

## TaxZone Newthwire

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### Editorial Note

Many of us, in our student days, were brought up on what were known as incomplete records. A small business, be it shop, farmer or motor engineer, would bring into the office a polythene bag filled with invoices (perhaps on a spike), receipts and bank statements. Some of the documents would be missing, and in order to prepare accounts one had to be a mixture of an accountant and a detective.

The books, such as they were, consisted of a written record of sales, and if one was fortunate, petty cash payments. Bank payments and receipts were ascertained from the bank statements, cheque stubs and paying-in book. A farmer might have had a professional stocktaking, but other trades did their own stock take. Debtors, creditors and work in progress demanded much detective work.

In effect the bank cash book was written up in the accountant's office, and the first major task was to effect a bank reconciliation. The next hurdle to overcome was to prepare a cash account. Inevitably this produced a cash difference. Traditionally, differences were either credited to sales or debited to drawings, but not until after a thorough investigation, including questions to the client, had taken place. Even in those days gross profit percentages were important.

Current Inland Revenue investigators would have had a field day' with each of these clients. Most were honest but not book-

keeping literate, but the occasional bad egg was around. I can remember a metal deed box being opened in the office after the death of a small greengrocer. It contained the sum of 11,000 in cash, which was an enormous sum in the late 1950s.



Regards

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### Disclaimer

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## PAYE

One item of bookkeeping and tax regulation goes right back to the mid 1940s. The existence of PAYE obligates any employer to keep the requisite PAYE records in respect of employees (and in the case of a company, directors). PAYE audit teams and Schedule E Compliance staff have powers unavailable to other members of the Revenue in that they may visit the premises of an employer to check PAYE and employment records.

A draconian penalty regime in respect of PAYE and P11D errors and failures should ensure that any sensible employer does his or her utmost to comply with the system, even if it represents unpaid tax gathering for the government.

### **Value Added Tax**

The first attack to breach informal practices was the advent of VAT in 1972. Customs & Excise officers undertook 'control visits' and had the power to examine the books of any trader, and claims for input tax could be refused and repayments denied if the proper documentation was not available. This was one of the first impetuses to proper record keeping.

## **The law and regulation**

### **The law**

Whether or not one remembers the days outlined above with affection, the plain fact is that the practices outlined above are now illegal. Section 12B, Taxes Management Act 1970 outlines the fact that an unincorporated business must, in effect, keep proper books of account for the benefit of the Inland Revenue.

Such books and records must also be retained for a period of five years and 10 months after the end of the relevant year of assessment. A mitigable penalty of up to 3,000 pounds can be imposed by the Revenue for failure to keep or retain the necessary records.

An additional reason for keeping a clean set of books is that they may be required to be produced during an Inland Revenue Enquiry or investigation. Now that enquiries and investigations are statutory and standardised, taxpayers and their advisers are in no doubt of what may be required. The Revenue may make application under section 19A, Taxes Management Act during a self-assessment enquiry, or alternatively one of the parts of section 20 may be invoked in more formal proceedings.

The books and records of limited companies are, in any case, subject to the provisions of the Companies Acts, which regulate the form of accounts as well as many other issues. Companies are also subject to SSAPs and FRSs, among other regulations, and their accounts must demonstrate a 'true and fair view' and 'materiality', as well as other concepts.

Additionally, a company is subject to paras 21-23 of Schedule 18 to the Finance Act 1998, as part of CTSA. Books and records must be retained for a period of six years after the end of the accounting period. Once again the penalty for non-compliance is a mitigable penalty of up to 3,000 pounds.

### **Regulation**

We live in a world of more and more regulation. The provisions of the Companies Acts, for instance, regulate the affairs of companies. Charities are now regulated strictly by the Charities Commission. Businesses within the financial sector are regulated by the Financial Services Authority – and so on. Most trades and professions now have some sort of regulatory body, which will have relevance to their book- and record-keeping.

A further incentive to keep proper books of account is the Proceeds of Crime Act 2002 and associated Money Laundering Regulations. Any valid defence against accusations of money laundering can best be achieved if the relevant transactions are shown clearly within the books and accounts of a business.

