DEPRECIATION AND TRADING STOCK – CONFUSION UNCONFOUNDED

by Barrie Akin

Accounting principles are not static - they have a tendency (rather akin to tax legislation) towards ever greater sophistication. But it is clear from the progress of *HMRC v. William Grant & Sons Distillers Ltd* and *Small (HMIT) v. Mars UK Ltd* through the Courts that judges and accounts do not mix well, even when the accounting issues are not particularly sophisticated. Fortunately, the fog of confusion that these cases have created in their passage through the Courts has finally been dispersed by the House of Lords[1].

The essential facts in both cases were straightforward. Part of the taxpayers' fixed asset depreciation was attributed to trading stock, as UK GAAP requires,[2] with accounting entries being made so as to ensure that the amount of annual fixed asset depreciation that was properly attributable to stock remaining unsold at the year-end ("Closing Stock") was taken out of the profit and loss account and added to the carrying value of Closing Stock in the companies' balance sheets. It was common ground that the two companies' accounts were drawn up in accordance with generally accepted accounting principles and complied with the provisions of the Companies Acts.

In their tax returns, the companies added back the net amount of depreciation that remained charged in their profit and loss accounts (i.e. excluding the amount that was attributable to Closing Stock) under the usual disallowance provision in s. 74(1)(f) Income and Corporation Taxes Act 1988. That provision says that, in computing the amount of the profits to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of:

> " …any sum employed or intended to be employed as capital in the trade…"

HMRC took the view that it was not sufficient that the net depreciation charge should be added back. They took the view that the amount of depreciation that had been removed from profit and loss and added to the carrying value of Closing Stock should also be brought into charge to tax. From an accountant's perspective, HMRC's approach looks odd. The disputed amount had not reduced the companies' accounting profit in the year in question – it appears in the balance sheet in the form of an increased cost of stock and if the stock is sold in a subsequent period, this amount will be treated as depreciation (and disallowed for tax accordingly, under s.74). Thus, the full amount of depreciation will have been taken into account in the periods to which it relates and disallowed in such periods. So why should it be the subject of an add back under s. 74(1)(f)? Surely, there is nothing to add back.

The judges did not (in the main) find the issue easy to decide. Indeed, there is every indication that some struggled to understand what was going on at all. Some also fell into the trap of seeking to expound or explain how companies account for stock in trade when it might have been more prudent to accept the undisputed accounting evidence.

When both cases came before the Special Commissioners[3], the companies' appeals were successful, but the Special Commissioners were troubled by the apparent discrepancy between the amount of depreciation that the Companies Act[4] requires to be taken into account in recording fixed asset values in the balance sheet and the net amount actually charged in the profit and loss account. This led them to give two reasons for allowing the companies' appeals. First, that only the net amount of depreciation had been deducted in the companies' profit and loss accounts, so that only that amount needed to be added back under s. 74(1)(f). Alternatively, they held that the depreciation excluded from the profit and loss account in respect of depreciation allocated to Closing Stock was not, for Companies Act reasons, acceptable as a deduction, so that the gross amount of depreciation charged to the profit and loss account (and not just the net amount) became disallowable. Nevertheless, an equal and opposite deduction (i.e. equal to the depreciation allocated to Closing Stock) should then be made in computing trading profit for taxation purposes so as to prevent the amount of depreciation[5] included in Closing Stock from being charged to tax as income. That alternative point, which was not actually argued before the Special Commissioners, was expressed to be the preferred reason for their decision. The problem faced by the Special Commissioner was, how to characterise the disputed amount. If the Companies Act required the whole of the deprecation to be taken into account, then the disputed amount appeared to be in the nature of a capital profit. If this analysis were correct, one would then have to face the question, how this "profit" was to be dealt with in the subsequent accounting period in which the stock is sold.

HMRC appealed against the Special Commissioners' decision. The *Mars* appeal was heard by Lightman J in the High Court. The *William Grant* appeal was heard by the Inner House of the Court of Session. Both appeals were successful. In *Mars*, Lightman J[6] held that the company had deducted the whole amount of its depreciation in the profit and loss account (some £41m) and that the transfer from profit and loss of some £3m as depreciation relating to Closing Stock (which was then added to closing stock) did not alter the character of the £3m as depreciation or disapply s. 74(1)(f) in respect of it. He went on to disagree with the Special Commissioners' view that only the net figure (some £38m) was deducted in the profit and loss account. He considered that the agreed evidence did not establish that the deduction of the net figure was in accordance with generally accepted accounting practice, but took the view that the evidence established that the full sum of £41m had been deducted but that the *effect* of the credit of £3m was that only the net sum was deducted. He accordingly considered that the £3m was disallowable under the provisions of s. 74(1)(f).

With all due respect to Lightman J, this approach is misguided. The learned judge fastened onto to words of the expert witnesses who gave evidence before the Special Commissioners[7] (in fact, it is clear that they did not agree on this point) and decided that the correct accounting approach was to regard the full amount of depreciation as having been charged to profit and loss. In saying that the credit to profit and loss that removed the element of depreciation relating to Closing Stock did not alter the character of the amount charged, Lightman J was clearly taking the view that s. 74(1)(f) overrode accounting principles in that respect. That cannot be disputed. But the statute does not say how one should decide what the actual charge for depreciation might be. Lightman J

seems to have placed importance on the mechanism adopted in charging depreciation to the exclusion of the result. The objective of accounting is to arrive at a profit or loss for the accounting period which properly reflects the economic result for that period. The precise way in which this is achieved in any period (which will frequently include *bookkeeping* adjustments at or after the year-end) will vary. There is often more than one way to make the individual bookkeeping entries. Deciding on the quantum of depreciation by reference to the way the company did its bookkeeping is, it is submitted, to prefer form over substance in an area where it is substance that is key. Accounting entries need not reflect individual transactions. They frequently adjust the accounts in order to reflect the correct economic outcome. It cannot be right to fasten on the mechanics of the bookkeeping entries and to ignore the true picture. In Gallagher v. Jones [1993] STC 537, Bingham MR said, at page 555:

> "... I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question, and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business."

