

THE 'TRUE AND FAIR VIEW' FOR PROFESSIONS AND THE 'ADJUSTMENT' ON WITHDRAWAL OF CASH BASIS

This Helpsheet is in two parts.

Part 1 reproduces a note prepared by the Tax Faculty of the Institute of Chartered Accountants in England and Wales providing guidance on the meaning of 'true and fair view' in the context of professional businesses. We are grateful to the ICAEW for permission to reproduce their note here. When originally published, the note contained 4 Annexes, A to D. Only Annex D is included in this Help Sheet.

Part 2 explains the 'adjustment' professional businesses need to calculate and provides examples and completion instructions for the relevant boxes on the Self-employment Pages of the individual Tax Return and the Trading and Professional Income Pages of the Partnership Tax Return.

PART 1: WITHDRAWAL OF CASH BASIS: GUIDANCE NOTE ON A TRUE AND FAIR VIEW

"Introduction

- 1 This note has been prepared by the Tax Faculty of the Institute of Chartered Accountants in England and Wales and agreed by the Inland Revenue who intend to include it in guidance to local tax offices.
- 2 The object of this note is to provide guidance on computing taxable profits of professional businesses so as to show a true and fair view of profits for tax purposes. The Inland Revenue has told us that their guidance to Inspectors on enquiries into work-in-progress stresses that an element of judgement is involved. We attach as Annex A an extract from the Revenue's forthcoming guidance to Inspectors. The full guidance will be published in the Revenue Manuals in due course when it has been finalised.
- 3 This note is designed to give practical help based upon Accounting Standards and practices current at November 1998. The Tax Faculty will keep under review the need to update this note as Standards and practices evolve.

Background

- 4 The Government announced on 22 December 1997 the withdrawal of cash basis practices for computing taxable profits of professional businesses in favour of a 'true and fair' approach.
- 5 In summary, the proposals are:
 - a) Statements of Practice A3 (cash basis for barristers) and A27 (cash bases for others) will cease to apply after 1999-2000; and
 - b) for 2000-2001 onwards profits for tax purposes must be based on accounting standards adjusted as required or permitted by tax law.

- 6 Head (b) in fact is the corollary of head (a). What is proposed is merely that the approach adopted by the Courts over many years, and re-emphasised recently in such cases as *Gallagher v Jones* (1993, 66 TC 77) and *Johnston v Britannia Airways Ltd* (1994, 67 TC 99), should be codified, making explicit by statute that which is already implicit in judicially developed doctrine.
- 7 The Revenue view of what this means is set out in paragraphs 24-26 of their March 1998 Budget Day press release IR 29 which is reproduced in Annex B.
- 8 There have been concerns that true and fair implies an audit and compliance with Companies Acts disclosure requirements. These concerns are misplaced: the legislation specifically confirms that no audit or Companies Acts disclosure requirements are imposed.

Date from which effective

- 9 Paragraph 3 of the Annex to IR 29 referred to above states that 'The first computations on the earnings basis will normally be for the twelve months ending on the accounting date in 2000-01. The debtors, creditors and work-in-progress used to calculate the catching-up charge at the end of the previous period will form the opening earnings basis figure'. Special rules apply for periods of account other than one year.

What is a true and fair view?

- 10 The concept of true and fair view is well known to accountants. It has been the fundamental basis of audited accounts for many years. Accounting Standards have been developed and published since the issue of SSAP I (Accounting for associated companies) in January 1971. These are required to be used in preparing accounts intended to give a true and fair view. As such, they are integral to the concept of a true and fair view. This is of course a dynamic concept. As new Standards and ASB pronouncements are published they will need to be taken into account in determining whether accounts give a true and fair view. However, Accounting Standards have been developed largely in the context of accounts prepared by companies which, in addition to giving a true and fair view, have to comply with disclosure requirements under the Companies Acts.
- 11 As accounts (and the Standardised Accounting Information (SAI) section of the Tax Return) are needed to quantify the amount of taxable profits, the tax requirement for such documents to show a true and fair view requires them to comply only with those parts of Accounting Standards that are germane to the calculation of profits. Many Accounting Standards affect the presentation of the profit and loss account and the balance sheet and the disclosures to be made by way of notes. For tax purposes such Standards only need to be applied so far as relevant and material to the computation of profits, i.e. to determine when profit arises and the amount of profit to be recognised.

