

Accounting for invoices received: court ruling and lessons for future 2/22/24



Senior Manager, Tax Reporting, Accounting
and Strategy, PwC Latvia
Juris Boiko

This article explores a court ruling that was issued after a review by the State Revenue Service (SRS) found that invoices a company had expensed in its books did not meet requirements of the Accounting Act. A tax audit found the invoices do not qualify as supporting documents because no services were provided in exchange and the invoices were prepared incorrectly. The company faced an additional corporate income tax (CIT) liability of more than EUR 5 million.

An agreement for capacity management services the company entered into with a related company had the SRS and the court debate the substance and existence of those services. Having read the agreement, the SRS and the court found it covers a very wide range of services, including administrative, technical, financial, advisory and commercial activities geared towards the company's strategic and day-to-day management. This range of services points to the fictitious nature of the transaction because the probability of a group company providing a full range of capacity management services in real business conditions should be assessed critically.

The audit found the company had formally recorded documents for receiving capacity management services from the related foreign company and understated the income chargeable to CIT. The SRS treated the transactions as shifting profits to the related foreign company (a transfer pricing adjustment). The related company's invoices had not been signed and did not mention being prepared electronically and valid unsigned. The company did not have the right to account for the invoices because the conditions under which a supporting document does not require a signature were not met under section 7.1(4) of the old Accounting Act or section 11(7) of the current Act. These clauses do not make any exceptions only because invoices have been issued by a related party. As correctly stated by the SRS, this just strengthens the finding that the documents are formal in nature because the discrepancies prevent the SRS from measuring the volume of activities stipulated by the capacity management services agreement and understanding the actual process and delivery to the customer in the particular period.

The agreement did not make any requirements for providing, accounting for, ordering, approving or controlling the services. The agreement did not make it clear what information or documents would confirm the provision of services, what data would be used, and how the documents would be prepared and signed. It was therefore concluded that the agreement is a formal one and does not reflect the real situation.

The related company's invoices did not state the volume, unit price or measurement of the services and made no reference to the agreement. The invoices could not be linked with the agreement and could not serve as the basis for setting a fee. The court agreed with the SRS's finding that the related company's invoices were not linked with the agreement because it was impossible to identify the main company's activities associated with the provision of services and there was no evidence of their volume or value.

The company said and the court agreed that any formal defects in transactional documents are not relevant as long as there is no doubt about the actual conduct of the transaction. However, since there is a

dispute over the actual conduct of the transaction, the existence of these circumstances should be assessed in conjunction with other evidence obtained and assessed in the lawsuit.

The court found the agreement was a formal one to minimise the part of profits chargeable to Latvian CIT. Looking from the hypothetical standpoint of an unrelated company, invoices issued by an independent service provider are based on costs incurred in providing the services, plus a markup.

In view of this, the SRS and the court found the company's accounting entries imply that the transactions in question have no substance and are therefore non-existent transactions aimed at shifting profits to the related foreign company. The related company's invoices do not meet the Accounting Act's requirements and cannot be treated as supporting documents.

Below are a few findings and recommendations that may help you avoid similar errors in the future:

1. Draft your agreements carefully. Describe in detail how the services will be provided and accounted for, plus any other necessary activities. Make sure that information and documents are exchanged.
2. As well as the invoice, retain any documents, statements or emails confirming that the services have been supplied/received.
3. Run internal checks to ensure your books comply with the law. Verify your active contracts and make sure the services do not overlap.
4. Consult legal and accounting experts to make sure your agreements and documents meet statutory requirements.
5. Keep your books in a way that allows a third party competent in accounting to obtain a true and fair view of your company's liabilities, assets and financial position on a given date and to follow each business transaction.
6. The CEO is responsible for keeping the books and for approving any invoices that are out of line with the Accounting Act. Revise your accounting policy to ensure it meets statutory requirements. If necessary, update the current version or draft a new one.