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The new revenue recognition standards have been issued and they could significantly impact the way organizations handle revenue reporting. With our experience in the new standards, financial reporting, tax implications, process and systems implementations, plus powerful accounting change tools, KPMG offers a seamless service to help you anticipate the effects and comply with the new rules. To learn more about how we can help you adapt to this changing world, download our brochure.

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When Revenue Recognition & Executive Pay Clash

Few companies have dived into an in-depth compensation analysis of how revenue recognition affects pay programs, says expert

By Joe Mont

The landscape for executive pay has been tumultuous in recent years, thanks to the Dodd-Frank Act, investor pressures, and the changing preferences and protocols of proxy advisers. So now let's throw one of the largest changes in the history of accounting standards into the mix.

Soon, public companies will be expected to begin implementing policies to comply with the new revenue recognition standard adopted by the Financial Accounting Standards Board in 2014. The standard, scheduled to go into effect at the start of 2017, reconceives business transactions as a series of performance obligations, with revenue recognized as each obligation within a transaction comes to pass.

The new standard is a tectonic shift in accounting, and it will affect everything from fraud risk assessments to internal control over financial reporting to, yes, executive pay—which is often based on an executive hitting revenue goals. Change the definition of "revenue" and all your pay calculations will feel the consequence.

"To the extent your executive compensation is triggered by company performance, or if there is a clawback for any restatements or errors, the new revenue recognition standards are going to be very difficult," says Kimberley Anderson, a partner with law firm Dorsey. "Companies are going to struggle with applying it properly."

Anderson

Clawbacks may be a particular concern as companies see revenue and earnings assessments fluctuate, perhaps greatly, from what they have been in past years and from what initial estimates assumed.

"For performance metrics that go out a few years, what do you do when you have that change in revenue recognition? Do you have to be able to modify for it? How do you adapt to it? Compensation committees will need to think seriously about the effect of the new rules, especially on performance-based pay," Anderson says.

"A company's executive compensation plan definitions, calculations, and targets should be evaluated in light of impending changes to its revenue recognition practices," says Marta Alfonso, a principal with accounting and advisory firm MBAF.

"Executive compensation plan changes should be considered to retain incentives that reward appropriate real growth in a company's revenue and net income."

The new standard may have unintended consequences on compensation packages that are designed to encourage revenue or net income growth—particularly for companies whose revenue is generated by contracts or make commitments as part of the sales process, such as providing support services to customers, says Robert Dyson, also with MBAF.

"Under the new rules, revenue is recognized when contractual obligations are satisfied, rather than based on the type of contracts or payment terms," he says. "As a consequence, companies may report lower current revenue if contractual income will be deferred, or less future revenue growth if contractual income will be accelerated."

Thus far, few companies have dived into an in-depth compensation analysis of how revenue recognition affects pay programs, says Jeff London, a partner with the law firm Kaye Scholer who specializes in compensation design. Bigger concerns, such as compensation disclosure rules pending from the Securities and Exchange Commission, and immediate business, such as upcoming annual meetings, have taken precedent.

> "To the extent your executive compensation is triggered by company performance, or if there is a clawback for any restatements or errors, the new revenue recognition standards are going to be very difficult."
>
> Kimberly Anderson, Partner, Dorsey

"There are things on the horizon that are much more urgent," he says. "The accounting standards rules have been somewhat falling by the wayside because nobody thinks it's a crisis."

Shifts in Focus & in Strategy

London does expect a greater focus on the issue once this year's annual meetings conclude. "Most, if not all, of the programs that are revenue-driven tend to be short-term programs and more likely to be annual bonus plans than stock compensation plans," he says. "You have to start thinking about short-term versus long-term, and whether you want to redesign some of those compensation programs. All bonus plans and compensation agreements will need to be reexamined, at least those that are based on metrics derived from revenue."

Alfonso

Because the new standard will record revenue differently, it may create more volatility and therefore less predictability. As a consequence, London predicts that companies will move away from long-term incentive plans with revenue-based metrics.

Another prediction, this one from Dayna

Harris, a vice president with Farient Advisers, an executive pay consultant: Expect a renewed focus on "goal setting" for executive pay packages. "The pay conversations this year will increasingly focus on providing clear disclosures on performance goals and why those metrics were set the way they were," she says. "This is going to be where the proxy advisory firms and investors will focus."

The spotlight will be on whether targeted performance levels are sufficiently rigorous, alongside a call for greater disclosure and transparency, Harris says. Some companies may be the focus of activist investors for lowering their targets to what will be seen as more easily achievable goals.

These reviews, however, may not adequately assess performance. Companies should be prepared to provide insights on why they made specific decisions—for example, talking about why revenue is declining and goals are lower, while a competitor's revenue is increasing, Harris says.

"Goal setting is not simply a quantitative exercise, but activist investors may treat it as such," a recent client advisory from Farient Advisers warned. It suggests that directors develop an easy-to-understand disclosure process to manage investor and proxy adviser concerns and to explain revenue matters that require a more nuanced view of operations.

Harris

"If you set a goal that is lower than last year's target, you want to explain that," Harris says. "There can be some very good reasons for why you would do that, because it's not just a quantitative thing." She expects to see greater standardization around disclosures related to performance in 2016 and beyond.

The focus on revenue and goal setting this year prompts a longstanding concern with executive pay. Performance goals are all well and good, but how do you design a program that rewards executives for efforts to build a company, but not take excessive risk in the name of personal profit?

"It is like a tightrope you are walking when trying to figure out what the right choices are," Harris says. "You want people to be working toward something that is harder to get, but you don't want them betting the farm and damaging the business."

She recommends a balanced pay program. "Some of it can be balanced in terms of the components of pay, having a mix of long- and short-term incentives, only some of which require goals. Stock options, for example, may not have to be tied to a particular performance goal," she says.