- 12 Two standards which are of great importance to accounting by professional businesses are those parts of SSAP 2 (Disclosure of Accounting Policies) which set out the four fundamental accounting concepts and SSAP 9 which relates to the valuation of stock and long-term contracts. The definition of stock as found in paragraph 16(d) of SSAP 9 states that it includes products and services in intermediate stages of completion. This clearly includes work-in-progress in a professional business.
- 13 SSAP 2 lists going concern, accruals, consistency and prudence as being four fundamental accounting concepts regarded as having general acceptability. To all intents and purposes, these are the same as the accounting principles codified in paragraphs 10-14, Schedule 4, Companies Act 1985 and reproduced in the Financial Reporting Standard for Smaller Entities (FRSSE). As noted in Annex B, the Revenue additionally accept the concept of materiality in arriving at a true and fair view of work-in-progress.
- 14 We include in Annex C a list of the other Accounting Standards that may need to be applied in particular circumstances.
- 15 The FRSSE, issued in November 1997, is relevant to many partnerships. It specifically makes clear that Accounting Standards are intended to apply to unincorporated entities as well as companies. But the main purpose of the FRSSE is to collect together in one place most of the requirements that small entities must follow.
- 16 A small entity for the purpose of the FRSSE follows the Companies Act criteria, i.e. a sole proprietor or partnership will be a small entity for any accounting year in which it does not exceed two or more of the following criteria:
- | | |
|-----------------------------|------------|
| Turnover | £2,800,000 |
| Balance sheet total | £1,400,000 |
| Average number of employees | 50 |
- 17 Although 'balance sheet total' under the Companies Acts is defined by reference to the statutory company accounting formats, it is clear that it means assets, i.e. neither liabilities can be netted off nor capital account balances can be deducted in arriving at the balance sheet total. An overdrawn capital account balance is not an asset.
- 18 The Foreword to Accounting Standards makes clear that the CCAB bodies expect their members to observe Accounting Standards and to justify any significant departure from them. It also states that compliance with Accounting Standards (other than in relation to immaterial items) 'will normally be necessary for financial statements to give a true and fair view'.

Valuation of work-in-progress

— Introduction

- 19 Many people are concerned about how one values professional work-in-progress. The first thing to be said is that work-in-progress, like stock, is an accounting concept. It is not for the Revenue to determine how to value it; it is solely a matter of the appropriate application of accountancy principles.

— Valuation

- 20 The basic principle, which is set out in SSAP 9, is that work-in-progress should be stated at the lower of cost and net realisable value. In the case of long-term contracts paragraph 28 of SSAP 9 requires each contract to be assessed as contract activity progresses. Paragraphs 28 to 30 give further guidance as to how this should be done. This part of SSAP 9 was an issue in *Symons v Weeks* (56 TC 630). This case emphasises the principle that profits should not be anticipated and that in ascertaining profits actually earned up to the balance sheet day inherent uncertainties as to the outcome of a contract require a cautious estimate of such profit to be made.
- 21 SSAP 2 is also relevant. The accruals concept requires that revenue and costs are 'matched with one another so far as their relationship can be established or justifiably assumed and dealt with in the profit and loss account of the period to which they relate'.
- 22 The purpose of work-in-progress is to relate expenditure on such work to the period in which the income it produces is earned. Accordingly if there is no expenditure there is no work-in-progress 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 because it is an appropriation of profits; accordingly there is nothing to be carried forward in respect of such time.
- Chargeable staff
- 23 A sole trader or partnership with no chargeable staff, i.e. fee-earning employees, will accordingly have no work-in-progress.
- 24 If an accountancy practice has chargeable staff, it will have work-in-progress. The starting point for valuing work-in-progress 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**

- 25 The key area of difficulty is what, if any, overheads should be included in the calculation of work-in-progress. 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.
- 26 Paragraph 17 of SSAP 9 defines cost as including such costs of conversion as are appropriate to the stock's condition. Paragraph 19 states that cost of conversion includes production overheads (as defined in paragraph 20) and any other overheads attributable in the particular circumstances of the business to bringing the product or service to its present location and condition. SSAP 9 was issued in 1975, although it was revised in September 1988, mainly to cover long term contracts. At that time few, if any, professional practices were incorporated. Accordingly the Standard does not specifically address the question as to what extent overheads of a professional practice constitute 'costs of conversion' in relation to work-in-progress. The SSAP 9 definitions are more appropriate to manufacturing operations.
- 27 Perhaps because there was no 'true and fair view' requirement, this is an area on which there does not appear to have been a consensus amongst practising accountants. Some firms of accountants that currently prepare accounts on an earnings basis exclude overheads whereas others include them. There has been no standard method of ascertaining overheads even where these are included.
- 28 However, the Revenue accept that the concept of materiality applies and believe that this obviates many of the potential problems. They have told the Tax Faculty that they do not wish to put firms, particularly small firms, which may not have the necessary overhead information readily available, to a considerable amount of extra work for little benefit.
- 29 On this basis the following approach will normally be acceptable, assuming of course that work is normally billed on a regular basis.
- a) The Revenue accept that overheads can be ignored in relation to a sole practitioner or partner's own time - so the value of work-in-progress for their time will be nil as there can be no work-in-progress in relation to a proprietor's labour.

