A TOOL FOR AUDIT COMMITTEES

PREPARING FOR THE NEW REVENUE RECOGNITION STANDARD

Introduction

The new revenue recognition standard[1] is historic in its breadth and impact across industries. Investors want to know the potential impact of the new standard now. Many companies will need to determine the impact on 2016 financial information and all companies are required to provide meaningful transition disclosure in 2016. It is urgent that audit committees understand how management is assessing the impact of the new revenue recognition standard and forging a successful path to its implementation.

"Implementation of the new standard requires significant effort by companies, including analyzing contracts and designing new systems, processes, and controls. Given the importance of high quality application of the standard, I believe executive management, the audit committee, and the company's external auditor should discuss implementation status and plans, as well as the allocation of sufficient resources with appropriate skill sets to execute the plan."

– James Schnurr, Securities and Exchange Commission (SEC) Former Chief Accountant, 12th Annual Life Sciences Accounting and Reporting Congress, March 22, 2016

Based on key messages from regulators, the Center for Audit Quality (CAQ) has developed this tool to help audit committee members succeed in their oversight responsibilities. This tool provides important questions to consider such as: How will revenue change? Is the company on track? How is the company preparing investors to understand the impact? Are new processes and controls being developed to ensure accuracy of the adoption of the standard? Are the appropriate disclosures being developed?

The new revenue recognition standard affects all entities – public, private, and not-for-profit – that have contracts with customers.[2] It is broad reaching across an organization and impacts many functional areas: accounting, tax, financial reporting, financial planning and analysis, investor relations, treasury (e.g., debt covenants), sales, legal, information technology, and human resources (e.g., employee compensation plans). It involves significant judgments and estimates, thoughtful revision of accounting policy, and new required disclosures.

Implementation is a significant effort. If companies have not begun the process already, it is imperative to start preparing immediately.[3] The effective date of the standard for calendar year-end public companies is ***January 1, 2018*** (annual reporting periods beginning after December 15, 2017, and interim reporting periods therein).[4]
For many companies, the new standard will require evaluation of 2016 and 2017 financial information under the new rules.

This publication has been organized into four sections to help audit committees succeed in their oversight of the implementation of the new revenue recognition standard. It provides examples of questions audit committees may ask of management related to the company's implementation efforts, but is not all-inclusive.

1 In May 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the boards) jointly issued a converged standard, Accounting Standards Update (ASU) *No. 2014-09, Revenue from Contracts with Customers* (Topic 606).
2 Except for certain items explicitly covered by other accounting standards such as leases, insurance contracts, and most financial instruments. For financial institutions, certain types of non-interest income are within scope of the new revenue recognition standard.
3. In a Bloomberg BNA article dated September 20, 2016, FASB Vice Chairman James Kroeker said that he was struck by the "pretty high" percentage of companies that haven't begun to adopt the standard – as signaled by the results of a polling question put to participants during the FASB's September 15, 2016 webcast on the subject. Available at http://www.bna.com/companies-prepare-asap-n57982077288/.
4 ASC 606-10-65-1(a). Initially the effective date for calendar year-end public companies was January 1, 2017. In August 2015, FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers – Deferral of the Effective Date*, to defer the effective date of ASU No. 2014-09 for one year. It is not expected to be deferred further.

I. ***Understanding the New Revenue Recognition Standard* – *What Is It?*** This section provides a brief overview of the core principles of the standard.

II. ***Evaluating the Company's Impact Assessment – How Will Revenue Recognition Change?*** This section assists audit committees in discussing with management the impact of the new standard due to various factors related to the company's business.

III. ***Evaluating the Implementation Project Plan – How Do We Need to Prepare?*** This section assists audit committees in their efforts to understand and evaluate management's implementation project plan.

IV. ***Other Implementation Considerations – What Else Do We Need to Consider?*** This section assists audit committees with other considerations such as transition decisions and new disclosure requirements.

I. Understanding the New Revenue Recognition Standard

What Is It? Being knowledgeable about this complex standard is integral to effective audit committee oversight of its implementation.

> Audit committee members should ask management to explain the standard and how it affects (or does not affect) the company.

For many companies, the amount and timing of revenue recognized may vary as a result of implementing the new standard compared with existing US generally accepted accounting principles (GAAP). For some companies, the amount and timing of revenue recognized may not be significantly different from current US GAAP, but an analysis to reach such a conclusion is necessary as the revenue recognition requirements are different under the new standard. The new standard will significantly impact all companies due to new required disclosures.

