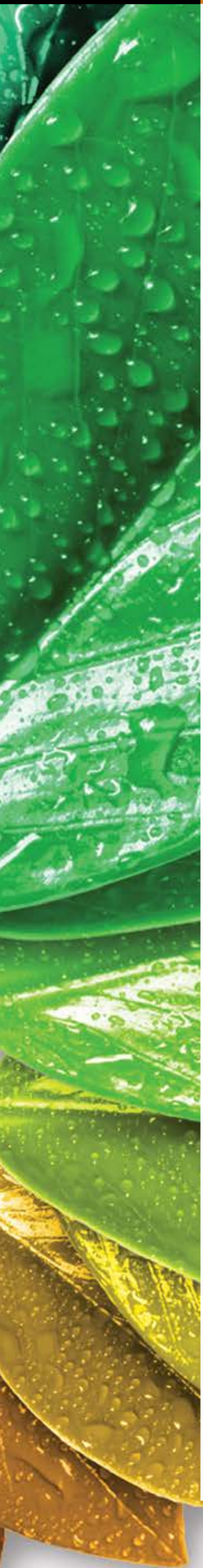
plante moran

audit • tax • consulting • wealth management

# ready for change?

## REVENUE RECOGNITION

## Private Equity and their Portfolio Companies



# Are you ready for principles-based revenue recognition?

## THE NEW GUIDANCE PROVIDES A PRINCIPLES-BASED, FIVE-STEP PROCESS

for recognizing revenue that's in sharp contrast to the current rules-based, industry-focused standards that have been followed for decades.

- ☑ Private equity funds will need to evaluate how they structure and record fees such as management fees, monitoring fees, and transaction fees. They will also need to evaluate the impact on the recognition of carried interest and performance-based fees.
- ☑ Private equity professionals will need to revise their approach to diligence, financial covenants, valuation models, EBITDA adjustments and exit strategies and structure.
- ☑ Portfolio companies will see a significant impact in when (and how) they recognize revenue, as well as in the disclosures in their financials.

If your portfolio company issues financial statements based on generally accepted accounting principles (GAAP) in the United States, the most important thing to understand about the new standard is that the transition will involve significant planning, training, and process changes, regardless of the effective date. Any delay on your part could cause difficulties as the effective date approaches. This is not like a tax deadline, where you can count on extensions.

# Pre-deal considerations

## EXIT STRATEGIES

The new revenue recognition model will be applied beginning in 2019 for nonpublic entities. While that seems far off, those planning to exit before the implementation date may still want to consider the effects of the new standard when adopted. If the changes result in a favorable revenue impact, entities might consider early adopting. Nonpublic companies can early adopt starting with 2017 year ends. Even if the standards are not early adopted, impact on revenue trends and forecasts will be important to potential investors.

## DUE DILIGENCE

A company's readiness to test, implement, and operate under the new standard may have significant implications for its appeal as a target company. As private equity firms review investment prospects, the new accounting standard should be included as part of due diligence. What is the impact to revenue, EBITDA, and taxes? Is the portfolio company prepared? Does it have the necessary resources, and are its contracts inventoried? These are key questions that will be important to a potential investor.

# Post-deal considerations

## EBITDA

Private equity professionals will need to consider how earnings before interest, taxes, depreciation, and amortization (EBITDA) will be affected. Implementation near the deal date will add difficulty in making projections and monitoring results. In addition, as contract assets and liabilities may be recorded as a result of applying the new standard, this could impact the working capital calculation at closing.

## EARNOUTS AND MANAGEMENT COMPENSATION

Contingent payouts such as management compensation and performance-based bonuses could be affected by changes to revenue and EBITDA adjustments. For example, an earnout based on EBITDA might be determined using historical EBITDA trends. If implementation occurs near the earnout period, the earnout calculation could be impacted and result in an unintended payout. Although clarifying that the earnout should be measured using revenue rules in place of the time of the transaction may seem like an easy alternative, it would likely be administratively difficult to track revenue under both the current and new revenue rules.

## DEBT COVENANTS

The new guidance could affect both the income recognized and the balance sheet position of many companies. As a result, the ability of organizations to meet covenant requirements set by their creditors could change upon implementation with no real change of the economics of the business. It will be important to understand the impact of the new standard on the company's metrics and ratios in negotiating the covenant terms with lenders, ideally before a waiver is needed.

# What you need to know

## FUND MANAGERS

The new revenue recognition standard will impact fund managers as revenue is generated from both management fees and incentive-based fees. The base management fee impact is expected to be minimal since these are typically based on a percentage of the committed capital of the fund. However, waivers, offsets and other reimbursements, which adjust these management fees, may be treated differently under the new guidance. In addition, any variable consideration, such as performance-based fees, will need to be estimated under one of two allowable methods, subject to a constraint.