- b) They are 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 work-in-progress.
- e) In the intermediate range it will normally be appropriate to recognise overheads, although at the smaller end of the range the Revenue would not object to the adoption of a fairly rough and ready approach to arriving at an appropriate figure.

The Tax Faculty believes that this is a reasonable approach to adopt.

— **Larger firms**

- 30 Applying the above guidance will be straightforward for smaller firms where work-in-progress is not material. In the case of larger firms each case must be considered on its own merits and in accordance with existing guidance on the valuation of work-in-progress contained in SSAP 9 and the concept of materiality whereby immaterial items can be ignored. In addition it is important to recognise the concept of consistency so that work-in-progress is valued on a consistent basis as between one accounting period and the next. It is unlikely that any work-in-progress in an accounting practice would fall to be regarded as a long term contract under the terms of SSAP 9, but it may do so in other professions; for example, architects, solicitors, surveyors and others. Treatment of contingent matters and legal aid work should be similar to the guidance given in paragraph 36 below.

— **No rigid rules**

- 31 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 29(a) to (c) above. In an extreme example (admittedly unlikely and perhaps contrary to the rules of his or her professional body), if a sole practitioner has only one client but has rendered no fee note to that client during his accounting year, he may need to treat some of the overheads as work-in-progress. However, it must be remembered that overheads would not relate to the work-in-progress to the extent that the office is needed as a base from which to generate new work, carry out marketing or administrative functions such as billing, etc.

32 The Revenue have told the Tax Faculty that Inspectors may wish to understand the basis on which work-in-progress has been calculated but the Revenue would not expect Inspectors to dwell on it, except where it did not appear to be calculated on a reasonable and consistent basis.

— **Absence of time records**

33 Some professional firms do not maintain time records. For example solicitors and patent agents will often charge a standard fee for a job. In such cases it is not necessary for the taxpayer to introduce time records where he does not need these commercially. Some other method to arrive at a work-in-progress figure will need to 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 work-in-progress. It may be possible to use statistical techniques to establish the likely number of jobs uncompleted at the year end and an appropriate cost figure.

— **Valuation: reduction to cost**

34 Many professional businesses nowadays record work-in-progress at selling price. It would clearly be conceptually wrong to value it at such a price when computing taxable profits. It is therefore necessary to reduce the book figure at selling price to arrive at the cost of work-in-progress. While there may be 'rules of thumb' which can often provide a reasonable approximation the individual circumstances need to be considered, and 'rules of thumb' may not always be appropriate.

35 It needs to be remembered that work-in-progress is the figure that the concept of matching requires to be carried forward. But SSAP 2 makes clear that the accruals concept is subservient to the concept of prudence. Among other things this prohibits the carrying forward of current expenditure to the extent that it is not recoverable. If a fixed fee has been quoted for a job the value of work-in-progress will not exceed that fee less the estimated costs that will need to be incurred to complete the job.

36 As with other judgements, the estimate of the net realisable value of work-in-progress should be made on the basis of the information available at the time the accounts are drawn up (see paragraph 43 onwards). Thus, where work is done on a speculative or contingency basis ('no win, no fee'), but it is clear at the time the accounts are drawn up that the case has been won and that the firm will at least recover its costs,

work-in-progress on the contract should be valued at cost. Where, however, the contingency has not been satisfied at that time, so that there is still a reasonable chance that the firm will recover nothing, the net realisable value of work-in-progress is likely to be nil. Paragraph 49 also gives guidance on the recognition of income and contingent fee cases.

— **Valuation: more complicated cases**

37 If the client is in a precarious financial position and unlikely to be able to pay for the work it is equally unlikely that the work-in-progress has any real value. As with stock, it is necessary to consider each item of work-in-progress to confirm that its net realisable value exceeds its costs and, if not, to write it down to that value. In the case of work-in-progress there is normally only one 'customer' for the work so the net realisable value will depend on an assessment of what that customer can be expected to pay for it. However, the concept cannot be taken too far. What is needed is not an assessment of what the customer will pay for the work in its current state; the assumption that the work will be completed needs to be made.

38 In some cases it may not be possible to arrive at a value for work-in-progress. *Mason v Innes* (44 TC 326) established that an author cannot have work-in-progress at least before he has entered into a contract with a publisher for the book and the Revenue accept this.

39 The definition of long-term contracts given in SSAP 9 is not easy to follow. The authors of UK GAAP (published by Ernst and Young) express the view that the wording is wide enough to require even uncompleted short contracts to be treated as long-term and comment 'This could hardly have been the Standard's intention'. They surmise that the crucial factor of the definition is consistency. They also suggest that the distinction that needs to be drawn is between short-term contracting businesses and long-term contracting businesses. A business engaged ordinarily in short-term contracts should normally account for all its contracts on a short-term basis.

