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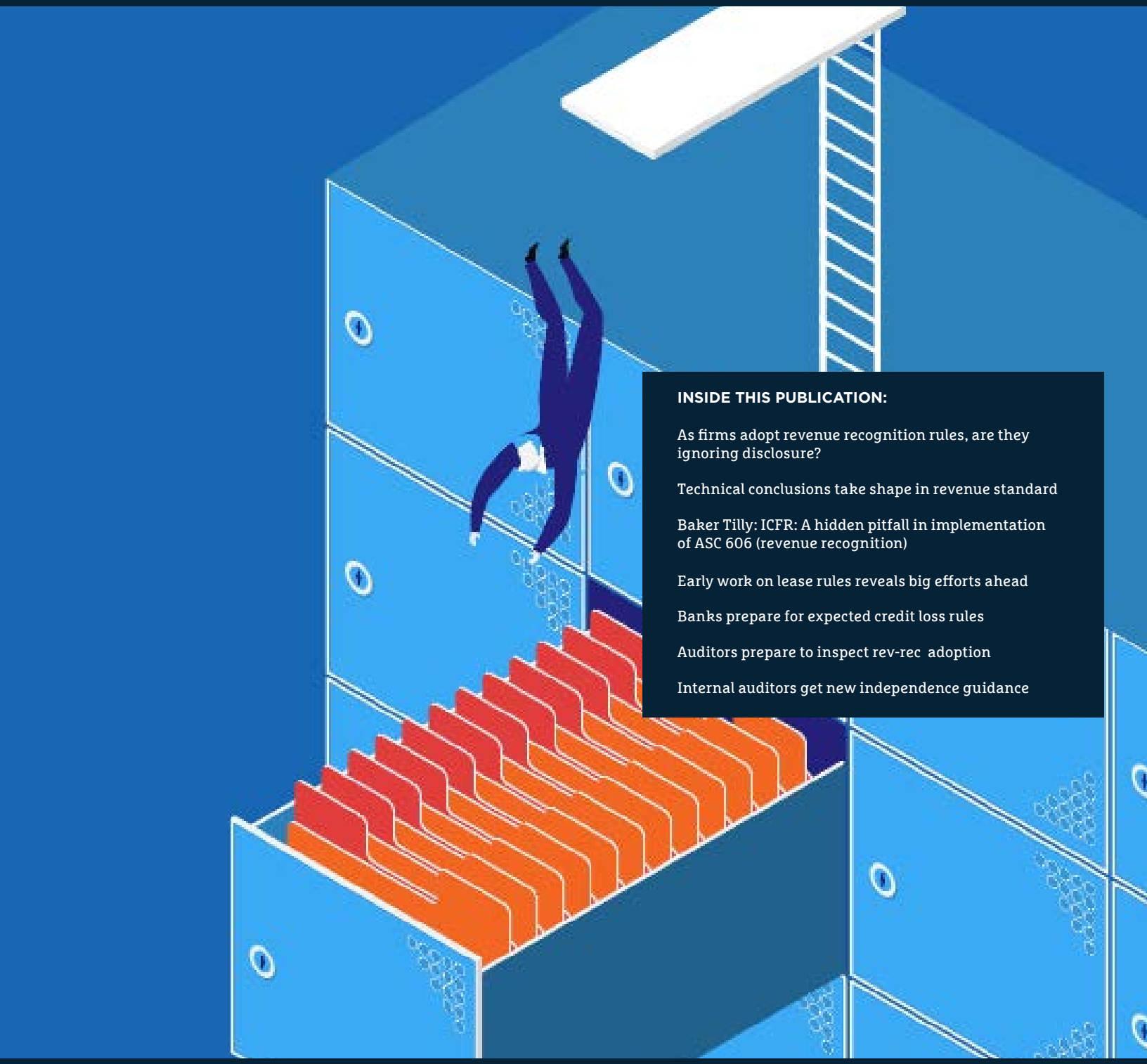

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Taking a deep dive into

Revenue recognition

An e-Book publication sponsored by BAKER TILLY

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Organizations assessing and implementing ASC 606 require a broad array of expertise and experience to assist them through this sea change. Baker Tilly Virchow Krause, LLP (Baker Tilly) is a nationally recognized, full-service accounting and advisory firm whose specialized professionals in accounting, consulting and tax understand the impacts of ASC 606. We are ready to assist with services from initial assessment through gap analysis and implementation.

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As firms adopt revenue recognition rules, are they ignoring disclosure?

The SEC has approved reducing the settlement cycle for most broker-dealer securities transactions by one day. It will also evaluate the possibility of end-of-the-day settlement cycles. **Tammy Whitehouse** reports.

Whether you think your company is ready for the new accounting for revenue recognition or not, you're probably not ready for the new disclosures. That's what experts are saying as they witness the scrambling at many companies to prepare for the biggest change in corporate accounting since Sarbanes-Oxley.

"Many companies are largely ignoring the disclosure requirements," says Eric Knachel, senior consultation partner at Deloitte & Touche. "They think it is a minor detail to be dealt with once the standard goes into effect, and that's a mistake. A big mistake."

Public companies are facing a Jan. 1, 2018, effective date for a massive change in how they will recognize revenue in financial statements, courtesy of the Financial Accounting Standards Board, which adopted the requirements in 2014 after spending more than a decade developing and writing the rules. A handful of companies have disclosed they will adopt the requirements early, but most companies have put off preparation for the new standard until this year.

"I think companies have always recognized there was going to be a need to accelerate their efforts, and I think that acceleration is taking place much more rapidly now than it did in the fourth quarter," says Michael Stevenson, a partner at BDO USA. In terms of preparing for the disclosure requirements, however, he sees companies working through the recognition and measurement requirements of the standard first, saving disclosure issues for later. "For the projects we're working on, it seems to me companies are employing a more linear approach," he says.

It's not uncommon for companies facing a new accounting requirement to begin by crunching the numbers, then sorting out what they need to disclose as a result. Knachel and others, however, are beginning to worry that companies have not completely digested the extensive scope of the new disclosure requirements, which includes information they may not be gathering as they prepare for the accounting requirements on the front end.

"Disclosure often is an afterthought," says Knachel. "It's like showing your work on a math problem. But here's the difference. Some of the disclosure requirements include information that will need to be separately obtained or separately analyzed. It's not a matter of showing your work. It's a separate problem."

