

BDO KNOWS: REVENUE RECOGNITION

TOPIC 606, REVENUE FROM CONTRACTS WITH CUSTOMERS – INCOME TAX IMPLICATIONS

Introduction

Companies in both the United States and abroad are racing toward the effective date of the new comprehensive revenue recognition standard, *Revenue from Contracts with Customers*.¹

ASC 606 is effective for public entities for annual reporting periods beginning after December 15, 2017 and one year later for private entities (i.e., 2018 and 2019, respectively). The new standard applies to all industries and all revenue transactions from contracts with customers. For a comprehensive overview of the new revenue standard, refer to [BDO Knows: Topic 606, Revenue from Contracts with Customers](#).

The adoption of the new standard will impact pretax income and consequently taxable income of all entities. Tax departments need to understand the standard's requirements and the impact it will have on pretax income and assets and liabilities related to revenue transactions from contracts with customers to accurately determine the current and deferred income tax impact.

The adoption of the new revenue standard will require making income tax related adjustments under ASC Topic 740 *Income Tax* (ASC 740) on the date of adoption. This newsletter addresses those adjustments in depth.

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¹ FASB Accounting Standards Codification (ASC) Topic 606 for companies reporting under U.S. GAAP, and IFRS 15 for companies reporting under International Financial Reporting Standards.



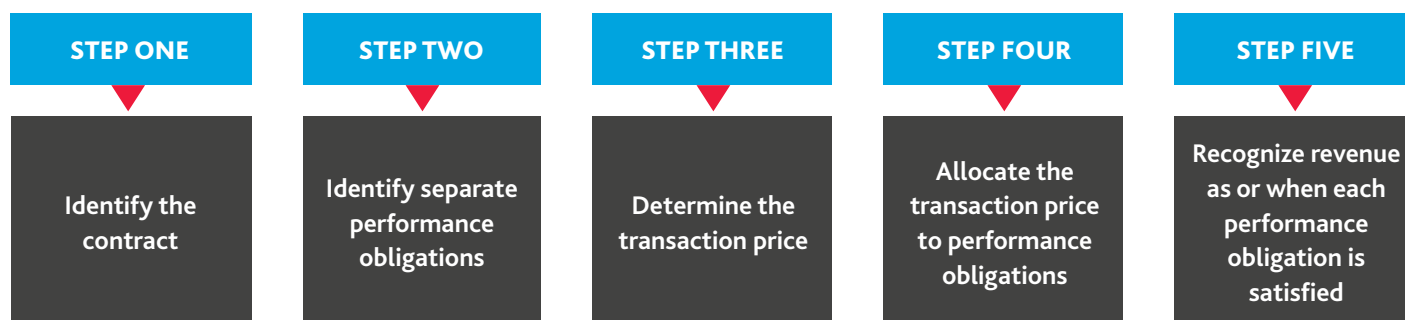
Overview of ASC 606

ASC 606 applies to all contracts with customers, except for the following: leases, insurance contracts, financial instruments and other contractual rights or obligations within the scope of other codification topics, guarantees (except certain warranties), and nonmonetary exchanges.

FIVE STEP ACCOUNTING MODEL

The standard establishes a five-step accounting model to determine the amount and timing of revenue recognition. Application of the five-step model results in revenue recognition when control over goods or services is transferred to the customer and the amount recognized is based on consideration provided for under the contract.

The application of the core principle is carried out in five steps:



- ▶ **Step 1:** Identify the contract(s) with the customer. A contract creates enforceable rights and obligations between a vendor and its customer and can be in any form.
- ▶ **Step 2:** Identify the separate performance obligation(s) within a contract. A performance obligation is a promise by a vendor to transfer goods or services to a customer which is both capable of being distinct (i.e., the customer can benefit on a stand-alone basis or in combination with other readily available goods and services), and is distinct within the context of the contract. In some cases, multiple promised goods and services, are combined into one performance obligation (e.g., supply of construction material and labor).
- ▶ **Step 3:** Determine the transaction price of the entire contract.
- ▶ **Step 4:** Allocate the transaction price (as determined in Step 3) to different performance obligations that have been identified in Step 2.
- ▶ **Step 5:** Recognize revenue when or as each performance obligation is satisfied (i.e., when the customer obtains control of the good or service). This may occur at a point in time or over time.

ASC 606 ADOPTION METHODS

The new standard can be adopted in one of two ways: (1) a full retrospective method, or (2) a modified retrospective method. Certain practical expedients are available under each method. The full retrospective method will result in an adjustment recognized to the opening balance of retained earnings as of the first day of the first year presented in the financial statements (i.e., January 1, 2016 for public calendar year entity that presents two comparative years) and full restatement of comparative figures presented. The modified retrospective method will result in an adjustment recognized to the opening balance of retained earnings as of the first day of the year of implementation (i.e., January 1, 2018 for public calendar year entity), with no restatement of comparative figures in prior years.

