[2017] UKFTT 0151 (TC)

TC05644

Appeal numbers: TC/2014/02775
TC/2014/02787
TC/2014/02788

CORPORATION TAX – Change in local currency – Whether accounts comply with UK generally accepted accounting practice – Yes – Whether exchange differences are "exchange losses" – Yes – Whether exchange differences "fairly represent" a loss – Yes – Appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

(1) SMITH AND NEPHEW OVERSEAS LIMITED
(2) T P LIMITED
(3) SMITH AND NEPHEW FINANCE HOLDINGS LIMITED **Appellants**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE JOHN BROOKS
JOHN AGBOOLA

Sitting in public at the Royal Courts of Justice, Strand, London on 5 – 8 December 2016

Julian Ghosh QC and Jonathan Bremner, instructed by Johnson Allen Tax Solicitors, for the Appellant

James Rivett and Emma Pearce, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. Following a change in their functional currency, from sterling to US dollars, as the result of a company reorganisation Smith and Nephew Overseas Limited ("SN Overseas"), T P Limited ("TP") and Smith and Nephew Finance Holdings Limited ("SN Finance") claimed foreign exchange losses in their tax returns for their accounting periods ended 31 December 2008 of $877,458,000 (£445,868,096), $271,925,000 (£138,188,096) and $178,408,000 (£90,652,234) respectively. They say that these exchange losses, which were included within the statement of total recognised gains and losses ("STRGL") by each of the companies in their respective accounts where they were described as a "Revaluation (loss)/gain on change in functional currency", arose as a result of the fall in value of the pound against the US dollar.

2. On 16 April 2014 HM Revenue and Customs ("HMRC"), which does not accept that the exchange differences shown in the companies' accounts represent losses or that the correct accounting treatment had been applied by the companies, issued closure notices, under paragraph 34(2) of schedule 18 to the Finance Act 1998 which disallowed the losses claimed by each of the companies and required certain amendments to each of their tax returns consequential on that disallowance.

3. SN Overseas, TP and SN Finance appealed to the Tribunal against the conclusion in those closure notices on 16 May 2014. In accordance with directions issued on 16 June 2014 their appeals have been joined to be heard together.

4. Mr Julian Ghosh QC and Mr Jonathan Bremner appeared for SN Overseas, TP and SN Finance. HMRC were represented by Mr James Rivett and Emma Pearce. We are grateful for the assistance given by their clear and succinct submissions, both written and oral.

Facts

5. The parties produced the following Statement of Agreed Facts:

The Smith & Nephew Group

(1) The Smith & Nephew Group is a multinational group engaged in the development, manufacture and marketing of medical devices. The headquarters of the Smith & Nephew Group is in the UK. The ultimate parent of the Smith & Nephew Group is Smith & Nephew PLC.

(2) Smith & Nephew PLC has two main trading groups:

(a) a trading group which comprises the international operations of the Smith & Nephew Group the entities within which trading group have at all material times prepared their accounts using US dollars as the functional currency and

(b) a trading group "the UK sub-group" that comprised the UK trading operations of the Smith & Nephew Group which for periods prior to 23 December 2008 prepared their accounts using sterling as the functional currency including all 3 Appellants in this case.[1]

(3) The First Appellant SN Overseas is a UK incorporated company which has at all material times been resident in the UK for the purposes of the UK corporation tax code.

(4) The Second Appellant TP is a UK incorporated company which has at all material times been resident in the UK for the purposes of the UK corporation tax code.

(5) The Third Appellant SN Finance is a company incorporated under the laws of the Cayman Islands, but has at all material times been resident in the UK for the purposes of the UK corporation tax code.

(6) The abbreviation S&N is used where Smith and Nephew representatives are acting on behalf of the Smith and Nephew group as a whole or conducting negotiations in relation to a number of the Appellants and not just one individual company.

(7) Smith & Nephew Investment Holdings Limited ("SNIH") is a UK incorporated company that acts as an investment holding company for the dormant subsidiary undertakings of the Smith & Nephew Group in the United Kingdom.

The inter-company position prior to 23 December 2008

(8) At all material times prior to 23 December 2008 the Smith & Nephew Group structure was such that each of the Appellants were subsidiaries of Smith & Nephew Investment Holdings, a UK incorporated subsidiary of Smith & Nephew UK Limited, which was in turn a UK incorporated subsidiary of Smith & Nephew PLC.

(9) As at 23 December 2008 the intercompany receivables were as follows ("**the Intercompany Receivables**");

(a) SN Overseas was entitled to an inter-company receivable of c. £1.63bn from Smith & Nephew Investment Holdings Ltd;

(b) TP was entitled to an inter-company receivable of c. £0.54bn from Smith & Nephew Investment Holdings Ltd; and

(c) SN Finance was entitled to an inter-company receivable of c. £0.34bn from Smith & Nephew Investment Holdings Ltd.

[1] At the material time in drawing their accounts the Smith & Nephew Group companies that are relevant to these proceedings applied accounting standard SSAP 20 'Foreign Currency Translation' which refers to the 'local currency' of a particular entity rather than its 'functional currency' which is the term used in more recent accounting standards (FRS 23 'the effects of changes in foreign exchange rates'). The term 'local currency' has a similar meaning as the term 'functional currency'. For the purposes of the Statement of Agreed Facts the term 'functional currency' is used.

(10) Although non-interest bearing, the Intercompany Receivables resulted in the Appellants (which were otherwise dormant) having to prepare annual tax returns reporting notional interest income arising on the Intercompany Receivables.

The background to the transactions

(11) On 12 November 2008, SNIH wrote to HMRC setting out a proposal for waiving the Intercompany Receivables and requesting clearances to the effect that;

(a) the credits arising in SNIH and conversely the debits arising from the release of the inter-company liabilities should not be brought into account for corporation tax purposes (Para 5 Schedule 9 FA96); and

(b) the debt waivers should be disregarded for capital gains tax purposes.

(12) On 25 November 2008, a paper (Paper No. 1311) was prepared describing the proposed debt waivers and tabled and approved at a meeting of the Finance & Banking Committee held on that day. The paper said that the debt waivers should be disregarded for all tax purposes but required that clearance to that effect should be received from HMRC.

(13) On 26 November 2008, at a meeting, HMRC refused to provide clearance to the proposal. HMRC indicated that the credits in SNIH and debits arising from the release of the inter-company liabilities (including the Appellants) should be ignored for tax purposes but provided no assurance as to the capital gains tax consequences of the proposal.

(14) On 28 November 2008, S&N met PWC. S&N raised the intercompany debt issue and the reorganisation through which they proposed to eliminate the loans. PWC suggested that as a result of the proposed transfer of ownership of SN Overseas and TP into the USD sub-group, substantial exchange losses would be recognised in the dormant company accounts and that, if additional transactions were effected, it might be possible to realise a tax deduction for the exchange loss arising in the statutory accounts, this is referred to as "**the PWC Proposal**". The PWC Proposal required that the companies enter into a non-hedging derivative transaction to which FRS 23 applied in the financial statements for the year ended 31 December 2008. PWC suggested that on this basis it would be possible to claim that the functional currency of SN Overseas and TP should have been US Dollars with effect from 1 January 2008.

(15) On 3 December 2008, the Smith and Nephew group, Head of Financial Reporting, Mark Tompkins, produced the first draft of an accounting paper entitled the "accounting issues discussion" (**'the Accounting Issues Discussion Paper'**) which considered the effect on the entity accounts of the functional currency change under FRS 23. This was based upon the PWC Proposal with the functional currency change supported by entering into a non-hedging derivative.

(16) On 9 December 2008, a paper was prepared for the Finance Director based on the PWC Proposal.

(17) On 10 December 2008, KPMG provided comments on the 3 December 2008 draft of the Accounting Issues Discussion Paper in connection with the PWC proposal, ultimately not a proposal implemented by the Appellants. KPMG noted in relation to the non-hedge derivative "*…it is unclear what the commercial rationale for the derivative is – this may be challenged by the tax authorities.*"

(18) On 10 December 2008, the Smith and Nephew group, Head of Financial Reporting, Mark Tompkins, produced the second draft of the "Accounting Issues Discussion Paper' incorporating the detailed comments of KPMG.

