Early thinking in adopting ASC 606

March 2018

SEC filings are showing most companies adopting the new revenue standard using the modified retrospective method. KPMG discusses the implications.

Applicability

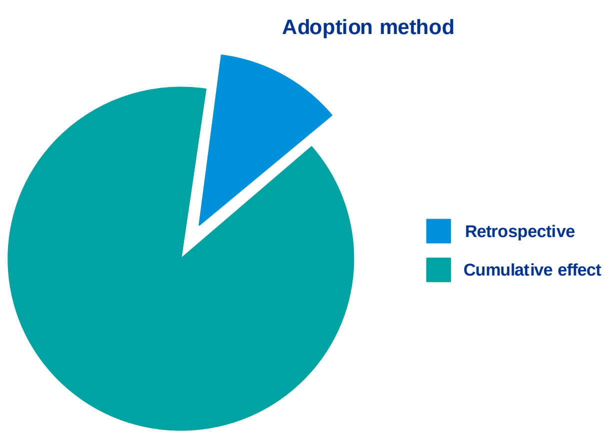
ASC 606, ASC 340-40, and all recently issued ASUs for these topics:

— All companies

Full retrospective or modified retrospective?

With 2017 calendar year-end 10-Ks having now been filed, we have an excellent opportunity to look at how companies are transitioning to the new standard, and to think about the implications for a company's communications and 2018 interim filings.

An overwhelming number of companies elected to adopt using the modified retrospective method (i.e. cumulative effect method) in transitioning to the new standard, which means that comparatives will not be recast. This also means that these companies will need to carry forward their previous revenue accounting into 2018 to comply with the disclosure requirements in the year of adoption.



Based on KPMG's 2017 Accounting Change survey and a review of company filings, it appears that the cumulative effect method was selected for a variety of reasons: it was less expensive, data for the full retrospective method was not easily available, and/or there was insufficient time to implement processes or controls to accommodate full retrospective adoption.

The cumulative effect method was especially popular for companies where the effect of adoption had minimal impact on trends. It's also possible that some companies that expect to file an offering document during 2018 preferred the cumulative effect method because it avoids having to revise earlier historical periods as part of the registration process.

A number of companies have not yet disclosed their planned method of adoption. This may indicate that they are still evaluating the effects of adoption and the best transition method. Companies may also be seeking information about how other companies in their industry are adopting the standard before they conclude. Company management is mindful of not only the time, effort and process needed to perform full retrospective adoption, but also the need to communicate meaningful information about the company's financial and business results. This reporting responsibility is more challenging when the cumulative effect method of adoption is used.

Disclosure considerations for the cumulative effect adopter

Note disclosures

While the cumulative effect method was elected by many companies, it has drawbacks, too. This method leads to the loss of comparability between and among financial statement reporting periods. For this reason, the standard requires a company using the cumulative effect method to disclose, in the year of adoption, the amount by which each affected financial statement line item changes between the application of ASC 606 and the previously effective legacy guidance. Retrospective adopters are not required to make this disclosure. SEC rules require this disclosure for each interim period as well.

For companies using the cumulative effect method, the challenges of retrospective adoption are replaced with the challenge of accounting for revenue from contracts with customers under both ASC 606 and legacy GAAP in the year of adoption.

Companies will need to implement or maintain processes and controls to determine how current period transactions would have been accounted for under legacy guidance – in essence, tracking two methods of accounting during the year of adoption. An explanation of the reasons for significant changes is also required, which will lead many companies to comment on current period results under the two methods.

The intent of these required disclosures is to provide investors and users of the financial statements the means to bridge their understanding of the effect on financial statement trends. However, companies should consider whether these disclosures adequately meet the needs of both the company and its investors. Management may find that it needs to provide additional disclosures in MD&A to convey the effect of the new standard on its financial statement metrics and trends.

MD&A disclosures

Without recasting prior year information in the financial statements, how are comparative periods being presented and discussed in MD&A?

Many companies sought the SEC's approval to disclose in MD&A the effect of the adoption on prior periods even though they were not planning to adopt using the full retrospective method. The SEC staff stated that providing this pro forma information is permissible if certain guidance is followed. For example, a company should disclose the effects on all financial statement line items affected (including expenses), and any assumptions or practical expedients used to develop the pro forma information. Moreover, companies should not provide full pro forma financial statements in MD&A when they are not using the full retrospective method of adoption.

This comparison will allow a company to isolate the effect of adopting the new standard and better communicate its financial and business results compared to prior periods. However, companies may not have quantified the effect of adoption on those prior periods or may not feel confident in disclosing that information without a rigorous process and the controls that would have been employed had the full retrospective method been used. In any event, companies need to consider how best to explain their financial statement changes, considering both accounting and business changes.

Other disclosure considerations

In the year of adoption, the SEC staff expects all annual disclosures prescribed in ASC 606 to be provided in the company's interim financial statements as well. This is true regardless of the method of adoption. Therefore, companies will disclose more about their current period transactions in their interim financial statements in the year of adoption than in interim periods for subsequent years. Companies will need processes and controls to ensure the completeness and accuracy of these disclosures.

Final thoughts

In closing, companies will need to determine how to use the information they have available, whether pro forma MD&A or required legacy GAAP note disclosures, to best tell their story to investors and other users of their financial statements.

More resources

Handbook	Assists you in gaining an in-depth understanding of the new five-step revenue model by answering the questions that we are encountering in practice, providing examples to explain key concepts and highlighting the changes from legacy US GAAP. Chapter 16 dealing with the effective date and transition is particularly relevant: — Section 16.3.90 discusses the specific transition disclosure requirements under the cumulative effect method. — Q&A 16.6.20 asks, Can an SEC registrant using the cumulative effect method of adoption provide disclosures in MD&A about the effect of adoption under a retrospective method?
Illustrative disclosures	We show how one fictitious company has navigated the complexities of the revenue disclosure requirements. It includes examples of both the full retrospective and the cumulative effect methods of adoption.