Executive View

ASC 606 implementation – don't forget internal controls and disclosures

July 24, 2017

With adoption of the new revenue standard underway for most companies, KPMG reports on areas that may be left as low priority – with potentially risky consequences.

Implementation is not just accounting

When implementing the new revenue standard, it is natural to focus on how the new accounting policies affect the financial results. However, a standard as pervasive as this one has impacts much broader than just accounting.

Implementation often requires cross-functional efforts and an evaluation of the entire organization, including but not limited to, IT departments, sales and marketing, compensation plans, investor relations, income taxes and contracting practices. Additionally, internal controls over financial reporting are likely to be affected both in the transition to the standard and in the ongoing reporting of revenue transactions.

As companies have started implementation, we have observed that some important aspects of implementation are often an afterthought until late in the process. But these broader aspects of adoption are often critical to a successful implementation. This includes internal controls over financial reporting and disclosures.

Leaving these items to the end of the process could lead to avoidable surprises during the period of adoption, resulting in additional cost and time required to complete the implementation and embed a sustainable, ongoing process within the organization. Here we discuss how internal controls and disclosures are critical to executing the implementation plan.

New or modified controls required even if financial results are unchanged

The adoption of the standard may impact process level controls for multiple core business processes, IT systems and financial statement disclosures.

Companies need to update accounting policies and related manuals, accounting position papers, process level flowcharts that describe the flow of financial information through the processes and systems, the design of related internal controls, and their processes to assess the effectiveness of internal controls. There may be many new risk points related to the new accounting that will require an internal controls response even if the financial statement change is not significant.

A critical aspect of implementation is to ensure that there are appropriate processes and controls to address the new judgments and estimates required by the standard. Many of the new judgments and estimates aren't required under legacy US GAAP. Therefore, companies may need new information, processes and controls outside of the controllership function, reaching into business and financial planning and analysis activities.

Furthermore, current processes may not function with the precision required to make estimates under the standard, and the existing objectives within those processes may not align with those under the standard. It is also important to consider the complexities and judgments required by the standard, the skill sets available within the company's shared services center and the impact that may have on where the operation of certain processes and controls resides.

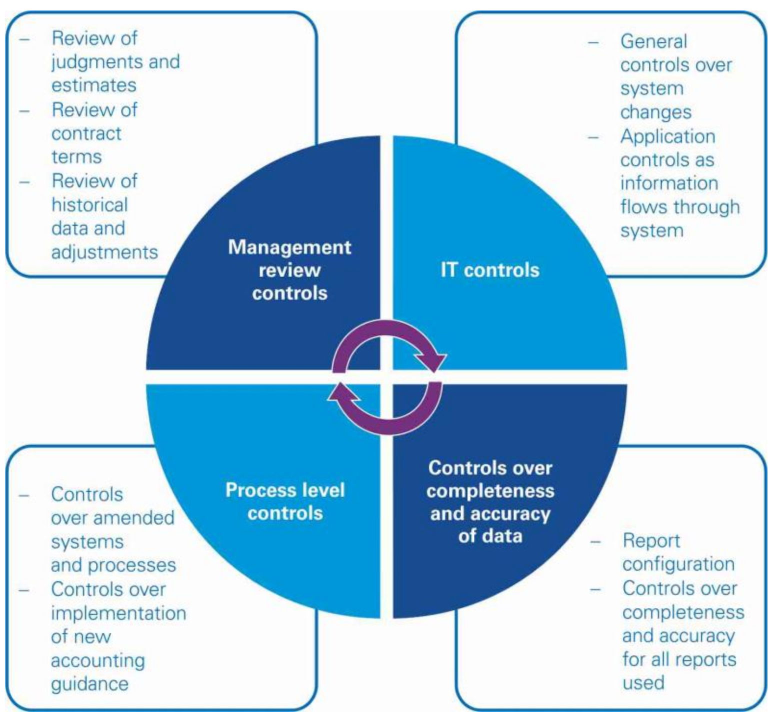
Product returns is an example where the financial reporting outcome may not significantly change, but the existing processes may not align with the objectives under the standard. A company will generally estimate product returns using an expected value (i.e. probability-weighted) method subject to the constraint on variable consideration. In contrast, under legacy US GAAP a company simply made its best estimate with no specified methodology.

Therefore, the current processes and controls around these estimates may not align with the standard. Regardless of the financial impact, the processes and controls may need to change to align with the objectives of the standard. This may also be the case in many other examples (e.g. other forms of variable consideration, warranties and contract existence) where the conclusion is similar to legacy US GAAP but the process needed to make that conclusion under the standard is different.

