THOMSON REUTERS
CHECKPOINT™

THE PPC
ACCOUNTING AND AUDITING UPDATE

APRIL 2019, VOLUME 28, NO. 4

Auditing Revenue after Implementation of FASB ASC 606

Depending on the complexity of an entity's revenue transactions, revenue may be more difficult to audit after implementation of FASB ASC 606, *Revenue from Contracts with Customers*. Recognition of revenue may be simple (e.g., in a point-of-sale retail environment) or may be more complex. Revenue recognition becomes more complex when the terms aren't standard (e.g., when rights of return, customer acceptance clauses, or extended payment terms exist), when sales involve multiple elements, when the amount of consideration is variable (e.g., it is dependent on certain events occurring or it fluctuates based on inputs and outputs), or when the earnings process occurs over time rather than at a point in time.

Practical Consideration:

Nonpublic entities were required to implement FASB ASC 606 effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. The guidance and practice aids in the 2019 editions of PPC's audit guides have been updated for FASB ASC 606.

Revenue Is a Five-step Process

As a reminder, FASB ASC 606 establishes a five-step approach for recognizing and measuring revenue. Those five steps are—

1. Determine the contract(s) with the customer.
2. Identify the contract's performance obligations.
3. Determine the transaction price.
4. For the performance obligations, allocate the transaction price.
5. As the entity satisfies a performance obligation, recognize revenue.

Auditing Implications of FASB ASC 606

Some of the ways in which FASB ASC 606 can be expected to affect the audit, particularly in the transition year, are discussed in the following paragraphs.

Risk Assessment and Other Planning. You need to focus on implementation of FASB ASC 606 well in advance of the start of the audit to allow additional time for adequate audit consideration. Extra care is needed in planning audit tests of compliance with transition requirements. You will also need to carefully assess the risks of material misstatement associated with the transition.

Preliminary Analytics. If implementation has a significant effect on the amount and timing of revenue recognition, there could be significant changes in key metrics, performance measures, and ratios.

Revenue Analytics. Analytical procedures related to revenue in the planning and review stages of the audit need to be updated. When developing expectations for analytical procedures, you need to factor in changes in revenue recognition policies and practices and, particularly, the effect of restating financial statement amounts in the year of adoption and transition to FASB ASC 606.

Engagement Team Discussion (Brainstorming). The discussion needs to include the development of ideas on how revenue recognition and disclosure may be susceptible to material misstatement in the transition year and in future periods. Also, the discussion needs to include an exchange of information on the different revenue streams and how the related practices, policies, and procedures (including controls) will change, and the effect on risks of material misstatement.

Fraud Considerations. In addition to the typical fraud risks related to premature revenue recognition or recording of fictitious revenue, FASB ASC 606 creates new opportunities to perpetrate fraud. For example, management may manipulate estimates of variable consideration or stand-alone selling prices.

Internal Control. Implementation of FASB ASC 606 requires management to make potentially significant changes in internal controls and related practices, policies, and procedures. Also, management needs to adopt controls designed specifically to deal with the transition requirements.

Materiality. If the adoption of FASB ASC 606 significantly changes the amount and timing of revenue, these changes may also significantly affect the benchmark you use in determining materiality for planning purposes. These changes may also affect qualitative factors used in the evaluation of audit adjustments because of the effect on trends, key metrics, performance measures, and ratios.

Significant Audit Areas. Because of the increased risks of material misstatement resulting from opportunities for error or fraud created by management's new significant judgments and estimates, revenue may be a far more significant area of audit focus than in previous audits.

Scoping and Audit Approach Decisions. Auditors potentially need to reassess scoping and the audit approach decisions about revenue testing made in prior audits.

Audit Sampling. Implementation of FASB ASC 606 may create a need for the increased use of audit sampling.

Auditing Accounting Estimates. The implementation of FASB ASC 606 may result in new, difficult-to-audit accounting estimates, such as estimating variable consideration in determining transaction price and estimating the stand-alone selling price in allocating transaction price to performance obligations.

Confirmations. Auditors may need to confirm contract terms, the date of approval of the contract, modifications during the period, presence or absence of side agreements or implicit agreements, and acceptance of a product or service.

Disclosure. The new FASB ASC 606 requirements to disclose quantitative and qualitative information about contracts with customers may result in planning and performing procedures specifically directed at validating disclosure information rather than just evaluating disclosures based on considering the information learned in applying audit procedures to account-balance assertions.

Management Representations. Auditors may need to obtain specific representations from management on the significant estimates and assumptions used in making FASB ASC 606 estimates, such as those for variable consideration and stand-alone selling price. Also, written representations on the presence or absence of unusual contract terms, including implicit terms based on customary business or industry practices or promises made to specific customers, may be necessary.

FASB Clarifies Collaborative Arrangements

In November 2018, the FASB issued ASU 2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction between Topic 808 and Topic 606*, which clarifies revenue recognition involving collaborative arrangements. A collaborative arrangement is a contractual arrangement where two or more parties are active participants in a joint operating activity. The parties bear significant risks, as well as the prospect of obtaining significant rewards, from the results of the operating activity.

FASB ASC 808 doesn't generally provide comprehensive recognition and measurement guidance for collaborative arrangements, so entities have historically either analogized the accounting for those arrangements to other accounting guidance or applied a different accounting method as a policy election. However, the recent accounting guidance in FASB ASC 606, *Revenue from Contracts with Customers*, raised questions about the applicability of the new revenue guidance to transactions involving collaborative arrangements. To address those questions, the amendments in ASU 2018-18 clarify revenue recognition with respect to collaborative arrangements through the interaction of FASB ASC 808 and FASB ASC 606.

