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Barristers' Accounts

Recent changes to the accounting rules are likely to increase the tax payable by barristers – here Julie Butler explains how to minimise their effect

Some seemingly technical changes to the Accounting Standards Board rules for calculating the profits of small businesses and professional practices are likely to have a major impact on lawyers and, particularly, on practising barristers. Typically, the new rules will require barristers to estimate the value of work-in-progress on their accounting date, and include that figure in their earnings for the year. Work-in-progress might include, for example, preparation for a case which has not yet come to Court, or preliminary work on drafting complex documents. Including work-in-progress at value (rather than, as heretofore, at cost, which was usually nil) will have the effect of bringing forward the time at which earnings and profits are recognised and, more significantly, the time at which income tax on those profits is payable.

The changes were promulgated by the Accounting Standards Board on 10 March 2005, in the form of *Urgent Issues Task Force Abstract 40: Revenue Recognition and Service Contracts*, commonly if not affectionately referred to as 'UITF 40'. This was part of the Accounting Standards Board's programme to tighten the rules governing the point at which earnings could or should be recognised – paradoxically, this programme was originally intended to ensure that profits could not be recognised before they were earned. As is well-known, too early recognition of profits which had not yet, and might never be, earned had led to disaster in Enron and some other high-profile corporate failures. But for barristers and other professional people, the effect of UITF 40 will almost always be to bring forward the time at which profits are recognised for accounting and tax purposes.

The technical background to the changes

The Bar Council published guidance on the application of UITF 40 to barristers in May 2006. The Tax Faculty of the ICAEW (Institute of Chartered Accountants in England and Wales) issued *Taxguide 5/06: Guidance Notes on the Tax Aspects of UITF Abstract 40* as late as July 2006. This gives members of the Bar little time to deal with the accounting and tax compliance implications of the new concepts.

The bottom line is that a barrister can no longer ignore all 'work in progress' regardless of the circumstances. This will result in accelerated income, profit and tax.

The tax year to 5 April 2006

Potentially the first tax year affected for barristers will be the year to 5 April 2006. The Tax Return for that year has to be filed by 31 January 2007 and the tax paid by the same date. Time is fast running out for those barristers who have not yet come to terms with the new rules and the consistent application of subjective professional judgment that they will involve (as explained below).

In more detail, UITF 40 applies to accounting periods ending on or after 22 June 2005. Accordingly, if the barrister's accounting date falls between 22 June (2005) and 5 April (2006), he or she will have to apply UITF 40 when completing his or her Tax Return for the year to 5 April 2006. However, if the barrister's accounting

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date falls between 6 April (2006) and 21 June (2006), implementation of UITF is deferred until the tax year 2006/07. This is best illustrated by two simple examples:

- Barrister's accounting date is 31 March: UITF 40 applies from 2005/06
- Barrister's accounting date is 30 April: UITF 40 applies from 2006/07

All barristers will need to establish procedures for implementing the new accounting policies that will evolve. For those with an accounting date falling between 22 June and 5 April, will there be time to come to terms with new concepts such as 'work in progress', 'contract activity for revenue recognition', 'adjustment income' and 'spreading relief' before the 31 January 2007 deadline for submitting the 2005/06 Tax Return?

The Accounting Guidelines and how they impact

Although the guidance published by the ICAEW is designed primarily to assist small businesses, it applies to all service providers who are affected by UITF 40. The guidance applies to UITF 40 only and does not address the application of comparable requirements in either FRSSE (the *Financial Reporting Standard for Smaller Enterprises*) or in International Financial Reporting Standards. It does affect barristers.

The provenance of UITF 40 begins with a Statement of Standard Accounting Practice, SSAP 9 *Stocks and Long-Term Contracts*, and a Financial Reporting Standard, FRS 5 *Reporting the Substance of Transactions: Revenue Recognition*. The latter was supplemented by an Application Note G *Revenue Recognition* (in accountancy shorthand, FRS 5 ANG), which made general rules for recognition of revenue. It introduced the notion that revenue should be recognised when the seller has a 'right to consideration'. UITF 40 interprets FRS 5 ANG.

A prudent estimate is required

Generally, if there is uncertainty about the amount of revenue that will be earned, the barrister should make a prudent estimate of the recognisable revenue. If in a rare case no reliable estimate can be made, revenue should not be recognised at all.

