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## Cost Value Reconciliations

For those in the construction sector, calculating the amount of income to report in your accounts in respect of contracts can be a minefield. This factsheet considers why it's important to do this accurately and what you can do to get it right.

### Why is it important?

A fundamental principle of taxation is that tax is charged on a business's profits which have been calculated in accordance with UK Generally Accepted Accounting Practice (GAAP) and then adjusted according to tax legislation.

If a business's profits have not been calculated in accordance with UK GAAP, the amount of tax payable is likely to be wrong.

In Mark Smith v HMRC (2012) TC02321, the taxpayer appealed against discovery assessments made by HMRC. The First-Tier Tribunal found in favour of HMRC because Mark Smith's method of recognising income from contracts was not in accordance with GAAP.

Companies must also follow UK GAAP as their accounts must give a True and Fair view.

### Recognizing revenue from construction contracts

In the UK, GAAP is set out in Financial Reporting Standards (FRS). FRS 102 applies to most companies, except micro-entities which apply FRS 105, but both standards mandate the same approach (as below).

Under UK GAAP, revenue in the accounts should be based on the stage of completion of the contract. So, if it is 50% of the way through, revenue should be 50% of the total contract value.

For profit, recognition requirements are a little more complex. In general, profit should be recognised in line with income, over the life of the project. So, if a project is due to make 10% profit, when it is 50% complete you would recognise 50% of the income and accrue costs so that profit of 10% is made on that income.

However, profit should only be recognised when the outcome of a contract can be reliably estimated. So many businesses may only recognise profit when the project is more than 20% complete, as before that they may deem the outcome to be uncertain.

Finally, losses should be recognised in full as soon as they are expected. For example, if a business looks at the total contract value of a project and compares it to costs already incurred, plus those it expects to incur to finish the project, and this shows that the project will make a loss, the entire amount of the loss should be recognised now, even if the project is only partially complete.

### Cost Value Reconciliations (CVR)

So, for the accounts of a business, there is a need to consider the state of completion of a project at each reporting date, as well as the total projected costs and ultimate profitability. This will get the accounts right and ensure the profit is correct as a basis for tax purposes.

This kind of analysis – what many call a CVR – is also vital as a management tool to ensure that the progress of projects and their ultimate profitability is monitored. This is particularly important in an inflationary environment and where there can be significant supply problems. Keeping the schedule of projected costs up to date enables management to identify where they need to work harder at cost control and / or liaise with client to discuss price changes.

## Further information

If you need any help in carrying out Cost Value Reconciliations (as there are a number of complications / options to consider in addition to the issues noted above), please speak to us and we will be happy to help.

In FRS 102, construction contracts are addressed from 23.17: https://www.frc.org.uk/library/standards-codes-policy/accounting-and-reporting/uk-accounting-standards/frs-102/