

Technical Factsheet 128

UITF Abstract 40 – Revenue Recognition and Service Contracts



Important information for members in public practice, and those working with or for businesses which provide services, has been published. ACCA has issued detailed guidance, consisting of the following sections:

- Overview
- ACCA view
- Effect of FRS 5 Application Note G and UITF Abstract 40
- Identification
- Prior Year Adjustment - accounts
- Calculation
- The continuing debate - alternative arguments and accounts treatment
- Alternative procedures to reduce the impact
- Questions (and answers)
- Appendix 1: ITTOIA 2005 for adjusted
- Appendix 2: Feedback form

OVERVIEW

The Accounting Standards board has stated:

“Urgent Issues Task Force (UITF) Abstract 40 ‘Revenue recognition and service contracts’, giving guidance on the recognition of turnover derived from contracts for professional and other services.

The Abstract was developed in response to requests that the UITF should clarify how the relevant accounting standards FRS 5 Application Note G ‘Revenue Recognition’ (issued in November 2003) and SSAP 9 ‘Stocks and long-term contracts’ (last revised in 1988) should be applied in respect of contracts for services that are not accounted for as long-term contracts. The main point at issue is when the applicable accounting literature requires or allows revenue to be recognised as contract activity progresses or on contract completion.

The Abstract explains that as a matter of principle there is no difference between the accounting required for long-term contracts and other contracts for services. The overriding consideration is whether the seller has performed, or partially performed, its contractual obligations. A principal conclusion of the Abstract is that where the substance of a contract is that the seller’s contractual obligations are performed gradually over time, revenue should be recognised as contract activity progresses to reflect the seller’s partial performance of its contractual obligations. In these circumstances it is inappropriate to defer recognition of revenue until contract completion.”

As you will have noted the Abstract needs to be adopted for periods ending on or after 22 June 2005. The ASB interpretation above will impact on accounting treatment of service contracts assuming the Inland Revenue follow the UITF practitioners’ and clients’ taxable profits.

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A basic overview of relevant accounts and tax treatment can be summarised as:

Revenue Recognition – Accounts

The Abstract details the rules for accounting for revenue from service contracts. In most cases, revenue for service contracts will now need to be accounted for under what is known as the 'stage of completion' method. In very simple terms, this means that if a contract is in progress at the year end, then the supplier of services would include the proportion undertaken to that date in its accounts. So if the contract is 75% complete, 75% of the contract value will be recorded in the accounts.

Implications of adopting UITF 40

Declared profits in the period covered by the change in accounting basis will increase. For tax purposes, the full amount of the uplift will be treated as arising (for income tax purposes) on the last day of the accounting period and will be subject to tax in that year as 'adjustment income'. The effect is that a one-off uplift in reported profits leads directly to a one-off uplift in the tax charge.

For service providers, the cash flow impact of a single charge will result in financial difficulties, and in some cases could force businesses to cease trading. This problem will be most acute for service providers where most of the revenue is earned by the owners rather than the employees or sub-contractors.

ACCA VIEW

When Application Note G (ANG) to FRS 5 came out, though we had opposed its publication, we concluded that it would not change substantially the existing treatments of many of our members in practice. ACCA put a note on its website setting out how it thought the Abstract applied (this was also circulated to members in practice). Work which in substance was for the delivery of a report, for example, such as tax advice, a tax return or audit should be recognised when that delivery took place.

In November 2004 the UITF published for comment a draft abstract on ANG and professional services. This distinguished between contracts for professional services treated as long-term contracts and those that are not. About the latter it said:

“Under a contract that is not accounted for as a long-term contract, revenue should be recognised as the seller's performance takes place. In some cases performance may take place as the work is carried out. Where, as is often the case, the substance of the contract is for the supply of time, this will reflect the time spent on the contract. In other cases, performance may take place on delivery and acceptance of an output, depending on the commercial substance of the agreement with the customer.”

ACCA's response was to challenge UITF on the phrase 'as is often the case' and emphasise the importance of delivery and acceptance of output for much of this sort of work. Again the proposals did not appear to imply a significant change from much current practice.

When UITF Abstract 40 was published in March 2005 crucial changes had been made to the text. The distinction between those contracts treated as long term and those that were not, had gone. It now stated much more generally 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 ...

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.”

The delivery of a report is not a conditional event to determine revenue recognition. Therefore, in effect UITF Abstract 40 is requiring a substantial number of service contracts to be treated as long term contracts. For long-term contracts in SSAP 9 there is often no work in progress as such, but debtor ‘amounts recoverable under contracts’. Where various prudential conditions have been met the measurement principle is the lower of net realisable value and cost plus attributable profit.

While it has been ACCA’s view that the meaning of UITF Abstract 40 is clear, there is a difference between agreeing that it is unambiguous and agreeing that it sets out the best treatment.

However, it has been published. It forms part of the body of guidance which helps to define what is meant by a true and fair view. Specifically the foreword to the UITF Abstracts states that:

“The Councils of the CCAB bodies expect their members who assume responsibilities in respect of financial statements to observe UITF Abstracts until they are replaced by accounting standards or otherwise withdrawn by the ASB.”

At present ACCA is approaching several organisations and preparing to approach HMRC in conjunction with other members of CCAB, if possible, with representative bodies of other service providers.