At a general law firm level, if a firm works on the basis of charge-out rates that are not always fully recovered, revenue should be recorded based on likely (lower) recoveries rather than nominal charge-out rates. If the revenue is not receivable in cash for an extended period, it would be appropriate to allow for this by discounting for the time value of money.

The Bar Council's current guidance on the application of UITF 40 to the computation of barristers' earnings, issued in May 2006, was an update of an earlier Guidance Note published on 10 March 1999 ('the 1999 Guidance').

'Activity' v 'completion'

Two principles predominate under the new rules:

- Contract activity rather than contract completion or invoicing is the focus of revenue recognition; and
- When work is partly performed at the end of the barrister's accounting period, the fair value of the right to consideration earned should be brought in as revenue.

If, in any particular case or matter, by the end of the accounting period work has been performed for which a barrister has 'obtained a right to consideration', then under UITF 40 that work should be taken into account in the same way and to the same extent as 'completed work', as explained in paragraphs 9 to 12 of the 1999 guidance.

The need for professional judgment

Work completed at the end of the barrister's accounting period must be brought into account as debtors, in the amount of the agreed or anticipated fee (the latter may necessitate professional judgment). In the case of incomplete work which straddles the end of the barrister's accounting period, it is necessary to bring in a reasonable estimate of the fee earned as a result of the work done by that date. All of the above is subject to the 'materiality concept' referred to in paragraphs 4 to 6 of the 1999 guidance.

'Spreading relief and 'adjustment income'

For the first year UITF 40 is adopted (tax year 2005/06 or 2006/07, as appropriate), taxable profits will be calculated using the new basis for calculating both the opening and the closing work-in-progress. However, there will be an additional tax charge on the 'adjustment income' – the difference between the old and the new valuations of the opening work-in-progress.

For example, suppose a barrister makes up his accounts to 31 December annually. On the old basis, his work-in-progress as at 31 December 2004 was (correctly) valued at nil and his 2004/05 tax assessment was calculated on that basis. However, following UITF 40, the valuation of the same work-in-progress rises to £15,000. The 31 December 2004 work-in-progress is not only the closing work-in-progress for 2004, it is of course also the opening work-in-progress for 2005. Accordingly, the difference between the old and the new valuations (£15,000) is the 'adjustment income' and is assessable in 2005/06.

The object, of course, is to ensure that no profits drop out of assessment on the changeover to the new basis of valuing work-in-progress.

However, unless the barrister elects otherwise, the 'adjustment income' is spread forward, so that one-third is assessed in the year UITF 40 is adopted and one-third in each of the two following years. Where the 'adjustment income' is exceptionally large in relation to profits, spread-forward over up to six years may be possible (section 102 and Schedule 15, *Finance Act 2006*).

Barristers in the first seven years of practice

The UITF 40 changes do not affect barristers in their first seven years of practice, who may continue to use a cash basis for tax purposes. How are the seven years defined? They run from the time barristers start 'holding themselves out' for fee-earning work.

The Bar Council's guidance

So what guidance does the Bar Council give in specific circumstances? The notes published in May 2006, *Application of UITF 40 to Barristers' Earnings*, say that:

No Win, No Fee Revenue should not be recognised until the case has been won. Only at that stage does the barrister have a right to any consideration (UITF 40, paragraph 27).

Pay at End The fee is not agreed in advance, nor is the rate fixed. Instead, the consideration is negotiated at the conclusion of the case. The difference from 'no win, no fee' is that a fee will always be due. Before UITF 40, this was included as soon as the fee was negotiated.

There is significant uncertainty about the amount of the fee that has been earned by an accounting date prior to the end of the case. Nevertheless, it is clear that the relevant fee is not nil. Under UITF 40 there are two possible arguments:

- Where there is some uncertainty about the fee but a reasonable estimate can be made, at least of the minimum that will be earned, then an estimate should be made of the proportion of the total fee that has been earned as a result of work done by the balance sheet date. This estimated amount should be included as revenue.
- Where there is genuinely so much uncertainty that no reliable estimate can be made of the total fee and of the part of that total that has been earned to date, no revenue should be recognised until such time as the uncertainty has reduced and a reliable estimate can be made. This might be at a later stage of the case or it might not be until the fee is negotiated at the end of the case, depending on the facts and circumstances. However, there is a general assumption that amounts can be estimated with sufficient reliability to be included in financial statements. Accordingly, non-recognition due to an amount not being reliably estimable should be very much the exception.

