The Great Accounting Challenge

KPMG's 2016 Accounting Change Survey

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Responding to revenue recognition and lease accounting changes

The task ahead is huge.

In KPMG LLP's (KPMG) survey, 80 percent of the respondents admit they are still assessing the impact of the new revenue recognition standard or, in some cases, have not yet begun their assessment. While a thorough assessment effort positions companies for a more effective design and implementation process, time is running short. Companies that are not able to wrap up their assessment in the near future may find themselves challenged to design and implement process and system changes before the effective date. These companies will be forced to rely on manual processes and manual controls when they "go live," delaying the introduction of new systems or other automated processes until sometime after the effective date.

Other key survey findings include the following:

- Many companies expect to implement a new software solution or other changes to existing systems;
- A large number of respondents stated they plan to address existing manual processes or other operational deficiencies as part of their implementation process;
- Most respondents are estimating that the total cost of implementation will be less than $1 million; however, as companies complete their assessment activities and begin designing and implementing a solution, cost estimates will likely increase; and
- 63 percent of respondents have not involved their tax professionals in their assessment or implementation activities; this is concerning as we believe tax is an area that will require attention.

Our survey also addresses progress made in evaluating and implementing the new leases standard. This standard was only issued a few months ago, and companies have an extra year for implementation (as compared to the revenue standard). However, our survey includes some preliminary signs that companies may be at risk of falling behind on that effort as well.

KPMG's 2016 Accounting Change Survey Results

The financial reporting community is grappling with two new accounting standards that are expected to have significant impacts on many companies. Implementing these new standards poses operational and financial challenges for many companies. In order to gain a greater understanding of where companies stand in this process, KPMG recently surveyed more than 140 companies (most of which are public), representing all major industries. Almost 80 percent of respondents had revenue of $1 billion or more. We hope the findings will provide valuable insights that can help your company as you work towards implementing these new standards.

Background

In 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued a new revenue recognition standard; the FASB has issued several amendments to the standard to clarify and interpret the requirements, culminating with amendments issued in the spring of 2016. The effective date is January 1, 2018, for calendar-year public companies and one year later for nonpublic companies. This new standard incorporates a single, principles-based accounting model for revenue recognition and disclosures. As a result, many companies are encountering significant changes to their historical revenue recognition policies.

As if revenue recognition did not present enough of a challenge for the financial reporting community, in February 2016, the FASB issued new rules on lease accounting, which have the effect of moving most operating leases onto a company's balance sheet. The new leasing rules take effect on January 1, 2019, for calendar-year public companies and one year later for nonpublic companies. Since most large companies have thousands of operating leases spread across numerous geographic locations, simply identifying these leases is likely to be a huge undertaking. These leases will then need to be abstracted, analyzed, entered into a lease accounting system, validated, and monitored through the lease term as they are accounted for on a company's balance sheet.

Revenue Recognition

Explore

- Implementation status
- Systems changes
- Operational challenges
- Implementation costs
- Business impacts
- Retrospective vs. cumulative adoption
- Tax implications

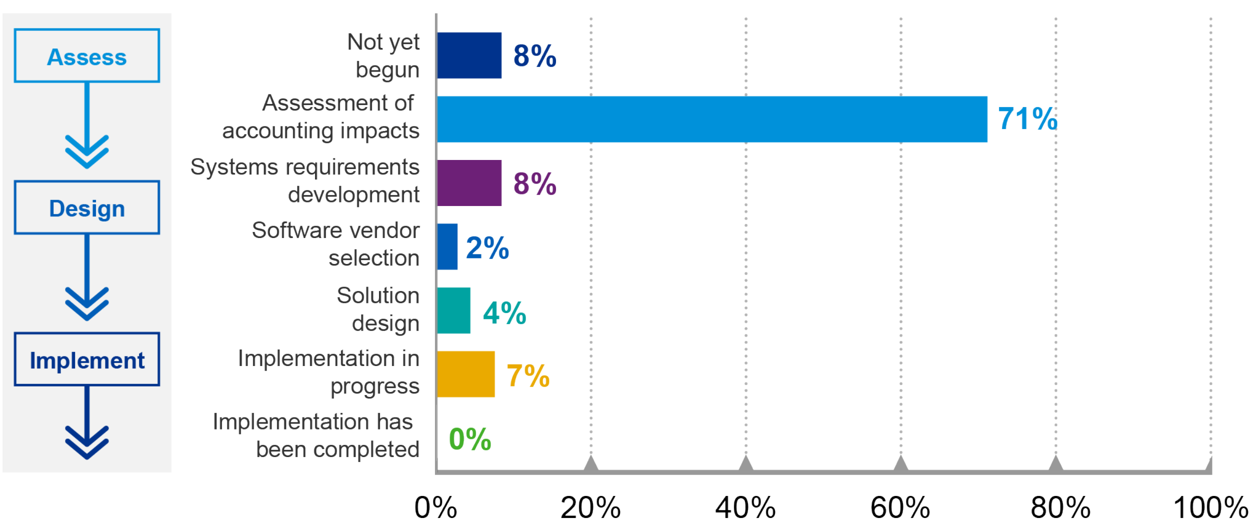
Many companies appear to be "stuck" in assessment activities

Almost 80 percent of the public companies in our survey have not yet made it beyond the assessment phase.

This comes on the heels of surveys conducted in the fall of 2015, which indicated that companies were already starting to fall behind in their implementation efforts. Considering similar concerns expressed by U.S. regulators[1], it would appear that many companies are struggling to complete their assessment activities. Making matters even more disturbing, additional information we have collected indicates that most of the companies in the assessment phase are just in the beginning of that process.

What will this mean with regard to these companies' ability to comply with the new standard? Time will tell. However, it is becoming increasingly evident that some companies will be forced to implement the standard using manual processes and controls without the ability to introduce system changes until sometime after the effective date. As reliance on manual processes increases, companies will be faced with heightened risk of errors, increased costs, and less efficient operations. In summary, these companies may be forced to reduce their implementation effort to an accounting "compliance" exercise, foregoing the opportunity to be strategic in how they operationalize the new rules and address other impacts on their business.

