Revenue Recognition
TAXING TIMES FOR MULTINATIONALS

Many Chartered Accountants have been used to preparing dual accounts for US parent companies while also meeting local statutory requirements so the news that the IASB and FASB had issued a combined revenue recognition standard was welcomed by all. But if the world did not have problems to solve, it would not need Chartered Accountants. **Richard Howard** and **Karen Frawley** turn the spotlight on some problems with the potential to create a perfect storm.

Irish GAAP has never been as prescriptive as US GAAP or IFRS when it comes to revenue recognition. As a result, many preparing statutory accounts applied the same revenue recognition principles as US GAAP.

With the adoption of IFRS 15 in 2017 (or ASC 606 for our US counterparts) Irish and US companies will apply the same revenue recognition standard, waving good bye to SOP 97-2 and 200+ other pieces of revenue recognition guidance under US GAAP. This means that IFRS and FRS 101 will be the same as US GAAP and the wording it uses suggests that FRS 102 will draw on the same guidance.

So what changes? Under existing US GAAP, the concept of Vendor Specific Objective Evidence (VSOE) requires that where there are multiple deliverables in a contract, and some of those deliverables do not have a separate identifiable sales price, revenue is recognised either over the term of the longest deliverable or when the final deliverable is provided.

Example: A company sold a perpetual software licence for $100,000 and as part of that deal gave the buyer a right to upgrades over a 12-month period. Since the right to upgrades was not sold separately, the $100,000 is required to be recognised over the 12 month period and not upfront.

This differs from IFRS and the new revenue recognition standard which allows multiple deliverables to be fair valued. So, in our example, the software could be assessed as being worth $85,000, while the right to upgrades could be assessed as having a fair value of $15,000, with the software revenue recognised up front and the right to upgrades recognised over the period the upgrade right exists.

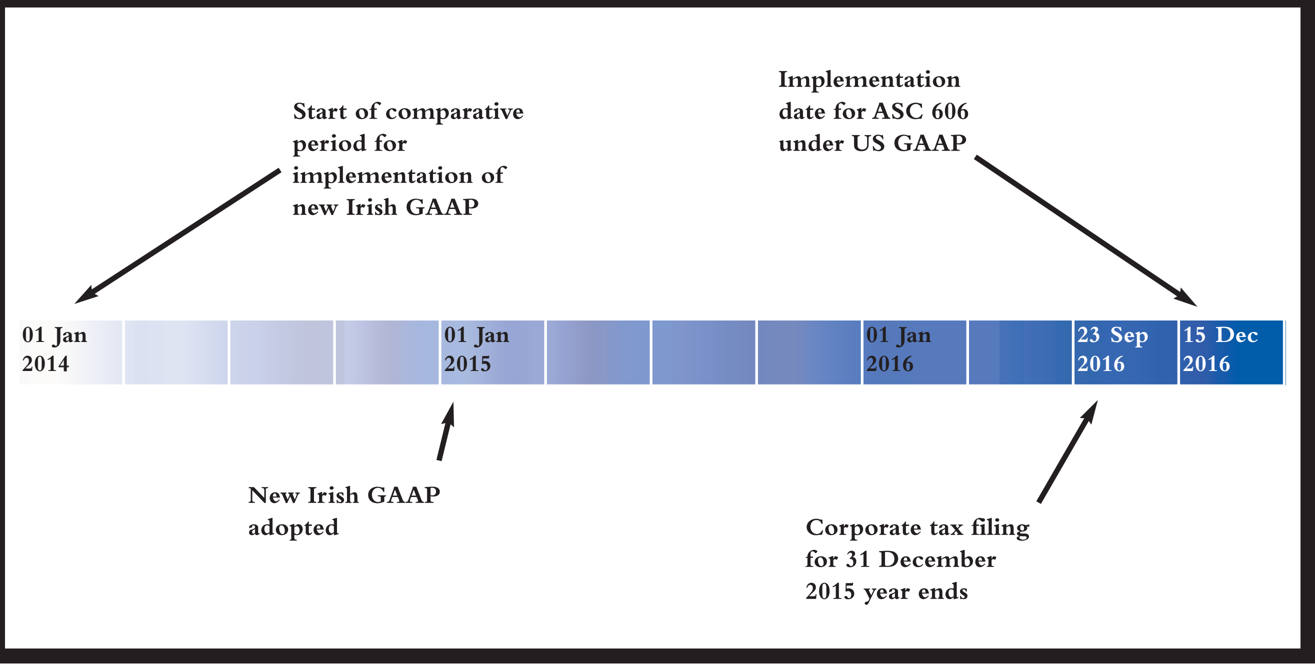
It is expected that the new revenue recognition standard will see billions of dollars recognised earlier by US-listed companies increasing profits and hence tax. This will especially apply to the enterprise software and telecommunications sectors.