Fixed Fee Cases A barrister works on certain types of publicly funded cases ('cost assessed', 'graduated fee' and 'prosecution'). These cases are done for a fixed fee. Before UITF 40, revenue was recognised on completion of the case. Is it right to say that UITF 40 can be read to give the same result? Another view appears to be that every case on which the barrister is working should be examined and that the proportion of the consideration which had accrued by the year-end should be included, even though there is as yet no right to that consideration. A further reason why one might argue that this is incorrect is that if the barrister who has prepared the case is unable to present it in Court, then the presenting barrister receives the whole of the fee.

The Bar Council advises that the appropriate accounting here is a matter of professional judgment depending on the facts of the situation. If the fee was agreed but the amount of remaining work and therefore time to be spent was open-ended and therefore very difficult to predict, one would either (a) recognise some revenue but on the basis of a very conservative estimate; or (b) argue that no reliable estimate can be made until the case is further progressed.

As to the point about potentially losing the fee if the barrister cannot appear in Court, the effect of this point on the accounting depends on the substance. If losing the fee due to being unable to present the case in Court is rare, one would either disregard it or make an overall reduction of a few percentage points in the overall revenue figure to allow for the rare case in that category. If it is common that a barrister prepares a case and is not able to present it, thereby losing the fee, it may be that there is not sufficient certainty to justify

recognition of revenue until the barrister does present the case in Court and is thereby assured of receiving the fee. Events after the balance sheet date (appearing or not being able to appear in Court) may of course reduce the uncertainty in some cases.

Legal Aid Cases Legal aid in some cases is not agreed until after the matter has been settled. In lengthy cases payments on account are made. This is a long and protracted procedure that can take many years. Often the payments on account will be for a greater amount than the eventually agreed fee and the barrister has to return the excess. Hitherto, it has been agreed with HMRC that the relevant tax point is payment, normally a payment on account, or the agreement of the fee, whichever comes first.

Again, under UITF 40 professional judgment has to be applied here and the accounting treatment will depend on the degree of uncertainty. In principle, revenue should be recognised according to the work done to date, rather than according to progress payments received. If a reasonable estimate can be made of the revenue that has been earned as a result of the work done to date, then that should be recognised. Prudence should be built into that estimate, in response to the uncertainty. It may be that the level of uncertainty is so high that no reliable estimate can be made until either later in the process or until the case is completed and the fee agreed. Finally, a barrister should not recognise all the progress payments received as revenue, even if they do bear a close relationship to the work done to date, if it is likely that some of the amounts received will have to be refunded.

Clearly the key is professional judgment and there will be uncertainty. The basic accounting principles and rules must be applied here – for example, consistency, and prudence where there could be refunds of fees already received. It is important to establish and document a policy, and to ensure that it is consistently applied with clarity, with an 'audit trail' of working papers that could be used to demonstrate that a reasonable policy has been carefully applied.

There may be a temptation for barristers to exaggerate the element of uncertainty and the need for professional judgment on questions of revenue recognition – and, conversely, for tax inspectors to underrate that uncertainty. Such difficulties can be minimised by the barrister establishing a clear revenue recognition policy and keeping the records necessary to show that it has been consistently applied.

Act now to avoid problems later!

The clear key is that every barrister must assess his or her position **now** and must be encouraged to do so by their long-suffering tax advisors. The application of UITF 40 will need a clear understanding of the accounting principles as well as the tax principles that surround this guidance on revenue recognition.

Julie Butler FCA is Managing Partner of Butler & Co, Bowland House, West Street, Alresford, Hampshire, SO24 9AT (telephone 01962 735544, e-mail j.butler@butler-co.co.uk).

She is also the author of 'Tax Planning for Farm and Land Diversification' (Second edition: ISBN 0754522180) and 'Equine Tax Planning' (ISBN 0406966540). To order a copy call Tottel Publishing on 01444 416119.