A practical concern that relates to the new revenue recognition standard is whether it leads to additional costs for companies, London says. Not only will lawyers be called in to review executive compensation plans, "if the revenue standard changes, executive compensation consultants are going to caveat everything by saying you need to run it by your accounting firm too." ■

REVENUE RECOGNITION IN A NUTSHELL

The following is from an overview of the new revenue recognition standard from the Financial Accounting Standards Board and International Accounting Standards Board.

Revenue is a crucial number to users of financial statements in assessing an entity's financial performance and position. However, revenue recognition requirements in U.S. Generally Accepted Accounting Principles (GAAP) differ from those in International Financial Reporting Standards (IFRSs), and both sets of requirements need improvement. U.S. GAAP comprises broad revenue recognition concepts and numerous requirements for particular industries or transactions that can result in different accounting for economically similar transactions. Although IFRSs have fewer requirements on revenue recognition, the two main revenue recognition standards, IAS 18, Revenue, and IAS 11, Construction Contracts, can be difficult to understand and apply. In addition, IAS 18 provides limited guidance on important topics such as revenue recognition for multiple-element arrangements.

Accordingly, FASB and IASB initiated a joint project to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRSs that would:

- Remove inconsistencies and weaknesses in existing revenue requirements.
- Provide a more robust framework for addressing revenue issues.
- Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
- Provide more useful information to users of financial statements through improved disclosure requirements.
- Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.
- To date, the boards have already hosted a number of workshops, webcasts and conferences on the revised Exposure Draft and have held a number of meetings with auditors, preparers, regulators and users. During these outreach activities, the staff sought to:
- Understand if the proposals are clear and can be applied in a way that effectively communicates the economic substance of transactions.
- Ensure the staff is aware of significant changes to current practice.
- Educate constituents about the proposals and basis for the Boards conclusions.

Source: FASB.

Strains Emerge on Revenue Rule Convergence

By Scott Taub
Compliance Week Columnist

The new standard on revenue recognition was the product of a long joint development effort by the Financial Accounting Standards Board and the International Accounting Standards Board. The standard is principles-based and provides a sound model and objective. Differences between the versions issued by the two boards are largely inconsequential. After working with the new standard and serving on the FASB/IASB Joint Transition Resource Group for Revenue Recognition (TRG), my initial support for the standard has only grown stronger.

FASB and IASB correctly realized that a broad, principles-based standard covering such an important area of financial reporting would need more than the normal amount of time to implement. The TRG was formed to discuss implementation questions, identify areas where more guidance might be helpful and, importantly, to increase the chance that the converged standard actually leads to converged and consistent accounting. While the implementation efforts are moving along well, the planned responses to certain implementation issues provide a case study in the different ways we handle things in the United States compared to those abroad.

Where We Agree

The TRG has met three times so far and discussed more than 20 issues, some of which had many sub-issues. Those discussions have shown that we understand the principles in the standard in the same way regardless of where we live, as there haven't been any issues where the view of the requirements of the standard differed between the U.S. and non-U.S. members. We owe that, at least in part, to the careful drafting of the standard done by FASB and IASB staff.

> I think it's interesting to consider why FASB and IASB react differently to similar matters, especially since the two boards have made clear that despite different paths in dealing with some of the issues that have been raised, they expect (except on one matter related to licenses) the same accounting outcomes.

Going further, no questions have arisen where U.S. and non-U.S. members of the TRG differed on whether the new standard was clear about how the question should be handled. And when we have concluded that the standard is unclear, we have all agreed, at least directionally, on what we thought the standard should say, or on how it should be applied in the absence of clarity.

So U.S. and non-U.S. accounting experts seem to have similar understanding of the new revenue standard and similar views as to where that understanding could be improved. This makes me more optimistic that converged standards, if based on sound principles, are likely to lead to converged and consistent accounting—which is, of course, the real goal.

Where We Don't Agree

At the last TRG meeting, we were merrily rolling along knocking off issues. We had several issues where the general consensus, on both sides of the Atlantic, was that a small amendment to the standard could eliminate potential diversity. Everybody seemed comfortable with that path forward, until the vice-chairman of IASB raised a concern that we too often suggested amending the standard to clarify something. IASB's subsequent actions have been consistent with his concern.

In several areas, FASB is leaning toward amending the standard to clarify certain points, while IASB has decided to leave the standard alone, relying on practice and the record of the TRG meetings to ensure that diversity in practice doesn't develop. Both the vice chairman's comments and IASB's subsequent decisions on moving forward show a reluctance to amend the standard to make clarifications, even though IASB agrees that the treatment FASB intends to clarify is in fact the treatment the boards intended when they drafted the standard—and even though TRG members seemed to agree that clarification would help.

This surprised me, especially given that IASB has long had a useful practice (called "Annual Improvements") of making minor changes to standards that are intended to clarify, but not change, the principles of the standard. Several areas where FASB has decided to pursue clarifications, but IASB has not, would be Annual Improvement candidates if they had been raised after the standard was in use—it seems odd not to provide the clarification simply because the issue was raised before adoption.

In two other areas, FASB intends to amend the standard to help practitioners more efficiently handle issues that will generally be immaterial. These relate to shipping of goods where title transfers when the goods leave the shipper's facility and what we would today consider "inconsequential or perfunctory" performance obligations. IASB, however, believes no further guidance is needed.

In both cases, the problem that FASB has decided to address doesn't relate to the standard, but rather to how practice would likely deal with what should be a minor matter. The new standard doesn't specifically provide for either (1) ignoring minor promised goods or services; or (2) treating shipping of goods owned by the customer as a cost, rather than a performance obligation.

In the absence of specific guidance on this point, accounting practices along these lines, which many companies would like to implement for convenience, would be treated as departures from GAAP. While their effects would almost certainly be immaterial, the concern (which I wrote about here recently) is that auditors in the United States would be

held to a standard of evaluating these accounting conventions that would require their effects to be calculated and evaluated. The result: a fair amount of non-value added cost and effort.