EFFECT OF FRS 5 APPLICATION NOTE G and UITF ABSTRACT 40

FRS 5 Application Note G impacts on all businesses that enter into contracts to provide services over a period of time. The Abstract requires revenue to be “recognised as the contract progresses to reflect the seller’s partial performance of its contractual obligations”. The Abstract states “the amount of revenue should reflect the accrual of the right to consideration as contract activity progresses by reference to the value of work performed”. Where contracts straddle a year end the Abstract states that it should be “accounted for as a long-term contract where contract activity falls into different accounting periods and it is concluded that the effect is material”.

Businesses that are affected will need to consider the extent to which income has been earned in respect of contracts that are incomplete at the year end and recognise this, including any profit element in the profit and loss account, together with any consequential tax liability. If appropriate, prior year comparatives should also be restated.

The interpretation set out in UITF 40 will need to be taken into account by all businesses when preparing accounts for periods ending on or after 22 June 2005 under UK GAAP. Bearing in mind that the Inland Revenue follows UK GAAP, it also appears reasonable to assume that tax treatment will follow the accounting treatment as suggested above. In effect, adoption of the accounting standard will probably see an advancement of profits with a consequential earlier liability to tax. A ‘one-off’ cost will arise to business.

However, at all times when considering application of UITF 40 you need to refer back to SSAP 9 and long term contract accounting and ensure when calculating amounts due under contracts not completed you consider, for example, that:

- prudently calculated profit should be recognised when the outcome of the contract can be assessed with reasonable certainty
- there will be a point before which no profit should be recognised
- it is necessary to take into account costs to complete
- income from approved variations needs to be conservatively assessed.

These considerations also apply to IAS 18 and are compatible with the Abstract.

UITF Abstract 40 can be downloaded from FRC's website at: www.apb.org.uk/asb/uitf/pub0758.html.

IDENTIFICATION

UITF Abstract 40 will need to be reviewed for a large number of clients. It has greatest impact on any proprietor who contributes a high percentage of the contract value.

For example:

Sales value £5,000

Cost

Partner time (notional charge out rate £100ph, hours expected 30) actual cost nil

Employees actual cost £1,500

Overhead actual cost £ 500

Time taken

Employees – 100%

Partners – 50%

Pre abstract

WIP £2,000 (£1,500 + £500)

Post abstract

Debtors: amounts due under contracts not yet invoiced
£3,500 (sales value £5,000 less (£100x(30hrs50%))

Increase of £1,500 (£3,500 - £2,000)

Listed below are VAT trade classifications to assist you in identifying clients or groups of clients affected by the Abstract. It is not comprehensive and the Abstract will apply to some and not all business activities listed below.

VAT trade classification

Agriculture and related services

Group 11, 12, 13, 14, 15, 20, 50

Publishing, printing and services

Group 221, 222, 223

Other transport equipment

Group 351

Construction

Group 451, 452, 453, 454, 455

Maintenance of motor vehicles and motorcycles

Group 502, 504

Wholesale trade and commission trade

Group 511

Repair of personal household goods

Group 527

Transport

Group 601, 602, 603, 611, 612

Travel agencies and other activities

Group 631, 632, 633, 634

Post and courier

Group 641

Financial intermediation, insurance and related activities

Group 651, 652, 660, 671, 672

Real estate

Group 701, 703

Computer and related activities

Group 721, 722, 723, 724, 725, 726

Research and development

Group 731, 732

Other business activities

741 Legal and accounting activities –

Patent and copyright agents

Barristers

Solicitors

Other legal (including arbitrators)

Accountancy

Tax services

Management consultancy

Market research

Advertising

Public relations

Financial consultancy

Business consultancy

Group 742 Architectural and engineering activities and related consultancy

Group 743 Technical testing and analysis

Group 744 Advertising

Group 745 Labour

Group 746 Investigation and security activities

Group 747 Industrial cleaning

Group 748 Miscellaneous business activities

Education – including driving schools

Group 801, 802, 803, 804

Health and social work – including Doctors, Dentists, Vets

Group 851, 852, 853

Activities of membership organisations

Group 911, 912, 913

Other service activities

Group 930.

This list illustrates how large the potential groups of clients affected by this Abstract is. You will also be aware of clients who may have secondary trades falling within the scope of the Abstract.

The key for all businesses will be to look for anyone involved in provision of services, no matter how remote this seems. For example, depending on the contract restoration work (for example furniture or building

restoration), design (clothing or artwork) or other contract supplies where the end result includes service (bespoke tailors) seemingly fall within the definition.

PRIOR YEAR ADJUSTMENT – ACCOUNTS

Where application of UITF 40 represents a change in accounting policy, by definition the effect is material, so comparative figures will need to be restated giving rise to a Prior Year Adjustment. As with any Prior Year Adjustment it should be clear from the accounts produced that they have been restated.

Example journals can be found later in this guidance.

The following course of action will be required:

- review WIP for prior years (both opening and closing balances for the prior year), amend for contracts in progress
- review any goodwill currently included in the balance sheet, amortised or written off. Amend for any historical contracts in progress. (Any adjustment to WIP will result in a revision of fair value of assets used for any prior year goodwill calculation)

If prior year amounts cannot be reliably estimated then, after considering Rulebook – Code of Ethics Fundamental Principles and requirements to comply with standards, consider inserting the following note in the year-end accounts, suitably amended to take into account any relevant business facts:

Unaudited accounts

The note below may be used where accounts may be seen by any third party.

