RESOLVING DOUBTS OVER UITF 40

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Background

In my article 'A Stealth Tax introduce by accountants?' (P.T.P.R. 2006 10(3) 55-69), I set out the background to the document from the Urgent Issues Task Force which was intended to resolve the question as to the interpretation of Application Note G to Financial Reporting Standard 5 ("FRS 5").

The Urgent Issues Task Force and FRS 5

The Urgent Issues Task Force is made up of leading members of the accounting profession, drawn from accountancy firms, law firms and industry because of their knowledge of the technicalities of financial reporting. The UITF defines as its main role:

> "*… to assist the ASB with important or significant accounting issues where there exists an accounting standard or a provision of companies legislation (including the requirement to give a true and fair view) and where unsatisfactory or conflicting interpretations have developed or seem likely to develop. In such circumstances it operates by seeking a consensus as to the accounting treatment that should be adopted. Such a consensus is reached against the background of the ASB's declared aim of relying on principles rather than detailed prescription.*"[2]

Although FRS 5 was first issued in 1994, the current confusion stems from an amendment to it made in November 2003 (with effect for accounting periods ending on or after 23rd December 2003). The amendment came in the form of an

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2 Foreword to UITF Abstracts, published by the Accounting Standards Board, February 1994

"Application Note" – namely Application Note G[3] which aimed to tackle the question as to when a business entity should recognise income in its accounts.

This had become of major concern to the Accountancy Standards Board because certain companies, particularly those in the information technology sector, were reflecting future income streams in their accounts once they had secured certain lucrative deals, even though the income would be earned (and received) over a number of years.

The purpose (and effect) of Application Note G was to ensure that income could not be recognised until the right to receive it had been earned. See Example.

Example

> *Suppose a business entered into a contract on 1st January 2007 to supply a service to a customer over a three year period. Suppose further that the contractual fee for the service was £3m.*
>
> *The mischief which led to the introduction of Application Note G was that the business might have shown £3m as turnover in its accounts for the accounting period which included 1st January 2007.*
>
> *Application Note G however ensures that the income must be spread over the period during which the income is earned (for example, £1m in each of the three years to 31st December 2009).*

A situation typical to that contemplated by Application Note G was where the service provider was providing a continuous or regular service over the lifetime of the contract – for example, the business was providing a 24-hour security guard for its customer's premises.

However, when Application Note G was published (both in the public consultation stage and after it was formally introduced) concerns were expressed about how it would apply in situations where the service being provided was more discrete. This was a particular concern in professional firms where a solicitor might be drafting a trust deed, a tax adviser might be preparing a client's tax return or an architect might be in the process of drawing up plans for a particular development. In all such cases, the work might not have been complete at the end of the firm's financial year and the question arises whether the firm should recognise the income

3 The original version of FRS 5 contained five Application Notes (lettered from A to E); Application Note F was added in 1998.

it has partially earned by the accounting date (and, if so, how much) even though it is not yet at a stage where it is ready to issue a fee note.

The relevant paragraphs of Application Note G were set out in my previous article and I do not repeat them here. However, suffice it to say that there were two schools of thought.

On the one hand, it was suggested by some that Application Note G should be interpreted in such a way that meant that the time on the clock (or at least the recoverable part of this time) at the year end (or, where the basis of payment would have been a flat fee, an equivalent proportion of the contract price relating to the time spent on the project so far) should have been included in the accounts as revenue of the year then ended.

On the other hand, others maintained that Application Note G referred to revenue being required to be recognised in the accounts if and only if there was a "right to consideration"– as these words are understood in the context of contract law – at the relevant accounting date.

With this controversy boiling[4], it then became the role of the Urgent Issues Task Force to arbitrate and determine how half-complete contracts should be accounted for. In March 2005, the Urgent Issues Task Force published an 'Abstract', known as UITF 40, which effectively held that the former of the two accounting treatments highlighted above was correct.

Rulings from the Urgent Issues Task Force not only represent best accounting practice but become compulsory within a few months after promulgation. In the case of UITF 40, its interpretation became mandatory with effect for financial statements ending on or after 22nd June 2005.

The tax impact of UITF 40

As is now well established (both under common law principles and statutory provision), the starting point for tax computations is the profit of a business as calculated in accordance with Generally Accepted Accounting Practice ("GAAP").

