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Accounting for Income Taxes Considerations of Adopting New Revenue Recognition Guidance

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by Jessica Blair, Eric Lucas, Jasmine Small, Jenna Summer, and Ashby Corum, Washington National Tax*

As entities prepare to adopt new revenue and contract cost recognition guidance for financial reporting, a key component of the analysis performed may be assessing the impact adoption has on accounting for income taxes. Entities will need to consider a variety of accounting for income taxes matters beyond the direct tax effect of changes to the financial reporting of revenue. This article explores some of the accounting for income taxes considerations of the new standard by analyzing how an entity may need to evaluate if and when changes to tax accounting methods are expected and permissible by the respective taxing authority.

Background: ASC 606, *Revenue from Contracts with Customers*

The Financial Accounting Standards Board issued Accounting Standard Codification ("ASC") 606,[1] *Revenue from Contracts with Customers*[2], to replace existing guidance under ASC 605, *Revenue*

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* Jessica Blair is a senior manager in, and Eric Lucas is the partner-in charge of the Income Tax and Accounting group in Washington National Tax ("WNT") and Jasmine Small is a manager in, Jenna Summer is a managing director in, and Ashby Corum is the partner-in-charge of the Accounting for Income Taxes group in WNT.

1 Available at www.fasb.org.

2 ASC 606 was originally issued as ASU 2014-09 and was followed with a series of additional ASUs to clarify application of the guidance and provide technical corrections.

Recognition, and introduce a new revenue recognition and cost model.[3] ASC 606 applies to contracts to deliver goods or services to a customer and results in the application of a five-step model to determine when to recognize revenue and at what amount.

For many industries, the application of ASC 606 will change the timing or amount of revenue from contracts for the delivery of goods or services reported in the financial statements. Under the new revenue recognition standard, a company may be required to unbundle contracts for goods and services, allocate revenue to each performance obligation in the contract, and potentially accelerate or decelerate each revenue stream as compared to existing accounting policies. In addition, the transaction price is not required to be fixed or determinable. Instead, variable consideration is included in the transaction price to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.

The issuance of ASC 606 also references new guidance on costs related to contracts with a customer under ASC 340-40, including the incremental costs to obtain a contract with a customer and costs incurred in fulfilling a contract with a customer that are not in the scope of other guidance. Incremental costs to obtain a contract with a customer are required to be capitalized if an entity expects to recover the costs and fulfillment costs are required to be capitalized if they are directly related to an existing contract or specific anticipated contract, generate or enhance resources that will be used to satisfy performance obligations in the future and are expected to be recovered. An entity will amortize the assets recognized for costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the goods or services to which the asset relates. The determination of capitalization versus expensing of costs is not an election in most cases as capitalization will be required if certain criteria are met. Companies can elect not to capitalize costs to obtain a contract if the amortization period of that asset would be less than 12 months. Generally, the application of ASC 340-40 and ASC 606 is anticipated to result in additional costs capitalized when compared to prior guidance.

As such, changes to the underlying financial reporting principles will require a careful evaluation of the potential income tax impacts, including whether new temporary differences are generated, whether the new standards are permissible methods of accounting that may be used for income tax purposes,[4] and whether there are other income or non-income tax effects.

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[3] The development and issuance of ASC 606 was done in conjunction with the International Accounting Standards Board ("IASB") and the related issuance of IFRS 15, *Revenue from Contracts with Customers*, and resulted in substantially converged standards; however, certain differences exist between the standards.

[4] While this article highlights U.S. federal tax accounting methods, entities may need to consider the specific requirements in foreign tax jurisdictions including whether a change in the group's financial reporting of revenue and contract cost recognition under U.S. generally accepted accounting principles ("U.S. GAAP") has occurred and whether the new method is a permissible method for the respective tax jurisdiction. For example, entities may need to consider whether the foreign tax jurisdiction would permit or require a revenue and contract cost recognition methodology consistent with that used for U.S. GAAP financial reporting for either statutory reporting or tax reporting and the means to implement a change, if permitted or required. Alternatively, the introduction of IFRS 15 principles into local tax or statutory principles may result in a close alignment of the local income tax revenue and contract cost recognition methodology with the group's U.S. GAAP recognition methodology.

Transition and Effective Date

ASC 606 is effective for public business entities and certain other entities for annual reporting periods beginning after December 15, 2017, including interim periods within such reporting period. For all other entities, ASC 606 is effective for periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019. Early adoption is permitted for all entities for annual periods beginning after December 15, 2016.

The amendments may be applied under either a full retrospective or a modified retrospective method. The full retrospective method requires entities to recognize a cumulative effect adjustment as of the beginning of the earliest period presented in the financial statements with the revised guidance applied to each prior reporting period presented. Under this method, practical expedients are available to simplify how contracts are restated or reduce the number of contracts to be restated.

