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Exposure Draft on Revenue Recognition: Tax Compliance Costs

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EXPOSURE DRAFT

ON REVENUE RECOGNITION – TAX COMPLIANCE COSTS

In June 2010, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) released an exposure draft (ED) proposing a new revenue recognition standard which will change the way revenue is recognised from a "risk and reward" approach to a "transfer of control" approach. The purposes of the ED are:

a To clarify and simplify the Generally Accepted Accounting Principles (GAAP) for revenue recognition

b To harmonise the US GAAP (which has numerous industry-specific standards for revenue recognition) with the IASB GAAP

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The ED also proposes to do away with IAS 18 on revenue recognition (our local equivalent is Financial Reporting Standards (FRS) 18 and IAS 11 (FRS 11 locally) on Construction Contracts. As Singapore adopts the IAS as its GAAP, the ED will therefore have implications in Singapore on the timing and amount of revenue recognised and consequently on the determination of income.

This article examines the tax implications arising from the adoption of the broad revenue recognition principles under the ED. Under the ED, revenue for goods and services is recognised when a company satisfies its performance obligations to its customer, that is, when control of goods and services is transferred. Indicators of transfer of control, not to be considered in isolation, would include the following:

- Whether customer has an unconditional obligation to pay
- Whether customer has a legal title
- Whether customer has taken physical possession
- Whether customer has specified the design or function of the good or service

Companies in Singapore and in many other countries generally do not keep two sets of books, one for determining accounting income and another for determining taxable income as it is costly to do so. Taxable income is generally derived from accounting income by making the necessary tax adjustments to accounting income.

In Singapore, income is assessable to tax when it is "accrued", which has been interpreted to mean "to which any person has become entitled" and in some other cases, when it becomes "due and payable". So "accrued" does not necessarily mean "paid". Accrued taxable income must be unconditional, that is, there must be a fixed right to receive the income and the amount can be reasonably determined.

This meaning of "accrued" in tax is somewhat different from the "accrual" system of accounting where revenue is recognised when earned (not when received) and expenses are recognised when incurred (not when paid). Consequently, revenue recognition for tax purposes may differ from accounting such as:

- Passive interest income which is taxable on a "due and payable" basis and this taxable point generally coincides with the point when cash is received whereas for accounting purpose, such interest income is recognised proportionately on a time basis.
- Property developer's income which is taxable upon the issuance of Temporary Occupation Permits when 85% of the purchase price of the units sold is due and payable. In accounting, developer's revenue may be recognised on a percentage of completion method and in some cases on a completed contract method.

Proposed new revenue recognition standard: moving from a "risk and reward" approach to a "transfer of control" approach

Arising from the ED, tax adjustments are necessary due to differences in the tax treatment and the accounting treatment in the following areas:

- ED proposes the time value of money (TVM) be taken into account to adjust the amount of promised consideration if the contract with a customer has a material financing component. An example would be a significant advance payment received before the transfer of control of goods or services, in which case, an interest expense will be imputed to reflect the TVM but will not be tax deductible. Correspondingly, an amount equal to the imputed interest expense will be recognised as a contract liability which will be recognised as revenue (which in this instance is non-taxable) when control is transferred to the customer.
- Existing financial reporting standard (FRS 39) requires allowance for credit losses in relation to trade debts to be made on an "incurred loss model". Generally, the incurred loss model is consistent with the tax law which allows bad debts arising from trade to be tax deductible only when they are incurred.

The ED proposes that the allowance for credit losses be made on an "expected loss model" basis by requiring the entity to adjust the amount of consideration to reflect the customer's credit risk to a probability-weighted expected amount at the initial measurement. Although the expected loss model enables an earlier and more timely recognition of credit risk, for tax purpose, this "expected loss", even though trade related, is not tax deductible at this juncture. If the credit risk does subsequently materialise, no further accounting entry for the credit loss needs to be taken into account under the ED but a tax adjustment will be required for the credit loss which is now tax deductible.

- Under the current accounting practice, warranties are generally not considered as elements of revenue. While revenue is fully recognised, a separate provision is set up for warranty to take into account possible defects that may arise after the risks and rewards have been transferred to the customer. However, the corresponding estimated warranty expense recognised is not tax deductible until it is actually incurred which may be in a different period. Under the ED, although deferral of revenue is required for warranty cases (be it warranties for faults that arise after the sale is made or for latent defects), it is taxable as per the current tax laws. When defects occur subsequently, warranty expense incurred will be recognised under the ED in the period in which the warranty performance obligation is satisfied. The actual warranty expense incurred therein will then qualify for tax deduction.

As taxable income is derived from accounting income, some of the differences between the tax and accounting treatment as described above will further increase the number of tax adjustments required in the tax computation and also the amount of tracking necessary to perform the required tax adjustments in subsequent period(s).

The introduction of FRS 39 *Financial Instruments: Recognition and Measurement* in 2005 required some financial instruments to be measured at fair value which may result in unrealised gains and losses being recognised in the accounting profit. However, under the well-established general tax principle regarding the recognition of gains or losses, gains/losses of a revenue nature must be realised before such gains are taxable as income or losses allowable as deductions. In order for tax treatment of such unrealised gains/losses to be aligned with the accounting treatment, the Singapore tax legislation was amended in 2007 to allow the fair value gains or losses to be treated as taxable/tax deductible even though they are unrealised. With the amendments, the reconciliation from accounting income to taxable income is minimised (unless the taxpayer opts out from this tax treatment).

If the ED should become an accounting standard, the tax authorities should consider aligning the tax treatment of revenue recognition to that of the proposed accounting treatment either by way of a concession or by amending the tax laws so as to minimise the number of tax adjustments required. The amount of tax revenue eventually collected is not expected to differ much from that under the existing revenue standard except perhaps for some time delays in tax collection resulting from the deferrals of revenue. With the alignment, this will also reduce the difficulty and confusion that may arise in dealing with two very different concepts of income.

In conclusion, the differences between taxable income and accounting income as a result of the ED lie mainly in the timing and the amount of revenue recognised. If the tax treatment is aligned to that of the proposed accounting treatment of revenue recognition, it will go a long way to minimise tax compliance costs for taxpayers.

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