Getting Ahead of the Curve: Issues to Consider Before New Revenue Recognition Accounting Standard Takes Effect

Companies should assemble a team to look at all areas that could be impacted by the adoption of ASC 606 in order to stay ahead of the curve.

The new revenue recognition standard ASU No. 2014-09, *Revenue from Contracts with Customers* (Topic 606) ("ASC 606") from the Financial Accounting Standards Board goes into effect for fiscal years starting after December 15, 2017. As a result, a public company reporting financial results under U.S. GAAP with a calendar year end would first be required to reflect ASC 606 in its Form 10-Q for the first quarter of 2018. Companies have the option of implementing ASC 606 with either a "full retrospective" or "modified retrospective" method. While the modified retrospective method does not require recasting prior periods, the full retrospective method requires recasting all prior periods presented in a report or registration statement that includes or incorporates by reference financial statements for any fiscal period after adoption (i.e., financial statements for any 2018 fiscal period). Companies adopting the full retrospective method should be mindful of circumstances that could cause them to accelerate the timing for recasting their prior audited financial statements or require recasting audited financial statements for FY 2015 as well.

Impact of Full Retrospective Method on Form S-3 Registration Statements

A company opting for the full retrospective method will need to be wary of filing a registration statement on Form S-3 any time *after* filing its Q1 2018 10-Q and *prior* to filing its FY 2018 10-K. During this window, in order to include three fiscal years of recast financial statements in the Form S-3[1], a registrant would need to (1) present its recast audited FY 2016 and 2017 financial statements on an accelerated timeline and (2) recast and present its FY 2015 audited financial statements. Absent filing a registration statement during this window, most companies using the full retrospective method would not need to present recast FY 2016 and 2017 financial statements until filing the FY 2018 10-K and would never need to present recast audited FY 2015 financial statements. A Form S-3 filed prior to the Q1 2018 10-Q could go effective without recasting historical financial statements, and a subsequent shelf takedown would also not require recast financial statements, even if the takedown happens during the window between the Q1 2018 10-Q and FY 2018 10-K filings. Because the FY 2018 10-K will include three years of recast financial statements (2016 through 2018), a Form S-3 filed after the FY 2018 10-K would not need to recast FY 2015 financial statements and would not require accelerated disclosure of recasted FY 2016 and 2017 financial statements.

While the SEC has noted that the "impracticability" exception in ASC Topic 250 (Accounting Changes for Error Corrections) may apply to avoid having to recast FY

2015, the SEC strongly encourages companies that plan to rely on the impracticability exception to consult in advance with the SEC's Office of the Chief Accountant. For companies that have Form S-3 registration statements that will expire prior to filing their FY 2018 10-K or who expect that their existing Form S-3 shelf registration statement will not have sufficient capacity to meet their needs through FY 2018, an easier path forward may be to simply file a new Form S-3 prior to the Q1 2018 10-Q filing.

Because ASC 606 is expected to impact almost every company to some degree, the SEC is focused on the SAB 74 transition disclosure being provided with respect to adoption of the new standard.

Impact of Either Method on SAB 74 Disclosures

Financial statement footnote disclosure is required prior to adoption of a new accounting standard pursuant to Staff Accounting Bulletin No. 74, Topic 11.M., *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period* ("SAB 74"). This transition disclosure is intended to preview the impact that a new accounting standard will have on a company's financial statements when the new standard is ultimately adopted. Because ASC 606 is expected to impact almost every company to some degree, the SEC is focused on the SAB 74 transition disclosure being provided with respect to adoption of the new standard.

ASC 606 impacts not only the face of the financial statements, through revenue measurement and presentation, but also disclosure and discussion about revenue in the footnotes to the financial statements, and MD&A if critical accounting estimates are involved. As a result, the SEC expects that SAB 74 disclosure should address the expected impact of ASC 606 to all these areas by the third quarter of this year, and the SEC staff will be monitoring filings for enhanced disclosures. Even companies that are not anticipating material *quantitative* changes to revenue from the adoption of ASC 606 will likely experience material *qualitative* changes in their footnote discussion about revenue. Companies should be working with their external auditors to craft appropriately enhanced SAB 74 disclosure for their upcoming 10-Qs that address all of these areas. It will likely not be sufficient for a company to simply state that it does not expect the new standards to have a material impact on its revenue.

In addition, the SEC's Chief Accountant recently emphasized that Audit Committees — as key "gatekeepers" — need to be in the loop on the adoption of the new standard and related disclosures, and that committee members should be asking the external auditors what they think of management's implementation efforts.

Impact on Incentive Compensation

Another important consideration that companies should discuss internally and with legal counsel is the impact the new accounting standard will have on incentive compensation, particularly with respect to executive compensation that must be disclosed in the proxy statement and other securities filings.

Revenue is often included as a performance target that determines the amount or the vesting of incentive compensation. Companies that adopt either the full retrospective or the modified retrospective method should consider what effect the change will have on their incentive compensation plans. Specifically:

- Will the selected method affect the amount payable or the vesting of incentive awards?
- Does the language in the relevant plan document or award agreement allow the plan administrator to modify targets for historical periods without creating issues with respect to participants, shareholders, Internal Revenue Code Section 162(m), or otherwise?
- Do the changes result in a windfall or volatility in results that would require an explanation to shareholder advocacy groups or a narrative in the proxy statement?
- What effect, if any, do the changes have under the company's compensation clawback policy?

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Companies should assemble a team to look at all areas that could be impacted by the adoption of ASC 606 in order to stay ahead of the curve. In addition to the issues discussed in this Kirkland Alert, there may be other issues that arise as a result of the adoption of ASC 606. For example, financial ratios in debt covenants may be impacted unless the governing agreements provide for the use of U.S. GAAP in effect as of the date of the agreements rather than at the time a covenant is tested.

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1 Item 11(b)(ii) of Form S-3 requires a company to include in a prospectus "restated financial statements … if there has been a change in accounting principles … where such change … requires a material retroactive restatement of financial statements."

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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