technical factsheet 130

UITF abstract 40

A major change in profit recognition and increase in tax liabilities

INTRODUCTION

As a result of the publication by the Accounting Standards Board (ASB) of an interpretation known as UITF 40 the accounting for service contracts will change significantly, increasing the reported profits and tax liabilities of many service providers such as solicitors, chartered surveyors, construction contractors and any other businesses providing services as opposed to goods. For ACCA members in practice not only will many clients be affected, but most accountancy practices will be impacted as well.

This note aims to set out the new rules and

- consider if there is any scope for not having to apply UITF40
- note the ways of mitigating the impact including the tax spreading concessions recently announced

A fuller description of the change was issued as Technical Factsheet 128.

THE RELEVANT UK STANDARDS

SSAP 9 sets out long term contract accounting based on a percentage of completion method for revenue recognition and the inclusion of prudently calculated attributable profit to be added to cost. The definition of long term contracts includes those which extend for over 12 months but also contracts with a shorter duration than one year if they are sufficiently material to the activity of the period that not to record turnover and attributable profit would lead to a distortion of the period's turnover and results such that the financial statements would not give a true and fair view.

Application Note G (ANG) to FRS 5 sets out the general principle on revenue recognition that revenue should be recognised to the extent that the right to consideration had been received. SSAP 9 was not changed by ANG and indeed the long term contract accounting was specifically noted to be unchanged.

Many practitioners concluded that ANG would not change substantially the existing treatments of revenue recognition. For example work which

- was not treated as under long term contracts under SSAP9 and
- 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, as that was when the right to consideration would arise.

An interpretation of SSAP 9 and ANG 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)

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It would seem therefore that the delivery of a report is not a conditional event to determine revenue recognition and that all service contracts should be treated as SSAP 9 long term contracts. 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 increased revenue and therefore profit will feed through as increased tax liabilities of clients and practices.

UITF40 applies to all accounting periods ending on or after 22 June 2005.

IS THERE ANY SCOPE FOR NOT HAVING TO APPLY UITF 40?

There seem two possible routes to consider – adopting International Financial Reporting Standards (IFRS) and using the FRSSE.

IAS18 Revenue

Any UK businesses (companies, LLPs and others) can opt to follow IFRS rather than UK standards.

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 ANG and UITF 40.

In respect of the fulfilment of particular conditions, such as the delivery of a report perhaps, however IAS 18 might to some extent be different from existing UK 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.

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.

FRSSE

The Financial Reporting Standard for Smaller Entities (FRSSE) is available for most entities (e.g. companies, LLPs and partnerships) that meet the Companies Act definition of a small company – essentially those not exceeding two of the following: a turnover of less than £5.6 million, net assets of £2.8 million and 50 employees. There is a 2002 version of the FRSSE which should be used for accounting periods which began before 1 January 2005 and the 2005 version to be used thereafter.

UITF 40 does not apply directly to entities using the FRSSE. They must however follow the relevant sections in the FRSSE (January 2005 version) 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
- and the definition of a long term contract, which is essentially the same as in SSAP9 noted above.

There is also in the *non-mandatory* Appendix 3 guidance which brings in the consensus from UITF 40. This guidance was not included in the FRSSE itself because it had not been subject to the due process of consultation (UITF 40 was issued after the ED of the FRSSE).

The 2002 version of the FRSSE includes very little on revenue recognition and the FRSSE requires users to look to other FRS and UITFs where the FRSSE itself does not deal with a subject. This would mean primarily reference to FRS5 ANG. As the 2005 version of the FRSSE interprets ANG in the context of smaller entities, following the 'think small first' principle users should use that when otherwise applying the 2002 version. Members should, however, avoid applying UITF 40 to any accounts ending before June 2005 as the tax spreading relief would then not be available (see below).

