What you need to know

- As companies prepare to adopt the new revenue recognition standard, they must consider the potential income tax accounting implications.

- Adoption of the standard may create new temporary differences or require the remeasurement of existing ones. It also may create process and system challenges if multiple “accounting bases” need to be maintained.

- Tax professionals should be actively involved in implementation discussions to make sure all implications are considered, regardless of whether the company has reached a conclusion on the pretax effects of adoption on financial reporting.

Overview

The new revenue recognition standard issued by the Financial Accounting Standards Board (FASB) will supersede virtually all US GAAP guidance on this topic, including industry and interpretive guidance. The standard, which was largely codified in Accounting Standards Codification (ASC) 606, provides guidance for all revenue arising from contracts to provide goods or services to customers (unless the arrangements are in the scope of other guidance, such as the guidance on leases).

As part of the project, the FASB also issued new guidance to account for any gains or losses resulting from the sale of nonfinancial assets or in substance nonfinancial assets that are not outputs of an entity's ordinary activities and are not businesses. This includes the sale of property, plant and equipment (including real estate) and intangible assets. This guidance is codified in ASC 610-20.
Adopting ASC 606 and related amendments likely will affect the accounting for income taxes because the timing of revenue recognition and gains from sales of nonfinancial assets for financial reporting purposes may no longer align with or may further diverge from their tax treatment.

As part of their processes to implement the new standard, companies should determine whether existing temporary differences require remeasurement or whether new temporary differences will arise when the new guidance is applied.

This publication is intended to be read in conjunction with our Financial reporting developments publication, *Revenue from contracts with customers (ASC 606)*.

**Background**

The new revenue recognition standard (ASC 606) requires entities to recognize as revenue the amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. That principle is applied using the following five steps:

1. **Step 1:** Identify the contract(s) with a customer
2. **Step 2:** Identify the performance obligations in the contract
3. **Step 3:** Determine the transaction price
4. **Step 4:** Allocate the transaction price to the performance obligations in the contract
5. **Step 5:** Recognize revenue when (or as) the entity satisfies a performance obligation

As part of the new revenue standard, the FASB also created ASC 340-40 to codify the guidance on other assets and deferred costs relating to contracts with customers. This guidance specifies the accounting for costs an entity incurs to obtain and fulfill a contract to provide goods and services to customers.

Companies need to consider the income tax implications of the new accounting guidance because they may need to record revenue for financial reporting purposes from contracts with customers at a different time than they record taxable income. Taxable income may vary across different jurisdictions. In the US, the Internal Revenue Code (IRC) and regulations require a company to recognize revenue in the tax year it is received or when all events have occurred that fix the company's right to receive the revenue and the amount can be determined with reasonable accuracy. Under the IRC, a company has a fixed right to revenue at the earliest of when the revenue is earned (i.e., required performance or events have taken place), when it is due to the company or when it is received by the company. In certain foreign jurisdictions, entities are required to use the local statutory basis or IFRS, which both may differ from the new US GAAP standard, as their tax revenue recognition method.

**Effective date and transition**

As a reminder, the standard is effective for public entities, as defined in the standard, for fiscal years beginning after 15 December 2017, and for interim periods therein. Nonpublic entities are required to adopt the guidance for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. Early adoption is permitted in fiscal years beginning after 15 December 2016.
The standard requires retrospective application; however, companies have a choice between full retrospective adoption and modified retrospective adoption. Under the full retrospective approach, entities have to apply the standard as if it had been in effect since the inception of all contracts with customers presented in the financial statements. Entities that elect the modified retrospective approach apply the guidance retrospectively only to the most current period presented in the financial statements, and they may elect to apply the modified retrospective method either to all contracts as of the date of initial application or only to contracts that are not completed as of this date.

**Tax accounting implications**

**Scoping**

Companies implementing the new revenue standard often start by identifying distinct entity-level revenue streams and conducting contract reviews within each revenue stream to apply the new accounting guidance at the contract level. Companies then use the results of this analysis to develop a preliminary accounting policy for both revenue recognition and costs to obtain or fulfill a contract.

In accordance with ASC 740-10-30-5, deferred taxes are determined separately for each tax-paying component in each tax jurisdiction. Therefore, in order to properly assess the income tax accounting effects of adopting the revenue standard, a company needs to assess its contracts and revenue streams at a jurisdictional level. Companies with operations and tax filings in multiple jurisdictions that haven’t grouped their revenue streams by jurisdiction as part of their process of evaluating the pretax effect of adoption should do so.

**Changes in temporary differences**

The timing of revenue recognition for financial reporting purposes may not align with the timing of revenue recognition for tax purposes. If that’s the case, a company recognizes and measures a temporary difference in accordance with ASC 740.

Companies may have new temporary differences or may be required to remeasure an existing temporary difference if adopting the standard changes the timing of revenue recognition for financial reporting purposes. Companies may need to revise their processes and data collection tools to capture any new temporary differences for tax accounting purposes.