The new approach to revenue recognition requires companies to identify their performance obligations to customers and allocate the purchase price under a given contract to each separate obligation. On the accounting side, they recognize revenue as they satisfy those obligations, and companies are working through ways to achieve that. They're also

required in disclosures, however, to explain when they expect to recognize revenue on remaining obligations. Some call it the "backlog" disclosure.

For long-term contracts with multiple performance obligations, that means some forward-thinking that companies may not be doing right now, says Knachel. "For disclosure purposes, you need to identify performance obligations you haven't met and how much revenue you expect to recognize for each obligation in subsequent years," he says. "So next year you expect to get X, in two years you expect to get Y, and in three years you expect Z. You have to go through that whole analysis."

In addition to the backlog disclosure, companies are required to explain where they are recognizing revenue in a given period for performance obligations satisfied in an earlier period. That one is commonly called the out-of-period revenue adjustment. It can arise with performance bonuses, Knachel says, where a future payment may be promised in a contract if certain performance thresholds are met. "Companies are not focused on tracking that right now," he says.

Another aspect of disclosure that is not top-of-mind for companies now is a concept many preparers already understand, but aren't considering so far in the context of the new revenue standard, says Knachel. Filing rules with the Securities and Exchange Commission require companies, when they adopt new accounting, to effectively include all new disclosures required under the new accounting in the first period they adopt, not just the interim disclosures that might be required for an interim period. "This is not new, but it's magnified here," he says. "It's probably lost in the enormity of what's going on right now."

In the case of revenue recognition, that will mean considerably more disclosure in the first quarter of 2018 than companies might expect, says Bill Tomazin, a partner at KPMG. "Companies are going to have to get their heads around that—not as they wander into calendar year 2018, but rather in preparation for the first quarter," he says. "It's a pretty extensive list of disclosures."

Eloise Wagner, a partner at EY, sees a wide range of approaches to prepare for disclosure requirements. Some companies that are further through their implementation efforts are exploring what information they will need to gather and what IT implications that might present.

Those companies are working through, for example, how to meet the disaggregation requirements in the standard, which require plenty of judgment, and how to gather data necessary to disclose balances for contract assets and contract liabilities as required. "This is where I see companies starting to think through where they may have disclosure gaps," she says.

Companies are also finding, particularly where disclosure requirements require judgement, accountants need to help of others, like legal consultation or investor relations, to determine what to disclose. "There's always a balance of how much you want to disclose to the world and how much competitive information you put out there," says Wagner. "Some of those decisions cannot be made by accountants alone."

Doug Reynolds, a partner at Grant Thornton, sees

"Many companies are largely ignoring the disclosure requirements. They think it is a minor detail to be dealt with once the standard goes into effect, and that's a mistake. A big mistake."

Eric Knachel, Senior Consultation Partner, Deloitte & Touche

"tremendous progress" being made at many companies to prepare for the new standard. He does, however, see companies moving more sequentially through the accounting and disclosure requirements, leaving disclosure preparation for the end.

"Maybe a thought is for companies as they consider each accounting item is to have another sheet of paper where they are looking at other information they are going to have to gather and disclose," he says. "It could run in parallel." ■

DISCLOSURE WOES

Below Deloitte discusses which disclosures might be difficult to implement:

Performance Obligations (Including Remaining Performance Obligations)

- In contrast to current guidance, the new revenue standard introduces a series of quantitative and qualitative disclosure requirements related to performance obligations that will be partially or entirely new for many entities. Under these requirements, entities must disclose:
- Qualitative information about the types of performance obligations, the nature of goods and services promised, and when the obligations are typically satisfied.
- Qualitative information about significant payment terms, warranties, and refund obligations.
- Quantitative and qualitative information about amounts allocated to remaining
- performance obligations, and when such remaining amounts will be recognized as revenue.
- Information about significant financing components and variable consideration.
- Performance obligations for which the entity acts as an agent.

It may be difficult for companies to determine the level at which to present information about their performance obligations and the nature of goods or services. Complying with the requirements related to remaining performance obligations (commonly referred to as "backlog disclosures") may be particularly challenging because of difficulties associated with identifying the remaining performance obligations. Further, determining when remaining performance obligations are expected to be satisfied is a matter of judgment, and the information disclosed may therefore be subjective.

Other aspects of the disclosure requirements related to performance obligations that may pose difficulties in an entity's implementation include:

- Identifying amounts and related drivers of variable consideration associated with performance obligations (including information regarding the estimation of variable consideration and any related constraints on the variable consideration and their potential effects on future cash flows)
- Assessing whether material rights exist, and the manner in which those rights would be disclosed within the context of other distinct performance obligations

Source: Deloitte

Technical conclusions take shape in revenue standard

Technical consensus is starting to gel in certain aspects of the new revenue recognition accounting requirements, but the answers are not black and white. **Tammy Whitehouse** has more.

Technical consensus is starting to gel on certain aspects of the new revenue recognition accounting requirements taking effect in 2018, but the answers are still not nearly as cut and dried as traditional, rule-following accountants might like.

At the Securities and Exchange Commission, the Office of the Chief Accountant is taking questions on literally every step of the new five-step process that all companies must follow beginning in January for determining when and in what amounts to recognize revenue in financial statements. A good number of the questions are focused on identifying performance obligations contained in contracts with customers, which is the second step of the five-step method.

Sylvia Alicea, a professional accounting fellow at the SEC, said during a recent Deloitte/Bloomberg BNA conference that companies need to study all the relevant terms and conditions in a given contract because

they may contain provisions that will be critical to the accounting conclusions. Termination clauses, repurchase rights, or put options, for example, could have a huge effect on determining what rights and obligations in a contract are enforceable, both for the registrant and its customer.

If a contract contains a right to terminate, that needs to be evaluated to determine whether it's substantive, Alicea said, as it could affect the duration of the contract, which affects the accounting. Firms also need to carefully evaluate how substantive a given put option might be, as that could affect the determination of whether a given transaction is a lease or a sale.

And all of that brings accountants back to the less-than-precise answer that is a common theme in arriving at accounting conclusions under the new, principles-based requirements: Use your judgment. "Registrants should carefully assess the specific facts and circumstances of each transaction, including all relevant contractual terms, and exercise reasonable judgement when identifying and evaluating each contract with its customers," Alicea said.