(19) Also on 10 December 2008, SN Overseas and a representative of PWC attended a case conference with Kevin Prosser QC on the PWC Proposal**.** Legal Professional Privilege has been asserted in respect of this advice.

(20) On 12 December 2008, a Finance and Banking Committee presentation was prepared.

(21) On 15 December 2008, S&N emailed Chris Jackson of PWC with an attachment entitled "FRS 23 specific paper" and the comment "The attachment was an attempt to try and specifically address the FRS 23 points. I would be grateful for any additional points you might have on this which might further strengthen our argument."

(22) On 15 December 2008, PWC's Chris Jackson replied S&N with comments on the "FRS 23 specific paper".

(23) On 16 December 2008, Mark Tompkins of S&N informed the group's auditors EY that "We have received written and verbal input into the papers to support the accounting treatment and both KPMG and PWC agree with the conclusion".

(24) On 16 December 2008, S&N met EY to discuss the proposed accounting treatment to be adopted by the Appellants.

(25) On 17 December 2008, and in the context of the PWC proposal which ultimately wasn't implemented, Tim Gordon of EY emailed Nick Johnson of S&N and questioned whether it had been correct to determine the functional currency of the UK sub-group as GBP Sterling following the restructuring in 2006 which created a separate sterling denominated sub-group. Specifically, *"… if …. the decision was wrong to leave [the UK sub-group] as £ functional at the restructure I presume that this would also apply to [SNIH] which would become $ functional from the same date creating a gain that would cancel out the loss?"*

(26) On 17 December 2008, Nick Johnson of S&N responded to EY with the comment that SNIH had followed SSAP 20 throughout 2006 to 2008 and would not change its sterling functional currency.

(27) On the 18 December 2008, S&N prepared a revised accounting paper concluded that the restructuring would change the Appellants' functional

currency under SSAP 20 to USD. On the same day, the final papers for the Finance and Banking Committee were prepared.

(28) On 18 December 2008, S&N wrote to EY the group's auditors for feedback on their conclusion regarding the change in the functional currency of the Appellants.

(29) On 19 December 2008, EY the group's auditors confirmed the trigger event for the change of functional currency would be the move of the entities under S&N Plc on the 23 December 2008.

(30) On 19 December 2008, a third draft of the Accounting Issues Discussion Paper was prepared after discussions with EY which did not encompass the PWC proposal. This draft of the paper reflected the accounting under SSAP 20 and was the final version approved by the Directors of the Appellants before the group restructuring that occurred on the 23 December 2008.

(31) From the 19 December 2008 to the 22 December 2008, S&N and Ashurst (Solicitors to S&N) exchanged draft versions of the legal agreements required to be implemented for the restructuring. A summary of the legal agreements was set out in an email from Tom Cartwright, Ashurst on 19 December 2009.

The restructuring

The SN Overseas and TP Share Purchase Agreement of 23 December 2008

(32) By an agreement dated 23 December 2008 between (1) Smith & Nephew PLC and (2) Smith & Nephew Investment Holdings Limited, Smith & Nephew PLC agreed to purchase from Smith & Nephew Investments Holdings Limited all of the issued share capital of SN Overseas and TP (**'the SN Overseas and TP Share Purchase Agreement of 23 December 2008'**).

(33) Under the terms of the SN Overseas and TP Share Purchase Agreement of 23 December 2008 the consideration payable by Smith & Nephew PLC to Smith & Nephew Investment Holdings Limited was £1,659,517,000 in respect of the entire issued share capital of SN Overseas and £524,243,000 in respect of the entire issued share capital of TP which was expressed to be payable on completion in cash (Clause 2.2 of the SN Overseas and TP Share Purchase Agreement of 23 December 2008).

(34) On 23 December 2008 Sterling/US dollar swap agreements were entered into between Smith & Nephew PLC and both SN Overseas and TP to hedge the one day exposure to foreign exchange risk from holding the sterling denominated Intercompany Receivables after the functional currency changed to US dollar and until the debts were settled on the 24 December 2008.

The SN Finance Share Purchase Agreement of 23 December 2008

(35) By an agreement dated 23 December 2008 between (1) Smith & Nephew PLC and (2) SNIH, Smith & Nephew PLC agreed to purchase from SNIH all of the issued share capital of SN Finance ('**the SN Finance Share Purchase Agreement**').

(36) Under the terms of the SN Finance Share Purchase Agreement the consideration payable by Smith & Nephew PLC to SNIH was £343,955,000 in respect of the entire issued share capital of SN Finance which was expressed to be payable on completion in cash (Clause 2.2 of the SN Finance Share Purchase Agreement).

(37) Sterling/US dollar swap agreements dated 23 December 2008 between Smith & Nephew PLC and SN Finance to hedge the one day exposure to foreign exchange risk from holding a sterling denominated intercompany receivable after the functional currency changed to US dollar and until the debt was settled on the 24 December 2008.

The TP Share Purchase Agreement of 24 December 2008

(38) By an agreement dated 24 December 2008 between (1) Smith & Nephew PLC and (2) SN Overseas, SN Overseas agreed to purchase from Smith & Nephew PLC the entire issued share capital of TP ('**the TP Share Purchase Agreement**').

(39) Under the terms of the TP Share Purchase Agreement the consideration payable by SN Overseas to Smith & Nephew PLC was US$ 3,500,000,000 in respect of the entire issued share capital of TP which was required to be satisfied on completion as to (a) in cash the amount of US$ 2,444,966,000 and (b) by the issue and allotment to Smith & Nephew PLC of one ordinary share in TP at a premium equal to the balance of the consideration (Clause 2.2 of the TP Share Purchase Agreement).

(40) So far as is material the effects of the TP Share Purchase Agreement were that (1) TP became a wholly owned subsidiary of SN Overseas; (2) the amount of the premium allocated to the share in SN Overseas transferred to the share premium account of SN Overseas and (3) the net intercompany receivable in SN Overseas was reduced to $200,000.

The Smith & Nephew USD Ltd Share Purchase Agreement of 24 December 2008

(41) By an agreement dated 24 December 2008 between (1) TP and (2) Smith & Nephew PLC, TP agreed to purchase the entire issued share capital of Smith & Nephew USD Limited from Smith & Nephew PLC ('**the Smith & Nephew USD Limited Share Purchase Agreement**').

(42) Under the terms of the Smith & Nephew USD Limited Share Purchase Agreement the consideration payable by TP to Smith & Nephew PLC was US$ 3,500,000,000 in respect of the entire issued share capital of Smith & Nephew USD Limited which was required to be satisfied on completion as to (a) in cash the amount of US$ 772,367,000 and (b) by the issue and allotment to Smith & Nephew PLC of one ordinary share in TP at a premium equal to the balance of the consideration (Clause 2.2 of the Smith and Nephew USD Limited Share Purchase Agreement of 24 December 2008).

(43) So far as is material the effects of the Smith & Nephew USD Limited Share Purchase Agreement of 24 December 2008 were that (1) Smith &

Nephew USD Limited became a wholly owned subsidiary of TP; (2) the amount of the premium allocated to the share in Smith & Nephew PLC in TP was transferred to the share premium account of TP and (3) the net intercompany receivable in TP was eliminated.

The SN Finance distribution of 24 December 2008

(44) By a resolution dated 24 December 2008 the board of directors of SN Finance resolved among other matters (i) to pay a dividend of £6,878.10 in respect of each ordinary share in issue amount to an aggregate of £343,905,000 payable to Smith & Nephew PLC as its sole shareholder (**'the SN Finance Distribution'**); (ii) the SN Finance Distribution was to be paid in US dollars in the aggregate amount of US$506,675,237 (using a £/US$ exchange rate of US$ 1.4733 being the spot rate payable on 23 December 2014); (iii) that the SN Finance Distribution should be paid out of share premium as to £342,903,000 in aggregate (i.e. US$ 505,198,990 at the spot rate) and paid out of profits as to £1,002,000 in aggregate (i.e. US$ 1,476,247 at the spot rate).[2]

(45) So far as is material the effect of the SN Finance Distribution was that substantially all of the intercompany receivables in SN Finance were eliminated (a balance of £54,000 remained).

Effect of the transactions on the 24 December 2008

(46) On 24 December 2008 the Intercompany Receivables were substantially settled (with the exception of the remaining balances of £54,000 in S&N Finance, and $200,000 in S&N Overseas).