As stated in the new standard, "The core principle of Topic 606 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."[5] In other words, a company will recognize revenue when the customer can use or benefit from the good(s) or service(s) provided.[6] To achieve that core principle, the new standard requires the following five steps:

STEP 1: IDENTIFY THE CONTRACT(S) WITH A CUSTOMER.

- An agreement is a contract when approved, identifies rights of the parties and payment terms, has commercial substance, and is probable of collection.

STEP 2: IDENTIFY THE SEPARATE PERFORMANCE OBLIGATIONS[7] IN THE CONTRACT.

- "Performance obligation" is a new term under the standard and judgment is required to identify all the unique performance obligations of a contract. What is the obligation of the vendor under the contract? What benefits (in the form of goods or services) does the customer receive? Is there more than one performance obligation?

5 FASB ASU No. 2014-09 Summary page 2 and FASB ASC 606-10-05-3 through 05-4 and 606-10-10-2 through 10-4.

6 See also The Journal of Accountancy article, *The new revenue recognition standard in plain English* by Monica Ursick http://www.journalofaccountancy.com/newsletters/2016/mar/revenue-recognition-standard-in-plain-english.html.

7 The standard defines a performance obligation as a promise in a contract with a customer to transfer to the customer either:
a. A good or service (or bundle of goods or services) that is distinct.
b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

STEP 3: DETERMINE THE TRANSACTION PRICE.

- A significant judgment in this step involves *variable consideration*, such as contracts that include bonuses, incentives, rebates, and penalties. These amounts will have to be estimated in determining the transaction price.

STEP 4: ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS IN THE CONTRACT.

- This step is required when there are multiple performance obligations. The allocation process is another area of judgment. The entity should determine the standalone selling price at contract inception of each performance obligation.

STEP 5: RECOGNIZE REVENUE WHEN (OR AS) THE ENTITY SATISFIES A PERFORMANCE OBLIGATION.

- A performance obligation is satisfied when the customer obtains control of the good or service (at a point in time or over time). Control is defined as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service.

> Companies must decide on a transition method. Audit committee members are encouraged to be involved in the oversight of this decision and consider the market impact. Companies should consider disclosing the transition method they elect once it has been decided.

> Upon adoption in 2018, for calendar year-end public companies electing retrospective application – sometimes referred to as "full retrospective application" – revenue for the period January 1, 2016 – December 31, 2018 will be required to reflect adoption of the new standard. Therefore, companies should not delay in evaluating revenue for the years 2016 and 2017 under the new standard.

To adopt the new standard, a company needs to elect either a full or modified retrospective application. Upon adoption, *full retrospective application*[8] requires a recast of prior-period financial statements – 2016-2017 – with the cumulative effect of initially applying the standard recorded as an adjustment to opening retained earnings as of January 1, 2016. This method improves comparability for users in the year of adoption. To prepare for such presentation, companies may benefit from evaluating revenue recognition on a parallel track beginning in 2016 (under the existing and new standards). A *modified retrospective approach*[9] does not require the prior-period financial statements to be recast; however, the cumulative effect of initially applying the standard is recorded as an adjustment to opening retained earnings of the period of initial application (as of January 1, 2018 for calendar year-end companies).

The following is a summary of transition options for public companies with a calendar year-end:[10]

- Full retrospective application
  - Apply the revenue recognition standard to all contracts with customers
  - 2016 and 2017 financial statements recast to reflect adoption of the new standard presented in 2018 financial statements
  - Date of cumulative adjustment: January 1, 2016, reflected in 2018 financial statements
- Modified retrospective application (cumulative effect at date of adoption)
  - Apply the revenue recognition standard to all contracts with customers (or elect to apply only to contracts that are not completed as of January 1, 2018)
  - Disclose the effect of applying the new revenue recognition standard (each financial statement line item impact) in 2018 (the year of adoption)
  - 2016 and 2017 financial statements are not recast, continue to report based on legacy accounting in 2018 financial statements
  - Date of cumulative adjustment: January 1, 2018, reflected in 2018 financial statements

8 As provided for in ASC 250-10-45-5 through 10 and discussed in ASC 606-10-65-1.

9 ASC 606-10-65-1

10 AICPA *Financial Reporting Brief: Roadmap to Understanding the New Revenue Recognition Standards*, page 28; ASC 606-10-65-1 also provides for certain practical expedients that may impact adoption.

II. Evaluating the Company's Impact Assessment

How Will Revenue Recognition Change? The new standard is considered broad and expected to have a sweeping effect on almost all companies. However, the degree of impact will vary based on a variety of company-specific factors. Management would likely perform a preliminary high-level *impact assessment* to consider how revenue will be recognized under the new standard followed by a detailed analysis that includes reviewing contracts with customers.