Eric Knachel, senior consultation partner on revenue recognition at Deloitte, says judgment is a big problem for a lot of companies. "The single biggest challenge of this standard across companies, in all industries, of all sizes, is balancing this notion of principles and judgment with consistency," he said. "It's not cookie-cutter. It's not black-and-white. How do you balance these things that are somewhat at odds or somewhat contradictory?"

That's the tall order companies must fill—and they only have a little more than six months to do so. More than three years after it was issued by the Financial Accounting Standards Board, the standard will finally take effect on Jan. 1, 2018.

At the recent conference, Alicea offered a little more advice to companies in the area of identifying performance obligations, but none of it is bright-line guidance that will tell companies exactly what to do. She referred instead to "important recurring takeaways" that companies might find helpful in identifying the unit of account.

For companies that are accustomed to the term "deliverable" under existing revenue recognition rules, be careful not to assume those are automatically "performance obligations" under the new standard, Alicea said. Every performance obligation requires a fresh look. In the specific fact patterns that have come to the attention of the OCA, "most of the registrants' conclusions regarding performance obligations happened to be consistent with their conclusions regarding deliverables under existing revenue guidance," she said, but that is not a given. Companies still have to do the analysis and document their conclusions.

Alicea also addressed questions on whether promised goods and services could be regarded as a single performance obligation under the new requirements. Offering no yes or no, she pointed out the standard requires analysis of whether those promised goods and services are both capable of being distinct and are in fact distinct within the context of the contract. Companies need to do the analysis of whether the promised goods and services are inputs to a combined output, and the standard provides examples that are intended to illustrate how the principle works. Use your judgment, Alicea said.

Paul Vigil, senior director at BMC Software, said his team is working through when to identify separate performance obligations in a contract and when to combine them. Software companies commonly have complex arrangements with customers that can be hard to pick apart, even for purposes of current accounting requirements. Contracts typically involve the licensing of technology and a host of add-ons, like implementation, customization, upgrades, services, and support.

"As much as there might be gray areas today, those are increasing (under the new standard)," he said. "We need to work through it with our auditors and get comfortable. That's a challenge for a lot of us. As accountants, we're used to being able to give definitive answers that don't change."

Questions about whether to combine or separate performance obligations are important for companies to work out because the accounting effect of different determinations can be significant, said Knachel. It could lead to a difference in whether more revenue is

recognized up front or over the life of a contract, which affects the timing of revenue. "I believe in the standard there tends to be a bias toward separating, but that's my personal observation," he said. "There could be instances where you do combine them. We're seeing it as a challenging area."

Companies also are struggling with determinations over when to recognize revenue at a point in time versus recognizing revenue over time, or over the life of an arrangement. The question surfaced recently at Johnson & Johnson when considering how to treat customized inventory, said Stephen Rivera, a senior director at the company. "If we're customizing inventory for a customer and it can't be resold, we might be recognizing inventory over time," he said. That leads to analysis of the legal question of whether the company has a right to payment, said Knachel, pointing out the need to have legal counsel involved in the analysis.

In another technical conundrum of transitioning to new rules, companies are asking whether they'll be allowed to apply the "residual method" to allocate a transaction price across performance obligations. That's a method whereby companies might assign pricing to performance obligations that are easy to price and then allocate what's left to something that's more difficult to price on a stand-alone basis.

Vigil said he expects instances where the residual method will be applied, but Knachel said it will not be common. "The hurdle to get to the residual method is high," he said. "I'm sure it will happen but I've yet to see a fact pattern where I've felt comfortable allowing the residual method." ■

KEY TAKEAWAYS

SEC Office of the Chief Accountant views on additional revenue standard questions.

- **The existence of a contract.** "..it would be inappropriate to account for a contract before the contract exists with both enforceable rights and obligations." — Sylvia Alicea
- **Application of the contract combination guidance.** "..the guidance in Topic 606 explicitly limits which contracts should be combined. In the consultation that OCA evaluated, the registrant had two contracts that were entered into at the same time and met some of the criteria for contract combination because they were: negotiated between all parties with a single commercial objective and were priced interdependently such that consideration paid under one contract was dependent on the price in the other contract. However, the contracts did not meet the requirement in Topic 606 to be with the same customer or related parties of the customer. Therefore, OCA objected to the registrant's extension of the contract combination guidance beyond those parties." — Sylvia Alicea
- **Application of the guidance on sales- and usage-based royalties.** "The application of the guidance for royalties is based on when a report with the amount of revenues earned is received, not when the royalty sale or use occurred. The standard setters did not provide a lagged reporting exception with the new standard. Accordingly, I believe companies should apply the sales- and usage-based royalty guidance as specified in the new standard. The reporting, which may require estimation of royalty usage, should be supported by appropriate internal accounting controls." — Wes Bricker

Source: Sylvia Alicea, Wes Bricker speeches

ICFR—A hidden pitfall in implementation of ASC 606 (revenue recognition)

Changes to accounting under ASC 606 will require scrutiny of internal controls over financial reporting (ICFR) beyond what most organizations are prepared for as the new standard is implemented. Authored by **Philip Santarelli**, CPA, Baker Tilly, Partner Emeritus.

ASC 606 brings new procedures to a company's accounting processes, regardless of the impact on top line revenue, and that means that companies will need to re-evaluate their existing processes and internal controls. Since ASC 606 is a principles-based standard, there are many more management estimates and judgments required compared to previous accounting standards and organizations' existing enterprise resource planning (ERP) programs are likely not currently configured to capture or properly report activity.

The time and effort necessary to implement the new standard due to these judgments will be substantial. Many organizations are unprepared for the changes to their systems and processes that will be required. Current revenue recognition controls must be adjusted to enable adequate documentation and control to support the needed judgments.

HIGHER SCRUTINY FOR INITIAL AUDIT OF ICFR

Auditors will be placing increased emphasis on the internal control over financial reporting (ICFR) issues in connection with annual audits covering the initial year of ASC 606 implementation. Auditors of public companies may begin their assessment of management's plans during the 2017 audit cycle. The level of attention will be on a spectrum, with accelerated filers receiving the most attention in connection with integrated audits.

SPECIFIC ASC 606 CONSIDERATIONS UNDER COSO FRAMEWORK FOR ICFR

Entities are expected to follow an established framework when designing ICFR, and in the U.S. the accepted framework is COSO.[1] The COSO components and principles thereunder can be a good framework for adjusting ICFR to the demands of ASC 606. Following are specific considerations related to ASC 606 for each COSO element that should be incorporated into an organization's ICFR.