40 Most professionals, other than in the construction industry, are unlikely to be involved in long-term contracts. For example the annual audit or accounting work for a client which is billed regularly is in practical terms a series of short-term contracts. Some corporate finance activities such as seeking over an extended period to find a buyer for a business might be long-term. Other examples are prolonged insolvency work in one company's liquidation and prolonged probate work by solicitors in handling a complex estate.

41 The Revenue would not normally seek to challenge whether a job is short-term or long-term where the case is billed periodically and profit recognised on such billing. However, if interim billing, or requests for payment, are held in suspense on the basis that the contract is long-term, and no income or profit is recognised, the Revenue could well challenge the treatment. The key factor is that the treatment should not lead to distortion of the turnover or results for the year.

— Examples

42 It was noted in paragraph 31 that it is not possible to lay down rigid guidelines. However, in order to provide further guidance, Annex D sets out five examples as to how the Faculty considers work-in-progress should be valued and calculated. The examples also highlight the types of problems which will occur in practice and how they may be resolved:

Example 1 Sole practitioner

Example 2 Chargeable staff and materiality

Example 3 Chargeable staff - accounting for work-in-progress

Example 4 Payments on account

Example 5 Year end problems.

— Time at which judgement is to be made

43 The Revenue recognise that preparing accounts to give a true and fair view of profits normally requires an element of judgement (see Annex A). For example someone needs to decide whether the work-in-progress 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.

44 Unlike companies (where accounts must be approved by the Board of Directors) unincorporated businesses are not required to follow any formal procedure for approving accounts. The Revenue 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.

45 While there is no requirement for accounts of unincorporated bodies to be signed by or on behalf of those approving them, or to be dated, it may well be helpful in giving certainty to the date of approval if accounts are signed and dated.

46 SSAP 17 (Accounting for post balance sheet events) requires events arising after the balance sheet date to be taken into account when they provide evidence of conditions existing at that date. In the case of a company the date of approval of the accounts is a convenient cut-off point to review post balance sheet events. Where a partnership has a formal procedure to approve accounts such approval might provide a convenient cut-off point. The Tax Faculty does not believe that where no such procedure exists it is necessary to attempt to identify a cut-off point.

47 The principle is that post balance sheet events need to be taken into account. Where work-in-progress is ascertained some time after the balance sheet date the review undertaken at that time will reflect post balance sheet events up to that time. We do not believe that any subsequent review is needed unless the taxpayer becomes aware of material knowledge that vitiates a decision made at the time the work-in-progress was ascertained. Common sense obviously needs to be used in determining whether subsequent material events are likely to occur after the time of the initial review.

— Income recognition and debtors

48 Profit cannot be deferred by leaving jobs in work-in-progress after they have reached a billable stage. Once a job has been completed the billable amount should normally be recognised as a debtor rather than work-in-progress. Where a request for payment is issued under the VAT Continuous Service rules, the issue of that request will normally trigger a requirement to regard the amount as a debtor for accounting purposes.

49 Paragraph 36 above discussed the treatment of contingent events in relation to work-in-progress. In the case of income recognition, the Revenue have told us that they accept that income need not be recognised for a job which depends on a contingency until that contingency is satisfied. For example, a lawyer who took on a case on a 'no win, no fee' basis need not recognise the fee until the case is won; only then is the condition met which is necessary to earn the fee. In addition, the Revenue accept that, for this purpose, it is open to the professional to deal with a large number of similar contingent fee cases either in the aggregate or to look at each one separately. Under the former approach it might be possible to say that a certain percentage will yield a fee and to recognise income accordingly. Under the latter approach there is no certainty that any particular case will yield a fee and so no income need be recognised for any of them until the contingency is satisfied in each case.

50 There is nothing special about valuing debtors of a professional practice: normal practice should be applied. It is as permissible to provide against bad and doubtful debts as in any other business.

— **Alternative acceptable accounting principles**

51 Some accountants are concerned that where there are two or more acceptable approaches to valuing work-in-progress the Inspector of Taxes may take a different view of which method ought to be adopted.

52 It is well enough established that the Revenue do not have the right to substitute one basis which is valid for tax purposes for another such basis. In *Pearce v Woodall-Duckham Ltd* (51 TC 273) for example Templeman J (later Lord Templeman) said: 'The company was entitled to produce accounts based on its on-cost method prior to 1969. The company was entitled, but not bound, to produce accounts for 1969 and subsequent years by the accrued profit method. The change was made for sound commercial reasons'. Equally the Revenue's view is that where a basis which is valid for tax purposes has been adopted in a taxpayer's accounts the taxpayer does not have the right to adopt a different basis in computing the profits figure to be entered on his Tax Return.

53 In *Johnston v Britannia Airways* (67 TC 99) Knox J said: 'Which of the three ways in which the attribution of cost to a period or periods of accounting is adopted is, in my view, essentially a matter of accountancy judgement, and I am quite unable to detect any legal basis for excluding any of them'. Admittedly in that case the Special Commissioners had expressed a preference for the method actually adopted by the taxpayer, but that was not the basis of their decision.

