and if they are made at the balance sheet date, they may be used as a substitute for investment schedules. It must, however, be remembered that in many cases they will not agree with the balance sheet total for investments because the book amount will not be included as part of the information.

47 Where statutory apportionments arise, any income apportioned to capital should be credited to trust capital account and not used to write down the investments concerned (see paragraph 66). To do otherwise would be meaningless unless accrued income were similarly dealt with on all investment transactions.

48 The composition of cash and bank balances as between capital, income and special funds should be shown. If the grouping adopted for the balance sheet as between capital, income and special funds makes it necessary, the bank balance(s) will have to be divided so that the appropriate amounts appear under their proper headings in the balance sheet, but the aggregate bank balance should also be shown.

49 A note should be made in respect of any known assets of which the amounts cannot be determined with substantial accuracy, for example, reversions and claims for damages.

Special funds

50 Where special funds arise by reason of the existence of separate trusts or settled funds within the main administration, the capital and liabilities of such special funds should be stated under separate headings and the corresponding assets should also be stated separately. The treatment of special charge on different funds will depend on the circumstances of the life tenants or annuitants (see paragraph 57). Where it is desired to show a special relationship between the funds (e.g., they are particular fractions of residue) it will be necessary to show the original capital of each fund inset, with the charge and related professional fees as deductions.

Capital account

51 The opening entries for any form of trust record will be derived from the cost or acquisition values of the assets concerned (see paragraph 41).

52 For deceased persons' estates, the opening entries should show the assets and liabilities at the figures applicable for estate duty purposes, a balance being struck to show the net estate subdivided, if necessary, to show:

(a) property on which duty either has been paid or is currently payable

(b) property not currently assessable to duty, and

(c) property exempt from duty.

53 The capital account for any period should show, suitably classified and in adequate detail, the extent to which the trust capital account has been affected by matters such as:

(a) surpluses or deficits on realisations

(b) taxation of capital gains

(c) adjustments of book figures to capital gains tax base values

(d) estate duty

(e) special charge imposed by the Finance Act 1968

(f) administration expenses

(g) changes for estate duty purposes as shown in corrective affidavits

(h) legacies, or appropriations to special funds, and

(i) statutory or equitable apportionments.

54 Separate figures should be presented for each part of a trust which has been split in accordance with the provisions of the Trustee Investments Act 1961; this may be achieved by presenting one account with several columns.

Estate duty

55 Where appropriate, the capital account should show the total on which estate duty is payable and the amount paid; also, the information relating to estate duty should include matters such as the lower rate of duty applicable to agricultural property and a reference to any property which is aggregable for duty purposes though not forming part of the estate for which the trustees are accountable. Any other material matters affecting the estate duty should also be stated in the capital account. If the detail is considerable, it should be relegated to a supporting schedule.

56 In some cases the agreement of valuations for estate duty purposes may be a protracted matter extended over several years; for example, where the estate includes interests in land, unquoted shares, or business goodwill. Where this occurs, the fact of the estate duty being provisional should be stated with an indication, where appropriate and practicable, whether the outstanding amount involved may be material.

Special charge

57 Where special charge (see paragraph 4) is paid out of a trust it is charged to capital in the same way as estate duty. Where particular funds are directed by a will to be free from duty the special charge may prove to be a charge against the residuary estate but normally it will be a charge upon the funds whose income gives rise to the tax paid. Where more than one person is interested in the income of one undivided fund then the various payments of the special charge will be charged to the capital of that fund and future shares of income will be adjusted. Professional charges for dealing with special charge will be dealt with in the same way as the tax itself.

Comparative figures

58 Comparative figures for the preceding period will not normally serve a useful purpose in the capital account.

Special funds

59 Special funds, dealt with separately in the balance sheet, should have their separate capital accounts (see also paragraph 23).

