

# Brief: Revenue Recognition Primer for Audit Committees



In May 2014, FASB issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers* and the International Accounting Standards Board (IASB) issued International Financial Reporting Standards (IFRS) 15, *Revenue from Contracts with Customers*.

FASB and the IASB have basically achieved convergence with these standards, with some minor differences related to the collectibility threshold, interim disclosure requirements, early application and effective date, impairment loss reversal, and nonpublic entity requirements.

This document will focus on the guidance in FASB ASU No. 2014-09 (revenue recognition standard), however the soon to be released AICPA “Financial Reporting Brief: Roadmap to Understanding the New Revenue Recognition Standard” will highlight the differences between the two standards.

The revenue recognition standard affects all entities—public, private, and not-for-profit—that have contracts with customers, except for certain items, which include leases accounted for under FASB *Accounting Standards Codification* (ASC) 840, *Leases*; insurance contracts accounted for under FASB ASC 944, *Financial Services—Insurance*; most financial instruments, and guarantees (other than product or service warranties).

## Principle

The revenue recognition standard eliminates the transaction- and industry-specific revenue recognition guidance under current generally accepted accounting principles (GAAP) and replaces it with a principle-based approach for determining revenue recognition.

The core principle of the revenue recognition standard is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those good or services.

To apply the revenue recognition standard, an entity should take the following steps:

1. Identify the contract(s) with a customer.
2. Identify the separate performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the separate performance obligations.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

Revenue would be recognized when a company satisfies a performance obligation by transferring a promised good or service to a customer, which is when the customer obtains control of that good or service.

### **Effective Date**

Public entities<sup>1</sup> are required to adopt the revenue recognition standard for reporting periods beginning after December 15, 2016, and interim and annual reporting periods thereafter (which equates to January 1, 2017, for public entities with a December 31 year-end). Early adoption is not permitted.

Nonpublic entities are required to apply the revenue recognition standard for annual reporting periods beginning on or after December 15, 2017, and interim reporting periods within annual reporting periods beginning after December 15, 2018.

Nonpublic entities may elect to apply the requirements of the revenue standard earlier as of the following annual reporting periods:

- a. An annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period (public entity effective date)
- b. An annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning after December 15, 2017
- c. An annual reporting period beginning after December 15, 2017, including interim reporting periods within that reporting period

### **Transition—Retrospective Adoption**

The revenue recognition standard should be applied retrospectively, and an entity can also use any combination of the optional practical expedients as discussed in the standard. An entity may also elect an alternative transition and recognize a cumulative adjustment to the opening balance of retained earnings for the year of adoption only for contracts open and uncompleted on the date of adoption.

The years that contracts will need to be restated and the date of the cumulative effect adjustment are dictated by how an entity chooses to apply either full retrospective adoption of the revenue recognition standard or a combination of the allowable practical expedients. If a public entity chooses full retrospective adoption, all contracts must be restated for 2015 and 2016 to show comparative financial statements with a cumulative adjustment as of January 1, 2015.

### **History and Background**

Current revenue recognition requirements in U.S. GAAP differ from those in IFRS. GAAP consists of broad revenue recognition concepts and numerous requirements for particular industries or transactions that can result in different accounting for economically similar transactions. Although IFRS has fewer requirements on revenue recognition, the main revenue recognition standards can be difficult to understand and apply.

In June 2010, the boards issued an exposure draft, but after receiving nearly 1,000 comment letters and conducting extensive re-deliberation and outreach activities with respondents, the boards decided that some items needed to be clarified, simplified, or revised. In November 2011, the boards issued a revised joint exposure draft. The boards hosted a series of public roundtables in 2012, and re-deliberated tentative conclusions based on feedback received throughout 2012 and the first quarter of 2013.

You can find additional information and AICPA resources on the revenue recognition standard at the

<sup>1</sup> A public entity is an entity that is any one of the following:

1. A public business entity
2. A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
3. An employee benefit plan that files or furnishes financial statements to the SEC

### **Reasons for Audit Committee Concern**

Because the revenue recognition standard will eliminate the transaction- and industry-specific revenue recognition guidance included in current GAAP and replace it with a principle-based approach, it is important for audit committees to gain an understanding of the standard and how it may impact the entity's revenue recognition.

The audit committee should be prepared to ask members of the company's management team specific questions about how the new revenue recognition standard will affect the entity's revenue recognition policies and ensure that management is prepared to adopt the standard.

### **Questions for audit committee consideration:**

- Has the audit committee discussed the adoption of the revenue recognition standard with company leadership?
- Does the audit committee believe that management understands how adoption of the revenue recognition standard will affect the company and its financial reporting process?
- Does the audit committee believe that management understands the full extent of the changes to the company and its financial reporting process?
- Does the audit committee have an oversight plan for monitoring the implementation and progress of adoption of the revenue recognition standard?
- What impact does the new revenue recognition standard have on internal control and financial statement presentation and disclosures?
- How will audit committee members become knowledgeable about the new revenue recognition standard?
- How will the audit committee understand and question management's revenue recognition accounting policy choices? (The new revenue recognition standard contains less detail than current GAAP.)
- How will the audit committee inform the board of directors, compensation committee and others of the impact of the company's transition to the revenue recognition standard?
- How will the audit committee know if management's informational goals for shareholders and analysts are being met?

### **Questions for audit committee and management review:**

- What are the changes to the entity's revenue recognition accounting policies due to adoption of the new revenue recognition standard? What is the potential financial impact of those changes?
- What are the tax implications of adopting the new revenue recognition standard? (Such as, change in tax accounting methods as well as transfer pricing and advance payments.)
- Are there particular revenue recognition accounting issues for the industry in which the entity operates?
- What type and level of education on the new revenue recognition standard will the company's employees need?
- What is the company's plan for educating stakeholders (investors, analysts, lenders, creditors, and the like) so that they understand accounting policy and financial statement changes?
- How will the company address the restatement of comparative periods and its possible impact on investors?
- What steps is the company taking now to prepare for adoption of the revenue recognition standard? Does the company have an implementation plan for adopting the revenue recognition standard?
- Does the company have a transition plan that includes financial assessment, key conversion activities, a timetable, required resources, and project- and change-management training?
- How will the revenue recognition standard affect the company's business practices? (Examples include changes to IT and other internal systems, risk monitoring and controls, contractual arrangements, lending agreements and covenant requirements, budgeting and

forecasting, key performance indicators, compensation, joint ventures and alliances, subsidiaries and legal issues, among other practices.)

- Will external advisors be used to help with the transition to the new revenue recognition standard? If yes, what will be their qualifications and roles?
- How will the new standard affect accounting for licenses, warranties, sales returns and doubtful accounts?

Additional information and insights on various issues impacting audit committees can be found at the AICPA's Audit Committee Effectiveness Center at:

[www.aicpa.org/FORTHEPUBLIC/AUDITCOMMITTEEEFFECTIVENESS/Pages/ACEC.aspx](http://www.aicpa.org/FORTHEPUBLIC/AUDITCOMMITTEEEFFECTIVENESS/Pages/ACEC.aspx)

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