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Navigating the New Revenue Recognition Standard

A Virtual Symposium for Private Equity Groups and their Portfolio Companies

January 24, 2018

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Today's Speaker

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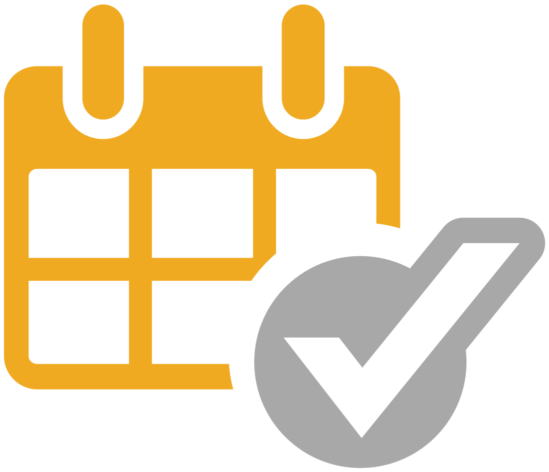
Today's Discussion
Revenue Recognition for PEGs and Portfolio Entities

- Background and Refresh
- Impacts and Considerations for PEGs and Portfolio Companies
- Highlights of Topic 606 Framework
- Presentation and Disclosure
- Key Takeaways and Next Steps



Objectives

By participating in this session, you should be able to:

- Identify next steps and best practices gleaned from public company implementation of the standard
- Describe the five-step model contained in the new revenue recognition standard along with other key concepts and principles

Background and Refresh

Background

- The FASB and the IASB have issued largely converged revenue recognition standards that will supersede virtually all revenue recognition guidance in U.S. GAAP and IFRS

- Why the change?
  - ➢ Inconsistencies in standards between U.S. GAAP and IFRS
  - ➢ Lack of consistent revenue recognition model
  - ➢ Simplify and reduce depth of guidance
  - ➢ Inadequate disclosures

- The new standards provide accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other U.S. GAAP or IFRS requirements, such as lease requirements)

- The core principle is that an entity will recognize revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer

Effective Dates and Transition Requirements

Effective dates

- Public entities: fiscal years beginning after Dec. 15, 2017, including interim periods within those fiscal years
- Nonpublic entities: fiscal years beginning after Dec. 15, 2018; interim periods beginning after Dec. 15, 2019
- Early application: permitted for all U.S. entities for fiscal years beginning after Dec. 15, 2016, including interim periods within those fiscal years

Transition

- Full retrospective application
  - Restate for all periods presented
- Modified retrospective application
  - Cumulative catch-up at the date of adoption

Impacts and Considerations for PEGs and Portfolio Companies

Industry Impact of the Adoption of ASC Topic 606

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
High	√		√				√		√
Medium		√				√		√	
Low				√	√				

Due to the new disclosure requirements, ALL companies with contracts in scope of the new standard will be impacted!

(1) Software & Technology
(2) Real Estate
(3) Life Sciences
(4) Financial services
(5) Manufacturing
(6) Construction
(7) Aerospace
(8) Healthcare
(9) Telecommunications

Impact and Considerations

- Overall, adoption of the new standard can impact companies <u>financial reporting</u> as follows:
  - Timing for recognizing revenue and related costs
  - What is included in revenue and related costs
  - Change presentation
  - Significantly expand disclosures related to revenue

KEY TAKE AWAY

This will require a comprehensive assessment of the Company's contracts with customers.

Every Company will be affected so do not wait to assess the impact!!

Impact and Considerations (Continued)

- Impact on EBITDA – If revenue recognition and/or accounting for related costs changes, how will EBITDA be impacted?
  - Debt compliance – many covenant definitions such as fixed charge and leverage ratios are impacted by EBITDA
  - Compensation
    - Many compensation arrangements including bonus and share based compensation plans are driven by EBITDA
    - Commission arrangements
  - Net asset value – What will be impact on a fund's NAV if on a Company's EBITDA is affected?
  - Management fees – Any impact to management fees charged to portfolio entities?
- Comparability of financial results when assessing quality of earnings that include periods involving pre and post implementation of Topic 606

Impact and Considerations (Continued)

- Sales and marketing – e.g., potential changes to structure of purchase and sales contract; identifying revenue impacts of customer provided incentives, discounts

- Impact to portfolio company with IPO exit strategy
  - ➢ Need to adopt Topic 606 before going public unless an emerging growth company
  - ➢ What changes to be made to company's processes and controls?

- IT systems – How does the system currently account for revenue and related contract costs? Will changes be necessary?

- Taxes – What impact will there be on timing differences?

Polling Question #1

Which of the following is not a reason that drove the change in the revenue recognition standard?