## THINGS TO REMEMBER

**Get started now**
The only way to know how long this will take for your organization is to do it.

**Don't wait**
Don't put it off because you don't believe it will affect you, or that you can catch up in the future.

**Avoid costs**
The process will be more painful, and more expensive, the longer you wait.

# How we can help

Our revenue recognition experts can assist your fund and portfolio companies in a number of ways. We can serve as an advisor, collaborate closely on all aspects, or a combination of the two.

## CUSTOM SOLUTIONS

FOR YOU AND YOUR PORTFOLIO COMPANIES

**We can serve as your advisor.**
Our team can provide feedback on your implementation efforts throughout the process.

### EVALUATE PLANS

We can evaluate your training plans and interpretations of the new standard and make recommendations for improvements.

### REVIEW ANALYSIS AND APPLICATION

As advisors, we will review your analysis and application of the standard and your methodology.

### PROVIDE RECOMMENDATIONS

We'll provide necessary recommendations and advise on your transition approach.

### CONSULT ON DESIGN AND MONITORING

During implementation and post-implementation, we'll further consult on your design and provide recommendations for your ongoing monitoring framework.

**We can take a more collaborative approach.**
Beyond advising, our team can share responsibility for the coordination and oversight of teams.

### COLLABORATE ON PROCESS
Collaboratively, we will help you determine areas of judgment applicable to contracts, develop a training plan and materials, and share in the delivery of the materials. Our experts will also assist with the development and implementation of your transition approach.

### PARTNER THROUGH TRANSITION
During implementation and post-implementation, we'll be by your side providing observations and insights for a successful transition, and will work with your team to establish a framework for monitoring compliance, analysis, and continuous improvement.

**We can help with the operational impacts of changes:**

### ENHANCE RELIABLE FINANCIAL REPORTING
We can advise you on new processes, systems, and controls required to ensure you produce high quality, timely, and reliable financial reporting under the new standard.

### ADDRESSING FINANCIAL COVENANTS
If you have financial reporting covenants, we can develop a financial bridge outlining changes to financial reporting to assist in communicating with lenders and other stakeholders regarding appropriate changes to financial covenants.

### EVALUATE ERP COMPLIANCE
We'll evaluate ERP system compliance required to support the new standard. If noncompliant, we can evaluate alternative solutions, including the implementation of new software solutions.

### ASSESS OPERATIONAL RISK
For portfolio companies — We can help assess operational risks which result from the new standard, including revised contract profitability, changes to financial ratios on company commitments, and contract administration inefficiencies.

For funds — We can help assess operational risks which result from the new standard, including due diligence and quality of earnings.

# The revenue recognition process

To appropriately recognize revenue under the new standard, each individual customer contract should be reviewed on its own merits.

**STEP ONE**
Identify contracts

**STEP TWO**
Identify performance obligations

**STEP THREE**
Determine transaction prices

**STEP FOUR**
Allocate transaction prices

**STEP FIVE**
Recognize revenue

### How much time will you need to implement the new standard?

The amount of time required for your organization to successfully implement the new standard lies in a number of variables.

| IMPLEMENTATION VARIABLE | POTENTIAL CHALLENGES | ADDITIONAL TIME REQUIRED? YES |
|---|---|---|
| REVENUE STREAMS | Extensive and diverse | ✓ |
| CONTRACT COMPLEXITY | Numerous, complex | ✓ |
| DATA AVAILABILITY | Data not currently available, or will require significant effort to compile | ✓ |
| PROCESSES AND SYSTEMS | Significant changes needed | ✓ |
| RESOURCES AVAILABILITY | Outside resources needed | ✓ |

