The Timing Is a-Changin': Income Tax Accounting Under the New Revenue Recognition Standard ASC 606

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Tax reform is roaring, and this isn't the only thing that needs to be considered for calendar-year-end companies. Just in time for the holidays, the Financial Accounting Standards Board (FASB) has delivered the gift of a new standard for revenue recognition in the form of ACS Topic 606, *Revenue from Contracts with Customers*, which supplants all previous guidance on accounting for revenue from contracts to provide goods or services to customers.

Like all the best holidays, the new standard promises to bring people together, requiring additional collaboration between tax departments, accounting, IT, sales and other departments in order to assure the availability of the necessary financial information to meet the new standard. Forget the office holiday party — this year's hottest invite is to the company's ACS 606 implementation task force.

The new standard under ASC 606 shifts revenue accounting from the existing rules-based system to a more principle-based approach to determining revenue recognition. Historically, companies utilized a realization principle, recognizing revenue as it was earned and realized. Under the new core principle, companies must recognize revenue in the amount the entity expects to be entitled to when it transfers control of a good or service to the customer.

The new revenue recognition standard will directly affect any organization that enters into contracts with customers to transfer goods or services, or that enters into contracts for the transfer of non-financial assets. Contracts governed by other existing accounting standards (e.g., insurance contracts or 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.

As companies adopt ASC 606, they need to be aware of the new standard's potential impact on their income tax accounting and reporting requirements. Specifically, implementation of the new revenue recognition rules may result in disparities between how companies record revenue for financial reporting purposes and when they record taxable income.

To prepare for this new method of revenue recognition, companies should consider taking a cross-functional approach to evaluating the systems and procedures under which revenues are recorded. New processes that allow for the recording of revenue in line with ASC 606 may need to be created and may require coordination between many departments within a company. Among the industries that are expected to be affected are the technology and software sectors, construction, telecommunications and any businesses that bundle products and services.

Effective Date

The new guidance, which was issued in an effort to align the revenue recognition standards of the FASB and the International Accounting Standards Board (IASB), applies to public entities for fiscal years beginning after December 15, 2017 (and for interim periods within that year), and for all other entities for reporting periods beginning after December 15, 2018.

The New Standard

Historically, companies utilized a realization principle, recognizing revenue as it was earned and realized. Under the new guidance, *companies must recognize revenue in the amount that entity expects to be entitled to when it transfers control of a good or service to the customer.* The new standard represents a shift from the existing rules-based system to a principle-based approach for determining revenue recognition. Under the new principle, revenue is recognized as control of the good or service is transferred.

The new principle is applied using the following five steps:

Step 1: Identify the contract with a customer.

Step 2: Identify the performance obligations in the contract.

Step 3: Determine the transaction price.

Step 4: Allocate the transaction price to the performance obligations in the contract (if there are multiple performance obligations).

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

Adoption Methods

To implement the new standard, companies will need to retrospectively apply ASC Topic 606 under one of two adoption methods: the full retrospective application or the modified retrospective application. Regardless of the method used, companies will face the challenges of maintaining a period of parallel financial and tax reporting under both the current and new standard rules.

Full Retrospective Adoption (the first day of the year presented): This method requires companies to apply the new standard to all existing customer contracts as of the beginning of the first historical period presented. Therefore, companies will need to restate all prior periods presented in the year of adoption.

Modified Retrospective Application (first day of the year of adoption): This method requires companies to apply the new standard to all new and remaining customer contracts as of the effective date. Therefore, companies will not need to restate prior comparative periods.

Under either adoption method, tax professionals will need to consider what specific information and analyses will be necessary to properly reflect the deferred income tax consequences related to the adoption.

Potential Tax Impacts and Areas of Caution

Impact on Tax Accounting Method

In many jurisdictions, including the United States, companies are required by law to use consistent financial statement and tax accounting methods when reporting similar transactions. Companies need to consider that, with the implementation of the new standard for financial reporting purposes, they may trigger a necessary change in tax reporting methodology as well. However, once a company has adopted a tax accounting method, the company must continue to use that method until the company files a request to change its tax accounting method with the Internal Revenue Service (IRS). The consistency requirement may constitute an accounting method change for which the company is required to obtain IRS consent without deviating from existing tax revenue recognition policies. Unless a change in method is listed as an automatic method change, any changes require approval from the IRS.

As the new standard is adopted, companies should review their current tax methods across jurisdictions to determine whether they may need to make method changes, and note the related requirements for such changes, such as the filing of Form 3115, Application for Change in Accounting Method, with the IRS in the U.S.

Impact on Temporary Differences

Under the new standard, companies may record revenue from contracts with customers for financial reporting purposes at a different time than they record the revenue for income tax purposes. When this occurs, the company will need to recognize and measure temporary differences in accordance with ASC 740. Going forward, this will continue to be a challenging concept and require a thorough review of existing and potential future timing differences. Companies may need to revise or create new data collection processes and controls to capture the relevant data.

Companies should consider whether the following circumstances might trigger new temporary differences:

- Changes in variable consideration (resulting from rebates, rights of return, price concessions and other items) leading to differences in the final transaction price.
- Changes in contract costs due to new capitalization rules and circumstances.
- Changes in distinguishing between implied price concessions (i.e., bad debt under legacy guidance) and customer credit risk within the final transaction price.
- Changes in the number of performance obligations identified for financial reporting purposes, including the new requirements on accounting for obligations such as renewals, free goods or services, and loyalty programs.

Impact on Multi-Jurisdictional Reporting

Under the new revenue recognition standard, it will benefit companies with multi-jurisdictional operations and tax filings to identify and group distinct revenue streams at the jurisdictional level. In accordance with ASC 740, deferred taxes are determined separately for each tax-paying component in each jurisdiction. By grouping revenue streams at the jurisdictional level, companies can conduct contract reviews within each stream, and thereby quantify and align any potential changes in the timing of revenue recognition in each jurisdiction.

Impact on Changes to Valuation Allowance

As outlined above, adoption of ASC Topic 606 may result in changes to a company’s deferred tax assets, timing of temporary difference reversals and/or changes to timing of future taxable income, which subsequently affects realizability of deferred tax assets. Companies will need to carefully consider the underlying circumstances to determine direct or indirect income tax effects, as changes in valuation allowance that are not a direct result of adopting the standards will need to be recorded in continuing operations. Additional allowances that do result from ASC Topic 606 will need to be recorded as part of companies’ retrospective adoption cumulative-effect adjustment.

Alvarez & Marsal Taxand Says:

The end of the year is almost here and with it the beginning of a new standard for revenue recognition in financial reporting. With ASC 606 kicking into gear on December 15, 2017 (for public companies; December 15, 2018, for all others), the standard for revenue recognition has shifted from a rule-based system to a principle-based approach that brings the U.S. and international standards closer together. The new standard requires that a company recognize revenue in the amount it expects to be entitled to when it transfers control of a good or service to the customer. Companies should be aware that these financial reporting changes may affect their reporting of income tax and may require processes and procedures for the recording of revenue to be revised or developed.

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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.

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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