The modified retrospective method requires entities to recognize the cumulative effect adjustment in retained earnings at the date of initial application, with no restatement of the comparative periods presented.[5] Under the modified retrospective method, in the period of initial application, disclosure is required of the quantitative effect and the significant changes between the reported results in the period of adoption under ASC 606 and those that would have been reported under revenue and contract cost recognition principles in effect prior to the adoption. A practical expedient is available under this method to simplify the restatement of contract modifications.

U.S. Federal Tax Revenue and Contract Cost Recognition in General

One of the most common income tax considerations an entity with significant U.S. operations may have to evaluate is its U.S. federal income tax accounting methods. In general, an accrual basis taxpayer recognizes income for U.S. federal income tax purposes in the period in which all events have occurred that establish the right to receive the income and the amount can be determined with reasonable accuracy (generally, the earliest of when payment is due, received, or earned). For services, revenue is earned when the services are provided. For sales of goods, income may be recognized upon shipment, delivery, acceptance, or title passage.[6]

To the extent a taxpayer receives advance payments for goods or services, there are several exceptions to the all-events test that may allow taxpayers to defer all or a portion of the inclusion of an advance payment in taxable income to a subsequent year.[7] Under Revenue Procedure 2004-34, a taxpayer may defer an advance payment for certain items for one year to the extent the advance payment is not recognized for financial reporting purposes in the year of receipt. A full inclusion method

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[5] The modified retrospective approach may be applied to all contracts or only those contracts that are not completed contracts at the date of initial application.

[6] *See* section 1.446-1(c)(1). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[7] Section 1.451-5 provides for a two year deferral in certain cases for advance payments for prepaid merchandise. Revenue Procedure 2004-34, modified by Revenue Procedure 2011-18, provides a one year deferral is applicable to inventory, prepaid services, intellectual property, mixed prepayments, and others.

is also available under Revenue Procedure 2004-34, allowing taxpayers to recognize income upon receipt of advance payments instead of deferring recognition to a later period.

For U.S. federal tax purposes, taxpayers generally deduct or capitalize costs associated with contracts based upon existing provisions in the Internal Revenue Code, Treasury regulations, or other applicable guidance. Generally, these costs are capitalized and amortized over the contractual term; however, certain exceptions exist that may prevent the need to capitalize such costs. For instance, sales commissions are common costs of executing a contract and are generally deductible when paid as employee compensation, regardless of the financial reporting treatment of such costs.

Change in Tax Accounting Method

A taxpayer may elect to or may be required to change tax accounting methods as a result of the implementation of the new revenue recognition standard for financial reporting purposes. A taxpayer who previously followed the financial reporting method of revenue and contract cost recognition for U.S. federal income tax purposes will need to evaluate whether the methods used for financial reporting after adoption of ASC 606 are permissible methods of accounting for U.S. federal income tax purposes. A taxpayer may discover that the historic tax accounting method is improper and requires a change in tax accounting method either to the ASC 606 method if permitted, or, to an alternative method permitted for U.S. federal income tax purposes.

General Tax Accounting Method Change Procedures

If a taxpayer changes its method of recognizing revenue for U.S. federal income tax purposes (for instance, revenue is recognized in a different pattern or period), it must file a tax accounting method change (reported on Form 3115, *Application for Change in Accounting Method*) with the IRS.[8] Tax accounting method changes that are described in the automatic consent procedures in Revenue Procedure 2017-30 must be filed with the original attached to the tax return for the year of change and with a copy filed with the IRS national office.

If the taxpayer's method change is not described in the automatic consent procedures, IRS approval of the change is not automatic and the taxpayer generally must receive a consent letter before the change may be implemented (referred to as non-automatic or advance consent changes). Non-automatic changes must be filed on Form 3115 with the IRS national office by the end of the year of change (for instance, December 31 for calendar-year taxpayers) rather than with the tax return for the year of change. Non-automatic changes require IRS filing fees and are typically more complex and time-intensive in comparison to automatic changes. The majority of revenue recognition related changes are currently non-automatic changes, except for changes under Revenue Procedure 2004-34. The IRS issued draft procedures under Notice 2017-17 that propose to allow changes related to the adoption of the new revenue recognition standard to be filed as automatic method changes. However, as of the

[8] The timing of filing Form 3115s may be limited if an entity is currently under exam or under continuous exam. In such circumstances, limited windows may be available to file method changes with the taxing authority.

date of this article those procedures have not been issued in final form and, accordingly, these method changes remain non-automatic at this time.

Financial Reporting Changes under the Deferral Method in Revenue Procedure 2004-34

The IRS views a change in the financial reporting method of recognizing revenue when a taxpayer has adopted the deferral method for advance payments under Revenue Procedure 2004-34 as a change in facts that requires a change in tax accounting method. The IRS treats this change as an automatic consent change but does not require the taxpayer to file a Form 3115. The procedures under section 16.10 of Revenue Procedure 2017-30 require that the taxpayer include a statement with the tax return for the year of change describing, among other things, the present and proposed methods. This change is implemented on a cut-off basis, meaning there is no section 481 adjustment as of the beginning of the year of change. The taxpayer applies the old method to amounts received and deferred prior to the beginning of the year of change and the new method to any advance payments received during the year of change and later years. A taxpayer who fails to formally make this change in tax accounting method may be viewed by the IRS as making an unauthorized change in method of tax accounting.

