



Tax Faculty

TAXGUIDE 08/06

UITF 40 and taxation

Guidance note issued by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in conjunction with the following professional bodies:

*The Association of Chartered Certified Accountants
The Chartered Institute of Taxation
The Institute of Chartered Accountants of Scotland
The Association of Accounting Technicians
The Association of Taxation Technicians*

and agreed by HMRC

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UITF 40 AND TAXATION

INTRODUCTION

- 1 This note has been prepared by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in conjunction with the Association of Chartered Certified Accountants, the Chartered Institute of Taxation, the Institute of Chartered Accountants of Scotland, the Association of Accounting Technicians and the Association of Taxation Technicians. It reflects discussions that those professional bodies have had with HMRC and has been agreed by HMRC. This document supercedes TAX 30/98 for accounting periods ending after 22 June 2005. The guidance in that note that is still of relevance in relation to WIP has been included, with some minor amendments, in this document.
- 2 The object of this note is to provide guidance on the practical issues that arise in computing taxable profits as a result of the introduction of UITF 40. This note deals only with the tax issues that arise when applying UITF 40 in practice and is intended to help members form their judgement as they apply UITF 40 to a client's individual circumstances. **It is not intended to give guidance on the interpretation of UITF 40.** On 15 August 2006 the CCAB issued detailed guidance (with examples) on the interpretation of UITF 40. That guidance can be found on the CCAB website at www.ccab.org.uk.
- 3 This guidance has been produced to assist small businesses, particularly those that might not have kept detailed records. Like UITF 40 itself it applies to all service providers, not merely professional firms.

BACKGROUND

- 4 The profits of a trade are required to be calculated for tax purposes in accordance with generally accepted accounting practice (GAAP) subject to any adjustment required or authorised by law (FA 1998 s 42; ITTOIA 2005, s 25). GAAP is defined as UK GAAP or international accounting standards (IAS) (ICTA 1988, s 832(1); FA 2004, s 50).
- 5 UITF 40 is an Abstract of the Urgent Issues Task Force of the Accounting Standards Board. It deals with revenue recognition in relation to the provision of services. UITF Abstracts are considered to be part of the corpus of UK GAAP. UITF 40 is intended to provide guidance in relation to the application of SSAP 9 and Application Note G to FRS 5. It applies to accounting periods ending on or after 22 June 2005 although earlier adoption was encouraged.

USE OF JUDGEMENT

- 6 The application of UITF 40 involves judgement. Where accounting standards involve judgment there is obviously no one "correct" judgement and thus no "correct" profit figure. There is a range of figures all of which accord with UK GAAP. HMRC is

entitled to question whether the policy you have adopted complies with UK GAAP, and whether the judgement you have made produces an estimate that is within a reasonable range based on reliable evidence. However HMRC is not entitled to substitute its own judgement for yours (although cases can occur where a judgment might be considered so extreme that they would want to question whether the accounting standard has properly been applied).

- 7 Accounts prepared in accordance with UITF 40 are required only for periods of account ending on or after 22 June 2005. Accordingly this note applies only for accounts ending on or after 22 June 2005.

CHANGE OF ACCOUNTING BASIS

- 8 UITF 40 is concerned with the timing of the recognition of income. It applies to all contracts for services, whether they are provided by an unincorporated business (sole trader/partnership), an LLP or through a limited company. If a business changes its accounting policy for revenue recognition – for example as a consequence of UITF 40 – the first adoption of this new accounting policy may give rise to a prior period adjustment for accounting purposes. The change from an accounting policy that was valid in the previous year to a new policy valid in the later year is referred to in the legislation as a change in the basis of accounting.
- 9 For tax purposes a change of accounting policy which gives rise to a prior period adjustment from one valid basis of accounting to another gives rise to “adjustment income” (Sch 22, FA 2002: Chapter 17, ITTOIA 2005). Although taxable as earnings, adjustment income does not form part of the trading profits for an individual or a partnership (s 228, ITTOIA 2005). The amount should be shown separately in box 3.82 of the individual’s tax return (or box 3.82 of a partnership return). It does not attract Class 4 national insurance contributions. For a company, the adjustment income is treated as a trading receipt and is accordingly included in the taxable trading profits (para 4, Sch 22, FA 2002). Any adjustment income will also need to be included in the calculation of Tax Credits.