54 In a recent case *A Firm v Honour* (1997 STC(SCD) 293) the Special Commissioners felt themselves entitled to substitute the Revenue's basis for the taxpayer's, albeit both were bases which accorded with normal accountancy principles. However the Revenue did not argue for this - they argued that the taxpayer's basis anticipated losses and needed to be adjusted as a matter of law to exclude such losses from the taxable profit, which is a different concept. It is understood that this case is going to appeal.

55 The Revenue consider that adjustments may also be needed to reflect other principles laid down by the courts in tax cases, such as the prohibition on anticipating losses. Such decisions were of course formulated in an environment where accountancy evidence was less frequently put before the courts. The Tax Faculty does not necessarily accept the Revenue's view. It believes that the current approach of the courts to accounting principles has created a number of unresolved issues that may have to be decided by the Courts at some stage.

11 November 1998."

(This, with the Annexes, was also published in Tax Bulletin issue number 38.)

ANNEX D (PARAGRAPH 42)

Examples of the valuation of work in progress

Example 1 Sole practitioner

John is a sole practitioner. He prepares accounts to 30 April each year. John employs a secretary at a salary of £15,000 pa but he has no other staff. His office rent is £6,000 pa and other overheads average £8,000 pa. In his client portfolio, he has one large client Maximus Ltd on which he uses two sub-contractors, Bill and Ben, each year. They do the bulk of the work in March and April. In March 2001 Bill invoices John for £2,000. Ben bills £3,000 but does not submit his invoice until May 2001. John bills Maximus Ltd £10,000 in May 2001. His agreement with Bill and Ben is that he will not pay them until he is paid by Maximus Ltd.

There is no work-in-progress in relation to John's own time. There will however be work-in-progress in relation to the time of Bill and Ben in respect of work done on Maximus Ltd. This will be the direct cost of their work and will amount to £5,000. It is irrelevant that Ben has not billed John by 30 April. As John has to prepare his accounts on an accruals basis he will accrue for the amounts that he owes Ben but will then carry that expense forward as work-in-progress. If Bill and Ben had not completed their work by 30 April John would only accrue his estimate of the part of their fees that relates to work done to that date. Thus, in Bill's case, John would accrue only for the relevant part of the £2,000 and would then of course carry the same amount forward as work-in-progress.

Example 2 Chargeable staff and materiality

Suppose that John in Example 1 had trained his secretary to also do book keeping work for two clients. She works 35 hours a week for 47 weeks a year (i.e. 1,645 hours a year). It takes her 5 hours a week to do the book keeping work. It is billed monthly in arrears. John charges each of the clients £200 a month for this service.

Although there is no work-in-progress at 30 April 2001 in respect of John's time there will be some in relation to the book keeping work. This might be calculated as:

Secretary's salary	£15,000
NI 12.2%	<u>£1,830</u>
	£16,830
Cost per hour: $\frac{£16,830}{£1,645} =$	£10.23

Work done but not billed for at 30 April 2001	
4 weeks x 5 hours x £10.23 per hour	£205
Work-in-progress	£205

John would probably not include the amount of £205 as work-in-progress because it is not material. Even attaching production overheads to the secretary's cost per hour is unlikely to render the figure material.

Example 3 Chargeable staff - accounting for work-in-progress

Peter and Paul are a two partner firm employing five chargeable staff plus two secretaries. Their profit and loss account shows the following:

Fees	£800,000
Salaries, NI and pension contributions	
professional staff	£140,000
secretaries	£25,000
Rent and premises	£30,000
Other overheads	£40,000

Peter and Paul record their work-in-progress at selling price. At 30 April 2001, the work-in-progress was £240,000. On analysis it is found that £105,000 of this is Peter and Paul's time and the rest staff time. An analysis of the fees shows that Peter and Paul have billed £350,000 in relation to their own time and £450,000 in respect of staff time.

There is no work-in-progress in relation to Peter and Paul's own time. There is work-in-progress in relation to staff time. The total of £135,000 (£240,000 less Peter and Paul's time of £105,000) needs to be reduced to cost.

The chargeable staff work a 35 hour week and occupy 40% of the premises. Of the other overheads, Peter and Paul are of the opinion that 50% of these costs are directly related to production.

Two possible methods of arriving at a figure of cost for work-in-progress are as follows:

— **Method 1**

One way to do this would be to use the ratio of the cost of work produced by staff during the year to the market value of that work.

Thus, the calculation is as follows:

$$\frac{(A + B + C) \text{ minus } D}{(E + F) \text{ minus } G} \times \text{Staff work-in-progress at selling cost}$$

where:

A = the salaries, NI and pension costs of professional staff - £140,000 in this case

B = the rent and premises costs attributable to the professional staff - 40% of £30,000 in this case, since they occupy 40% of the premises, i.e. £12,000.

