Avoiding common errors when computing business profits

HMRC produce a range of Toolkits for agents, which highlight errors commonly made in returns so that agents can take steps to avoid them. The business profits toolkit provides guidance on errors that are found in relation to business profits for small and medium-sized businesses. They are helpful to anyone computing taxable business profits.

Risk area 1 – Record keeping

Good record-keeping is essential for business profits to be calculated correctly. Poor records may result in sales or allowable expenditure being omitted from the accounts, with the result that the level of profit or loss is incorrect.

Risk area 2 – Business income

The profit or loss will only be correct if all income is included in the accounts. Unless the business is an unincorporated business that has opted to use the cash basis, business income should be included on an accruals basis, matching the income to the period in which it was earned.

Not all sources of business income will be immediately obvious – the income of the business may, for example, include scrap sales, contra sales or barter arrangements. Cash sales may also be overlooked.

Risk area 3 – Expenditure

To ensure that the profit is not overstated, all allowable expenditure should be taken into account. However, a deduction is only permitted for expenses which are wholly and exclusively incurred for the purposes of the business. Attention should also be paid to specific prohibitions, such as for business entertaining.

Purchases and expenses should be reviewed to ensure that they have been included.

Sole traders and partnerships comprising individuals can use simplified expenses rather than claiming actual expenses.

Risk area 4 – Stock and work in progress

Where the business is one that holds stock, care must be taken to include it at the correct value – this is the lower of cost and net realisable value. Errors will arise if stock is overlooked or valued incorrectly.

Work-in-progress can be a complex area and advice should be taken to ensure that the treatment is correct.

Risk area 5 – Miscellaneous items

Miscellaneous areas should also be considered. These may include a review of post-balance sheet events and consideration as to whether any adjustment to the accounts is required. Staff costs should also be reviewed and amounts unpaid nine months after the end of the period should be added back. As far as directors are concerned, consideration should be given to the date on which amounts are credited to the director’s loan account.