Accounting for Income Taxes Consequences

Background

ASC 740, *Income Taxes*, provides a tax liability or asset shall be recognized based on the provisions of ASC 740 for the estimated taxes payable or refundable on tax returns for the current and prior years and a deferred tax liability or asset shall be recognized for the estimated future tax effects attributable to temporary differences and carryforwards.[9] Deferred tax liabilities are measured by multiplying the applicable tax rate by the taxable temporary differences while deferred tax assets are measured multiplying the applicable tax rate by the deductible temporary differences and operating loss carryforwards, plus tax credit carryforwards.[10] The applicable tax rate utilized in the measurement of deferred tax assets (liabilities) is defined in the codification as the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized.[11]

An entity should include the current and deferred tax effects of its tax positions in the financial statements only when it is more likely than not that the tax position will be sustained based on its technical merits. Recognized tax positions are measured at the largest amount of tax benefit greater than 50 percent likely of being realized. Any difference between the amount reflected within the income tax return and that recognized within the financial statement is reflected as an unrecognized tax benefit within the financial statements.

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[9] ASC 740-10-25-2.

[10] ASC 740-10-30-5.

[11] ASC 740-10-30-8.

Accounting for the Income Tax Effects of Changes in Accounting Principles

The retrospective application of a change in accounting principle shall only include the direct effects of the change in accounting principle. The direct effects include the recognized changes in assets or liabilities necessary to effect the change in accounting principle and related changes such as an effect on deferred tax assets (liabilities). The retrospective adjustments do not include indirect effects, such as a nondiscretionary royalty payment that is based on a reported amount such as revenue. Those indirect effects that are incurred and recognized are reported in the period in which the accounting change is made.[12]

As the effect on income taxes of adoption and transition to ASC 606 are direct effects of the change, those effects should be recognized as part of the change in accounting principle and should follow the transition method adopted by the entity. In other words, if an entity elects to utilize the full retrospective method, the deferred tax expense (benefit) in the prior periods is retrospectively adjusted and allocated using the step-by-step approach applied to the retrospectively adjusted numbers and reported in the prior periods as is any adjustment to deferred tax assets (liabilities). If an entity elects to use the modified retrospective approach, the prior periods are not recast for the effects of adoption. The cumulative effect of a change in accounting principle, including the direct income tax effects of the transition adjustment are reflected in retained earnings. The adjustment is either reflected at the beginning of the earliest year presented within the financial statements (full retrospective) or at the beginning of the year of adoption (modified retrospective).

Accounting for Changes in Tax Accounting Methods

As noted above, changes in tax accounting methods for U.S. federal income taxes may be executed by filing a Form 3115 that is automatically accepted by the taxing authority (or in limited situations, by attaching a statement to the tax return), or filing a Form 3115 that requires approval by the taxing authority. Entities should assess which tax accounting methods associated with revenue and contract cost recognition will either be required to be changed or that the company will voluntarily choose to change and consider the method of affecting the change in order to assess the timing and impact of a change to the financial statements. An entity may need to consider the guidance on accounting for uncertainty in income taxes, including whether the IRS would initiate a tax accounting method change, prior to obtaining the audit protection that typically accompanies a taxpayer initiated tax accounting method change through the filing of a Form 3115. The below summarizes considerations of various tax accounting method changes that may be encountered as companies review revenue and contract cost recognition methodologies:

- If an entity is filing a Form 3115 for an automatic change, whether changing from a permissible method or from an impermissible method, we believe the impact of the change should be reflected within the financial statements when an entity commits to making the tax accounting method change. An entity's commitment to making the method change is supported by

[12] ASC 250-10-45-8 and the ASC Master Glossary definition of *direct effects of a change in accounting principle* and *indirect effects of a changing in accounting principle*.

preparing and submitting a Form 3115. As a result, we generally believe the impact of an automatic change in a tax accounting method should be reflected in the interim period which includes the filing of a copy of Form 3115 with the IRS national office prior to the issuance of the financial statements. As such, in general, if the change in tax accounting method request has not been filed, the entity should prepare its financial statements as if no change has or will occur.[13]

- An entity using the deferral method for advance payments under Revenue Procedure 2004-34 may be required to change its tax accounting method due to the adoption of ASC 606 by attaching a statement to the annual U.S. federal income tax return.[14] Since an entity generally prepares its income taxes calculations and accounts based on elections that it expects will be made in filing its tax return,[15] we believe the impact of a change made in this manner should be reflected once the entity expects to execute the change. Since no actions are required by the taxpayer, until the filing of the annual tax return, and there is no Form 3115 to file a copy of with the IRS national office in this instance, this commitment would *not* need to be evidenced by the filing of any forms in the period the company commits to making the election.[16]

