Private Equity

Revenue recognition

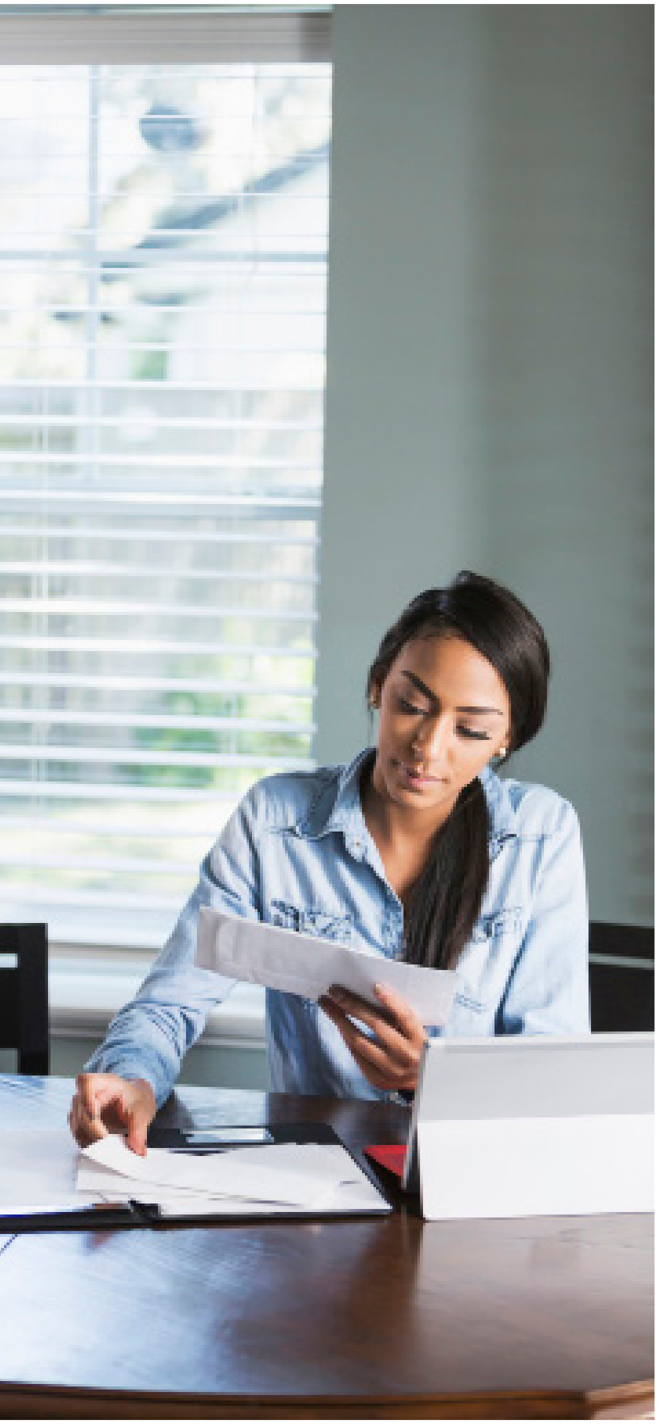
How an accounting standard can impact your deal

CFGI

The new accounting standard for revenue recognition (ASC 606), which goes into effect early next year for privately held companies is just an accounting change, right? Not at all. It could prompt private equity firms to adjust the way they project the growth of portfolio companies and revise the way they market those companies for sale.

The goal of the standard is to create a comprehensive revenue recognition model that is agnostic to all industries and capital markets and increases comparability of companies' financial statements. To do so, it ties the recognition of revenue more closely to when control of a product or service is transferred to a customer. Depending on the type of company, that could mean big changes to key financial metrics and ratios, including EBITDA, and could impact the financials in ways that could have an impact on debt covenant compliance, taxes, mergers and acquisition activity, and other exit strategies such as IPOs.

You may feel an impact whether buying or selling



On the buy side, it's important that private equity (PE) firms understand the standard well enough to evaluate the impacts during their due diligence. If a target hasn't yet implemented the standard, the PE firm needs to understand what the financials will look like in the future once the new rules become effective for all companies.

On the sell side, PE firms need to make sure their portfolio companies have implemented the new standard or be able to provide an explanation of why they have not and their action plan to do so in due course. This is especially important if the potential buyer is a public company that has already complied with the new standard.

