# Revenue Recognition Webinar:

What Private Equity Needs to Know | January 19, 2017

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# Agenda

**Introduction to ASC Topic 606: Revenue from Contracts with Customers**

- Highlights of each step of the model
- Examples & industry considerations
- Investor considerations

**Impact beyond financial reporting**

- Pre-deal considerations
- Post-deal considerations

# About Plante Moran

## AUDIT, TAX, CONSULTING & WEALTH MANAGEMENT LEADERS

**Plante Moran is one of the nation's leading accounting, tax, and management consulting firms with alliances throughout the world. We have a team of experts dedicated to serving private equity clients and their portfolio companies in building value throughout the lifecycle of the deal.**

- Founded in 1924
- 2,200+ professionals
- 22 locations
- 20,000+ clients
- 350+ portfolio companies
- 250+ private equity clients
- 200+ deals completed in the last year
- 10 affiliates including investment bank, PMCF

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# Meet Today's Presenters

## CHRISTA LABROSSE, CPA, PARTNER

Christa is a partner and a member of Plante Moran's Professional Standards Team. She is the industry technical lead for the firm's service industry and is leading the firm's efforts related to implementation of the new revenue recognition standard. Her role is to maintain firsthand knowledge of developments in the profession, both in auditing and accounting. She provides staff and clients with interpretations and explanatory materials on professional pronouncements and performs pre-issuance quality control reviews of financial statements to ensure that professional standards are maintained in actual practice.

## CHRIS JENKINS, CPA, ASSURANCE SENIOR ASSOCIATE

Chris has more than 12 years of experience in the financial services industry, specializing in providing assurance, valuation, and consulting services to a client base ranging from private equity and venture capital to hedge funds and family offices. He manages various audit and consulting services including financial statement audits, due diligence projects, internal audits, and SEC reporting. Chris leads the firm's CPE program for investment fund auditors by syndicating and sharing knowledge obtained from several business valuation courses.

## MELISSA LYNCH, CPA, ASSURANCE SENIOR ASSOCIATE

Melissa has more than 13 years of experience providing accounting, auditing, and consulting services to organizations both privately held and private equity owned. She is the professional standards team leader for the service industry. Melissa acts as the technical colleague on various assurance engagements, performs pre-issuance quality control reviews on financial statements, and develops and teaches accounting and auditing training programs for professional staff.

## ANDREA SLABINSKI, CPA, ASSURANCE ASSOCIATE

Andrea has more than 11 years of experience serving complex clients by helping them meet the critical business matters facing growing companies. She has worked with several companies as they have grown from small businesses with limited controls to complex, sophisticated companies to satisfy professional boards or private equity owners. Andrea serves as a technical standards reviewer for client financial statements, as well as an audit senior manager on various large, technically challenging engagements. She is involved in both developing and delivering technical trainings on various topics.

# Introduction to ASC Topic 606: Revenue from Contracts with Customers

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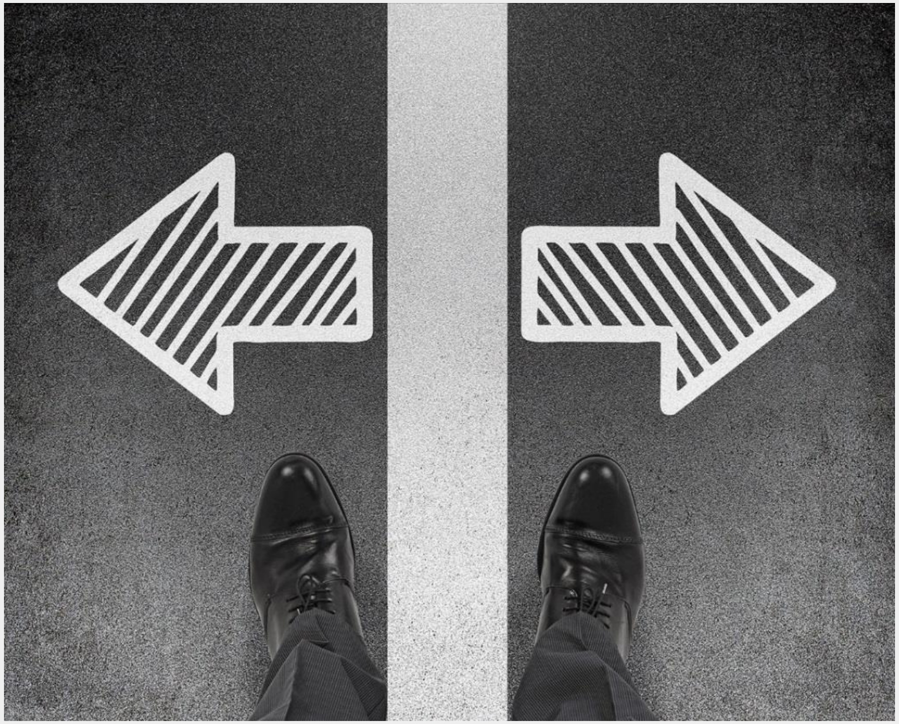
# ASC Topic 606:
# Revenue from contracts with customers