- If an entity is filing Form 3115 for a non-automatic change from either a permissible or impermissible tax accounting method, the entity should generally consider the recognition and measurement provisions of ASC 740 to determine whether it is appropriate to account for the change before receipt of the consent letter from the IRS. In assessing the recognition and measurement criteria of ASC 740, we believe an entity generally should determine whether the change itself is more likely than not of being sustained considering administrative practices and precedents of the taxing authority; however, sufficient evidence must exist in order to support the conclusion that the change is more likely than not to be accepted by the taxing authority prior to receipt of the consent letter. If an entity concludes the change is more likely than not of being accepted, we generally believe an entity should account for the change, including both the protection from an IRS initiated change and the taxpayer initiated change, when it has an intent to file the change and that intent is supported by filing the change in a timely manner (for instance, prior to the issuance of the financial statements). If an entity cannot conclude the change in tax accounting method is more likely than not to be accepted by the taxing authority, we believe any impact as a result of the change should be reflected within the financial statements only upon receipt of the consent letter.[17]

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[13] See Question 16.5.30 of KPMG's *Revenue Recognition* (September 2017) handbook for further discussion.

[14] Attaching a statement to the return to change a tax accounting method is still considered an automatic method change; however, the taxing authority permits taxpayers to attach a statement in this instance, rather than filing a Form 3115, for administrative relief.

[15] ASC 740-10-55-23.

[16] See paragraph 3.061 of KPMG's *Accounting for Income Taxes* (October 2017) publication for further discussion.

[17] See paragraphs 3.065 and 3.025 of KPMG's *Accounting for Income Taxes* (October 2017) publication and Question 16.5.30 of KPMG's *Revenue Recognition* (September 2017) handbook for further discussion.

If an entity determines that its historic tax accounting method is not a permissible method, the recognition and measurement attributes should be considered in assessing whether an unrecognized tax benefit exists, along with any potential interest and penalties that could be assessed by the taxing authority. We believe any impact of a potential IRS initiated method change as a result of impermissible methods should be reflected within the financial statements until a commitment is made to obtain the audit protection afforded by filing a Form 3115 (automatic or non-automatic that is more likely than not of being accepted) to correct such methods in a timely manner or upon receiving approval for the change. Additionally, with respect to tax accounting method changes prompted by a change in accounting principle used for financial reporting purposes, we believe the impact of that change should not be reflected prior to the adoption of the new accounting principle.

Other Income and Non-Income Taxes Considerations upon Adoption of ASC 606

Upon adoption of ASC 606, an entity may need to address considerations associated with income and other taxes beyond U.S. federal tax accounting method consequences. Changes in the amount or timing of revenue or contract cost recognition as a result of adoption of ASC 606 may have an impact on other income tax matters, such as an entity's transfer pricing, including the methodology utilized to support its transfer price, the measurement of its state deferred taxes or foreign tax accounting methods. Further, other taxes may also be implicated as a result of application of the new standard including, but not limited to, sales and use taxes, excise taxes, value-added taxes or gross-receipts taxes. While these matters are not specifically addressed herein, entities should assess whether any adjustments to amounts recognized are indirect effects of the accounting change that should be reported in the period the accounting change is made.[18]

Disclosure Requirements Prior to Adoption

In the periods prior to adoption, an SEC registrant should consider the following disclosures:

- Brief description of the new standard, the date adoption is required and the date the registrant plans to adopt (if earlier)
- Discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined
- Discussion of the impact of adoption or a statement that the impact is not known or reasonably estimable
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard

The SEC stated that registrants should disclose a description of the effect of accounting policies that the registrant expects to apply, if determined, and a comparison with existing accounting policies, along

[18] For additional information and further considerations, refer to KPMG's Defining Issues No. 16-16, *Revenue Standard Portends Potential Tax Changes*.

with a registrants progress in implementing ASC 606 (including implementation matters that remain pending). Accordingly, registrants may need to consider how to disclose the progress and remaining analysis required associated with both income and other taxes. Further, if a registrant anticipates a significant change in a tax accounting method as a result of adoption of ASC 606, consideration may need to be given as to whether disclosure would be appropriate.

Disclosure Requirements upon Adoption

A variety of disclosures are required in the interim and annual period of adoption of ASC 606 and those disclosures may vary based on the manner of adoption. Included within those disclosures for a full retrospective adoption is the impact of adoption on any affected financial statement line item for the historical periods being retrospectively adjusted. Conversely, an entity electing modified retrospective adoption is essentially required to maintain dual reporting for the year of initial application of ASC 606 and disclose the amount by which each financial statement line item is affected in the year of initial application of ASC 606.

The direct effects of a change in accounting principle, in general, are included in the above disclosures, including the deferred tax effects of the changes. If a company happens to also have a change in tax accounting method in the year of initial adoption of ASC 606, we would not expect the tax accounting method change to be considered a direct effect. Accordingly, we would generally expect the income tax effects included in the above disclosures to effect deferred taxes. If an entity is required to change a tax accounting method as a result of adoption of ASC 606, we believe consideration should be given as to whether this is an indirect effect of adoption and disclosure made of a description of the indirect effect and the amounts that have been recognized in the current period.