The standard requires new information for both accounting and disclosure purposes. This information could reside within the sales process, contracting process, legal review process and many other areas outside of traditional accounting and finance. The disclosure requirements may be onerous and require system changes even for companies that may not have significant accounting changes.

Regardless of where the information resides or whether it is captured systemically or manually, internal controls will need to be put in place to ensure the data being captured and generated by reports is complete and accurate.

SEC registrants will need to consider the potential effect of changes in internal controls on management's requirement to make certain quarterly and annual disclosures and certifications about disclosure controls, procedures and internal controls.



One-time controls over transition will need to be established

On transition, a company needs controls over historical contracts and the process to assess historical contracts that will be relevant to applying the chosen transition method. These controls will be different from ongoing controls over the standard because they will be active just once, upon adoption. After adoption, these transition controls may no longer be required.

Because the entry to record the transition to the standard is made to opening retained earnings, controls will need to be established to ensure the accuracy of that number. These adoption and implementation controls will have many components, with many aspects of judgment and information produced by the company. Careful consideration is needed over the design and implementation of these controls.

Companies will be affected by the standard differently depending on their industry. Some revenue arrangements will result in an acceleration of revenue recognition while others will result in a deferral of revenue. Contracts that are in the scope of the standard will need to be reviewed by company personnel and evaluated to determine how to apply the standard to the contract.

Companies should consider the following in adopting and implementing standard.

- Hundreds or thousands of contracts may need to be evaluated.
- There may be questions about which contracts fall under the scope of the standard or are partially in scope.
- A population of contracts that is subject to a transition adjustment (i.e. open contracts) may need to be defined.
- New processes to identify and account for contract modifications on an ongoing basis may need to be developed.

There are also many qualitative factors, both internal and external, that will need to be weighed when considering the relative benefits, costs and complexities of each transition option. For example, many companies rely heavily on IT systems for revenue reporting so they will need to consider the feasibility and costs of making required changes to their IT systems to comply with the selected transition options.

Transition could entail having parallel processes and controls in years during which the company accounts for revenue under both legacy US GAAP and the standard if the company has chosen to transition using the full retrospective approach, and parallel reporting of 2018 disclosures if the cumulative-effect method is chosen. In turn, this might stress the company's control environment and activities because employees will have to apply two separate standards as well as two sets of processes and controls.

Implementation controls over transition require significant judgment. Companies should discuss the types of controls needed as early as possible. These conversations should include a diverse group of people in order to plan how these controls will be performed and determine their related effects.

Significantly expanded disclosure requirements

While companies evaluate new accounting policies and establish processes to recognize and measure revenue, they should not lose sight of the significantly expanded disclosure requirements. Companies should also ensure that the systems, processes and controls being implemented are sufficient to also capture information needed for the new disclosures. In addition, we believe disclosures will be an area of particular focus by investors and regulators.

The standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. The objective of the disclosures is to provide sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Specifically, the standard includes disclosure requirements for:

- disaggregation of revenue;
- contract balances, including changes during the period;
- performance obligations;
- significant judgments; and
- assets recognized to obtain or fulfill a contract, including changes during the period.

One challenging area is the requirement to disaggregate revenue into categories that depict how the nature, amount, timing and uncertainty of the revenue and cash flows are affected by economic factors. Companies will need to apply significant judgment to determine the level and amount of disaggregation, which would include but is not limited to information provided to analysts, disclosed on earnings calls or included in MD&A and information used by management or others to evaluate performance and allocate resources. In addition to the judgments required to determine the appropriate level of disaggregation, systems and processes will need to be in place to extract the data at the appropriate level.

Another challenging area is the disclosure of the transaction price allocated to the remaining performance obligations. Companies with long-term contracts not only need to determine the revenue recognized for a particular contract during a reporting period, but they also need to disclose the remaining amount of revenue to be recognized for that contract as well as the amount of revenue recognized in the current period that is attributable to performance completed in previous periods.

— Under legacy US GAAP, when a company entered into a contract near period end but the amount of performance was not significant, it may not have focused its time and effort on the accounting for that contract. The accounting did not have a significant effect on results of that fiscal year and there was no financial statement disclosure requirement.
— Under the standard, because the company needs to disclose the transaction price associated with that performance obligation, a full analysis of the accounting for that contract will be required. While this disclosure is often referred to as backlog, it will likely differ from the bookings or backlog disclosures many companies make under SEC regulations. If the SEC requirements remain unchanged, companies may need to understand the difference in requirements for these disclosures in order to explain the difference to investors.