OPENING ACCRUED INCOME

- 10 The prior period adjustment resulting from the change to a new accounting policy compliant with UITF 40 restates the opening balance sheet to what it would have been had the new accounting policy been in place in the previous period. The business needs to calculate what the accrued income figure would have been at the end of the previous year had the new policy been in place at that time. It also needs to revisit the work-in-progress (WIP) figure to remove any contracts for which the new policy would have recognised accrued income and released WIP to the profit and loss account to match revenue recognition.
- 11 Many businesses may have difficulty in ascertaining the correct amount of this adjustment because they may not have perceived the need for such an adjustment at the time that the previous accounts were finalised and may therefore not have either retained or brought into existence the records needed to calculate the adjustment.

Even where records are available, it may be very difficult at this stage to make the judgements required by UITF 40 because such judgements made now will inevitably be affected by hindsight.

- 12 HMRC has confirmed that it will accept any reasonable method of calculating this adjustment that is in accordance with UK GAAP.
- 13 One acceptable method might be to take the ratio of the current year's closing accrued income (under the new policy) to sales billed in an appropriate period after the current year end, and apply that ratio to sales billed in the same period after the previous year end. This may be a reasonable estimate of the amount of the prior period adjustment to accrued income. The second part of the adjustment would then be to take the previous year's closing WIP and release it, except for those contracts for which the new policy retains WIP (see paragraphs 28 to 38 below). The combination of the two parts would produce the prior period adjustment. Billed sales may be looked at over a period of a month or perhaps three months after the year end, depending on the nature of the business and experience.
- 14 Some professional firms and many other businesses do not maintain time records. For example some charge a standard fee for a job and some estimate an individual fee for each job and bill that estimated amount. In such cases it is not necessary for the taxpayer to introduce time records where he does not need these commercially. Some other method of estimating the amount of income that falls to be recognised under UITF 40, and any WIP figure, should be adopted. Where cost details are kept on individual client files a "stocktake" may be possible. Where a "billing exercise" is carried out close to the year end, it may be possible to record details of work not being billed. A review of invoices rendered after the year end may provide a guide to income to be recognised.
- 15 It should be stressed that we are not saying that the adjustment ought to be calculated on one of these methods but merely that, if the circumstances fit, they are acceptable methods to HMRC. The records that an individual business has maintained might be sufficient to enable a more accurate assessment to be made.
- 16 HMRC recognises that many small businesses will have difficulty in arriving at the prior period adjustment. It is not the intention of HMRC to scrutinise this adjustment in the event of an enquiry provided that the method of arriving at it seems reasonable in all the circumstances.
- 17 Where the nature of the business has changed during the year consideration will need to be given to the most appropriate way to calculate the prior period adjustment. Provided that a record of what has been done and why (including what records were or were not available that would have influenced the judgement actually made) is maintained, HMRC will accept the method adopted provided that it is reasonable in all the circumstances.

EVIDENCE OF JUDGEMENT

- 18 Businesses are not expected to spend undue time in seeking to achieve a spurious accuracy in making the judgements that need to be made to determine the amount of income that needs to be recognised under UITF 40 and the amount, if any, that remains within WIP at the year end.
- 19 As with other judgements, the estimate should be made on the basis of the information available at the time the accounts are drawn up (see paragraph 24 onwards).
- 20 HMRC does not expect a business with a large number of similar jobs to have necessarily considered each job individually but realises that, for convenience, the business may well have categorised its jobs and made a judgement in relation to such category on an overall basis. HMRC will therefore not expect to see detailed records showing the judgement made for each individual job. HMRC will, however, expect a business to retain sufficient records to show the basis on which the judgement was made, including the basis on which any percentages adopted in a percentage based approach were arrived at. Normally a statement setting out the categories into which uncompleted jobs at the year-end were split, the judgement made for each category and the reason for that judgement will be sufficient.

Example

- 21 A small professional firm deals solely with personal tax returns. The firm might keep a note of work done at the year end on its uncompleted contracts along the lines of:

At the year end the work done on personal tax returns consists mainly of asking clients for information. Our experience shows that in approximately 10% of such cases information has been obtained from clients who expect the return to be completed promptly and such returns are normally completed by the year-end but not yet approved by the client so no bill has been raised. . Some work will be undertaken for the fee after the return is signed, such as checking HMRC calculations, correspondence with the client and HMRC, notification of amounts payable, etc. It is estimated that this will amount to 20% of the total work undertaken. Accordingly 80% of the full fees in relation to these open jobs has been recognised as income on a job-by-job basis. In the remaining 90% of tax return jobs, no information has been received from clients and therefore no substantive work has been performed by the year end. No income has therefore been recognised. Any costs that have been incurred on those jobs have been included in WIP.