Summary

The adoption of ASC 606 may result in certain entities changing accounting principles used for financial reporting simultaneously with changes in tax accounting methods for those same revenue streams or contract costs. Careful consideration should be paid to the transition methods and adjustments made for financial reporting purposes in order to ensure the company's deferred tax assets (liabilities) are appropriately reflected upon adoption. The impact of these changes in accounting principles used for financial reporting along with the changes in tax accounting methods are further exemplified in the following illustrations which may represent some of the more common U.S. federal income tax accounting method impacts of adopting ASC 606; however, entities are likely to have other tax considerations upon adoption.

Illustrations

Example 1: Taxpayer Using a Deferral Method under Revenue Procedure 2004-34

Facts

Software Company SC, a calendar year-end SEC registrant, enters into a two-year software license and support agreement with Customer A for $400 on July 1, 2016. The software was delivered and operational and Customer A paid $400 on the same date the agreement was made. Under ASC 605

(historical U.S. GAAP) Company SC recognized revenue straight-line over the life of the agreement (two year period in this instance); however, Company SC adopts ASC 606 on January 1, 2018. ASC 606 treats the license and support services as separate performance obligations. The software license, which was valued at $300, is deemed to be a point-in-time performance obligation and will be recognized on the July 1, 2016 delivery date. The support services performance obligation is deemed to be satisfied over time, and its revenue is deemed to be recognized as $25, $50 and $25 in 2016, 2017 and 2018, respectively.

For tax, Company SC is on a one-year deferral method under Revenue Procedure 2004-34. Although Company SC will continue to follow this method after the adoption of ASC 606, the company is deemed to have a change in tax accounting method due to the change in recognizing advance payments for financial reporting purposes. In accordance with Section 16.10 of Revenue Procedure 2017-30, Company SC would attach a statement with the required information to its tax return for the year ended December 31, 2018. In accordance with Section 16.10(2)(a) of Revenue Procedure 2017-30 this change is made on a cut-off basis and only applies to advance payments received on or after the beginning of the year of change. Thus, the revenue recognized for U.S. federal income tax purposes prior to January 1, 2018, is unchanged and there is no cumulative adjustment (section 481(a) adjustment).

Assume a 40 percent tax rate and no valuation allowance is required.

The following table reflects the financial reporting of revenue on the contract with Customer A (including deferred revenue), and the associated deferred taxes and income tax expense (benefit) under ASC 605. The table also presents the activity in 2018 had ASC 605 continued to be followed for financial reporting purposes.

ASC 605 Application	2016	2017	2018
Revenue for financial reporting	$100	$200	$100
Deferred revenue for financial reporting	300	100	-
Revenue for U.S. federal income tax	100	300	-
Current tax expense (benefit)	40	120	-
Deferred revenue for U.S. federal income tax	300	-	-
Deductible (taxable) temporary difference [19]	-	100	-
Deferred tax asset (liability)	-	40	-
Deferred tax expense (benefit) [20]	-	(40)	40
Total income tax expense (benefit) [21]	$40	$80	$40

[19] Calculated as financial reporting deferred revenue less revenue deferred for U.S. federal income tax purposes.

[20] Calculated as the beginning-of-year deferred revenue related deferred tax asset (liability) less the end-of-year deferred revenue related deferred tax asset (liability).

[21] Current tax expense (benefit) plus deferred tax expense (benefit).

Full Retrospective Approach

Under the full retrospective approach, Company SC applies the new revenue recognition standards at the start of the earliest comparative period presented in the financial statements, in this case January 1, 2016.

ASC 606 Application: Full Retrospective [22]	2016	2017	2018
Revenue for financial reporting	$325	$50	$25
Deferred revenue for financial reporting	75	25	-
Revenue for U.S. federal income tax	100	300	-
Current tax expense (benefit)	40	120	-
Deferred revenue for U.S. federal income tax	300	-	-
Deductible (taxable) temporary difference	(225)	25	-
Deferred tax asset (liability)	(90)	10	-
Deferred tax expense (benefit)	90	(100)	10
Total income tax expense (benefit)	$130	$20	$10

No adjustment would be required to opening retained earnings in this instance as the contract began subsequent to the date the financial statements reflect the adoption of ASC 606. Upon adoption of the new standard, the adjustments to recast prior year revenue, deferred revenue, deferred tax assets (liabilities) and deferred tax expense (benefit) are reflected in the balance sheet and statement of operations. As discussed above, in this particular fact pattern, this tax accounting method change is implemented on a cut-off basis. Thus, the amount of revenue recognized for tax purposes does not change in 2016 or 2017. However, the change to the timing of revenue recognition for financial reporting purposes results in related adjustments to deferred tax balances during those periods.

Modified Retrospective Approach

Under the modified retrospective approach, revenue for 2016 and 2017 as reported under ASC 605 is not adjusted because the new standard is only applied from the date of initial application (calendar year 2018 in this instance). An adjustment is made to increase 2018 opening retained earnings for the $75 of additional revenue that would have been recognized in prior periods under the new standard. This amount is partially offset by the adjustment to retained earnings of $30 associated with the change to the opening deferred tax asset resulting in a net adjustment to opening retained earnings of $45.