The modified retrospective adoption method will require additional disclosures in the adoption period, including the amount by which each financial statement line item is affected due to the application of the new revenue recognition standard and an explanation of the reasons for significant changes.

BDO OBSERVATION

Most entities are expected to adopt the standard using the modified retrospective method to avoid restatements of comparative periods. However, they still need to determine the date-of-adoption impact on all financial statement line items from all outstanding revenue contracts. Tax departments need to understand the impact on financial statement line items to accurately determine the cumulative income tax adjustment. This effort requires close collaboration of accounting and tax departments.

Questions & Answers

TAX LAW

Q1. What is the relevant level of assessing income tax impacts?

A1. An assessment of expected changes in tax filings will have to be performed for each tax jurisdiction and tax filing structure (i.e., consolidated return vs. stand-alone separate return) which is the relevant unit of reporting income taxes. Under ASC 740, temporary differences are tracked and measured by tax paying entity and tax jurisdiction.²

BDO OBSERVATION

The standard focuses on contracts with customers; thus, an evaluation of where contracts with customers exist in a global organization is critical to identifying potential income tax impacts. For example, a U.S. multinational entity with multiple controlled foreign corporations (CFCs) would need to identify CFCs that have contracts with customers separately from CFCs whose income is derived from an intercompany arrangement such as "cost plus" entities. The latter group of entities might not see significant change to their income tax reporting unless their cost reimbursement also changes due to changes in revenue recognition at the parent entity or another related entity.

Q2. How does the new revenue standard impact revenue recognition for income tax purposes?

A2. Generally, revenue recognition for book purposes is the starting point for determining revenue recognition for tax purposes. Therefore, when book recognition changes, it is likely that tax recognition will follow suit, absent specific tax rules that permit or require divergence from book accounting.

In the United States, taxable income is generally computed under the method of accounting used to determine income for financial reporting purposes.³ So if revenue recognition changes for book purposes, tax would also have to change unless a

² ASC 740-10-30-05

³ Treas. Reg. §1.446-1(a). Note, however, that there are often deviations from book treatment that are explicitly permitted or required by tax rules; in such instances, the taxpayer must maintain accounting records (e.g., a reconciliation of any differences between book and tax) to support its tax return filing.

special exception is provided under existing or forthcoming U.S. federal tax rules governing revenue recognition.

For federal income tax purposes, under an accrual method of accounting, revenue is includible in gross income when all the events have occurred to fix the taxpayer's right to receive the revenue and the amount thereof can be determined with reasonable accuracy.

All events have occurred at the earliest of when the payment is earned through performance, when the payment is due to the taxpayer, or when payment is received by the taxpayer.

As an exception to the general all-events test described above, if a taxpayer has contracts with customers that involve advance payments, a one-year tax deferral of revenue recognition is permitted provided the payment is deferred for book accounting (Rev. Proc. 2004-34 for advance payments of services, certain goods, etc.). However, if the advance payments are related to inventorable goods (sale of goods properly includible in inventory, or agreements that can be satisfied with goods), the payments may qualify for a two-year tax deferral of revenue recognition (refer to Treas. Reg. §1.451-5(c)(1)).

BDO OBSERVATION

After understanding the financial statement impact by line item, tax departments will need to evaluate relevant tax rules in material jurisdictions where contracts with customers exist to determine whether revenue recognition changes are required for tax purposes. This task would require considerable effort and coordination from tax departments globally. The purpose of this evaluation would be twofold: (1) identify and evaluate application of relevant tax rules and (2) determine what tax elections or administrative filings are necessary to effectuate a change in revenue recognition (in some instances, administrative filing might be required to retain current revenue recognition for tax). In the U.S. federal jurisdiction, an administrative procedure for all tax accounting method changes is available through the filing of Form 3115, Application for Change in Accounting Method. Q&A #'s 6-8 explain the procedural requirements for accounting method changes and the U.S. GAAP implication.



Q3. How is variable consideration treated for ASC 606 and is that treatment similar or different for income tax reporting?

A3. Under the new standard, variable consideration is included in the transaction price to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. Variable consideration is estimated by using either the expected value method or the most likely amount method, whichever method is expected to better predict the ultimate consideration. The expected value method is generally utilized when a contract may result in a range of possible outcomes, such as a purchase price that is either increased or decreased based on whether or not different performance metrics are met; the most likely amount method is generally utilized when a contract only has two possible outcomes, such as a performance bonus that will or will not be received.

For U.S. federal tax purposes variable consideration is recognized into gross income when the taxpayer's right to receive the income is considered "fixed" and the amount can be determined with reasonable accuracy.

BDO OBSERVATION

The accounting for variable consideration includible in the transaction price will likely result in a temporary difference between book income and taxable income. This is because book recognition of variable consideration would occur earlier than tax if at contract initiation it is considered probable that a significant reversal in revenue recognized will not occur. For U.S. federal tax purposes, variable consideration would not be includible until it is fixed and determinable.