Note to the accounts

UITF Abstract 40 issued by ASB changes the previously recognised accounting practice of recording firms' partly completed contracts. Any change of this nature requires last year's figures to be retrospectively restated. Due to [records not being available to assess contract completion, complexity, unreliability of alternative methods and/or burden on the business] the [directors/partners/proprietor] are unable to reliably estimate the restatement.

Using previously recognised methods of accounting, the profits' for the current and comparative year were £.... and £....The current year's profit on the revised basis adopting UITF Abstract 40 is £.... The comparative and current years' profits have been calculated using different accounting rules and consequently in the opinion of the [directors/partners/proprietors] they are not an accurate reflection of the business profits, nor a basis on which analytical review of comparatives can be assessed. The balance sheet has been drawn up using the revised rules and consequently will form the basis for future years' profits.

For Unaudited company accounts consider adding

The Directors acknowledge their obligation to prepare accounts for each financial year which give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period.

For the reasons noted above the Directors have been unable to comply with the requirements set out in UITF Abstract 40.

Unaudited accounts – Prior Year Adjustment note

If you have adjusted for UITF Abstract 40 amending contracts, WIP and goodwill if applicable, consider inserting the following note in the accounts:

Note to the accounts - Prior year adjustment

The accounts have been restated to incorporate the impact of UITF Abstract 40 issued by ASB. This change sets out rules for accounting for revenue from service contracts. In the majority of cases, revenue from service contracts will now need to be accounted for under what is known as the 'stage of completion' method. In very simple terms, this means that if a contract is 75% complete at the year end, then the supplier of services would include 75% of the value of the contract in its accounts. The previous accounting treatment recognised the amounts as work in progress at the lower of cost or net realisable value. The change has resulted in profits available for distribution increasing after tax by £....

Summary of the prior year accounting impact	£
Reduction in Stock – Work in progress	(X)
Increase in Debtors – Amounts due under contracts	X
Increase in Creditors – Corporation tax	(X)
Prior year adjustment – increase in distributable profits	X
Amend for any amounts falling due in more than one year.	

Audited Accounts – SAS 450 consideration

SAS 450 Opening balances and comparatives should be reviewed for all audits.

Auditors will have to consider issuing a qualified Audit Report where applicable for non-compliance with UITF Abstract 40.

For periods commencing after 15 December ISA (UK and Ireland) 510 Initial engagements – opening balances and continuing engagements – opening balances and ISA (UK and Ireland) 710 Comparatives should be reviewed.

CALCULATION

Using time records, WIP lists, diary notes, after date invoices or your usual source to prepare a list of active clients with details of the value of any work undertaken at the year end (this is likely to be similar to your previous years WIP listing). Remove from the list (as at the year end) any completed work not yet billed for inclusion in Debtors – accrued income.

- exclude any balances considered to be uncertain. For example – if no contract exists, contracts detailing a critical event, factors not within the control of the client
- write off irrecoverable balances and insignificant amounts – Remember SSAP 9 comments:
 - prudently calculated profit should be recognised when the outcome of the contract can be assessed with reasonable certainty; and there will be a point before which no profit should be recognised
- assess stage to completion, using time records, WIP lists, diary notes or any other source. In certain cases you may need to use the firm's historical recovery records, or amounts written off. Remember to take into account any costs to complete. [Account for any expected loss (as per long term contract requirements) at the earliest point and spread value of service over amount to complete]
- calculate value of Debtors: amounts due under contracts not yet billed
- note all key reasons for decisions and any assumptions made as this may assist with any future enquiry with HMRC.

You may wish to record the suggested items above in a simple spreadsheet:

Value of amounts billed under contracts not yet billed				
Client name	WIP	Completed work unbilled	Uncertain recovery	Irrecoverable amounts
	£	£	£	£
	x	(x)	(x)	(x)

Value of amounts billed under contracts not yet billed (cont)		
Stage to completion	Amounts due under contracts not yet billed	Notes
%	£	
x	X	

Journals required

The figures calculated using the spreadsheet above, can be inserted into the journals noted below.

The current year and prior year journals have been noted below – suggested prior year journals are numbered 2-5. For prior year both the opening and closing WIP will require adjustment.

Any impact on profit share or goodwill calculations will also require a prior year adjustment. Using the definition of purchased Goodwill ((FRS 10) “The difference between the cost of an acquired entity and the aggregate of the fair values of that entity’s identifiable assets and liabilities.”), uplifts of fair values (change from WIP to amounts due under contracts) will result in recalculation of goodwill.