Control environment considerations

Does management, including the board, understand the new standard and the impacts it may have on the organization? This is a key piece in the control environment and sets the tone for the organization.

FREE ASC 606 ESSENTIAL GUIDE

Understand the 5 elements of ASC 606 (identifying the contract, identifying the performance obligations, determining the transaction price, allocating the transaction price, recognizing revenue) and the challenges each presents to organizations in our essential guide on bakertilly.com/asc606.

1 Currently Internal Control — Integrated Framework, which was issued in May 2013 and effective on December 15, 2014, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The 2013 COSO framework superseded the 1992 framework.

- Management and the board have obtained an understanding of the new standard
- Internal audit has been informed of the upcoming changes and is involved with the change process
- Adequate personnel resources have been allocated to the process:
  - Personnel have received training and understand the entity's revenue streams
  - Cross functional teams have been organized
- Change management processes are in place

RISK ASSESSMENT CONSIDERATIONS

The organization will need to fully understand and weigh the risks the adoption of the new accounting standard will pose.

- The entity has undertaken an assessment of the risks associated with the adoption
- Understands how an entity's unique revenue streams may be impacted by the standard
- Considered the transition method and the risks related to that choice
- Understands the risks associated with dual accounting records for a period of time
- Adequately considered the controls to deploy for transition accounting
- Considered the need for new or revised controls to address the five steps of revenue recognition
- Considered the need for new or revised controls to adequately address the enhanced disclosure requirements

CONTROL ACTIVITIES CONSIDERATIONS

New control activities will be required addressing the five elements (steps) and the related estimates and judgments. These will also likely include more documentation supporting the estimates and may include more entity level controls than previously deemed necessary.

> Organizations will need to design and implement new controls to address the new processes and judgments they adopt to implement ASC 606.

Specific control activities related to the ASC 606 five elements

1. Identifying the contract

- Supporting contract recognition for oral agreements:
  - Considering the legal issues
- Determining collectibility
  - Standard credit verification processes
  - Expanded processes when implicit price considerations are in play
- Evaluating whether contracts should be combined
- Assessing specific accounting for contract changes
- For contracts not recognized; reassessment processes

2. Identifying performance obligations

- Determining the promises in a contract
- Explicit as well as implicit promises
- Determining whether a performance obligation is distinct in the context of the contract
- Assessing warranties, implied, explicit, extended

> Many organizations are unprepared for the amount of time disclosures will now take: Each judgment will need adequate disclosure in the financial statement.

3. Determining the transaction price

- Support for estimating variable consideration
- Applying the probability weighted approach or the most likely outcome approach
- How was the probability of the constraint on recognition of variable consideration determined
- Assessing the fair value of non-cash consideration
- Issues related to a possible finance component for long term contracts
- Periodic reassessment of variable consideration
- Assessment of amounts due to customers (refund liabilities)
- Handling catch up revenue adjustments
- Handling variable consideration when ERP cannot

4. Allocating the transaction price

- Supporting standalone selling prices
  - Estimating when not sold separately
- Applying discounts
  - Proportionately
  - To selected performance obligations
- Applying changes to allocation when estimated variable consideration changes

5. Recognizing revenue

- Determining whether to recognize at a point in time or over time
- For over time reocgnition, supporting the criteria for passage of control
  - Determining whether the consideration subject to an enforceable right matches cost plus margin
- Recognition pattern
  - Input measures-subject to constraints
  - Output measures-reflective of progress toward contract completion

DISCLOSURE CONSIDERATIONS

Under ASC 606, disclosures are extremely robust. This is an area for which organizations should allow additional time and effort during implementation and in the early years of adoption.

- Controls over disclosure information not in accounting records:
  - Uncompleted contracts
  - Changes in contracts: cumulative catch-up adjustments
- Qualitative disclosures
  - Significant estimates and judgments: variable consideration; financing element; applying the constraint and releasing the constraint; how discounts were applied; how refund obligations were determined, etc.

TRANSITION CONSIDERATIONS

Organizations will need to determine how they will transition to the new accounting standard. Beyond the determination of which transition method, organizations will need to take a close look at how they will accomplish the documentation during the transition period of the actual accounting and management's estimates and judgments.

- Process for dual accounting records during the transition period(s):
  - Maintaining integrity and reliability of off-line record-keeping processes
  - Entity level reviews for estimates and related judgments
- Support for applying any practical expedients
- SEC issuers have current period disclosures required under SAB 74 (SAB Topic 11.M); non-SEC issuers should also consider engaging stakeholders to communicate transition plans and potential effects on the financial statements

INFORMATION AND COMMUNICATION CONSIDERATIONS

The information needs of ASC 606 and the transition are extensive. Companies will need to gather information that previously did not need to be documented as part of the accounting process and may not exist in easy to access or consistent locations.

- Will likely need to be gathered from across the organization: contracts, implied promises, side deals, etc.
- Assessing completeness & accuracy of such data will be critical

MONITORING ACTIVITY CONSIDERATIONS

Monitoring activity is likely to be increased, both on an ongoing basis and as it relates to the transition process. The internal audit function, management and board are likely to have roles in the monitoring function. Organizations should prepare to incorporate this activity across these functions.

ADDITIONAL CONSIDERATIONS

- The early effective date (1/1/2018) applies to public companies and not-for-profit organizations that are conduit debt obligors
- External auditors and regulators are highly likely to pay critical attention to ICFR over the implementation of ASC 606
- Public companies subject to Sarbanes-Oxley reporting requirements will need to have robust controls in place to avoid disclosing material weaknesses in Section 404 reports
- Not-for-profit organizations subject to Yellow Book requirements will also need to have robust controls to avoid deficiencies in internal control reporting and potential additional attention from oversight agencies

The adoption of ASC 606 will present significant challenges to existing ICFR systems; many companies are likely to find that their enterprise resource planning (ERP) systems were not designed to capture or report the information required for ASC 606 accounting and disclosures. ICFR and ERP system changes should be addressed as soon as possible in order to achieve a smooth and compliant transition to ASC 606.

The time and resources needed to implement ASC 606 could be substantial. Organizations should begin to evaluate the time and effort the implementation will require of their internal staff and external vendors.

Visit bakertilly.com for more information on revenue recognition or to learn how Baker Tilly specialists can help.

