Too Hot to Handle: Implementing Two Significant Accounting Standards at the Same Time

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Abstract

Companies will face the historic challenge of implementing two major changes in the United States' Generally Accepted Accounting Principles (GAAP) in more than 50 years Revenue Recognition, and Accounting for Leases. Due to the delay of the Revenue Recognition's effective period for publicly traded companies and as of this writing, the forthcoming approval and issuance of the new lease standard, companies will have to rally internal and external resources to address an unprecedented transformation of accounting policies, business practices, accounting systems, training, and overall processes to effectively implement these two standards. We have integrated discussions with interviewed professionals and the FASB/IASB Joint Transition Group for Revenue Recognition's (TRG) guidelines on developing an implementation plan for revenue recognition. Specifically, all suggest a systematic planning and implementing approach for a new major standard such as revenue recognition. The essential elements of any plan are outlined with commentaries from the professionals we interviewed.

Keywords: revenue recognition, accounting for new lease standard, implementation plan, transformation of accounting policies

1.1 Introduction

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their converged Revenue Recognition standard ASC 606 (Accounting Standards Update No. 2014-09) on May 28, 2014, and by July 9, 2015, the FASB issued a delay (Accounting Standards Update No. 2015-14) approximately 18 months before the original 2016 effective date for publicly traded companies. The reason for the delay in the effective date for the Revenue Recognition was primarily due to companies beginning to recognize the enormous impact the implementation of this new standard would have on their organization's reporting. This was before companies could anticipate the issuance of the new lease standard, which has gone through a long series of development processes between FASB and IASB that would overlap with the effective period of revenue recognition. The FASB has worked diligently with accounting firms and stakeholders through the FASB/IASB Joint Transition Group for Revenue Recognition (TRG) to offer advice, ideas, and facilitate discussions regarding implementation issues or unique challenges that will not be covered by rules-based guidance in the future.

Likewise, the FASB has encouraged firms, along with various professional organizations, to not wait on the approval of the new lease standard that was issued on February 25, 2016 (Accounting Standards Update No. 2016-02). As early as 2012, consulting firms and professional organizations were issuing white papers and articles encouraging companies to launch an inventory of their leasing contracts to begin the intensive process for evaluation of the terms and conditions that will generally lead to classification of all or most leases as capital. At the moment, FASB and SEC both disclose their concerns regarding the new standard setting and its further application. FASB intends to slow down these two accounting standards due to the potential implementation issue for the firms even-though a transition group was created to provide insights. From an SEC standpoint, how to ensure these two new standards are implemented correctly remains a top concern. These concerns are not only from the external regulation perspective but also from the internal control standpoint for every individual company that will adopt the new principles. Based on the articles that we have reviewed on major business websites, most of them express the same concerns as SEC and FASB disclosed previously. CCH Daily mentions "Changes to revenue recognition rules simply make accounting more complicated", while Accounting Today discloses that most companies have not completed their assessment based on their survey.

According to a recent article in Accounting WEB, newly appointed SEC Chief Accountant Wesley Bricker points out that "Internal controls will be vital in implementing the new Financial Accounting Standards Board rules, which are designed to improve comparability of companies' reported revenues." The key to successfully implementing the new accounting standard is to perform assessment as early as they can before it is officially adopted, however, it is not an easy process. According to a recent article in the *Wall Street Journal* (Murphy 2016), there are more than half a trillion dollars in leases currently classified as operating leases, which will affect financial statements of thousands of U.S.-based firms. Lessees fear the consequences of the potential adverse impact of the transformation from classifying operating leases to a capital lease could have on key financial ratios. Both lessees and creditors have expressed their respective concerns over the impact of the new leasing standard on the access to capital due to current requirements stated in loan covenants. Access to capital may be even more profound since the new lease standard will require all leases to be included on the balance sheet, ushering in a new era of transparency for investors with the cost to companies to be measured for years to come.

Another major challenge is the lack of clarity regarding the coordination of external party's collaboration with the implementation of these two major changes in accounting treatment. One of the key challenges is for corporations that operate in multiple states who will mediate the interpretation of revenue recognition if the performance obligation is now viewed to occur outside of the tax jurisdiction? Will the respective state-taxing authorities accept the new translation and interpretation? This is more than a mere timing difference; rather, it is a jurisdictional revenue classification issue. External collaboration and coordination are justifiably as important for the implementation of the new lease standard changes. The advent of technology presented a new opportunity for external auditors to enhance audit efficiency with the implementation of electronic bank account confirmations. Yet, it was essential to have the support of the regulatory bodies such as the ASB and PCAOB along with the American Bankers Association (Fox, White Paper, n.d.). Will the ABA advocate to banks to implement changes in the application of loan covenants to consider the impact of the new leasing standard? Today's digital global economy has presented considerable market survival challenges for many industries, consuming C-suite's strategic energy, leaving very little time to focus on regulatory matters such as the forthcoming two accounting standards. The timing of these two standards mandated for implementation is not ideal for the current state of corporate affairs especially for publicly traded companies whose shareholders care for dividends, P/E and EPS and less about accounting standards. Let us think about it. These standards have supported the economy since the 1970s; thus, this is what the Baby Boomers, Generation X, and Millennials know. Chief financial officers understand the reasons for these changes primarily to enhance financial reporting to stakeholders. However, in light of the spectrum of structural challenges each organization is facing in the dynamic marketplace, it is hard to rally executive support per various surveys such as the one from Deloitte (DiLeo and Knachel 2016).