4 This issue was probably of more interest than most other accounting matters since it directly affected the calculation (and acceleration, possibly) of taxpayers' taxable profits.

In the case of most unincorporated businesses affected by the ruling, the first accounts prepared under the new rules will be those ending in the 2005/06 tax year with some not affected until 2006/07.[5]

The end of the problem?

In many quarters, it was thought that UITF 40 would bring an end to the debate. The only questions that were thought to remain were how to deal with the acceleration of taxable profits (partially resolved by provisions included in Schedule 15 to the Finance Act 2006) and how these rules would be applied to partnerships (see, for example, 'Thinly spread?', Tony Jenkinson, *Taxation*, 26th October 2006).

However, there have continued to be some rumblings concerning the application of UITF 40 and, in December 2006, a document was jointly published by the Association of Accounting Technicians ("AAT") and the Association of Taxation Technicians ("ATT") giving their understanding of how UITF 40 should be interpreted in practice.[6]

As will be seen, the further guidance from the AAT and ATT has reignited the UITF 40 debate.

The AAT/ATT guidance

Most of the AAT/ATT makes good sense. The guidance explains the role of the Urgent Issues Task Force within the overall scheme of financial reporting. It continues to analyse the wording of Application Note G and, in particular, those paragraphs that relate to incomplete work at the end of an accounting period.

It is this latter point which I have often discussed when lecturing to (mainly) solicitors on the issue. I have provided the example of a complex trust deed which a solicitor starts to prepare in December but finishes in January. In my example, I have assumed that the solicitor has an accounting date of 31st December. I then outline the two schools of thought regarding Application Note G. Noting that paragraph G6 refers to the solicitor recognising revenue to the extent that he or she

5 Even those taxpayers not directly affected by UITF 40 until 2006/07 might find that payments on account for that year (the first of which was payable on 31st January 2007) would be increased as a result of the change.

6 This guidance is available on the AAT and ATT websites (www.aat.org.uk and www.att.org.uk).

has obtained the right to consideration I then ask the question how much they think that a solicitor can invoice for at the time that the trust deed is half complete. As readers will no doubt imagine, the typical answer I get to this question is unprintable.

The AAT/ATT guidance provides a careful analysis of the wording of Application Note G, for example, noting that it is "plainly founded on the principles of contract law" and "the right to consideration" must be interpreted in that light. Consequently, the AAT and ATT argue, the solicitor with half a trust deed need not recognise income in relation to the notional fee that might have been raised at the end of the year.

My personal view is that the AAT/ATT interpretation of Application Note G is spot-on although I can understand the reason why many commentators favoured the alternative reading.

However, where I strongly disagree with the AAT/ATT guidance is that the issue can be considered solely by looking at the text of Application Note G. I do not come to this conclusion with any enthusiasm. However, a professional adviser must advise on the law as it is rather than as it might have been.

The suggested approach

As a barrister, the situation I might come across is an enquiry into a tax return where the accounting profits have been prepared in accordance with the AAT/ATT guidance and HMRC are suggesting that taxable profits have, as a result, been understated.

As previously noted, the first thing that needs to be considered is GAAP. On this point, the AAT/ATT guidance states:

> "*First we need to appreciate what UITF 40 is and, more importantly, what it is not. It is not an Accounting Standard; it is merely an interpretation of an amendment (Application Note G) to an accounting Standard (FRS 5). A UITF Abstract cannot be construed as amending or overriding an accounting standard.*[7] *If we regard FRS 5 as the accounting equivalent of ICTA 1988, then Application Note G is the Finance Bill which amends that Act and UITF 40 is nothing more than the Treasury's Explanatory Notes to the Finance Bill (this view has been put forward in meetings with members of the ASB and UITF, who have accepted this interpretation). It*

7 This point is attributed to the foreword to the UITF Extracts referred to above.

> *is of interest and may be of assistance in interpreting the amended Act, but it has no authority in its own right. (It is unfortunate that by commentators constantly referring to UITF 40, rather than Application Note G, the former has acquired a perceived authority in the eyes of many.)"*

It is this paragraph which highlights the flaws in the AAT/ATT guidance.

Part of the problem is relying upon the analogy with tax legislation. It is undoubtedly correct that an Abstract from the Urgent Issues Task Force may not add new financial reporting rules and is limited instead to interpreting existing standards. One can also see the attraction of likening an Abstract to a Treasury Explanatory Note, especially in this post-*Pepper v Hart* age when a Court can, in cases of real doubt, refer to the Note as a valid aid to statutory interpretation.