The new accounting guidance may change a company's pattern of revenue recognition and expense recognition for contract costs in a way that creates new temporary differences. Changes to pretax accounting may include:

- A company may identify more performance obligations for financial reporting purposes than the number of deliverables it identified under legacy guidance, due to the new requirements on accounting for free goods or services, customer award credits or loyalty programs and options for additional goods or services in the future (including renewals).

- The transaction price may change due to the new requirements on accounting for variable consideration resulting from items such as rebates, price concessions, performance bonuses and rights of return; noncash consideration; consideration payable to a customer; and significant financing components.

- A company may be required to reduce the transaction price for implied concessions that it considered bad debts under legacy guidance.

- Contract costs may differ because the new revenue standard requires capitalization in certain circumstances.
The timing and amounts of gains recognized from sales of real estate may change, along with when a company can derecognize real estate assets.

Changes to existing deferred tax assets and liabilities resulting from the initial adoption of the standard should be included in the cumulative-effect adjustment as of the date of initial application.

**Tax method changes**

When a company determines its taxable income each year and prepares its tax returns, it is required by tax law in many jurisdictions (including the US) to use consistent tax accounting methods for similar transactions, just as it is required to consistently apply accounting policies when preparing its financial statements in accordance with US GAAP. Once a company adopts 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 appropriate taxing authority.

Every year, the Internal Revenue Service (IRS) issues a list of automatic method changes companies can voluntarily make with the filing of their annual income tax returns. Changes to methods that aren’t listed in the IRS guidance require approval from the IRS National Office and are commonly referred to as nonautomatic method changes. As companies implement the standard, they should assess their current tax methods to understand whether voluntarily changing to another tax method would be permissible and beneficial or whether it would be required. Entities should carefully consider the requirements related to tax method changes in each tax jurisdiction.

Companies considering method changes also should familiarize themselves with the appropriate method change filing requirements in the various jurisdictions in which they operate. For example, in the US, companies that elect to make a tax method change need to file a Form 3115.

Companies contemplating changes in tax methods will need to evaluate the existing methods and available alternatives in each jurisdiction in which the company operates. Differences in tax law may affect the recognition of taxable income and therefore the measurement of temporary differences, both at adoption and after adoption. In addition, a tax method change that may be automatic in one jurisdiction may require approval in another jurisdiction. Further, certain foreign jurisdictions may default to local statutory accounting for tax purposes, and the statutory accounting may automatically change with the required adoption of IFRS 15.

The IRS has released a proposed Revenue Procedure, which would expand automatic method changes to assist companies as they adopt ASC 606. Companies should monitor developments.

**Tax accounting implications**

If a company elects to make a tax method change (i.e., a change from one permissible tax accounting method to another), we generally would expect the financial statement consequences of the tax method change to be recognized as a component of income tax expense from continuing operations.

For an automatic change from one permissible tax accounting method to another, we believe the financial statement effect of that change generally should be recognized when the Form 3115 is filed with the IRS National Office. We also believe that a company generally will file Form 3115 in the same accounting period as it concludes that it has the intent and ability to file the form.

In certain cases, however, an entity may conclude that, based on the facts and circumstances, it should recognize the income tax accounting effects of a tax accounting method change in the financial statements prior to filing Form 3115 (i.e., a company may conclude that it has the intent and ability to file an automatic change on Form 3115, but it may not have done so as of the balance sheet date).
For nonautomatic changes, a company files a Form 3115 with the IRS National Office during the tax year in which the company would like to change its tax accounting method and must receive written consent from the IRS National Office before changing its tax accounting method for the year. For a nonautomatic change from one permissible tax accounting method to another, we believe the financial statement effect of that change should be recognized in the period in which the company receives notification of the IRS National Office's approval of the change (i.e., when all procedures necessary to effect the change have been completed).

A company that keeps an existing tax method should consider whether any new temporary differences will be created and whether any changes to temporary differences will result from adoption, as discussed above. If a company's existing tax method results in revenue recognition consistent with its current book method, the company may need to retain its existing accounting systems to continue to compute taxable income under its tax methods or develop new processes to identify and reconcile book revenue under the new standard to the company’s tax revenue recognition method. A company also may need to keep its existing accounting systems in place or implement new processes if it plans to change methods but is required to obtain approval for the method change or expects a delay for another reason.

Regardless of whether a company determines a change in tax method is appropriate, adoption of the standard likely will result in changes to historical temporary differences.

**How we see it**

Accounting for revenue recognition under ASC 606 likely will be more complex than under legacy guidance. While changing a tax method in an effort to more closely match the book method of accounting for revenue may appear to lessen the administrative burden of determining revenue under different book and tax methods, companies should consider any additional challenges that may result, including changes they would need to make to existing systems and processes for determining revenue for tax purposes. Further, a company may not be able to fully align its tax and book methods.