Income account

60 The purpose of an income account is to inform those interested as to the amount, sources and division of income and, occasionally, to assist in the understanding of the taxation position. The main emphasis, according to circumstances, should be one or more of:

(a) the stewardship of the trustees, when much detail will be shown

(b) the pattern of income, when the grouping of the figures will be used to produce significant totals, for instance, the income from fixed interest and other types of investment or, possibly, the significant diversification of investments. This will help the appraisal of future requirements and budgeting

(c) division of income, as in cases where apportionments are made or there are several funds each with a different life tenant

(d) assistance to beneficiaries and trustees in adjusting or understanding their taxation, where, for example, relief is available against surtax for estate duty on accrued income (Section 19, Finance Act 1956) or there are assessments on property income.

61 The form of the accounts must be that which is most apt to the trust, comprehensible to trustees and beneficiaries (who may not be business-trained) and useful in managing the trust. Items should be grouped in appropriate classifications; for example, interest on Government securities, dividends, interest of mortgages, rents, business profits, credit from realised capital on equitable

apportionments. All items involving considerable detail, such as investment income, should be included in total only, with supporting schedules showing the details. If appropriate, comparative figures should be given.

Income

62 The trustees are normally required to account for income when it is receivable, so that the account will not generally include accruing income. Items in the hands of agents, such as rents collected but not handed over to the trustees, should be regarded for accounting purposes as having been received. Consideration should be given to the effect of any distortion caused by the exclusion of accrued items, for example, where a company alters its dividend-paying time-table and, as a result, the accounts include more or less than a normal year's income. Where material distortion occurs, a note on the accounts or a reference in the accompanying report will be necessary in most cases. Income received in advance of due date should be carried forward in the balance sheet.

63 Where a trade is carried on by trustees, the usual accounting principles applicable to a trading concern should be followed so far as relates to the trading profit and a note on the accounts will be necessary to indicate that this basis has been applied. The trading activity will sometimes have an accounting year which does not coincide with the trust accounting year, and the results should then be incorporated in the trust accounts on the basis of the trading year. Again an explanatory note on the accounts will be necessary.

64 Where there are relatively few changes on capital account, an income account, not accompanied by a balance sheet, may be acceptable. There will also be cases where no formal account is needed, for example where all income is mandated to one life tenant or where the disposal of income is so straightforward that a copy of the Inland Revenue form R59 or R59A (Trust Estate: Statement of Income for the year ending 5th April) is an acceptable substitute.

65 Income may be received:

(a) gross but liable to income tax by direct assessment

(b) net after deduction of tax

(c) net under special arrangement, e.g., building society interest

(d) exempt from tax, e.g., National Savings Certificates interest.

It should be made clear whether the income is shown gross or net and any charge for tax should be related to the income being taxed. The form of presentation will depend largely on the circumstances of the trust, in particular the types and number of sources of income and the period(s) covered by the accounts.

Statutory apportionments

66 In accounting for deceased persons' estates, investments are normally shown cum dividend. Where, in such a case, all or part of a dividend after death is apportioned to capital, it should not be deducted from the book amount of the investment but should be added to the balance of the estate capital account. Thus the investment will continue to be accounted for at probate (and capital gains tax) value. Where the investment is shown ex dividend then the dividend apportioned to capital will usually be credited to the account for those dividends which are separately shown in the Inland Revenue affidavit. Ultimately any balance on this account will be written off to estate capital account.

Expenditure

67 The income account should include all amounts payable in respect of the accounting period including, where material to a proper view of the distributable income, amounts accrued up to the accounting date but not then due for payment. Annuities payable are not normally accounted for on an accruals basis although there will be cases where an income account would give an incorrect view of the amount of the surplus income if no accrual were made.

68 Items of expenditure and other deductions from income should be grouped in appropriate classifications; for example, administration expenses, interest on overdraft, income tax, interest on estate duty and other taxes, annuities, transfer to capital as a result of apportionments.

Tax on income

69 The charge for income tax will exclude tax on short-term gains under Case VII of Schedule D, as that will be a charge against capital. As indicated in paragraph 65, the treatment of the charge for tax on income will depend upon the form of presentation of the accounts. Where tax has still to be assessed on income shown in the accounts, due provision should be made. Any adjustment to the tax of earlier years should be shown separately.