EXAMPLE 1 – VARIABLE CONSIDERATION

An entity enters into a contract to produce and sell 1,000 units per year of Product A for \$100 each for the next four years, with a \$4,000 performance bonus to be paid in year 4 if all the units are delivered on time. The performance bonus represents variable consideration. All products are expected to be delivered on time, entitling the entity to receive the \$4,000 performance bonus.

Revenue Recognition Principles	Year 1	Year 2	Year 3	Year 4	Total
ASC 606 Revenue Recognition	\$101,000	\$101,000	\$101,000	\$101,000	\$404,000
Tax Revenue Recognition	\$100,000	\$100,000	\$100,000	\$104,000	\$404,000
Timing Difference: DTA/(DTL)	(\$1,000)	(\$1,000)	(\$1,000)	\$3,000	\$0

For book purposes, the company determines that the performance bonus is attributable to the entire contract, as opposed to any specific performance obligation(s). As such, it will be recognized ratably over the four years as the company delivers each item because it anticipates it will satisfy the requirements to receive the bonus, and therefore concludes at contract inception that it is probable that it will not have to reverse revenue. The company will update its assessment of variable consideration at the end of each reporting period. However, for tax purposes the entity's "fixed" right to receive the bonus does not occur until year 4 when all the units have been delivered on time; therefore the bonus is not recognized until year 4 for tax purposes. The difference in timing of the recognition of the performance bonus results in a deferred tax liability in year one as the income is recognized for book purposes, but not for tax purposes. The cumulative \$3,000 deferred tax liability is reversed in year 4 when the entire performance bonus is recognized for tax purposes.

Under ASC 740, temporary differences arise from a difference between the book carrying value of an asset or a liability and the tax basis. In this example, the entity recognizes a contract asset related to the value of the performance bonus as it transfers control of each unit. For tax purposes, the entity has no basis in the contract asset. Recovery of the contract asset in year 4 through full payment would trigger a current tax expense. Hence, this contract asset creates a taxable temporary difference related to revenue recognition. Q&A #9 explains how to recognize the temporary difference related to revenue recognition.

Q4. How are advance payments treated for ASC 606 and is that treatment similar or different for income tax reporting?

A4. Under the new standard, payments received in advance of satisfaction of the related performance obligation (“advance payments”) are generally included in the transaction price and allocated to performance obligations. However, they must be evaluated to determine the appropriate pattern and timing of recognition. Additional accounting implications will exist if an upfront payment relates to a significant financing component, material rights granted to a customer, termination penalties, or enforceable rights to payment for performance completed to date.

For U.S. federal tax purposes, tax deferral of advance payments is generally allowed in the year of receipt if the payment is deferred, in whole or in part, beyond the year of receipt for financial reporting purposes. However, the new standard could change the timing or/and pattern of revenue recognition for financial reporting purposes, thereby triggering a “book-to-tax” conformity change for tax purposes (this is required under Reg. 1.451-5 or Rev. Proc. 2004-34).

BDO OBSERVATION

As under current revenue recognition rules, advance payment arrangements that have a contract period longer than two tax years will likely result in a temporary difference between book income and taxable income. This is because tax will generally recognize the entire deferred revenue balance remaining in the second year of the contract, while book will recognize the revenue when or as the performance obligation(s) are satisfied. Advance payments that result in unearned revenue (i.e., liability) for book purposes that have already been recognized in taxable income result in a deductible temporary difference and a deferred tax asset. Any additional accounting implications, such as a significant financing component, would need to be evaluated for any further deferred tax treatment.

EXAMPLE 2 – ADVANCE PAYMENTS

On January 1, 2017, Entity A enters into a three-year agreement and identifies the following performance obligations:

1. Software license for \$6,000 (standalone selling price); the software is considered functional intellectual property under the licensing guidance in ASC 606, and
2. Ongoing software maintenance services, including unspecified upgrades and routine technical support, for \$3,000 (standalone selling price); the maintenance is considered a stand-ready obligation satisfied ratably over the three-year period.

Total purchase price of \$9,000 (software and maintenance services) is required to be paid upfront on January 1, 2017, and the license is transferred to the customer on that date. Entity A is currently using the deferral method under Rev. Proc. 2004-34 to defer tax recognition of income in accordance with its book treatment in the year of receipt, with any remaining amounts to be included in income in the next tax year.

On January 1, 2018, Entity A elects to implement the new revenue standard utilizing the modified retrospective method. Entity A performs the following analysis and determines that the tax revenue recognition for the above contract is altered as a result of implementing the standard.

For book purposes, the agreement includes two performance obligations: software license and ongoing maintenance services. Under ASC 606, the software license revenue would have been recognized in 2017 when the software license is provided to the customer and the customer obtains control. This is because the license agreement grants the customer a right to use the IP as it exists at a point in time (“functional IP”), thereby requiring revenue recognition at the point of transfer as opposed to over the license period. The revenue from the software maintenance performance obligation is recognized over the maintenance term as it is deemed a stand-ready obligation. Consequently, when Entity A adopts ASC 606 on January 1, 2018, it should reduce the deferred revenue liability related to IP license from \$4,000 to zero through opening retained earnings as shown later.