However, the Treasury Explanatory Notes are prepared at the same time as the Finance Bill clauses to which it refers and will therefore not necessarily deal with all disputes that might arise in practice. (Were such disputes foreseen at the time it is likely that the legislation itself would deal explicitly with the point in question.) In contrast, an Abstract from the Urgent Issues Task Force is prepared only when issues of doubt have been highlighted in practice. In this sense, an Abstract of the Urgent Issues Task Force, which is binding on the accountancy profession, is more akin to a decision of the House of Lords. Of course, there are some constitutional differences in that the Urgent Issues Task Force comes under the umbrella of the Financial Reporting Council and the Accounting Standards Board whereas the ultimate Court of the land is (in practice at least) separate from both the legislature which passes the legislation and the executive which sponsors it. The analogy is not perfect but at least one knows that a decision of the House of Lords (like an Abstract from the Urgent Issues Task Force) is directed to a particular point of dispute. Furthermore, a decision of the Urgent Issues Task Force (like some of those of the House of Lords) might not be received with universal acclaim and it is only right that practitioners or others should be able to suggest reasons why the wrong conclusion might have been reached. However, pending any change in the law (or an alternative decision being reached), such a ruling represents a binding resolution of the matter.

Can UITF 40 be ignored?

Returning to my hypothetical example of accounts prepared in accordance with the AAT/ATT guidance, how would I advise a taxpayer whose accounts were now under enquiry? If I were able to put forward to HMRC an argument that, notwithstanding UITF 40, it remained possible for accounts to be prepared without recognising the 'half-earned' income, I would not hesitate to advise the client

accordingly – especially, given my understanding of the wording of Application Note G.

The ultimate test, however, is to consider how the matter would be resolved in the Courts. In order to overturn a challenge by HMRC regarding a particular set of accounts, I would have to require HMRC to prove that the originally submitted accounts had not been prepared in accordance with GAAP. Even though I am a Fellow of the Institute of Chartered Accountants in England and Wales, a Court should not permit me, as advocate, to adduce evidence of what constitutes GAAP. I could refer a Court to the body of financial reporting standards and invite the Court to deduce its own conclusion but the true test is not how a lawyer would interpret the guidance but what is the actual practice endorsed by the accountancy profession. This should be determined by bringing to the Court expert witnesses from the field of financial reporting.[8] Even to the extent that there is no consensus within the profession (noting, in particular, the recent document from the AAT and ATT) I would nevertheless expect a Court to uphold UITF 40 as representing the 'correct' practice.

I would be more prepared to fight UITF 40 (perhaps in a different forum) if I saw any merit in the proposition that it was wrongly issued and therefore should not be binding on the accountancy profession. However, in the present circumstances, I do not believe that such a position is sustainable. This is because, in my respectful submission, the Urgent Issues Task Force was correct in reaching the decision it did in UITF 40.

The key to UITF 40

The problem which most commentators have overlooked is that UITF 40 did not merely provide an interpretation of the disputed wording of Application Note G, which now forms part of FRS 5.[9]

Whilst the AAT/ATT guidance correctly attributes the statement that UITF 40 forms an interpretation of Application Note G to the August 2006 guidance document published by the Consultative Committee of Accountancy Bodies ("CCAB") in August 2006, such an assertion should not be taken as authoritative.

8 For an example of the importance of accountancy evidence, I would refer the reader to the decision of the House of Lords in *Sharkey v Wernher* (1955) 36 TC 275 where Lord Radcliffe's speech (at p. 302) refers to the fact that the case was decided in the absence of accounting evidence.

9 Apart from my previous article, the only other article that I have seen which correctly explains the true effect of UITF 40 is that by Robert Maas in 'A red herring?' *Taxation*, 18th May 2006.

The CCAB is a well-respected voice amongst the accountancy profession and the wider disciplines. But it is a body independent of the Financial Reporting Council. Therefore, any assertion by the CCAB, whilst undoubtedly persuasive, is no more authoritative than an interpretation of, say, the inheritance tax legislation by the Chartered Institute of Taxation or STEP.