(47) Also on the 24 December 2008 the 1 day forward contracts expired.

The inter-company position after 24 December 2008

(48) So far as is material the cumulative net effect of the transactions that occurred on 23 December 2008 and the 24 December 2008 was that (1) the Appellants ceased to be subsidiaries of Smith & Nephew UK Limited; (2) the Appellants became subsidiaries of Smith & Nephew PLC and (3) the Intercompany Receivables were substantially eliminated.[3]

(49) In the circumstances with effect from 23 December 2008 for accountancy purposes there was a change in the functional currency of each of (1) SN Overseas (2) TP and (3) SN Finance from sterling to US dollars.

Events after the restructuring up to the filing of the accounts

(50) On 8 January 2009, PWC emailed Mark Humphreys of S&N and stated that "*Our total costs including our Accounting Technical input and all meetings/calls with QC etc are £34k.*"

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[2] For the purposes of these proceedings it is accepted that as a matter of the law of the Cayman Islands there was no restriction on the part of SN Finance in funding the SN Finance Distribution from its share premium account.

[3] Subject to the exception of the remaining balances of £54,000 in SN Finance, and $200,000 in SN Overseas

(51) Around the end of April 2009, S&N's finance committee considered whether to record the exchange differences arising in the current reporting period from 1 January 2008 to 23 December 2008 as losses through the Profit and Loss or the Statement of Total Recognised Gains and Losses in the statutory accounts of the Appellants.

(52) On 11 May 2009, the final version of the Accounting Issues Discussion Paper was produced.

The Appellants' accounts for the period ended 31 December 2008

(53) On 11 August 2009, EY provided their 2008 statutory audit letter which only applied to SN Overseas and TP of the three Appellants and it confirmed that they expected to issue an unqualified opinion and in respect of the functional currency change and that the resultant foreign exchange adjustment recognised through reserves that they concurred with the accounting treatment adopted by management.

(54) On 12 August 2009, the accounts of each Appellant were approved by the Directors.

(55) On 13 August 2009, EY signed the audit opinion in respect of SN Overseas and TP that these Appellant's accounts gave a True and Fair view.

(56) Each Appellants functional currency changed from sterling to US dollars on 23 December 2008 and the Intercompany Receivables were denominated in sterling.

(57) On 23 December 2008 each Appellant changed functional currency to US Dollars but each Appellant still held the Intercompany Receivables but denominated in sterling which gave each Appellant a potential exposure to foreign exchange gains and losses on that day. However, each Appellant hedged any potential exposure to foreign exchange gains and losses on 23 December 2003 by entering into one day forward exchange contracts which ensured that no Appellant was exposed to foreign exchange gains or losses.

(58) Each of (1) SN Overseas (2) TP and (3) SN Finance produced statutory accounts for the accounting period ended 31 December 2008 which were prepared in US dollars.

(59) The Appellants prepared the accounts in US dollars for the accounting period ended 31 December 2008 and each Appellant recognised certain exchange differences (**'the Exchange Differences'**):

(a) SN Overseas recognised an exchange difference of $877,458,000 during the period ended 31 December 2008;

(b) TP recognised an exchange difference of $271,925,000 during the period ended 31 December 2008; and

(c) SN Finance recognised an exchange difference of $178,408,000 during the period ended 31 December 2008.

(60) The Exchange Differences were not reflected in the profit and loss accounts produced by each of the Appellants for the period ended 31 December

2008 but were in each instance included within the STRGL by each Appellant and described as '*Revaluation (loss)/gain on change in functional currency'*.

(61) There were no Exchange Differences reported in the Smith & Nephew Plc group accounts as a result of the restructuring.

The Appellants' tax returns for the period ended 31 December 2008

(62) Each Appellant prepared its tax return for the period ended 31 December 2008 on the basis that the Exchange Differences each gave rise to an 'exchange loss' within the meaning of s 103(1B) FA 1996 on the part of each Appellant which arose as a result of the movement between the US dollar and Sterling applied to the Intercompany Receivables and was recognised in each Appellants' statement of recognised gains and losses within the meaning of s 84A(3) FA 1996. For the avoidance of doubt that treatment is disputed by HMRC.

The distributable reserves

(63) The accounts of each Appellants under the Accounting Policies section entitled "*Change of functional currency*" disclosed the Exchange Differences in reserves as follows: *"The resulting revaluation reserve balance is recognised through the Statement of total gains and losses, and is non-distributable in nature. As a consequence of the change, the company will retain the distributable reserves and pay its dividends in US Dollars."*

(64) The Finance & Banking Committee paper no. 1322 described the restructuring proposal for SN Overseas and TP and stated "*Distributable reserves – The above transactions will not result in any block in upstream intercompany dividends.*" In the same paper at section 1(b) it was proposed that SN Overseas would pay a dividend on 23 December 2008 of £31,989,000 as part of the restructuring transactions on the day of the local currency change.

(65) SN Overseas proposed and paid a dividend to its sole shareholder (SNIH) on the 23 December 2008.

(66) TP did not pay any dividends during the restructuring in 2008.

(67) The Finance & Banking Committee paper no. 1323 proposed in section 1(c) & 1(d) that SN Finance would pay dividends out of share premium and retained profits on 23 December 2008 as part of the restructuring transactions on the day of the local currency change.

(68) SN Finance proposed and paid a dividend of £342,903,000 from its share premium account and £1,002,000 from retained earnings to its sole shareholder, Smith and Nephew Plc, on the 23 December 2008.

(69) SN Overseas's and TP's accounts did not show any distributions between 2009 and 2013.

(70) In the year ended 31 December 2013 SN Overseas and TP carried out capital reductions.

(71) In the year ended 31 December 2013, SN Overseas carried out a capital reduction, which was agreed to by S&N Plc as sole shareholder. The reduction in share capital was set off against the foreign currency revaluation reserve loss of $818,249,000.

(72) In the year ended 31 December 2013, SN Overseas as sole shareholder of TP Limited passed a resolution to set off the foreign currency revaluation reserve loss of $253,577,000 against share premium account.

(73) The paper for the F&BC meeting which approved the capital reductions by SNO and TP Limited commented that "*the loss on the conversion of the sterling intercompany loans … has caused a dividend trap in the chain of holding companies above SNUSD ... [which] is the largest source of distributable profit for PLC.*"

(74) In the year ended 31 December 2014, S&N Plc contributed $1,670,000,000 for one share in SN Overseas. SN Overseas contributed $1,670,000,000 for one share in TP. TP paid a dividend of £775,000,000 to SN Overseas and SN Overseas paid a distribution of $775,000,000 to S&N Plc.

The Closure Notices

(75) In each Closure Notice the conclusion identified by HMRC in relation to the Exchange Differences was;

(a) that the claims for non-trading loan relationship debits did not accord with UK generally accepted accounting practice; and

(b) to disallow the debits claimed in each Appellants' tax return for the accounting period ended 31 December 2008 in respect of the Exchange Differences on the basis that the Exchange Difference did not give rise to debits for the purposes of Chapter II Part IV FA 1996; and

(c) to require pursuant to para. 34(2A) schedule 18 FA 1998 certain amendments to each Appellants' tax return for later periods consequential on the disallowance of the debits claimed in each Appellants' tax return for the accounting period ended 31 December 2008.

Legislative framework

6. Unless otherwise stated all subsequent statutory references are to sections and sub-sections of the Finance Act 1996.

7. Insofar as applicable to the present case s 80 provides:

> (1) For the purposes of corporation tax all profits and gains arising to a company from its loan relationships shall be chargeable to tax as income in accordance with this Chapter
>
> …
>
> (5) Subject to any express provision to the contrary, the amounts which in the case of any company are brought into account in accordance

> with this Chapter as respects any matter shall be only amount brought into account for the purposes of corporation tax as respects that matter.

8. Section 81(1) provides:

> Subject to the following provisions of this section, a company has a loan relationship for the purposes of the Corporation Tax Acts wherever–
>
> > (a) the company stands (whether by reference to a security or otherwise) in the position of a creditor or debtor as respects a money debt; and
> >
> > (b) that debt is one arising from a transaction for the lending of money;
>
> and references to a loan relationship and to a company's being party to a loan relationship shall be construed accordingly.