For tax purposes, revenue recognition of cash received toward the license and service performance obligations in years 2 and 3 can be deferred one year (i.e., \$4,000 related to license and \$2,000 related to service can be deferred for tax purposes until 2018). This tax treatment is allowed since deferral is also required for book purposes. The table below summarizes revenue recognition for tax purposes under current GAAP.

TAX ACCOUNTING METHOD CHANGE IMPACT

Tax Revenue Recognition (Under Current GAAP)	2017	2018	2019	Total
Tax Revenue Recognition – License	\$2,000	\$4,000	\$0	\$6,000
Tax Revenue Recognition – Maintenance	\$1,000	\$2,000	\$0	\$3,000
Total Tax Revenue Recognition Under Current GAAP	\$3,000	\$6,000	\$0	\$9,000

Presently, the tax accounting method procedural requirements with respect to this specific fact pattern are unclear.

One possible avenue is to treat the change in book recognition of revenue as a change in method of accounting for tax purposes. In particular, section 16.10 of Rev. Proc. 2017-30 allows taxpayers that are currently on the deferral method under Rev. Proc. 2004-34 to file an automatic accounting method change if the taxpayer changes the manner in which it recognizes advance payments in revenues in its applicable financial statements. This change is presently made on a cut-off basis, and applies only to advance payments received on or after the beginning of the year of change (i.e., 2018). Any advance payments received prior to 2018 are accounted for under Entity A's former method of accounting. Under this approach, the taxpayer would file an accounting method change under Rev. Proc. 2017-30 with no section 481(a) adjustment. Any advance payments received in 2017 would continue to be accounted for under Entity A's "old" method of accounting.

The Internal Revenue Service is currently in the process of issuing guidance related to the procedures for taxpayers to file accounting method changes made in connection with ASC 606 (Q&A #6 "BDO Observation" #2 discusses the proposed guidance). Accordingly, it is possible that the IRS will address fact patterns similar to the one described in this example. Thus, it remains to be seen whether there may be definitive guidance as to whether the approach outlined above (e.g., filing an automatic method change on a cut-off basis) is appropriate.

TAX TEMPORARY DIFFERENCE IMPACT (the following table summarizes the temporary differences due to the contract):

Book Balance Sheet	January 1, 2017	December 31, 2017	January 1, 2018	December 31, 2018	December 31, 2019
Deferred Revenue – License	\$6,000	\$4,000	\$0	\$0	\$0
Deferred Revenue – Maintenance	\$3,000	\$2,000	\$2,000	\$1,000	\$0
Total Book Basis in Deferred Revenue Liability	\$9,000	\$6,000	\$2,000	\$1,000	\$0
Tax Balance Sheet	January 1, 2017	December 31, 2017	January 1, 2018	December 31, 2018	December 31, 2019
Deferred Revenue – License	\$6,000	\$4,000	\$4,000	\$0	\$0
Deferred Revenue – Maintenance	\$3,000	\$2,000	\$2,000	\$0	\$0
Total Tax Basis in Deferred Revenue Liability	\$9,000	\$6,000	\$6,000	\$0	\$0

For ASC 740 purposes, deferred tax accounting is a "balance sheet approach" of comparing the book basis and tax basis in assets and liabilities to identify temporary differences.

On January 1, 2017, upon receipt of the purchase price Entity A has book and tax basis of \$9,000 in the deferred revenue liability. During 2017, Entity A recognizes \$3,000 of revenue for book purposes, and \$3,000 of revenue for tax purposes due to “book-to-tax” conformity. This creates a deferred revenue liability of \$6,000 as of December 31, 2017 (the contract price related to year 2 and 3 for license and maintenance) for both book and tax and no temporary difference.

On January 1, 2018, as a result of the adoption of the new revenue standard the deferred revenue liability related to the license performance obligation is adjusted through opening retained earnings as the IP license revenue would have been included in book income in 2017 under ASC 606. However, assuming that the taxpayer is not allowed a section 481(a) adjustment, for tax purposes the tax basis in the deferred revenue liability does not change resulting in a taxable temporary difference between book and tax basis of \$4,000 as of January 1, 2018 (tax basis of \$6,000 vs. book basis of \$2,000).

Entity A records the following entries **on January 1, 2018 due to ASU 606 adoption** to reflect the book basis adjustment in the deferred revenue liability and the resulting deferred revenue liability taxable temporary difference.

Deferred Revenue	\$4,000
Opening retained earnings	\$4,000
Opening retained earnings	\$1,600 (\$4,000 × 40%)
Deferred tax liability	\$1,600 (\$4,000 × 40%)

During 2018, revenue included in taxable income is \$6,000 whereas only \$1,000 is included in pretax income, resulting in a \$5,000 book-to-tax difference on the tax return (i.e., an “M-1” adjustment).