More importantly, in this particular case, the assertion is only partially correct. Whilst it is undoubtedly true that the debate concerning the interpretation of Application Note G led to the issue of UITF 40, it is not correct to suggest that the only effect of UITF 40 is to assist in the interpretation of Application Note G. First, it should be noted that Application Note G (as indeed is the rest of FRS 5) is not a stand-alone standard determining how a single transaction or state of affairs should be reported in an entity's financial statements. Instead, it provides the underlying rule that the substance of the situation should be reported rather than its strict legal form. In other words, FRS 5 should not be looked at in isolation of other Financial Reporting Standards or their predecessors, the Statements of Standard Accounting Practice. Indeed paragraph 43 of FRS 5 provides:

> "*The FRS sets out general principles relevant to the reporting of all transactions. Other accounting standards, the Application Notes of the FRS and companies legislation apply general principles to particular transactions or events.*"

Furthermore, the wording of UITF 40 itself makes it clear that the debate surrounding Application Note G can be resolved by referring also to the Statement of Standard Accounting Practice relating to stocks and long-term contracts ("SSAP 9").[10]

Under SSAP 9, there has long been a requirement that income on long-term contracts should be prudently recognised whilst the contract progresses, whether or not the contract permits stage payments to be made. For example, if a two-year construction project worth £2m (and an estimated profit of £1.2m) were undertaken and after one year half the costs had been incurred and half the construction work had been undertaken, SSAP 9 would have required the business to report £1m income from the project as part of its turnover together with costs of £400,000. This accounting treatment remains unchanged following the issue of Application Note G.

The wording of SSAP 9 has led most (if not all) of the accountancy profession to treat as a long-term contract only those contracts which are expected to last more

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10 Indeed, paragraph G14 of Application Note G explicitly provides that SSAP 9 is not amended by Application Note G although the Note does provide additional guidance on the recognition of turnover from long-term contracts.

than a year. However, SSAP 9 does explicitly provide that shorter contracts might come within the definition.

> "*Some contracts with a shorter duration than one year should be accounted for as long-term contracts if they are sufficiently material to the activity of the period …*"[11]

Therefore, it is clear that even long before Application Note G, there was a firm basis for the requirement that revenue had to be recognised in the accounts before the completion of a contract. Applying this to a professional services business, this could be relevant, for example, if a sole-practitioner solicitor's practice was wholly dedicated to dealing with major fraud cases, where litigation could last for years. In such a case, SSAP 9 would require the solicitor to reflect a proportion of the fee income during the life of a particular case even if payment is not due until the conclusion of the matter. The same accounting treatment would have been required even if the contract was likely to last less than a year but the contract spanned two accounting periods.

What is less clear from the wording of SSAP 9 is the application of SSAP 9 in cases where an individual contract is less significant to the financial performance of the firm. For example, suppose that half of the income of an accountancy practice is derived from bookkeeping, payroll and company secretarial services and the other half relates to the preparation of tax returns. The firm's year end is 31 December by which time 40% of its clients' tax returns have been submitted to HMRC and the rest are 90% complete. In such a situation, it is likely that the income from no one tax return would be sufficiently significant to the firm to come within the meaning of 'material'. Consequently, it is likely that, prior to Application Note G (and in many cases, even subsequent to Application Note G being published), such firms would not have considered treating such cyclical pieces of work (none of which is likely to last for more than a year) as long-term contracts.[12]

However, this point is dealt with in paragraph 14 of UITF 40, which I believe represents the key to the Abstract. In particular:

> "*The UITF takes the view that in considering whether contracts for services should be accounted for as long-term contracts,* ***the aggregate***

11 Paragraph 16 of SSAP 9.

12 One should further recall that before the introduction of section 42 of the Finance Act 1998, many of these firms would have paid tax on the cash basis and so the value (cost or sales) of any work-in-progress at the year end would have been of little significance to the Government.

> ***effect*** *of all such contracts on the financial statements as a whole should be considered."*
> [emphasis added]

In other words, it is not sufficient for firms to consider individual contracts in isolation. UITF 40 now makes it clear that the overall impact of all such contracts must be considered. If these contracts (in the aggregate) are material to the overall set of accounts being prepared, then they must be accounted for as long-term contracts in accordance with SSAP 9.