9. Section 82(1) provides:

> For the purposes of Corporation Tax–
>
> > (a) the profits and gains arising from the loan relationship of a company, and
> >
> > (b) any deficit on a company's loan relationship,
>
> shall be computed in accordance with this section using the credits and debits given for the accounting period in question by the following provisions of this Chapter.

10. Section 84 provides:

> (1) The credits and debits to be brought into account in the case of any company in respect of its loan relationships shall be the sums which, when taken together, fairly represent, for the accounting period in question –
>
> > (a) all profits, gains and losses of the company, including those of a capital nature, which (disregarding interest and any charges or expenses) arise to the company from its loan relationships and related transactions; and
> >
> > (b) all interest under the company's loan relationships and all charges and expenses incurred by the company under or for the purposes of its loan relationships and related transactions.
>
> (2) – (4) …
>
> (5) In this Chapter "related transaction", in relation to a loan relationship, means any disposal or acquisition (in whole or in part) of rights or liabilities under that relationship.

11. The "profits, gains and losses arising to a company from its loan relationships and related transactions" include exchange gains and losses arising to the company from its loan relationships (see s 84A(1)). However, s 84A goes on to provide:

(2) Subsection (1) above is subject to the following provisions of this section.

(3) Subsection (1) does not apply to an exchange gain or loss to a company to the extent that it arises–

(a) in relation to an asset or liability representing a loan relationship of the company, or

(b) as a result of the translation from one currency to another of the profit or loss of part of the company's business,

and is recognised in the company's statement of recognised gains and losses or a statement of changes of equity.

(3A) Subsection (1) does not apply to so much of an exchange gain or loss arising to a company in relation to an asset or liability representing a loan relationship of the company as falls within a description prescribed for the purpose in regulations made by the Treasury.

…

(8) The Treasury may by regulations make provision for or in connection with bringing into account in prescribed circumstances amounts in relation to which subsection (1) above does not by virtue of subsection (3) or (3A) above, have effect.

12. The Exchange Gains & Losses (Bringing into Account etc) Regulations 2002 were made under s 84A(8). Regulation 13 of which provides:

(1) This regulation applies in the circumstances prescribed by paragraphs (2) and (2A) below.

(2) The circumstances prescribed by this paragraph are where there is a disposal of an asset by a company and the asset disposed of represents a loan relationship of the company in relation to which exchange gains or losses have fallen within subsection (4) of section 84A.

(2A) The circumstances prescribed by this paragraph are where there is a disposal of an asset in an accounting period beginning on or after 1st January 2005 representing a loan relationship in relation to which exchange gains or losses were recognised in the company's statement of recognised gains and losses or statement of changes in equity.

(3) Where this regulation applies, an amount equal to the amount of any net gain or net loss shall be brought into account, for the purposes of Chapter 2, as a credit or debit (according to whether it is an amount of net gain or net loss) in respect of the loan relationship for the accounting period in which the disposal occurs.

(4) For the purposes of this regulation, the amount of any net gain or net loss shall be calculated by finding the aggregate of the amounts representing the exchange gains and losses which fell within paragraphs (2) and (2A).'

13. Section 85A provides:

> (1) Subject to the provisions of this Chapter (including in particular, section 84(1), the amounts to be brought into account by a company for any period for the purposes of this Chapter are those that, in accordance with generally accepted accounting practice, are recognised in determining the profit or loss for the period.
>
> (2) If a company does not draw up accounts in accordance with generally accepted accounting practice ("correct accounts")–
>
> (a) the provisions of this Chapter apply as of correct accounts had been drawn up, and
>
> (b) the amount referred to in this Chapter as being recognised for accounting purposes are those that would have been recognised if correct accounts had been drawn up.

14. Returning to the Finance Act 1996, s 85B(1) provides:

> Any reference in this Chapter to an amount being recognised in determining a company's profit or loss for a period is to an amount being recognised for accounting purposes–
>
> (a) in the company's profit and loss account or income statement,
>
> (b) in the company's statement of recognised gains and losses or statement of changes in equity, or
>
> (c) in any other statement of items brought into account in computing the company's profits and losses for that period.

15. Exchange gains and exchange losses are defined by s 103(1A) as profits or gains or losses:

> … which arise as a result of comparing at different times the expression in one currency of the whole or some part of the valuation put by the company in another currency on an asset or liability of the company.

Section 103(1B) provides that:

> Any reference in this Chapter to an exchange gain or loss from a loan relationship of a company is a reference to an exchange gain or loss arising to a company in relation to an asset or liability representing a loan relationship of the company.

16. Therefore, to summarise the legislation, s 85A requires a company to draw up its accounts in accordance with UK GAAP and s 85B requires the amounts brought into account to be recognised in either the company's profit and loss account, income statement or, as in the present case, the STRGL. Under s 84(1)(a) a company must bring into account the credits and debits in respect of its loan relationships which fairly represent all profits, gains and losses etc. for the accounting period in question. As is clear from s 84A(1), these include its exchange gains and losses unless these are in relation to an asset or liability arising as the result of a loan relationship or the translation from one currency to another and is also recognised in the STRGL (see s 84A(3)).

17. Although s 84A(3) would appear to preclude exchange gains and losses from being brought into account this is not the case if Regulation 13 of the Exchange Gains & Losses (Bringing into Account etc) Regulations 2002 applies. If it does, as in the present case, where the companies fall within the circumstances prescribed by Regulation 13(2A), Regulation 13(3) requires an amount equal to the amount of any loss to be brought into account, in effect reinstating the sum excluded by s 84A(3).

Issues

18. The following issues arise:

(1) Whether the appellants' accounts comply with UK generally accepted accounting practice ("GAAP");

(2) Whether the Exchange Differences are "exchange losses" within s 103; and

(3) Whether the Exchange Differences "fairly represent" a loss arising to the appellants' (or any of them) during the period ending 31 December 2008 as defined by s 84(1).

GAAP compliant

19. It is clear from s 85A (see paragraph 13, above), and not disputed, that for amounts brought into account by a company for any period to be recognised in determining its profit or loss for a period its accounts must be GAAP compliant. However, the parties do not agree that the accounts of the appellants in this case are GAAP compliant. Mr Ghosh, for the appellants, contends that they are whereas Mr Rivett, for HMRC, says otherwise.

20. Both rely on expert accountancy evidence. The appellants on that of Mr Peter Hogarth, the Senior Accounting Technical Partner of PricewaterhouseCoopers LLP ("PwC"), who heads the firm's team responsible for providing technical advice to its audit engagement teams in matters of complex accounting such as the application of accounting standards and the exercise of judgement in accounting areas. He is a principal author of PwC's *Manual of Accountancy – UK GAAP* and *Manual of Accounting – IFRS for the UK* and is a Fellow of the Institute of Chartered Accountants of England and Wales ("ICAEW") and a member of its Financial Reporting Committee. Mr Hogarth's Report was produced on 22 May 2015 and an 'Addendum' to that Report was produced on 7 October 2015. He gave oral evidence before us and was cross examined by Mr Rivett.

21. Mr David Chopping, on whose evidence HMRC rely, like Mr Hogarth, is a Fellow of the ICAEW. He is also a member of the Institute of Chartered Accountants of Scotland and is a Senior Partner in Moore Stephens LLP, Chartered Accountants with responsibilities for the firm's Audit Technical Department. Mr Chopping writes, lectures and provides advice on financial reporting, both IFRS and GAAP, and auditing and is Chairman of the ICAEW's Technical and Practical Auditing Committee and a member of its ISA Implementation sub-committee. Mr Chopping

produced his Report on 15 June 2015 and a Supplemental Report on 9 October 2015. He too gave oral evidence and was cross examined by Mr Ghosh.

22. In addition to their individual reports Mr Hogarth and Mr Chopping produced a Joint Report on 17 December 2015 in which they set out the key matters on which they agreed and those on which they differed.

23. It is not disputed that s 226A of the Companies Act 1985, which required the financial statements of a company to provide a "true and fair view" of its state of affairs and profit or loss, provided the legislative background to assessing whether the appellants' accounts are UK GAAP compliant notwithstanding Mr Hogarth's erroneous reference to the Companies Act 2006 in his Report. Indeed, Mr Hogarth, who fully accepted that he had referred to the current legislation in his Report rather than that which it had replaced, described the true and fair requirement as:

> "… the overarching principle against which all accounts should be judged."