**Background**

**Scope**

**Effective dates**

- U.S. GAAP public business entities & IFRS – 2018 (annual & interim periods)
- U.S. GAAP nonpublic companies – 2019 (annual periods)



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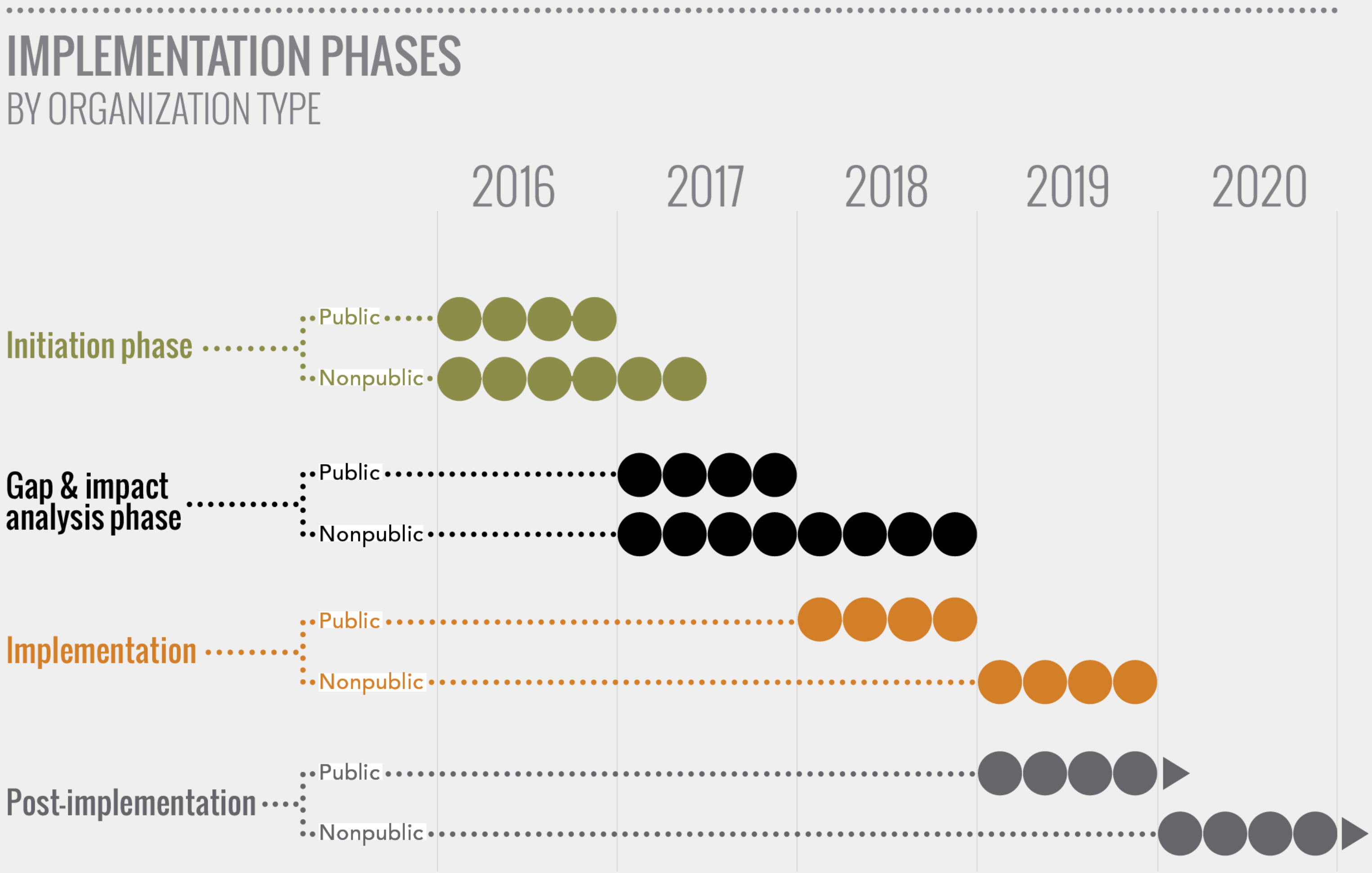
# Timeline


IMPLEMENTATION PHASES
BY ORGANIZATION TYPE
2016
2017
2018
2019
2020
Initiation phase
Public
Nonpublic
Gap & impact analysis phase
Public
Nonpublic
Implementation
Public
Nonpublic
Post-implementation
Public
Nonpublic

# Impacts beyond financial reporting

## PRE-DEAL CONSIDERATIONS

- New investments
- Valuation model adjustments
- Historical comparisons
- Exit strategies
- Due diligence

## POST-DEAL CONSIDERATIONS

- EBITDA
- Earnouts and management compensation
- Debt covenants
- Fair value measurements
- Tax

# Core principle & five steps to apply

## CORE PRINCIPLE

**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**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# How does this apply to my portfolio companies?

