ASC 606: Are You Prepared?

AUDITBOARD

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Introduction

When the IASB and FASB issued a joint press release[1] on May 28, 2014 announcing new revenue recognition standards for revenue from contracts with customers, the adoption deadline seemed a long way off. After pushback from companies across various industries, the implementation date was extended by one year, granting companies more time to update their policies and systems to adhere to the new standards.

Now, with the adoption deadline just around the corner, many audit executives are still unsure whether their processes and procedures will adequately meet the new standards.

Do you feel confident that your systems and controls will be ready for the auditors when the first round of post-adoption testing occurs?

This whitepaper will provide background on ASC 606 and highlight best practices and adoption controls for companies to follow during the year of adoption. In addition, it will provide insight into what your external auditors will be expecting.

1 http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176164075286

What Is ASC 606 and Why Was It Implemented?

The new revenue recognition standard represents a joint move by the IASB (responsible for IFRS) and the FASB (responsible for GAAP) to align revenue recognition methodology across the two standards. The objective is to "improve the financial reporting of revenue and improve comparability of the top line in financial statements globally." Many users of financial statements felt that IFRS wasn't detailed enough, while GAAP was too prescriptive. The new method provides a framework for companies to operate within, and demands much more comprehensive disclosure requirements. The new guidance aligns GAAP and IFRS across industries, which, using the old methods, often employed different accounting practices for transactions that were economically similar.

> *"The core principle of the new standard is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration (that is, payment) to which the company expects to be entitled in exchange for those goods or services."* [2]
>
> *-FASB*

[2] http://www.fasb.org/jsp/FASB/Page/BridgePage&cid=1351027207987

When Do The New Standards Go Into Effect?

Public companies are required to adhere to the standards for financial reporting periods (including interim reporting periods) beginning after December 15, 2017.

Private companies get an additional year and are required to adhere to the standards beginning December 15, 2018.[3]

[3] https://www.iasplus.com/en-us/standards/fasb/revenue/asc606

Differences v.s Existing Standards?

Previously, GAAP had industry-specific revenue recognition guidance, which made it difficult to compare financial statements across different industries. In the new standard, companies will utilize the 5 Step Model to determine when revenue should be recognized, regardless of industry:

1. **Identify The Contract**
2. **Identify The Performance Obligations Within The Contract**
3. **Determine the Total Transaction Price**
4. **Allocate The Transaction Price To The Performance Obligations**
5. **Recognize Revenue When/As The Entity Satisfies The Performance Obligations**

Because more judgement will be involved in determining when to recognize revenue, additional disclosure requirements are now required around the **nature, amount, timing,** and **uncertainty** of revenue and cash flows. For example, companies must disclose the underlying judgments and assumptions that were used to allocate revenue into appropriate categories, allocate transaction price to the remaining performance obligations for existing contracts, and any other inputs that factor into the determination of revenue recognition.[4]

[4] https://www.iasplus.com/en-us/standards/fasb/revenue/asc606

Adoption Controls: Nature and Objectives

To help ensure compliance with the new standards, companies should consider implementing specific "adoption controls" to help with the transition. Adoption controls will have the following characteristics and objectives:

- These will be specific controls related to the adoption of the new standard
- Likely operating in the year of adoption only (FY17/FY18)
- Will mitigate key risks associated to the adoption of new standards
- Must be performed by competent control owners
- Must be appropriately documented, and must be performed timely
- Can either be new controls or changes to existing controls
- Along with new controls, companies will need to update their accounting policies and procedures to reflect the new guidance

Additional considerations related to adoption controls include:

- Accounting systems will need to be updated to ensure they are effectively applying the new guidance
- There will be new application controls and potentially new systems to help meet the new standards
- New key reports & changes to existing key reports must be accounted for
- New completeness and accuracy testing for new key reports.
- New disclosure requirements related to judgment and assumptions
- Documentation must be much more robust when assumptions are being used (e.g., how control owners determine how to allocate the contract price out to the specific performance obligations within the contract)
- Contract data and relevant "data points" must be complete and accurate in order to meet the new standards

Example Adoption Controls

Below are several examples of adoption controls that can be implemented to help with the transition. These include Entity Level Controls, Business Process Controls, and IT General Controls. During the year of adoption, it may be beneficial to classify these adoption controls separately for audit purposes.