The new standard offers two transition options – modified or full retrospective. Under full retrospective, an entity can choose to apply the new standard to all its contracts – and retrospectively adjust each comparative period presented in its 2017-2018 financial statements if it waits until the mandatory effective date.

Under the modified approach, an entity can recognize the cumulative effect of applying the new standard at the date of initial application – and make no adjustments to its comparative information. However, the company will need to report under both legacy and new accounting rules during the year of adoption.

The choice of transition option can have a significant effect on revenue trends. For example, if a company elects modified retrospective, i.e., cumulative catch-up, it may not be appropriate for a sponsor to look at trends from 2017 – 2019 because the periods will be presented on different accounting bases. Buyers may discount the offer price because of the lack of comparability. Therefore, to maximize value, private companies that may be involved in potential sale-side transactions might want to strongly consider adopting ASC 606 on a retrospective basis.

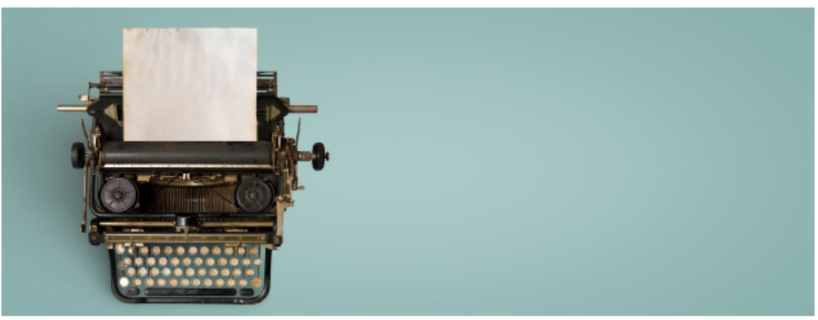
Take a SAAS company that has $9 million in revenue and their contracts have two deliverables/obligations that are distinct from each other. Under the standard, depending on the obligations outlined in the contracts, some of the revenue may now be recognized upfront, and some revenue may be recognized over time. The result is that revenue will temporarily increase, creating a temporary blip in profitability or EBITDA.

Or consider a pharmaceutical company that currently recognizes revenue only when their distributor sells to the end customer. Under the new standard, the company may be able to recognize revenue earlier based on when "control" has transferred, or when the product is provided to the distributor. Further, certain contract-related costs like sales commissions, which were previously expensed when incurred, may now have to be capitalized and amortized over the life of the contract, which would increase EBITDA in certain periods.

Under legacy GAAP, some companies didn't expressly disclose their unbilled receivables – a very risky account which represents revenue recognized, but which can't currently be billed to customers under the terms of the contract. Under ASC 606, unbilled revenues are now captured as part of a "contract asset" account, the balances of which need to be clearly disclosed in the financials. Prospective buyers should scrutinize this account during their due diligence process as it carries significant risk if the target's estimates of contract profitability, or the customer's ability/intent to pay, turn out to be different than initial expectations.

The bottom line is that even if a company's total revenue doesn't change, the "timing" of when the revenue is recognized will likely change which may have an impact on key metrics during the acquisition and divestiture processes. Private equity firms should understand how to tell the story as to why revenue year over year is different even if the overall profitability is the same.

The value creation story may change



When a company implements the new standard, private equity owners may need to rewrite the value creation story they tell potential buyers. PE firms use financial modeling to identify and project revenue streams, then devise a strategy for improving those numbers with the goal of exiting the investment in a set number of years. These growth projections are the heart of their story

Under the new rules, the whole model may be impacted as a result of the revenue numbers reported in your financial statements changing. It will make it harder to tell your story to attract buyers even if nothing actually changes in the performance of the company. You need to be smart about how you tell the story and how the financial statements reflect that story.

Given the complexities of ASC 606, implementation will require a carefully planned methodology and an experienced project management team. Unlike some previous standards, ASC 606 requires significant effort, knowledge, and judgment to ensure that disclosures in the financial statement are accurate, complete, and timely. The new guidelines also add significant new disclosure requirements that may vary across different companies based on their operations. It will be very difficult to use boilerplate disclosures to satisfy the requirements in ASC 606. Most businesses will need to seek outside advisors since in-house ASC 606 expertise is few and far between.

Time is running out

As the effective date of ASC 606 is imminent, implementing ASC 606 should be a high priority for portfolio companies. If an acquisition is in your future, you may have to modify or normalize the information you receive from the target company (seller) to compare apples to apples to get a good sense of the impact on key metrics, ratios, EBITDA.

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