Entity A records the following income tax provisions entries in the 2018 fiscal period.

Current tax expense	\$2,400 (\$6,000 × 40%)
Income tax payable	\$2,400 (\$6,000 × 40%)
Deferred tax liability	\$2,000 (\$5,000 × 40%)
Deferred tax benefit	\$2,000 (\$5,000 × 40%)

Total income tax provisions in 2018 related to this contract is \$400 – or, the applicable tax rate of 40 percent times pretax income of \$1,000.

By the end of 2018, the deferred revenue liability has a deductible temporary difference balance and a deferred tax asset of \$1,000 gross). In 2019, the deferred tax asset is reversed, resulting in a deferred tax expense.

BDO OBSERVATION

The adoption of ASC 606 (on January 1, 2018 for public calendar year entities) is a change in accounting principle, the tax effects of which are required to be recognized through opening retained earnings (see Q&A 9 for additional discussion).

An entity generally **cannot** wait until the preparation of the 2018 federal income tax return to quantify tax adjustments triggered by ASU 606 adoption. While an entity is allowed to file an “automatic” method change on Form 3115 as of the date its federal income tax return is due (including extensions), for financial reporting purposes, public entities must determine and quantify the impact of voluntary “automatic” method changes (or changes in underlying facts that cause a tax method change as described in the example above) due to the new standard no later than Q1 2018 to be reflected in opening balance of retained earnings.

That said, the IRS issued a proposed revenue procedure on tax method changes that, if finalized, will provide additional guidance on the procedure and timing. Consequently, Notice 2017-17, if finalized, could impact financial reporting of tax method changes (see Q&A #6 for discussion of proposed Notice 2017-17).

Moreover, it is expected that the ASC 606 pre-adoption disclosure in the 2017 annual reports will include anticipated effects on income taxes. Therefore, when information is available, entities need to determine and quantify these effects as early as the preparation of the 2017 annual reports.

BDO OBSERVATION

This example illustrates the potentially significant impact on the software industry. In the example the vendor does not sell the license, upgrades, or technical support separately, and therefore under previous U.S. GAAP could not establish vendor specific objective evidence (VSOE) of fair value for any of these items. As a result the vendor recognizes revenue for the license and maintenance (i.e., the entire contract price) ratably over the contract term under previous U.S. GAAP. Upon adoption of ASC 606, a significant portion of the transaction price is recognized as revenue at the date of transfer of the software license. Because revenue recognition for book purposes is accelerated the revenue recognition for tax purposes is also accelerated under the "book-tax" conformity principle.

Q5. How are costs to obtain and fulfill contracts treated for ASC 606 and is that treatment similar or different for income tax reporting?

A5. The new standard requires capitalization of incremental costs to obtain a contract with a customer if the entity expects to recover the costs. Incremental costs of obtaining a contract are costs that would be avoidable absent obtaining a contract with a customer (for example, a sales commission). Capitalized costs are amortized for financial reporting purposes if the amortization period is greater than one year.

For tax purposes, typically costs to obtain a contract are capitalized and amortized over the contract term which would be consistent with book. However, certain costs may qualify for immediate deduction on the return, creating a book-to-tax temporary difference related to capitalized costs. The terms and circumstances of each contract will have to be analyzed to determine if costs to obtain contracts must be capitalized or immediately deducted for tax purposes.

The new standard may also require capitalization and amortization of costs to fulfill a contract in certain circumstances. Similar to costs to obtain a contract, costs to fulfill a contract that result in a balance sheet asset which has no tax basis (i.e., the cost is currently deductible) would result in a deferred tax liability.

Q6. Will an entity have to file an accounting method change as a result of the adoption of ASC 606?

A6. Adoption of the new standard may create or increase differences between financial accounting and tax reporting rules. Taxpayers will have to determine if an accounting method change is required (under relevant tax rules and depending on the taxpayers' current method of accounting for tax purposes) or desirable as a result of the new revenue standard. **Tax method changes are used only to affect changes in "timing" differences and not in amount of revenue or expense.**

BDO OBSERVATION

In the U.S. federal jurisdiction, generally, tax method of revenue recognition follows book method of revenue recognition. If revenue recognition changes under ASC 606, a tax accounting method change may be required. However, sometimes retaining tax method even when book method changes would be allowable. In such instances, no method change is necessary for a taxpayer intending to remain on its existing tax method of accounting (assuming the method is proper).

The Internal Revenue Service ("IRS" or the "Service") provides procedures governing how to make changes in tax methods of accounting. Certain enumerated accounting method changes are granted automatic consent ("automatic changes") by the IRS in Rev. Proc. 2017-30 or its successor, provided that the taxpayer complies with all terms and conditions under the procedures.