[See chart on next page]

[22] In accordance with the full retrospective transition, the 2016 and 2017 periods are recast as if ASC 606 was applied for the respective periods.

ASC 606 Application: Modified Retrospective [23]	2016	2017	2018
Revenue for financial reporting	$100	$200	$25
Deferred revenue for financial reporting	300	100	-
Preliminary adjustment to opening equity [24]	-	-	75
Adjustment to opening temporary difference	-	-	(75)
Adjustment to opening deferred tax asset	-	-	(30)
Net adjustment to opening equity			45
Revenue for U.S. federal income tax	100	300	-
Current tax expense (benefit)	40	120	-
Deferred revenue for U.S. federal income tax	300	-	-
Deductible (taxable) temporary difference	-	100	-
Deferred tax asset (liability)	-	40	-
Deferred tax expense (benefit)	-	(40)	10
Total income tax expense (benefit)	$40	$80	$10

As reflected in the tables above, the difference in the carrying amount of deferred revenue under an ASC 605 approach and ASC 606 approach would result in a cumulative effect adjustment to 2018 beginning retained earnings of $75 in order to adjust the financial reporting carrying amount of deferred revenue from $100 to $25. The adjustment of the financial reporting carrying amount of deferred revenue to $25 would result in a corresponding reduction of the $40 deferred tax asset reflected as of December 31, 2017, to a $10 deferred tax asset at January 1, 2018. Consequently, as a result of the $75 remeasurement reflected for financial reporting purposes, a corresponding $30 reduction in the deferred tax asset occurs. Since the deferred tax adjustment is a direct effect of the accounting change, it is also presented as an adjustment to 2018 beginning retained earnings.

Example 2: Taxpayer Changing to Deferral Method under Revenue Procedure 2004-34

Facts

Company X, a restaurant franchisor, charges its franchisees an up-front fee for franchise rights. The franchise agreements are for a ten year period and the up-front fees are assessed and collected at the time locations are on boarded. Company X assessed and collected up-front franchise fees of $100, $200, $300, and $400 in 2015, 2016, 2017 and 2018, respectively, based on the number of locations on boarded in each of those years. Under ASC 605, Company X generally recognizes revenue at the time the restaurant location commences operations.[25] Company X adopts ASC 606 on January 1, 2018, and concludes that ASC 606 requires the up-front franchise fees to be recognized over the term of the franchise agreement.

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[23] In accordance with the modified retrospective transition, the 2016 and 2017 periods continue to be presented based upon prior guidance under ASC 605 and are not recast to reflect the impact of ASC 606 application.

[24] Calculated as the difference between deferred revenue of $100 under ASC 605 as of the end of the year immediately prior to adoption of ASC 606 and deferred revenue of $25 as of the end of the prior year as if ASC 606 had been applied.

[25] For simplicity in this example, it is assumed all locations are opened at December 31 of the respective year.

For U.S. federal income tax purposes, Company X historically has not applied the deferral method under Revenue Procedure 2004-34 and instead included in taxable income advance payments in the period received (full inclusion method). As a result of the deferral of the up-front franchise fees under ASC 606, Company X determines that it will file Form 3115 to change its tax accounting method for the tax year ended December 31, 2018 in order to adopt the one year deferral method for advance payments under Revenue Procedure 2004-34. Company X anticipates filing the Form 3115 as an automatic method change attached to its 2018 tax return when filed in October 2019, with a copy filed with the IRS national office at the same time.

Assume a 40 percent tax rate and no valuation allowance is required.

Under ASC 605, the following table reflects the financial reporting of the revenue stream (including deferred revenue), and the associated deferred taxes and income tax expense (benefit). The table also presents the activity in 2018 had ASC 605 continued to be followed for financial reporting purposes.

ASC 605 Application	2015	2016	2017	2018
Franchise fee revenue for financial reporting	$100	$200	$300	$400
Deferred revenue for financial reporting	-	-	-	-
Revenue for U.S. federal income tax [26]	100	200	300	400
Current tax expense (benefit)	40	80	120	160
Deferred revenue for U.S. federal income tax	-	-	-	-
Deductible (taxable) temporary difference	-	-	-	-
Deferred tax asset (liability)	-	-	-	-
Deferred tax expense (benefit)	-	-	-	-
Total income tax expense (benefit)	$40	$80	$120	$160

Full Retrospective Approach

Under the full retrospective approach, Company X applies ASC 606 at the start of the earliest comparative period presented in the financial statements, in this case January 1, 2016. As a result, an adjustment will be made to opening equity on that date to reflect the difference in revenue that was recognized under ASC 605 in prior years and what would have been recognized had ASC 606 been applied in prior years. In this case the $100 revenue which was recognized up-front in 2015 under ASC 605 would have been recognized over the ten year agreement period under ASC 606 and a corresponding adjustment is made to reduce opening retained earnings and establish the deferred revenue liability that would have been recognized at the end of the prior period under ASC 606. This amount is partially offset by the adjustment of $40 associated with the change to the opening deferred tax asset resulting in a net adjustment to opening retained earnings of $60.

