

## **UITF ABSTRACT 40: REVENUE RECOGNITION AND SERVICE CONTRACTS FREQUENTLY ASKED QUESTIONS**

### **1. Who has issued this guidance?**

The guidance has been issued by the Accounting Standards Board (ASB) as Urgent Issues Task Force (UITF) Abstract No 40. UITF Abstracts are approved by the ASB before issue.

### **2. Why has the UITF developed this guidance?**

The publication on 10 March 2005 by the ASB of Urgent Issues Task Force (UITF) Abstract 40 'Revenue recognition and service contracts' marked the culmination of a controversy that split the accountancy profession over the previous 18 months.

The controversy dates back to November 2003, when the ASB issued Application Note G (AN G) on 'Income recognition', for application to financial periods ending on or after 23 December 2003. The ICAEW had opposed the publication of AN G. In our response to the exposure draft we said that, 'the attempt to provide principles on revenue recognition seems premature and should not be pursued. We recommend that any amendment to FRS 5 is restricted to practical guidance on specific types of transactions, with the objective of reducing variation in accounting practice.'

AN G caused immediate and widespread uncertainty about the correct accounting for service contracts that were not treated as long-term contracts under SSAP 9. Many commentators believed that it required service providers to recognise revenue on partially completed short-term contracts, in effect leading to an acceleration of income and profit recognition in the first year of application. However the drafting of AN G led other commentators to the conclusion that this could not be what the ASB intended. This uncertainty was only ended by the publication of UITF Abstract 40.

### **3. Why didn't the ICAEW provide guidance for members on Application Note G?**

Earlier attempts by the ICAEW to resolve some of the problems caused by AN G drew criticisms from members, on two principal grounds: firstly, that the ICAEW

could safely leave the issue to be decided by evolving practice; and secondly that the ICAEW's interpretation of AN G was wrong.

The ICAEW was never in a position to sidestep the need for guidance, as the issue needed to be addressed in the context of Limited Liability Partnerships ('LLPs'). In December 2003, the Chairman of ASB's Financial Sector and Other Special Industries Committee (FSOSIC) wrote to the Consultative Committee of Accountancy Bodies ('CCAB'), which is responsible for the Statement of Recommended Practice on 'Accounting by Limited Liability Partnerships':

*'It seems likely that the [requirements of AN G] could have an important impact on the financial statements of LLPs, particularly those that provide a service over a significant period, for example, during the development of the Application Note a question was raised on audit services. In view of the Application Note being possibly of particular interest to those businesses that operate as LLPs, FSOSIC asked that I urge you to start work as soon as possible on a revision to the SORP to give guidance on revenue recognition.'*

Although such guidance on revenue recognition would have been provided in the specific context of LLPs, it would have been perceived as having general application. In order to expedite the process, the ICAEW agreed to work outside the SORP framework under the auspices of the Financial Reporting Committee. Accordingly, a preliminary draft of guidance was developed, which was made public in March 2004. The draft attracted over a hundred responses from members, many of them taking issue with its conclusions as to the correct accounting treatment. Members also pointed out that earlier recognition of profit, coupled with corresponding earlier payment of tax, could be financially damaging for some firms.

In the circumstances the ICAEW accepted that it was not in a position to issue guidance. However, there was broad agreement that members' interests and the public interest required that the issues should be resolved. Therefore, in July 2004, the Chief Executives of the CCAB bodies wrote to the Chairman of the ASB requesting that the UITF should be asked to publish an authoritative interpretation of AN G. (The UITF is a sub-committee of the ASB, and UITF Abstracts are approved and issued by the ASB.) We understand that other bodies, including The Law Society, did likewise. It was therefore not within the ICAEW's power to prevent the UITF looking into the issue.

The UITF duly issued a draft Abstract on 'Revenue recognition and service contracts' in November 2004, and ultimately issued Abstract 40 in March 2005. The final text was significantly different from the exposure draft and confirmed that revenue on service contracts should be accrued as contract activity takes place.

**4. What are the key principles underlying the guidance?**

The key principles are set out in the consensus. In particular, paragraph 26 of the Abstract states:

*‘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. 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.’*

**5. Which business sectors are affected by the Abstract?**

The UITF consensus applies to all contracts for services, so all types of entity in all business sectors are potentially affected. However, it was within professional service firms (including firms of accountants and solicitors) that uncertainty regarding Application Note G was greatest.

