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Audit Committee *Brief*

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have been collaborating for several years on an initiative to improve, streamline, and, when possible, converge key accounting standards. Among the significant areas being addressed are revenue recognition, financial instruments, and lease accounting. The boards' efforts are drawing closer to completion, and several important decisions and releases are slated for the coming months.

When finalized, these new standards have the potential to dramatically change the way companies account for many of their most common transactions. Audit committee members may wish to stay updated on the progress of these projects and to consider potential implications for their companies, because the converged standards will affect financial reporting across a broad range of organizations and industries. It will also be important to confirm that management is adequately preparing for the anticipated changes. Further, maintaining a dialogue with members of management regarding their feedback during the comment letter process will enable audit committees to see that their organizations have a voice in shaping the final guidelines.

This *Audit Committee Brief* highlights recent standard-setting developments related to revenue recognition, financial instruments, and lease accounting, and includes questions audit committees should consider in preparing for changes.

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Revenue recognition

The FASB and IASB are completing deliberations on their November 2011 revised exposure draft, *Revenue from Contracts with Customers*, and plan to issue a final standard soon, likely during the second quarter of 2013. This standard will have significant ramifications for companies; it outlines a single comprehensive model for revenue arising from contracts with customers and will supersede most current revenue recognition guidance. In many cases, the standard will change the timing of when an organization books amounts on the "top line." The boards' aim is to improve the consistency of requirements; the comparability of practices across organizations, jurisdictions, and industries; and the usefulness of disclosures.

Proposed revenue model

The principle underlying the proposed revenue guidance 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." Put more simply, the objective is to record the amount of revenue in a pattern that depicts the transfer of control of the underlying good or service.

The proposed model includes five steps for recognizing revenue; the following is a high-level summary of the approach.

Step 1

Identify the contract

According to the proposed standard, its provisions would apply to contracts if:

- The contract has commercial substance (if the contract will affect risk, timing, or cash flow)
- All parties have approved the contract and are committed to carrying out their obligations
- The entity can identify each party's rights for the goods or services to be transferred and the associated payment terms.

The proposed standard also covers situations where entities would be required to combine a group of contracts and provides guidance on accounting for contract modifications.

Step 2

Identify separate performance obligations

A good or service would represent a separate performance obligation if it is "capable of being distinct" (i.e., the customer can benefit from the good or service on its own or with other available resources) and "distinct in the context of the contract" (i.e., the good or service is not highly dependent on or highly interrelated with other promised goods or services).

Step 3

Determine the transaction price

The entity would determine the expected amount of consideration in exchange for promised goods or services. Under the proposed model, an entity would estimate the transaction price, including variable consideration, the time value of money, noncash consideration, and consideration payable to the customer. The price could be fixed, or could vary due to items such as discounts, refunds, credits, pricing concessions, or incentives.

Step 4

Allocate transaction price to performance obligations

When a contract contains multiple separate performance obligations, an entity would in most cases allocate the transaction price to each obligation on the basis of the stand-alone selling price. Acceptable methods for estimating the stand-alone selling price would include expected cost plus margin, adjusted market assessment, and a residual approach when the selling price is uncertain or highly variable.

Step 5

Recognize revenue as performance obligations are satisfied

A performance obligation would be satisfied when control of the underlying goods or services for the obligation is transferred to the customer. In applying the proposed model, an entity would evaluate whether control of a good or service is transferred over time or at a point in time. If control is transferred over time, revenue would be recognized by measuring progress toward satisfying the obligation in the manner that best depicts the transfer of goods or services to the customer.

Revenue example

Telecommunications entities currently reporting under U.S. GAAP, and most reporting under IFRS, apply a "contingent revenue cap" to the amount of revenue to be recognized upon the sale of a handset. This limits the amount of revenue to be recognized upon the delivery of a handset and results in the recognition of service revenue over time as billed. The proposed guidance requires an entity to allocate contract consideration to the separate performance obligations (for example, the handset and subsequent wireless service) on a relative stand-alone selling price basis and does not include such a cap.

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Transition process and time frame

The boards have tentatively determined that the final standard will be effective for reporting periods beginning on or after December 15, 2016, for public entities, and December 15, 2017, for nonpublic entities. Early application is not permitted for public entities, but nonpublic entities may adopt the final guidance early as long as their adoption date is not earlier than that for public entities. While the effective dates may seem a long way off, there are numerous issues that should be considered upon issuance of the final standard, including transition requirements, organizational and investor education, system implementation processes, and other necessary preparations.