[26] The tax accounting method applied is the full inclusion method (for instance. including income in U.S. federal taxable income in the period of receipt). The 2018 amount reflects the revenue that would have been recognized for U.S. federal taxable income purposes as if there would be no change in the tax accounting method.

ASC 606 Application: Full Retrospective [27]	2015	2016	2017	2018
Preliminary adjustment to opening equity [28]	$-	$(100)	$-	$-
Adjustment to opening temporary difference	-	100	-	-
Adjustment to opening deferred tax asset (liability)	-	40	-	-
Net adjustment to opening equity	-	(60)	-	-
2015 Franchise fee revenue for financial reporting	100	10	10	10
2016 Franchise fee revenue for financial reporting	-	-	20	20
2017 Franchise fee revenue for financial reporting	-	-	-	30
2018 Franchise fee revenue for financial reporting	-	-	-	-
Total revenue for financial reporting	100	10	30	60
2015 Franchise fee related deferred revenue	-	90	80	70
2016 Franchise fee related deferred revenue	-	200	180	160
2017 Franchise fee related deferred revenue	-	-	300	270
2018 Franchise fee related deferred revenue	-	-		400
Total deferred revenue for financial reporting	-	290	560	900
Revenue for U.S. federal income tax [29]	100	200	300	400
Current tax expense (benefit)	40	80	120	160
Deferred revenue for U.S. federal income tax	-	-	-	-
Deductible (taxable) temporary difference	-	290	560	900
Deferred tax asset (liability)	-	116	224	360
Deferred tax expense (benefit)	-	(76)	(108)	(136)
Total income tax expense (benefit)	$40	$4	$12	$24

As reflected in the tables above, the difference in the carrying amount of deferred revenue under the different standards would result in a cumulative effect adjustment to beginning retained earnings at January 1, 2016, of $100. As the adjustment changes the financial reporting carrying amount of deferred revenue, the income tax consequences are also considered and would result in an increase in the opening deferred tax asset of $40. The increase in the deferred tax asset is a direct effect of the accounting change and is also reflected through the cumulative effect adjustment in retained earnings.

Assuming the Form 3115 is filed with the 2018 U.S. federal income tax return on October 15, 2019, as an automatic change and the copy is also filed with the IRS national office on October 15, 2019 (prior to the issuance of the Q3 2019 Form 10-Q), the impact of the change in tax accounting method is reflected in the interim period in which management commits to making the change, demonstrated by the filing of the copy of Form 3115 prior to the issuance of financial statements. In this instance the impact of the change is reflected during Q3 2019.

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[27] Under the full retrospective method, the 2015 column is presented in accordance with ASC 605 whereas the 2016 through 2018 columns reflect application of ASC 606. 2015 is presented solely for comparative purposes as it would not be presented within the audited 2018 financial statements.

[28] Up-front franchise fee revenue originally recognized in prior years under ASC 605 that would have been deferred revenue under ASC 606 as of the January 1, 2016 adoption date.

[29] As is described further below, the U.S. federal income tax amounts are computed as if no change in the tax accounting method would be made; consequently, the amounts reflected continue to be based upon a full inclusion methodology.

While Company X is adopting the deferral method under Revenue Procedure 2004-34, no favorable section 481(a) adjustment is reflected as the deferred revenue for financial reporting was not initially eligible for deferral and therefore the application of the change in tax accounting method is applied solely to revenue earned subsequent to the effective date of the change in tax accounting (on a cut-off basis).

Further, the $400 advance payment associated with the up-front franchise fee received in 2018 and deferred for financial reporting purposes until 2019 and future periods would continue to have its tax effect reflected in the 2018 financial statements under the full inclusion method as required under the historic tax accounting method and would result in an additional amount of income taxes payable during preparation of those financial statements. This approach is followed regardless of the amount deferred for financial reporting purposes and Company X's contemplation of changing its tax accounting method with the filing of the 2018 U.S. federal income tax return. The impact of the change in tax accounting method to the 2018 tax year would be reflected in the Q3 2019 financial statements when a commitment to making a change is evidenced by the filing of a copy of Form 3115 with the IRS national office. The change is expected to result in a reduction to both income taxes payable for 2018 and the deferred tax asset for deferred revenue that would have existed as of the end of 2018. These offsetting adjustments would be reflected in the 2019 financial statements.

The impact of the change in the tax accounting method on the 2018 amounts to be reflected in the 2019 financial statements is summarized in the following table.