- 22 This example is given purely as an example of the level of information that in the event of an enquiry HMRC might expect to have been maintained. In practice, a professional firm is likely to provide a number of different types of services and uncompleted work may need to be categorised by reference to the type of work and different stages of completion. A similar degree of information would of course be expected for the other categories of work.
- 23 We would also stress that this example is not intended as an indication of how to apply UITF 40. That is a matter of judgement based on your individual interpretation

of the application of UITF 40 to a client's circumstances with the help of the CCAB guidance of 15 August 2006. HMRC will expect the percentages and estimates used to be based on reliable evidence and may ask to see it.

THE DATE JUDGEMENT FALLS TO BE MADE

- 24 HMRC recognises that preparing accounts in accordance with GAAP normally requires an element of judgement. For example someone needs to decide what is the appropriate amount to recognise as revenue on a particular job or whether the WIP on a particular piece of work should be valued at cost or at net realisable value. Such judgements should be made on the basis of the information available at the date the accounts of the business are approved.
- 25 Unlike companies (where accounts must be approved by the Board of Directors) unincorporated businesses normally have no statutory requirement to follow any formal procedure for approving accounts. HMRC will accept as the "date of approval" any date on which a procedure recognisably similar to that followed by companies is completed. For small partnerships and sole practices this would be when the proprietors give their approval to the accounts. For larger partnerships there might be a body such as an Executive Committee which approves accounts for submission to a general meeting of partners. The "date of approval" would be the date of approval by the Executive Committee.
- 26 While there is no general legal requirement for accounts of unincorporated bodies to be signed by or on behalf of those approving them, or to be dated, clearly there is a point in time at which the accounts are considered final. If this is not identified there will be scope for argument as to what that point was. It would obviously be helpful in discussing post balance sheet events with HMRC to have clear evidence available of the date of approval.
- 27 FRS 21 (events after the balance sheet dates) requires events arising after the balance sheet date to be taken into account if they are adjusting events, i.e. they provide evidence of conditions that existed at the balance sheet date. The principle is that adjusting post balance sheet events need to be taken into account. Thus, in the case of a company, the date of approval of the accounts is a cut-off point to review post balance sheet events. Similarly, where a partnership has a formal procedure to approve accounts, the date of approval would evidence the cut-off point. Decisions will need to be taken at that time as to what revenue falls to be recognised under UITF 40 and what is included in WIP.

WORK-IN-PROGRESS

- 28 As the cost of work done in producing the revenue recognised is an expense of the period in which it is recognised, for many, if not most, contracts that have recognised income there will be no unexpensed amount to be carried forward and thus no work-in-progress. The CCAB guidance note does not spell out what will remain in WIP after applying UITF 40 but it can be inferred from it that WIP is likely to include the following:

- (i) The cost of speculative work where there is no contract in place and where there is a reasonable expectation that the cost will be recovered from someone.
- (ii) Cases where a right to consideration does not arise until the occurrence of a critical event that is wholly outside your control (a provision in the contract with the client that he need pay you only when he signs the return would not meet the test as the trigger, namely sending him the return, is within your control).
- (iii) The costs relating to conditional or contingent contracts.
- (iv) Cases where no reliable estimate of revenue can be made. These are likely to be rare.
- (v) Cases where the point has not yet been reached at which there can be said to be any right to consideration.
- (vi) The surplus of cost over income recognised, where there is a possibility of recovering it at a later date but it is not prudent to recognise the whole amount as income.

In some of the above cases the net realisable value may well be nil.

Valuation of work in progress

29 Work-in-progress, like revenue recognition, is an accounting concept. It is not for HMRC to determine how to value it; it is solely a matter of the appropriate application of accountancy principles.

30 The purpose of WIP is still to relate expenditure on such work to the period in which the income from that work is recognised. Accordingly if there is no expenditure there is no WIP to be matched with the income of a later period. There is of course no expenditure included in the profit and loss account in respect of the proprietor's or partners' time in an unincorporated business because that is an appropriation of profits; accordingly there is nothing to be carried forward in respect of such time.