C = the proportion of the other overheads attributable to professional staff - 50% of £40,000 in this case

D = the cost of the opening work-in-progress - none in this case

E = the proportion of the total fees of £800,000 billed in the year attributable to professional staff - £450,000 in this case

F = the selling price of closing work-in-progress attributable to professional staff - £135,000 in this case

G = the selling price of the opening work-in-progress attributable to professional staff - none in this example.

The work-in-progress in this example is therefore:

$$\frac{(\pounds140,000 + \pounds12,000 + \pounds20,000)}{(\pounds450,000 + \pounds135,000)} \times \pounds135,000 = \pounds39,692$$

Note: In this example, it is assumed for simplicity that there is no opening figure for work-in-progress. If there was opening work-in-progress, it would be necessary (as stated in the formula above) to deduct its opening cost from the numerator and its opening market value from the denominator.

— **Method 2**

Another method would be to identify the hours of staff work-in-progress and multiply this figure by an estimated average staff cost per hour. In the example on page 8, it is assumed that the staff cost per hour for each employee is based upon 1,820 hours, i.e. 35 hours x 52 weeks a year. The staff hours of work-in-progress of 2,100 come from the records.

Total staff work-in-progress at selling price	£135,000
2,100 hours of staff work-in-progress	
Average cost of professional staff is:	
Professional staff salaries	
<u>£140,000</u>	£15.38
(5 x 1,820 hours)	
Add: Production overheads	
Rent and premises	
<u>(£30,000 x 40%)</u>	£1.32
(5 x 1,820 hours)	
Other overheads	
<u>(£40,000 x 50%)</u>	£2.20
(5 x 1,820 hours)	
Notional hourly cost	£18.90
Value of work-in-progress is:	
2,100 x £ 18.90	£39,690

There is no single right method to value work-in-progress. In our view, either method should be an acceptable method of valuing work-in-progress.

In practice, the Revenue accept that the materiality concept would not require the inclusion of an overhead loading for such a small firm. The overheads of around £7,400 are not material in relation to the profit of the firm (which is over £550,000). However, the example includes the overhead calculations by way of illustration.

Example 4 Payments on account

a) Peter and Paul in Example 3 have set up a standing order for one client, ABC Ltd who pays them £1,000 a month on account of fees. The main work on the job is done in June.

b) Peter is a little worried about the financial stability of another client, Fred Smith Ltd, and accordingly asked the company for £10,000 on account of the year's fee in April 2001. At that time the work-in-progress on the clock (at selling price) was £8,000 of which £2,000 was Peter's time and the balance staff time.

How should these payments be reflected, if at all, in the calculation of work-in-progress?

a) Payment from ABC Ltd

At 30 April 2001 Peter and Paul will have received £10,000 payment (i.e. 10 payments of £1,000) from ABC Ltd for work not yet done. That would not relate to work-in-progress. It would simply be carried forward in the balance sheet as a creditor as being amounts invoiced in advance.

b) Payment from Fred Smith Ltd

There are two possible ways to deal with the £10,000 from Fred Smith Ltd. Which is correct will depend on the exact transaction with that company. If Peter simply asked for a cheque the amount received is a creditor in the same way as that from ABC Ltd.

In addition Peter and Paul will have work-in-progress (calculated as in Example 3) in respect of Fred Smith Ltd of:

$$\frac{(140,000 + 12,000 + 20,000)}{(450,000 + 135,000)} \times £(8,000 - 2,000 \text{ i.e. } \text{minus Peter's time}) = £1,764$$

If Peter invoiced the £10,000 as a payment on account Peter and Paul would probably need to recognise at least part of it (i.e. £8,000) as income and would then have no work-in-progress in relation to Fred Smith Ltd, and a balance of £2,000 will be handled in the accounts as a creditor on account of work not yet done.

The Revenue may seek to challenge cases where there appears to be an attempt to defer income recognition.

Example 5 Year end problems

When Peter and Paul prepare their accounts to 30 April 2001 they realise they have two problem areas.

a) There is £15,000 time on the clock for MNO Ltd. Last year's fee was £6,000. Another £2,000 of time will be needed to finish the job. There is no way that MNO Ltd will accept a bill for £17,000.

b) Peter did not realise that the cheque from Fred Smith Ltd has been dishonoured. A further £6,000 of staff time has been spent and the total time on the clock is now £14,000. Fred Smith's financial problems are now so acute that it will clearly go into liquidation unless Peter spends further time on installing a new accounting system for the company.

a) MNO Ltd

Peter and Paul will need to assess what they believe MNO Ltd will pay. Suppose they think it is £8,000. They then analyse the £17,000 of time and discover that £6,000 is Paul's time and £11,000 staff time.