24. This Companies Act requirement has been supplemented by Statements of Standard Accounting Practice ("SSAP") and UK Financial Reporting Standards ("FRS") issued by the Accounting Standards Board. Both experts, having considered the relevant accounting standards, agreed that:

(1) there was a change in the appellants' local currency on or around 23 December 2008 from Sterling to US Dollars;

(2) accounts for each financial year should be prepared in a single currency, being the local currency as at the end of the financial year (ie US Dollars);

(3) SSAP 20, *Foreign currency transaction* was the relevant standard in accounting for foreign currency transactions in the accounts for the year ended 31 December 2008;

(4) FRS 23 *The effects of changes in foreign currency rates* is a more recent UK GAAP standard that deals with foreign currency transactions, but that it was not applicable to, nor applied by the appellants;

(5) SSAP 20 is silent on how to account for a change in local currency;

(6) companies ordinarily apply one of two approaches for accounting for a change in local currency, the Foreign Operation method or the Single Rate method, either of which may be appropriate depending on the facts and circumstances;

(7) in the absence of an explicit accounting method dealing with a transaction or balance, FRS 18, *Accounting policies*, requires the directors to develop accounting policies that they judge to be the most appropriate to the companies' particular circumstances for the purposes of giving a true and fair view; and

(8) the objectives against which the directors should judge the appropriateness of accounting policies are relevance, reliability, comparability and understandability.

(Section 226A of the Companies Act 1995 and the relevant parts of SSAP 20, FRS 23 and FRS 18, the accounting standards to which Mr Hogarth and Mr Chopping mainly refer in their individual and Joint Reports, are set out in the appendix to this decision).

25. Although, as we have noted, Mr Hogarth and Mr Chopping agreed that FRS 23, which refers to both changes in functional currency and presentation currency (ie the currency in which an entity's financial statements are presented), did not apply, Mr Chopping in his Report referred to paragraph 35 of FRS 23 emphasising that a change in an entity's functional currency must be applied "prospectively" from the date of the change. However, in evidence in chief he accepted that little weight could be attached to the use of "prospectively" in FRS 23 agreeing with Mr Hogarth who noted that FRS 23 "does not directly address how amounts expressed in the old currency should be expressed in the new functional currency for periods before the date of change."

26. In essence, the difference between the experts was in relation to the approach adopted by SN Overseas, TP and SN Finance for accounting for a change in their functional currency. Mr Hogarth considers that the appellants were correct to adopt the Foreign Operation method whereas Mr Chopping is of the view that, in the circumstances of this case, only the Single Rate method is appropriate. Before we consider these differences, it is convenient to first set out Mr Hogarth's description of the Foreign Operation and Single Rate methods for accounting for a change in functional currency which was not challenged.

27. He said:

> "The foreign operations method, as the name might suggest, treats the results and financial position prior to the date of change of local currency in effect as if that were an attempt to account for a foreign branch. The rules in SSAP 20 for a foreign branch are that the profits and losses are translated ideally at an exchange rate that ruled on the days when the transactions occurred. In reality, it was an average rate for the period.
>
> It would also hold that the balance sheet is translated at each relevant balance sheet date, be it 1 January 2007, 31 December 2007 and so on.
>
> The resulting exchange differences that arise are recorded in the STRGL, the statement of total recognised gains and losses. Those exchange differences would relate to two things, essentially: re-translating the opening balances at the 1 January to end of year rate, reflecting the movement in the translated value of those balances over the course of the year, and the difference between the results for the year translated at average rates and again the translation of year end balances.
>
> So the procedure is similar to what would be applied by a group seeking to consolidate an overseas subsidiary in order to encompass the overseas results in a single group reporting currency.
>
> The single rate method, by contrast, takes all of the items, all of the balances and all of the results prior to the date of change and translates them all as a single exchange rate, being the rate in force on the date

> when the local currency changed. So 23 December, 24 December 2008 in this case.
>
> A consequence of using the single rate method is, of course, that because all of the results prior to that date are translated as a single rate, there are no exchange differences that could arise."

28. Support for the Foreign Operation method can be found in guidance from the manuals of three of the "Big Four" accountancy firms.

29. Deloitte in its *UK GAAP 2010* Manual refers (at '9 – Changes in reporting currency') to the Foreign Operation Method as "preferable" and "most appropriate" method "consistent" with FRS 23. PwC in its *Manual of accounting UK GAAP 2010* (at paragraph 7.13.5) refers to a company having "an accounting policy choice". KPMG in its 2015-16 manual, *Insights into IFRS KPMG's practical guide to International Reporting Standards*, recognises (at paragraph 2.7.320.40) that a company has a choice as to whether to adopt the Foreign Operation method or the Single Rate method despite the 2007-08 edition of the manual (to which Mr Chopping had referred in his Supplemental Report) making no reference to the Foreign Operation Method and stating that only the Single Rate method was appropriate (see at paragraphs 2.7.50.10 to 2.7.50.30).

30. However, as Mr Hogarth accepted, while such guidance is "not authoritative" it does "describe what many accountants in those larger firms see as practice on a day-to-day basis".

31. In relation to the objectives of FRS 18 – relevance, reliability, comparability and understandability – Mr Hogarth says that the Foreign Operation method provides information that is relevant to users of the accounts in that it indicates SN Overseas, TP and SN Finance operated in a multi-currency environment and were exposed to foreign exchange movements. It is also relevant that the Foreign Operation method presents foreign currency assets held at each period end translated at the rate applicable on that date.

32. Mr Chopping accepts that as a result of the fall of the pound against the dollar SN Overseas, TP and SN Finance received fewer dollars from the settlement of their sterling denominated Intercompany Receivables on 24 December 2008 than they would have done a year previously. He also accepts that if the pound had not fallen as much against the dollar as it did, the cash element of the consideration SN Overseas and TP provided to Smith & Nephew PLC would have been greater and share premium less. However, he does not accept that the Foreign Operation method would provide relevant information to the users of the companies accounts. This was, he said, because they were not exposed to currency fluctuations or real economic loss and that the Foreign Operation method did not reflect the underlying transactions, events and conditions whereas his preferred method, the Single Rate method did. He therefore considers that only the Single Rate method provides relevant information.

33. Mr Chopping also maintains that because of the lack of exposure to any foreign exchange loss only the Single Rate method, which would not give rise to the recognition of any such losses, could provide reliable information for users of the

accounts. However, Mr Hogarth, in his Addendum to his first Report, referred to there being "a genuine economic impact" as a result of the reorganisation which only the Foreign Operation method recognises. As such, he considers that it is that method which provides reliable information.

34. Notwithstanding Mr Chopping's view that only the Single Rate method could provide comparable information of the performance and position of the companies in 2007 and 2008 and that change in currency could have been the subject of a note to the accounts, there was no real challenge to Mr Hogarth's evidence, in the Addendum to his Report, that he did not consider the Single Rate method:

> "… to provide comparable information for users of the accounts since the Single Rate method translates balance sheets at a single rate as at the date of the change in local currency rather than the dates prevailing at those dates and thus misrepresents the value in the reporting currency (USD) of monetary assets and liabilities held at this balance sheet dates."

35. In relation to understandability, Mr Chopping accepts that a user of the accounts of SN Overseas, TP and SN Finance, prepared using the Foreign Operation method, would understand what the companies had done but said that the accounts were not understandable because the companies had not been exposed to currency fluctuations. This contrasts with Mr Hogarth's opinion that the accounts were understandable to users although he accepted that the disclosure "could have been better" and that it was not possible to say that one method was preferable to another as either was "only as good" as the explanation given in the accounts.

36. Having heard and seen the examination in chief and cross examination of both expert witness we preferred the evidence of Mr Hogarth over that of Mr Chopping. Mr Hogarth was, as Mr Rivett recognised, "a fair and helpful witness" who was willing to clarify and where necessary correct errors, eg accepting that it was the Companies Act 1985 rather than the Companies Act 2006 to which he had referred to in his Report that was applicable. In contrast Mr Chopping appeared to seek to avoid giving direct answers to questions put to him in cross examination and gave the impression, contrary to the overriding duty of an expert to help the Tribunal on matters within his expertise, of seeking to argue HMRC's case, eg his contention that because of the use of the word "business" in an example in the manual, Deloitte's guidance (that the Foreign Operation Method was the preferable and most appropriate method) was applicable to only operating and not investment companies.