KPMG observation

Best practice includes preparing a mock disclosure before the effective date.

This will help companies evaluate whether they:

— meet the overall disclosure objective of the standard; and
— have the appropriate processes and systems in place to extract the information needed for the disclosures.

SEC continues to focus on SAB 74 disclosures

SEC guidance requires registrants to disclose the potential effects that recently issued accounting standards will have on their financial statements when adopted. The SEC expects the level and specificity of these transition disclosures to increase as registrants progress in their implementation plans. The SEC has also stated, when the effect is not known or reasonably estimated, that a registrant should describe its progress in implementing ASC 606 and the significant implementation matters that it still needs to address.

SEC Staff Accounting Bulletin No. 74 (SAB 74), which is codified in SAB Topic 11.M, requires an SEC registrant to disclose the potential effects that recently issued accounting standards may have on the financial statements when the standards are adopted.

The objectives of the disclosure are to:

— notify the reader that a standard has been issued that the registrant will be required to adopt in the future; and
— assist the reader in assessing the significance of the effect that the standard will have on the registrant's financial statements when adopted.

Therefore, for reporting periods after the issuance of ASU 2014-09 (introducing ASC 606) but before it is adopted, a registrant's disclosures should include the following:

— a brief description of ASC 606;
— the date that adoption is required and the date that the registrant plans to adopt, if earlier;
— a discussion of the methods of adoption allowed by the standard and the method the registrant expects to use, if determined;
— a discussion of the effect that adoption of the standard is expected to have on the registrant's financial statements, unless not known or reasonably estimable. In that case, a statement to that effect may be made; and
— the potential effect of other significant matters that the registrant believes may result from the adoption of the standard is encouraged – e.g. technical violations of debt covenant agreements, planned or intended changes in business practices.

The SEC staff announced that, consistent with SAB 74, when the effect of a standard is not known or reasonably estimable, a registrant should consider additional qualitative disclosures to assist financial statement users in determining the significance of the effect that the standard will have on the financial statements when adopted. The SEC staff expects disclosures to include:

- a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison with the current accounting policies; and
- the registrant's progress in implementing the standards and the significant implementation matters that it still needs to address.

The purpose of these disclosures is to ensure financial statement users understand the significance of the effect that the standard is expected to have on the company's financial statements, as well as a clear timeline of the registrant's expected implementation of the standard.

Registrants will exercise judgment when determining the nature, extent and location of the SAB 74 disclosure, and it is generally not necessary to provide duplicative disclosures in the MD&A and notes of financial statements.

- If the change in accounting is deemed by the registrant to be pervasive or material to the overall financial statements, that may indicate that the SAB 74 disclosure in the notes to the financial statements is required, regardless of whether the transition method is retrospective.
- If the registrant expects the adoption of the standard to have a significant, but not pervasive, effect on its financial statements, there is more flexibility in the location of the SAB 74 disclosures.

In addition, at the December 2016 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff stressed the importance of transition disclosures to investors. The SEC staff expects to issue comments on materially deficient disclosures in its review of filings. Registrants should avoid boilerplate transition disclosures and provide investors with useful information about adoption and implementation efforts.

Reminder on effective dates

	Annual reporting periods after
Public business entities and not-for-profit entities that are conduit bond obligors	**December 15, 2017 including interim reporting periods within that reporting period.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
All other entities, including SEC registrants that are Emerging Growth Companies	**December 15, 2018 and interim reporting periods within annual reporting periods beginning after December 15, 2019.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period or interim reporting periods within the annual period subsequent to the initial application.

KPMG Financial Reporting View

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FRV focuses on major standards (including revenue recognition, leases and financial instruments) – and also covers existing US GAAP, IFRS, SEC matters, broad transactions and more.

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Insights for financial reporting professionals

Here are some of our resources dealing with revenue recognition under the standard.	
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.
Issues In-Depth	Provides you with an in-depth analysis of the standard under both US GAAP and IFRS, and highlights the key differences in application of the standard. Additionally, chapter 14 provides implementation considerations.
Illustrative disclosures	We show how one fictitious company has navigated the complexities of the revenue disclosure requirements.
Transition options	Assists you in identifying the optimal transition method.
Industry guidance	Including franchisors, real estate, engineering and construction, aerospace and defense, freight and logistics, software and SaaS, healthcare, manufacturers and consumer products.

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