> My biggest concern is that, despite the stated intentions of reaching the same accounting, different words will inevitably lead to differences in journal entries over time.

FASB has tentatively decided to attempt to assist in this matter by exempting shipping and small promises from being considered promised goods or services. As such, not treating them as performance obligations wouldn't be a departure from GAAP at all, so there would be no need for further evaluation. IASB, in contrast, received no indication that its practitioners would have similar difficulties, and therefore isn't intending to amend its version of the standard to address this matter.

Why React Differently?

I have preferences as to how these matters should be handled, but pushing my views is not the reason I wrote this column. I think it's interesting to consider *why* FASB and IASB react differently to similar matters, especially since the two boards have made clear that despite different paths in dealing with some of the issues that have been raised, they expect (except on one matter related to licenses) the same accounting outcomes.

As I stated above, this isn't a matter of people reading or understanding the standards differently. Nor do the differences lie with different views on what the accounting should be. Instead, it appears that external factors are weighing on board members. As the external factors faced by the two boards are different, we are getting different reactions.

For IASB, there is great concern about stability in the standards. IASB standards must be "endorsed" before they become part of the official accounting standards in many jurisdictions. In some cases, Europe has raised concerns about endorsing standards or has endorsed standards late. Changing a standard might well increase the chance of endorsement problems like these.

In addition, IASB has consistently worried about being seen as anything other than "principles-based," as that might lead to resistance. There is a fine line, perhaps, between clarifying principles and writing rules. I saw both of these concerns lead to decisions on standard-setting matters while I was serving as a member of the IFRS Interpretations Committee, and I have no doubt they are in play here.

FASB board members, on the other hand, have heard the same things from the staff of the Securities and Exchange Commission that the rest of us in the United States have heard: that consistency in application is important, and the SEC will issue guidance to that end if necessary. Board members have also heard about practice concerns relating to immaterial items and may fret that the standard may be blamed for inefficiencies.

Since "endorsement" isn't an issue FASB needs to worry about, there aren't similar concerns on that front. And while FASB board members might share similar concerns to some IASB board members regarding amendments to the standard possibly leading to calls for extending the effective date, calls for extensions are already pretty loud in the United States. That's not the case overseas.

So here we sit, with agreement on what the standard says and what the accounting should be, but different views on how best to achieve that accounting. My biggest concern is that, despite the stated intentions of reaching the same accounting, different words will inevitably lead to differences in journal entries over time. Any other belief is, I fear, a delusion. ■

Scott Taub is the former deputy chief accountant of the SEC, and played a key role in the Commission's implementation of Sarbanes-Oxley and was responsible for the day-to-day operations in the Office of the Chief Accountant. Taub also served as the SEC observer on FASB's Emerging Issues Task Force and as chair of the accounting and disclosure standing committee of the International Organization of Securities Commissions.

In March 2007, Taub joined Financial Reporting Advisers, a Chicago-based company formed in 2003 by three of Taub's long-time colleagues and former Arthur Andersen professional standards group partners. FRA provides accounting advisory services, SEC reporting advisory services, litigation support services, and dispute resolution services.

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Published online 11/25/14

The New Revenue Recognition Standard

Planning and Implementing a Successful Transition

By Tim Lashua, Managing Director, Accounting Advisory Services, KPMG LLP.

As a compliance professional, you already know about the new revenue recognition standard that was released in May 2014 by the Financial Accounting Standards Board and the International Accounting Standards Board (collectively the "Boards"). You probably also noted that on July 9, 2015, FASB voted to defer the adoption of the new standard for one year, so reporting will be affected only for fiscal periods beginning after Dec. 15, 2017 (for public companies). IASB is expected to do the same.

The compliance date might seem a long way off, but now is the time to start planning and preparing your transition to the new standard. In the following pages, we will discuss the challenges and issues involved in implementing the new standard, the importance of governance and effective project management, four steps to a successful transition, and the potential impact of the transition on compliance professionals.

Now is the time to start

The deferral of the standard's effective date should not be viewed as a reason to delay evaluating how it impacts your business. The new revenue standard will affect not just the accounting and finance department but also complex business processes throughout the entire company. In fact, many organizations will need the extra year to develop or modify processes, controls, and systems around collecting data, processing information, and producing financial reporting in line with the new accounting standard.

Keep in mind that everything about the transition to the new standard will take considerable time for your organization to address—often much more than expected. Time will be needed to properly understand the principles of the new standard and how they fit with organizational goals, train stakeholders, and determine how and when revenue and their associated costs should be recognized. Even more time will be required to adopt new processes and controls, modify or implement new IT system components, change business strategies, and adjust product lines. Each of these tasks may take many months to complete, depending on the complexity of the changes to your organization.

In short, now is the time to start the transition process. The task of implementing a new standard of this nature and magnitude can be overwhelming, so having an experienced team and making sufficient time for planning and preparation is critical to the success of the organization.

Build a strong team

A key requirement for the transition is a strong team for project governance and management. The first step is to identify and include the right stakeholders across different functions and business segments. These individuals must have a working knowledge of the standard, the ability to assess ongoing progress, and a strong commitment to a successful implementation.

Coordinating the efforts of a large and diverse group of stakeholders will require a well-developed project governance and program management office (PMO). Designed to achieve a well-orchestrated and efficient implementation, the PMO should support the following activities:

For stakeholder commitment —

» make sure that key individuals are involved up front and then engaged at set intervals throughout the implementation

» develop and support a clear communications plan tailored for various stakeholders and executive sponsors

» prepare and distribute a detailed timeline of activities for stakeholders, with critical dates and potential dependencies highlighted

» discuss ongoing developments with all stakeholders to provide opportunities for input, improvement, and value-add.