A. Need to largely converge revenue recognition standards guidance issued by the FASB and IASB.

B. Need to improve the transparency as to how entities recognize revenue

C. Need to simplify and reduce the depth of guidance

D. Need to move to a more rule based standard

Highlights of Topic 606 Framework

The Five Steps of Revenue Recognition

1. Identify the contract(s) with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognize revenue when (or as) the entity satisfies the performance obligations

Step 1 – Identify the Contract(s) with the Customer

The new revenue model will be applied to a contract only when all of the following conditions are met:

- Each party has approved the contract and is committed to perform their respective obligations
- Each party's rights regarding the goods or services to be transferred can be identified
- The payment terms for the goods or services to be transferred can be identified
- The contract has commercial substance
- Collection is probable
- A contract does not exist if each party can terminate the contract prior to any performance occurring without having to compensate the other party

Step 2 – Identify the Separate Performance Obligations in the Contract

- Performance Obligation – An entity’s promise to transfer a good or service

- Each performance obligation is either:
  - Distinct (as defined in the standard)
  - A series of distinct goods or services that are substantially the same and have the same pattern of transfer

- Focus is on the customer’s point of view – The customer must be able to benefit from the good or service on its own or with other resources that are readily available

- <u>NOT</u> limited to goods or services explicitly stated in the contract. (Consider implicit performance obligations)

Step 3 – Determine the Transaction Price

Determining the transaction price can be straightforward, such as where a contract is for a of goods or services in a reasonably short timeframe. determinable amount of consideration in return for a determinable number

Complexities can arise where a contract includes any of the following:

- Variable consideration
- A significant financing component
- Noncash consideration
- Consideration payable to a customer
  - Discounts
  - Rebates

Variable Consideration

1. **Expected Value Method**
   Estimates variable consideration based on the range of possible outcomes and the probabilities of each outcome
2. **Most Likely Amount Method**
   Estimates variable consideration based on the single most likely amount in a range of possible consideration amounts

Common Forms of Variable Consideration

- Price concessions
- Prompt payments discounts
- Volume discounts
- Rebates
- Pricing based on an index

Step 4 – Allocate the Transaction Price to the Performance Obligations

- The transaction price should be allocated to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the seller expects to be entitled in exchange for transferring the good or service to the customer

- If more than one performance obligation exists, consideration should be allocated based on the relative standalone selling prices of the goods or services at the inception of the contract

- When a purely observable stand-alone price is not available, methods of estimating the stand-alone price include (but are not limited to):
  - **Adjusted market assessment**
  - **Expected cost plus a margin**
  - **Residual approach**

Step 5 – Recognize Revenue

- **Basic Principle** – Revenue is recognized when (or as) performance obligations are satisfied by transferring a promised good or service (i.e., an asset) to a customer

- Performance obligations may be satisfied *either*:
  - At a single point in time (physical delivery)
  - Over a period of time (provides services)

- A good or service is transferred <u>over time</u> and revenue is recognized over time, if **one** of the following criteria is met:
  - Customer simultaneously receives and consumes benefits
  - The entity's performance creates or enhances an asset that the customer controls
  - The entity's performance does not create an asset with alternative use to the entity, <u>**and**</u> the entity has an enforceable right to payment for performance completed to date

- Accounting for shipping and handling activities
  - When performed before transfer of control to customer, accounted for as fulfillment activities
  - When performed after transfer of control to customer, facts and circumstances of contract will determine if these activities are a promised service or not
  - Entity allowed to make an accounting policy election for these activities to be accounted for as fulfillment activities
  - If revenue is recognized before these activities occur, shipping and handling costs must be accrued.

Revenue Recognition: Before and After

ASC Topic 605	ASC Topic 606
Persuasive evidence of an agreement	*Contract = An agreement that creates enforceable rights and obligations (may be written, oral, or implied by customary business practice with a customer).*
Seller has delivered/performed	*Revenue is recognized when performance obligations are satisfied. For performance obligations satisfied at a point in time, revenue is recognized when the customer obtains control of the asset. For performance obligations satisfied over time, revenue is recognized using a measure of progress toward completion.*
Sales price is fixed or determinable	*Determining a transaction price includes "constraining" revenue to an amount that is not subject to significant revenue reversal (threshold = probable which is lower than "fixed" criteria)*
Collectibility is reasonably assured	*Collectibility threshold evaluated to determine if a contract exists.*

Specialized Topic – Costs to Obtain a Contract

- Under the new guidance, the incremental costs of obtaining a contract with a customer are recognized as an asset if the entity expects to recover them (less than one year practical expedient provided).

- The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission).

- Once capitalized, the asset shall be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.

- Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

- The new guidance may be a significant change in practice for entities with contract periods greater than one year that historically have expensed the costs of obtaining a contract and now will be required to capitalize them.

Polling Question #2

Which of the following is not one of the 5 steps of the new revenue recognition standard:

A. Determine the transaction price

B. Determine if collectibility is reasonably assured

C. Identify customer contracts

D. Allocate the transaction price to performance obligations

E. Identify performance obligations in the contract

Presentation and Disclosure

Presentation of Contract Assets and Contract Liabilities

A contract asset or liability is generated depending on the relationship between the entity's performance and the customer's payment.

- When an entity satisfies a performance obligation by transferring a promised good or service, the entity has earned a right to consideration from the customer.

- If an entity has an unconditional right to receive consideration from the customer, the right is accounted for as a receivable and presented separately from other contract assets. A right is unconditional if nothing other than the passage of time is required before payment of that consideration is due.

