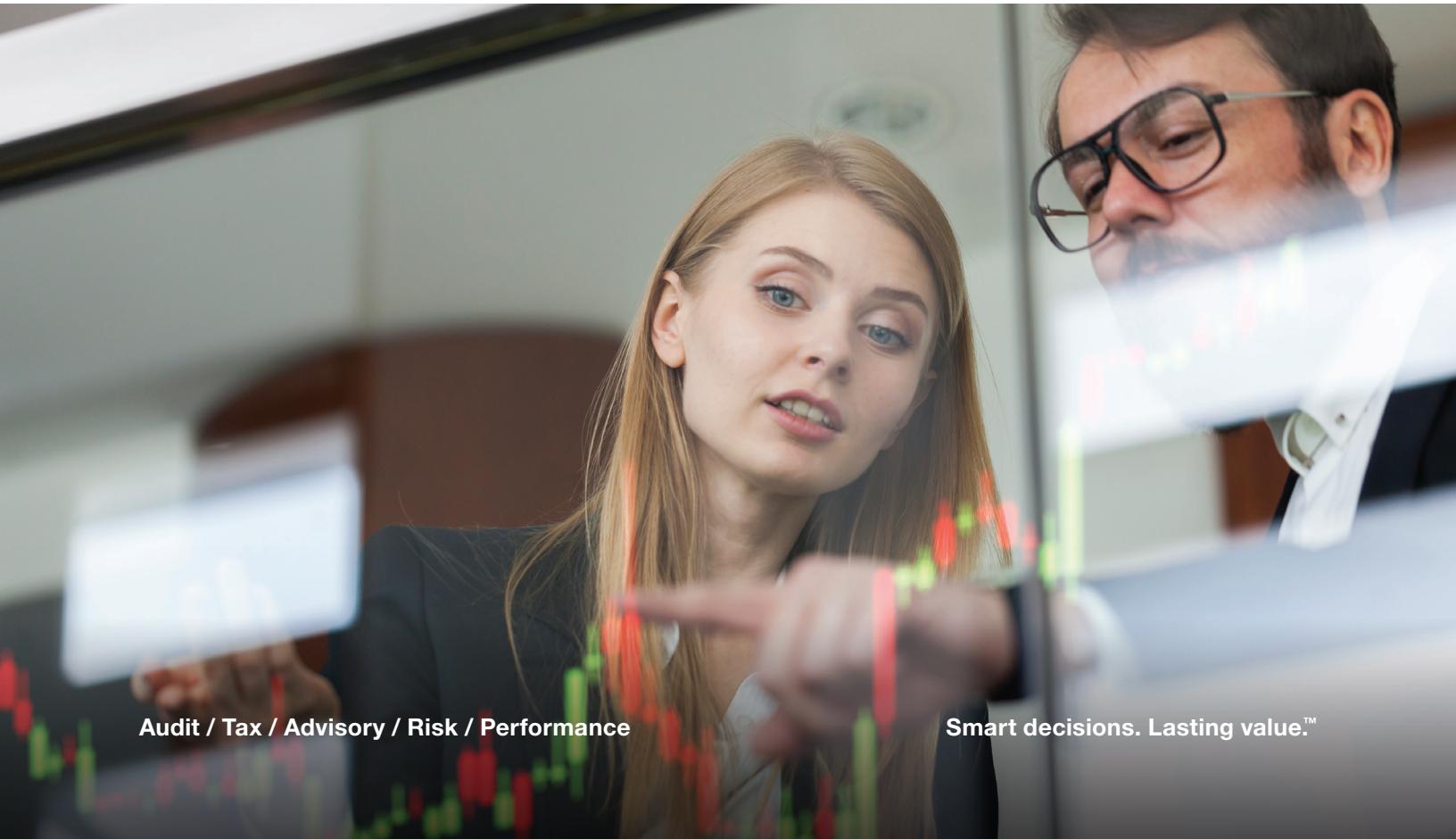


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ASC Topic 606: Make Sure Your Portfolio Companies Are Ready

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The sweeping new revenue recognition standard from the Financial Accounting Standards Board (FASB) is going to affect nearly every private equity group (PEG) and portfolio company to some extent. For some, the effects will be relatively modest, but others might encounter significant unforeseen complications. To avoid surprises, PEGs should be asking questions right now.