**6. How do I account for a contract that straddles my year end?**

The UITF provide the following guidance in paragraphs 25 and 26:

*‘A contract for services 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. In determining whether contracts should be accounted for as long-term contracts, the aggregate effect of all such contracts on the financial statements as a whole should be considered.’ (paragraph 25).*

*‘Revenue should be recognised as contract activity progresses to reflect the seller’s partial performance of its contractual obligations.’ (paragraph 26)*

**7. Does the Abstract significantly change accounting for service contracts?**

Paragraph 4 of the Abstract emphasises that the contract terms and commercial substance of contracts for services vary considerably in practice, and that each entity needs to develop an appropriate accounting policy. In some cases, a single approach will be appropriate for all contracts; in others, different approaches will be required for different classes of contracts. The UITF in paragraphs 26 and 27 also emphasises that the accounting treatment per contract will depend on the substance of the contract.

Where an entity that has not previously recognised revenue on a contract that straddles the year end until work on the contract has been completed (or substantially completed) establishes that the substance of a relevant contract is that the seller’s contractual obligations are performed gradually over time, a change in accounting will be required in that the entity will now have to recognise revenue in line with the stage of completion of the contract.

**8. Does the Abstract extend the definition of long-term contract in SSAP 9?**

The UITF comment on this issue in paragraphs 2 and 9 of the Abstract.

‘In this Abstract, 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.’ (paragraph 2)

‘Application Note G confirms that SSAP 9 should be applied in accounting for long-term contracts. It is consistent with, and does not amend, the requirements of SSAP 9.’ (paragraph 9)

**9. On which contracts that straddle the year-end will revenue now have to be recognised as contract activity progresses?**

The UITF explain in paragraph 25 of the Abstract that a contract for services 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. However, as explained in paragraph 24, contracts for services should not be accounted for as long-term contracts unless they involve the provision of a single service, or a number of services that constitute a single project.

**10. Are there any contracts that will not have to be accounted for as long-term contracts even when activity straddles the year end?**

Contracts that require services to be provided on an ongoing basis rather than the provision of a single service (or a number of services that constitute a single project) do not fall to be accounted for as long-term contracts under SSAP 9. The Abstract provides the following example:

‘A contract to provide repetitive services (such as general professional advice, accounting support, help desk support, maintenance or cleaning) on an ongoing basis should not be accounted for as a long-term contract’. (paragraph 12)

The UITF’s general principles for revenue recognition apply to such contracts, see question 3 above.

**11. What about contingent fees?**

The UITF in paragraph 27 explain that, 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. As elaborated in paragraph 19, this only applies where the right to consideration is conditional or contingent on a specified future event or outcome, the occurrence of which is outside of the control of the seller.

**12. How do I judge if a contract is material?**

The UITF explain in paragraph 25 that, in considering whether contracts should be accounted for as long-term contracts, the aggregate effect of all such contracts on the financial statements as a whole should be considered.

**13. I completed work on an assignment before the end of the financial year, but I did not raise a fee note until after the year end. Do I have to recognise revenue on this assignment?**

The date that the fee note is raised has no bearing on the accounting required under the Abstract. Similarly, Application Note G in paragraph G3 explains that the seller's right to consideration does not necessarily correspond to amounts falling due in accordance with a schedule of stage payments.

**14. On the last day of the financial year, I took a non-refundable deposit in respect of an assignment. Should I recognise this payment as revenue?**

Merely accepting a deposit does not amount to performance under the contract. Revenue should only be recognised when performance has taken place.

**15. *Not currently used.***

**16. In practice, will all WIP now be accounted for at expected billing value?**

A number of members have raised questions about work in progress, and about the treatment of equity partners' time. It is worth bearing in mind that the Abstract deals with revenue recognition, and so the provisions of SSAP 9 in relation to work in progress ('services in intermediate stages of completion') are not changed. Professional work in progress should continue to be valued at the lower of cost and net realisable value, as required by SSAP 9.

Where revenue is recognised in respect of the related contracts, 'the amount by which recorded turnover exceeds payments on account should be classified as 'amounts recoverable on contracts' and separately disclosed within debtors' (SSAP 9, paragraph 30(a)). The basic accounting is to:

- credit turnover, and
- debit 'amounts recoverable on contracts' (shown separately on the balance sheet under debtors)

with revenue for the period, ascertained as set out in the Abstract. It is therefore irrelevant whether or not equity partners' time is regarded as a cost, because the

amount of revenue will reflect the fair value of the services provided, including equity partners' time.