Status of revenue recognition implementation – Public companies

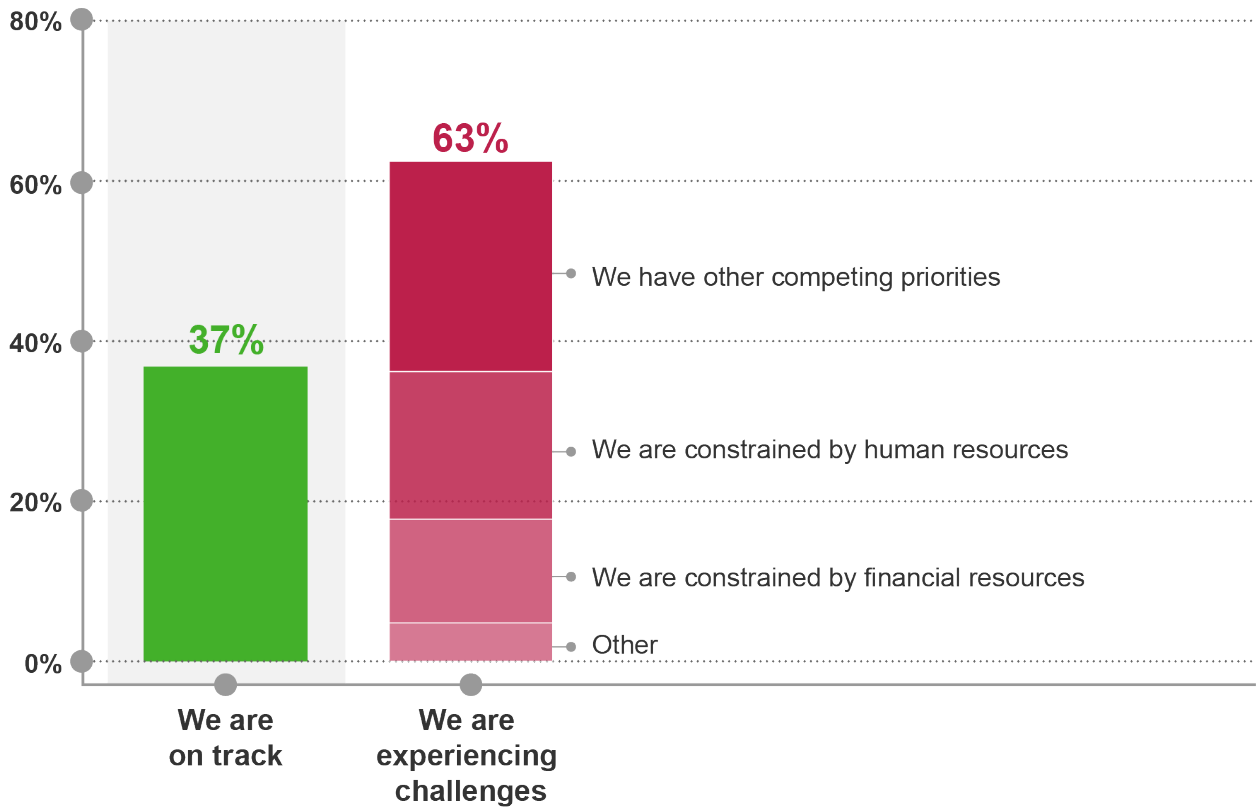


[1] *James V. Schnurr, Chief Accountant, Office of the Chief Accountant of the SEC, stated in March 2016 that "implementation efforts appear to be lagging at many companies."*

Based on our survey, more than 60 percent of respondents admitted that they are behind schedule.

Companies indicated that they were not meeting their goals because they had competing priorities, were restrained by manpower, and/or faced financial limitations. These findings are consistent with what we have heard in the marketplace.

Challenges in completing revenue recognition implementation



Companies expect to make system changes

Many respondents to our survey are expecting to implement new systems, or to change existing systems, in order to “operationalize” the new standard and/or automate parts of their revenue process that are currently handled manually.

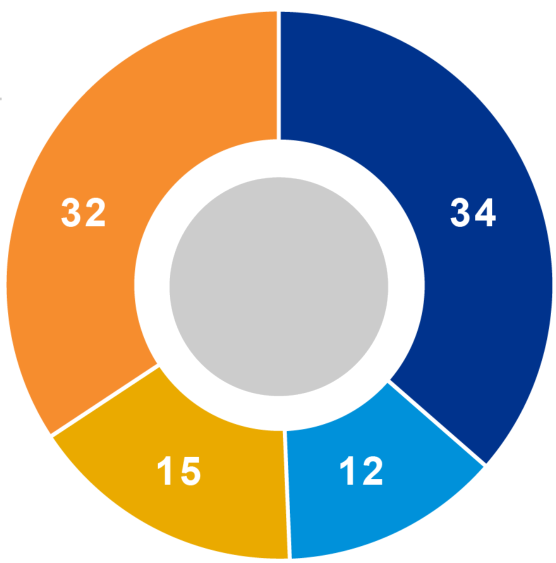
In our survey, approximately one-third of the respondents are not currently sure whether they will or will not need to implement system changes. For the remainder of the respondents, approximately half stated that they are expecting to implement changes to their existing systems or to implement new systems, while the other half believe such changes are not necessary. Implementing systems, including configuration of the software, can easily require between 9 and 12 months. Companies expecting to make these types of changes should work hard to wrap up their assessment and complete their design activities, including the selection of a software package, as soon as possible, so they can begin that implementation process.

Changes to revenue accounting systems

Note: Refers to number of respondents

No system changes are planned.

- We will utilize existing processes and systems.
- We will handle required changes manually or via Excel®.



System changes are planned

- We will be implementing changes to existing systems.
- We will be implementing a new software solution.

Addressing pre-existing operational challenges

We asked the survey participants whether existing manual processes will be addressed as part of implementing the new revenue standard. Of the three-quarters of participants who had made the determination, 49 percent of them stated that they planned to address manual accounting processes or other operational deficiencies as part of their implementation process. This is a laudable goal. However, companies that are behind in their implementation efforts may soon realize they are running out of time and therefore no longer have the luxury of addressing these pre-existing operational challenges.

Some companies may soon realize they are running out of time to address pre-existing operational challenges.