For automatic changes, a taxpayer obtains the Service's consent to change to the new method upon attaching the Form 3115, Application for Change in Accounting Method, to the timely filed (including extensions) federal income tax return for the taxable year of change and filing a copy of the Form 3115 with the IRS office in Covington, Kentucky, on or before the filing date of that return. No IRS user fee is required with an automatic change.

While there are an increasing number of automatic changes each year, any accounting method change not specifically listed as an automatic change under Rev. Proc. 2017-30 or its successor is, by default, an advance consent change ("non-automatic change").

Unlike an automatic change, a non-automatic change entails a written submission of the legal authorities supporting the change in method, an IRS user fee, a higher level of review by the Service, and an accelerated due date. A non-automatic Form 3115 must be filed with the IRS National Office in Washington, D.C., on or before the **last day** of the taxable year of change. A taxpayer has secured consent from the Service to change to the new method when the Service provides a written consent agreement in response to the non-automatic Form 3115 and the taxpayer (1) timely signs and returns the consent agreement to the IRS National Office and (2) attaches a copy of the signed consent agreement statement to its federal tax return for the year of change.

BDO OBSERVATION

The IRS has issued a proposed special revenue procedure (Notice 2017-17) to solicit comments on the method change procedures in anticipation that many taxpayers will request consent to change a method of accounting for one or more items of income as a result of, or directly related to, the adoption of the new revenue standard. The change will be for the same taxable year that the new standard is adopted for financial accounting purposes (a "qualifying same-year method change").

Notice 2017-17 sets forth a proposed revenue procedure for obtaining **IRS automatic consent** to make a qualifying same-year method change. Taxpayers requesting consent for automatic changes for which existing guidance (including Rev. Proc. 2017-30 or its successor) already provides automatic change procedures must use the existing automatic change procedures to make a request. If existing guidance does not provide automatic change procedures, the proposed Notice can be used provided that the method change would comply with section 451 of the Code or other guidance regarding the tax year of income inclusion.

Additionally, the proposed revenue procedure prescribes that multiple requests to make qualifying same-year method changes may be made in a single request. Stakeholders were invited to submit comments on the proposed revenue procedure by July 24, 2017.

The status of the proposed revenue procedure should be monitored as it might provide the procedures required for filing a tax accounting method change due to ASC 606 implementation.

Q7. How will an entity account for the cumulative effect of tax accounting method change?

A7. An accounting method change generally results in a cumulative catch-up adjustment ("section 481(a) adjustment") which is calculated as of the beginning of the year of change. This calculation is required even if the statute of limitation for the prior taxable year(s) is closed.

A cumulative section 481(a) adjustment that is an increase to taxable income (a "positive" or unfavorable adjustment) must generally be recognized in taxable income over four years; while a section 481(a) adjustment that is a decrease to taxable income (a "negative" or favorable adjustment) is taken entirely in the year of the change.

The recognition and measurement of temporary differences related to assets and liabilities affected by changes in tax accounting methods are explained in ASC 740-10-55-58 through 55-63.

For financial reporting, a tax accounting method change could result in an initial catch-up adjustment which affects the current income tax provision and a temporary difference which affects the deferred tax provision. The temporary difference arises from the recognition of a positive cumulative catch-up adjustment (i.e., deferred income for tax purposes) required to be included in taxable income over four years. A method change may also impact the tax basis of inventory relative to the book value, creating another temporary difference.



Q8. When should an entity account for the cumulative effect of tax accounting method change?

A8. Generally, the effect of a voluntary election to change tax method is recognized on the approval date or on the filing date if approval is not necessary (i.e., “automatic” method changes).

This means that no recognition should be given in the financial statements for the expected tax return effect from non-automatic tax accounting method change until the period in which the IRS provides a written consent agreement.

For automatic method changes involving proper methods, the timing of recognition should coincide with management’s decision and expectation to file an automatic change because there are no administrative hurdles or approvals potentially preventing the acceptance of an automatic method change.

BDO OBSERVATION

The new standard is effective on January 1, 2018 for public calendar year entities. For these entities, it is expected that most tax method changes resulting from ASC 606 implementation will be made with respect to the 2018 tax year, not before.

Due to adoption of ASC 606, entities would need to determine whether the new book treatment is proper under federal tax principles and which changes affect the timing of revenue recognition. If the entities choose to keep tax methods consistent with the new book treatments, the appropriate change(s) in method of accounting are required to be filed with the IRS along with calculating the section 481(a) adjustment (unless the “cut off” method is required) as of the beginning of the year of change (If applicable).

As stated before, entities should monitor the outcome of IRS proposed Notice 2017-17 which, if finalized, would impact method changes due to ASC 606 adoption.

ACCOUNTING FOR INCOME TAXES

Q9. How will an entity recognize the current and deferred income tax effect arising from ASC 606 adoption under the modified retrospective method?

A9. ASC 740-20-45-11(a) requires that **all tax effects** related to adjustments to retained earnings due to change in accounting principle be recognized in retained earnings.