1. ENTITY LEVEL CONTROLS

- A governance model or committee has been established to properly oversee the adoption of the new standards.
- Training programs have been implemented to ensure employees have the capabilities and skills to support the future state of the organization.
- An adoption Memo outlining the overall approach that is being taken has been reviewed and approved.
- Population of new disclosure requirements and analysis of existing disclosure gaps has been reviewed and approved.
- The approach that is being elected for maintaining dual accounting records during adoption has been reviewed and approved.
- A new revenue recognition checklist which utilizes the 5 Step Model has been created, approved by Corporate Accounting, and added to the Accounting Policies & Procedures.
- New Disclosure Requirements Policy has been reviewed, approved and distributed to appropriate parties (e.g., accounting and finance personnel).

2. BUSINESS PROCESS CONTROLS

- Contract Inventory and documentation of the assessed impact to each contract has been reviewed and approved.
- Each contract has been reviewed to identify what changes, if any, are required to adhere to the new standards. Summary of required changes by contract has been reviewed and approved by appropriate personnel.
- A new template that clearly outlines the rationale behind the assumptions that were chosen, how those assumptions were applied to the contract, and ultimately what the results of applying those assumptions are to revenue recognition has been reviewed and approved.

3. IT CONTROLS

- Any changes to the system that are made in order to properly apply the new standards, including user acceptance testing sign-off has gone through Change Management approval.
- All changes that are made to contract management/revenue recognition systems have been documented and approved.
- All new contract management applications or modules to the GL have undergone interface testing.
- All relevant stakeholders have approved any new system implementation plans.
- A Data Conversion testing strategy which covers conversion accuracy, completeness reconciliation, data integrity and remediation of defects has been implemented.

External Auditor Expectations

Once the adoption deadline arrives, external auditors will begin testing to the new standards. Management should begin assessing the internal controls related to financial reporting, including disclosure controls, as soon as possible. The company should have adoption controls designed, executed and monitored before the first post-adoption 10-Q is filed. External auditors will only begin opining on these controls with the first post-adoption 10-K filing (i.e., the end of the first fiscal year which begins after 12/15/2017 for public companies) but they will begin testing the controls in calendar Q1 2018. It is important to have the processes in place well before the auditors begin testing as deficiencies identified in Q1 2018 have a better chance of being remediated by year-end than those identified later in the year.

Conclusion

In this whitepaper, we have provided background as to why the new revenue recognition standards were released, as well as what the major changes will be. We have also provided example "adoption controls" that can be implemented to help ensure a smooth transition to the new standards. While AuditBoard has many value-added benefits compared to more manual, spreadsheets-based SOX management environments, a key benefit is that AuditBoard comes pre-loaded with a benchmarked library of risks and controls (including ASC 606 Adoption Controls) that is available to users, free of charge.

AuditBoard is the leading software solution for managing, reporting on, and analyzing critical internal controls data in real-time. AuditBoard was designed and purpose-built to make SOX and internal controls simple. Our product helps internal auditors work more efficiently by addressing their biggest pain points: spreadsheet volume, version control, data redundancy, and status reporting. To learn how AuditBoard can change the way your Internal Audit team works, **contact us here** or visit **www.auditboard.com**.

JUDSON AIKEN

Judson Aiken, CPA, is a Manager of Product Solutions at AuditBoard. Before joining AuditBoard, Judson spent 5 years at EY in the Risk Advisory practice supporting SOX and Internal Audit engagements in the Media & Entertainment and Technology sectors. Judson's focus at AuditBoard is helping new clients migrate their existing SOX management environments into the AuditBoard platform while striving to provide the best product solutions for his clients.

KIM LE

Kim Le is the Founder & CEO of professional services firm A2Q2 where her specialized team of CPAs helps high-growth companies solve challenges in accounting processes, systems , data analytics, internal controls, Sarbanes-Oxley Compliance and business process re-engineering. After immigrating to the United States from a refugee camp in Malaysia, Kim went on to study accounting and began her career at Arthur Andersen. She founded A2Q2 in 2003 and has since received numerous awards and recognition including being named as one of the 100 Most Influential Women by Silicon Valley Business Journal and receiving the President's Award by Ascend Leadership two years in a row.