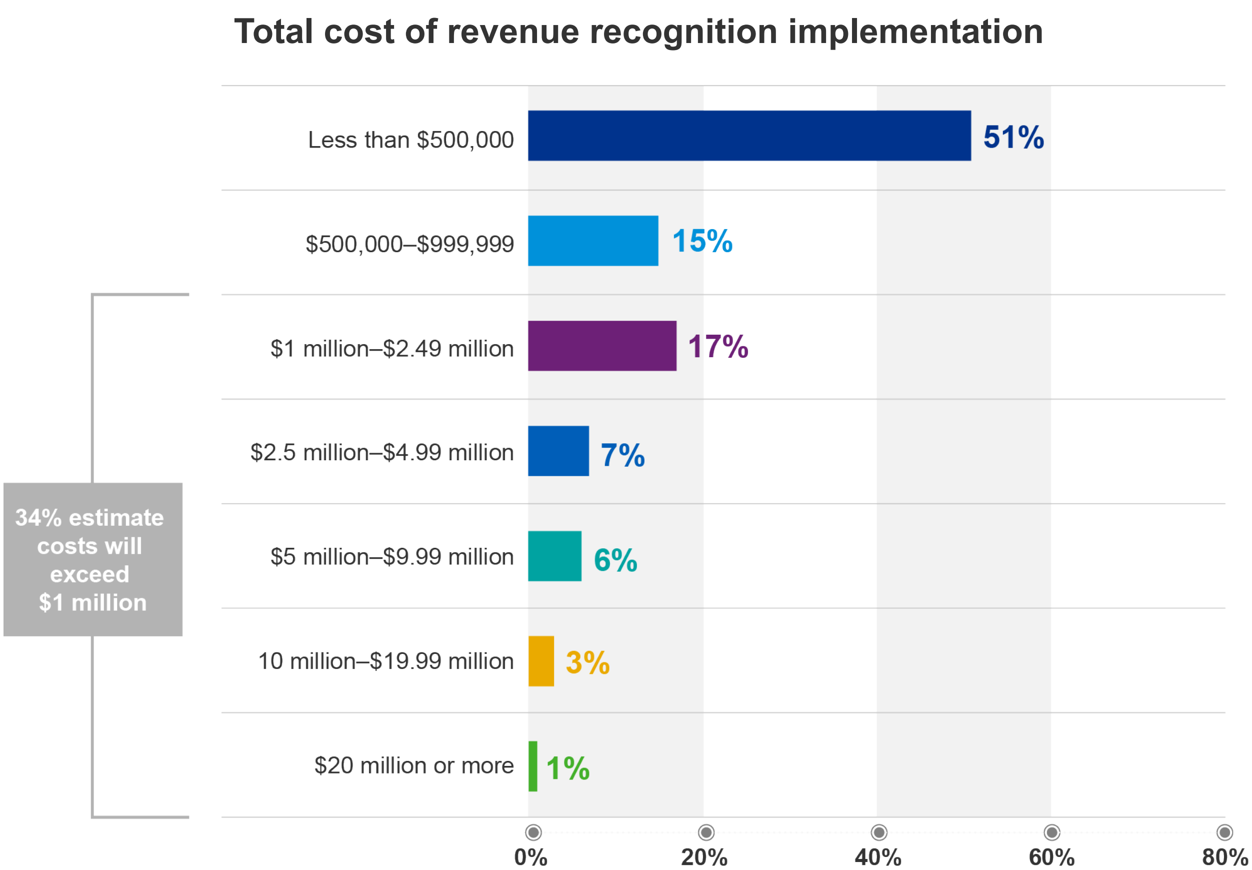
Revenue recognition software packages

When asked which revenue recognition automation software their companies were considering to address the new rules, almost one-third said they were not planning to use automation software and another one-third said they were not sure. For the remainder, SAP® was most commonly cited, followed by RevPro, in-house software, RevStream, and Oracle®.

The implementation effort is potentially costly

Companies should consider whether they have set aside enough in their budget to cover the cost of completing the implementation.

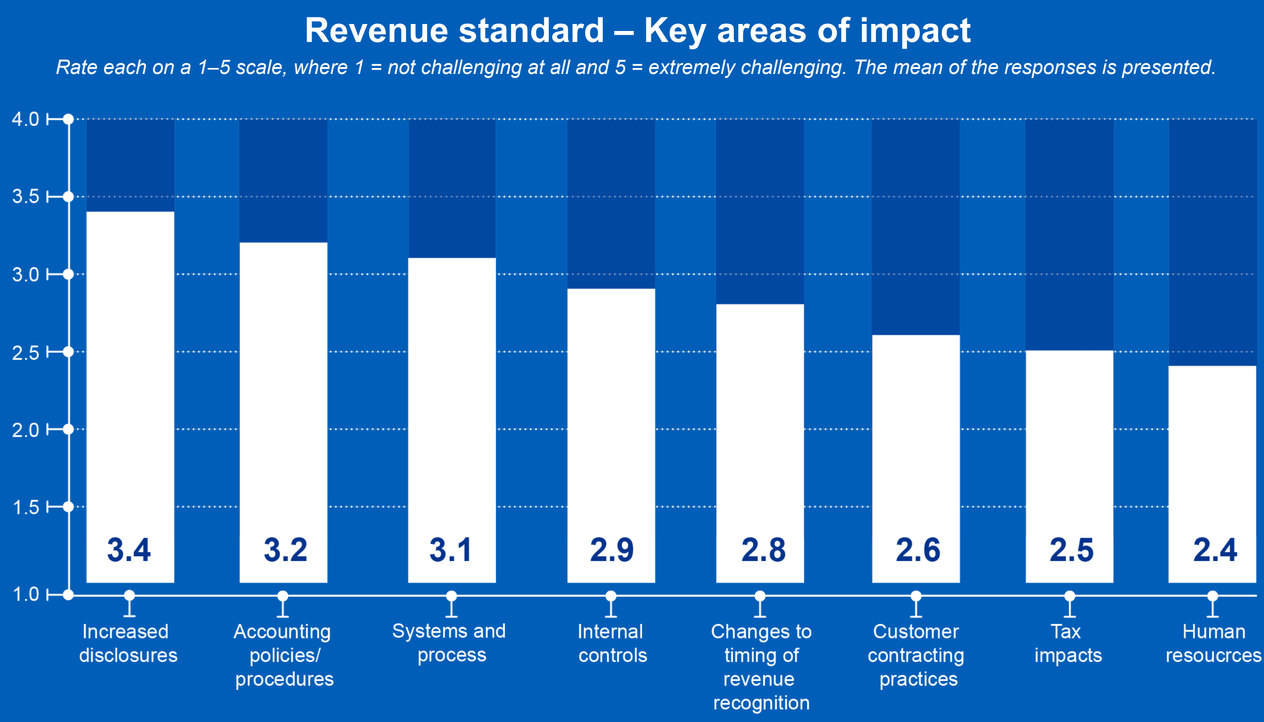
For those with relatively significant accounting changes, the cost of both internal and external resources can be substantial. In our survey, the majority of respondents were able to provide a cost estimate, and 34 percent of those believe that the total cost will be in excess of $1 million. Given that many companies are currently only in the early parts of their assessment phase, cost estimates may increase substantially as companies gain better insight into compliance requirements.



Companies expect many areas of their business to be affected

The requirement for increased disclosures was identified as the area of greatest impact.

This is not surprising, given the dramatic increase in revenue-related disclosures the new standard requires, and the fact that even companies whose revenue recognition is not expected to significantly change will still need to make process and system changes to support these new disclosure requirements.



It is also not unexpected that systems and process were included in the top three areas where respondents see the most impact, and that internal controls, which are often integrally related to systems and processes, were also expected to be significantly impacted. The fact that so many respondents believe systems and process will be affected is concerning given that most companies are still in their assessment phase and have yet to start designing or implementing system or process changes.

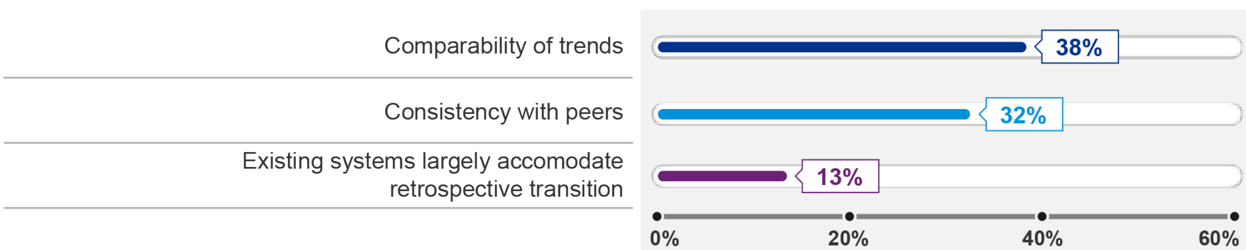
Companies are considering retrospective transition, but concerns about feasibility remain

Survey respondents were not asked about whether they had made a decision concerning which transition method they would follow, but rather we focused on what factors were leading them to consider each transition method.

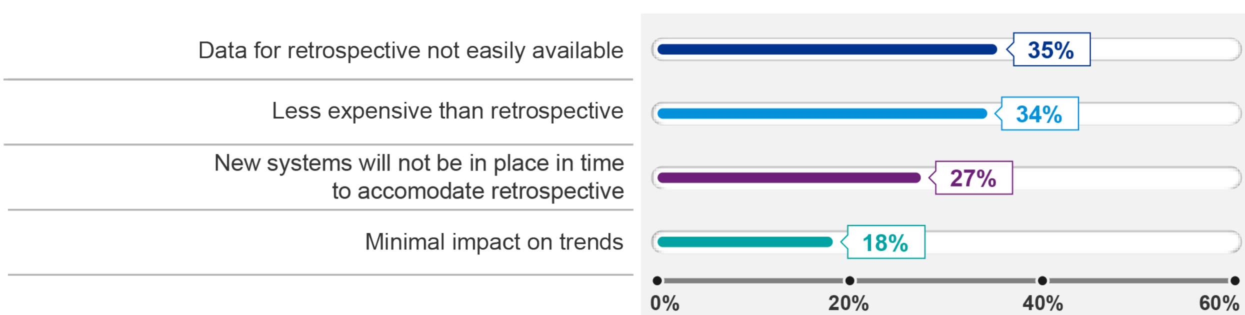
Consistent with the survey results, in practice, we are seeing that many companies that are considering adopting the standard retrospectively are doing so out of a desire to maintain trends or comparability with peers.

