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Follow the cutoff rules for revenue and expenses

Timing counts in financial reporting. Under the accrual method of accounting, the end of the accounting period serves as a strict “cutoff” for recognizing revenue and expenses.

However, during the COVID-19 pandemic, managers may be tempted to show earnings or reduce losses. As a result, they may extend revenue cutoffs beyond the end of the period or delay reporting expenses until the next period. Here’s an overview of the rules that apply to revenue and expense recognition under U.S. Generally Accepted Accounting Principles (GAAP).

GENERAL PRINCIPLE

Companies that follow GAAP recognize revenue when the earnings process is complete, and the rights of ownership have passed from seller to buyer. Rights of ownership include possession of an unrestricted right to use the property, title, assumption of liabilities, transferability of ownership, insurance coverage and risk of loss.

In addition, under accrual-based accounting methods, revenue and expenses are matched in the reporting periods that they’re earned and incurred. The exchange of cash doesn’t necessarily drive the recognition of revenue and expenses under GAAP. The rules may be less clear for certain services and contract sales, tempting some companies to play timing games to artificially boost financial results.

RULES FOR LONG-TERM CONTRACTS

The rules regarding cutoffs recently changed for companies that enter into long-term contracts. Under Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, revenue should be recognized “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 the goods or services.”

The guidance requires management to make judgment calls about identifying performance obligations (promises) in contracts, allocating transaction prices to these promises and estimating variable consideration. These judgments could be susceptible to management bias or manipulation.

In turn, the risk of misstatement and the need for expanded disclosures will bring increased attention to revenue recognition practices. So, if your business is affected by the updated guidance, expect your auditors to ask more questions about cutoff policies and to perform additional audit procedures to test compliance with GAAP. For instance, they'll likely review a larger sample of customer contracts and invoices than in previous periods to ensure you're accurately applying the cutoff rules.

FOR MORE INFORMATION

Contact us if you need help understanding the rules on when to record revenue and expenses. We can help you comply with the current guidance and minimize audit adjustments.