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Revenue recognition and private equity

Why should you care?

If you think implementation doesn't affect your private equity portfolio companies, think again.

For private equity portfolio companies, the new revenue recognition standards issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) could change several key financial metrics and ratios, including revenue and EBITDA. But it is also likely to have broader implications—for example, in M&A transactions, there may be impacts pre-transaction, post-transaction, and with ongoing fair value measurements. Corporate processes, controls, and IT systems will likely feel the effects, too. The combined impact makes this a serious topic for consideration by private equity investors.

But first…a little background is in order. In 2014, after 12 years of work, the FASB and IASB issued new standards for recognizing revenue from contracts with customers. Contained in FASB's Accounting Standard Codification (ASC) 606 and IASB's International Financial Reporting Standard (IFRS) 15, the guidelines take effect for public companies in 2018 and private companies in 2019. The goal was to create a single, comprehensive revenue recognition model across all industries and capital markets. ASC 606 and IFRS 15 achieve that goal by focusing on a core principle to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled to in exchange for those goods or services.

To implement the standard, public and private companies alike have been completely re-evaluating how they account for revenue. This is arguably the most profound new compliance change to affect corporate finance since the Sarbanes-Oxley Act of 2002. Implementation may require considerable efforts to understand the accounting issues and the broader implications for processes, controls, and systems. So, if you think this doesn't affect your private equity portfolio companies, think again. The following are several specific considerations.

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Pre-transaction considerations

New investment due diligence

You'll want to assess how prepared the potential portfolio company is for the accounting change, potential impacts to the company's cash-flow projections, and costs and resources needed to implement the standard. If new financing arrangements are contemplated, it would be prudent to consider impacts on financial metrics before negotiating debt covenants.

Exit strategies

The standard could result in potential changes to pricing and market strategy of the portfolio company.

Post-transaction considerations

Management compensation, performance bonuses, and incentive compensation

By evaluating existing compensation plans, you can determine whether the plans require modification to align accounting treatment and goals while still incentivizing employees.

Debt covenant

It will be important to monitor existing debt covenants to prevent violations stemming from any potential accounting changes.

Taxes

You will need to assess how changes in the timing of revenue recognition versus cash receipts potentially impact recognition of tax expenses, benefits, and deferrals as well as state apportionment factors, sales and property taxes, and transfer pricing.

Ongoing portfolio company fair value measurement

The adoption of ASC 606 or IFRS 15 is likely to have considerable effect on key valuation inputs and operating metrics of portfolio companies, including:

Historical metrics

Consistency of historical financial metrics, such as revenue and EBITDA.

Implementation

Impact of implementation on peer company financial metrics used in a market approach valuation mode—for example, guideline public company (GPC) or guideline transaction method (GTM).

Timing

Consideration of the timing of when peer companies adopt ASC 606 or IFRS 15, as well as the method of adoption—i.e., retrospective vs. modified retrospective with cumulative effect adjustment at beginning of period:

- Alignment of entry multiple pre- and post-adoption of ASC 606 or IFRS 15.
- Impact on portfolio company cash-flow projections.
- Adjustments to valuation models to account for the items noted above.

Because of changes to these inputs, ASC 606 and IFRS 15 may have a variety of positive and potentially negative impacts on the overall valuation of a portfolio company. Each portfolio company, and each customer contract, may need to be evaluated to assess the impact on the valuation.

Let's talk

To learn more about ASC 606 or IFRS 15 and their implementation in portfolio companies, please contact:

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