However, the reasons companies were thinking about following a cumulative effect transition method were somewhat surprising. The top three reasons companies were considering cumulative effect adoption all related to concerns over the feasibility of retrospective adoption. Respondents are concerned about the availability of data for retrospective adoption, the cost of retrospective adoption, and whether new systems needed to accommodate that transition method would be in place in time. It is not surprising, therefore, that the majority of respondents to our survey indicated they are still considering both retrospective and cumulative effect transition methods.

Key drivers of retrospective adoption



Key drivers of cumulative effect adoption



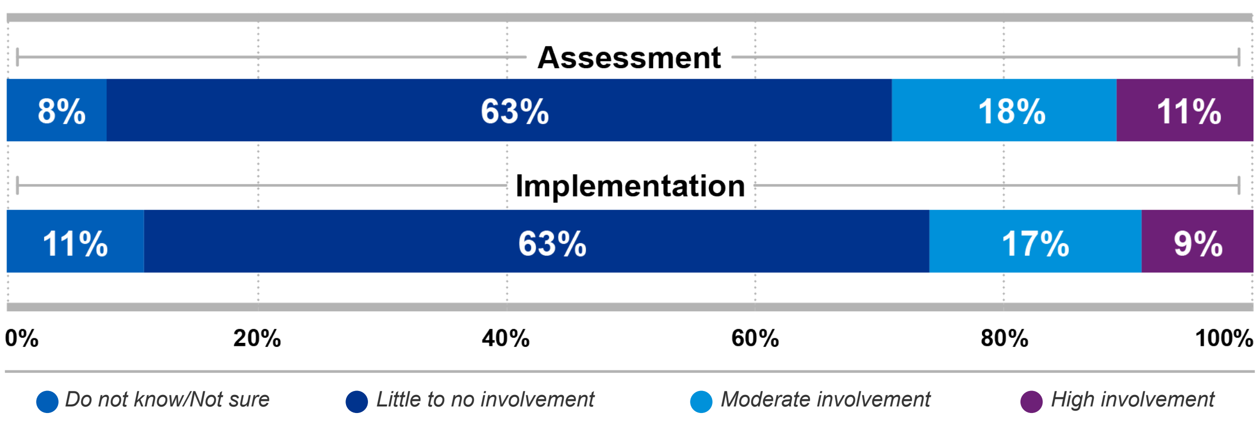
Companies may be underestimating tax issues

Only 29 percent of companies said that their tax professionals were involved in the assessment phase and only 26 percent were involved in the implementation phase of the revenue recognition rules. The lack of involvement of tax professionals poses a potential problem since the new revenue recognition rules are likely to impact many areas of tax. You should consider how these areas may be affected:

- Existing tax compliance processes
- Taxable income
- Accounting for income taxes (ASC 740)
- Tax accounting method changes
- Other areas of tax, including transfer pricing.

In addition, for federal income tax purposes, it is common for an organization to use one or more tax methods of accounting that approximate, or rely heavily on, the revenue recognition policies and methods used for financial reporting purposes. Thus, changes to the underlying financial accounting methods, processes, data, and information technology systems used to support such methods will require a careful evaluation of the impacts to tax accounting positions, policies, and calculations.Therefore, it is important to include tax professionals into the assessment and implementation discussions to help ensure that the tax compliance and reporting needs are identified and evaluated and that any necessary changes to tax, processes, and systems are made in a timely fashion.

Tax involvement in revenue recognition implementation



A call to action

The deadline for adopting the new revenue recognition rules is quickly approaching.

Boards of directors, particularly their audit committees, are expecting management to have a clear plan for implementation and to be seeing tangible progress. If you have resource constraints or competing priorities, now is the time to secure an outside advisor to assist and to establish a dedicated team to drive your implementation effort. If your organization is “stuck” in the assessment phase, you also might benefit from having an outside advisor, whose guidance can help clarify the path to completion. Finally, having a dedicated professional project manager for this project can help instill the discipline and accountability that is needed to meet the approaching deadline.

What steps should you take in the near term?

Scope revenue streams and locations;

Determine how your current accounting policies and disclosures will change under the new rules;

Evaluate transition options and conclude on your approach;

Identify new data and information requirements;

Define future state process, including the role of systems;

Consider evaluating software vendor packages; and

Prepare a road map for remaining implementation activities

Explore

- Impacted leasing profiles
- Implementation status
- Cost expectations
- Implementation challenges
- Tax impacts
- Financing effects

Leasing

Lease accounting – the financial costs and operational effort may be underestimated

The new leasing rules are anticipated to have a sweeping effect, requiring an estimated $2 trillion of operating lease commitments to be reflected as a liability on corporate balance sheets.

It is not unusual for a large corporation to have hundreds, if not thousands, of leases. These frequently involve not only real estate but also equipment, automobiles, and other industry-specific leased items. Based on our observations in the marketplace, identifying, abstracting, reviewing, and analyzing these leases can easily require thousands of hours of internal and external resources. If companies underestimate the total lease implementation effort, funding requests for 2017 and 2018 activities may not cover the actual cost of implementation.

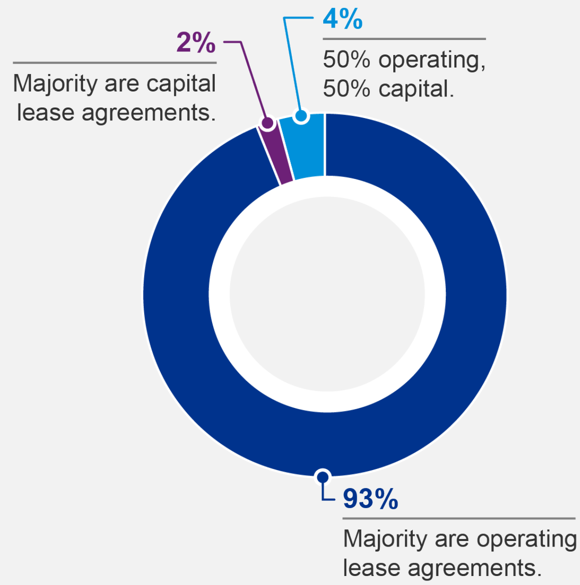
Some leasing profiles are more impacted than others.

The new rules will impact lessees more than lessors, in particular, lessees with a high volume of operating leases sourced from multiple locations. In our survey, 86 percent of respondents were primarily lessees, with most of their leases classified as operating leases.