Adopting the new standard under the modified retrospective method requires the cumulative **pretax and income tax effects** of applying the standard to be recognized in the opening balance of retained earnings as of the first day of the year of implementation (January 1, 2018 for calendar year public entities).

EXAMPLE 3 – MODIFIED RETROSPECTIVE METHOD

Entity A elects to implement the new standard utilizing the modified retrospective method. The entity performs the book analysis of implementing the standard on a legal entity, tax jurisdictional basis and determines that deferred revenue will be significantly impacted as following:

Deferred revenue that has already been recognized for tax purposes in prior tax periods will no longer be recognized for financial reporting purposes.

The entity records the following entries on January 1, 2018 to reflect the adoption of the revenue standard impact on deferred revenue.

Deferred revenue	X
Opening retained earnings	X
Opening retained earnings	Y
Deferred tax asset	Y

The entity must credit the deferred tax asset for the amount that has already been recognized for tax purposes but will never be recognized in the income statement. If Entity A had provided a valuation allowance against the deferred tax asset, it would also be reversed through opening retaining earnings as part of the cumulative accounting adjustment.

EXAMPLE 4 – MODIFIED RETROSPECTIVE METHOD

Entity A elects to implement the new standard utilizing the modified retrospective method. The entity performs the book analysis of implementing the standard on a legal entity and tax jurisdictional basis and determines that deferred revenue will be significantly impacted, as follows:

The entity received cash in 2017 and deferred revenue recognition for book and tax in accordance with Rev. Proc. 2004-34 as of December 31, 2017. Under ASC 606, the deferred revenue liability would be reversed as part of the cumulative effect adjustment recorded on January 1, 2018 (i.e., adjust opening balance of retained earnings).

The entity would record the following entries on January 1, 2018 to reflect the adoption of the revenue recognition standard impact on deferred revenue.

Deferred revenue	X
Opening retained earnings	X
Opening retained earnings	Y
Deferred tax liability	Y

For tax purposes the entity will have to establish a deferred tax liability for the cash received in 2017 that book reversed into the opening balance of retained earnings. On the December 31, 2018 tax return the deferred tax liability will reverse through the income statement when the revenue is recognized for tax purposes.

Q10. How will an entity recognize the current and deferred income tax effect arising from ASC 606 adoption under the full retrospective method?

A10. Adopting the new standard under the full retrospective method requires the standard's principles to be applied retrospectively to each prior reporting period presented in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 45-10.

For comparative periods presented in the financial statements (e.g., 2016 and 2017 for public entities adopting ASC 606 on January 1, 2018 that present two comparative years), the specific effects of the new standard should be reflected in the line items shown as comparable figures are required to be restated. The current and deferred income tax effects of restating the comparative periods should be recognized through the income statement. That is, both pretax income and income tax provisions of the comparative periods are restated.

The cumulative effect of applying the new standard on periods prior to the ones presented in the financial statements should be recognized through the opening balance of retained earnings of the first period presented (i.e., January 1, 2016 for calendar year public entities adopting ASC 606 on January 1, 2018 that present two comparative years). The current and deferred income tax effects, if any, on earlier periods from implementing the standard should be recognized through the opening balance of retained earnings on the same date.

BDO OBSERVATION

The restatement of financial statements required for the adoption of ASC 606 under the full retrospective method will generally not require taxpayers to amend their prior year tax returns, but a change in book revenue recognition could possibly result in the filing of an accounting method change.

Q11. How could the adoption of ASC 606 impact an entity's valuation allowance analysis?

A11. A valuation allowance is generally recognized when negative evidence outweighs positive evidence as explained in ASC 740-10-30-05:

Deferred tax assets must be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance shall be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.⁴

The implementation of the new standard coupled with potential changes in tax filing requirements could alter the existence, measurement, and timing of reversal of deferred tax assets and deferred tax liabilities related to revenue. Evaluating the potential impact must be done on tax entity and jurisdictional basis.

The new standard could also cause changes in the timing and quantity of revenue recognized for financial reporting purposes, thus impacting expectations about an entity's forecast of future taxable income.

These potential implications could affect an entity's judgment regarding the realizability of deferred tax assets and the need for a valuation allowance.

Q12. How should an entity account for the change in a valuation allowance due to the adoption of ASC 606 (i.e., what is the intraperiod allocation of a valuation allowance adjustment)?

A12. It depends on what adoption method the entity elects.

If the entity elects the modified retrospective method, the entity will record the change in valuation allowance caused by the adoption of the standard through the cumulative effect adjustment recorded in the opening balance of retained earnings in the year of implementation (i.e., January 1, 2018 for calendar year public entities).

If the entity elects the full retrospective method, the entity will record the change in valuation allowance related to any impact associated with periods not presented on the financial statements through the opening balance of retained earnings of the first period presented. If there is a change in valuation allowance related to the comparative periods presented on the financial statements, the change would be reflected in the income statement due to restatement of comparative figures.