The accountancy institutes all have their different regulatory regimes for members. The members of the ICAEW have voted recently to bring in what is known as 'Practice Assurance' (although only 16% of members voted). The result of this is that individual practice will have to pay a further annual fee, and may be visited for the purpose of the examination of clients' files and papers. This is intended partly to update the JMU Monitoring Visits, which only concerned auditing practices.

## **The role of the accountant**

The professional accountant has a crucial role in the context of book- and record-keeping. Decisions made and actions taken when a client is first engaged will have far reaching consequences as regards compliance, financial susceptibility and business success.

Ideally the first meeting with a business client should include a major discussion regarding book keeping and accounting systems. This is very basic, but vital to a successful relationship between accountant and client. The client can be reminded early on that a good set of books will probably save him accountancy fees.

At its most basic advice can be given on the actual books that a business should keep, and how they should be written up. Even if the client is not computerised the accountant's office will be, and education regarding the coding of book entries will be a vital part of client education.

Clients should be encouraged to write up the books of account regularly. This will include recording petty cash payments daily, and making sure that the bank statement is reconciled with the cash book regularly, and that the cash account also agrees. I appreciate that some of this is idealistic and that actual life is not like this, but one can only try!

In the case of larger businesses the accountant may be able to promote his or her services by suggesting that monthly/quarterly management accounts are prepared, and offering the services of the practice in that respect.

## **Annual accounts**

In this wire I am concentrating mainly on the unincorporated business. The accounts and audit of limited companies are beyond my remit, but are controlled by the Companies Acts and CCAB regulations.

For an unincorporated business I see the bare minimum as the preparation of a trading and profit and loss account and then a balance sheet. In a trading situation the gross profit percentage will be an important part of the accounts, and it is wise to identify the reason for variations before the accounts are finalised and then explain them when they are submitted to the Revenue. If not, the inspector is likely to institute a full self-assessment enquiry.

In non-trading situations, there may be a profit and loss account or an income and expenditure account, but always a balance sheet. My view is that a balance sheet is vital, even if it only includes motor car, bank balance, debtors and creditors, drawings and capital account. Although details of drawings are not part of what the Inland Revenue can legally ask for, a demonstration of the taxpayer's means and his or her ability to live financially, can allay the inspector's suspicions.

Personally, I would go further, and provide full accounts even if the turnover is 15,000 pounds or less. There are stories of numerous Revenue enquiries where 'three line accounts' only are submitted. Going the extra mile is likely to save all concerned time and money in the long run. Such businesses have been the recipients of 'enabling letters', regarding which there has been recent adverse publicity, and the more evidence that can be produced to protect the client the better.

It should be remembered that all the accounts figures must later be transposed on to the self-employed part of the SA tax return. I would include the figures for the very small business in those sections, even if the turnover is less than 15,000 pounds. I submit the accounts to the Revenue in all instances, making reference to the enclosures in the tax return 'white space' and also in an attached letter.

## **Tax return record-keeping**

It is also important that information for the preparation of the tax return is also kept and retained. Even if the taxpayer is not liable to tax this could be important, as there is always the possibility of a tax reclaim.

Any taxpayer can keep the following items, among others, in an annual file:

- Form P60 and monthly payslips. Form P45 where appropriate. Also copy of form P11D.
- Details of DWP benefits received. This will be notified at the beginning of each year by the DWP.
- Dividend counterfoils in respect of dividends received and stock dividends in respect of shares, unit trusts and investment trusts.
- Statements in respect of share and other investments purchased and sold. Also any other chargeable capital gains.
- Annual statements from banks and building societies of interest received and tax deducted.
- Details of ISAs. They need not be declared, but need to be evidenced.
- Where property is owned, details of rents received, expenses and interest paid. The lender may need to be approached for a certificate of interest paid.
- A note of capital gifts made for IHT purposes. Also gifts made out of income. This could be vital information on a subsequent death.
- Details of charitable gifts made by Gift Aid or under deed of covenant.
- Statement from the NSB regarding NSB investment account interest for the year.
- Details of pension premiums paid in respect of personal pension plans, AVCs etc.
- Income from annuities, estates etc., as evidenced by forms R185E.
- Statements from insurance companies regarding life assurance 'gains'.
- Details of allowable professional subscriptions paid.