Reference	Description	Account	DR	CR
1	Amounts due under contracts not yet invoiced, UITF abstract 40 calculation Spreadsheet reference ...	Debtors: Amounts due under contracts - not yet invoiced	X	
1	Amounts due under contracts not yet invoiced, UITF abstract 40 calculation Spreadsheet	Profit and Loss Account - Turnover		X

	reference ...			
2	Prior year adjustment Amounts due under contracts not yet invoiced, UITF abstract 40 calculation Spreadsheet reference ...	Debtors: Amounts due under contracts - not yet invoiced	X	
2	Prior year adjustment Amounts due under contracts not yet invoiced, UITF abstract 40 calculation Spreadsheet reference ...	Profit and Loss Account - Turnover		X
3	Prior year adjustment Tax on Uplift of Cost of open contracts to Value of work performed	Profit and Loss Account - Taxation	X	
3	Prior year adjusted Tax on Uplift of Cost of open contracts to Value of work performed	Creditors - Corporation Tax		X
4	Prior year adjustment WIP	Profit and Loss Account - WIP closing	X	
4	Prior year adjustment WIP	Balancesheet - WIP		X
5	Prior year adjustment WIP	Profit and Loss Account - WIP opening	X	
5	Prior year adjustment WIP	Retained profit/partner profit share (agreed allocation for existing partners)		X
6	Current year opening figures Adjusted for prior year adjustment	Profit and loss account - Turnover - opening Debtors:	X	

		Amounts due under contracts - not yet invoiced		
6	Current year opening figures Adjusted for prior year adjustment	Prior year adjustment Retained profit/partner profit share (agreed allocation for existing partners)		X
6	Current year opening figures Adjusted for prior year adjustment	Creditor – corporation tax		X
6	Current year opening figures Adjusted for prior year adjustment Opening WIP reduced to reflect the change	Profit and loss account – Opening WIP		X

THE CONTINUING DEBATE – ALTERNATIVE ARGUMENTS AND ACCOUNTS TREATMENT

Following the issuing of UITF Abstract 40, many commentators have suggested alternative accounting treatments to those contained within the Abstract. A selection of the comments can be found below.

For Unincorporated Entities Ignore UITF 40

Any accounts prepared for tax purposes are required by the Inland Revenue to be prepared on a 'true and fair' basis, following generally accepted accounting standards i.e. UITF 40. The UITF forms part of the body of guidance which helps define what is meant by 'true and fair'. You should assume accounts not prepared on this basis will be subject to investigation by HMRC.

Adoption of the FRSSSE

UITF 40 does not itself apply to entities using the FRSSSE.

For accounting periods which began on or after 1 January 2005 the relevant sections in the FRSSSE (January 2005 version) must be followed, particularly:

- paragraph 4.3 – “Where a seller has partially performed its contractual obligations, it recognises revenue to the extent that it has obtained the right to consideration through its performance” - i.e. virtually identical to ANG
- the definition of a long term contract, which is essentially the same as in SSAP 9 noted above.

FRSSSE users have to consider whether the second (SSAP 9) extract is not really requiring them to do what has already been made clear in UITF Abstract 40.

There is also in the non-mandatory Appendix 3 'guidance' which brings in UITF Abstract 40's key points.

Does the FRSSSE in any case require preparers to consider FRS and UITF when using and interpreting the FRSSSE? It would seem not in this case. Paragraph 4 of the Status of the FRSSSE says:

“For transactions or events not dealt with in the FRSSSE, smaller entities should have regard to other accounting standards and UITF Abstracts, not as mandatory documents, but as a means of establishing current practice”.

In this case the FRSSSE does deal with revenue recognition and so strictly speaking UITF 40 does not need to be considered.

For any year ends that start before 1 January 2005, the June 2002 version of the FRSSSE should be used. This includes the definition of long term contracts but no extract from ANG. The true and fair requirement, however, would mean its general principles should be considered as current practice.

In conclusion, when preparing accounts in compliance with the FRSSE, the definition and other requirements concerning long term contract accounting that derive from SSAP9 and the provisions of FRS 5 Application Note G must be applied. Any specific extra guidance from UITF40 need not be applied for now.

Adoption of International Accounting Standards

UK companies and LLPs can opt to follow IFRS rather than UK standards. This option is to use one set or the other and would not allow entities to follow some IAS and not others.

In the ASB's technical plan for the convergence of UK standards with IAS the current intention is to issue IAS 18 as a UK standard by the end of 2005 replacing FRS 5's Application Note G (and so also presumably UITF 40).

The principle in IAS18 is that service revenue should be recognised according to the stage of completion, that is, using the percentage of completion method. ASB's view is that UITF Abstract 40 and Application Note G are broadly comparable to IAS 18 in this regard.

However, in two particular respects IAS 18 might be different from existing UK GAAP as outlined above. First, all of the following specific conditions have to be met:

- the amount of revenue can be measured reliably
- it is probable that the economic benefits associated with the transaction will flow to the entity
- the stage of completion of the transaction at the balance sheet date can be measured reliably
- the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

When not all of these are met and therefore the outcome cannot be estimated reliably, revenue is recognised only to the extent of the expenses recognised that are recoverable.

During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the transaction costs incurred. Therefore, revenue is recognised only to the extent of costs incurred that are expected to be recoverable.

Second, on the question of fulfilment of particular conditions, such as the delivery of a report perhaps, 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”.

In conclusion, though the broad principles of IAS 18 are similar to UK GAAP, the more detailed conditions make the two potentially different. Any entity adopting IFRS to avoid some of the consequences of UITF Abstract 40 though able to use IAS 18, would have to comply with all other relevant international standards.

Amendment to Contracts for Services

Removal of any right to monies, so any amounts due are only receivable under the contract on delivery of report or return.