Where revenue has been recognised on a contract and related costs have been carried in work in progress, the accounting is to:

- credit work in progress, and
- debit profit and loss account

with the relevant amounts. This will have the effect of recognising profit in line with SSAP 9: 'Where the outcome of a contract can be assessed with reasonable certainty, the prudently calculated attributable profit should be recognised as the difference between turnover and the related costs.'

#### **17. How do I measure revenue on long-term service contracts?**

Revenue is recognised as contract activity progresses to reflect the seller's partial performance of its contractual obligations. Where the substance of the obligation is to provide the services of staff (i.e. where the seller earns the right to consideration as each unit of time is worked), the amount of revenue may be derived from the time spent.

#### **17A. How do I derive the amount of revenue from the time spent on a contract?**

Where the seller is required 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, the amount of revenue will reflect the fair value of the services provided as a proportion of the total fair value of the contract, which will reflect the time spent and the skills and expertise that have been provided.

As revenue is recognised to reflect the quantum of work actually carried out, it will not necessarily accrue evenly over the term of a contract. Furthermore, although time booked at standard charge-out rates will normally fairly reflect the value of the work carried out on a contract, this may not always be the case. Firms might look at their pricing structures and charge-out rates to ensure that policies with regard to allocation of overheads, recognition of profit and other matters do not distort the amount of revenue recognised on a contract.

Fair value will also take account of any uncertainties as to the amount that the customer will pay, as explained in paragraph 28 of the Abstract.

#### **18. When does the Abstract come into effect?**

The accounting treatment required by the Abstract should be adopted in financial statements relating to accounting periods ending on or after 22 June 2005, but

earlier adoption is encouraged. See FAQ 19 for the impact of applying the FRSSE.

**19. Paragraph 21 of UITF 40 states that entities applying the ‘FRSSE currently applicable’ are exempt from the Abstract. Does this in effect delay the impact of the new rules?**

Paragraph 21 sets out the standard ASB wording, included in all new standards and Abstracts, that users of the FRSSE are exempt from its requirements. The practical impact of this paragraph is not straightforward and is considered below.

***Periods ending prior to 22 June 2005***

UITF 40 applies to accounting periods that end on or after 22 June 2005. The Abstract (paragraph 30) states that ‘earlier adoption is encouraged’, but early adoption would be voluntary.

Thus subject to voluntary early adoption, accounting periods that come to an end before 22 June 2005 are not affected by the provisions of UITF 40, except in so far as corresponding amounts are restated in the following set of accounts. For example, accounts for a period ending on say 31 March 2005 or 31 May 2005 will not be affected, although the 2005 numbers might be restated in the 2006 accounts.

***Periods ending after 22 June 2005 - no use of the FRSSE***

Where the FRSSE is not applied, any set of accounts for a period ending on or after 22 June 2005 should be prepared in accordance with the requirements of UITF 40.

***Periods ending after 22 June 2005 - use of the FRSSE***

The 2005 version of the FRSSE applies to accounting periods beginning on or after 1 January 2005. It incorporates the principles of Application Note G in a new chapter 4 on revenue recognition. UITF 40 was issued after the exposure draft on the 2005 FRSSE was published and accordingly a decision on whether to incorporate any of its requirements within the FRSSE itself will be taken after consultation when the FRSSE is next updated.

However, it is notable that the ASB has included the ‘consensus’ section of UITF 40 in full in paragraphs 29-34 of Appendix III to the 2005 FRSSE as general guidance on revenue recognition in the context of service contracts. Paragraph 27 of Appendix IV to the 2005 FRSSE explains that the rationale for including this material was ‘to assist entities using the FRSSE’. Members exercising professional judgment to revenue recognition issues arising in relation to FRSSE accounts are very likely to look to UITF 40 as persuasive evidence of current accepted practice in relation to all periods commencing on or after 1 January 2005

and may also look to UITF 40 for guidance in relation to periods ending on or after 22 June 2005 that commence prior to 1 January 2005. In this context, members should be aware that the final paragraph of the 'General' section of the 'Status of the FRSSE' states:

*'Financial Statements will generally be prepared using accepted practice and, accordingly, for transactions or events not dealt with in the FRSSE, smaller entities should have regard to other accounting standards and UITF Abstracts, not as mandatory documents, but as a means of establishing current practice'.*

Further guidance to this effect is provided in Appendix IV. Paragraph 32 explains that, although FRSSE users are exempt from other standards and Abstracts, where there is no 'accounting guidance... provided within the FRSSE' the accounts should be prepared in accordance with 'accepted practice', and goes on to state:

*'If a practice was clearly established and accepted, it should be followed unless there were good reasons to depart from it. Accordingly, preparers and auditors should have regard to SSAPs, FRSs and UITF Abstracts, not as mandatory documents, but as a means of establishing current practice'.*

#### **19A. So can I use the FRSSE when preparing partnership accounts?**

The FRSSE may be applied to the financial statements of 'small' companies (as defined in companies legislation) and most other entities that would qualify as 'small' if they had been incorporated under companies legislation.

However, at present the FRSSE is generally used in practice only by limited companies. This is reflected in the decision to include in the 2005 version the full accounting provisions of the Companies Act 1985 applicable to small companies. The incorporation within the standard of a considerable volume of legislative material applicable solely to companies may make use of the FRSSE by unincorporated entities less attractive, although the legislative material is not binding on other entities and is shown in small capitals to distinguish it from the requirements of the FRSSE.

It should be noted that an unincorporated business that chooses to take advantage of the limited measurement differences between full UK GAAP and the FRSSE must prepare annual financial statements fully compliant with the FRSSE, not just in accordance with some or all of the FRSSE measurement rules.

#### **20. Do comparatives have to be restated?**

Where applicable, corresponding amounts should be restated.

**21. Is the UITF guidance consistent with international accounting standards?**

Paragraph 20 of IAS 18 *Revenue* states:

*‘Where the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date.’*

Paragraph 26 of the Abstract states:

*‘Where the substance of a transaction is that the seller’s contractual obligations are performed gradually over time, revenue is 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.’*

**22. Is the guidance consistent with TAX 30/98?**

Please see our tax FAQs. As noted there, now that UITF 40 is in force, much of TAX 30/98 is superseded. We are considering with HMRC what further guidance should be issued in this area to replace TAX 30/98.

**23. What can be done by businesses that face a major increase in tax?**

In cases where revenue is recognised earlier than hitherto the related tax liability will be correspondingly earlier. We have developed Support Materials to help members deal with the implications for their own and clients’ businesses. We are also seeking an option for businesses to spread the increased tax over a number of years (see the *Revenue Recognition and Service Contracts* page on the website).

**24. Is the ICAEW issuing detailed guidance on this topic?**

The ICAEW believes that the Abstract is sufficiently clear for members to be able to use their professional judgement regarding its application. It is possible that further guidance may be required in other contexts - for example, in relation to limited liability partnerships. Any Institute material that is developed will be referred to on the *Revenue Recognition and Service Contracts* page on the website.

**25. What is the ICAEW doing to help members in this area?**

In addition to these and future accounting and tax FAQs and any other guidance material published (see the *Revenue Recognition and Service Contracts* page on the website), ICAEW support for members will include:

- Support Material to help member firms to deal with the Abstract in their own practices and to form the basis of financial advice to clients (see the *Revenue Recognition and Service Contracts* page on the website);
- Seeking with other CCAB bodies to obtain spreading relief (see the *Revenue Recognition and Service Contracts* page on the website) and discussing with HMRC what further guidance should be issued to replace Tax 30/98, which dealt with the withdrawal of the cash basis in 1998;
- Advice from the Technical Enquiries Service on the accounting implications of the Abstract.

**26. This change has serious financial implications. What can I do?**

The effect of recognising revenue and profit earlier than hitherto will in many cases result in a one-off increase in profits in the first year of application. Depending on cash flows, this may give rise to financial problems for some members when the resulting tax bill falls due. The Institute has joined with other professional bodies to try to ameliorate the tax effects (see the *Revenue Recognition and Service Contracts* page on the website).

*The above FAQs provide general guidance and do not purport to deal with all possible questions and issues that may arise in any given situation. Primary source material should always be consulted. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this guidance can be accepted by the authors or by the Institute.*

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