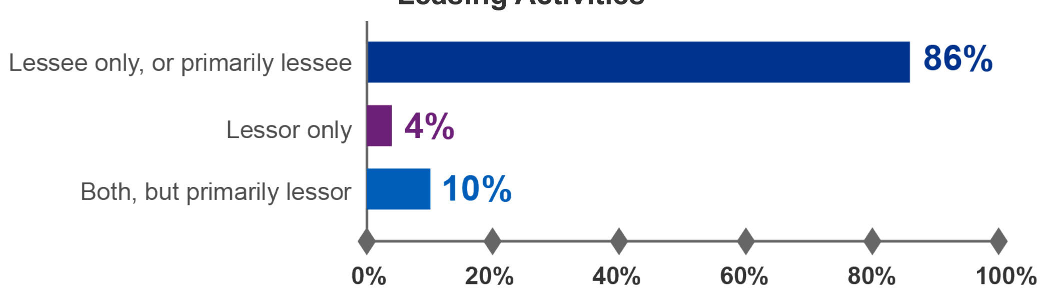
Multinational corporations are also more impacted as they will need to deal with another level of complexity. Because the IASB classifies all leases as finance leases whereas the FASB maintains the distinction between operating and finance leases, U.S. multinational companies may need to implement two different sets of leasing rules to account for their lease contracts under two different financial reporting systems.

Type of lease contracts – Lessees

Note: The total is not equal to 100 percent due to rounding.



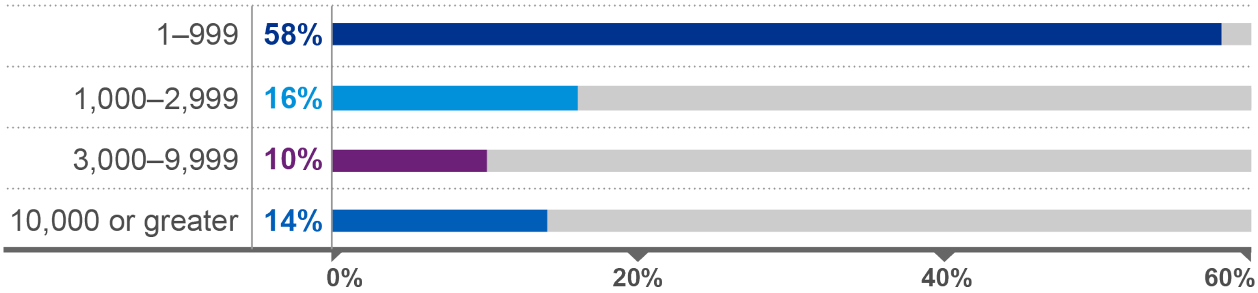
Leasing Activities



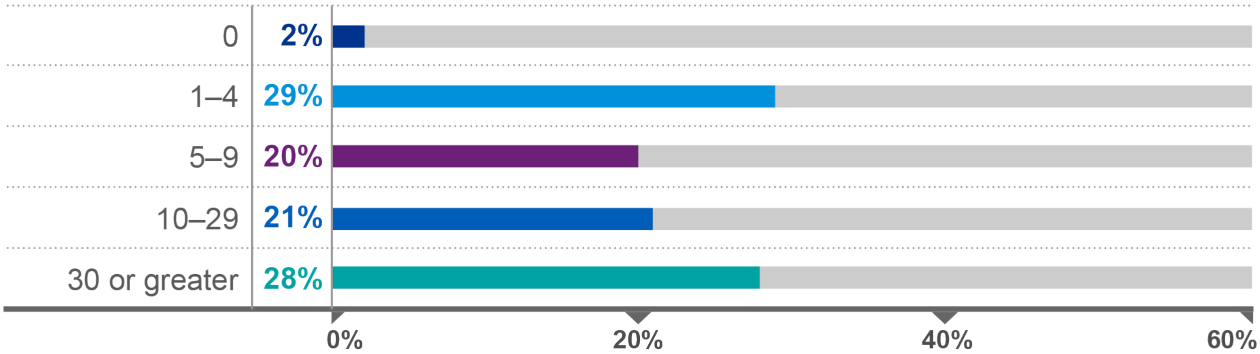
While a large percentage of survey participants indicated that their companies have less than 1,000 leases, nearly half of our respondents need to pull original lease contract data from more than ten physical locations. Just finding and collecting data will, therefore, be a significant task for most companies. Many companies may find that the original estimates of their lease population is understated, as up until now, some embedded leases may not have clearly been identified as operating leases since the accounting for them was not substantially different. Now, however, those embedded leases will need to be identified and accounted for separately from their host contract.

Number of leases

Note: The total is not equal to 100 percent due to rounding.



Number of locations with leases



Companies need to act soon

According to our survey, more than 50 percent of respondents have not started to assess the impact of the new leases standard.

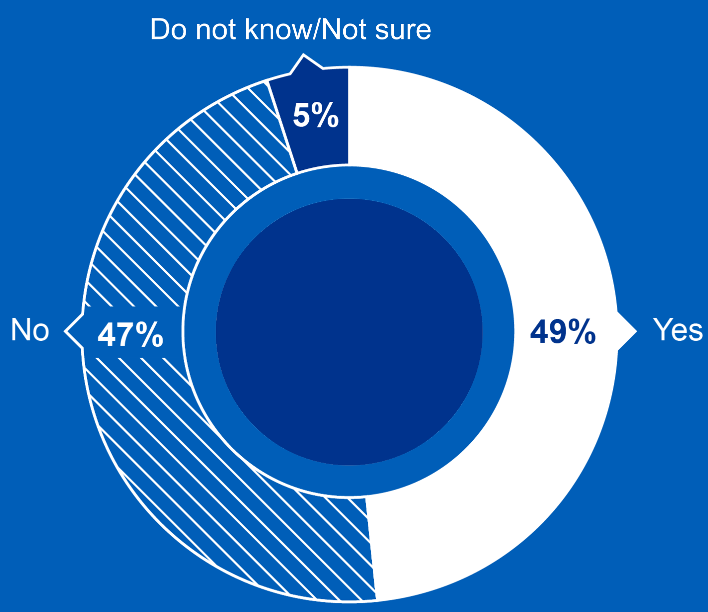
If companies do not begin soon, they may risk not having an implementation plan that aligns with their operational improvements strategy and reporting requirements that are needed to comply with the new leasing rule.

Even though the leasing standard will not become effective until 2019, the time horizon is not that far off given the effort involved. Unlike revenue, leasing is not core to most companies' businesses. Therefore, many companies do not currently have a leasing system to house lease contracts, much less capture appropriate data and automate the accounting for leases. The requirements of the new leasing rules will necessitate that many companies implement such a system.

Additionally, calendar-year companies need to capture this data as of January 1, 2017 in order to comply with the required transition method. This is not just a basic accounting exercise. Companies will need to ensure that their implementation plans not only align for accounting transition, but also account for the design and implementation of any desired system changes, which can easily take longer than a year to successfully implement.

Has your company started to assess the impact of the new leases standard?