This approach may provide some scope for avoiding accounting and tax consequences of UITF Abstract 40 although it carries some potentially serious commercial risks for the client. Principal amongst these risks is that to be effective the contract will need to provide for payment only being made on the occurrence of a critical event in the future that is outside the control of the service provider.

ALTERNATIVE PROCEDURES TO REDUCE THE IMPACT

The impact of the UITF will result in many businesses considering alternatives to mitigate the impact of UITF pronouncement.

Revise Billing Procedure

Many businesses will have to reconsider billing frequency. Service contract billing should be undertaken as work progresses, for many clients this will be a significant change.

Businesses who provide services will need, as a result of UITF Abstract 40 to consider monthly or quarterly billing. The aim is to reduce unbilled work and improve cashflow for those businesses.

Incorporation of Unincorporated Businesses

If the business currently operates as a sole practitioner or partnership and the principals are paying tax at 40%, transferring the business to a limited liability company may reduce effective tax rates. Other matters will of course also need to be considered.

Any transfer will also have to reflect UITF Abstract 40, plus any valuation of the business will need to consider impact of the change. If using profits as a basis for valuation these will need to be adjusted to ensure they are comparable.

Changing the Accounting Reference Date

It may be possible to defer adoption of UITF Abstract 40 by suggesting a new accounting reference date. An enquiry should be made and the impact on all areas of changing the accounting year needs to be assessed. Recommending this option should be considered only as part of a total review and not as a short term deferral option.

Adoption of the FRSSE

As discussed above, arguably deferral may also be achieved by the adoption of the FRSSE by those companies entitled to apply it in preparing their accounts.

Remember SSAP 9

At all times when considering application of UITF Abstract 40 you need to refer back to SSAP 9 and long term contract accounting and ensure that when calculating amounts due under contracts not completed you consider, for example, that:

- prudently calculated profit should be recognised when the outcome of the contract can be assessed with reasonable certainty
- there will be a point before which no profit should be recognised
- it is necessary to take into account costs to complete
- income from approved variations needs to be conservatively assessed

When the outcome cannot be estimated reliably, revenue is recognised only to the extent of the expenses recognised that are recoverable. During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the transaction costs incurred.

Therefore, revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the transaction cannot be estimated reliably, no profit is recognised. When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognised and the costs incurred are recognised as an expense.

QUESTIONS

What is the key aim of UITF Abstract 40?

The key aim is included in paragraph 26:

“When the substance of a contract is that the seller’s contractual obligations are performed gradually over time, revenue should be recognised as contract activity progresses to reflect the seller’s partial performance of its contractual obligations. The amount of revenue should reflect the accrual of the right to consideration as contract activity progresses by reference to value of the work performed”.

What businesses are affected by the Abstract?

All businesses supplying services via a contract for services will need to review the impact of the Abstract. A list of some of the affected businesses can be found in the guide.

The UITF Abstract will result in items previously held as work in progress now being classified as contracts due for completion. What is the likely impact on businesses?

ACCA has conducted a telephone survey of members with the following results:

	Percentage Increase (%)
Solicitors	30 to 500
Accountants	minimal to 400
Architects	100
Plumbers	minimal
Engineers	20 to 300
Doctors	minimal to 100
Dentists	minimal to 400
Farmers (including contracting)	minimal to 500
Barristers	100.

(The percentage increase shows the expected uplift from WIP to Debtors - amounts due under contracts not yet invoiced.)

Is SSAP 9 changed by the Abstract?

Paragraph 2 of the Abstract states “the term ‘accounted for as a long term contract’ refers to the method described in SSAP 9 ‘Stocks and long-term contracts’ of recognising revenue as contract activity progresses”.

As previously mentioned when considering the impact of UITF Abstract 40 the SSAP 9 requirements:

- prudently calculated profit should be recognised when the outcome of the contract can be assessed with reasonable certainty
- there will be a point before which no profit should be recognised
- it is necessary to take into account costs to complete
- income from approved variations needs to be conservatively assessed

Does the Abstract change the treatment of completed work not yet invoiced?

The treatment of completed work not yet billed remains unchanged. The amounts will be recognised as Debtors – Prepayments and accrued income.

I issue bills every six months, how do I treat unbilled amounts?

The services provided are likely to represent separate transactions. Each of these separate transactions will need to be considered. The accounting treatment will be:

- completed work not yet invoiced will need to be treated as Debtors – Prepayments and Accrued Income
- partly completed work will need to be further reviewed and included as Debtors – Amounts Recoverable on Contracts.

How should I explain the change to my clients?

The ASB interpretation – UITF Abstract 40 will impact on accounting treatment of service contracts and, assuming the Inland Revenue follow the UITF, practitioners' and clients' taxable profits.

1 Revenue Recognition - Abstract 40

This sets out 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. In very simple terms, this means that if a contract is 60% complete at the year end, then the supplier of services would include 60% of the value of the contract in its accounts.

2 Implications of adopting UITF 40

There will be a one off uplift in declared profits in the period covered by the change in accounting basis. For tax purposes, the full amount of the uplift will be treated as arising (for income tax purposes) on the last day of the accounting period and subject to tax in that year as 'adjustment income'. The effect is that a one-off uplift in reported profits leads directly to a one-off uplift in the tax charge.

