Revenue recognition in service contracts - UITF 40

Contacts
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- the SA Orderline on **0845 9000 404** for helpsheets

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This helpsheet gives information on the accountancy and tax changes brought in by the accounting requirements in Urgent Issues Task Force Abstract 40 (UITF 40) about recognition of turnover from contracts for professional and other services. Read it if you provide your services under contracts which span your accounting date.

This is a complex area. You may want to discuss it with your tax adviser, if you have one.

UITF 40 is part of UK Generally Accepted Accounting Practice (GAAP). Your tax may be affected because the tax calculations of people carrying on trades, professions or vocations are based, before any tax adjustments, on accounts prepared using GAAP.

UITF 40 was issued on 10 March 2005 and affects accounting periods ending on or after 22 June 2005. It applies to all sizes of business, including those smaller businesses that can use the shorter version of the accounting standards – Financial Reporting Standards for Smaller Entities (FRSSE).

The helpsheet is divided into two sections – the first explains the accountancy changes brought in by UITF 40, and the second covers the tax changes which follow from the accountancy changes and the entries you will need to make on your tax return.

For more details about the accountancy and tax changes, see the Business Income Manual, from page BIM74200 in the manuals section of *The Library*, at **www.hmrc.gov.uk**

Accounting practice

This section gives a brief non-technical overview of the accountancy changes in UITF 40.

If you have a tax adviser you may wish to discuss these changes with them. The text of UITF 40 is available on the Financial Reporting Council (FRC) website. Go to **www.frc.org.uk/asb/uitf** to view a copy. Further guidance is at **www.hmrc.gov.uk** where you will find the Consultative Committee of Accountancy Bodies (the CCAB) guidance note ‘Guidance on the application of UITF 40 ‘Revenue recognition and service contracts” and ‘The Institute of Chartered Accountants of England and Wales (ICAEW) Taxguide 08/06’. The Association of Chartered and Certified Accountants (ACCA) has published the same material as Technical Factsheet 135.

What is affected by the UITF 40 changes in accounting practice?

UITF 40 is about the value to include in your accounts for contracts for services where the work is not finished at the accounting date. It does not affect profit for the period for contracts started and completed in full in one accounting period. The change affects only the valuation of services performed, not goods produced.

UITF 40:
• requires the business to bring into turnover the value of work done under the service contract. Revenue or income builds up over the life of the contract, rather than when the work is completed or the client is invoiced
• means that some individuals and firms will bring income into account at a time earlier than before.

Businesses which are affected will:
• change the way they deal with uncompleted work and recognise income, and
• in the first year for which UITF 40 applies, reconsider the accounts prepared for the previous year to take into account any prior period adjustment (see overleaf).

How this new accounting practice differs

UITF 40 refers to when the turnover generated by service contracts is brought into your accounts for those contracts that have not been completed by the end of your accounting period. Under earlier accounting practice, the accounts for many businesses only showed the cost of the work done by the end of the accounting year as 'work in progress' and did not recognise any profit on the work done to date. Changes made by UITF 40 mean that the accounts will now recognise the turnover or sales value of the work done, and show the related cost as an expense in the same period. However, although UITF 40 has changed the timing of recognition of turnover for most service contracts, there are some instances where it has not. In these cases the related cost of work performed to date will still be carried forward as work in progress – there is more on work in progress in the ICAEW's Taxguide 08/06.

If you provide services you will now need to include an amount for your own time in turnover for the work done by the year end. This is sometimes described as including the 'profit element' in the accounts.

Previously, individuals or partners did not need to include an amount in their accounts to recognise the value of their time on uncompleted contracts. They did include the cost of, say, employees who were working on uncompleted contracts, but not any profit element for those employees. Now businesses should include a proportion of the sales value of the contract to reflect not only the work done by employees but also that done by the owners of the business.

Where payment for the work done has not been received by the end of the accounting period debtors will be increased by the same figure as the value of the work done.

There is no change in the rule that turnover must be included in the accounts even though you may not have received payment, or even issued an invoice at your accounting date.

The type of contracts affected

The changes affect contracts for services. These include contracts which used to be dealt with as 'work in progress'.

A service contract is a contract for carrying out a particular piece of work – for example, researching and writing a report for a client.

If you have no buyer in mind for your work, for example, your work is speculative, then UITF 40 does not apply since there is no contract for the supply of services to a customer until a sale is made. However, UITF 40 applies equally to oral contracts as it does to formal written contracts.

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How to work out how much income to recognise

The amount of extra turnover which you will have to recognise depends on the nature of the service. It might, for example, be the agreed price allocated between the hours already spent on the work and the hours still to be worked, but there is no single rule. You should normally spread the expected turnover fairly over the contract – for example, if the contract will take 200 hours and only 100 hours have been worked by the accounting year end then it would be fair to include 100/200 of the contract price.

You may want to discuss this area in more detail with your tax adviser if you have one. Alternatively, the CCAB's 'Guidance on the application of UITF 40 'Revenue recognition and service contracts" mentioned on page 1 provides detailed examples.