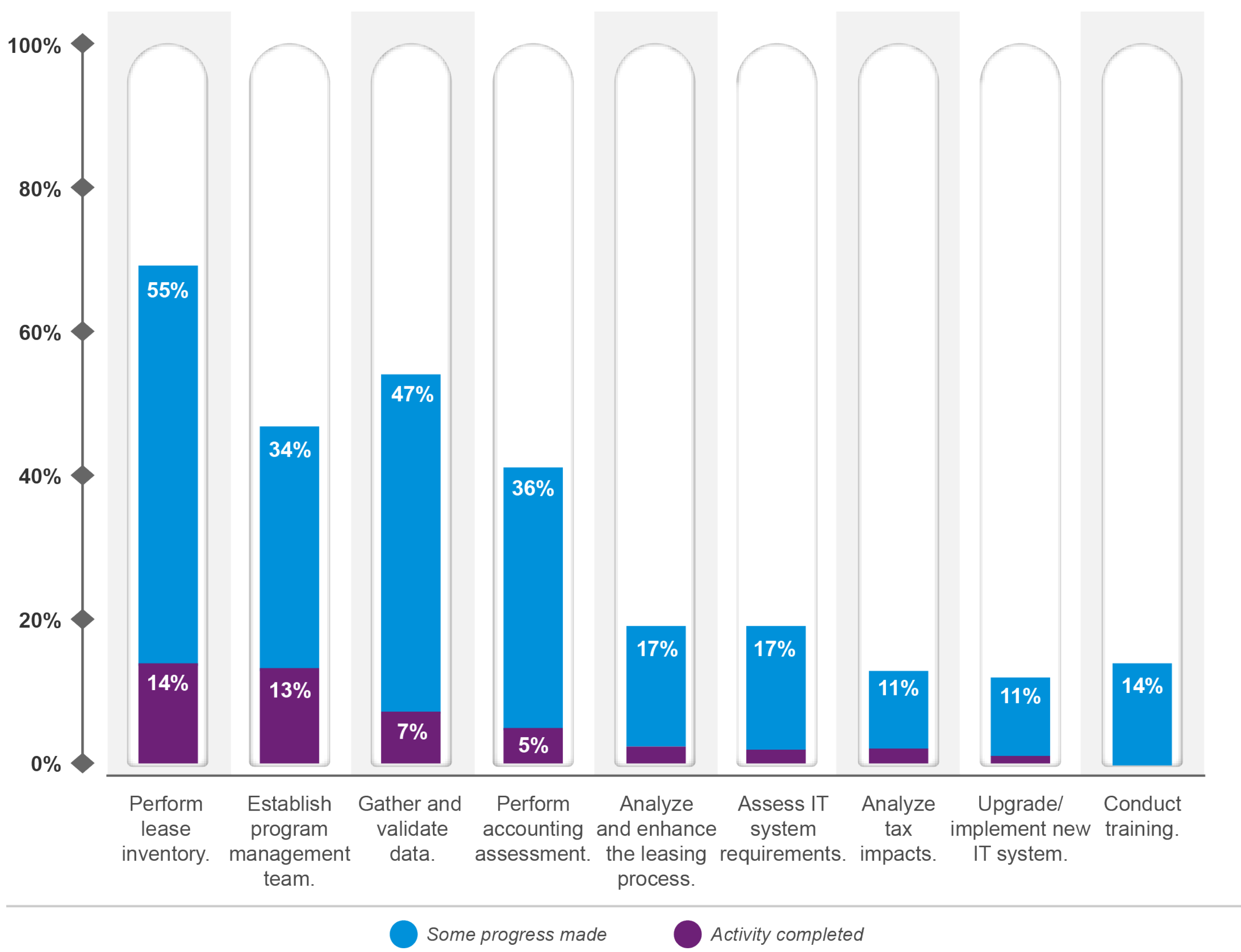
Note: The total is not equal to 100 percent due to rounding.



Progress has been slow.

While 49 percent of the respondents indicated that they have started assessing the impacts of the leasing standard, less than 15 percent have completed a lease inventory and only 5 percent have performed an accounting assessment. Additionally, more than 50 percent of respondents have not yet established a program management team, which is one of the very first steps needed in the assessment phase. Since many of these companies have not even begun the process, they may be surprised by how much effort it requires.

Progress made on lease standard implementation

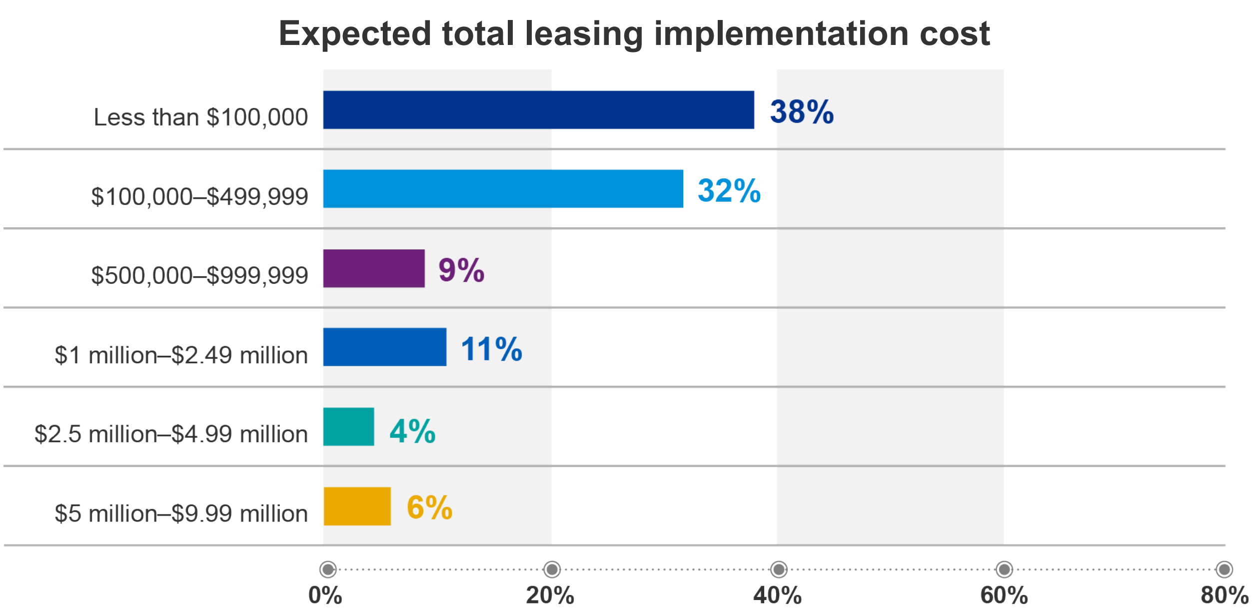


Cost expectations appear unrealistic

A large percentage (46 percent) of respondents indicated that they did not yet know what the costs would be.

However, of those who had made a cost estimation, an overwhelming 70 percent believe this implementation would cost less than $500,000. Given that most of our survey respondents have not yet started analyzing the leasing process or assessing IT system requirements, many companies may be setting unrealistic budget projections for their implementation efforts. Considering that the time needed to identify, read, interpret, abstract, and report one single lease can take four to ten hours, there will likely be a significant amount of financial investment above and beyond the IT systems selection and implementation component that many companies may not have considered.

Similarly, the need to capture leasing data in an automated process to facilitate financial reporting and disclosures will require, at a minimum, system enhancements, if not a completely new lease accounting system. As the implementation process continues, it is probable that companies will be facing higher than anticipated costs. Budgeting adequate costs in advance is obviously preferable.



How hard will it be?