37. We were also concerned with Mr Chopping's reliance on KPMG's 2007-08 manual in his Supplemental Report to counter the statement in Mr Hogarth's Report in relation to the Deloitte manual. Although it would appear that his failure to refer to the 2015-16 KPMG manual, of which he was not aware, was, to adopt the language of the penalty provisions, careless rather than deliberate, we would have expected an expert witness to have been aware of the latest guidance and ensure it was brought to our attention.

38. We therefore conclude that by adopting the Foreign Operation method the accounts of SN Overseas, TP and SN Finance do comply with UK GAAP. We find support for our conclusion not only from the evidence of Mr Hogarth but also the manuals of Deloitte, PwC and KPMG and the fact that on 13 August 2009, EY signed the audit opinion in respect of SN Overseas and TP to the effect that these companies accounts gave a True and Fair view (see paragraph 5(55), above).

Exchange losses

39. Having found that the appellants' accounts are UK GAAP compliant it is necessary to consider whether the Exchange Differences shown in them are "exchange losses" within s 103 (as set out in paragraph 15, above) which defines "exchange losses" as those:

> "… which arise as a result of comparing at different times the expression in one currency of the whole or some part of the valuation put by the company in another currency on an asset … of the company."

40. Mr Ghosh emphasised, that in comparing the value of an asset at different times, it must be remembered that nothing has happened or been done to that asset. It is the movement of exchange rates, an external factor, which gives rise to an exchange gain or loss. Once such an exchange loss has been identified, he contends that under Regulation 13(3) of the Exchange Gains & Losses (Bringing into Account etc) Regulations 2002 an amount equal to the amount of any gain "shall" be brought into account and therefore no further enquiry or consideration of the legislation is required.

41. However, Mr Rivett contends that it is necessary to consider the interpretation of "loss" in its statutory context as it is apparent from cases such as *Explainaway Ltd v HMRC* [2012] STC 2525, *Stagecoach Group Plc v HMRC* [2016] UKFTT 120 (TC) and *Union Castle Mail Steamship Company Ltd v HMRC* [2016] UKFTT 526 (TC). He says that the accounts do not necessarily completely answer the question of whether there is a loss notwithstanding the intention of the legislation to align the identification of profits and losses with their accounting treatment.

42. Mr Rivett submits that neither SN Overseas, TP nor SN Finance have suffered a loss for the purpose of the statutory provisions because they suffered no exchange rate exposure in relation to the Intercompany Receivables which were sterling assets, held in sterling companies within a sterling subgroup, with a functional currency of sterling and, with the exception of one day at the end of 2008, the functional currency was exactly the same as the assets held. He submits that all that arose were arithmetic differences which are not losses but merely a change in calibration which is confirmed by the fact that the accounts reported that the Exchange Differences were not realised losses (see paragraph 5(60), above). Also, that SN Overseas paid a dividend of £31,989,000 to SNIH on 23 December 2008 (see paragraph 5(65), above) which it could not have done if the Exchange Differences had represented a real or economic loss (see s 263 Companies Act 1985). Therefore, as in *Stagecoach* and *Union Castle* there was no actual, economic or real loss.

43. Mr Ghosh submits that in this case the exchange losses, as recognised in the companies' UK GAAP compliant accounts, arose not as the result of the application of any scheme or arrangement but because of valuations made by reference to exchange rates at different times, clearly something beyond the control of the companies concerned. We agree with him when he says that the circumstances are very different from those in *Stagecoach* and *Union Castle*. In the present case there is no question of the companies having to generate a loss by dealing in the assets which has come about by the application of the variation in foreign exchange rates and the fall in value of sterling against the US dollar over the period concerned, something entirely external to the assets and not within their control.

44. Given that an exchange loss is the comparison at different times the expression in one currency of the valuation put by the company in another currency in relation to an asset we find that it must, in essence and notwithstanding Mr Rivett's submissions to the contrary, be an arithmetical exercise. We also note that the legislation does not refer to there being any exposure to exchange rates between the two dates for there to be such a loss, just a comparison at different times first in one currency and then in another.

45. Such a comparison at different dates is not a novel concept. In *The Spanish Prospecting Company Limited* [1911] 1 Ch 92 Fletcher Moulton LJ considered the legal meaning of the word "profits" saying, at 98:

> ""Profits" implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of a gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates."

46. Therefore, as there was a fall in the value of the assets, the Intercompany Receivables, in the present case at the second date, 31 December 2008 when compared with their value as at 31 December 2007 as stated using the Foreign Operation method in what we have found to be UK GAAP compliant accounts it must follow that the Exchange Differences are exchange losses within s 103.

Fairly represent

47. Mr Rivett contends that because of the inclusion of "fairly represent" in s 84(1) a company is required to evaluate the amounts brought into account by s 85A and s 85B in its GAAP compliant accounts to ascertain whether those amounts are sums which "fairly represent" the profits, gains losses etc. This, he says, imposes an additional obligation on a company and is not a restatement of the "true and fair" requirement, had it been s 84(1) would have referred to "true and fair" rather than "fairly represent". He submits that this "fairly represent" requirement is an overarching test, a "sanity check" and is a "fail-safe" to prevent what is in effect an arithmetic difference giving rise to a loss.

48. However, we agree with Mr Ghosh that it does no such thing and find support for our view in the judgment of the Chancellor in *Greene King Plc Greene King Acquisitions Ltd v HMRC* [2016] EWCA Civ 782 where he said:

> "71. … Mr Gardiner [counsel for the appellants] referred to and relied upon the following statement in the judgment of Moses LJ in *DCC Holdings (UK) Ltd v HMRC* [2009] EWCA Civ 1165, [2010] STC 8:
>
> > "[63] Section 84(1) is the machinery by which all interest under DCC's loan relationships is brought into account. The section poses a second statutory question, namely whether any particular sum when taken together with the other sums which fall to be brought into account fairly represents all the interest including that which is the mere product of a statutory fiction. That question is different and additional to the first question, whether the sums are in accordance with an accruals basis of accounting. The introduction of that distinct additional question suggests the possibility but, I accept, not the necessity of some process of adjustment. It suggests that there may be some room or adjustment of the sums which would otherwise be given by the application of an authorised accounting method, or, at the very least suggests that in some cases the identification process in s.84(1) will not merely be resolved by an authorised accounting method."
>
> 72. Mr Gardiner described the "fairly represent" requirement as a "sanity check" for the accounting to be overridden where there is no real or commercial profit from a loan relationship.
>
> …
>
> 76. I do not accept that analysis of Mr Gardiner. In the first place, it is to be noted that in *DCC Holdings (UK) Ltd v HMRC* in the Supreme Court ([2010] UKSC 58, [2011] STC 326) Lord Walker JSC, with whom the other Justices agreed, said at [35] that he doubted Moses LJ's analysis of section 84(1) as containing two criteria, one of which was required to yield to the other. Lord Walker considered that the words in section 84(1) had to be construed as a composite whole.
>
> 77. Secondly, no evidence was given … to support Mr Gardiner's analysis. … In effect, Mr Gardiner had to advance his analysis as a matter of law. I do not consider that PLC [the appellant] can do so. What is in issue is the fair representation of credits and debits in accordance with "an authorised accounting method" for the purposes of section 84(1). There is no scope for some other method set by the court itself."

49. We also note that before the *Greene King* judgment was handed down by the Court of Appeal the Tribunal in *Union Castle* had also rejected a "fairly represent" override advanced by Mr Ghosh, then appearing for HMRC. Although these cases were, as Mr Rivett said, concerned with different statutory provisions and language to the present case, the argument that "fairly represent" created an additional overarching requirement was nevertheless clearly rejected.

50. We therefore agree with the Tribunal in *Union Castle* (see at [53] to [56]) that the words "fairly represent" have been included in the legislation for an identification and/or timing purpose to identify from entries in the accounts those credits or debits which arise, in that case from derivatives and the present case a company's loan relationships, and which entries are appropriate in a particular accounting period.

51. Accordingly, we find that the Exchange Differences do "fairly represent" a loss arising to the appellants', as defined by s 84(1), during the period ending 31 December 2008

Summary of conclusions

52. Therefore, to summarise our conclusions we find:

(1) The accounts of SN Overseas, TP and SN Finance are UK GAAP compliant;

(2) the Exchange Differences are "exchange losses" within s 103; and

(3) that they do "fairly represent" a loss arising to the appellants' during the period ending 31 December 2008 as defined by s 84(1).