How the changes affect the profits for tax purposes

The following information applies to accounts ended in the years to 5 April 2006 or 5 April 2007 – the first accounts ending on or after 22 June 2005. It is retained here as background information to the calculation of the amount to spread.

What happens on the change of accounting policy

Accountancy

A change from one correct policy used to draw up business accounts to another requires an accountancy adjustment to the accounts for the first period using the new policy. This is called 'a change in accounting policy' and the adjustment which arises is called a 'prior period adjustment'. The adoption of a new accounting policy can be voluntary where a trader believes that a different accounting policy is more appropriate to its particular circumstances, or mandatory where the Accounting Standards Board (ASB) or the Urgent Issues Task Force (UITF) introduces new or amended requirements as is the case with UITF 40.

Tax

Tax law covers such changes in accounting policy. If the prior period adjustment is positive (for example, there is an increase in profit), it is taxed and if it is a negative adjustment it is deducted from the business profits. This ensures that all taxable receipts are taxed and all allowable expenses are deducted in calculating the profits over the life of a business.

In the case of a move from a previously correct way of drawing up business accounts to the method required by UITF 40, the adjustment will be positive – there will be additional taxable income in the first accounts ending on or after 22 June 2005.

The adjustment occurs in one year only – the year in which the new accounting policy is first adopted. For the profit of the year of change itself and the following years, the new policy is used consistently and there is no further tax adjustment.

The following example will help you understand how the adjustment is calculated. It refers only to the calculation of the prior period adjustment and the tax adjustment, not the figures for turnover or profit for the year itself – these will be calculated based on the new policy.

Example

Anita is a self-employed management consultant. She draws up her accounts to 31 December each year. She has one fee-earning employee, who assists her with research, at a cost to Anita of £25 an hour.

At 31 December 2004 she and her assistant are half way through writing a report. She estimated the report would take them 200 hours each and it would be finished in February 2005. Her time records show that she and her assistant had each spent 100 hours on the report as at 31 December 2004 and her contract shows she will be paid £40,000 for the completed report.

In her accounts for 31 December 2004, Anita showed work in progress of £2,500, being 100 hours of her assistant's time at a cost of £25 per hour.

In her accounts for 31 December 2005 she must include both opening and closing figures for work affected by UITF 40. She must restate the opening figures to increase sales and debtors by £20,000 (being 200 hours at £100 an hour – half the value of the contract) and eliminate the previously stated work in progress of £2,500.

The prior period adjustment (and tax adjustment) will be £17,500. This figure is not credited to the profit and loss account for the year but is taken to the capital account.

Notes

- Anita does not record any cost for her own time in 2004 because she is a sole trader (see above).
- Overheads have been ignored for simplicity.
- The precise method of calculating figures for work in progress and for UITF 40 turnover/debtors will depend on the facts.

In this example, if there were no specific tax rules, the profit arising from the work done on the report before the change in accounting policy:

- would not be taxed before the change because it would not be included under the previous accounting policy, and
- would not be taxed after the change because it was earned, in accordance with UITF 40, before the change
- the bookkeeping for the prior period adjustment is as follows:

Debit	Debtors/accrued income	£20,000
Credit	Work in progress (balance sheet)	£2,500
Credit	Capital account	£17,500 (sales £20,000 less WIP (P&L) £2,500)

How the adjustment is taxed – spreading

Introduction

The tax adjustment that can be spread arises on a change of accounting policy where:

- in the first period of account ending on or after 22 June 2005 you follow Generally Accepted Accounting Practice (GAAP) and adopt the principles for revenue recognition of service contracts contained in UITF 40
- in the period before you followed GAAP but not UITF 40.

Spreading is therefore only available for the adjustment income arising from following UITF 40 for the first time in the first period of account ending on or after 22 June 2005. If you adopted the accounting policy contained in UITF 40 in a period of account ending before 22 June 2005, you will not be able to spread any adjustment income arising from the earlier change in accounting policy.

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The adjustment calculated above is not taxed in one year but is spread over a period of three to six years. The exact length of the spreading period depends on the size of the adjustment and the amount of your profits. Apart from, exceptionally, the last year of the spreading period, the adjustment will not be more than one sixth of your profits in any one year.

Detail

You do not have to make any special claim for spreading, however you can make an election for the adjustment to be taxed more quickly – see below.

Once the adjustment income attributable to UITF 40 has been calculated it is spread according to the following rules.

In each of the first three tax years, the lower of:
- one third of the adjustment income, and
- one sixth of the profits of the business

is taxed.

In this context 'profits' means the profits of the business calculated for Income Tax purposes leaving out any adjustment expenses (arising from any other change in accounting policy) or any capital allowances or balancing charges.

In the fourth and fifth years if there is any adjustment income not yet taxed, the same test applies. However if the amount remaining is lower than the other two figures, it will be taxed.

In the sixth year, any remaining adjustment income is taxed.

The yearly charge is often referred to as an instalment.

Even if, unusually, there are other amounts of adjustment income in the year, only that relating to the adoption of UITF 40 is spread.