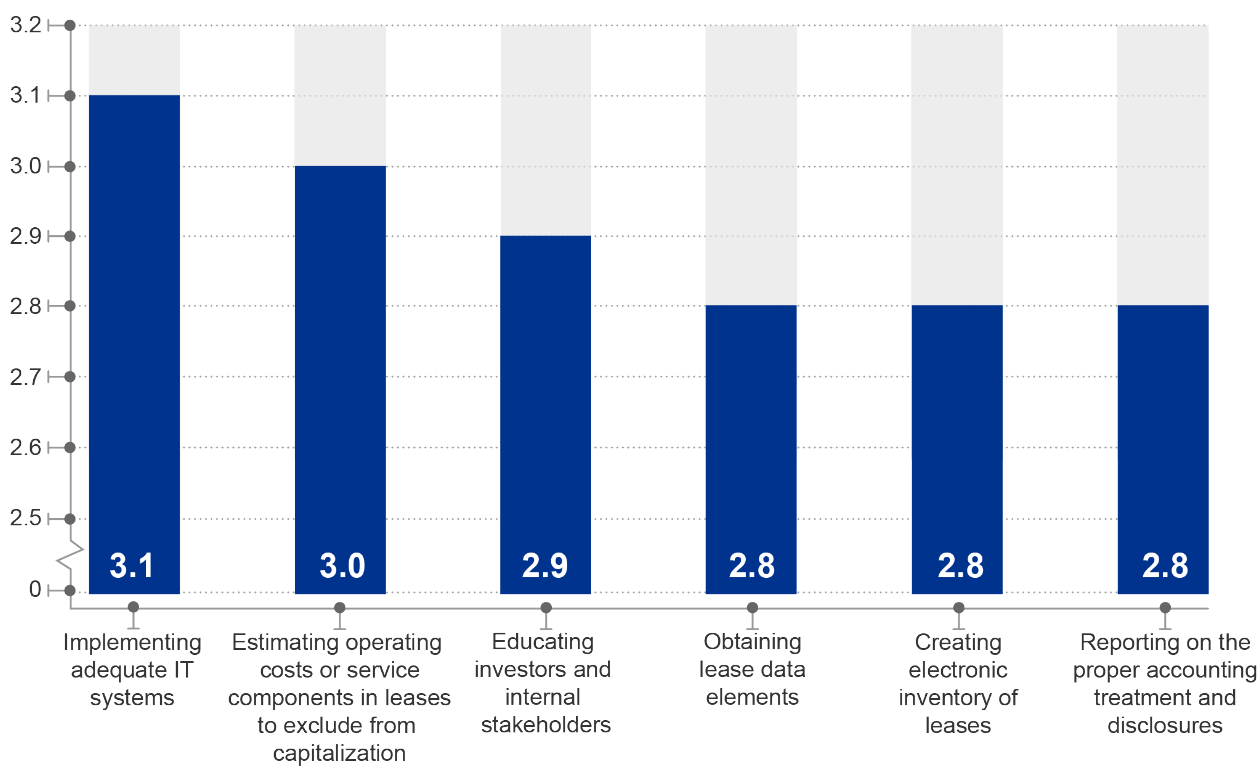
Many companies have yet to assess their IT system requirements and may not know how complex the process may be.

The leasing standard requires added complexity in calculating journal entries needed to record operating leases on the balance sheet on the effective date and thereafter. As more companies begin to evaluate IT solutions that can meet the new leasing financial reporting requirements, they will also need to consider the challenge of migrating and/or mining data between the legacy environment and the future state.

Other challenges include an increased use of estimates and judgments as well as educating investors and internal stakeholders. While collecting data and completing their inventory of leases ranked lower on the challenge scale, companies may not realize the amount of time that exercise requires.

Challenges of implementing the leasing standard

Rate each on a 1–5 scale, where 1 = not challenging at all and 5 = extremely challenging.The mean of the responses is presented.



We also took the opportunity to ask respondents about which automation software they may be considering to address the requirements of the new leasing standard. Nearly three-quarters of the participants are not sure which system they would choose or are not planning to use a software solution to help with compliance. Of the respondents who are planning to use a system, Oracle Property Manager and IBM® TRIRIGA® are top of mind.

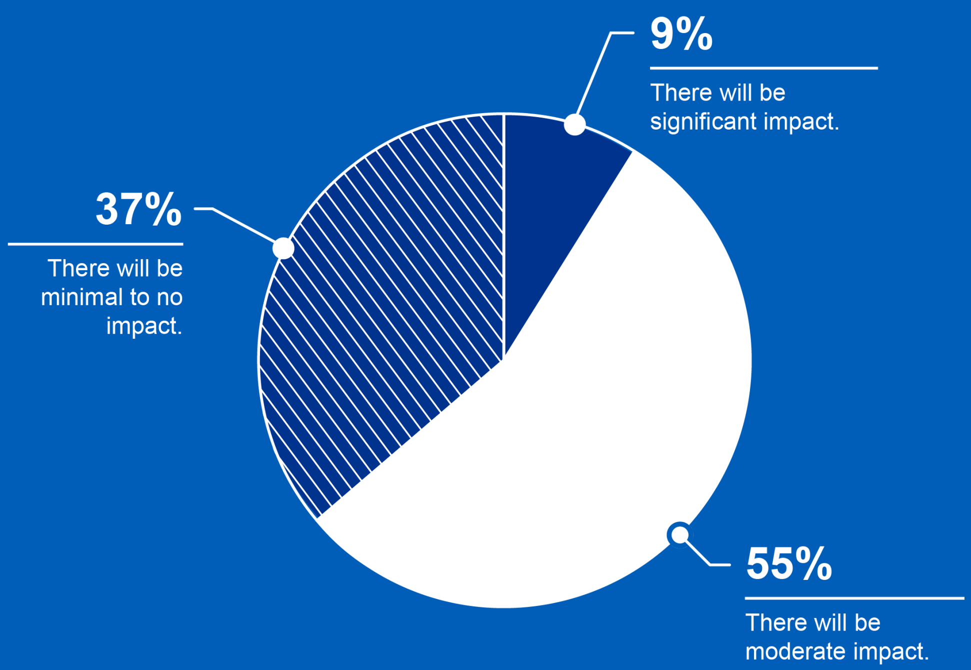
Tax impacts — a consideration that may be overlooked

In terms of the tax impact, 37 percent of respondents expect the new standard to have minimal or no impact on tax reporting, 55 percent expect a moderate impact, and only 9 percent expect a significant impact.

Tax is yet another area that needs to be considered in the leasing implementation effort. Companies should incorporate tax personnel early in the process to (1) educate the company's tax function on the anticipated changes to the company's financial accounting for leases, and (2) identify and assess any potential tax implications of such changes. (For example, recording significant additional assets and liabilities result in book-to-tax reporting differences that may augment existing or create new deferred tax items). A company's tax function will have its own data needs to support compliance with the current tax rules. In the context of financial accounting policy and system changes, ensuring the ongoing effective compliance and reporting will require the early involvement of tax professionals. If this does not occur, companies risk having tax be supported by manual processes and manual data feeds after the effective date. Manual processes are obviously not preferable.

Leasing impacts on tax reporting

Note: Percentages may not sum to 100 percent due to rounding.