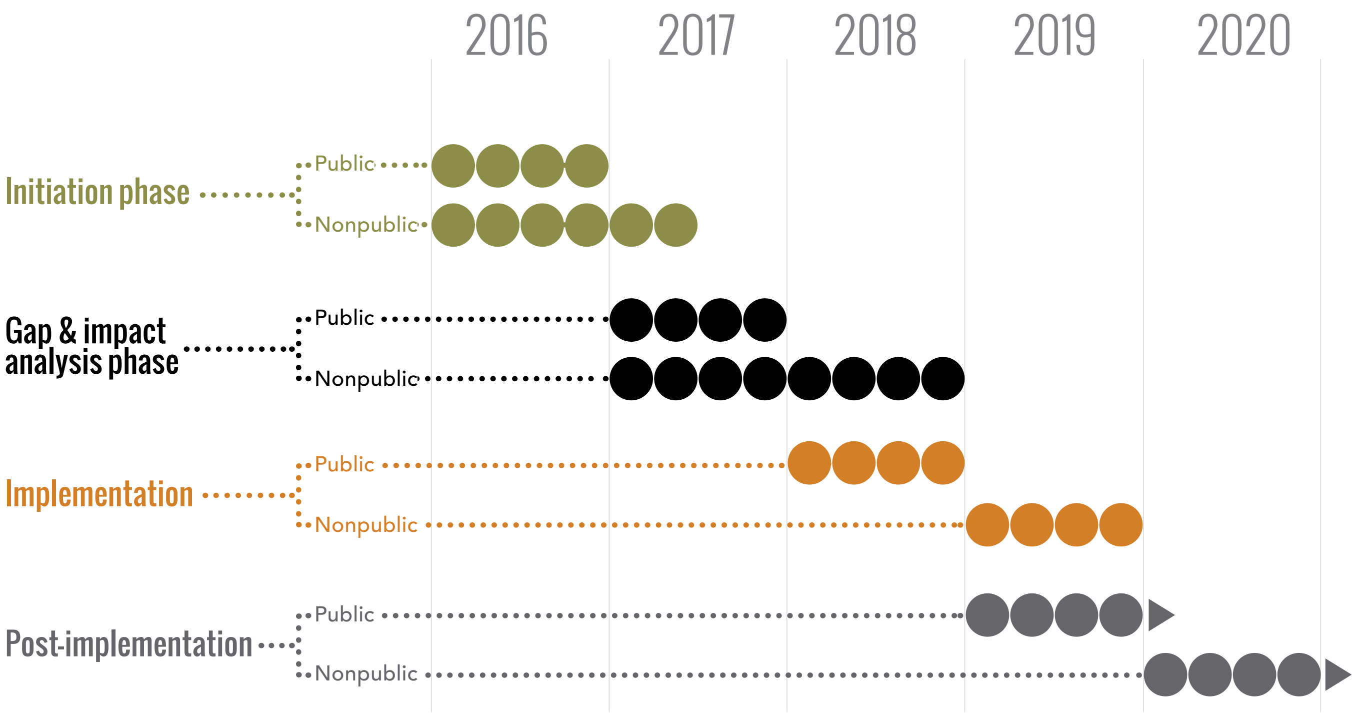
# Timeline and implementation steps

The new standard that governs the recognition of revenue from contracts with customers is currently scheduled to become effective for all nonpublic entities in 2019. It's easy to dismiss this deadline as "years away," but the work needed to prepare for this change is quite possibly unlike any accounting implementation project your organization has undertaken before.

The implementation can be broken down into four phases.

## IMPLEMENTATION PHASES

BY ORGANIZATION TYPE



## Initiation phase

**2016–early 2017** for nonpublic entities

**Assign staff to become your experts.** They'll take the lead on understanding and implementing the new revenue recognition standard.

*Note: Be mindful of accounting, financial reporting, tax, internal audit, sales operations, IT, legal, and human resources implications.*

**Read the standard or a summary of the standard.**

**Determine areas of judgments in the standard applicable to your contracts.**

**Inventory contracts and terms.**

**Develop an internal training plan.**

**Understand current processes and system capabilities** related to initiation, storing, and accounting for contracts.

**Determine project management tools.**

**Evaluate any new long-term contracts.**

## Gap & impact analysis phase

**2017–2018** for nonpublic entities

**Determine what interim disclosures** will need to be made before the standard is effective.

**Apply the new model** to selected contracts. Evaluate the changes from current GAAP to the new revenue standard and evaluate the impact.

**Develop a methodology** for applying and documenting key judgments and estimates.

**Determine the transition approach** to be applied (cumulative-effect or retrospective).

**Evaluate necessary changes** to business processes, IT systems, and internal controls.

**Evaluate how the standard will affect operational and performance metrics** and other areas of your organization.

*Note: Consider the timing of revenue recognition, balance sheet impact, disclosures, accounting policies, tax, and other contractual arrangements (leases, covenants, compensation, earn-outs).*

**Educate key stakeholders** (audit committee, board of directors, investors, and others) on the impact of the changes to your organization.

## Implementation

**JANUARY 1, 2019** for nonpublic entities

**Apply the transition methodology** selected to contracts in place.

**Apply the new standard to contracts** entered after the implementation date.

**Execute changes** to business processes, IT systems, and internal controls.

**Execute changes required** in other areas of your organization.

*Note: Consider the timing of revenue recognition, balance sheet impact, disclosures, accounting policies, tax, and other contractual arrangements (leases, covenants, compensation, earn-outs).*

## Post-implementation

**Establish processes** to evaluate instituted business processes, IT systems, internal controls, and other changes.

To learn more, visit
**revrec.plantemoran.com**

plante moran

audit • tax • consulting • wealth management

**Plante Moran clients:**

Contact a member of your engagement team

**All others:**

MICHELE E. MCHALE
**Private Equity Practice Revenue Recognition Leader**
michele.e.mchale@plantemoran.com
248.223.3579

CHRISTA LABROSSE
**Revenue Recognition Implementation Team**
christa.labrosse@plantemoran.com
313.496.7228