The cost of the staff work-in-progress is then (per Example 3):

$$\frac{(140,000 + 12,000 + 20,000)}{(450,000 + 135,000)} \times £11,000 = £3,234$$

As this is less than net realisable value of the contract the work-in-progress is £3,234.

b) Fred Smith Ltd

As far as Fred Smith Ltd is concerned Peter and Paul would probably decide that the likelihood of recovery of any of the staff time is now remote and thus not recognise any work-in-progress in respect of such time at 30 April.

If they think that Peter will need to incur, say, a further £2,000 of time but will then be able to bill and recover both that additional time and the whole of the £14,000 outstanding, the work-in-progress at 30 April will be arrived at as in Example 4.

If they think that Peter will only be able to collect a lesser sum they will need to form a view as to whether or not this will be less than the cost figure in arriving at the work-in-progress at 30 April.

PART 2: THE 'ADJUSTMENT' ON WITHDRAWAL OF CASH BASIS

The object of the 'adjustment' is to ensure that when a professional business moves from a 'cash' or other 'conventional' basis to a 'true and fair view' basis all taxable receipts are taxed (over the lifetime of the business) once and once only. Likewise all allowable expenses are allowed once and once only.

A positive 'adjustment' is taxable under Case VI of Schedule D and should not be included as part of the professional profits chargeable to tax under Case II of Schedule D. This means in particular that it is not included in computing the amount of the profit chargeable to Class 4 National Insurance Contributions. It is, however, 'earned income' and the instalment charged for any year is treated as part of 'net relevant earnings' for personal pension relief and retirement annuity relief purposes.

It may be easiest to show how the 'adjustment' is calculated by an example. You may want to look back to Part I which covers what is meant by a 'true and fair view' basis and, in particular, gives details as to what should be counted as work-in-progress.

Example 1

Angela is an accountant. She prepares her accounts on a 'bills delivered' basis without work-in-progress. Her accounts are drawn up for tax purposes to 30 April 2000. At that date she had completed work worth £10,000 which she had not yet billed and uncompleted work-in-progress with a cost for tax purposes of £20,000. She had also issued an interim bill for £2,000 for work which remained uncompleted at 30 April 2000. The client paid the £2,000 in March 2000. The work was completed in May 2000, when the fee was regarded as 'earned' for accountancy purposes.

Her accounts for the year ending 30 April 2001 must be on a 'true and fair view' basis. Thus they will include 'opening' and 'closing' figures for debtors, creditors and work-in-progress in accordance with generally accepted accounting practice. In particular those accounts will have 'opening' figures which include the £10,000 in debtors, the £20,000 in work-in-progress and the £2,000 as a payment in advance, with no corresponding 'closing' figures for the previous year.

The amount of her adjustment will therefore be a positive figure of: £10,000 + £20,000 *minus* £2,000 = £28,000.

Without the adjustment the debtors of £10,000 and the work-in-progress of £20,000 would not be taxed. For example, the

debtors will not be taxed under the cash basis because nothing was paid in that period; and they will not be taxed under a 'true and fair view' basis because they were earned before this period started. So they are added in arriving at the Case VI charge.

The £2,000 interim payment, on the other hand, is deducted to avoid a double charge. The £2,000 interim payment will be taxed as part of the professional profits of both the year to 30 April 2000 and the year to 30 April 2001. The payment was received in the first of these years (which is on the cash basis) and earned in the second (which is on a 'true and fair view' basis). But the double charge is eliminated by deducting £2,000 from the adjustment otherwise taxable under Case VI. (If the £2,000 was the only item in the adjustment computation, it would yield a Case II deduction for the year ended 30 April 2000, instead of a reduced Case VI charge.)

The result should always be that over the lifetime of the business all taxable receipts are brought in, either in the accounts or in the 'adjustment', once and only once and all allowable expenses are likewise allowed once and only once.

Unless you elect otherwise (see below) the 'adjustment' will be charged to tax in ten instalments over the tax years 2000-2001 to 2009-2010 inclusive ('spreading').

The only exception is if your accounts are made up to 5 April 2001 and no accounts have been made up to any earlier date in the tax year 2000-2001. In that case the 'adjustment' is charged to tax in ten instalments over the tax years 2001-2002 to 2010-2011 inclusive. This does not apply where your accounts are made up to 31 March even though for some other purposes they may be treated as if they were made up to 5 April.

We can illustrate the way spreading works by returning to the example.

Angela is entitled to spreading, so the adjustment will, unless she elects otherwise, be charged as income for the tax years 2000-2001 to 2009-2010 inclusive. The amount charged for each of the first nine years, again unless she elects otherwise, will be the smaller of £2,800 and 10% of her taxable professional profits (before capital allowances) for that year. For 2009-2010 any remaining uncharged amount will be charged to tax.

If Angela ceases business in 2004-2005 then for 2005-2006 to 2008-2009 (i.e. the remaining four of the first nine years) the amount charged will be £2,800. The 10% profit cap can no longer apply since there are no longer any profits.