Conclusion

In summary, it is wholly understandable why Application Note G led to two different schools of thought over its interpretation, particularly in the cases of professional services firms. Reading the Note in isolation, I would not have hesitated to agree with the proposition that no accountant need include income in his or her accounts representing the time spent on an incomplete tax return. Furthermore, I fully respect the view that UITF 40 could not and should not have reinterpreted the words 'right to consideration' in such a way that could have had this effect.

However, in my view UITF 40 does not do this. In addition, UITF 40 does more than simply interpret Application Note G. It tells the accountancy profession how to determine which contracts are to be accounted for as long-term contracts for the purposes of SSAP 9. The Urgent Issues Task Force is fully within its bounds to do this and, consequently, UITF 40 is binding.[13]

As I mention in my earlier article, a letter from the Accounting Standards Board to the Chartered Institute of Taxation notes that accountants in practice had long been ignoring the correct application of SSAP 9 and this became apparent only when people started to debate the impact of Application Note G. With hindsight this is a pity because many practices will find that UITF 40 will give rise to many more cash-flow problems than section 42 of the Finance Act 1998, yet this time around spreading relief was only begrudgingly given, for three to six years (rather than ten) and only to those practices that delayed implementation of UITF 40 until the last possible moment.

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13 For the purposes of completeness, it should be noted that UITF 40 was not originally applicable to entities which were able to apply the Financial Reporting Standard for Smaller Entities ("FRSSE") (paragraph 21 of UITF 40). However, the FRSSE has since been modified and now incorporates UITF 40, in relation to accounting periods commencing on or after 1st January 2007.

Postscript

At the time of writing this article, two letters were published in *Taxation* expressing sympathy with the AAT/ATT stance.[14] One of these letters included two questions, which apparently had been raised with the 'accounting established' without any answer. I hope that the following comments, read in conjunction with the above article, will satisfactorily address these two queries.

1. *How did a measure, which was intended to stop businesses anticipating revenue, end up being interpreted as meaning that they would now have to recognise revenue earlier than before?*

As set out above, Application Note G was intended to tackle the perceived problem of businesses recognising income long before the income had been earned. In my view it clearly addressed this problem by ensuring that reported turnover did not include revenue until such time as it had been earned – the right to consideration.

As to the converse, I share the writer's disbelief that Application Note G could have been interpreted in such a way as to require work-in-progress (which is not at a stage at which an invoice can be raised) to be recognised at sale price. Whilst I recognise the fact that there is some logic in accounts showing income as it is being earned, having grown up with the accounting concept of prudence, I maintain the view that Application Note G would not have required this (and that it did not have such an effect).

Therefore, the direct answer to the question is that Application Note G did *not* have the effect of requiring income to be recognised earlier than before.

However, as is now established, GAAP does now require income to be recognised earlier than before. But this is not specifically because of Application Note G. It is because of UITF 40. UITF 40 was born out of the controversy surrounding Application Note G and, but for Application Note G, would doubtlessly never have been issued. However, UITF 40 clarifies how SSAP 9 should be interpreted. As a consequence of the clarification of how SSAP 9 should operate, many professional businesses are now learning that they are obliged to recognise fee income earlier than they would otherwise have done.

Therefore, whilst Application Note G was a necessary ingredient as far as the course of history was concerned, the revised interpretation of SSAP 9 (contained in UITF 40) could have been published without it.

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14 *Taxation,* 1st February 2007, Vol 159(4093), pages 126–127.

2. *What changed GAAP? If it was Application Note G, why did the Accounting Standards Board say nothing had changed? If it was UITF 40, why was the Task Force not acting ultra vires its terms of reference which prevent it from amending or overriding an accounting standard?*

As the question recognises, an Abstract of the Urgent Issues Task Force cannot amend or override an accounting standard. Any change must come through amendments to existing accounting standards and/or the introduction of new ones.

Application Note G did make such a change (and it was within the powers of the Accounting Standards Board to introduce a change). That change was to tackle the problem of income being recognised prematurely. Application Note G did not, however, change the accounting treatment relating to work-in-progress and that is the reason why the ASB would have said that nothing had changed in this area.

Although UITF 40 has led to a revised understanding of the accounting treatment of work-in-progress, it did so simply by clarifying the operation of SSAP 9. That, again, is something that the Urgent Issues Task Force is perfectly entitled to do given that "there [existed] an accounting standard [SSAP 9] … where unsatisfactory or conflicting interpretations [had] developed".