So could preparers of FRSSE accounts reasonably choose not to follow the non-mandatory guidance provided by the ASB in Appendix 3 and still show a true and fair view? They would need to have good grounds for doing so. Possible grounds might include

- the guidance is of lesser status in particular because it has not been subject to due process and the accounting prescribed was a major change to existing common practice and was considered controversial by many respected commentators
- the perhaps vital point from UITF 40 about critical events being wholly outside the seller's control (paragraph 19 see above) was not followed because that particular point is not even included in Appendix 3 and on this point other guidance was followed instead
  - IAS 18 (see above)
  - the definition of a contingent asset from FRS 12 where the uncertain future event must be "not wholly within the entity's control"

On the other hand

- members in practice and others should be aware that the while non-mandatory the ASB are clearly intending that the UITF 40 principles should be considered when using the FRSSE which is why the consensus was included in the Appendix 3 and the point reiterated in their recent newsletter Inside Track 46 http://www.asb.org.uk/asb/publications/it33_p265.html.
- furthermore the advisory accountant function of HMRC have indicated that they consider the principles of UITF 40 should be followed when accounts are prepared using the FRSSE (including the point about the seller's control over the occurrence of critical future events in paragraph 19) and may take action against non-compliant tax payers.
- the ASB intend to propose that UITF 40 guidance be fully incorporated into the FRSSE on its next revision in the next year or two. This proposal would be subject to due process and consultation and it is not a foregone conclusion that it would go through

Using the FRSSE to achieve a different result from applying UITF40 is therefore a possibility, but members should be aware that this

- will represent a controversial treatment including potentially with HMRC
- might only provide temporary relief from the impact if the FRSSE were to be revised to fully incorporate the UITF40 material.

CAN OTHER ACTION BE TAKEN TO MITIGATE THE IMPACT OF UITF 40?

If UITF 40 (or its general principles via the FRSSE) is adopted there may be a number of ways in which the profit and cash flow impact of the change can be mitigated.

Tax spreading
The Government has announced that legislation will be introduced in the Finance Bill 2006 to spread the impact of UITF Abstract 40 over three years with spreading being available for up to six years where the impact is greatest. The relief will be available for all businesses and will also apply to adopters of IAS 18. Spreading applies on the adoption of UITF Abstract 40 from the first period of account ending on or after 22 June 2005.

The Rules, we understand, will allow for upward adjustments to be spread over three to six years. Each year, one third of the adjustment will be taxable, subject to an upper limit of one sixth of that year's trading profits. This continues for up to five years, or until the adjustment has been fully taxed. After five years, any untaxed balance will be fully taxable in the sixth year. To the extent possible within the true and fair view it may be advantageous to maximise the uplift given the deferral of tax.

A very simple example of a seriously affected business

Upward adjustment £120,000

Taxable profits for years 1 to 6   £60,000 pa

Year 1 to 5 uplift £10,000 pa (The lower of 1/3 of the uplift (£40,000) or 1/6 of profits (£10,000)

Year 6 balance £70,000 (Upward adjustment £120,000 less £50,000)

The spreading concession is not available to early adopters and so members should avoid applying the UITF 40 principles to pre-June 2005 year ends. The accountancy profession is still trying to change this for those who are already early adopters (for example those who changed policy when ANG came into effect).

It is expected that HMRC and the profession will issue agreed guidance on UITF 40 in due course, which would replace the guidance on revenue recognition known as PN 28. HMRC have informed ACCA that they regard PN 28 as no longer applicable when UITF 40 comes in.

Granting spreading is clearly an important concession by the Government and will go a long way towards making the cash flow impact acceptable. Members however should be aware that having granted spreading HMRC are likely to be looking closely at tax returns of appropriate businesses for the UITF 40 uplift and hence the use of the related spreading provisions.

Prompt billing
The impact of the change is directly related to the value of work done which is unbilled at the end of the period. Practitioners and any of their clients affected can by billing as promptly as possible and by billing on an interim basis before all of the work is complete therefore attempt to speed up the cash inflows to help pay for the extra tax

This may be more difficult where there has been an established track record, but can often be acceptable to customers where these arrangements are set out before work commences and there is adequate notice that this will be the pattern.

Prudent assessment under SSAP9
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 costs will generally exclude partner/owner time for unincorporated businesses and LLPs.

Changes in contractual terms
ANG 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
- the work for unforeseen reasons took much longer than expected

CONCLUSIONS

UITF 40 will have a significant impact speeding up the profit recognition and increasing the tax liabilities of enterprises providing services, including accountancy practices.

There may be ways of not having to apply UITF 40, but these carry some risks – for example the use of the FRSSE to avoid the impact represents a controversial interpretation and perhaps only temporary relief.

The spreading concessions provided by the Government will allow any increase in tax to be spread over 3 to 6 years.

There are other ways of reducing the cash flow impact of the change including

- prompt billing
- prudent estimations of attributable profit

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