EXAMPLE 5 – CHANGE IN VALUTATION ALLOWANCE

Entity A elects to implement the new standard utilizing the modified retrospective method. The entity has previously recorded a full valuation allowance against its deferred tax assets prior to the implementation of the new standard. The entity performs the book analysis of implementing the standard on a taxpaying entity and jurisdictional basis and determines that additional deferred tax assets should be recognized through the cumulative-effect adjustment that is recorded through the opening balance of retained earnings in the year of implementation. The entity also determines that the additional deferred tax assets are not realizable on a more likely than not basis.

The entity records the following entries on January 1, 2018 to reflect adoption of the revenue recognition standard impact on the change in valuation allowance.

Deferred tax assets	X
Opening retained earnings	X
Opening retained earnings	Y
Valuation allowance	Y

NOTE: If instead of a deferred tax asset, Entity A would be required to recognize a new deferred tax liability (DTL) due to ASC 606 implementation, any valuation allowance release due to this incremental source of income would also be recognized through opening retained earnings.

Q13. How could the adoption of ASC 606 impact an entity's outside-basis difference in an investment in foreign operations?

A13. An entity will generally record a deferred tax liability if its book basis in a foreign subsidiary exceeds the tax basis.⁵ However, there is an exception to the recognition of a deferred tax liability. The "indefinite reversal exception" is outlined in ASC 740-30-25-17 and 25-18 and permits management to make an assertion that foreign unremitted earnings are indefinitely reinvested provided there are reinvestment plans.

If an entity's financial reporting basis in a foreign subsidiary is less than the tax basis in that subsidiary, a deferred tax asset is generally not recognized until it is apparent that the temporary difference will reverse in the foreseeable future (generally interpreted to be within one year).⁶

The implementation of the new standard could alter an entity's foreign subsidiaries' opening balance sheets for financial reporting purposes, thus altering the entity's financial reporting basis in the subsidiaries. This could change the outside basis difference and consequently the outside-basis deferred tax liability if the entity does make the indefinite reinvested assertion.

The intraperiod allocation for an outside-basis deferred tax accounting due to ASC 606 implementation should follow the same intraperiod allocation rules explained in the valuation allowance Q&A above.

Q14. Are there income tax disclosures due to the adoption of ASC 606?

A14. There are no specific income tax disclosure requirements in ASC 606.

We expect the disclosures under Staff Accounting Bulletin No. 74 (codified in SAB Topic 11-M⁷) in the 2017 annual financial statements to include disclosure of the anticipated effect on income tax which would be recognized as part of the cumulative adjustment when adopting the new standard. We expect the interim period disclosure in Q1 2018 to also explain the cumulative pretax and income tax adjustment recognized in opening retained earnings.

⁵ ASC 740-30-25-05

⁶ ASC 740-30-25-09

⁷ *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*

OTHER POTENTIAL TAX IMPLICATIONS OF ASC 606

Q15. How could the adoption of ASC 606 impact an entity's state and local tax compliance?

A15. The new standard could impact state and local taxes in a number of different ways including:

- ▶ States and local jurisdictions which follow the federal income tax rules will be impacted if tax methods of revenue recognition change for federal purposes as those changes will flow into the state and local returns.
- ▶ Revenue-based apportionment factors used for calculating state and local tax expense could be impacted due to changes in amount and timing of revenue recognition which will impact the tax rate used to measure state and local deferred income taxes.
- ▶ Other state and local taxes such as sales/use tax or gross receipts tax could be impacted as a result of the new timing and/or quantity of revenue recognition for book purposes.

Q16. How could the adoption of ASC 606 impact an entity's foreign taxes and U.S. taxation of foreign operations?

A16. The new standard could impact foreign income taxes and U.S. taxation of foreign operations in a number of different ways including:

- ▶ In many jurisdictions, country-specific or local statutory reporting is the basis for income tax filings.
- ▶ Some foreign jurisdictions will make changes to their tax regulations related to revenue recognition to address changes in anticipation of adopting ASC 606 or IFRS 15.
- ▶ The amount and timing of revenue recognition for controlled foreign corporations (CFC) could impact the following items:
 - a. Earnings and profits,
 - b. Foreign tax credit,
 - c. Calculation of subpart F income (including the potential need to record deferred tax liabilities on subpart F income expected to be realized in the future), and
 - d. Repatriation planning.

Q17. How could the adoption of ASC 606 affect an entity's tax process, procedures and internal controls?

A17. The adoption of the new revenue recognition standard will inevitably cause some changes in processes and systems within many organizations given that revenue recognition generally impacts many facets of the organization including sales, contract negotiations, net income, debt covenants, executive compensation, employee compensation, human resource policies, and more. Current tax processes, documentation and internal controls related to income tax may also need to be modified to ensure that current and future information is available to support tax accounting methods and revenue related temporary differences.

BDO OBSERVATION

Entities may be required to generate and maintain additional supporting documentation for tax purposes to substantiate their tax accounting methods on top of any documentation required to support revenue recognition under the new standard.



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