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U.K.: Business Review, Key Performance Indicators (KPIs), ES5 and the Impact on the Tax Adviser

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Will 2006 be remembered as the year that tax advisers had to seriously consider the liaison with reporting accountants and break away from auditors where appropriate?

Has the tax adviser thought at length how involved they may have to be with the introduction of Business Reviews, ES5 and the KPIs? How can a Business Review *not* include tax considerations?

I. What are the KPIs?

"Key Performance Indicators" (KPIs) are factors that measure effectively the development, performance or position of the business of the company, (s234ZZB (5) CA85). This definition is rather vague and leaves it open to directors to set such KPIs as they see fit. Whilst undertaking this task the tax position of the company or LLP cannot be overlooked. The DTI guidance says that it is for the directors to decide exactly what information to include about their particular company provided that the information is relevant to an understanding of the business. In the absence of a requirement to use the same KPIs on a year-by-year basis it leaves scope for abuse, such as selectively using those KPIs that show the company's performance in a favourable light and this includes tax.

II. The Application of Business Review Requirements

The Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005, SI 2005/1011 has introduced new and more extensive requirements for a business review in the directors' report. This requirement does not apply to all companies.

The original requirement for quoted companies to produce an Operating and Financial Review, OFR, was removed by the Companies Act 1985 (Operating and Financial Review) (Repeal) Regulations 2005, SI 2005/3442, which came into force on January 12, 2006.

III. Small Company Exemption

Small companies escape the need for a business review.

The requirement for all companies, other than those meeting the small company criteria, to include a business review in their Directors' Reports is now set out in section 234ZZB of the 1985 Act and is effective for financial years which begin on or after April 1, 2005.

IV. The LLP has to Consider Compliance

So the non-corporate tax adviser is feeling rather smug about escaping these considerations, but what about the LLP?

The LLP has to contemplate the business review requirements as part of possible Companies Act compliance.

The LLP Regulations 2001 state that part VII of the Companies Act is applicable to LLPs. The Companies Act 1985 s.234 falls within part VII of the Act. However, Schedule 1 to the Regulations lists a large number of sections which are modified or dis-applied including Ss.234 to 234ZZB.

There are some very significant LLPs in the accountancy, legal and tax professions. With the introduction of the (possibly over reported) UITF40 there could be some interesting input required from the accountancy world as to compliance and to the tax "gurus" as to what might provide a fair review and a description of the uncertainties. Have those associated with LLP's given this due consideration to the impact of the Companies Act? Likewise, a revision to the SORP on Limited Liability Partnerships was issued on March 31, 2006. It will apply to LLPs with accounting periods ending on or after that date. The principal revisions proposed arise from the need to reflect FRS 25: Financial Instruments – Presentation and Disclosure and to address the issue of UITF 40.

V. So what must the Business Review Contain?

Accounts for years ending March 31, 2006 onwards must contain:

- A fair review of the business and company; and
- A description of the principal risks and uncertainties facing the company.

Clearly the tax impact of performance, risk and uncertainty must be given consideration and this will create interesting interaction for the reporting accountant and the tax adviser.

VI. Failure to Comply

Failure to comply with the Directors' Report requirements may lead to civil and/or criminal penalties being applied. The Financial Reporting Review Panel, part of the Financial Reporting Council, has the legal authority to review companies' Directors' Reports, from April 1, 2006 and, if necessary, may go to court to compel a company to revise its report.

The Secretary of State and the FRRP have the power to enforce the new requirements for accounting periods beginning

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on or after April 1, 2006 (CA 85 s 245A) but criminal penalties for breaching such requirements are effective immediately.

VII. Business Review Criteria

The criteria the business review must meet are as follows:

- Be a balanced and comprehensive analysis of the development and performance of the company during the financial year, and the position of the company at the end of the year;
- Be consistent with the size and complexity of the business;
- Include analysis using financial Key Performance Indicators, to the extent necessary for an understanding of the development, performance or position of the company.
- Where appropriate, include analysis using other Key Performance Indicators, including information relating to environmental and employee matters (this will include employment taxes issues); and
- Where appropriate, include references to, and additional explanations of, amounts included in the annual accounts of the company. The tax implications of these amounts must be considered at all times.

One of the problems of supplying any view on financial (tax) matters is that it can be used "against" the provider. This potential disadvantage will not be lost on the tax adviser. So what company (or LLP) tax angles are likely to impact from April 1, 2006 (for accounting periods on, or after April 1, 2005)? Due consideration must be given to Corporation Tax, VAT, PAYE, Employee Benefit Schemes and of course Income Tax for all LLPs.

VIII. What are Possible Key Tax Facts that should be Given Consideration?

Some suggestions are as follows:

- Registered tax planning schemes;
- Tax risks and uncertainties;
- Ongoing tax enquiries;
- Areas of the company's activity that might be risk assessed as capable of giving rise to a tax enquiry;
- Associated companies;
- Close investment – holding companies (CIHC) – letting to connected persons;
- EMI options – Corporation Tax relief for share cost;
- Employers' contributions to registered pension schemes;
- Corporate gift aid;
- Film tax relief;
- Research and development tax relief;
- IBA – stock holding trade;
- Business premises renovation allowances;
- Purchase of own shares;
- Ascertained share valuations.

It is not suggested that all the above will have to be included but they will cause some possible consideration for the tax adviser and reporting accountant.

IX. Ethical Standard 5: Provision of Non-Audit Services to Audit Clients

The consideration of the tax implications of the business review and the KPIs has come to the forefront of the tax adviser's mind at the same time as consideration is being given to tax services being provided to audit clients. This overflow of deep thinking could result in further fascinating interaction between the auditor and the tax adviser.

Tax services cannot be provided to an audit client where this would involve acting as an advocate for the audit client, before a tax appeal and/or court tribunal, in the resolution of an issue material to the financial statements, or where the outcome of the tax issue depends on an audit judgement. This is a complete prohibition – there are no safeguards considered adequate to counter the perceived threat that arises through representing a client to the General or Special Commissioners. It will be essential for the tax department to liaise with the audit department.

Transaction-based, corporate finance or tax planning services may cause problems. Where an audit principal has or ought to have reasonable doubt about the appropriateness of an accounting treatment related to the advice to be given the firm should not provide the non-audit taxation service to the audit client.

X. "ES-PASE"

So those tax advisers involved only in the audits of smaller entities are probably feeling comfortable but … what of ES-PASE?

ES-PASE defines small entities in the United Kingdom in broadly similar (but not identical) terms to the Companies Act 1985 "small company" criteria, with variations on that theme for other types of entity, such as charities or pension schemes. Criteria for entities in the Republic of Ireland are slightly different. (For auditors of Irish companies – small entity criteria for the Republic of Ireland are detailed in the re-issued April 2005 ES PASE paragraph 4, (ii)).

ES-PASE also makes available optional exemptions from:

- The prohibition on representing audit clients at a tax appeals tribunal or court;
- The prohibition on providing taxation services, unless management is sufficiently "informed" to make independent judgments and decisions in relation to them.

Where an audit firm takes advantage of ES-PASE in respect of the above, the audit report must state that fact and the notes to the accounts must indicate the nature of the taxation service provided.

So is the tax department having to consider disclosure in the business review and disclosure in the audit report?

One clear key fact that arises from a review of the Business Review legislation and guidance is that auditors and reporting accountants will have to liaise with tax department/tax advisers to ensure that disclosure is complete and understood at all levels.

Are the control procedures in place? It looks like 2007 will start with some very interesting tax risk management considerations.

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