For effective program management —

» develop an integrated PMO framework for governance, processes, data, and technology

» create, follow, and update when necessary a project management plan populated with key activities and milestones

» develop a risk register that is actively managed against parallel or dependent projects

» ensure consistent prioritization and decision-making criteria across opportunities

» identify opportunities to streamline and improve processes and business practices as part of the adoption

» implement an ongoing monitoring plan.

Four steps to a successful transition

Due to the sheer size of this project, we recommend a four-step approach that can break down the transition process into more manageable phases, coordinate changes to processes and systems, include time for dual-reporting prior to the effective date, and address unforeseen complexities.

1 – Assessment

The first step is to perform a high-level assessment of your organization's readiness for implementing the new standard. This can be done in house or you may decide to use a third-party advisor to help you with the assessment.

A detailed accounting gap analysis may uncover several issues that must be addressed. Even if the organization does not expect significant changes to the pattern in which revenue is recognized, the standard calls for several new and expanded revenue-related disclosures.

The accounting and finance department cannot work in a silo to develop an effective adoption strategy. They need the input, support, and knowledge across the breadth of the organization, including tax, information technology, internal control, sales and marketing, contracting and pricing, mergers and acquisitions, investor relations, human resources, and compensation and benefits. Using a skilled and robust cross-functional team will help ensure that the needs and goals of all stakeholders are properly addressed.

Key objectives for the assessment include the following:

» organizing the accounting change program within the organization

» identifying critical change drivers associated with current and future selling models

» understanding how the expected accounting changes will affect the organization

» identifying stakeholders who require accounting change communications and training

» assessing resource management needs

» measuring the quality and availability of data, and where new data sets will be required

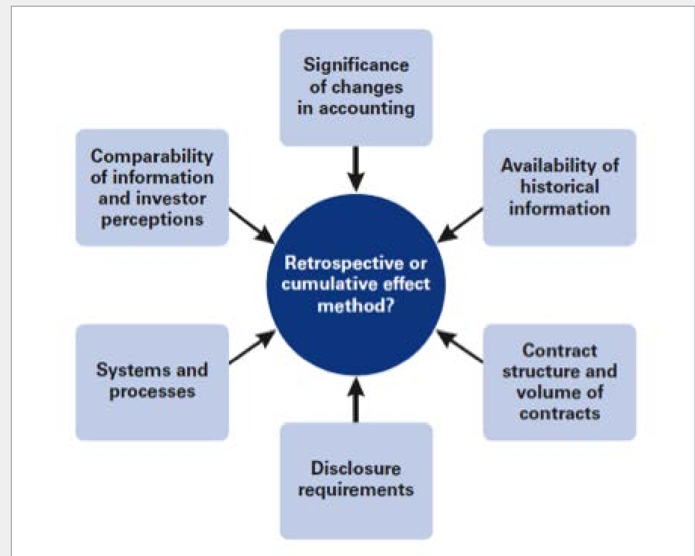
» documenting the current IT systems landscape used in revenue streams

» determining whether change is required to existing systems, including any financial consolidation and reporting systems

» determining whether new systems and processes are required to better automate revenue recognition and product delivery

» understanding when to begin high-level plans for assessment, design, and implementation

2 - Choosing your transition method



Based on your assessment and other factors, you can choose between two transition methods that address the needs of your organization.

Retrospective (with optional practical expedients): Under the retrospective method, organizations would recognize the cumulative effect of applying the new standard at the start of the earliest comparative period presented (typically two years prior to the effective date.)[1]

Cumulative effect: Under this method, organizations recognize the cumulative effect of applying the new standard at the date of initial application, with no restatement of the comparative periods presented. In other words, the comparative periods are presented in accordance with legacy GAAP.

The choice of a transition option requires careful deliberation that should include input from various stakeholders. In particular, organizations need to consider the potential effects of each transition option on the trends in revenue and certain

1 The SEC stated that it will not object if registrants applying the standard retrospectively only apply it to periods covered by the financial statements

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costs (such as customer contract origination costs) in the financial statements. When selecting a transition method, you will need to understand how to apply each transition option, and you should be able to answer the following questions.

» What is the impact and effect of each transition option? For example, will it mean that revenue from a contract is presented more than once or will revenue deferred under legacy GAAP never be recognized in profit or loss?

» What is the effect of applying the practical expedients if the retrospective method is selected?

» What is the effect if certain costs, expensed as incurred under legacy GAAP, are now required to be capitalized and amortized under the new standard?

» Do I have the full set of data required for a retrospective adoption given legacy systems and significant acquisitions? Do I have the ability to process information in parallel during my comparative periods?

» What are the change requirements that I need to address in my existing and/or new systems to enable complete and accurate financial reporting across the organization?

IT is a key function that often affects the choice of a transition method. Many organizations rely heavily on IT systems for revenue reporting so they need to consider the feasibility and costs of making required changes to their IT systems to comply with the selected transition option. There is no "one size fits all" solution—it will depend on each organization's specific circumstances, and which factors are valued the most. Some organizations may consider comparability of information to peers to be most valuable while others may prioritize the cost of implementation. At the same time, an organization may value comparability as most important but determine that the retrospective method is not feasible because it cannot make the necessary system changes in the required timeframe at a reasonable cost.

Depending on the nature of your customer contracts and the goods or services you are selling, the impact to revenue may not be clear until additional implementation guidance is issued by the Boards or interpretations are made by FASB's Transition Resource Group ("TRG") or other organizations. Closely monitoring implementation topics and issues will need to be a core responsibility as you progress toward adoption. Many organizations may not be able to make a definitive choice on a transition method. As a result, contingency plans may be needed for both so either option can be selected at any point prior to adoption.

The choice of the transition option will have a significant effect on an organization's overall implementation plan, so it is important that you start taking the following actions immediately:

» Determine the contracts that may need to be restated and the information needed to restate them.

