

# The Last Word

Julie Butler FCA considers the changes being brought about by FRS18 and its impact on the prudence concept.

With taxable profits increasingly reflecting accounting profits under section 42, Finance Act 1998 and under UK GAAP, the need for tax advisers to become fully conversant with the tax implications of both current and proposed accounting standards is more and more relevant. This was emphasised in the March 2001 Small Business Tax Review paper, which featured in last month's issue of TAXline, as the Revenue is consulting on how better to align business accounts and tax computations.

Clearly accounting standards do impact on accounts of non-company entities which are essentially prepared for tax purposes. An example of this is Financial Reporting Standard (FRS) 18 on 'Accounting Policies'. FRS18 was published in December 2000 and basically applies to accounting periods ending on or after 22 June 2001 and is, therefore, extremely relevant to accounts and tax computations currently being prepared.

For tax purposes the main emphasis is prudence and FRS18 replaces Statement of Standard Accounting Practice (SSAP) 2 bringing with it many changes to fundamental concepts which have been with us for 28 years.

Under FRS18 where there is uncertainty, prudence requires more confirmatory evidence about existence and greater reliability of measurement for an asset or a gain than it does for a liability or a loss. Unlike SSAP2, FRS18 does not link the notion of prudence with ultimate cash realisation. The FRS18 sets it out as follows.

One aspect of prudence as described in SSAP2 was that revenue and profit should be included in the profit and loss account only when realised in the form either of cash or other assets, the ultimate cash realisation of which would be assessed with reasonable certainty. Under SSAP2 the FRS18 states that it was used to ensure that only gains that were reasonably certain and are unlikely to reverse were included in the profit and loss account. To quote direct from the FRS 'the smoothing of reported profits has become as great a concern as their overstatement and as a result the deliberate understatement of assets and gains and the deliberate overstatement of liabilities are no longer seen as a virtue'. The suggestion here appears to be that in the name of prudence, people were understating such assets as work-in-progress and overstating such liabilities as litigation. The FRS18 is, therefore, potentially handing the Revenue authorities more ammunition to throw at overcautious valuations and specific liability provisions.

Of all the accounting policies the concept of prudence was the one that was most easily understood by the business community, particularly when it was viewed in the context of assessing future tax liabilities. The business community in general is reluctant to pay tax on profits which are not yet realised and they have great empathy with the realisation principle of SSAP2 as set out in appendix iv of FRS18.

The impact of this very fundamental change to accounting policies on both tax computations and client viewpoint is obvious. Appendix iv states 'in conditions of

uncertainty prudence requires more confirmatory evidence about the existence of an asset or gain than about the existence of a liability or loss.'

The tax profession is increasingly aware of the need to fully understand the tax implications of financial reporting standards and the review of these will obviously have to go hand-in-hand with changes to tax law and the impact of tax cases. There is the added complication of international standards as shown by the potential impact of IAS41 in last month's TAXline (see practical point 104).

Matters are helped by the Institute's technical release 4/01 which does say that international standards should not be adopted until they have been incorporated into UK standards.

However, for tax planning purposes they gave a clear indication of how important it is for the tax profession to be involved in those standards at a very early stage.

As we wave goodbye to 28 years of SSAP2 and embrace the impact of FRS18 and the fact that the prudence concept merely becomes part of the exercise of caution there are clearly some interesting future discussions between the business community and their tax advisers.

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The full version of FRS18 appeared in the January 2001 issue of Accountancy (at page 141) or can be ordered from ABC publications by calling 020 7833 3291

