

SHOCK tactics

Lawyers, accountants, surveyors and architects could be in for a shock when their next accounts are due, warns leading Kent accountancy firm Burgess Hodgson.

A change in UK accounting practices means that, from June 22nd this year, they will be hit with a one-off tax charge that could cause severe cash-flow problems.

These changes in accounting standards will alter the way that professionals such as lawyers account for work-in-progress. Their effect is not selective: they will hit limited liability partnerships and companies as well as other professionals who provide services such as accountants, and architects.

But, predicts Colin Slater, partner at Burgess Hodgson, it is lawyers who could face a hefty tax bill for work they are doing but for which they have not yet been paid who will be hit the hardest. "It's big money, and most people don't realise it's going to hit them," he says. The tax charge could represent 50 per cent or more of a business's annual tax liability, and many organisations will not yet have received the funds on which they will be taxed.

Colin estimates that the average cost will be about a month's worth of billing. "Would you want to write the tax man an extra cheque equivalent to a month's worth of billing?" he says. "For many people, this may be actually more than their yearly tax payments."

It's a serious problem, and one that could bring severe cash-flow problems to many large and small companies.

In the wake of amendments by the Accounting Standards Board to one of its financial reporting standards, known as FRS5, professionals will be taxed on their work-in-progress earlier - and potentially at full selling value rather than the cost, as has traditionally been the case.

"The way in which most service providers value their work in progress for accounting practices is at cost," explains Colin. This means that a professional practice with, for example, 50 fee earners and ten partners may have, at any one time, a million pounds worth of ongoing work, valued at selling price (this would apply to any practice of substance, and lots of smaller ones).

And while, under the previous British accounting standards, a firm would bring in work in progress only to the extent of cost, (perhaps about 300,000) under international accounting procedures, they will now bring in not the cost, but a proportion of the selling price (perhaps about 900,000). The potential one-off tax bill would be of the order of 240,000.

As a result situations may arise where solicitors working on a long probate case could be taxed on the selling price of time spent on the case up to the end of their accounting year, even though they will not

be paid until the case finishes. "The effect of that is to bring in the partner time and the profit element," explains Colin. "And, we are talking about big money, because most professional practices bringing in only cost are only probably bringing in a third of the selling price."

The key issue is when firms should recognise revenue and therefore include work done at sales value in their accounts, rather than carrying at cost in work in progress.

The new rules mean that law firms are faced with a tricky judgement: how to assess on a job by job basis the degree of performance of the work for the client and the fair value to be recognised as sales income - even though a bill may not have been raised. The difficulty for service firms arises because it is not as clear when performance takes place as when physical goods are delivered, for example.

In the past, most service providers in this situation would have recognised revenue (i.e. accounted for turnover) only when a sales invoice was raised. If that was not until the end of the job, the cost of doing the work would have been treated as work in progress (according to Statement of Standard Accounting Practice (SSAP) 9).

The new standard distinguishes between two types of contract for services - those where the fee is contingent or conditional and depends on the occurrence of a critical event that is outside the control of the seller, and those where in substance the seller's contractual obligations are performed gradually over time.

Time-based work and work in progress are the areas which are likely to see the greatest change in the reporting of turnover or profit. Management systems must be able to distinguish which jobs are time-based and which are not.

"The first thing is to recognise that this situation exists," explains Colin. "Unfortunately, there is still an argument in the accountancy profession over exactly what it all means." But, he says, there are things companies can do about it now. One way to help mitigate the problem would be for a firm to send out its bills more regularly, because this means the work in progress goes down.

"It would also help to bill quicker," says Colin. "Some firms only bill clients on an annual basis. This means that potentially you could have a large amount of money on the time ledger for a particular client of work in progress, which could be taxed if its falls into your accounting period. People will have to look at on account billing at a much greater extent. This is particularly the case for lawyers who are notoriously slow at sending out bills."

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Work in progress
+
new accounting
procedure
=
big tax headache

»VISION« »STRATEGY« »PLANNING«