PHILIP SANTARELLI, CPA, BAKER TILLY, PARTNER EMERITUS

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Early work on lease rules reveals big effort ahead

Waiting in line behind revenue recognition, new requirements to bring leases on to corporate balance sheets are starting to win pockets of attention. **Tammy Whitehouse** explores.

Looming large in the sphere of big accounting changes, new requirements to bring leases on to corporate balance sheets are starting to win pockets of attention. That attention is mixed, however, as companies enter the home stretch in adopting even bigger change to the way they recognize revenue in financial statements.

At a national accounting conference in December, the vice president and corporate controller for Comcast sat on a panel to discuss what companies were accomplishing in preparing for the new lease accounting requirements. Those rules take effect in 2019, a year after the 2018 starting date for the new revenue recognition requirements.

"In terms of where we are in adopting the new lease standard, I'd like to tell you where we are in adopting the revenue standard," said Daniel Murdock, who has since been promoted to senior vice president, chief

accounting officer, and controller at Comcast. "We're busy working on revenue recognition."

That's still true for many companies heading into springtime, experts say, although they are beginning to worry about what lies ahead for companies that haven't yet even taken preliminary steps to prepare for new lease rules. "It's fair to say the average company still has quite a bit of work to do," says James Barker, senior consultation partner for leasing at Deloitte & Touche. "People are still very focused on revenue but companies do need to keep their eye on the ball on this one."

Some companies have taken some significant measures, says Daryl Buck, national managing partner at Grant Thornton. "Some have identified their strategy and their team, and they've mapped out how they are going to get to the finish line," he says. Those tend to be the larger companies with plenty of staffing so they can devote some to revenue recognition and others to the lease standard, he says. "Not everyone has that luxury of having those resources. A lot of companies are using the same people to do both projects."

Companies definitely are tuned into the topic, says Mike Stevenson, national assurance partner at BDO USA, based on much higher-than-usual traffic to a recent webinar, even when no continuing professional education credit was offered. "The interest is there, but what companies are doing depends," he says. "Large companies with large lease portfolios are keenly aware of the task that's ahead. They are asking a lot of questions about not only impacts, but also business process changes and systems changes."

Still, not every company should be concerned about implementing the leasing standard right away, says Alex Zhang, a partner at audit firm UHY. He poses three questions to companies to quickly gauge their exposure and their readiness to apply the new rules: How familiar are you with the new standard? How many leases do you have? What is your approach to adopting the new standard?

"If you don't have a lot of leases, it's not too complicated," he says. "But if you use a lease strategy in

WHAT DOES THE NEW GUIDANCE DO?

Below, FASB discusses the new lease guidance.

Under the new guidance, a lessee will be required to recognize assets and liabilities for leases with lease terms of more than 12 months.

Consistent with current GAAP, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. However, unlike current GAAP, which requires only capital leases to be recognized on the balance sheet, the guidance in the ASU will require both types of leases to be recognized on the balance sheet.

The ASU permits private companies to use risk-free rates when determining the present value of lease liabilities.

The ASU also will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. These disclosures include qualitative and quantitative requirements, providing additional information about the amounts recorded in the financial statements.

As previously indicated, the accounting by organizations that own the assets leased by the lessee—also known as lessor accounting—will remain largely unchanged from current GAAP. However, the ASU contains some targeted improvements that are intended to align lessor accounting with the lessee accounting model and with the updated revenue recognition guidance issued in 2014. ■

Source FASB

your business, you need to be prepared."

At audit firm RSM, partner Rich Stuart says he sees folks who are finding the project more difficult than they initially expected. "They weren't aware of the magnitude of change," he says. "They didn't realize the time it was going to take to get all the information into one place. It's taking more time to adopt, and they've got to get more people involved than they originally thought."

Companies that haven't done much as yet to adopt the standard may find themselves in a pinch for resources, says Stuart. Larger companies with larger groups of people tend to be the early movers on the leasing standard because they have the staffing. Companies starting early are the first ones reaching out to third-party providers for assistance.

As more firms enter the demand stream, they will find themselves at the back of the line, says Stuart. "If you find yourself a couple months to the effective data and you haven't started, then you look for resources, you may find yourself in quite a bind," he says.

In some cases, the companies digging in early are reaching out to industry peers and collaborating on interpretations of the new standard, says Kimber Bascom, a partner at KPMG. While the Financial Accounting Standards Board and the American Institute of Certified Public Accountants formed formal groups and processes for vetting questions and interpretations on revenue recognition, the same mechanism isn't taking shape for the lease accounting standard.

That has prompted companies to reach out to one another, says Bascom. "They are methodically working through questions they have, trying to get to some consensus, and where they don't they're reaching out to FASB or the Securities and Exchange Commission or their auditors to try to work through questions," he says.

Some of the questions surround the very starting point in the standard—defining a lease—so as to understand what arrangements are affected by the new accounting requirements, says Deloitte's Barker. The new standard provides a slightly different definition of a lease compared with historic interpretation or market understanding of what constitutes a lease, leading to some analysis of arrangements that are not traditionally regarded as leases.

That includes, for instance, service arrangements that include use of assets, so the lease is embedded into a service contract, says Barker. Common examples include service agreements involving medical equipment, or cable plans that include the provision of a cable box. "There are still several of those kinds of things being considered," says Barker.

Companies also are working through interpretations around how to treat variable payment methods compared with fixed payments, says KPMG's Bascom, as well as how to carve up contracts that include both lease and non-lease components. In addition, companies are working through how to transition to the new guidance. "The mechanics of transition in some cases are somewhat challenging," he says.

Sheri Wyatt, a partner at PwC, says the biggest challenge she sees in companies that are preparing is determining exactly what belongs in the lease population and assuring the population is complete. "There's a need for that extra level of comfort around the completeness of information now that leases are going on the balance sheet," she says.

The next challenge is assuring the data is complete, she says. Many companies have long used tools like spreadsheets to keep track of leases for asset management purposes, but those tools likely don't capture the same data now needed to meet the new accounting requirements. "How do I fill those gaps?" she says.

Wyatt is cautioning companies against doing any window shopping for technology solutions before they've done a thorough assessment of their needs. "I've seen a few cases where companies evaluate system solutions but then are not able to make a decision because they hadn't gone through an assessment of their current state," she says. "You need that gap assessment to understand what your business requirements are." ■

Banks prepare for expected credit loss rules

Amid changing revenue recognition rules, banks face even bigger changes in recognizing expected credit losses, a rule everyone else needs to follow, as well, writes **Tammy Whitehouse**.