For Incorporated businesses this applies for periods ending on or after 22 June 2005. For 30 June year ends any tax would be due on 1 April 2006.

Under ITTOIA 2005 the sum would be entered in the tax return for 2005/06, with tax payable by 31 January 2007.

The above is intended as a guide and does not look at instalment payments, short periods or any alternative treatment agreed with HMRC.

3 Cash flow

The business will face a payment of tax in respect of the change (this may be reduced subject to any successful

negotiation). The working capital requirement, for most businesses cash availability, will need to be factored into this one off possible tax charge. Accordingly cash flow forecasts and business plans will need to be prepared for this purpose

Should I issue clients a separate letter to show the impact UITF Abstract 40 may have?

You will need to keep your clients informed. Use your normal method of communication, phone, letter, email, newsletter or meetings. A proforma text to insert in any communication has been produced below.

Proforma text

Important information: The following change may impact on your accounts and increase the tax you owe.

The following change needs to be adopted for periods ending on or after 22 June 2005. The ASB interpretation of revenue recognition (UITF Abstract 40) will impact on accounting treatment of any service contract and assuming the Inland Revenue follow the UITF your taxable profits.

A basic overview of relevant accounts and tax treatment can be simply summarised as:

Revenue Recognition – Accounts

The Abstract details the rules for accounting for revenue from service contracts, so will effect any provision of services you are undertaking but haven't invoiced in full. In most cases, revenue for these service contracts will now need to be accounted for under what is known as the 'stage of completion' method. In very simple terms, this means that if a contract is in progress at the year end, then the supplier of services would include the proportion undertaken to that date in its accounts. So if the contract is 75% complete, 75% of the contract value will be recorded in the accounts.

Tax implications of adopting UITF 40

Declared profits in the period covered by the change in accounting basis will increase. For tax purposes, the full amount of the uplift will be treated as arising (for income tax purposes) on the last day of the accounting period and will be subject to tax in that year as 'adjustment income'. The effect is that a one-off uplift in reported profits leads directly to a one-off uplift in the tax charge.

For service providers, the cash flow impact of a single charge will result in financial difficulties, consequently I would advise you to plan for this now. This problem will be most acute for service providers where most of the revenue is earned by the owners rather than the employees or subcontractors.

The following example highlights the impact

Sales value £5,000

Cost

Partner time (notional charge out rate £100ph, hours expected 30) actual cost nil

Employees actual cost £1,500

Overhead actual cost £ 500

Time taken

Employees – 100%

Partners – 50%

Pre abstract

WIP £2,000 (£1,500 + £500)

Post abstract

Debtors: amounts due under contracts not yet invoiced
£3,500 (sales value £5,000 less (£100x(30hrs50%))

Increase of £1,500 (£3,500 - £2,000)

As you will realise the impact on UK business is great and discussions are being undertaken to reduce this impact. However, because of the potential impact and concern it

may cause in the financial community, I suggest you or you with our assistance review how your business will suffer under the treatment.

Will incoming partners joining a firm now be affected by the change?

Unless the partnership agreement specifies an alternative treatment, incoming partners' share of profits would be based on profit for the year, this will reflect the opening and closing adjustments to profit and loss account in respect of Debtors Amounts due under contracts not yet billed.

However, partners leaving in the current or prior year and partners joining in prior years will need to review any partnership agreement made to assess how the following will be treated:

- uplift caused by PYA: this may be treated as a one off charge to income
- how prior year adjustments profit share should be treated
- how revisions to capital or current accounts or actual or notional goodwill should be adjusted.

Should I issue a separate letter of engagement to clients if I undertake work for clients?

A separate letter of engagement should be issued for any request to assess the impact UITF Abstract 40 will have, first period calculations or system changes. In addition to standard terms the letter should include a suitable limitation of liability clause and a comment regarding the possibility of investigations by HMRC.

A sample letter for ACCA members can be obtained from ACCA UK's Technical Advisory Service by calling 020 7059 5920.

What will be the tax treatment?

We are approaching several organisations and are preparing to approach HMRC in conjunction with other members of CCAB, if possible, with representative bodies of other service providers. As mentioned in the guidance any information you can provide about the effect on you or your clients will assist.

ITTOIA 2005 for adjusted income has been reproduced for your information, see Appendix One.

Technical Factsheet 128

Issued 06/05

APPENDIX I: ITTOIA 2005 FOR ADJUSTED

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

CHAPTER 17 – ADJUSTMENT INCOME

Introduction

226 Professions and vocations

The provisions of this Chapter apply to professions and vocations as they apply to trades.

Adjustment on change of basis

227 Application of Chapter

- (1) This chapter applies if:
 - (a) a person carrying on a trade changes, from one period of account to the next, the basis on which profits of the trade are calculated for income tax purposes,
 - (b) the old basis accorded with the law or practice applicable in relation to the period of account before the change, and
 - (c) the new basis accords with the law and practice applicable in relation to the period of account after the change,

but does not apply to income which is charged in accordance with section 832 (relevant foreign income charged on the remittance basis).

- (2) The practice applicable in any case means the accepted practice in cases of that description as to how profits of a trade should be calculated for income tax purposes.
- (3) A person changes the basis on which profits of a trade are calculated for income tax purposes if the person makes-

- (a) a relevant change of accounting approach (see subsection (4)), or
- (b) a change in the tax adjustments applied (see subsections (5) and (6)).

