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New Revenue Recognition Standard plus SEC's Aggressive Policing Equals Potential Exposure for Tech Companies

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Early this year, the Securities Exchange Commission (SEC) resolved an enforcement action against the former CFOs of a Silicon Valley tech firm, requiring them to pay back about $500,000 in bonuses and stock sale profits. The SEC brought the action because the software firm committed revenue recognition accounting fraud resulting in a multi-year restatement. The agency clawed back the CFOs' compensation, despite the fact that the SEC did not accuse the CFOs of any wrongdoing.

In announcing the initial case against the company in September 2014, the SEC touted the case as evidence of its aggressive policing of revenue recognition matters, warning public companies against "cutting corners on …internal controls over financial reporting…. Weak internal controls create greater opportunity for accounting fraud, and investors are left holding the bag."

The SEC's more assertive presence in the area of financial reporting is particularly noteworthy in light of the Financial Accounting Standards Board's (FASB) new revenue recognition standard, which many companies are in the process of implementing in advance of its effective date (currently slated for January 2018 for public calendar year-end companies, assuming the recently proposed one-year deferral is finalized). The new standard replaces most industry-specific revenue recognition guidance, resulting in companies in some industries, such as telecommunications and software generally recognizing revenue earlier while other industries, such as asset management, may be required to record revenue later than they do currently.

In announcing the new standard, the FASB noted that in the computer software industry, "revenue will be recognized predominantly earlier" than it is today. As contingent caps on recognizing revenue are removed from current generally accepted accounting principles (GAAP), including requirements to establish fair value through vendor-specific objective evidence (VSOE) for undelivered items, revenue may be accelerated. However, if credit issues for customers are prevalent, such as for companies entering new and high risk markets, revenue could be deferred beyond what is recognizable today. While technology companies are analyzing the impact of the new standard, areas that are proving particularly challenging include the age-old question of separation of elements in bundled arrangements and how to allocate the consideration, particularly with licenses and post-contract support (PCS), and new questions such as how to capture required disclosure information, assessing the significance of a financing component, and mandatory capitalization of certain acquisition and fulfillment costs.

In the recent SEC case, which applied current revenue recognition standards, the company generated a third of its yearly revenues from professional services. According to its public filings, the company recognized revenue for both "time and materials" and "fixed fee" contracts as the services were performed. However, contrary to GAAP, the company recorded employee hours and customer billings for services not yet performed ("pre-booking") and failed to report service time worked in order to conceal budget overruns ("under-booking"). These practices led the company to conclude that it could no longer rely on its calculation of VSOE of fair value for professional services, resulting in an overstatement of revenue of approximately $70 million and a multi-year restatement. Not surprisingly, the SEC's order against the company found that internal accounting controls "were ineffective to counter-balance the revenue and margin targets set by senior management."

In light of the SEC's increased scrutiny of revenue recognition issues, coupled with the coming changes to the revenue recognition standard and likely impact on systems, tech and software companies in particular should start now to prepare. To that end, certain precautionary steps will help ensure successful implementation and decrease the possibility of unwanted regulatory attention.

1. Understand how your contracts will be impacted from a technical accounting standpoint. Obtain a thorough understanding of the standard's requirements and consult with experts to help assess the impacts. Key areas for technology companies, including defining performance obligations, and determining the nature of

a license, are still being debated by the standard-setters, so keep track of the changes and technical interpretation activity. In a principles-based standard, more judgments on accounting policy will be necessary, and companies should aim to reflect the substance of transactions within the confines of the standard. Of course any key policy decisions should be disclosed.

2. Start early. Delaying assessments and implementation may result in rushed decisions about documentation required to support the additional judgments, estimates and policy decisions. Many companies are finding systems changes, even entirely new systems, will be needed, which can be costly and time-consuming to implement. Others are finding that thousands of contracts will need to be reviewed to determine the impact, given a preponderance of non-standard terms.
3. Ensure you have complete and accurate data before getting started. Locate the contracts, including side letters and other enforceable documents, and understand the relevant terms in accordance with the law in that jurisdiction. Throughout an assessment process, it's common to identify issues where current accounting isn't meeting GAAP requirements. The SEC has made it clear these must be assessed as errors for materiality rather than included in the cumulative effect of the adoption. Also, don't forget to assess any errors for control implications carefully, as even immaterial errors could be a material weakness.
4. With the increased judgments under the new standard, especially requirements to estimate consideration, come additional opportunities for fraud or regulatory investigations and accusations of fraud. Now is the time to examine your company's controls to ensure the appropriate preventative and detective measures are in place to support those subjective estimates.
5. Anticipate required disclosures, even in the interim prior to adoption. As the effective date nears, the SEC will expect companies to provide more disclosures about the anticipated effects of the new standard, implementation and planned method of transition, along with any significant changes in the control environment.

With a little planning and diligence, and a lot of documentation and disclosure, you can reduce or even avoid that unwanted attention from the SEC, and ensure a smooth transition to the new rules.

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