Customer Contract Accounting — Bottom of the 9th Inning

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I vividly recall the moment in the summer of 2014 while attending a CPE event at the Miami Marlins Park. Sitting in a room of primarily controllers and chief financial officers, those on the front lines of what was about to come, it became clear that we were in for a heavy dose of CPE on a newly issued U.S. GAAP standard on revenue recognition for customer contracts.

While many of the in-depth details were more than most could absorb in a two-hour session, I could not help but ponder what all of this meant to the tax professional. Although we tax professionals have come to expect and embrace changes to rules and regulations, the thought of understanding the guts of the new GAAP standard and implementing an effective plan to "ring fence" this left me secretly hoping for more time or perhaps a change in course. The answers to the concerns that engulfed me that day were outside the scope of the seminar, and I left with more questions than answers. My thoughts were quickly diverted upon the opening pitch of the baseball game — at least for a little while.

Roughly three years have lapsed since my experience, and the new rules are now basically upon us. The new standard is effective for reporting periods of public organizations beginning after December 15, 2017, including interim reporting periods within that year. All other entities will be affected beginning one year later for reporting periods beginning after December 31, 2018, including interim reporting periods beginning after December 15, 2019.

Since the announcement, controversial political elections, expectations of much needed reforms to our nation's healthcare and tax systems, and significant geopolitical events around the world have largely captured our focus. However, through all of this, there are people who have maintained an eye on forthcoming GAAP changes designed to bring about increased reporting consistencies across industries and geographical boundaries. Like the anticipated IFRS tsunami that came before it, many believe the effects of the new guidance will be far-reaching, rippling from the accounting department to those in information technology, finance, legal and human resources. How an organization will adapt its information systems to capture info on a contract-by-contract basis, modify its existing debt covenants to comport with the new metric, review any triggering effects the changes may have on existing M&A earn-out provisions, and review executive bonus plans based on historical metrics are just a few of many areas to be addressed. The challenges here for many organizations could be overwhelming, even for the tax professional.

We first wrote about the new revenue recognition standard in our *Tax Advisor Weekly* dated November 11, 2015. This prior article introduced the topic, provided some technical accounting background and addressed some of the tax principles governing revenue recognition under IRC Section 451 and the Treasury regulations. Our intention here is to emphasize the importance for the tax professional to be actively involved with the planning and implementation of an effective "ground game" based on foresight and collaboration across the organization.

Now codified as ASC 606 (previously ASU 2014-09), "Revenue from Contracts with Customers," this is the first of other future U.S. GAAP standards that is expected to fundamentally change the way in which many stakeholders view our world of debits and credits

— ranging from the way information systems capture financial information to the processes and controls that will be implemented to make this all work. The new standard is generally directed towards organizations that enter into contracts with customers to transfer goods or services, and enter into contracts for the transfer of nonfinancial assets. Contracts within the scope of other existing accounting standards (e.g., insurance contracts, leases) as well as other specifically enumerated contracts (e.g., financial instruments, certain guarantees and certain nonmonetary exchanges) are outside the scope of ASC 606, so a careful analysis of its impact will be required. Most importantly, the standard will shift us from our existing rules-based system to a more principle-based approach for determining revenue recognition — another step along the path to convergence with International Accounting Standards.

Make no mistake about it. While we tax professionals plan for and anxiously await the enactment of major tax reforms, the adoption of the new revenue recognition standard will give us plenty to think about. One of the more obvious areas expected to impact the tax function may include the ongoing availability of financial information needed to support existing revenue recognition tax methods based on the current GAAP standards. The problem here is that the tax people typically do not "own" this information and must rely on others to obtain it, for its accuracy and for its completeness.

This situation presents two alternatives:

(1) Request that those responsible for an organization's accounting and IT functions continue to maintain whatever information is necessary to continue an existing tax accounting method that is based on "former" GAAP (potentially requiring a "shadow" accounting system which is part of any updated system); and

(2) Request an accounting method change from the IRS to adopt a new revenue recognition method that conforms with the new GAAP standards (using the argument that the "new" GAAP method clearly reflects income under IRS standards).

Although the latter alternative appears to be the most attractive, it brings with it a great deal of additional time-consuming analyses and filings with the IRS that will require human capital, the necessary time and perhaps budget. Whether the government will be able to timely respond to the barrage of highly fact-sensitive change requests is questionable. Further, how the IRS would determine if any proposed tax methods based on new GAAP meet the clear reflection of income standard will be interesting to see.

The new GAAP standard may also bring challenges for preparing an organization's income tax provision under ASC 740. Besides properly accounting for deferred taxes on a prospective basis, the new standard contains two potentially complicated transition methods:

1. The **full-retrospective method** will require a determination of the cumulative effect of the change through the earliest date that comparative financial information is presented **and** a recast of all prior year comparative information presented in the financial statements.
2. The **modified-retrospective method** will be applied to all new contracts entered into on or after the effective date. For any contracts with existing obligations as of the effective date, a cumulative catch-up adjustment must be made to the opening equity for the year of adoption. A recast of prior year comparative information will **not** be required.

In either case, it will be important for the tax professional to understand beforehand which of the two methods will be adopted by the organization and what specific information and/or analyses will be required to properly reflect the deferred income tax consequences associated with the adoption. Now is the time to begin the dialogue with an organization's financial statement auditors about expectations for the income tax function and documentation of the processes and procedures to be undertaken.

Alvarez & Marsal Taxand Says:

The adage "If you fail to plan, you are planning to fail" is particularly relevant for us as the future of GAAP becomes increasingly different from that which we learned during our academic and professional careers. I often remind others that most of us tax professionals have our roots in financial accounting — the language of the chief financial officer and an organization's investors. We continually find ourselves in environments requiring some level of proficiency in GAAP to understand the information and its impact on the organization as part of our responsibility to get the "right" answer.

With the go-live date around the corner, the prudent course is to get into the game now by actively engaging in dialogue with internal cross-functional teams and/or outside advisors, by attending internal and/or external training sessions addressing the upcoming changes, and by carefully thinking about the critical processes and procedures needed to both adopt and incorporate such GAAP changes into income tax accounting for financial and tax reporting. It is the bottom of the 9th inning — are you ready?

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Flashing Yellow: Income Tax Implications of Non-GAAP Adjustments

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Top Income Tax Provision Purchase Accounting Considerations

If Jimmy Fallon had a tax background and were to write one of his thank-you notes for this topic, it might read “Thank you, purchase accounting, because regular accounting for income taxes wasn’t complicated enough.”

Revenue Recognition... Interrupted?

In May 2014, in an effort to align standards, the FASB (Financial Accounting Standards Board) and IASB (International Accounting Standards Board) issued final standards on revenue recognition. These final standards were the product of an FASB/IASB joint project that spanned several years.

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