(4) A "relevant change of accounting approach" means a change of accounting principle or practice that, in accordance with generally accepted accounting practice, gives rise to a prior period adjustment.

(5) A "tax adjustment" means any adjustment required or authorised by law in calculating profits of a trade for income tax purposes.

- (6) A "change in the tax adjustments applied"-
- (a) does not include a change made in order to comply with amending legislation not applicable to the previous period of account, but
 - (b) includes a change resulting from a change of view as to what is required or authorised by law or as to whether any adjustment is so required or authorised.

228 Adjustment income and adjustment expense

- (1) An amount by way of adjustment must be calculated in accordance with section 231.
- (2) If the amount produced by the calculation is positive, it is treated as income and charged to income tax under this Chapter.

It is referred to in this Chapter as "adjustment income".

- (3) If the amount produced by the calculation is negative, a deduction is allowed for it in calculating the profits of the trade.

It is referred to in this Chapter as an "adjustment expense".

- (4) This section is subject to section 234 (no adjustment for certain expenses previously brought into account).

229 Income charged

- (1) Tax is charged under this Chapter on the full amount of any adjustment income arising in the tax year.
- (2) This is subject to-
 - (a) sections 237 to 239 (which provide for spreading of adjustment income), and
 - (b) Part 8 (foreign income: special rules).

230 Person liable

The person liable for any tax charged under this Chapter is the person receiving or entitled to the adjustment income.

231 Calculation of the adjustment

The amount of the adjustment is calculated as follows.

Step 1

Add together any amounts representing the extent to which, comparing the two bases, profits were understated (or losses overstated) on the old basis.

The amounts are:

	<i>Amounts</i>
1	Receipts which on the new basis would have been brought into account in calculating the profits of a period of account before the change, so far as they were not so brought into account.
2	Expenses which on the new basis fall to be brought into account in calculating the profits of a period of account after the change, so far as they were brought into account in calculating the profits of a period of account before the change.
3	Deductions in respect of opening trading stock or opening work in progress in the first period of account on the new basis, so far as they- (a) are not matched by credits in respect of closing trading stock or closing work in progress in the last period of account before the change, or (b) are calculated on a different basis that if used to calculate those credits would have given a higher figure.
4	Amounts recognised for accounting purposes in respect of depreciation in the last period of account before the change, so far as they were not the subject of an adjustment for income tax purposes, where such an adjustment would be required on the new basis.

Step 2

Then deduct any amounts representing the extent to which, comparing the two bases, profits were overstated (or losses understated) on the old basis.

The amounts are:

	<i>Amounts</i>
1	Receipts which were brought into account in a period of account before the change, so far as they would not have been so brought into account if the profits had been calculated on the new basis.

2	Expenses which were not brought into account in calculating the profits of a period of account before the change, so far as they- (a) would have been brought into account for a period of account before the change if the profits had been calculated on the new basis, and (b) would have been brought into account for a period of account after the change if the profits had continued to be calculated on the old basis.
3	Credits in respect of closing trading stock or closing work in progress in the last period of account before the change, so far as they- (a) are not matched by deductions in respect of opening trading stock or opening work in progress in the first period of account on the new basis, or (b) are calculated on a different basis that if used to calculate those deductions would have given a lower figure.

An amount so deducted may not be deducted again in calculating the profits of a period of account.

Treatment of adjustment income and adjustment expense

232 Treatment of adjustment income

- (1) Adjustment income is treated as arising on the last day of the first period of account for which the new basis is adopted.
- (2) But this is subject to sections 235 (cases where adjustment not required until assets realised or written off) and 236 (change from realisation basis to mark to market).
- (3) Adjustment income is treated for the purposes of Chapter 1 of Part 10 of ICTA (loss relief) as profits of the trade for the tax year in which tax is charged on it.

- (4) In the case of an individual whose income from the trade is-
- (a) earned income within section 833(4)(c) of ICTA, or
 - (b) relevant UK earnings within section 189(2)(b) of FA 2004,
- adjustment income is similarly earned income or relevant UK earnings.

233 Treatment of adjustment expense

- (1) An adjustment expense is treated as an expense of the trade arising on the last day of the first period of account for which the new basis is adopted.
- (2) But this is subject to sections 235 (cases where adjustment not required until assets realised or written off) and 236 (change from realisation basis to mark to market).

Expenses previously brought into account

234 No adjustment for certain expenses previously brought into account

- (1) This section applies if, as a result of a change of basis, expenses brought into account before the change on the old basis would on the new basis be brought into account over more than one period of account after the change.
- (2) In such a case-
 - (a) no adjustment is made under this Chapter, and
 - (b) in calculating the profits of the trade no deduction is allowed for the expenses for any period of account after the change.

Realising or writing off assets

235 Cases where adjustment not required until assets realised or written off

- (1) This section applies if there is a change of basis resulting from a tax adjustment affecting the calculation of any of the following amounts.
- (2) The amounts are-
 - (a) any amount brought into account in respect of closing trading stock or closing work in progress in the last period of account before the change of basis,
 - (b) any amount brought into account in respect of opening trading stock or opening work in progress in the first period of account on the new basis, and
 - (c) any amount brought into account in respect of depreciation.
- (3) Adjustment income or (as the case may be) an adjustment expense is treated as arising only when the asset to which it relates is realised or written off.