- If an entity has a conditional right to receive consideration from the customer, the right is accounted for as a contract asset. The right would be conditional, for example, when an entity first must satisfy another performance obligation in the contract before it is entitled to payment from the customer.

- When the customer performs first (e.g., by prepaying its promised consideration), the entity has a contract liability.

Annual Disclosure Requirements

The objective of the new disclosure requirements in the new standard is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows from contracts with customers.

To achieve that objective, an entity is required to disclose qualitative and quantitative information about all of the following:

- Its contracts with customers
- The significant judgments, and changes in the judgments, made in applying the guidance to those contracts
- Any assets recognized from the costs to obtain or fulfill a contract with a customer.

The detailed disclosure requirements of each of these topics differ for public and nonpublic entities.

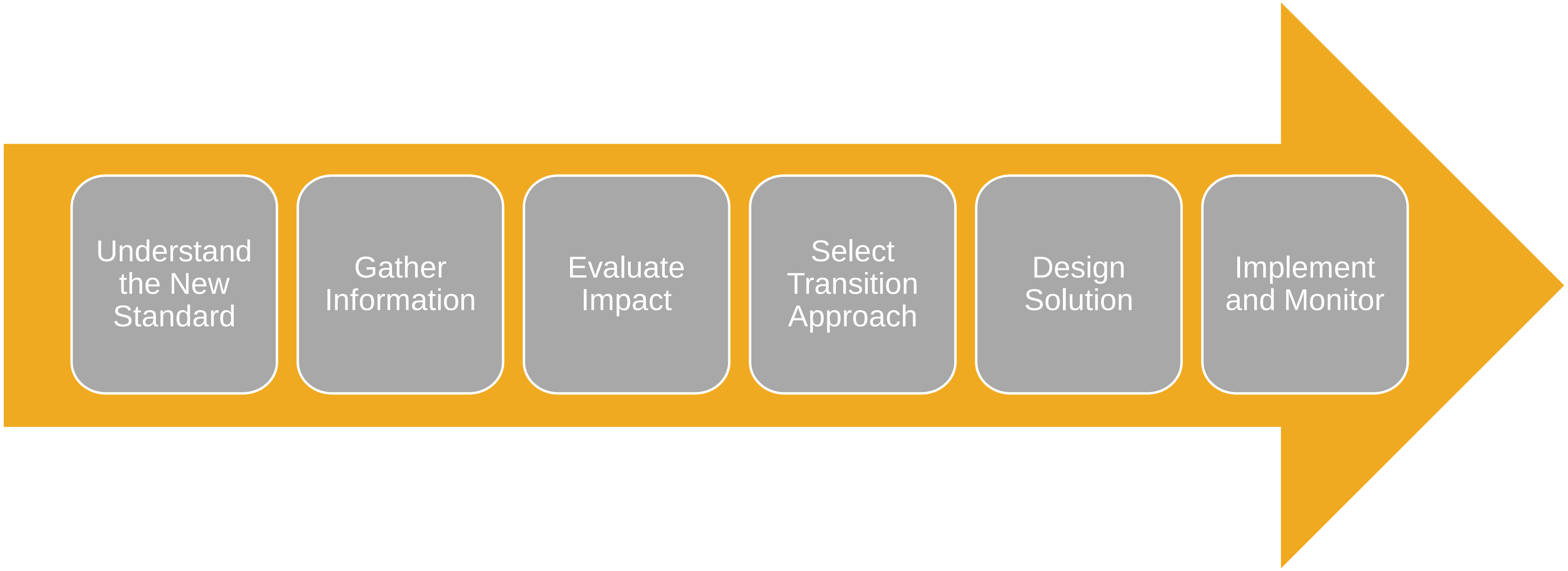
Key Takeaways and Next Steps

Key Takeaways and Next Steps

Topic 606 implementation – Where to Begin??

- Implementation Suggestions
  - Start early – Do not wait
    - Lack of time and resources so important to start early
    - New revenue recognition standard is not going away
  - Appoint a steering committee/team of individuals with one individual responsible for overseeing the process.
    - Consider possibility of having core implementation team covering multiple portfolio companies.
  - Establish a timeline with specific dates and monitor progress
  - Develop a framework
    - Ensure all five steps are addressed

Next Steps (Continued)



Resources to Help Understand the New Standard

Resources to help you:

- Crowe Horwath LLP Revenue Recognition Resource Center: Includes our guidance along with industry-specific guidance. www.crowehorwath.com/revenue-recognition

- Transition Resources Group for Revenue Recognition (TRG): The TRG was formed by the FASB and IASB to help determine whether more guidance was needed to address implementation questions and to educate constituents. http://www.fasb.org/jsp/FASB/Page/LandingPage&cid=1176164065747

- AICPA Revenue Recognition Task Forces: The AICPA has formed 16 industry task forces to help develop a new Accounting Guide on Revenue Recognition that will provide illustrative examples for how to apply the new revenue recognition standard. www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/Pages/RevenueRecognition.aspx.

- The industries involved with this project are:

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

Questions?

Crowe Horwath.

Thank you

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