Entities applying the model could adopt either retrospective transition or a modified approach. Under the retrospective transition approach, when a company adopts the new standard, it generally must provide comparable reporting for all periods presented in a set of financial statements. The details can become quite technical, but in effect, the company must recast the prior year's revenue amounts (and, in many cases, costs and amounts related to revenue) to conform to the requirements of the new standard. This will be a significant change, and some companies may consider running parallel reporting (under current standards and the new standard) prior to adoption to confirm that the amounts required to be reported upon transition are captured, provide for a real-world testing environment, and implement appropriate changes to internal controls.

Under the modified approach, an entity would recognize "the cumulative effect of initially applying the revenue standard as an adjustment to the opening balance of retained earnings in the year of initial application (comparative years would not be restated)." While this approach does not require the recasting or restatement of prior years, it is not as straightforward as simply applying the new revenue standard to new transactions. It would require companies to apply the standard to all revenue contracts that are open at the date of adoption. Thus, a company would need to determine for outstanding revenue contracts the impact of applying this standard partway through the life of the contract.

The standard would apply to contracts created on or after the effective date and to existing contracts as of the effective date, but not to contracts completed before the effective date. In the year of adoption, entities would be required to disclose the financial statement line items affected by the standard's application.

For a more detailed discussion of the revenue model's provisions and required disclosures, please refer to Deloitte's March 5, 2013, *Heads Up.*

Revenue recognition disclosure requirements

The proposed standard calls for expanded quarterly and annual disclosures regarding revenue recognition. The boards' stated objective in requiring additional disclosures is to "enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." Areas requiring disclosure would include, among others:

- Significant judgments affecting the amount and timing of revenue recognition
- Methods and assumptions used to determine the transaction price and allocate amounts to performance obligations
- Information about assets recognized as costs to obtain or fulfill a contract, including the closing balance, current-period amortization, and amortization method used
- Policy decisions regarding the monetary value of time and costs to obtain or fulfill contracts
- A disaggregation of revenue to "depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors"; the method by which management analyzes revenue in determining disaggregation would need to be considered
- Certain information about changes in contract balance.

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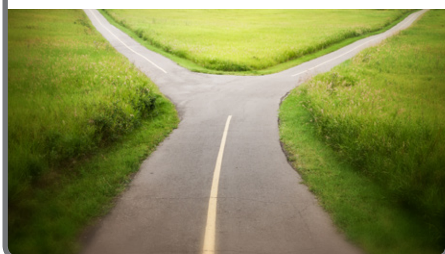
Two roads diverged: differing approaches to credit loss models

The FASB and IASB impairment models are similar in several respects. For example, entities would use similar information under both models to measure expected credit losses, and both models remove any threshold for recognizing such losses.

However, under the IASB's model, an entity's measurement of expected credit losses would generally differ depending on whether there has been a significant deterioration in the credit quality of the financial asset. The entity would use a dual measurement approach to calculate impairment: either lifetime expected credit losses or 12-month expected credit losses. Under the FASB's model, entities would use a single measurement approach, which is meant to be the equivalent of the lifetime expected credit loss model. Please see the appendix of Deloitte's March 12, 2013, *Heads Up* for a more detailed analysis of the differences between the proposals. The deadline for submitting comments to the IASB is July 5, while comments on the FASB's credit loss proposal are due by May 31.



Financial instruments

The FASB released for public comment on February 14, 2013, a proposed Accounting Standard Update (ASU) on classifying and measuring financial instruments. The intent of the ASU is to increase the convergence between U.S. GAAP and IFRS and simplify classification methods. The proposal applies to all companies and a wide range of financial instruments (with certain exemptions[1]), including receivables, loans made to customers, debt securities, and equity investments.

The FASB proposal requires entities to classify most financial assets into one of three categories:

- Fair value through net income (FV-NI; often referred to as mark-to-market accounting)
- Fair value through other comprehensive income (FV-OCI; marked to fair value on the balance sheet, with changes in fair value generally reflected in equity (OCI) and then recycled to income when the gain or loss is realized)
- Amortized cost (often referred to as historical cost)

While the FASB proposal would retain three categories for classification as is generally provided today for investments other than loans, the classification of financial assets would be based on the instrument's cash flow characteristics and the business model in which it is managed. This could have significant implications; based on cash flow characteristics, certain investments carried at cost today would be required to be accounted for at fair value, and the business model test would differ from the model used today for classifying loans.

Liabilities would generally be classified as amortized cost, with a few limited exceptions. If an entity has elected the fair value option for a financial liability, any changes in fair value attributable to instrument-specific credit risk are recognized directly in equity (OCI) rather than in net income.

In March, the FASB held a podcast explaining key elements of the proposed financial instrument measurement and classification framework. Companies are encouraged to submit comments to the board by the May 15, 2013, deadline. Deloitte's February 14, 2013, *Heads Up* provides further information on the financial instruments project.

1 Instruments exempted from the scope of the proposal include stockholder's equity, stock compensation arrangements, pension plan assets and obligations, lease receivables and payables, financial guarantee contracts, and derivative instruments under ASC 815.