» Determine which business segments are most affected by the new revenue standard and consider prioritizing those first.

» Consider contributing to your specific systems vendor roadmap to influence the capture of key industry requirements that can be reflected as "standard" in your adoption of new/upgraded technology solutions.

» Consider implementing a sub-group within the overall project team responsible for implementation to focus on transition option considerations.

» Monitor the activities of implementation groups established by FASB, TRG, IASB and the AICPA and views articulated by the SEC.

3 – Design

During this phase, the organization should draft new accounting policies and accounting/reporting procedures, define systems, process, controls, and training requirements, and develop an implementation plan to be used during the transition period. The plan may include dual financial reporting needs, as well as the future state.

The design document should contain the future-state strategic vision, organizational structure, integrated technology considerations, and process design requirements for end-to-end revenue and cost recognition processes. The document will identify the data and systems architecture necessary to integrate and automate business capabilities.

The new design provides a detailed blueprint for implementation. The implementation plan itself should highlight key milestones, checkpoints, and potential dependencies that will impact the overall timeline and roadmap.

4 – Implementation

During this phase, the organization should configure, build, and test systems and processes; conduct trainings and roll out reporting packages and guidelines; implement parallel interim procedures and draft comparative financial statements; and implement permanent plan procedures and establish the future state plan.

While focusing on the implementation, keep in mind that you might have other competing projects that demand attention and resources. For example, your organization could be planning a change in business models, new products, IT system upgrades,

or the adoption of other new accounting guidance such as the Boards' joint projects on Lease Accounting and/or Financial Instruments. If that is the case, effective management becomes critical. You will have to identify projects and initiatives that require coordination and prioritize them across people, process, technology, and governance. Developing a portfolio management strategy, governance framework, and performance measures will help you achieve your desired goals and business value.

An organization may value comparability as most important but determine that the retrospective method is not feasible because it cannot make the necessary system changes in the required timeframe at a reasonable cost.

After the implementation of the new revenue standard, the organization will be required to sustain both the future state and the "old" state for a period of time to comply with disclosure requirements in the year of adoption. You need to determine ahead of time whether your organization is ready to run parallel processing under new and current revenue accounting for the close cycle and is able to produce financial reporting with appropriate disclosures at a more disaggregated level where required.

You also need to remember that over the next few years, your organization will have to continue with assessing and implementing the new standard while maintaining business-as-usual operations. Verify that your organization has enough resources to accommodate the extra workload required for both of these objectives.

Impact to stakeholders

It's clear a lot of work will need to be done by the accounting, finance, and technology teams. What about the compliance personnel?

Internal audit:

Regardless of the transition option elected, organizations will need adequate processes and controls to ensure that the information used to comply with the new transition requirements is complete and accurate.

If an organization selects the retrospective transition method, there will be two years in which dual processing and financial reporting of transactions is required: under legacy GAAP and under the new standard. Even if the cumulative effect method is selected, in the year of adoption, the company is required to disclose the amount by which each financial statement line item changed in current year as a result of applying the new standard and explain significant changes between amounts reported under the new revenue standard versus legacy guidance. To comply with these requirements, dual processing and parallel financial reporting may be required in the year of adoption. With either transition method, it may require two parallel different sets of policies, processes, technology, and controls.

In addition, the new standard may increase the number of risk areas to an organization that will need to be mitigated. Simply stated, the new standard requires more judgment and estimates, and more often. For example, the new standard requires that an organization estimates transaction price at contract inception, including any variable consideration and the related constraint, and updates the estimate at each reporting period for any changes in circumstances. Determining the transaction price may require several judgments and estimates to be made, and this can lead to an increased risk of error and fraud and an increased need for good processes, technology, controls, policies, and contemporaneous documentation. Internal audit may want to focus on developing a strategy for ensuring that changes in policies, procedures, processes, technology, and controls are consistently adopted across the organization. The more judgments and estimates required, the more important it is to have a robust and well-documented set of internal controls over financial reporting.

Internal audit professionals might want to consider the cost and timeframe for designing and implementing these processes, technology, and controls when choosing a transition method. Some organizations may want to implement their process and control changes before signing any certifications relating to internal controls under the Sarbanes-Oxley Act. This way, the changes can be documented and tested and any deficiencies addressed before year-end.

Legal:

Companies should consider business practices and strategies, such as pricing, marketing, and contracting that are affected by the implementation of the standard. Planning for changes in pricing strategies may be critical and require coordination with legal and business operations personnel.

The first step of the new standard is to identify the contracts with a customer. A contract is defined as an agreement between two or more parties that creates enforceable rights and obligations. Enforceability is a matter of law. This may be different from jurisdiction to jurisdiction in which a company operates

around the world. A company may have the opportunity to amend their terms and conditions, agreements, and contracting practices at this time.

Risk:
Changes in earnings may affect compliance with debt covenants or financial assurance tests. Negotiations of new borrowings may need to include provisions that allow covenant ratios to be reset to reflect the impact of the new standard. Failure to include these provisions could cause companies to seek amendments to the contractual terms, and this may be a costly process. To the extent that current outstanding debt arrangements with financial covenants will be in place subsequent to the effective date, companies should proactively consider whether those arrangements need to be amended to avoid a potential covenant violation. Similarly, companies subject to financial assurance tests will need to consider the impact on their forecasted compliance with the requirements.

Tax:
The change in revenue recognition caused by the new standard could also impact the income tax reporting and related financial reporting for income taxes. This is becoming an active part of assessment activities, with the IRS issuing Notice 2015-40 requesting comments on the impact of the new revenue recognition standard by Sept. 16, 2015.

Tax professionals need to be involved in assessing the standard's impact. More specifically, they need to understand any changes in the amount or timing of revenue recognition that may result for financial reporting purposes to evaluate the impact on taxes.

Examples of tax implications include changes to —

» accounting for financial reporting purposes that may not be acceptable for income tax purposes, resulting in temporary differences between financial results for accounting and tax purposes.