Revenue recognition may be the biggest accounting change many companies are facing in the near term, but new rules for recognizing expected credit losses are causing just as many headaches in certain places.

Banks are the first to feel the pangs of this particular accounting standard, given the enormity of the credit instruments they carry on their balance sheets. "This is their revenue recognition," says Jonathan Prejean, managing director at Deloitte & Touche.

While the requirements don't kick in until 2020, companies outside of financial services would be wise to tune in. "Don't ignore it," says Prejean. "Think about who has large receivables, like trade receivables." Companies in healthcare and telecommunications, for example, often carry large receivable balances, he says, so they will likely be affected as well.

The Financial Accounting Standards Board adopted Accounting Standards Update No. 2016-13 to require companies that carry debt instruments to change the way they recognize losses on those balances. Current accounting prohibits entities from reflecting losses in financial statements until they are more likely to occur, giving investors little forewarning.

The catastrophic effects of that approach played out in the financial crisis, prompting FASB and the International Accounting Standards Board to require a more forward-looking approach. Now both rulebooks require entities to do some forecasting, apply their historic experience, then estimate and report how much they expect to lose on their loan portfolios.

The IFRS standard, called IFRS 9, takes effect in 2018, but it requires a somewhat different approach to estimating expected losses. FASB's model, commonly known as the current expected credit loss (CECL) model, requires companies to book an expected loss from the day an instrument is added to the books. IFRS 9 looks a little further into the future.

Financial institutions, which will experience the biggest changes under the new requirements, should tune in to the implementation activity taking place at companies adopting IFRS 9, says Anshu Agarwal, executive director in EY's financial services advisory practice. Banks have struggled with underestimating the significance of the accounting change, with a lack of data as well as the quality of data, and with reconciling their different systems for finance and risk, she says.

In the U.S. "it is of utmost importance that banks develop a detailed implementation plan assessing current data availability, models, and impairment methodologies all the way through designing, building, and deploying their implementation plan," says Agarwal.

The largest banks are making some progress, says Prejean. Given the effective date of 2020, they want to be prepared to run parallel systems in 2019 so they can have "dress rehearsals" in 2018 to test out their new approaches, he says.

"A lot of banks are either finalizing what they are going to do with their models or are in that model design phase," he says. "Once they decide what model to use, that drives other aspects of implementation. What data do you need? What processes do you set up? The majority if not all have a plan in place."

Smaller banks are further behind, says Brad Bird, national assurance director at BDO USA. "They're more keenly aware of the composition of

"It is of utmost importance that banks develop a detailed implementation plan assessing current data availability, models, and impairment methodologies all the way through designing, building and deploying their implementation plan."

Anshu Agarwal, Executive Director, Financial Services Advisory Practice, EY

their portfolios at the end of the most current year, and they're getting a sense of whether they should look at categories of loans more granularly," he says. "They're getting an understanding of what's in their loan portfolio, the types of risks, and how they are going to use that to populate the model, whatever that's going to be when they move forward."

To some extent, all banks, especially smaller ones, are troubled by a kind of "chicken and egg problem," says Graham Dyer, a partner in Grant Thornton's accounting principles consulting group. Banks need historical data on which to base a model, but they need a model to know what historical data to gather to plug into it. Banks may have annualized loss data, for example, but not necessarily full life-of-loan loss data on certain instruments.

Even bigger banks are going forward with their models with some trepidation about how they will be accepted by auditors and regulators, says Deloitte's Prejean. "There's a lot of room for interpretation," he says. "There are some questions out there as to what the expectations are. What's going to be acceptable? What's acceptable for one bank may not be acceptable for another."

Questions are still circulating, says Dyer, around how to estimate expected losses over the life of loans. The FASB standard says estimates should focus on expected credit losses over the life of the loan unless the entity can expect a loan to be restructured in a troubled debt restructuring. The standard also tells entities to pool similar loans.

"People have asked how those concepts fit together," says Dyer. "Should you project troubled debt restructurings on a pool basis or individual loan basis? I don't think the profession has reached a consensus on that question at all."

The Financial Accounting Standards Board has formed a Transition Resource Group to take and vet implementation questions, but the group has so far received no submissions, a spokesman said, although the board understands some entities may be in the process of drafting or preparing questions for submission.

The key principle entities should embrace as they move forward, says Prejean, is to assure forecasting for accounting purposes is consistent with forecasting used elsewhere in the business, including for risk, finance, and other compliance purposes. CECL results will be reported more frequently than, say, the comprehensive capital analysis and review required by the Federal Reserve or stress testing required under Dodd-Frank. "But forecasting in the CECL model should not be inconsistent with that forecasting," he says.

It's too soon for entities to be able to say in quantitative detail how the standard will affect their loan loss allowances, although the general expectation is that losses will go up given the forward-looking nature of the new requirement. A recent Deloitte survey found most banks are expecting loan impairments to rise at least 10 percent, and most expect volatility in the income statement. But it's nearly three years until the standard takes effect, says Rahul Gupta, a partner at Grant Thornton. "Right now your expecta-

tions are going to be different than they are going to be on Jan. 1, 2020," he says.

Barry Pelagatti, assurance partner at BDO USA, cautions entities to scrutinize sales pitches for models that are sold as plug-and-go to comply with the new standard. "You can't lose in translation that while the model may mathematically work, you have to be able to support the inputs," he says. "Some of the salesmanship out there is all you have to do is give us the raw data, put it in the machine, and you're done. Companies may be hearing only what they want to hear." ■

DELOITTE SUMS UP IFRS 9

Below, Deloitte offers a summary of the International Accounting Standards Board's IFRS 9.

FRS 9 Financial Instruments is the IASB's replacement of IAS 39 Financial Instruments: Recognition and Measurement. The Standard includes requirements for recognition and measurement, impairment, derecognition and general hedge accounting.

Overview of IFRS 9—Classification of financial instruments

Initial measurement of financial instruments

Under IFRS 9 all financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs. This requirement is consistent with IAS 39.

Financial assets: subsequent measurement

Financial asset classification and measurement is an area where many changes have been introduced by IFRS 9. Consistent with IAS 39, the classification of a financial asset is determined at initial recognition, however, if certain conditions are met, an asset may subsequently need to be reclassified. Subsequent to initial recognition, all assets within the scope of IFRS 9 are measured at:

- amortised cost;
- fair value through other comprehensive income (FVTOCI); or
- fair value through profit or loss (FVTPL).