- Contracts currently accounted for under multiple deliverable or proportional performance methods
- Performance or incentive based income
- Consignment arrangements
- Disclosures
- Customer loyalty programs
- Bill and hold arrangements
- VSOE
- Set up costs & nonrefundable upfront fees
- Performance bonuses
- Tooling
- Extended payment terms
- Volume discounts
- Transition
- Contract modifications
- Principal vs. agent
- Sales commissions
- Allocation of Discounts
- Costs to fulfill contracts
- Contingent Revenue
- Contracts entered into simultaneously
- Licenses
- Discounted goods or services
- Repurchase agreements
- Consideration payable to a customer

# Step 1: Identify the contract with the customer

## CONSIDERATIONS:

- Approval
- Collectability
- Combination of contracts
- Contract modifications
- Repurchase agreements
- Individual purchase orders
- Change orders – approved & unapproved
- Oral agreements
- Side agreements

# Step 1: Identify the contract with the customer

## INDUSTRY & INVESTOR CONSIDERATIONS

- Business to business
- **Contractors**
- **Healthcare**
- Manufacturing & distribution
- **Professional services**
- Retail
- **Technology**

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# Step 2: Identify the separate performance obligations in the contract

## CONSIDERATIONS:

- Contracts currently accounted for under multiple deliverable or other proportional performance methods
- Combination of performance obligations
- Licenses
- Customer options
- Tooling
- Warranties
- Nonrefundable upfront fees
- Bill & hold arrangements

# Step 2: Identify the separate performance obligations in the contract

**Example: Contractor enters into a contract to build a hospital and a parking garage.**

## WHAT ARE THE PERFORMANCE OBLIGATIONS?


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# Step 2: Identify the separate performance obligations in the contract

## INDUSTRY & INVESTOR CONSIDERATIONS

- Business to business
- **Contractors**
- Healthcare
- Manufacturing & distribution
- **Professional services**
- Retail
- **Technology**

# Step 3: Determine the transaction price

## CONSIDERATIONS:

- Variable consideration
- Constraint on variable consideration
- Financing component
- Noncash consideration
- Consideration payable to a customer
- Rights of return
- Performance bonuses
- Customer loyalty programs
- Volume discounts
- Contingent revenue

# Step 3: Determine the transaction price

**Example 1: An entity enters into a contract with a customer to build an asset. The promised consideration is $2.5 million, but that amount will be reduced or increased depending on the timing of completion of the asset. Specifically, for each day after the deadline that the asset is incomplete, the promised consideration is reduced by $10,000. For each day before, the promised consideration increases by $10,000.**

HOW MUCH OF THE PERFORMANCE BONUS SHOULD PROFESSIONAL SERVICES FIRM INCLUDE IN THE TRANSACTION PRICE?

# Step 3: Determine the transaction price

**Example 2: Business to business enterprise enters into a $1 million contract to provide services.  The contract allows for deferral of customer payments over a time period significantly past the date that the services have been performed.**

## WHAT IS THE CONSIDERATION UNDER THE CONTRACT?


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# Step 3: Determine the transaction price

## INDUSTRY & INVESTOR CONSIDERATIONS

- **Business to business**
- **Contractors**
- **Healthcare**
- **Manufacturing & distribution**
- **Professional services**
- **Retail**
- **Technology**

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# Step 4: Allocate the transaction price to separate performance obligations

## CONSIDERATIONS:

- Relative standalone selling price
- Significant estimates
- VSOE no longer a consideration for software companies

## SUITABLE ESTIMATION METHODS:

- Adjusted market assessment
- Expected cost plus margin
- Residual transition price

# Step 4: Allocate the transaction price to separate performance obligations

## EXAMPLE: IMPACT OF VARIABLE PRICING

### Assumptions:

- Minimum production units at beginning of contract
- Pricing does not change from original contract