Chargeable staff

31 Work-in-progress should include staff costs, materials cost and overheads. It follows that a sole trader or partnership with no chargeable staff, ie fee-earning employees, may accordingly have no WIP.

32 If a service business has chargeable staff, it will have WIP. The starting point for valuing WIP is that salaries and other costs directly attributable to productive staff, such as national insurance and pension contributions, should be matched with the earnings that their work generates. The principle is to carry forward costs that relate to a later period, not to anticipate profits that will not be earned until a later period.

Overheads

33 The key area of difficulty is what, if any, overheads should be included in the calculation of WIP in accordance with SSAP 9. The only case which appears to relate directly to the recognition, or otherwise, of overheads for tax purposes, *Duple Motor Bodies v Ostime* (1961, 39 TC 537) was decided before the introduction of SSAP 9. In that case the Commissioners found as a fact that the company's policy of including only direct costs in the valuation of its work in progress accorded with generally

accepted accounting practice. It is unlikely that such a policy would now accord with SSAP 9 and so it would no longer accord with generally accepted accounting practice.

34 HMRC accepts that the concept of materiality applies to overheads in a small business and believes that this obviates many of the potential problems. HMRC does not wish to put taxpayers, particularly small businesses, which may not have the necessary overhead information readily available, to a considerable amount of extra work for little benefit.

35 On this basis the following approach will normally be acceptable.

- a) HMRC accepts that overheads can be ignored in relation to a sole practitioner's own time - so the value of WIP for their time will be nil as there can be no WIP in relation to a proprietor's labour.
- b) HMRC is prepared to accept that in most cases overheads in relation to staff time of a sole practitioner are likely to be immaterial.
- c) Similarly in a two, three or four partner firm staff overheads can legitimately be regarded as immaterial in most cases. However this may depend to an extent on the ratio of partners to productive staff.
- d) In a large firm, with many fee-earners located in substantial premises, it is right to recognise a fair proportion of overheads in calculating WIP.
- e) In the intermediate range it will normally be appropriate to recognise overheads, although at the smaller end of the range HMRC would not object to the adoption of a fairly rough and ready approach to arriving at an appropriate figure.

36 The professional bodies believe that this is a reasonable approach to adopt.

37 It is not possible to lay down rigid rules as to what to do. There might be instances where the inclusion of overheads is appropriate even in cases within paragraph 35(a) to (c) above. In particular HMRC would not normally regard the complete omission of overheads as acceptable in a capital intensive business. It should be remembered that overheads would not relate to the WIP to the extent that, for example, an office is needed as a base from which to generate new work, carry out marketing or administrative functions such as billing, etc.

38 HMRC have told the professional bodies that it may wish to understand the basis on which WIP has been calculated but that it would not expect to dwell on it, except where it did not appear to be calculated on a reasonable and consistent basis.

THE SPREADING PROVISIONS

39 Following representations, the Government announced in the 2005 Pre Budget Report a spreading relief for those service providers facing an adjustment income charge. Full details of the spreading relief are set out in Schedule 15 to the Finance Act 2006.

Paragraph 2 provides that any adjustment income will be spread over three years but in certain circumstances the spreading may be extended to six years.

Start date

40 Paragraph 1(1) states that spreading relief is only available to businesses in respect of changes brought about by UITF 40 in the accounting period which includes the date 22 June 2005

41 Spreading will therefore not be available:

- where businesses adopted UITF 40 earlier than its official start date of accounting periods ending on or after 22 June 2005 (i.e. accounting periods ending in the period from publication of UITF 40 on 10 March 2005 to 21 June 2005) or
- in respect of any changes caused by the adoption of Application Note G.

Spreading mechanism

42 The adjustment income that is treated as arising and chargeable to tax in the first three years is the lower of:

- One-third of the adjustment income; and
- One-sixth of the profits of the business, *before* capital allowances and any other reductions in profit reflecting other changes in accounting policy.

43 If all of the adjustment income has not been taxed by the end of three years the spread continues in years four and five until the adjustment income is all used, with any remaining balance being taxed in year six. The amount is subject to the taxpayer electing to bring forward some or all of the adjustment income

44 Further guidance on the spreading provisions is contained in the Tax Faculty's guidance note TAXGUIDE 5/06. A copy of the guidance note can be downloaded via the ICAEW website at www.icaew.co.uk.

FH/RM

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