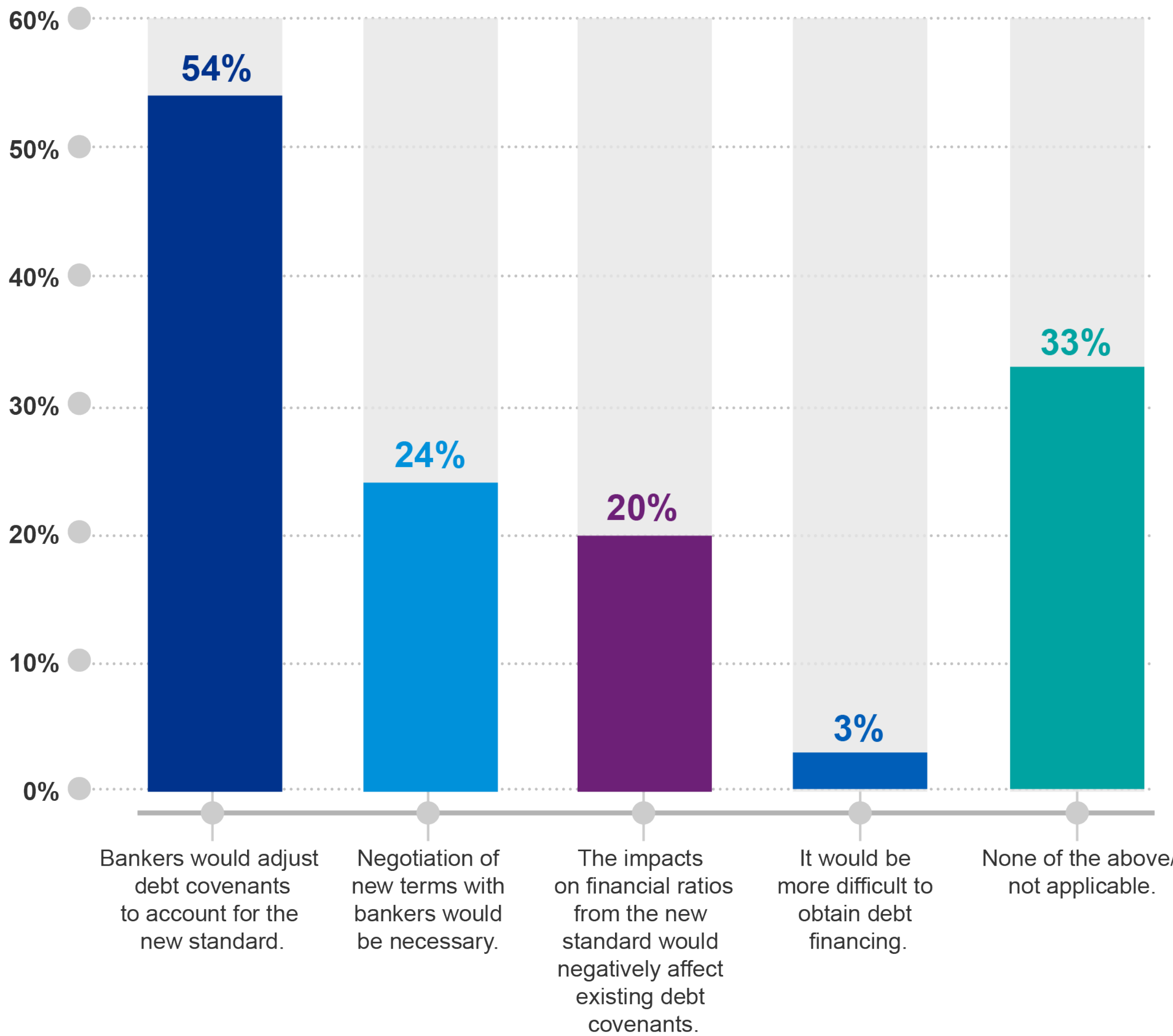


Financing will be affected

Adding leases to the balance sheet may have some effect on obtaining financing in the future.

A large percentage of the respondents (54 percent) said that they thought the new standard would result in bankers adjusting debt covenants to allow for the reduction in net worth ratios that will result from grossing up the balance sheet. However, another significant percentage (47 percent) of the respondents believe that there may be negative implications on financing. Some believe they may be required to renegotiate terms, some say existing debt covenants would be negatively impacted, and others believe that the balance sheet changes may make it more difficult to obtain future financing.

Impact of leasing standard on financing



Call to action

As revealed previously, many companies have not yet taken any significant steps to respond to the new leasing standard.

In order to gain a coherent understanding of the potential operational challenges that may lead to unexpected costs from implementing the rules, companies will need to act immediately. While the leasing implementation effort requires different steps from that of revenue recognition, establishing a project management team that is similar to the one for revenue recognition is a critical early step. This dedicated team can assist in performing a thorough assessment—a phase that cannot be delayed if you want to position your company for timely compliance.

What steps should you take now?

Start your assessment and:

- Identify preliminary inventory of leases
- Review lease reporting and policies, disclosure gaps, and tax policies
- Identify process and key control impacts
- Perform contract reviews by asset class and analyze areas for embedded lease arrangements
- Understand practical expedients that are available upon transition

Plan for your implementation:

- Analyze system options by also considering current process and reporting needs
- Develop high-level solution blueprint
- Map future state process, including system output to meet end-user needs
- Document system and integration requirements
- Document a detailed plan to transition

As leasing is not core to the operating strategy of many of the companies surveyed, the approach to implementation will require consideration of all aspects of a company that are involved in the leasing life cycle—from the procurement of a lease through the reporting of that lease. This may also present opportunities to rethink current processes and controls and even enhance their efficiency. However, the most critical part of the implementation process will be a well-thought-out thorough plan to help ensure that all significant objectives are identified. The proper team in the organization needs to be assembled and tangible steps outlined to provide a clear road map for the effort ahead. This is a company-wide process.

Conclusion

The message is clear:

For many companies, implementing the new revenue recognition and lease accounting standards will be a complex effort that requires a significant amount of planning and coordination.

To minimize business disruption and improve the chances of a smooth transition, financial reporting executives are advised to prioritize their immediate implementation goals. For revenue recognition, companies need to conclude their assessment activities as soon as possible, design required changes to processes and systems, and begin the implementation of those changes. For leasing, companies need to begin assessing the impact of this standard while also identifying and gathering their population of lease agreements and working toward developing a thorough implementation plan.

About KPMG

KPMG: an experienced cross-functional accounting change team; a global network

KPMG's Accounting Change specialists combine industry knowledge and technical experience to provide companies with holistic advice on uncovering how accounting and financial reporting policies, processes, and systems will need to change to comply with the new rules.

Our global network of professionals is helping many companies to understand the impact of these new rules and to implement the required changes; our experience has provided us the insights into how companies in various industries will be affected and the steps that they can take now to help ease transition to the new standards.

How KPMG can help

Revenue recognition

We have focused our resources on developing innovative tools and methodologies to support companies in addressing the unique accounting, financial reporting, process, and systems impacts of the new revenue recognition standard through all phases of the implementation effort. We offer a suite of proprietary solutions which assist in the accounting, tax, reporting, and program management aspects of a company's revenue recognition implementation to help with not only a smooth transition but also operational improvements to drive tangible business value.

Leasing

Our experience with accounting change has positioned us well to not only provide timely advice on the impacts of the new leasing standards, but also to enhance current leasing processes, communicate with stakeholders, and provide training and change management support to facilitate a smooth transition to the new standard. Our thorough solution also includes a Web-based application, KPMG Leasing Tool for IBM TRIRIGA, that leverages the IBM TRIRIGA platform to assist in operationalizing the standard. Our configuration to enhance the TRIRIGA platform to comply with the leasing standards includes our accounting change methodology, including our Accounting Diagnostic, lease activity business intelligence reporting, and financial reporting and disclosures. By combining KPMG's accounting experience with IBM's technology platform, we are able to offer a distinct solution to effectively comply with the new leases standard.

Please visit our Web site for the following:

KPMG’s Revenue Recognition Accounting capabilities

KPMG’s Lease Accounting capabilities

KPMG Leasing Tool for IBM TRIRIGA

KPMG guidance on new revenue rules

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Thank you.