It is also clear that Lightman J did not justify his conclusion by reference to the provisions of the Companies Acts as to how depreciation should be provided, a point which had troubled the Special Commissioners. Lightman J also disagreed with the Special Commissioners' alternative view that the effect of disallowing the £3m would be to tax a capital profit on the increased carrying value of Closing Stock. He took the view that Mars had turned the depreciation into income by adding it to trading stock. As with the Special Commissioners, it would appear that he misunderstood the effect of the company's accounting for depreciation in Closing Stock.

The *William Grant* appeal was heard by the Inner House of the Court of Session in 2005.[8] The leading judgment of the majority was delivered by Lord Penrose. It is difficult to follow and extremely difficult to précis. In paragraph 80 he says:

> "In my opinion, the amount of depreciation that falls to be taken into account for closing stock in expressing the carrying amount is the amount apportioned out of gross depreciation provision for the period. If that is done, there remains nothing in the name of depreciation in stock available to credit directly to the gross depreciation charge against revenue. The result is that there must be added back the whole depreciation computed for the accounting period. That is, the amount that falls within s. 74(1)(f) in respect of depreciation in accounts prepared under the Companies Act is the amount of depreciation that requires to be written off in terms of para 18 of Sch 4, whatever the application of that sum in or towards the indirect production costs of other assets, and in particular stock."

Lord Penrose accordingly took the view that the full amount of depreciation must be disallowed, even if it was not deducted in the profit and loss account. Lord Osborne

agreed with Lord Penrose's judgment and added[9] that the inclusion of depreciation in Closing Stock, it ceased to be depreciation. He then said:

> "In my opinion, it follows from that state of affairs, that that portion of depreciation, along with the remainder, requires to be added back in the year in question, as part of the gross depreciation, in consequence of the provisions of s. 74(1)(f) of the 1988 Act."

It seems clear that Lord Osborne took the view that the gross amount of depreciation for Companies Act purposes should be regarded as included in profit and loss, even if part of it had, for all economic purposes, been removed from the profit and loss account.

The dissenting judgment of Lord Reed is, in contrast, a model of clarity.

> "... the purpose of s. 74(1)(f) ... is to ensure that, for the purposes of taxation, a company's profits are not reduced by any deduction in respect of capital employed in the business. Accordingly, to the extent that the company's reported profits have been reduced by any such deduction (including any deduction by reason of depreciation in the value of fixed assets), s. 74(1)(f) requires the deduction to be cancelled by adding back an equivalent amount.
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> The whole of the provision for depreciation in the value of fixed assets made in a company's balance sheet in respect of a given year has to be added to its reported profits ... only if those profits have been reduced by deducting the whole of that provision. Whether that has occurred is a question of fact. If part of the depreciation provision has not been so deducted in the year in question, but has been carried forward to a subsequent year, then s. 74(1)(f) does not require it to be 'added back'"

Both taxpayers appealed to the House of Lords[10]. The appeals were successful. The leading speech was given by Lord Hoffman, who made it clear that he considered the question to be how much depreciation had been deducted. He then went through the facts and said[11]

> "... I should have thought it was plain and obvious that, as only [the net amount of depreciation] has been deducted, s. 74(1)(f) does not require [the depreciation attributable to Closing Stock] to be added back."

He went on to dismiss HMRC's contentions to the effect that the accounting treatment adopted by the companies did not accord with fundamental principles of accounting and that paragraph 18 of Schedule 4, Companies Act 1985 required the gross amount of depreciation to be charged to profit and loss. The House of Lords decision is a victory for common sense. The effect of the decisions in the High Court and the Court of Session was that expenditure that would be deducted in future years was disallowed immediately. No convincing justification for such an arbitrary result was offered by the lower Courts. It is also worrying that judges still feel able to produce judgments that analyse accounting

in detail, often going beyond the expert evidence. This is very noticeable in the judgment of Lord Penrose, which is frequently obscure, but others are also not without blame here. At least, none went as far as Lord Millett in *Commissioner of Inland Revenue v. Secan Ltd* 74 TC 1 in the Hong Kong Court of Final Appeal. His statements (among others) that

> "..the amount or value of an asset is a credit on the asset side of the balance sheet.."

and

> "...the cost of ... purchases (the debit) is normally matched by the increase in the value of stock (the credit) ..."

simply cannot have come from the accountancy experts who gave evidence in that case. Many non-accountants are perplexed by the expressions "credit" and "debit", being accustomed to meet them in the context of a bank statement. Bank statements are extracts of the bank's books, and are therefore the mirror-image of the depositor's position. Perhaps Bingham MR's dictum (above) that judge-made rules should not in general override accounting principles should be extended – judges should not seek to explain the working of accounting unless they are *very* sure of their ground.

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[1] [2007] STC 680 (HL)
[2] See now FRS 15
[3] They were heard together: [2004] STC(SCD) 253
[4] Paragraph 18 of Schedule 4
[5] What the Special Commissioner referred to as the "capital amount".
[6] [2005] STC 958. The case bypassed the Court of Appeal under the "leap frog" provisions of the Administration of Justice Act 1969
[7] See para 16 of the judgment
[8] Reported in [2006] STC 69
[9] Para 98
[10] They were heard together: [2007] STC 680
[11] Para 13