Completion of Tax Return

Enter in box 3.82 of the Self-employment Pages of your Tax Return the amount of the 'adjustment' which is being charged to tax for

the year. Please also enter in the 'Additional information' box on Page SE4 of the Self-employment Pages:

- the total amount of the 'adjustment'
- the amount (if any) charged to tax in earlier years
- the amount charged to tax this year
- the amount to be charged to tax in future years.

Election to be taxed on more than the minimum

For any year you can elect to be charged on more than the minimum instalment. You may want to do this, for example, if you have losses from another business that you want to set against other income. To make an election all a sole practitioner needs to do is to enter the amount on which you wish to be charged (provided it is at least the minimum) in box 3.82.

If you make an election then you need to go back to your original calculation of the 'adjustment' and reduce the 'adjustment' by the extra amount on which you elected to be charged. Future minimum instalments will then be worked out using the revised figure for the adjustment.

Angela's 'adjustment' (above) was £28,000. Suppose that up to and including 2004-2005 her business profits were at least £28,000, but for 2004-2005 she elects to be charged on £4,800 rather than on the minimum of £2,800. In other words she elects to be charged on £2,000 more than the minimum.

For future years the 'adjustment' is treated as if it was £28,000 minus £2,000 = £26,000. This means that (provided her business profits for 2005-2006 to 2008-2009 inclusive) are at least £26,000 she will be charged on 10% of 26,000 = £2,600 for each of the years 2005-2006 to 2008-2009 inclusive, and then on the remaining £1,600 for 2009-2010.

In some cases this revision may mean that the full amount of the 'adjustment' is charged over a period less than ten years.

Partnerships and the 'adjustment'

For Partnerships the 'adjustment', and the instalment to be charged each year, is calculated in exactly the same way as for a sole practitioner. However the tax is charged on the partners rather than on the partnership. The way in which the 'adjustment' is apportioned between partners can best be illustrated by another example.

Example 2

Boris & Co is a partnership of solicitors, with an accounting date of 30 June. Thus their last accounts on the 'old' basis are to 30 June 2000, and the adjustment is calculated as at that date.

The partners are entitled to spreading from 2000-2001 to 2009-2010 inclusive.

For 2000-2001 the instalment is apportioned according to the profit-sharing arrangements for the year ended 30 June 2000. For 2001-2002 the instalment is apportioned according to the profit-sharing arrangements for the year ended 30 June 2001. This use of 30 June continues even if the partnership accounting date changes.

Thus, for example, the adjustment instalment for 2004-2005 will be charged on all those (and only on those) who were partners at some time during the year ending on 30 June 2004, and in accordance with their profit-sharing arrangements for those twelve months.

Now suppose the partnership is dissolved on 31 December 2005 and the business comes to an end. For 2005-2006 the apportionment is, as before, according to the profit-sharing arrangements for the year ended 30 June 2005. For the remaining years 2006-2007 to 2009-2010, however, the apportionment is made according to the profit-sharing arrangements for the period from 1 July 2005 to 31 December 2005.

The 'profit-sharing arrangements' here are the entitlement of the partners to share in profits of an income nature for the relevant period. The instalment should be apportioned in the same way as if it was an additional business receipt for the relevant period.

Completion of Returns

The amount of the 'adjustment' which is being charged to tax for the year should be entered in box 3.82 of the Partnership Return. Please also enter in the 'Additional information' box:

- the total amount of the 'adjustment'
- the amount (if any) charged to tax in earlier years
- the amount charged to tax this year
- the amount to be charged to tax in future years.

Copy the figure in box 3.82 into box 11A on the partnership statement and then apportion this figure between the partners in the way set out above. Each partner should enter his or her share of the instalment in box 4.12A of the Partnership Pages of their own Tax Return.

Election to be taxed on more than the minimum

For any year the partners can elect to be charged on more than the minimum instalment. Because this affects the tax liability of all the partners an election to do this must be made by all the partners whose liability is affected. If one or more partners do not sign the notice even though the majority do the election cannot be admitted.

In the example given above, an election to be charged on more than the minimum for 2004-2005 would have to be made by all those who were partners in Boris & Co during the year ended 30 June 2004.

If the partners want to be charged on more than the minimum the partnership should:

- enter the amount on which they wish to be charged (provided it is at least the minimum) in box 3.82
- send the partnership's Inland Revenue office a notice signed by all the partners whose tax liability is affected agreeing to be charged on more than the minimum. The notice must reach the Inland Revenue office by 31 January following the end of the year of assessment. For example, a notice for 2000-2001 must reach the Inland Revenue office by 31 January 2002.

If the partners elect to be taxed on more than the minimum for a particular fiscal year then for each subsequent year the instalment to be allocated between the partners is to be recalculated in the same way as for a sole trader (see the example of Angela above).

These notes are for guidance only, and reflect the position at the time of writing. They do not affect any rights of appeal.