53. The appeal is therefore allowed.

Appeal Rights

54. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

JOHN BROOKS
TRIBUNAL JUDGE

RELEASE DATE: 8 FEBRUARY 2017

APPENDIX

COMPANIES ACT 1995

226A Companies Act individual accounts

(1) Companies Act individual accounts must comprise–

(a) a balance sheet as at the last day of the financial year, and

(b) a profit and loss account.

(2) The balance sheet must give a true and fair view of the state of affairs of the company as at the end of the financial year; and the profit and loss account must give a true and fair view of the profit or loss of the company for the financial year.

SSAP 20 – FOREIGN CURRENCY TRANSLATION

Part 1 – Explanatory Note

Background

1. A company may engage in foreign currency operations in two main ways:

(a) Firstly, it may enter directly into business transactions which are denominated in foreign currencies; the results of these transactions will need to be translated into the currency in which the company reports.

(b) Secondly, foreign operations may be conducted through a foreign enterprise which maintains its accounting records in a currency other than that of the investing company; in order to prepare consolidated financial statements it will be necessary to translate the complete financial statements of the foreign enterprise into the currency used for reporting purposes by the investing company.

…

The individual company stage

4. During an accounting period, a company may enter into transactions which are denominated in a foreign currency. The result of each transaction should normally be translated into the company's local currency using the exchange rate in operation the date on which the transaction occurred; however, if the rates do not fluctuate significantly, an average rate for a period may be used as an approximation. Where the transaction is covered by a related or matching forward contract, the rate of exchange specified in that contract may be used.

5. Once non-monetary assets, eg plant, machinery and equity investments have been translated and recorded they should be carried in the company’s local currency. Subject to the provisions of paragraph 30 concerning the treatment of foreign equity investments financed by foreign currency borrowings, no subsequent translations of these assets will normally need to be made.

6. At the balance sheet date monetary assets and liabilities denominated in a foreign currency, eg cash and bank balances, loans and amounts receivable and payable should be translated by using the rate of exchange ruling at that date, or, where appropriate, the rates of exchange fixed under the terms of the relevant transactions. Where there are related or matching forward contracts in respect of trading transactions, the rates of exchange specified in those contracts may be used.

7. An exchange gain or loss will result during an accounting period if a business transaction is settled at an exchange rate which differs from that used when the transaction was initially recorded, or, where appropriate, that used when the transaction at the last balance sheet date. An exchange gain or loss will also arise on unsettled transactions if the rate of exchange used at the balance sheet date differs from that used previously.

8. Exchange gains or losses arising on settled transactions in the context of an individual company’s operations have already been reflected in cash flows, since a change in the exchange rate increases or decreases the local currency equivalent of amounts paid or received in cash settlement. Similarly, it is reasonably certain that

exchange gains or losses on unsettled short-term monetary items will soon be reflected in cash flows. Therefore, it is normally appropriate, because of the cash flow effects, to recognise such gains and losses as part of the profit and loss for the year; they should be included in profit and loss from ordinary activities unless they arise from events which themselves would fall to be treated as extraordinary items, in which case they should be included as such items.

9. When dealing with long-term monetary items, additional considerations apply. Although it is not easy to predict what the exchange rate will be when a long-term liability or asset matures, it is necessary, when stating the liability or the asset in terms of the reporting currency, to make the best estimate possible in the light of the information available at the time; generally speaking translation at the year-end rate will provide the best estimate, particularly when the currency concerned is freely dealt in on the spot and forward exchange markets.

10. In order to give a true and fair view of results, exchange gains and losses on long term monetary items should normally be reported as part of the profit or loss for the period in accordance with the accruals concept of accounting; treatment of these items on a simple cash movements basis would be inconsistent with that concept. Exchange gains on unsettled transactions can be determined at the balance sheet date no less objectively thane exchange losses; deferring the gains whilst recognising the losses would not only be illogical by denying in effect that any favourable movement in exchange rates had occurred bit would also inhibit fair measurement of the performance of the enterprise in the year. In particular this symmetry if treatment recognises that there will probably be some interaction between currency movements and interest rates and reflects more accurately in the profit and loss account the true results of currency movement.

11. For the special reason outlined above, both exchange gains and losses on long term monetary items should be recognised in the profit and loss account. however, it is necessary to consider on the grounds of prudence whether the amount of the gain, or the amount by which exchange gains exceed past exchange losses on the same items, to be recognised in the profit and loss account should be restricted in the exceptional cases where there are doubts as to the convertibility or marketability of the currency in question.

12. Gains or losses on exchanges arising from transactions between a holding company and its subsidiaries, or from transactions between fellow subsidiaries, should normally be reported in the individual company's financial statements as part of the profit or loss for the year in the same way as gains or losses arising from transactions with third parties.

Part 1 – Definition of terms

…

39. A company's *local currency* is the currency of the primary economic environment in which it operates and generates net cash flows.

FRS 23 – THE EFFECTS OF CHANGES IN FOREIGN CURRENCY RATES

…

Change in Functional Currency

35. ***When there is a change in an entity's functional currency, the entity shall apply the translation procedures applicable to the new functional currency prospectively from the date of the change.***

36. As noted in paragraph 13, the functional currency of an entity reflects the underlying transactions, events and conditions that are relevant to the entity. Accordingly, once the functional currency is determined, it can be changed only if there is a change to those underlying transactions, events and conditions. For example, a change in the currency that mainly influences the sales price of goods and services may lead to change in an entity's functional currency.

37. The effect of a change in functional currency is accounted for prospectively. In other words, an entity translates all items into the new functional currency using the exchange rates at the date of the change. The resulting translated accounts for non-monetary items are treated as their historical cost. Exchange differences arising from the translation of a foreign operation previously recognised through the statement of total recognised gains and losses in accordance with paragraphs 32 and 39(c) are not reclassified from reserves to profit and loss until the disposal of the operation.

USE OF A PRESENTATION CURRENCY OTHER THAN THE FUNCTIONAL CURRENCY

Translation to the Presentation Currency

38. An entity may present its financial statements in any currency (or currencies). If the presentation currency differs from the entity's functional currency, it translates its results and financial position into the presentation currency. For example, when a group contains individual entities with different functional currencies, the results and financial position of each entity are expressed in a common currency so that consolidated financial statements may be represented.

39. ***The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedures:***

> ***(a) assets and liabilities for each balance sheet presented (ie including comparatives) shall be translated at the closing rate at the balance sheet date;***
>
> ***(b) income and expenses for each income statement (ie including comparatives) shall be translated at exchange rates at the date of the transaction; and***
>
> ***(c) all resulting exchange differences shall be recognised through the statement of total recognised gains and losses.***

40. For practical reasons, a rate that approximates the exchange rates at the dates of the transactions, for example an average rate for the period, is often used to translate income and expense items. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

41. The exchange differences referred to in paragraph 39(c) result from:

> (a) translating income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate.
>
> (b) translating the opening net assets at a closing rate that differs from the previous closing rate.

These exchange rate differences are not recognised in profit or loss because the changes in exchange rates have little or no direct effect on the present and future cash flows from operations. The cumulative amount of the exchange differences is resented separately in reserves until disposal of the foreign operation. When the exchange differences relate to a foreign operation that is consolidated but not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and recognised as part of, minority interest in the consolidated balance sheet.

42. ***The results and financial position of an entity whose functional currency is the currency of a hyperinflationary economy shall be translated into a different presentation currency using the following procedure:***

> ***(a) all amounts (ie assets and liabilities) recognised through the statement of total recognised gains and losses, income and expenses, including comparatives) shall be translated at the closing rate at the date of the most recent balance sheet, except that;***
>
> ***(b) when amounts are translated into the currency of a non-hyperinflationary economy, comparative amounts shall be those that were presented as current year amounts in the relevant year financial statements (ie not adjusted for subsequent changes in the price level or subsequent changes in exchange rates).***

43. ***When an entity's functional currency is the currency of a hyperinflationary economy, the entity shall restate its financial statements in accordance with FRS 24 before applying the translation method set out in paragraph 42, except for comparative amounts that are translated into a currency of non-hyperinflationary economy (see paragraph 42(b)). When the economy ceases to be hyperinflationary and the entity no longer restates its financial statements in accordance with FRS 24, it shall use as the historical costs for translation into the presentation currency the amounts restated to the price level at the date the entity ceased restating its financial statements.***

Translation of a Foreign Operation

44. Paragraphs 45-47, in addition to paragraphs 28-43, apply when the results and financial position of a foreign operation can be included in the financial statements of the reporting entity by consolidation, proportionate consolidation or the equity method.