The above list is by no means exhaustive, and there are many other possibilities in connection with more complex returns. However, it does represent the items more commonly encountered.

Some accountants deal with tax return information by sending the client a long checklist of items, and completing the return based on this information. In my view, it is wise to also have some personal contact, as items can easily slip through the net otherwise.

### **Accounts books and records**

We now turn to the actual business books and records. This is probably fairly obvious, but the following cover the affairs of most small businesses:

- Bank cash book.
- Petty cash book
- Bank statements
- Stock records
- Invoices (both sales and purchases) and receipts
- Used chequebooks and paying in books
- Sales records
- Purchase records
- Fixed assets register - the accountant may need to keep this
- Wages book and PAYE records.

At the year-end details of debtors and creditors will need to be ascertained. In many instances this is the job of the accountant, after enquiry. Similar considerations apply to work in progress, which for an unincorporated business can still be valued at the lower of cost and market value, except in the specific circumstances outlined in the revisions to FRS 5.

I take as read that the type of businesses I am considering will not keep a nominal ledger. In my student days we used to write up a bound book, and then later on make closing entries. Nowadays, the basis of the final accounts will be the extended trial balance, whether or not this is prepared on a manual or computerised basis.

### **Specific items**

A client needs to be made aware of specific items that need to be recorded correctly in the books of account. In this respect I will not go into the VAT aspect, which is another issue altogether.

### **Motor expenses**

Clients need to be made aware of the principles of a tax claim for a business motor vehicle. Assuming that the business owns a car, which has some private use, the proprietor should be encouraged to include all motor running expenses in the books in a particular column.

The vexed question of a mileage record then needs to be raised. In reality the most that can be expected is for a businessman to record business and private mileage separately over a typical sample month in the year. It should be possible to agree a private use percentage with the client, and justify it to the Revenue.

In my view it is best to record all the expenses in the accounts and then make an add-back in the tax computation. This accords with the entries on the SA form for self-employment.

### **Drawings**

Cash and cheque drawings should be separately recorded in both cash book and petty cash book, and the client should be encouraged to earmark a separate column in the books for these items. At the year end the accountant will identify other items that are wholly private, and these should be debited to drawings. Where part of an expense is tax claimable my practice is to debit the items in the accounts and deal with the disallowance in the tax computation. This could involve, as well as motor expenses, private telephone and so on.

The Inland Revenue has no legal right to have an analysis of drawings. Nevertheless, all concerned may consider it judicious to supply this information in certain circumstances for the benefit of the client and the business.

### **Spouse's or partner's salary**

Many small businesses employ 'the other partner' on a part-time basis. In other instances they may be in partnership. There are a number of principles to remember in connection with a salary.

First the amount paid should be commensurate with the responsibility, hours worked and experience of the person concerned, so that the salary can be justified for tax purposes. Second the amount must be actually paid, and not adjusted through a book entry in the nominal ledger.

Where tax is payable, the appropriate PAYE records must be kept. Even if the amount paid is less than the tax exemption limit it is wise to fill in the appropriate forms. For national insurance purposes, eligibility to certain state benefits commences at a much lower figure than the tax and NIC exemption figures, so that attending to this chore may be productive.

### **Use of home**

Where the home is used partly, wholly or occasionally for business purposes, something can be claimed in the accounts. The client should be encouraged to retain the bills for council tax, other services and utilities and repairs, insurance, cleaning etc, so that calculation can be made and claim made at the year end. This will be adjusted through the drawings account. The success of such a claim always depends on justification. The basis of such a claim has been dealt with exhaustively in previous wires and on the AccountingWEB site generally.

## Conclusion

Finally, the most important thing of all is to know your client and his or her business and eccentricities. Items will be picked up in conversation from time to time that don't necessarily appear in the books of account. As you know the business better and better, this may be reflected on how you finalise the accounts. Within the fee scale agreed, regular contact and perhaps meetings are advised.

## Ask a question

Readers with a current case should post their query in Any Answers.

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