70 There may be cases where the presentation alone cannot make clear how the tax is related to the income shown in the accounts, for instance where:

(a) tax is assessed under Schedules B or D and the charge does not represent standard rate on the income for a particular accounting year

(b) the rule *in re Pettit* applies (i.e. certain annuities paid free of tax)

(c) trust income is assessed to tax directly on the life tenant.

In all such cases an appropriate explanatory note should be made in the accounts.

Balance of income

71 The income account should show the balance available after debiting all items chargeable against income. It should show the manner in which the net balance has been applied by the trustees; for example, amounts divided amongst the beneficiaries and transfers to accumulations accounts, indicating the bases of division in cases such as those where adjustment is required for interest on advances of capital to beneficiaries.

Schedules and subsidiary accounts

72 Wherever possible, detail should be relegated to schedules and subsidiary accounts, leaving only the significant totals in the main accounts.

73 Appropriate cross-references should be given in both the main and the subsidiary documents.

Investments

74 The investment schedule should be so prepared as to enable totals in the main accounts to be identified readily. The grouping of the items in the schedule should therefore correspond with the grouping adopted in the balance sheet and it may be necessary to present more than one schedule. Where the trustees have applied the Trustee Investments Act 1961 the schedule(s) should show clearly to which part of the fund each investment has been allocated.

75 Special funds dealt with separately in the balance sheet or income account should in any case have their separate investment schedules.

76 The following information will normally be relevant in the investment schedules(s) although it may not all be necessary in every case:

(a) description, nominal amounts and book amounts of investments; also in the case of quoted investments, the values at 6th April 1965 where relevant for capital gains tax purposes and, unless a broker's valuation is attached, the market values. In case of investments outside the Scheduled Territories, the extent to which the premium on investment currency has been taken into account in arriving at the valuation should be stated. In the case of unquoted investments, a valuation will not normally be available. It may, however, be helpful for the schedule to include the date of the latest valuation and the value placed on them

(b) in the case of mortgages, details of the amount, security, rate of interest, and due dates thereof, with particulars of any arrears of interest

(c) the gross or net amount of interest and dividends (see paragraph 65)

(d) acquisitions, disposals and revaluations of investments during the period and resultant surpluses or deficits

(e) statutory apportionments of dividends between capital and income, shown item by item. (Equitable apportionments do not usually fall to be dealt with item by item and should therefore be explained in the capital and income accounts by narration or, if appropriate, by reference to a separate schedule)

(f) in the case of real estate and leasehold estate, the probate value, cost or other book amount, as applicable, with such details as tenure, property expenses suitably analysed, rents receivable and particulars of any arrears

(g) in the case of life assurance policies, the aggregate premiums paid to date (plus, in the case of an existing policy acquired, the value at the date of acquisition), brief details of the sums assured and maturity dates of the policies and, if relevant, their surrender values.

Accounts with beneficiaries

77 Accounts with beneficiaries should generally be presented. This is particularly important where the details are complicated; for example, where there are periodical payments on account of income, accumulations accounts, maintenance accounts, or special difficulties. It is desirable that beneficiaries should be able to verify easily any amounts shown in the accounts as having been paid to them.

Capital cash summary account

78 A capital cash summary account, containing in summarised form all significant information regarding the receipts and payments on capital account during the period covered by the accounts, may sometimes be helpful in larger estates. The information shown by such a summary account is not normally apparent in the capital account, which includes transactions other than receipts and payments. The summary account therefore provides a link between the capital cash shown in the balance sheet and that shown in the previous balance sheet.

Other schedules

79 Examples of other matters, for which separate schedules should be prepared where the detail involved makes it desirable, are the following:

(a) debtors

(b) creditors

(c) taxation, where the tax position of the trust is complex

(d) executorship, administration or management expenses on both income and capital accounts

(e) pecuniary and specific legacies, showing those paid or satisfied

(f) estate duty, where the detail is considerable, showing specifically any amounts charged to individual beneficiaries.

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