The following questions may help audit committees evaluate management's impact assessment:

1. How has the impact of the revenue standard on the company been assessed? Who was involved in the assessment? Were all relevant parties involved, such as accounting, tax, financial reporting, financial planning and analysis, investor relations, treasury (e.g., debt covenants), sales, legal, information technology, and human resources (e.g., employee compensation plans)?

2. What factors went into management's impact assessment? Some of these factors may include:
   - Industry
   - Key judgments
   - Differing revenue streams/varying types of contracts
   - Performance obligations
   - Impact to accounts other than revenue

3. What is the impact of the standard on the company's revenue streams and related activities? Impacted revenue may include:
   - Simple point-of-sale transactions
   - Multiple goods or services as part of a sale (bundled goods or services)
   - Reward or loyalty programs
   - Vendor incentive programs or penalties
   - Rebate programs, return or refund provisions
   - Contingencies, warranties, or guarantees
   - Licenses or royalty agreements
   - Contracts that change throughout the term
   - Long-term (more than one year) contracts
   - Non-interest fees or other non-interest income
   - Long-term construction contracts
   - Variable or contingent consideration
   - Collaborative agreements

4. What are other considerations that may impact the company under the new standard, such as:
   - Costs to obtain or fulfill a contract
   - Employee compensation plans or debt covenants linked to revenue
   - Changes to tax accounting methods and deferred taxes

5. When will management provide pro-forma financial statements, including disclosures, to the audit committee to demonstrate the expected impact of the new standard on revenue?

6. How does the company's external auditor view the company's impact assessment? How has the external auditor been involved and what are the auditor's views on management's assessment of the impact of adopting the new revenue standard, changes to critical accounting policies and practices, and the company's overall readiness?

III. Evaluating the Implementation Project Plan

How Do We Need to Prepare? Due to the breadth and scale of the new revenue standard, it is expected that companies will develop an implementation project plan, communicate it to the audit committee, and provide updates to the audit committee on a regular basis. Audit committees should consider asking the following questions regarding management's plan:

THE PLAN

1. How are milestones established and monitored?

2. How will the audit committee be apprised of status? How will the audit committee know if the project is on plan? Audit committees may want to consider requesting a quarterly progress report from management.

3. How is management updating the audit committee on progress of outside constituents that are supporting management in implementation (i.e., internal auditors, outside legal counsel, IT vendors, other consultants)?

4. What is the view of the external auditor as it relates to management's implementation plan? Will management's implementation plan provide the auditor with sufficient time to complete the audit?

5. What are the views of third-party vendors (consultants, etc.) who have been engaged by management regarding the implementation plan? How does the company's implementation plan compare to other companies and best practices? Are there any concerns of which the audit committee should be aware?

CULTURE AND RESOURCES

6. Is there a strong tone at the top that supports the effort required to implement the new standard? Is implementation receiving the appropriate resources and priority?

7. Is the accounting team experienced with a sufficient level of company knowledge to understand the impact of the new standard? Will significant judgments about implementation be made and approved centrally (e.g., at corporate) or throughout the organization (e.g., at a business unit level)?

8. Are accounting personnel involved in advising the business about the impact of sales contract terms as the sales personnel negotiate the contract (such that they can evaluate the impact on revenue recognition during the contract drafting process)?

> *"Disclosure regarding what is changing, why it is changing, and how, as well as the company's adoption plan and potential impact on financial results, will be useful to investors and should be disclosed."*
>
> – Wes Bricker, SEC Chief Accountant, AICPA National Conference on Banks and Savings Institutions, September 21, 2016

INVOLVEMENT OF STAKEHOLDERS

9. Has the new standard been socialized across the organization (such that key stakeholders are aware of how the new standard will impact the company)? Are key decision makers aware of the judgments that need to be made at a business-unit level?

10. Has an internal communication plan been established?

11. How will training be developed and rolled out across the organization?

12. What is the plan to communicate the impact of the adoption of the new revenue standard to investors? In addition to robust transition disclosures, how will the company manage investor expectations?

ACCOUNTING POLICY AND SIGNIFICANT ACCOUNTING JUDGMENTS

13. Who is responsible for new accounting policy decisions and how does the company plan to revise written accounting policies?

14. Who has reviewed significant company contracts and determined how to recognize revenue in accordance

> *"The preparation of the transition disclosures should be subject to effective ICFR and disclosure controls and procedures. As management completes portions of its implementation plan and develops an assessment of the anticipated impact the standard will have on the company's financial statements, internal and disclosure controls should be designed and implemented to timely identify relevant disclosure content from the implementation assessments and to ensure, where necessary, that appropriately informative disclosure is made."*
>
> – Wes Bricker, SEC Chief Accountant, 35th Annual SEC and Financial Reporting Institute Conference at USC, June 9, 2016

with the new revenue standard? Who has approved such judgments? Have significant judgments been reviewed by the external auditor? Have significant judgments been communicated to the audit committee?