» attribution of revenue to goods and services included in multiple element arrangements, which would result in changes in how sales and use taxes are calculated.

In addition, system requirements should be evaluated to determine if and how to automate tax reporting for revenue recognition. Equally important is the need to consider the impact of indirect tax on changes to revenue scenarios and any other tax derivations of revenue such as transfer pricing and jurisdictional allocations. This also includes the impact of the tax payments required on adoption if the timing of revenue recognition changes.

Conclusion

The new revenue standard will affect different organizations in different ways. You might determine that the impacts are minimal. However, you might find yourself faced with substantial changes that will require a major implementation or business transformation effort, including—

» changes in the amount or timing of revenue and earnings that could result in changes in key performance indicators or other metrics used to communicate financial results.

» changes in revenue and earnings that might impact sales commissions, bonuses, and other employee incentive plans.

» changes in earnings that might affect compliance with debt covenants or financial assurance tests.

Failure to address these issues in time has the potential of incurring significant costs to your organization, may result in potential financial restatements, and may affect your organization's performance and share price. That is why you should start carefully evaluating the risks and requirements involved with this milestone change—and start this process sooner rather than later.

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The Slog Begins to Adopt New Revenue Standard

Tech companies say more time is necessary so regulatory bodies can issue more guidance

By Tammy Whitehouse

The Financial Accounting Standards Board's goal of implementing its new, principles-based standard for revenue recognition by 2017 is starting to collide with business and regulatory reality, as different parts of Corporate America grow more vocal about their ability—or lack thereof—to manage the task.

The implementation of the massive new standard has become a wait-and-see exercise for many companies as FASB considers whether to provide more guidance on some key aspects of the requirements, and possibly delay the effective date.

The Joint Transition Resource Group that is fielding implementation questions on behalf of FASB and the International Accounting Standards Board has cataloged 40 separate issues so far that warrant discussion. The American Institute of Certified Public Accountants also has 16 different industry-focused task forces exploring dozens of issues as well, some of which the groups have referred to the TRG.

That process has bubbled up three significant aspects of the standard where FASB has instructed its staff to perform additional research to determine if additional guidance is warranted.

For example, FASB is taking a look at questions around licenses to determine whether companies need more guidance to address uncertainties about how to comply with the requirements. The questions are particularly important for companies that deal heavily with intellectual property: software, research, and entertainment, to name a few.

Staff members are exploring concerns around how to identify performance obligations in arrangements with potentially multiple obligations bundled into a single contract and how to determine if a company is recognizing revenue as a principal in a contract or as an agent of someone else, which affects whether to recognize revenue on a gross or net basis. FASB also is considering practical expedients in some granular aspects of the standard.

With all of those questions swirling, FASB also is performing research and outreach to determine if companies need more time to implement the new standard, which takes effect in 2017. Given the financial statement requirement to present three years of comparative data under the new revenue recognition rules, a 2017 effective date means companies need to be gathering information and preparing comparative data with the opening of their 2015 reporting year.

Prabhakar Kalavacherla, a partner with KPMG, says different companies are affected in different ways by the current areas of uncertainty. Companies in the media and entertainment sectors, for example, might need more clarity about how to address revenue arising from licensing arrangements before they can move forward. "But there may be companies that don't have a lot of licenses, so they may feel they are ready to move on," he says.

Conflicting Opinions Emerge

FASB is getting that exact message in the early unsolicited letters it has received from companies discussing whether the effective date should be deferred. General Dynamics, a $30 billion aerospace and defense company, says it has committed considerable resources into preparing for a 2017 implementation.

"If you are considering a delay in the effective date, we ask that you do not penalize the companies that have moved forward on a project plan to meet the Jan. 1, 2017, effective date by preventing the adoption of the update on the existing schedule," wrote Kim Kuryea, controller and principal accounting officer for the company. "There are significant internal efforts and consulting costs being incurred for IT and non-IT related implementation activities. These costs will naturally and inevitably grow if the implementation period is extended."

> "There are significant internal efforts and consulting costs being incurred for IT and non-IT related implementation activities."
>
> Kim Kuryea, Controller and Principal Accounting Officer, General Dynamics

On the other hand, a half dozen technology companies, including Adobe Systems and Symantec, sent FASB a joint letter asking for a two-year delay in the effective date. "Detailed analysis and evaluation of the new revenue standard leads us to conclude that additional implementation guidance and time is required, especially specific to arrangements that include licenses," the companies wrote.

The tech companies say more time is necessary so regulatory bodies can issue more guidance, which the companies need to develop their implementation plans. Plans for what? The tech companies gave a litany of concerns that spanned the whole quote-to-cash cycle: go-to-market strategies, tax planning, procedures for internal operations and financial planning, internal control over financial reporting, monitoring controls, and ERP systems. Plus time to communicate with and educate stakeholders both inside and outside of the company.

FASB said recently it is researching not only a delay in the effective date, but also whether to permit companies to move forward in 2017 if they are prepared to do so. FASB's standard prohibits any early adoption ahead of the effective date to avoid any confusion about comparing financial performance between businesses that early-adopt and those that don't. (IASB's standard allows early adoption.)

Brian Marshall, a partner with McGladrey, says the TRG has reached some conclusions on issues that will not be incorporated into GAAP, but still provide some guidance on how to move forward. One in particular, he says, focuses on collectability. The TRG agreed that companies accounting for a large portfolio of like contracts should assess the likeli-

hood of collection as a whole, and if collection is probable, companies should recognize the full transaction price as revenue, then recognize bad debt expense for the amounts that are not expected to be collected.

Many of the issues the TRG has addressed and not referred to FASB or IASB for consideration have been left to the corporate accounting officer's judgment, Marshall says. "There are a number of issues where they've said we don't think any guidance is necessary, but there is going to be a lot of judgment involved," he says. "That's the theme for the standard as a whole."