Companies that keep their existing tax methods will need to be sure to maintain appropriate processes, systems and controls to properly apply their existing tax methods.

**Other adoption considerations**

*Cumulative-effect adjustment*

Entities need to record a cumulative catch-up adjustment as of either the first day of the first year presented (for full retrospective adoption) or the first day of the year of adoption (for modified retrospective adoption). Entities need to consider the current and deferred tax consequences associated with the individual items included in the cumulative-effect adjustment they will need to make at the date of initial application. An entity that applies the full retrospective method of adoption also may need to adjust its previously reported tax provision and temporary differences for purposes of recasting the 2016 and 2017 financial statements.

*Changes to valuation allowance*

The adoption of ASC 606 may result in a change in deferred tax assets, the timing of temporary difference reversals or a change in expectations as to the timing of future taxable income, which may affect judgments regarding the realizability of deferred tax assets.
For example, consider a company that has recorded a full valuation allowance against its deferred tax assets. When this company adopts ASC 606, it records additional deferred tax assets, which it determines are also not realizable. Therefore, the company records an additional offsetting valuation allowance as part of the cumulative-effect adjustment. Changes in the valuation allowance that are not a direct result of adopting the standard are recorded in continuing operations. Careful consideration of the facts and circumstances is necessary to determine whether an income tax effect is direct or indirect.

**Disclosure requirements**

Public companies are required to disclose the effect of adopting new accounting standards in future periods in accordance with Securities and Exchange Commission (SEC) Staff Accounting Bulletin Topic 11.M (issued as SAB 74). If a registrant does not know or cannot reasonably estimate the effect that the adoption of a new standard will have on its financial statements, it should make a statement to that effect and consider providing qualitative disclosures to help the reader assess the potential significance of the effect on the registrant’s financial statements. These disclosures should include a description of the new standard’s effect on the registrant’s accounting policies and provide a comparison to the registrant’s current accounting policies. Further, the staff members in the SEC’s Office of the Chief Accountant have said they expect disclosures to evolve over time to include quantitative best estimates of the effect of adopting the standard, the status of the implementation process and a discussion of any significant issues that have not yet been addressed.

A registrant that expects adopting the revenue standard to have a significant effect on income tax accounts should disclose that fact. It is therefore critical for a company’s tax department to be involved in assessing the potential effect.

If a company chooses the modified retrospective approach, management will, in the year of adoption and in interim periods in that year, need to quantify and disclose the effect of applying the standard for each financial statement line item, including income taxes.

Further, a company must disclose a qualitative explanation of the significant changes between the reported results under the new revenue recognition standard and legacy guidance. These disclosures effectively require an entity to keep two sets of accounting records in the year of adoption.

**Other tax technical considerations**

As companies adopt the new standard, they should consider the various tax technical issues that may arise as a result of adoption. In many cases, a review of current tax methods will highlight where a change in tax method may be required.

Under current US tax law, companies are allowed to defer the recognition of advance payments for tax purposes, but only to the extent amounts are deferred for financial reporting purposes. A company following this deferral method likely will be required to make a tax method change if there is a change in the amount of revenue deferred for financial reporting purposes.6

Companies also should consider the implications of the standard and related amendments on other areas of tax, including state and local taxes.
Next steps

Tax and accounting professionals need to be involved in implementing the new revenue standard, including its effect on income tax accounting. Action items may include:

- Grouping revenue streams by jurisdictions in which the company operates to evaluate potential changes in the timing of revenue recognition
- Identifying potential tax amounts (e.g., deferred taxes, outside basis differences, disclosures) reflected in the financial statements that could be affected by changes to book revenue recognition patterns
- Gaining an understanding of existing tax methods and permissible alternatives
- Assessing the expected effect of adoption on income taxes, for purposes of SAB 74 disclosures
- Evaluating whether the existing accounting systems or data collection methods must remain in place in order to track current tax-basis accounting
- Evaluating whether changes to existing processes and internal controls are needed to calculate temporary differences that did not exist under legacy guidance

Endnotes:

1. ASC 606, Revenue from Contracts with Customers, issued as Accounting Standards Update (ASU) 2014-09 and later amended by other ASUs.
2. ASC 610-20, Other Income — Gains and Losses from the Derecognition of Nonfinancial Assets, applies similar concepts to those articulated in ASC 606. While the remainder of this publication focuses on ASC 606, entities also should evaluate tax accounting implications of ASC 610-20 and ASC 340-40.
4. IFRS 15 Revenue from Contracts with Customers is effective for all companies after 1 January 2019. While IFRS 15 is largely converged with ASC 606, there are certain key differences that can lead to different accounting.
5. Refer to Section 8.7 of our Financial reporting developments publication, Income taxes, for more discussion of changes in tax accounting methods.
6. Ibid.