

## **UITF Abstract 40 - Revenue recognition and service contracts**

On 10 March 2005 the Accounting Standards Board (ASB) issued UITF (Urgent Issues Task Force) Abstract 40 (UITF 40) which is effective for accounting periods ending on or after 22 June 2005. It has a profound effect on all service providers trading as a limited company. Examples would be architects, engineers, agricultural contractors, estate agents and many others.

To summarise, in respect of service contracts, the generally accepted method of accounting for them was as follows:

- Revenue on completed work would be recognised in full, even if it had not been billed at the year end.
- Uncompleted work would be recognised as work-in-progress (WIP), represented by the costs incurred to date but not recognising any revenue (nor prospective profit) at the year end.

UITF 40 sets out further rules for accounting for revenue from service contracts. In the majority of cases, revenue for service contracts will now need to be accounted for under what is known as the “stage of completion” method. Broadly speaking, this means that if a contract is 60 per cent complete at the year end, then the supplier of services would include 60 per cent of the value of the contract in its accounts.

This method of accounting for revenue is very different to that adopted previously, where no revenue was recognised until work was completed but the provider would include costs on uncompleted work in WIP.

The result of adopting UITF 40 will be a one off uplift in declared profits in the period covered by the change in accounting basis.

### **Impact of the change**

#### *Incorporated businesses*

UITF 40 will be an element of Generally Accepted Accounting Practice as defined in TCA97 s4 for companies with accounting periods ending on or after 22 June 2005.

Typically the net effect will be to bring forward unbilled revenues to the Profit and Loss account of an earlier accounting period. Pursuant to TCA97 s76A(1), there will be a corresponding impact on the assessable profits and hence a Corporation Tax charge. For many companies this means that they will be paying tax on profits that they have not yet billed or received, and if there are insufficient funds within the company to pay a dividend, also paying a surcharge on undistributed income.

Finance Bill 2006 specifically allows the uplift in profits caused by the first time application of UITF 40 to be spread over 5 years. The Bill is silent on whether the surcharge can be spread over five years.

### *Unincorporated businesses and partnerships*

There is no similar requirement for unincorporated entities to prepare accounts to Generally Accepted Accounting Practice standards for tax purposes. Unincorporated entities may use Statement of Practice SP-IT 02/92 which allows sole traders and partnerships to use the existing method of calculation. Where you use Statement of Practice SP-IT 02/92 to calculate work in progress you will need to include an accounting policy note to say that 'The financial statements have been prepared for the purposes of calculating the tax liability of XXX' and remove all references to 'true and fair' or other accounting standards.

Where unincorporated businesses prepare accounts to reflect a true and fair view under GAAP, and are therefore preparing accounts under a conventional basis as defined in TCA97 s91(5), the provisions of TCA97 s94(3) will apply. In brief summary, TCA97 s94(3) charges the uplift in profits as a consequence of the new WIP valuation rules as a receipt under Case IV of Schedule D.

### **Tax Implications**

For Corporation Tax purposes, the changes will have effect for companies with accounts periods ending on or after 22 June 2005. Therefore there are almost immediate consequences for many companies in their computations of preliminary tax.

For Income Tax purposes, if the company chooses to prepare accounts that show a true and fair view, the changes will earliest affect the computation of preliminary tax for 2005 for those cases where the accounts for Case II purposes are made up to periods ending on or after 22 June 2005. Where they choose to prepare accounts for the purposes of calculating the tax liability there will be no effect.

### **Accounting treatment**

UITF 40 requires that you 'restate' the financial statements to reflect the change. In practice this means that for a December 2005 year end you will calculate the December 2005 work in progress based on UITF 40 and recalculate the 2003 and 2004 work in progress figures based on UITF 40. 2003 is needed to ensure that the profit and loss account for 2004 is correct. The overall increase in profits caused by the change will then be spread over five years in your tax computation.

Spreading of the tax change over five years will give rise to a deferred taxation charge of the total amount spread forward in year one (i.e. four fifths of the additional tax as one fifth will have been paid in year 1), and a deferred tax credit in year 2 to 4 of one fifth of the amount spread out.