Marshall

John Armour, managing director at CBIZ MHM and a member of the TRG, says the questions around identifying distinct performance obligations might prove to be an obstacle to continued implementation planning for many companies.

"That is the unit of account that defines where you're going to measure revenue," he says. "If I can't define the thing that I'm measuring yet, if there's still uncertainty around that, I can't implement."

The debate, Armour says, focuses on whether the new standard requires companies to define a much larger number of distinct obligations than they have in the past. Some are saying yes, while others say they can continue doing what they've done in the past. "They can't both be right," he says. ■

GENERAL DYNAMICS SEEKS DELAY

Below is an excerpt from General Dynamics' letter to FASB Technical Director Susan Cosper, in which VP and Controller Kimberly Kuryea seeks a delay on revenue recognition changes.

In light of the FASB's recent discussions on Topic 606, General Dynamics wishes to provide you our perspective on the implementation of the new standard, in particular with respect to interpretive guidance and the timing of implementation. General Dynamics, with over $30 billion of annual revenues, is an aerospace and defense company that offers a broad portfolio of products and services in business aviation, combat vehicles, weapons systems and munitions, shipbuilding, and communication and information technology systems and solutions. We currently recognize the majority of our revenues under the percentage of completion method in accordance with Topic 605. Although we feel that Topic 605 is a comprehensive (and well understood) accounting model, we have supported the FASB and International Accounting Standards Board objective of a single, common revenue recognition model. Accordingly, since the issuance of Accounting Standards Update 2014-09 (update), we have worked diligently on an implementation plan to meet the effective date of Jan. 1, 2017. We have been following the public concerns related to the standard, including the need for interpretive guidance and additional time for implementation. We would like to share our experience and opinions on these matters.

We understand some have expressed that there is a need for clarification of the principles outlined in the update. We believe this is a natural reaction to a standard that is more principles-based than rules-based. In fact, questions continue to arise as we analyze our contracts under the provisions of the Update. However, we have accepted that judgment is required and believe we can apply that judgment consistently across our contract portfolio. We also know concerns have been raised regarding whether the Update will yield consistent application among companies. We believe the FASB has made a number of decisions in writing the Update that have improved comparability. Therefore, we urge that caution be exercised as consideration is given to issuing interpretive guidance that could convert this principles-based standard into a set of prescriptive rules. The result may appear to increase consistency, but the rules may not adequately consider the nuances of individual contracts. We believe when practitioners appropriately use judgment in applying principles to varying facts and circumstances and disclose these key judgments in the notes to the financial statements that investors are better informed.

For example, there has been much discussion over the proper application of the second criteria in 606-10-25-19 (distinct within the context of the contract). In our defense businesses, we produce highly complex systems designed to our customer's unique specifications. Although we may produce more than one unit, we believe there are frequently either significant integration services or highly interrelated activities that do not make the individual units distinct within the context of the contract. This conclusion requires significant judgment and a close examination of the complex facts and circumstances. We are concerned that interpretative guidance in this area could inadvertently create an arbitrary rule that in practice would require these contracts to be accounted for in a manner that may not reflect the substance of the contract. Although rules may drive uniformity, the most representationally faithful answer may not result.

We also understand that others have expressed their desire for a delay in the effective date of the update to provide more time for implementation. We would like to apply the amendments in the update retrospectively to each prior period and are preparing to gather the necessary data beginning with the first quarter of 2015 (i.e., running parallel). If you are considering a delay in the effective date, we ask that you do not penalize the companies that have moved forward on a project plan to meet the Jan. 1, 2017 effective date by preventing the adoption of the update on the existing schedule. There are significant internal efforts and consulting costs being incurred for IT and non-IT-related implementation activities. These costs will naturally and inevitably grow if the implementation period is extended. We appreciate there are circumstances where certain companies or industries may need more time, but we believe there are other companies who committed themselves financially and strategically in good faith to the original timeline and they should not be disqualified from transitioning on Jan. 1, 2017.

Source: General Dynamics.

Preparing Your Board for Revenue Recognition

By Stephen Davis and Jon Lukomnik
Compliance Week Columnists

The first rule of care and feeding of directors and CEOs is "no surprises." A major one is lurking in the new revenue recognition rules adopted by the United States and Europe, due to be implemented in 2017.

While the accounting world is abuzz with news about the pending changes to the rules for revenue recognition, and the profound effect they could have well beyond the corporate accounting department, the rest of us are asleep.

That could be a huge problem. Revenue is such a fundamental building block that the rule change will affect everything from executive compensation to fraud prevention to internal controls to the cost of the external audit to how—and how much—markets value companies. Simply put, the rules change everything. And not enough people are paying attention.

The good news is that most financial officers seem to be at least somewhat familiar with the new standards. According to a recent survey for the Financial Executives Research Foundation (FERF), only about 16 percent of finance professionals have not yet considered the effect of the new rules, even though they don't take effect for most companies for another two years.

The bad news, however, is that more than 80 percent of directors either haven't even begun to consider the new rules or have only "somewhat" considered them. Amongst audit committee members, the number isn't much better: 74 percent have not thought about the issue or have done so only cursorily. Indeed, the report estimates that only about 5 percent of directors, whether or not they are on the audit committee, have significantly considered how the revenue recognition rules will affect their companies.

What's the big deal, you might ask? The rules (designed to replace myriad inconsistent, industry-specific do's and don'ts with a more coherent set of underlying principles and objectives) won't take effect until reporting periods after Dec. 15, 2016. That's nearly two years from now.

But directors are paid to look ahead. The adoption time frame is already colliding with some fundamental boardroom decisions, such as the shape of executive compensation programs and strategic plans, both of which are based on multi-year horizons.