Mark to market

236 Change from realisation basis to mark to market

- (1) This section applies if there is a change of basis from-
 - (a) not recognising a profit or loss on an asset until the asset is realised, to
 - (b) bringing assets into account in each period of account at a fair value.
- (2) So far as-
 - (a) a receipt within item 1 of step 1 in section 231 represents the fair value of an asset that is trading stock, or

(b) an expense within item 2 of that step relates to such an asset, adjustment income or (as the case may be) an adjustment expense is treated as not arising until the period of account in which the value of the asset is realised.

- (3) In the case of adjustment income, this is subject to any election under section 237 (election for spreading).
- (4) In this section "trading stock" has the same meaning as in section 174.

237 Election for spreading if section 236 applies

- (1) If section 236 applies, the person who is liable to tax on any adjustment income may elect for the adjustment income to be spread over 6 periods of account.
- (2) The election must be made on or before the first anniversary of the normal self-assessment filing date for the tax year in which the change of basis occurs.
- (3) If an election is made, an amount equal to one-sixth of the amount of the adjustment income-
- (a) is treated as arising, and
 - (b) is charged to tax,
- in each of the 6 periods of account beginning with the first period to which the new basis applies.
- (4) But if, before the whole of the adjustment income has been charged to tax, the person permanently ceases to carry on the trade, the whole of the amount so far as not previously brought into charge to tax-

- (a) is treated as arising, and
 - (b) is charged to tax,
- immediately before the cessation.

Spreading of adjustment income: barristers and advocates

238 Spreading on ending of exemption for barristers and advocates

- (1) If an individual makes a change of basis-
- (a) on ceasing to take advantage of the exemption given by section 160 (barristers and advocates in early years of practice), or
 - (b) on that exemption coming to an end,
- any adjustment income is spread over 10 tax years as follows.
- (2) In each of the 9 tax years beginning with that in which the whole amount of the adjustment income would otherwise be chargeable to tax, an amount equal to-
- (a) one tenth of the amount of the adjustment income, or
 - (b) if less, 10% of the profits of the profession of the tax year,
- is treated as arising and is charged to tax.
- (3) For this purpose "the profits of the profession" means the profits as calculated for the purposes of this Part leaving out of account any allowances or charges under CAA 2001.
- (4) In the tenth tax year the balance of the adjustment income is treated as arising and is charged to tax.
- (5) If, before the whole of the adjustment income has been charged to tax, the individual permanently ceases to carry on the profession, this section continues to apply but

with the omission of the alternative limit in subsection (2)(b).

- (6) This section is subject to any election under section 239 (election to accelerate charge).

239 Election to accelerate charge under section 238

- (1) An individual who under section 238 is liable to tax for a tax year on an amount of adjustment income may elect for an additional amount to be treated as arising in the tax year.
- (2) The election must be made on or before the first anniversary of the normal self-assessment filing date for the tax year.
- (3) The election must specify the amount to be treated as income arising in the tax year (which may be any amount of the adjustment income not previously charged to tax).
- (4) If an election is made, section 238 applies in relation to any subsequent tax year as if the amount of adjustment income (as reduced by any previous application of this section) were reduced by the amount given by the following formula-

$$A \times \frac{10}{T}$$

where-

A is the additional amount treated as arising in the tax year for which the election is made, and

T is the number of tax years remaining after that tax year in the period of 10 tax years referred to in section 238.

Supplementary

240 Liability of personal representatives if person liable dies

- (1) This section applies in the case of the death of a person who would otherwise have been liable to tax under this Chapter on adjustment income.
- (2) The tax under this Chapter for which the person would otherwise have been liable-
- (a) is to be assessed and charged on the personal representatives, and
 - (b) is to be a debt due from and payable out of the deceased's estate.
- (3) The personal representatives may make any election under this Chapter that the deceased might have made.

APPENDIX II : FEEDBACK FORM

We welcome any feedback you can provide. Below is a simple form which will help you provide such feedback. Completed feedback forms should be returned to the Technical Advisory Team by fax on 020 7059 5959.

Any information provided will not be used for any other purpose other than using the information to make representations on your behalf. Also, all information provided will be treated as confidential and the source will not be divulged nor quoted as the source.

UITF Abstract 40

To practitioners

What has been the impact of this on the valuation of your WIP?

WIP valued at cost

Does your current cost include partner time, employee time, overheads?

What is the recovery rate?

Do any clients pay by standing order?

If WIP is valued at full recoverable amount, what would be the increase in percentage terms?

Has it been time consuming to identify and compute the valuation of WIP to recognise revenue?

Have any of your clients expressed concern about the impact of the guidelines?

How aware are your clients generally of UITF Abstract 40?

Do you have an idea of how much this will impact on your clients?

NOTES

UITF Abstract 40

Client information

What has been the impact of this on the valuation of your
WIP?

WIP valued at cost

Does your current cost include partner time,
employee time, overheads?

What is the recovery rate?

Do any clients pay by standing order?

If WIP is valued at full recoverable amount, what would be
the increase in percentage terms?

Has it been time consuming to identify and compute the
valuation of WIP to recognise revenue?

NOTES