### **Technical considerations**

An interpretation of SSAP 9 and Application Note G TO FRS 5 in relation to contracts for services was published as UITF 40 in March 2005, which stated that “Where the substance of a transaction is that the seller’s obligations are performed gradually over time, revenue is recognised as contract activity progresses to reflect the seller’s partial performance of its contractual obligations. This is the case where the substance of the obligation is ..... to require the seller to use its skills and expertise in carrying out acts that will take some time to perform, even when the output is encapsulated in a document, such as a report.” (UITF40 paragraph 18)

Where the substance of a contract is that a right to consideration does not arise until the occurrence of a critical event, revenue is not recognised until that event occurs. This only applies where the right ... is conditional ... on a specified future event, the occurrence of which is outside the control of the seller.” (paragraph 19)

Members should consider the contractual position on the range of services involved. If the contract means that the service provider will absolutely not earn the right to consideration until some particular event occurs (for example contingency fees in legal cases or in the raising of finance), then the income should not be recognised as contract activity progresses. Where the fees charged are based on the time and experience of the staff working on the assignment, then the right to consideration would appear in principle to accrue as contract activity progresses, subject to a prudent assessment of how much revenue should be recognised taking into account what the client is likely to pay. If work on an audit, a tax return or a set of accounts is 50% complete at the year end then in principle 50% of the estimated revenue should be recognised as a debtor and accrued in the accounts, whether this has been invoiced to the client or not. Service providers will therefore no longer have any work-in-progress, but in its place there will be more revenue and more debtors. This earlier recognised revenue and therefore profit will feed through as increased immediate tax liabilities of clients and practices.

#### *The IFRS option and IAS18 Revenue*

Any entity whether incorporated or not can opt to follow IFRS rather than UK / ROI GAAP. IFRS has a slightly different requirement to UITF 40.

The principle in IAS 18 is that service revenue should be recognised according to the stage of completion, that is using the percentage of completion method and therefore very much the same principles as Application note g to FRS 5 and UITF 40.

In respect of the fulfilment of particular conditions, such as the delivery of a report, IAS 18 might to some extent be different from existing UK/ROI GAAP as outlined above. Paragraph 25 says ‘For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time,

revenue is recognised on a straight line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed.'

For example the annual accounting and tax compliance service may be provided to a small business for an annual fee. Though there may be some level of contact and minor matters dealt with during the year, the completion of the accounts and the related tax return might represent such a significant act and the annual fee recognised at that point.

Members giving advice on this option should be aware that adopting IFRS would mean compliance with all IFRS (and not simply with IAS 18) and that some of the standards might involve other changes in treatments and onerous accounting measurements and disclosures.

There are some arguments about the possibility of applying the FRSSE 2005 and therefore avoiding UITF 40, and this is discussed at [http://www.accaglobal.com/pdfs/members\\_pdfs/compendium/130.pdf](http://www.accaglobal.com/pdfs/members_pdfs/compendium/130.pdf) . The feasibility of using the FRSSE is not certain and at best it may only be a temporary measure.

#### **Mitigation factors where UK/ROI GAAP is applied**

Tax spreading is discussed above, but prompt billing and interim billing will also mitigate the problems. SSAP 9 also requires that you use prudence to calculate long term work in progress.

The value of the long term contract balances should not be overstated. SSAP 9 includes guidance to try to ensure that the level of attributable profit on long term contracts is estimated prudently. So for example it states that

No attributable profit can be recognised until the profitable outcome can be assessed with reasonable certainty.

- There will be a point in any contract before which no profit should be recognised and that decision should take into account the nature of the business concerned
- Any attributable profit should be calculated on a prudent basis taking in all estimated costs to complete
- Income from variations in the service provided should be recognised prudently and only when there is sufficient evidence of acceptability to the customer.

It should be noted that attributable profit must be based on full expected sales value less estimated costs and that for unincorporated businesses these costs will generally exclude partner/owner time.

#### *Changes in contractual terms*

Application note G to FRS 5 and UITF 40 depend on the service provider having a right to consideration as the service is provided and not simply upon completion of the contract. This would for example often be the case with standard engagement letters for accounting services. It would be possible to alter the terms of future engagements so that specifically no consideration arose until delivery of reports to clients. Any such change could not be retrospective and so the initial impact of UITF 40 cannot be avoided in this way and it could only affect future years. Members should be aware that though this might help to mitigate the future tax effect of UITF 40, it might have other unintended adverse financial consequences including the ability to charge for example when

- engagements were terminated part way through because of insolvency,
- a change of ownership or for other commercial reasons

Brendan Murtagh FCCA

Member of ACCA Council and partner in LHM Casey McGrath, Chartered Certified Accountants.