For example, the performance metrics for long-term executive compensation plans generally cover a three-year time period. That means compensation committees are deciding on long-term incentive plans now without being aware that the way those metrics are calculated will change midway through the performance period. The results may surprise your CEO and your board … and that generally is not a good thing.

Similarly, a recent McKinsey study notes that most directors believe a strategic planning period should span four years or more. Though many companies don't meet that standard and use only two, many do have three- or four-year plans. Will the changing patterns of revenue recognition affect those plans? The truth is that most boards just don't know.

The point is that the changes to how revenue is recognized will have multiple spill-over effects, from executive compensation to calculating debt coverage ratios.

So what should you do?

First, be sure your finance department is familiar not only with the new revenue recognition rule and guidance, but also with how it will affect your company—and it almost certainly will affect your company somehow. Will the effects be material? Good question. While only 17 percent of the respondents to the FERF survey said they expect the new guidance to cause material changes to the income or balance statements, 23 percent admitted they didn't know, and a whopping 41 percent didn't answer the question.

Second, understand that an unlikely entity—the general counsel's office—may have the key to understanding, and potentially determining, if revenue recognition is likely to be accelerated or delayed. The reason is that while new guidance eliminates specific revenue recognition rules and replaces them with judgment, that judgment has to be based on certain events and conditions, such as contract terms that spell out when "control" is transferred. If you have contracts that are long-term, multiparty, include variable consideration (such as volume discounts or rebates), or sell software or other licensed products, there are more wrinkles.

The point is that the changes to how revenue is recognized will have multiple spill-over effects, from executive compensation to calculating debt coverage ratios.

In almost all those cases, the starting point for your exercise of judgment is for the contracts to state explicitly what the performance obligation is, and what will satisfy transfer of control. So make sure your finance department coordinates with your counsel's office to understand what's likely to happen and, if necessary, to try to revise contracts as needed.

Third, create an intra-company working group to study the potential effect of the revenue recognition rules, and have them start working immediately. We strongly suggest it include the counsel's office for the reason above.

Make sure that working group casts a wide net and looks at all functional areas, with an eye to any metrics that include revenue. For example, internal controls may need to be harmonized to the new rules. The changes may affect some companies in areas as widespread as financing (will it affect your loan agreement coverage ratios?) to customer service

(do volume discounts or return policies change revenue recognition patterns?). If the changes will be material enough, you might want to bring in your investor relations department, so that it can start preparing your shareowner base.

Although only a few companies reported that they anticipate actually changing fundamental business practices as a result of the new rules, explaining the likely effects in advance to your shareowners and the analyst community can only be a good thing.

Once the plan is in place, be sure to figure out the best way to brief the board. Focus on what the directors need to know about the specific effects on your company, and on how the revenue recognition changes may affect board-specific responsibilities, such as changes to financial statements and executive compensation.

As a follow-up, provide a periodic progress report to the board or audit committee, up to and through adoption. After all, you'll all be living with this project for a long time. ■

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RECENT COLUMNS BY DAVIS & LUKOMNIK

Below are some recent columns by Compliance Week Columnists Stephen Davis and Jon Lukomnik. To read more, please go to www.complianceweek.com and select "Columnists" from the CW toolbar.

Activism With Sharper Elbows
Shareholder activism is always simmering in the United States and overseas, so predicting more of that in 2015 is not news. Compliance Week columnists Stephen Davis and Jon Lukomnik, however, have provocative predictions about how activism will unfold next year—including potentially toxic fights with Corporate America, pressure on proxy advisory firms, and more investor collaboration.
Published online 01/06/15

Metrics Misused: The Executive Pay Example
The complaint is a common one in governance circles: everyone talks about the importance of long-term value, and then follows the market's mantra for short-term results. Why? Executive compensation tied to the wrong metrics doesn't help. Columnists Stephen Davis and Jon Lukomnik pick apart the fallacy of tying pay to Total Shareholder Return and give examples of metrics that drive future growth.
Published online 12/09/14

A Turning Point in the Standoff With Proxy Advisers?
Regulators are looking to curtail abuses by proxy advisory firms with new rules that include a mechanism for companies to complain about unfair treatment. While some CEOs and boards may be eager to use these new tools as weapons against them, columnists Stephen Davis and Jon Lukomnik urge caution. They explain the new rules and potential consequences of misusing them.
Published online 11/04/14

Achieving Transparency Without Divulging Secrets
While boards play close to the vest for competitive and security reasons, it doesn't mean investors should be left in the dark. Columnists Stephen Davis and Jon Lukomnik follow a shift from disclosure of specific facts to disclosure of policies, processes, and actions that they say will enable investors to more directly judge not what the company has done, but whether the board is doing its job well.
Published online 10/07/14

Social Media Virality and the Ice Bucket Challenge
This summer the Ice Bucket Challenge went viral, raising awareness and funds to fight ALS. What does the phenomena have to do with corporate governance? A lot, it turns out. Columnists Stephen Davis and Jon Lukomnik explore the elements of viral social media campaigns and how companies can guard against viral criticism that, like the Ice Bucket Challenge, can spread fast and wide.
Published online 09/03/14

Answering the Call for Better Cyber-Security Disclosure
What types of disclosures do investors want to judge a firm's cyber-security readiness, and how should a company craft its disclosures to meet those needs without telling hackers exactly where the weak spots are? Part of the answer, say columnists Stephen Davis and Jon Lukomnik, is to look at inputs to decisions rather than outputs. More of their views on tackling cyber-security disclosure are inside.
Published online 08/05/14

Over There: The Globalization of Corp. Governance Regulation
It used to be that U.S. companies could keep up with governance regulation by keeping a watchful eye on the SEC and occasional legislation from Congress. Not anymore. As columnists Stephen Davis and Jon Lukomnik explain, the future of corporate governance law, regulation, and enforcement is being forged as much in Brussels, London, and other distant locales, as it is in Washington, D.C.
Published online 07/01/14