### Outcome:

- Total revenue is the same, timing is different

| Year | Contract price | Estimated units produced / sold | Old GAAP Per unit revenue | Old GAAP Total Revenue | New GAAP Per unit revenue | New GAAP Total Revenue |
|---|---|---|---|---|---|---|
| 20X1 | $30 | 1,000 | $30 | 30,000 | $26 | 26,000 |
| 20X2 | $28 | 1,000 | $28 | 28,000 | $26 | 26,000 |
| 20X3 | $26 | 1,000 | $26 | 26,000 | $26 | 26,000 |
| 20X4 | $24 | 1,000 | $24 | 24,000 | $26 | 26,000 |
| 20X5 | $22 | 1,000 | $22 | 22,000 | $26 | 26,000 |
| | | 5,000 | | 130,000 | | 130,000 |

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# Step 4: Allocate the transaction price to separate performance obligations

## INDUSTRY & INVESTOR CONSIDERATIONS

- Business to business
- **Contractors**
- Healthcare
- Manufacturing & distribution
- **Professional services**
- Retail
- **Technology**

# Step 5: Recognize revenue when (or as) each performance obligation is satisfied

## CONSIDERATIONS:

- Over time
- Point in time
- Principal vs. agent
- Consignment

**Performance obligations are satisfied over time if any of the following criteria are met:**

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs
- The entity's performance creates or enhances an asset that the customer controls as it is created or enhanced
- The entity's performance does not create an asset with an alternative use to the entity and the entity has a right to payment for performance completed to date

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# Step 5: Recognize revenue when (or as) each performance obligation is satisfied

**Example 1: Enterprise enters into a three-year maintenance contract with a customer.**

## SHOULD REVENUE BE RECOGNIZED AT A POINT IN TIME OR OVER TIME?

**Performance obligations are satisfied over time if any of the following criteria are met:**

- Customer simultaneously receives and consumes
- Customer controlled
- No alternative use AND right to payment

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# Step 5: Recognize revenue when (or as) each performance obligation is satisfied

**Example 2: Company enters into a contract to build a custom tool, built in the company's shop and shipped to customer upon completion of the tool**

## SHOULD REVENUE BE RECOGNIZED AT A POINT IN TIME OR OVER TIME?

### REMINDER:

**Performance obligations are satisfied over time if any of the following criteria are met:**

- Customer simultaneously receives and consumes
- Customer controlled
- No alternative use AND right to payment

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# Step 5: Recognize revenue when (or as) each performance obligation is satisfied

## INDUSTRY & INVESTOR CONSIDERATIONS

- **Business to business**
- **Contractors**
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- **Manufacturing & distribution**
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# Balance sheet implications

## INCREMENTAL COSTS OF OBTAINING A CONTRACT — COMMISSIONS

## CONTRACT FULFILLMENT COSTS

- Contract asset
- Contract liability

# Disclosure requirements

**The objective of the disclosure requirements is for an organization to disclose sufficient information for users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.**

**Disclosures are extensive, both qualitatively and quantitatively.**

**Revenue**

- Disaggregation of revenue
- Amounts recognized relating to performance in previous periods

**Contracts**

- Information about contract balances and changes
- Information about performance obligations
- Amounts allocated to remaining performance obligations

**Significant judgments**

- Timing of and methods for recognizing revenue
- Determining the transaction price and amounts allocated to performance obligations

# Transition methods

FULL RETROSPECTIVE

MODIFIED RETROSPECTIVE

# Impacts beyond financial reporting

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# Private equity fund financial statements

## EXPECTED IMPACT:

- Limited*

## CONSIDERATIONS:

- Management fee revenue
- Carried interest
- Management fee waivers & reimbursements
- Other incentive or performance fee revenue and capital allocation

# Impacts beyond financial reporting

## PRE-DEAL CONSIDERATIONS

- New investments
- Valuation model adjustments
- Historical comparisons
- Exit strategies
- Due diligence
- Costs & resources needed by portfolio company to prepare and implement the standard

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# Impacts beyond financial reporting

## POST-DEAL CONSIDERATIONS

- EBITDA
- Earnouts and management compensation
- Debt covenants
- Fair value measurements
- Tax
- Costs & resources needed by portfolio company to prepare and implement the standard

# Key takeaways

- The new standard applies to companies in all industries, including private equity funds and their portfolio companies.
- The timing of revenue recognition and the balance sheet could be affected by the implementation of the standard.
- Consider how you evaluate new investments, including historical comparisons and valuation model adjustments.
- Management of the portfolio companies may be different in the future – consider EBITDA, management compensation, debt covenants.

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# Q&A - Thank you for attending

## FOR MORE INFORMATION VISIT **REVREC.PLANTEMORAN.COM**

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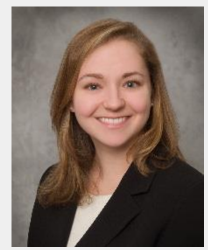

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