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Lease accounting

The FASB and IASB issued exposure drafts in August 2010 on recognizing lease assets and liabilities in the statement of financial position. A revised exposure draft with significant revisions is expected to be issued for comment during the second quarter of 2013.

The intent of the leasing project is to provide a clearer and more consistent representation of leasing transactions in the financial statements by including information on rights and obligations that exist under a lease contract. Under the proposed standard, most leases, including those currently classified as operating leases, would be recorded on the balance sheet.

The model would generally require all leases of physical assets to be accounted for on a company's balance sheet as liabilities, and would generally require the amount recorded as a liability to be based on the non-cancellable term of the lease, with optional renewal periods where there is a significant economic incentive to exercise the option. The amount recorded would be based on the required fixed-lease payments in the contract plus adjustment provisions for certain indexes (such as a CPI adjustment factor) and certain guarantees. A lessee would recognize a corresponding right-of-use asset when it records the liability.

The boards have tentatively decided that for operating leases not currently on the balance sheet, companies could apply the proposal retrospectively or use a modified retrospective approach for all leases outstanding during any period presented in the financial statements. The boards also recently decided that lessees that currently account for leases as capital leases and lessors that currently account for leases as finance and sales leases would be grandfathered in. Lease agreements modified after the adoption of the proposed guidance would no longer qualify for grandfathering under the present requirements.

Deloitte's September 27, 2012, *Heads Up* provides an in-depth analysis of decisions on the leasing project.

Approaches for lessee profit and loss recognition

Two approaches would be used for amortizing right-of-use assets: interest and amortization (I&A) and straight-line expense (SLE). The approach would be based on the nature of the underlying asset. Specifically, leases of property that begin in the earlier stages of a property's estimated useful life or are not for a long term would generally be accounted for using the SLE approach. In contrast, leases of assets other than property would generally be accounted for under the I&A approach unless they are relatively short-term. For leases accounted for using the I&A approach, the right-of-use asset would be amortized in the same manner as other nonfinancial assets. Companies would present interest and amortization expenses separately in the income statement. For leases accounted for using the SLE approach, amortization would be calculated as the difference between the total straight-line lease expense (total undiscounted lease payments divided by the lease term) and the interest expense related to the lease liability for the period. Amortization and interest expense would be combined and presented as a single amount.

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James L. Kroeker
Former SEC Chief Accountant

Principal, Deloitte & Touche LLP

Key questions for audit committees

- Has the company established a project management team(s), and does the team involve other functions such as tax, IT, marketing, and investor relations?
- What are the highlights of the implementation plan, including timelines, necessary investments, and required changes to processes and systems?
- Given the significant impact of these standards, such as the revenue recognition standard's effect on the top line, will the controllership group be able to build broad support across the company to adequately address successful implementation, and are there sufficient resources to achieve success?
- How is management evaluating and responding to needed changes to the design and operation of the company's internal controls related to these standards?
- Does management anticipate changes to business practices, contracting, sales term, or existing contracts? If so, what is the nature of the changes, and are such changes being driven solely by accounting considerations?
- SEC guidance requires companies to discuss the impact of recently issued accounting standards. What steps is the company taking to consider the implications for reporting and how it will inform investors about changes anticipated in future reports?
- What effect does management anticipate that the adoption of the new standards will have on its use of non-GAAP measures, including whether it is anticipated that new non-GAAP measures will be utilized?
- The new revenue recognition standard is much less prescriptive, particularly in situations where there is existing industry guidance, than current U.S. GAAP. What process will management use in reaching sound interpretive conclusions? How does management anticipate working with others, such as industry groups, professional associations, and the external and internal auditors?

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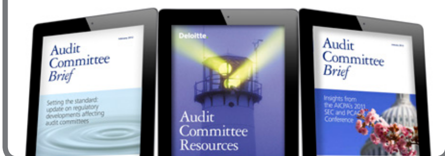

Conclusion

The FASB and IASB have been actively pursuing convergence efforts in recent months and are slated to propose and finalize standards in the coming year that will apply to a wide cross-section of transactions and affect every company. Audit committee members may benefit from reviewing the exposure drafts for financial instruments and leasing and the final revenue standard when it is issued, discussing potential impacts with company management, and encouraging management to provide feedback on areas of particular relevance or concern. Although it will be a few years before the convergence standards are fully implemented, companies should consider the implications of requirements as they are advanced so that there will be a smooth transition period for systems, processes, and financial reporting and disclosure mechanisms, with minimal surprises.

Additional resources

Boards Preparing to Issue Final Standard on Revenue Recognition

FASB Issues Proposed ASU on Classifying and Measuring Financial Instruments

FASB Settles on Single Impairment Model for Financial Assets

Overview of Board Decisions on the Leases Project

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