More than an accounting issue

For some entities, the effects of the FASB's new revenue recognition standard could extend far beyond accounting and financial reporting. In addition to potentially changing how portfolio companies recognize and report revenues, the standard could lead some PEGs to change key aspects of how they do business, including how they evaluate acquisition targets and make future acquisition decisions.

While the new revenue recognition framework seems straightforward at first glance, a number of interpretive issues could complicate its application.

To help prepare, organizations should begin to familiarize themselves with the new guidance to better understand how the changes might affect their business processes. In addition, organizations should expect that the implementation of the new revenue standard will require significant time and resources. Although some of the implementation tasks can be outsourced, the effort still will require direct management consideration and decision-making. That is why it is imperative implementation efforts get underway well before the standard becomes effective.

Asking the right questions

For nonpublic companies, the new standard becomes effective for annual reporting periods beginning after Dec. 15, 2018 – in other words, 2019 annual financial statements – and interim reporting periods beginning after Dec. 31, 2019 – in other words, monthly statements in 2020.

For most companies, adopting the new standard is not a matter of simply applying a new formula or making simple adjustments. To meet the deadlines and avoid delayed audits, the time to get started is now.

Unfortunately, the broad scope of the new standard can make it hard to decide where to start. Here are some questions that PEGs should be asking their portfolio companies – and their finance and executive teams – to get started:

1. Do we fully understand how sweeping these changes might be?

The new revenue recognition standard replaces substantially all existing revenue recognition guidance and affects all entities – public, private, and not-for-profit – that enter into contracts with customers to transfer goods or services or enter into contracts to transfer nonfinancial assets. That description encompasses virtually every PEG – and virtually every company in a PEG's portfolio.

At a minimum, all companies likely will have to disclose more about their revenue recognition policies and provide some level of disaggregated revenue data. Beyond that, the impact will differ across

various industries, and it may even vary among individual companies within the same industry. Important variables include the basic terms and conditions of a company's contracts with customers, such as the nature of promised goods and services, payment terms, and rights of return.

This broad scope will affect financial reporting and accounting, tax, legal, and treasury functions at both the PEG and portfolio company level, but it also can have a significant impact on IT departments, human resource functions, organizational processes and controls, and even sales and marketing departments.

Private equity groups also will need to consider the effects of Accounting Standards Codification (ASC) Topic 606, "Revenue From Contracts With Customers," on a variety of pre- and post-transaction business functions and decisions, including:

- Cash flow projections
- Financial metrics and ratios
- Quality of earnings
- Loan covenant targets
- Valuation models
- Earn-out targets and achievements
- Exit strategies

Given the possible broad implications, companies should involve stakeholders across the organization when assessing the anticipated impacts of the new standard.

2. What are the industry-specific issues and challenges associated with our portfolio companies?

The new revenue standard affects each industry differently. The technology, aerospace, and telecommunications industries will be especially affected, but real estate, construction, and healthcare also might encounter significant impacts. Even financial services, manufacturing, and hospitality companies might need to make changes.

Revenue from licenses and royalties also will be more complicated. In software companies, for example, the sell-through revenue recognition method now will be largely eliminated, and vendor-specific objective evidence (VSOE) no longer will be required before license revenue is recognized. In the aerospace industry, elimination of the milestone method could affect the timing of revenue recognition for certain contracts. And companies in a variety of industries will need to rethink the way they account for change orders and other contract modifications.

For some industries, the impact of the new standard might be limited to more robust documentation and disclosure requirements. But for others, the effects will be more fundamental and will vary significantly according to their industry.

3. How do we make the right choice between the implementation alternatives?

The new standard requires companies to adopt its provisions on a retrospective basis. However, companies may choose to adopt using either a full or modified retrospective approach.

Under a full retrospective approach, companies would restate prior periods to show what results would have been had the new revenue standard always been applied.

Under a modified retrospective approach, companies would record a cumulative effect adjustment as of the beginning of the period of adoption to show what the effect of adoption is on open contracts as of the adoption date. Prior periods would not be restated.

While the instinctive reaction might be to lean toward the modified approach because it appears to require far less data and computational work, this might not necessarily be the best choice.

For example, the modified approach can hinder historical performance comparisons. Not only could this complicate management decision-making when evaluating acquisition targets, it also could affect the reporting of results to investors and other stakeholders.