If a participant in a collaborative arrangement is a customer for a distinct good or service (referred to as a unit of account), the other participant in the arrangement should account for the revenue for the unit of account in accordance with FASB ASC 606. When a collaborative arrangement transaction isn't with a customer for a unit of account, the transaction is outside the scope of FASB ASC 606 and should be accounted for by analogy to relevant accounting literature. If an appropriate analogy doesn't exist, the unit of account should be accounted for according to a reasonable, rational, and consistently applied accounting policy. Also, the revenue from collaborative arrangements outside the scope of FASB ASC 606 may not be presented with revenue from contracts with customers in the financial statements.

For public business entities, the amendments in ASU 2018-18 are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. For all other entities, the amendments in the ASU are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted, but not before adoption of FASB ASC 606.

The ASU requires retrospective application of the guidance to the date of the initial application of FASB ASC 606 for either all collaborative arrangement contracts or only those that aren't completed at the date of the initial application of FASB ASC 606. In addition, the practical expedient for contract modifications provided within the modified retrospective transition method in FASB ASC 606 may be applied. The method selected and any practical expedients utilized should be disclosed.

Disclosing Client Information in Connection with a Quality Review

The AICPA's Professional Ethics Executive Committee (PEEC) recently issued the interpretation *Disclosing Client Information in Connection with a Quality Review* (ET 1.700.110) under the *Confidential Client Information Rule* (ET 1.700.001).

The *Confidential Client Information Rule* provides that a member must not disclose confidential client information without specific consent of the client, with limited exceptions. However, it isn't clear in the guidance whether quality reviews are included in those exceptions to obtaining client consent.

The new interpretation under the *Confidential Client Information Rule* clarifies that quality reviews are included in the list of exceptions by permitting members to disclose confidential information in connection with a tax practice quality review (for example, a voluntary tax practice review) without obtaining client permission if certain conditions are met.

Using *Quick Start* Drives Audit Efficiency

Checkpoint Engage™ is a fully integrated online audit solution that provides you with the efficiency, accuracy, and consistency to manage your accounting and audit processes. Through its cloud-based approach, Checkpoint Engage™ allows real-time collaboration of your audit team without version control issues, provides an enhanced risk-based audit program design, and provides the option to create an engagement using *Quick Start* functionality.

What Is *Quick Start*?

Quick Start creates an illustrative set of internal control documentation and a set of audit programs that are pre-tailored based on predefined characteristics applicable to small, noncomplex entities. The predefined programs need to be further tailored by comparing the characteristics unique to your engagement to those specified in *Quick Start*.

The PPC Accounting and Auditing Update is published monthly by Thomson Reuters/ Tax & Accounting, P.O. Box 115008, Carrollton, Texas 75011-5008, (800) 431-9025.

THOMSON REUTERS™

Tax & Accounting - Checkpoint
P.O. Box 115008
Carrollton, Texas 75011-5008
UNITED STATES OF AMERICA

ADDRESS SERVICE REQUESTED

PRSRT STD
U.S. POSTAGE
PAID
Thomson

Benefits

Using *Quick Start* helps drive efficiency when auditing small, noncomplex entities by beginning such audits with a pre-populated set of planning content and audit programs that are developed by PPC's expert authors and pre-tailored for the unique characteristics of those types of clients. *Quick Start* can also assist less experienced auditors and staff with risk identification, risk assessment, and tailoring of audit programs. This saves reviewer time by allowing them to review the predefined planning content and revise it where needed for the entity, rather than starting with blank forms.

Consider the Characteristics of the Audit

When considering whether to use *Quick Start*, it's necessary to consider whether the characteristics of your entity align with the characteristics described in the *Quick Start* module. Those general characteristics include—

- There will be no reliance on the operating effectiveness of controls to reduce the control risk assessment, and substantive procedures alone are effective in responding to identified audit risks.
- The entity's accounting personnel are generally competent to process data and make decisions necessary to perform their assigned duties.
- No fraud risks are identified except the risks of improper revenue recognition and management override of controls, and management override of controls is addressed in the general audit program.
- There are no known significant deficiencies or material weaknesses in the control environment that would require modification of the audit programs.
- Audit procedures are either performed entirely at year-end or are applied to transactions through an interim date and completed as part of the year-end procedures.

If the above general characteristics don't apply to your entity, it may not be appropriate to use *Quick Start* to create the engagement. Additionally, industry-specific engagements may have different general characteristics to consider.

Using Professional Judgment Is Still Required

It's also critical to remember that *Quick Start* is a starting point for the audit, and the planning documentation needs to be tailored based on your judgment and the unique operating environment and risks of the specific entity. Using *Quick Start* still requires significant professional judgment by you to ensure that identified risks, risk assessments, and audit programs are tailored appropriately for each audit.

Industry Availability of *Quick Start*

Quick Start is available with certain existing Checkpoint Engage™ audit engagement titles, including—

- Audits of Nonpublic Companies (ASB).
- Audits of Nonprofit Organizations (NPO).
- Audits of Local Governments (ALG).
- Audits of Employee Benefit Plans (EBP).
- Construction Contractors (CON).
- Dealerships (DLR).
- Homeowners' Associations (HOA).
- HUD Audits (HUD).

Practical Consideration:

For more information about Checkpoint Engage™ and *Quick Start*, visit the website at **tax.thomsonreuters.com/en/checkpoint/engage**, or call a Thomson Reuters representative at (800) 431-9025.