The FVTOCI classification is mandatory for certain debt instrument assets unless the option to FVTPL ('the fair value option') is taken. Whilst for equity investments, the FVTOCI classification is an election. The requirements for reclassifying gains or losses recognised in other comprehensive income (OCI) are different for debt and equity investments. For debt instruments measured at FVTOCI, interest income (calculated using the effective interest rate method), foreign currency gains or losses and impairment gains or losses are recognised directly in profit or loss. The difference between cumulative fair value gains or losses and the cumulative amounts recognised in profit or loss is recognised in OCI until derecognition, when the amounts in OCI are reclassified to profit or loss. This contrasts with the accounting treatment for investments in equity instruments designated at FVTOCI under which only dividend income is recognised in profit or loss with all other gains and losses recognised in OCI and there is no reclassification on derecognition.

Source: Deloitte

Auditors prepare to inspect revenue recognition adoption

Public companies beware: Auditors plans to scrutinize the impending switch to new revenue recognition accounting. **Tammy Whitehouse** has more on what companies can expect as they implement the new revenue recognition regulations.

The 2017 year-end audit cycle will still consist of companies mostly following current revenue recognition rules, with only a handful adopting early. As firms move through implementation, auditors plan to take a hard gaze over management's shoulder to study how they are preparing for the new accounting and how they will explain it to investors.

All public companies will be required to follow the new revenue recognition accounting requirements beginning in 2018, and firms are widely expected by regulators and auditors to follow a robust process for making that change to their accounting processes, even if the change won't produce a material effect on financial metrics. The latest poll, this one from KPMG taken in early December, suggests the vast majority of companies are still stuck in the assessment phase, trying to figure out how they are affected and what they need to do to comply with the new rules.

"Companies are behind," says Betsy Meter, an audit partner at KPMG. "It is starting to pick up in the first quarter, which is a good sign, but it's going to condense a lot of work that needs to get done in the next 10 months." That's leading to some concerns about resource constraints. "There's a significant amount of work auditors need to do to not only understand the adoption of the standard but also controls. Even if companies do not expect the impact to be significant, there's still a methodical, well-thought-out assessment process that needs to be done around the new model," says Meter.

The audit profession is training and developing tools now that will help them with their own transition to performing audits of the new accounting, experts says. BDO USA, for example, is developing tools like checklists, questionnaires, and a workbook that can be used across the global network for organizations that are adopting either under GAAP or international standards, says Bryan Martin, a national assurance partner at the firm.

Auditors have been engaged from the beginning, when the Financial Accounting Standards Board issued the new requirements in 2014 and even before, studying the standard and considering how it will be applied to different sectors or fact patterns, says Glenn Richards, a senior manager at Crowe Horwath. Now those who have become specialists in certain aspects are leading internal efforts to train others. "Those are your people who are writing the new audit program set-ups that the firms are going to apply when it is rolled out firm-wide," he says.

All of that activity is preparing auditors to ask plenty of questions, as 2017 progresses, about how companies are going through their own preparation for the new accounting. "Questions are starting to come in from the practice, and that's encouraging," says Martin. "As we come out of the 10-K filing season, discussions will only pick up in pace."

Auditors are seeking meetings with management to understand not only the financial statement impact of the new standard, but also to assess the implementation effort and the tone, says Steele. "We need to understand that management has taken this seriously and has allocated sufficient resources and skill sets," she says. "Auditors are asking probing questions."

Where those questions lead to raised eyebrows, auditors will adhere to standards that guide their communications with audit committees, says Steele. "If we have concerns regarding management's application of the accounting, we have to get out in front of the audit committee and have those discussions early," she says. "That's why we as a firm are stressing to our practitioners to have those conversations early in the process to understand the implementation effort."

Sara Lord, national director of assurance services at RSM, says firms should be prepared to work closely with auditors as they move through adoption this year. "Don't wait until the end," she says. "Just like management's learning in this phase, we are too."

Given how heavily the new accounting relies on management estimates and judgments, auditors will need plenty of evidence and documentation to get comfortable with the new accounting. "As auditors, we need to be able to go in and understand those estimation points along the way," she says. "We don't want to get to the end and have a discussion

about something that happened at the beginning that changes the entire pathway of the accounting."

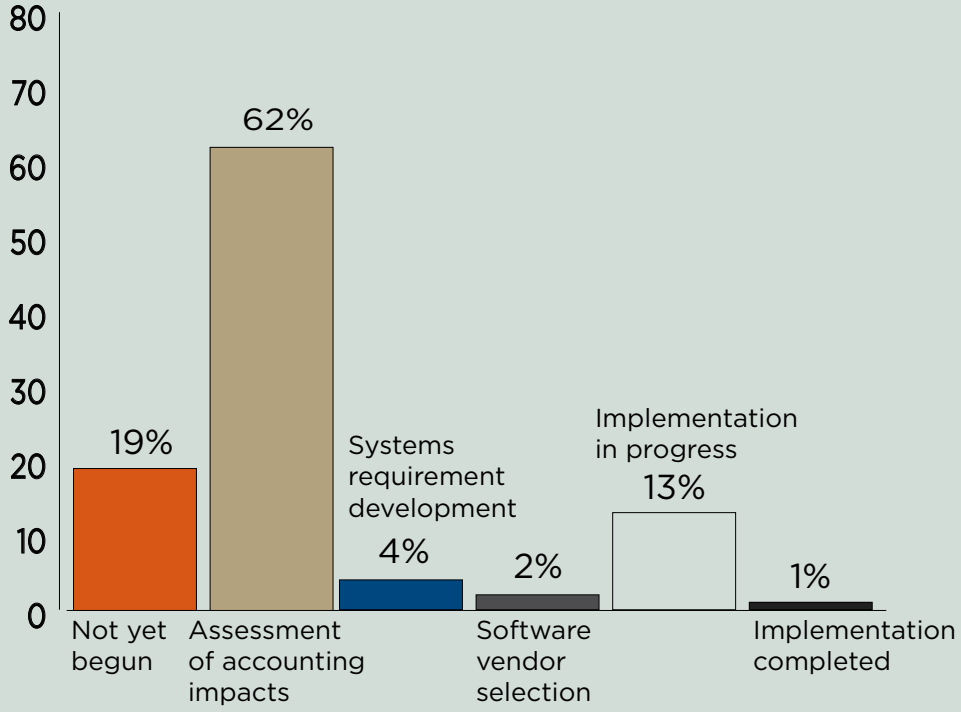
Bert Fox, a partner at Grant Thornton, says auditors plan to spend plenty of time this year studying what management has done to prepare. "How much change will they have from existing standards?" he asks. "How much time and effort have they put into the implementation process? Did they hire a third-party expert? Or are they doing it on a bare-bones budget?"