The majority of C-level executives that responded to the surveys did not support the new lease standard, did not drive their organization to prepare in advance, and did not offer any indication that they would be in compliance upon the effective date. Organizations similar to individuals; often like to procrastinate when it comes to doing anything that is important until we just have to, which is often a just-in-time effort. Imagine the challenge for these organizations when they have to implement an unprecedented change in their accounting treatments, which will have a critical impact on their financial statements, ratios, potential access to capital, and treatment in the capital markets. Who would rush to this party? We have read the spectrum of accounting firms, publishers, regulatory bodies, and other affiliated sources regarding the challenges forthcoming for implementing revenue recognition. We wanted to gather more primary information thus we met with partners from international accounting firms in audit and tax, a research fellow from a major research foundation, and a director of financial reporting for a division of a Fortune 50 company to discuss their insights, opinions, and observations regarding their clients and respective organization's readiness. Overall, the professionals we interviewed believed that their clients or company was not prepared nor were these enterprises investing as they should in the internal and external resources in advance as recommended by regulators and accounting firms. The professionals strongly believed that their clients or organization were waiting until the year of the effective date for Revenue Recognition in 2018 (DiLeo and Knachel 2016), and will do the same for leases 2019 effective date (David and Josh 2015) before they initiate any significant implementation activities. The professionals strongly believed that due to other pressing demands for resources from financial, capital, and human resources that it will be very challenging for companies to devote, direct and allocate sufficient resources as required in a timely manner to implement these two standards simultaneously me specially small to medium-sized enterprises.

We have integrated discussions with the interviewed professionals to further discuss the issues and challenges surrounding this unique phenomenon. Specifically, the major accounting firms' transition guides, along with the TRG, all suggest a systematic planning and implementing approach for a new major standard such as revenue recognition. The essential elements of any plan are outlined below with commentaries from the professionals we interviewed.

1.2 Developing a Plan

A key first step is to develop an implementation plan, which must include pre-effective date steps, effective date steps such as first year of an audit, and post implementation steps. This planning stage should be where all firms are presently operating, but according to 2015 PwC-FERF Revenue Recognition Survey results, "Many companies do not yet have a complete understanding of how the standard will affect their organizations. A majority (75%) of respondents has not yet completed their initial impact assessment, and almost 27% of respondents have not begun an assessment." A director of financial reporting from a Fortune 50 company noted that their financial team across the company met shortly after the issuance of the new revenue recognition standard in May 2014 and determined that because of the lack of internal resources they needed external assistance from a consulting firm to assist with planning and implementation processes . However, several of the smaller to mid-size public companies and many of the private companies do not possess the financial resources or network to secure such services in a timely manner. The overall challenge for developing an implementation plan even with the significant guidance available is the coordination of the resources. Per the AICPA (2016) and consultants from Big 4 (DiLeo and Knachel 2014; *PwC* 2014), the implementation plan must be comprehensive and consider human resources, accounting policies and procedures, accounting systems, contracts and legal aspects in general, training, customer agreements, sales, marketing, information technology, along with jurisdictional tax issues. The collaboration and coordination of accomplishing key project milestones with a diverse group ranging from Finance to HR to IT to Legal to Marketing to Risk Management, and possibly more is a major challenge to seek to integrate into one cohesive and achievable plan with limited resources, especially time. All of this has to be accomplished while executing the normal day-to-day roles and responsibilities of the firm's business affairs. All of our professionals noted that this reminded them of the post-SOX era, and how demanding it was on talent retention due to the stressful long hours operating under very tight deadlines.

When the PCAOB proposed the addition of the Auditor Discussion & Analysis section, the major firms and several companies opposed the idea for various reasons particularly the adverse impact to their already tight schedule to complete fieldwork to issue a report within the SEC's filing deadlines for publicly traded companies (Glover and Reidenbach 2012). The lease standard was just issued; thus, firms and companies will have to begin the same discussion and planning process that is place for Revenue Recognition. It is difficult to imagine that as the SEC noted in their 2012 Final Report (U.S. Securities and Exchange Commission 2012), the costly impact of adopting IFRS was unjustifiable for US enterprises; yet, the implementation of these standards within the same period essentially is a mini-adoption or convergence effort that will be painful for many companies as well as present a major challenge for internal and external auditors. "Will there be sufficient talent to sustain the enormous effort required as described by the TRG for implementing revenue recognition, and an expected similar level of effort required to implement the new leasing standard?" Talent acquisition is one of the top issues for accounting firms and for the accounting profession overall (AICPA, 2016). During a recent training session for the finance team for a Fortune 500 corporation, the corporate controller noted that in the midst of their global challenges, drastic shifts in their consumer behavior consumption patterns and their ongoing technology integration efforts—"there are virtually no excess resources to even begin to consider these two new standards and frankly will not begin a focus until the CFO mandates the investment which is not expected to be in a proactive manner"