2018 Method Change Summary	Before 3115	After 3115	Change
Franchise fee revenue for financial reporting	$60	$60	$-
Total deferred revenue for financial reporting	900	900	-
Franchise fee revenue for U.S. federal income tax [30]	400	-	(400)
Tax accounting method change	-	-	-
Net taxable income	400	-	(400)
Income taxes payable	(160)	-	160
Deferred revenue for U.S. federal income tax	-	400	400
Deductible (taxable) temporary difference	900	500	(400)
Deferred tax asset (liability)	$360	$200	$(160)

Modified Retrospective Approach

Under the modified retrospective approach, revenue for 2016 and 2017 as reported under ASC 605 is not adjusted because revenue recorded under ASC 606 is only presented from the date of initial application (January 1, 2018 in this instance). An adjustment is made to reduce 2018 opening retained earnings by $336 for the deferred revenue that would have been recognized in prior years deferred under the new standard of $560, partially offset by the adjustment to the opening deferred tax asset of $224.

[30] The up-front franchise fee revenue was recognized for U.S. federal income tax purposes in the year the fees are assessed prior to filing Form 3115, resulting in $400 originally recognized for the 2018 accounting for income taxes calculations and subsequently deferred until the following tax year after the filing of Form 3115, revising the revenue recognized in 2018 to zero.

ASC 606 Application: Modified	2015	2016	2017	2018
2015 Franchise fee revenue for financial reporting	$100	$-	$-	$10
2016 Franchise fee revenue for financial reporting	-	200	-	20
2017 Franchise fee revenue for financial reporting	-	-	300	30
2018 Franchise fee revenue for financial reporting	-	-	-	-
Total revenue for financial reporting	100	200	300	60
2015 Franchise fee related deferred revenue	-	-	-	70
2016 Franchise fee related deferred revenue	-	-	-	160
2017 Franchise fee related deferred revenue	-	-	-	270
2018 Franchise fee related deferred revenue	-	-	-	400
Total deferred revenue for financial reporting	-	-	-	900
Preliminary adjustment to opening equity [32]	-	-	-	(560)
Adjustment to opening temporary difference	-	-	-	560
Adjustment to opening deferred tax asset (liability)	-	-	-	224
Net adjustment to opening equity	-	-	-	(336)
Revenue for U.S. federal income tax [33]	100	200	300	400
Current tax expense (benefit)	40	80	120	160
Deferred revenue for U.S. federal income tax	-	-	-	-
Deductible (taxable) temporary difference	-	-	-	900
Deferred tax asset (liability)	-	-	-	360
Deferred tax expense (benefit) [34]	-	-	-	(136)
Total income tax expense (benefit)	$40	$80	$120	$24

As reflected in the tables above, the difference in the carrying amount of deferred revenue under an ASC 605 approach and an ASC 606 approach would result in a cumulative effect adjustment to retained earnings at January 1, 2018, of $(560). As the adjustment increases the financial reporting carrying amount of deferred revenue by $560, the income tax consequences are considered and result in a corresponding increase in the related opening deferred tax asset at January 1, 2018, of $224. The increase in the deferred tax asset is a direct effect of the accounting change and is also reflected as a cumulative effect adjustment in retained earnings.

Similar to the full retrospective approach, the impact of the Form 3115 automatic change in tax accounting method will not be reflected until the interim period in which management commits to making the change, which is generally demonstrated by the filing of a copy of the form. As such, for all financial reporting periods

[31] Under the modified retrospective method, the 2015 through 2017 columns are presented in accordance with ASC 605 whereas the 2018 column reflects application of ASC 606. 2015 is presented solely for comparative purposes as it would not be presented within the audited 2018 financial statements

[32] Calculated as the difference between deferred revenue of $0 under ASC 605 as of the end of the year immediately prior to adoption of ASC 606 and deferred revenue of $560 as of the end of the prior year as if ASC 606 had been applied

[33] As the U.S. federal income tax amounts are computed as if no change in the tax accounting method would be made, the amounts reflected continue to be based upon a full inclusion methodology.

[34] Equal to the change in the net deferred tax asset (liability), as adjusted for the cumulative effect adjustment to deferred taxes reflected in retained earnings

prior to the reflection of the change in tax accounting method in Q3 2019, the full inclusion method will be utilized in the calculation of current and deferred tax balances.

While Company X is adopting the deferral method under Revenue Procedure 2004-34, no favorable section 481(a) adjustment is computed as the application of a cut-off basis, thereby resulting in only the 2018 revenue being eligible for deferral for U.S. federal income tax purposes.

Further, as with the full retrospective method, the $400 advance payment associated with the franchise fee received in 2018 and deferred for financial reporting purposes until 2019 and future periods would have its tax effect reflected in the financial statements under the full inclusion method during preparation of the 2018 and 2019 financial statements prior to the filing of a copy of the Form 3115 with the IRS national office.

Conclusion

The adoption of the new revenue recognition guidance may result in significant changes within the financial statements. Prior to adoption of the new standard, entities need to understand and assess the potential impact of financial reporting changes on accounting for income tax matters upon adoption and the potential for future changes to tax accounting methods along with any other potential income tax implications. As part of this assessment, entities should ensure the accounting for income taxes impact of the method of adoption and any change in tax accounting methods are appropriately reflected within the financial statements.