Fox says he sees some constraints already in the marketplace for people who can provide companies with assistance. "For companies that haven't engaged someone and are going to need to, they're going to find it limited, and prices have gone up," he says.

In a worst-case scenario, if a given company really has not done enough to be ready for the new accounting, auditors could find themselves unable to complete an audit, says Fox. "I do think a lot of companies have taken a cursory view of the new standard," he says. "It could get to a point where we could say we can't do this audit, or we talk to them about starting to declare they have material weakness in internal control. We could also get to a point where a client will not be able to file timely."

Steele says the key takeaway for companies is to keep auditors in the loop. "Take auditors along for the journey," she says. "Talk to auditors now about the evidence you expect to be able to provide to them and allow auditors to ask probing questions." ■

What is your organization's progress toward adopting the new revenue recognition standard?



Source: KPMG

Internal audits get new independence guidance

New standards tell internal auditors to safeguard their independence when asked to perform work other than internal audit—like helping with revenue recognition. **Tammy Whitehouse** reports.

The Institute of Internal Auditors took steps in 2016 to update the professional standards that guide internal auditors with changes that are taking effect in 2017. Although not enforceable by any regulatory body, IIA's professional standards help internal auditors provide the kind of objective assurance companies need to help them remain compliant with a host of regulatory mandates, not the least of which includes Sarbanes-Oxley compliance with internal control reporting.

One of the hallmarks of a sound internal audit function is that it remains independent of company management, ideally reporting directly to the audit committee to provide an objective set of eyes and ears on various operations within the company. In heavily regulated industries, like financial services, that's a common model, says Dawnella Johnson, a partner in risk consulting at Crowe Horwath. "At the biggest banks, it's very unlikely that the chief audit executive would play any other role," she says.

According to the IIA's "three lines of defense" model for managing risks, operational managers have primary responsibility in the first line of defense to guard the firm against risk, while risk management and compliance serve as their backstop in the second line of defense. The role of internal audit is to provide independent assurance of the organization's risk strategy, positioning them as a third line of defense.

Given internal auditors' expertise in all things risk and control, however, it can be difficult for companies to lay off asking internal audit to help with tasks such as managing risk or designing internal controls to mitigate risk. "There's a recognition that chief audit executives are subject matter experts in risk management," says Mark Kultgen, national leader of internal audit and Sarbanes-Oxley services at RSM. "Married with organizational pressures to do more with less, there comes a point where chief audit executives are asked to perform duties outside of internal audit."

That prompted the IIA to address in its professional standards how audit executives can take measures to assure their independence and objectivity is protected, even when they are pulled in on risk management or other consulting jobs. "Our standards are staying current with where practice is evolving," says Lisa Hirtzinger, vice president on global standards and guidance at the IIA.

The updated standards seek to address situations where audit executives are asked to perform certain risk functions, making them less objective when it comes time to perform an audit of the company's risk assessment or risk management activities. The standards also address concerns when audit executives are asked to perform consulting roles in any number of areas, impairing their objectivity when later tasked with auditing that area. It puts the auditor in the position of auditing his or her own work, essentially.

The new guidance tells auditors if they can't mitigate conflicts through staffing—assigning different auditors on audit work than those who provided risk or other consulting services—then they can be forthright and disclose concerns to management and the audit committee. The guidance explains the kind of communication the chief audit executive should provide to the board and management, and it enhances the requirement for chief audit executives to report on

their quality assurance and improvement programs, as well as their level of conformance with standards.

"It enables auditors to embrace that role of providing objective, independent assurance, but also be a resource within the company because of the knowledge auditors have," says Brian Christensen, Executive Vice President of global internal audit at consulting firm Protiviti. "It provides a great opportunity for internal auditors to step up and meet the needs of the world around us."

The guidance doesn't mean a shift in the core principles, but rather good governance practices, says Johnson. "The best organizations are probably doing things like this already, but now the standards say overtly to think this through," she says.

The new guidance enables internal audit to continue to increase the value it can bring to organizations, says Frank Campagna, managing director in risk and advisory services at accounting firm CBIZ. "The value proposition for internal audit is that it's become a real risk business," he says. "The best companies that have included risk in decision making have averted risk disasters more than companies that have not."

The revenue standard provides a timely example of where internal auditors are likely to be drawn in to assist with designing new controls that they later might be asked to test. Companies are required to adopt the massive new accounting standard on revenue recognition in 2018, and experts have lamented for months that many companies were moving too slowly through the process of assessing how they will be affected by the standard and preparing to implement it.

2017 will be crunch time to alter processes to produce revenue numbers under the new accounting in time for the 2018 reporting year. It's likely at least some internal audit functions will play some kind of role to support revenue recognition adoption efforts in some organizations, says Christopher Cimino, a partner in advisory, risk, and compliance at KPMG.

"Revenue recognition starts with the accounting, but it flows through to people, processes, and technology, and internal audit may be participating along the way to provide that real-time point of view," says Cimino. "Companies are really starting to get moving on revenue recognition, and internal audit often has a seat at the table. If you fast-forward to when new processes and controls are in place, you are going to want to do some evaluation."

The standards will not steer internal audit away from having a role in the revenue recognition adoption effort, but will help them do so in a way that will not impair their objectivity or independence. That could prove important when external auditors determine to what extent they will rely on internal audit's work as they perform their own audit procedures. ■

IIA STANDARDS INTRO

Below is an excerpt from the Introduction to the Standards.

The purpose of the Standards is to:

1. Guide adherence with the mandatory elements of the International Professional Practices Framework.
2. Provide a framework for performing and promoting a broad range of value-added internal auditing services.
3. Establish the basis for the evaluation of internal audit performance.
4. Foster improved organizational processes and operations.

The Standards are a set of principles-based, mandatory requirements consisting of:

- Statements of core requirements for the professional practice of internal auditing and for evaluating the effectiveness of performance that are internationally applicable at organizational and individual levels.
- Interpretations clarifying terms or concepts within the Standards.

Source: The IIA

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