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ASC 606 AND TAXABLE REVENUE

The new revenue recognition standard combined with tax code changes introduced by the Tax Cuts and Jobs Act will impact when taxable revenue is recognized. **BY ROBERT BLOOM**

CONGRESS PASSED the Tax Cuts and Jobs Act (TCJA) in December 2017. It’s now a little more than a year later, and tax professionals are still only beginning to understand many of its provisions. To comply with the new law, tax professionals will need to learn about the new accounting revenue recognition standard, *Revenue from Contracts with Customers*, issued as a joint endeavor by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Known as Accounting Standards Codification (ASC) 606 or International Financial Reporting Standard (IFRS) 15, the standard represents a major change in revenue recognition. In the United States, ASC 606

went into effect in 2018 for publicly listed companies and in 2019 for private companies.

Accounting income is accrual-based, reflecting revenue when the earnings process is complete. U.S. Generally Accepted Accounting Principles (GAAP) are concerned with measuring the revenue that’s highly probable of receipt in terms of cash inflows and reflecting income by matching the expenses incurred in the same period to generate those revenues. Taxable income hasn’t had that orientation. Revenue in taxation, assuming that tax professionals are using accrual accounting, is required to meet an “all events test” to qualify for inclusion in taxable income. This test is two-pronged: (1) The right to receive is fixed, and (2) The amount can be determined with reasonable accuracy.

THE REVENUE RECOGNITION STANDARD

ASC 606 was issued in 2014. The previous revenue standard in the U.S. was a hodgepodge of many different industry rules. The current formulation of the standard has a decidedly legalistic flavor in terms of focusing on probable contractual performance. Traditionally under U.S. GAAP, “probable” has been considered to mean a high probability, often at least 60%. On the other hand, under IFRS, “probable” refers to “more likely than not,” connoting a probability of more than 50%.

The new standard lacks the specificity typical of

TO COMPLY WITH THE NEW LAW, TAX PROFESSIONALS WILL NEED TO LEARN ABOUT THE NEW ACCOUNTING REVENUE RECOGNITION STANDARD.

U.S. accounting principles, and its application is highly dependent on accountants' judgment. Applying ASC 606 consists of five steps. Step 1 is to determine if a contract exists and, if so, to delineate its specific characteristics. (A contract is defined as an agreement between two or more parties creating enforceable rights and obligations.)

Step 2 is to analyze the contract to pinpoint the promises pertaining to the transfers of goods or services that each party makes to the other. Revenue is to be recognized when transfers occur. If those actions are distinct, then they represent performance obligations that need to be accounted for separately. Should the contract include significant financing across more than one year, present value analysis is applied.

Step 3 is to identify the transaction price reflecting the amounts to be received from the transfers of goods or services, which may involve not just fixed consideration but also "variable consideration." The actual revenue reported should reflect variable consideration from sales returns and allowances, refunds, discounts, incentives, and bonuses. This consideration is estimated

by using a "most likely" approach if there are limited alternative outcomes or an "expected value" approach if there's a range of outcomes. The consideration is included in the revenue, assuming that a significant reversal in the amount recognized won't occur.

Step 4 is to determine how to allocate the transaction price among the contract performances by finding stand-alone prices for each performance obligation.

Step 5 entails revenue measurement by allocating it to the individual performance obligations that have been satisfied. The obligations may be fulfilled at a particular point in time, which is usually the case with goods, or over a specified time period with services.

THE IMPACT OF ASC 606

Under ASC 606, revenue may be reported sooner than was previously the case based on satisfying performance obligations under contracts. Unlike most accounting standards, this standard is viewed as more of a guiding principle than a set of prescriptive rules to follow. It relies heavily on the judgment of management and independent auditors to esti-

mate revenue. According to the new IRC §451(b), added by the TCJA (amending IRC §451 and applying to taxpayers having an applicable certified financial statement), adherence to ASC 606 may recognize taxable revenue earlier than under the traditional "all events test" in some situations. Hence, the new tax law and new revenue standard should produce fewer book-tax differences and higher taxable income sooner than under the previous standard.

In more concrete terms, under the new tax law, accounting revenue reported in Year 1 generally can't be considered tax revenue in Year 2. Both accounting and tax revenue usually must be reported in the same year. For example, under ASC 606, licensors are required to fully report revenue from licensing agreements during the first year of a multiyear contract, contrary to previous accounting practice, if the licensors have performed their obligations fully. Therefore, tax revenue would follow the accounting revenue and report such revenue in the first year.

ALIGNING TAXABLE AND ACCOUNTING REVENUE

What, conceivably, could be the rationale for this attempt by the IRS to align taxable revenue with accounting revenue? Presumably, accounting revenue under ASC 606 will show revenue earlier, an opportunity for the IRS to raise its revenue collections sooner. This situation is reminiscent of what happened under the Tax Reform Act of 1986 (H.R.

3838). In a similar fashion, the IRS attempted to raise additional revenue by no longer permitting companies to follow the accrual accounting method for bad debts whereby estimates of uncollectible accounts are made in each period of sales and matched against those sales in the income statement. For tax reporting since the 1986 Act, companies have had to postpone the bad debts deduction on the tax return to the period when the accounts are actually deemed to be uncollectible and therefore written off.

Alignment of tax and accounting revenue recognition would simplify IRS audits since much of the revenue will be the same for both tax and accounting purposes. Converging these two revenue calculations could impose a restraint on artificial earnings management. In any case, it remains to be seen how many companies will be showing revenue earlier for accounting than before, thereby reporting revenue in a less conservative manner. Finally, one must wonder whether the new reporting requirement will constitute a disincentive for companies to follow the new accounting revenue recognition criteria since tax revenue will now follow accounting revenue. **SF**

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