4. How will the new standard affect our future acquisition decisions?

The target company's chosen adoption methodology might directly affect key financial ratios. Historical trends and performance comparisons can be directly affected by the new standard, particularly if a target's adoption approach differs from the approaches of its industry peers. Deals could look deceptively promising by comparison – or promising deals could appear less so.

The due diligence team will need to understand the standard and, in particular, must recognize how the chosen transition methods affect revenues, earnings, and future revenue projections.

Future acquisition decisions also should take into account how – and how well – a target company is handling the transition.

The new standard also might affect post-merger integration efforts. Rationalizing and standardizing revenue recognition policies could be significantly complicated when the acquisition target's methods are at variance with those of the rest of the portfolio.

5. Is our implementation plan adequate – and achievable?

The new standard's scope and complexity make adoption much more resource-intensive than is typical with the transition to new accounting guidance. Because of this scope, implementation may require a dedicated team in each company.

In addition to allocating adequate resources, companies also must allocate adequate time. Waiting until the fourth quarter of 2019 could lead to missed deadlines and delayed audits – with all the financial and reputational risks those events entail.

Above all, PEGs should recognize that implementation of the standard is not just a mechanical process or change in reporting – it has operational and even strategic impacts. Critical decision-making in the transition cannot be outsourced or delegated to the finance team alone.



Developing an action plan – no time to lose

Even if a company ultimately experiences minimal changes to how it reports revenue, the process of implementing ASC 606 will still be time-consuming and labor-intensive. Variables that might add to the complexities include the number of revenue streams, the number and types of performance obligations with customers, a company's payment terms, the costs incurred to obtain contracts, and the quality and availability of data and records.

At a minimum, PEGs should expect it will take several rounds of information gathering, data analysis, decision-making, and documentation to complete the process, as illustrated within the steps in the exhibit.

Exhibit: ASC 606 implementation plan

1 Understand the new standard The new standard contains many nuances and complexities. It will require significant professional judgment in its application. Crowe has issued guidance to assist.	2 Gather information Obtain an understanding of current and in-process customer agreements as well as relevant policies, procedures, data, and systems involved.	3 Evaluate impact Establish a cross-functional team, including accounting, tax, HR, IT, legal, and sales, to evaluate the impact across the entire organization.	4 Select transition approach Significant planning should go into the selection of the transition approach.	5 Design solution Based upon the magnitude of the impact, develop a project plan and timeline, and secure necessary resources to meet the effective date.	6 Implement and monitor Execute the project plan, monitor its status, and communicate with relevant stakeholders.
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Source: Crowe analysis

Fortunately, a number of resources are available to help PEGs and their portfolio companies manage the implementation process. For example, professional groups such as the American Institute of CPAs (AICPA) have published extensive online guidance.



The AICPA formed industry task forces to develop a new “[Revenue Recognition: Audit and Accounting Guide](#)” that provides examples for applying the new standard across 16 specific industries:

- Aerospace and defense
- Airlines
- Asset management
- Broker-dealers
- Construction contractors
- Depository institutions
- Gaming
- Healthcare
- Hospitality
- Insurance
- Not-for-profit
- Oil and gas
- Power and utility
- Software
- Telecommunications
- Timeshare

Regardless of a private equity organization’s industry focus, size, or strategic direction, its management team – and its portfolio company executives – should seek competent professional resources to help them manage the implementation and anticipate possible complications.

ASC Topic 606 at a glance: The five-step approach

The new revenue recognition standard is designed to eliminate the transaction- and industry-specific guidance under previous U.S. generally accepted accounting principles and replace it with a principles-based approach for determining revenue recognition. Here’s how Accounting Standards Update 2014-09 describes the core principle upon which ASC 606 is built: “(A)n entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.”

According to ASC 606, to put that broad principle into practice, a company must apply five steps to determine when and how to recognize revenue:

1. Identify the contract(s) with a customer.
2. Identify the company’s performance obligations under the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations under the contract.
5. Recognize revenue as performance obligations are satisfied.

Those five steps might seem straightforward enough at a high level, but PEGs and their portfolio companies alike should expect to encounter complications as they put the steps into practice. More information about the new revenue standard can be found at these websites:

- [AICPA revenue recognition site](#)
- [Crowe revenue recognition resource center](#)
- [FASB/International Accounting Standards Board Joint Transition Resource Group for Revenue Recognition](#)



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