…

DISCLOSURE

51 ***In paragraphs 53 and 55-57 references to a 'functional currency' apply, in the case of a group to the functional currency of the parent.***

52. ***An entity shall disclose:***

> ***(a) the amount of exchange differences recognised in profit or loss except for this arising on financial instruments measure at fair value through profit or loss in accordance with FRS 26;***
>
> ***(b) net exchange differences recognised through the statement of total recognised gains and losses, and accumulated in a separate reserve, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.***

53. ***Where the presentation currency is different from the functional currency, that fact shall be stated, together with disclosure of the functional currency and the reason for using a presentation currency.***

54. ***When there is a change in the functional currency of either the reporting entity or a significant foreign operation, that fact and the reason for the change in functional currency shall be disclosed.***

55. ***When an entity presents its financial statements in a currency that is difference from its functional currency, it shall describe the financial statements as complying with Financial Reporting Standards only of they comply with all the requirements of each applicable Standard and each applicable interpretation of those Standards including the translation method set out in paragraphs 39 and 42.***

FRS 18 – ACCOUNTING POLICIES.

Summary

a. Financial Reporting Standard 18 sets out the principles to be followed in selecting accounting policies and the disclosures needed to help users to understand the accounting policies adopted and how they have been applied.

b. The FRS defines accounting policies, and estimation techniques used in implementing those policies. Accounting policies should be consistent with accounting standards, Urgent Issues Task Force Abstracts and companies legislation. Where this requirement allows a choice, the FRS requires an entity to select those accounting policies judged to be most appropriate to its particular circumstances for the purpose of giving a true and fair view.

c. An entity should judge the appropriateness of accounting policies to its particular circumstances against the objectives of relevance, reliability, comparability and understandability. The constraints that an entity should take into account are the need to balance the difference objectives, and the need to balance the cost of providing information with the likely benefit of such information to users of the entity's financial statements.

d. An entity's accounting policies should be reviewed regularly to ensure that they remain the most appropriate to its particular circumstances. An entity should implement a new accounting policy if it is judged more appropriate to the entity's particular circumstances than the present accounting policy.

e. The FRS requires specific disclosures about the accounting policies followed and changes to those policies. It also requires, in some circumstances, disclosures about the estimation techniques used in applying those policies.

Financial Reporting Standard 18

OBJECTIVE

1. The objective of this FRS is to ensure that or all material items:

> (a) an entity adopts the accounting policies most appropriate to its particular circumstances for the purpose of giving a true and fair view;
> (b) the accounting policies adopted are reviewed regularly to ensure that they remain appropriate, and are changed when a new policy becomes more appropriate to the entity's particular circumstances; and

(c) sufficient information is disclosed in the financial statements to enable users to understand the accounting policies adopted and how they have been implemented.

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ACCOUNTING POLICIES

Accounting policies and financial statements

14. **An entity should adopt accounting policies that enable its financial statements to give a true and fair view. Those accounting policies should be consistent with the requirements of accounting standards, Urgent Issue Task Force (UITF) Abstracts and companies legislation.**

15. **If in exceptional circumstances compliance with the requirements of an accounting or UITF Abstract is inconsistent with the requirement to give a true and fair view, the requirements of the accounting standard or UITF Abstract should be departed from to the extent necessary to give a true and fair view. In such circumstances, the disclosures set out in paragraph 62 should be provided.**

16. An entity will not depart from the requirements of an accounting standard or UITF Abstract where a true and fair view can be achieved by additional disclosure. In such circumstances, the requirements of the accounting standard or UITF Abstract are not inconsistent with the requirement to give a true and fair view.

17. **Where it is necessary to choose between accounting policies that satisfy the conditions in paragraph 14, an entity should select whichever of those accounting policies is judged by the entity to be the most appropriate to its particular circumstances for the purpose of giving a true and fair view.**

18. The provision of additional disclosure will not justify or remedy the adoption of an accounting policy other than that which is judged by the entity to be most appropriate to its particular circumstances for the purposes of giving a true and fair view. The appropriateness of accounting policies to an entity's particular circumstances is judged by the reference to the objectives and constraints set out in paragraphs 30 and 31.

19. Financial Statements need to reflect, in an appropriate manner and as far as is practicable, the effects of transactions and other events on an entity's financial performance and financial position. Accounting policies assist in this process by providing a framework within which elements of financial statements such as assets and liabilities, are recognised, measured and presented. They enhance the comparability of financial statements by helping to ensure that similar transactions are reflected in a similar way.

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Objectives and constraints in selecting accounting policies

30. **The objectives against which an entity should judge the appropriateness of accounting policies to its particular circumstances are:**

(a) relevance;
(b) reliability;
(c) comparability; and
(d) understandability.

31. **The constraints that an entity should take into account in judging the appropriateness of accounting policies to its particular circumstances are:**

(a) the need to balance the different objectives set out in paragraph 30; and
(b) the need to balance the cost of providing the information with the likely benefit of such information to users of the entity's financial statements.

32. Although these objectives and constraints are discussed individually below, they are considered together in judging the appropriateness of accounting policies to an entity's particular circumstances.

Relevance

33. The objective of financial statements is to provide information about an entity's financial performance and financial position that is useful for assessing the stewardship of management and for making economic decisions. Financial information is relevant if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions. Relevant information possesses either predictive or confirmatory value or both.

34. Appropriate accounting policies will result in financial information being presented that is relevant. Where more than one accounting policy would achieve this result, an entity will consider which of those policies presents the most relevant financial information in the context of the financial statements as a whole. In identifying that accounting policy, an entity will consider which measurement basis is the most relevant and how to present information in the most relevant way.

Reliability

35. Financial information is reliable if:

(a) it can be depended upon by users to represent faithfully what it purports to represent or could reasonably be expected to represent and therefore reflects the substance of the transactions and other events that have taken place;
(b) it is free from deliberate or systematic bias (ie it is neutral);
(c) it is free from material error;
(d) it is complete within the bounds of materiality; and
(e) under conditions of uncertainty, it has been prudently prepared (ie a degree of caution has been applied in exercising judgement and making the necessary estimates).

36. Appropriate accounting policies will result in financial information being presented that is reliable. They will present transactions and other events in a way that reflects their substance. A transaction or other event is faithfully represented in financial statements if the way in which it is recognised, measured and presented in those statement corresponds closely to the effect of that transaction or event.

37. Often there is uncertainty, either about the existence of assets, liabilities, gains, losses and changes to shareholders' funds, or about the amount at which they should be measured. Prudence required that accounting policies take account of such uncertainty in recognising and measuring those assets, liabilities, gains, losses and changes to shareholders' funds. In conditions of uncertainty, appropriate accounting policies will require more confirmatory evidence about the existence of an asset or gain that about the existence of a liability or loss, and a greater reliability of measurement for assets and gains than for liabilities and losses.

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Comparability

39. Information in an entity's financial statements gains greatly in usefulness if it can be compared with similar information about the entity for some other period or point in

time, and with similar information about other entities. Such comparability can usually be achieved through a combination of consistency and disclosure. The disclosures required in respect of an entity's accounting policies, and any changes to those policies, are set out in paragraph 55

40. Appropriate accounting policies will result in financial information being presented in a way that enables users to discern and evaluate similarities in, and differences between, the nature and effects of transactions and other events taking place over time. In selecting accounting policies, an entity will assess whether accepted industry practices are appropriate to its particular circumstances. Such practices will be particularly persuasive if set out in a SORP that has been generally accepted by an industry or sector.

Understandability

41. Information provided by financial statements needs to be capable of being understood by users having a reasonable knowledge of business and economic activities and accounting and a willingness to study with reasonable diligence the information provided. Appropriate accounting policies will result in financial information being presented in a way that enables its significance to be perceived by such users.