The implementation dates for new Irish GAAP and the US GAAP reporting framework illustrated in *Figure 1* together with the tax filing deadlines show the potential impact on reporting and tax payments.

For the company in our example, under new Irish GAAP, $85,000 of revenue would be recognised up front in 2015 with $15,000 deferred over 12 months. However, under US GAAP the full $100,000 would be recognised over 12 months.

Imagine you are the Finance Director of an Irish subsidiary of a US MNC with

Figure 1: Implementation dates for Irish GAAP and US GAAP with tax filing deadlines



thousands of similar contracts (many non-standard) and you will quickly see how interesting life is likely to become over the next three years.

To complicate matters further, the taxation of transitional adjustments, ongoing cash tax implications and tax accounting changes also need to be considered.

Moving to new accounting standards has an immediate impact on the taxation of transitional adjustments. Irish tax rules on a change of accounting policy were introduced by Revenue in anticipation of the transition to full IFRS by some companies in 2005 but this legislation will have much wider application from 2015 as many Irish entities move to FRS 102.

The transitional measures involve identifying the profits, losses and expenses that would otherwise fall out of the reckoning and subsequently taxing or allowing those items as appropriate over a five-year period. Entities will need to consider the impact of these adjustments on cash tax payments and incorporate them into their budgeting and planning activities.

On a group basis, companies may also need to assess the transfer pricing impact. Where local companies recognise revenue differently from their parent company this may have an impact on royalty rates based on revenue or on other transfer pricing considerations. The language in inter-company agreements may also need to be tightened up to reflect the appropriate GAAP.

The cash flow significance of the adoption arises from the ongoing impact on tax calculations. The starting point for taxable income is profit or loss as stated in the local GAAP accounts. Where income is recognised earlier, cash tax payments will also fall earlier. A potential deferred tax effect arising on the different accounting treatment for tax purposes may also arise.

MORE QUESTIONS FOR FINANCE DIRECTORS!

Since we have asked more questions than provided answers in this article, it may be appropriate to continue in that vein by concluding with some further questions that Finance Directors may need to ask:

- Do I have the necessary information to assess the fair value of my deliverables for revenue recognition and who is going to make that assessment of fair values?
- Do I have a system that will then allow me to pull the required information? (For the bonus point, don't forget your comparative figures.)
- If the answer to 1 and 2 above is 'No', the next question must be, do I have the budget or time to then allow me to do what needs to be done?
- If I make the above assessments for local GAAP purposes, am I happy that others in my group will agree with the same fair values when they change over in 2017?
- Have I assessed the knock on impact of any royalty payments based on sales? Does our agreement state US GAAP or local GAAP numbers are the base or is it silent?
- If the basis changes, will this affect transfer pricing arrangements?
- Have I considered the tax and cash impact of earlier revenue recognition, including any adjustment to opening reserves?
- And finally, for US GAAP reporting in 2015 and 2016, do I have a deferred tax impact based on deferred revenue differences?

For many multinational companies (especially enterprise software vendors), the next three years could be a complex and costly time. Preparation and early consideration of the issues raised in this article will be critical.

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