Each instalment of the adjustment income does not count as profit for the purposes of National Insurance contributions (NICs) but is part of self-employment income for tax credits purposes and so should be included on the claim or renewal form. Trading losses from other years may be set against the adjustment income in the same way as they are set against trading income.

Cessation

Where the business has ceased, in the year of cessation the lower limit of one sixth still applies. In subsequent years only the one third alternative applies until the full adjustment has been charged.

Death

The personal representatives are assessed where the person who would otherwise be liable has died. The personal representatives can make any election which the deceased person would have been able to make.

Election to accelerate payment of the tax adjustment

If you want to pay the tax arising on the adjustment income more quickly, then you can make an election. This election will mean that an extra amount of adjustment income is treated as arising in a particular tax year. The election must be made before the first anniversary of the normal tax return filing date for a tax year and must show how much extra adjustment income you want to have taxed in that tax year. In future years, if there has been an election, the original adjustment income is treated as being reduced by the amount charged early.

For example, if there is adjustment income of £6,000 and an election has been made to charge an extra £1,000 in year one, when comparing one third of the adjustment income with one sixth of the profits, in the following year the amount of adjustment income for comparison is £5,000 not £6,000.

Partnership

The adjustment is calculated from the figures in the partnership accounts in exactly the same way as a person who carries on business on their own account. It is charged each year on the individual partners.

For the first year each instalment is apportioned among the partners in accordance with their profit-sharing entitlement in the 12 months ending immediately before the date on which UITF 40 was adopted.

For subsequent years each instalment is allocated or apportioned according to the profit sharing arrangements for the 12 months immediately before the relevant anniversary of the date when UITF 40 was adopted (the date on which UITF 40 was adopted is the first day of the period of account when UITF 40 first applied). So the period of apportionment for any tax year is the 12 month period following the period of apportionment for the previous tax year.

This means that, as partners come and go, the individuals who are charged to tax will change, as will the amount on which they are charged as profit-sharing entitlements change. This also means that any election to pay more than the normal instalment for any year must be made by all the partners who are charged for that year.

For example, if a partner retired from a partnership (with a period of account ending on 30 June 2005) at the end of June 2004, they would not be a member of the partnership when the uplift took place. They may not expect to bear any of the adjustment income charge. Nonetheless part of the adjustment income assessable in 2005–06 will be allocated to the departing partner in accordance with that partner's profit share for the year ending 30 June 2004.

In the same way a partner who joins a firm after the uplift (say on 1 July 2006) and before the three to six year period expires will not have been a partner when the uplift arose, but will bear a proportion of the amount assessable in each year based on their share of profits for the relevant 12 month period to 30 June. For 2008–09 the new partner will have a share of the adjustment income based on the profit share in the 12 months to 30 June 2007 – the year in which they were first a partner.

There is nothing to prevent departing or joining partners from seeking an indemnity from the other partners to cover any charge.

Partnership cessations

Where a profession or vocation carried on by a partnership ceases (or is deemed to have ceased) each partner's share of any amount chargeable on or after the cessation is worked out as follows:

- if the cessation is on the date when UITF 40 is adopted, according to the profit sharing arrangements for the 12 months ending immediately before that date
- if the cessation occurs after the adoption of UITF 40 but on or before the first anniversary of that date, according to the profit sharing arrangements for the period between that date and the date of discontinuation
- if the cessation occurs after the first anniversary of the date of adoption of UITF 40, according to the profit sharing arrangements for the period between the immediately preceding anniversary and the date of cessation.

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Any election described above made after the cessation must be made by each former partner separately.

Where to put these adjustments on the tax return

Each instalment of the adjustment should be shown separately in box 70 of the *Self-employment (full)* pages or box 3.82 of the Partnership Tax Returns and not included in the trading profit. Explain in the 'Additional information' box, box 102 on page SEF 6 of the *Self-employment (full)* pages, or box 3.116 of the Partnership Tax Return that the entries arise from the adoption of the UITF 40 and give the following information:
- the total amount of the adjustment
- the instalment this year
- the amount to be charged in future years.

Make sure that the instalment is distinguished in the comments in box 3.116 or box 102 on page SEF 6 from any instalments resulting from the withdrawal of the cash basis.

For partnerships, copy the figure in box 3.82 or box 70 on page SEF 4 into box 11A on the partnership statement and then apportion this figure between the partners as above. Each partner should enter their share of the instalment in box 9 of the *Partnership* pages of their tax return.

If a partner has left the partnership in the previous tax year, deduct their share of the tax adjustment from the total and enter the net amount in box 3.82 or box 70 on page SEF 4. This figure will then be entered in box 11A on the partnership statement and split between the remaining partners according to their shares. A reconciliation should be shown in box 3.116 of the Partnership Tax Return or box 102 on page SEF 6 of the *Self-employment (full)* pages.

The departed partner should show their share in box 16 in the 'Other UK Income' section on page TR 3 of their tax return. A description of the income should be given in box 20 on page TR 3, or if there is not enough space, box 19 on page TR 6 should be used instead.

These notes are for guidance only, and reflect the position at the time of writing. They do not affect any rights of appeal. Any subsequent amendments to these notes can be found at **www.hmrc.gov.uk**