1.3 Plan Execution

Once a comprehensive plan is developed, the implementation journey begins. Akin to Sarbanes-Oxley, there were no precedents. This required significant judgment between management, auditors and regulators for resource allocation and policy development. Likewise, the implementation of the plan for Revenue Recognition will require significant judgment on defining elements such as the performance obligations. Software providers (Robert 2015), accounting firms, and professional associations are urging companies to launch an implementation plan early enough to integrate the two required standards into their business systems.

Revenue Recognition standard will require different processes to occur from defining performance obligations, attaching variable consideration to each, and then measuring the fair value of the event to record a revenue entry. Likewise, because of Accounting for Leases standard most financial leasing transactions will now result in the recording of an asset and a liability, and establishing the related amortization and expense recognition entries.

For companies that deploy very complex organizational arrangements these two new standards could adversely impact their business models, or present key challenges for implementation due to their overlap in some cases. Changes to software and business system designs need sufficient planning and internal collaboration to ensure compliance, efficiency, and alignment with the organization's operational policies and procedures. Accounting firms along with corporations all note that talent acquisition and retention efforts are their number one issue. One of the partners noted that this would place a major strain on an already tight employment market for the pipeline of auditors and corporate financial reporting professionals. SEC's Commissioner, Mary Jo White, stated in her keynote address at the 2015 AICPA National Conference, "I have growing concerns about the amount of work required of some audit committees. The increasing workload may dilute an audit committee's ability to focus on its core responsibilities…" (U.S. Securities and Exchange Commission 2015). What would this time period for back-to-back implementation of these two standards do to audit committees? Furthermore, recent reports noted that since Sarbanes-Oxley, the demands for CFOs—who now have to sign off along with the CEO on the financial statements—are becoming harder to fill their positions.

1.4 Theory/calculations

One of the most complicated steps in the process of applying the new Revenue Recognition standard is considered to be the *identification of performance obligations,* which is where a lot of attention has been placed. TRG issues deal a lot with this step. Another difficult part is that there is so much *estimation almost in every step* of the calculations. The Revenue Recognition standard will require management to estimate for allocating the price and calculating the revenue to be recognized. This will require significant review by auditors, both internally and externally, along with the SEC's examination division during the initial transition. Similar companies may apply the new principles-based standard differently, which could lead to unintended consequences i.e., the global uniformity that FASB and IASB sought in this initiative.

Similar challenges lie ahead for the implementation of leases, which historically allowed for considerable options for classification and placement on the balance sheet. While there will be less judgment than the current accounting treatment, the initial transition will present significant challenges. Contracts may be rewritten if not terminated due to the lack of affordability, or other financing options may be sought. This will require management, including the board of directors, to review their overall business strategy; particularly in industries where historically they have been allowed to finance the use of assets as off-balance sheet transactions.

1.5 Discussion

1.5.1 Other Key Implementation Issues

This article would be remiss if there was no discussion of the almost 25 million privately held companies (U.S. Census Bureau; Doidge, Karolyi and Stulz 2015), 99% of which are small enterprises (U.S. Small Business Association 2012). More than for SC Johnson Wax & Company or Bechtel Engineering or Koch Industries, all of which are multi-billion dollar enterprises and operate in substances with the transparency in financial reporting as their publicly traded peers, our concern is about those small enterprises, many of which have complex organizations with joint ventures, comprehensive customer contract-based transactions, and highly regulated activities. These organizations do not have the human resources, financial capital, corporate knowledge, and overall wherewithal to launch implementation of these two standards. Yes, the Private Company Council, of which one of the authors sat on the Blue Ribbon Panel that led to its creation, will provide some relief but the significant challenges will still remain.

The professionals we interviewed all noted that peak market demands for professionals place an amazing strain on their resources. Talent retention will become a bigger challenge when normal staff utilization of 75% to 80% becomes in effect more than 100%. This leads to burnout and potential changes in profession. Implementation of both new accounting standards will have significant impact on policies, procedures, contracts and business systems.

While this will be an economic boost for the professional service firms, it will also place a heavy burden on their human resource capital. Once the effective periods for these two standards are active, the market will not support any delays; thus, the “show must go on”.

1.6 Conclusion

Theoretically, all well thought out plans should have a post-evaluation period. However, due to the circumstances noted such as talent shortages, knowledge shortage, and overall constraints on organizational resources, including the audit committee and external auditors will there be an opportunity to effectively evaluate the success of the implementation of the two standards. The FASB and IASB will have to probably commission studies to determine whether the intended outcomes were achieved, and what if any unintended consequences occurred during the process.

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