15. How do significant accounting judgments compare to peers and competitors?

16. Have accounts been evaluated for appropriate presentation based on the new standard?

CONTRACTS

17. Are tax accounting methods changing and how does the new standard affect the company's tax planning?

18. How are new and existing contracts being reviewed to determine revenue recognition under the new standard?

19. What is the company's scoping process to undertake the review of its contracts? Who is responsible for this significant judgment? What is the external auditor's view of the approach?

SYSTEMS AND CONTROLS

20. Are internal controls related to the adoption of the standard being appropriately designed and tested by management? How will internal controls related to disclosure of the adoption impact be documented and tested? Has the external auditor assessed the design of such controls?

21. How will changes in internal controls related to the adoption of the new revenue standard be disclosed?[11]

22. Are systems adequate to account for revenue under the new standard? If manual processes are necessary, what controls are in place to ensure completeness and accuracy of accounting for revenue, including any data inputs?

23. How is internal control over financial reporting (ICFR) impacted? Who is responsible for changing, updating, and reviewing processes, controls, and related documentation impacted by the new standard? How do existing control deficiencies, including significant deficiencies or material weaknesses, impact control considerations in implementing this new standard?

11 In accordance with SEC rules, paragraph (c) of Item 308 requires the company to disclose in each quarterly and annual report whether or not there were changes in the company's internal controls in the last quarter that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

IV. Other Implementation Considerations

What Else Do We Need to Consider? There are several key policy decisions to make in advance of adopting the new standard, including a focus on transition and new required disclosures.

The following questions may be helpful to audit committees as they engage with management during the implementation.

"The SEC staff has long advised that a registrant should provide disclosures to investors of the impact that a recently issued accounting standard will have on its financial statements when that standard is adopted in a future period (so-called "transition disclosures"). Without adequate transition disclosures, investors may not be prepared to fully understand changes in the company's financial performance from one period to the next and the impact of adopting a new accounting standard. Investors should expect the level of disclosures to increase as companies make further progress in their implementation plans."

– Wes Bricker, SEC Chief Accountant, Baruch College Financial Reporting Conference, May 5, 2016

TRANSITION METHOD

1. What transition method does the company plan to use to adopt the new standard? How does the company plan to handle dual recordkeeping efforts between the new standard and the old standard due to the retrospective impact? How will the cumulative catch-up adjustment be calculated?

2. Has the company considered early adoption, as permitted?

DISCLOSURES

3. Has the company disclosed the potential effects of the future adoption of the new standard[12] in interim and annual filings leading up to the effective date? If quantitative amounts are not known, has the company provided qualitative or directional disclosures?[13]

4. What is management's strategy for identifying, drafting, and communicating to the audit committee any new disclosures required as a result of the standard?

5. To the extent that information for new disclosures is not currently available, how will the company develop new processes and controls to obtain required information?

12 SEC Staff Accounting Bulletin (SAB) No. 74 (Topic 11:M), Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period, requires that when a recently issued accounting standard has not yet been adopted, a registrant discuss the potential effects of the future adoption in its interim and annual SEC filings. SAB 74 disclosures are required in both the notes to the financial statements and MD&A.

13 At the September 22, 2016 Emerging Issues Task Force meeting, SEC Assistant Deputy Chief Accountant Jenifer Minke-Girard indicated that when a registrant is unable to reasonably estimate the impact of adopting the revenue standard, the registrant should consider providing additional qualitative disclosures about the significance of the impact on its financial statements. She further noted that the SEC staff would expect such disclosures to include a description of: (1) The effect of any accounting policies that the registrant expects to select upon adopting the ASU. (2) How such policies may differ from the registrant's current accounting policies. (3) The status of the registrant's implementation process and the nature of any significant implementation matters that have not yet been addressed.

Resources

EXECUTIVE SUMMARIES

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2. AICPA: *New Revenue Recognition Accounting Standard—Learning and Implementation Plan* (September 2016)
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TECHNICAL GUIDES

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14. FASB/IASB: *Joint Transition Resource Group for Revenue Recognition Page*
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15. Grant Thornton: *New Developments Summary Revenue recognition take two! NDS 2016-09* (June 2016)
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    http://rsmus.com/what-we-do/services/assurance/revenue-recognition-in-motion.html

About the Center for Audit Quality

The CAQ is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.