Why private companies should care about the new revenue guidance now

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606), which added Topic 606 to the FASB’s Accounting Standards Codification (ASC) and will replace almost all pre-existing revenue recognition guidance in legacy U.S. generally accepted accounting principles with a robust framework for addressing how an entity should account for its revenue. Public entities must comply with ASC 606 in 2018, while private companies must adopt the standard in 2019. Although the FASB provided delayed effective dates for ASC 606, it was with the understanding that implementation of that guidance would be a significant undertaking for many (if not most) entities.

Our whitepaper, Light the fire: Private companies and the new revenue guidance, demonstrates that, upon implementation, the degree of change to a specific entity’s revenue recognition policies and the effects the changes have on the entity’s financial statements will vary depending on the nature and terms of the entity’s revenue-generating transactions. And, although the income statement impact of the adoption of ASC 606 will be different for every entity, it is clear that entities in virtually all industries will be significantly affected by the increased volume of revenue-related information required to be disclosed in the financial statements. However, many companies underestimate the amount of effort it will take to develop and implement a good plan for the adoption of the standard.

In this whitepaper, we begin with five good reasons to start the implementation process early and keep the fire of urgency burning:

- Starting early can limit disruptions throughout the organization. If not properly managed in advance, the implementation process could be overwhelming.
- If done thoughtfully and thoroughly, implementation of the new standard can provide an opportunity to consider strategic operational issues such as improving efficiency, enhancing information systems and strengthening processes and controls.
- Financial metrics, such as EBITDA and balance sheet ratios, may change. This could impact negotiations with lenders and potential acquirers so should be addressed sooner rather than later.
- Understanding the impacts early enables companies to contemplate making changes to contract terms and pricing policies to achieve the desired revenue model under the new standard.
- Starting the implementation process early enables more time to engage and train resources throughout the organization so they are prepared to report under this new complex standard once it becomes effective.
What are the primary operational challenges associated with implementation of ASC 606?

Because in many cases ASC 606 provides principles that are replacing prior rules, the use of good judgment in making policy elections and significant estimates will be critical and will require insights from experienced people. For example, the determination of the amount of variable consideration (e.g., rebates, discounts, allowances, penalties, bonuses incentives) to include in the transaction price requires estimations and use of seasoned judgment. There may be a need to hire or train people to be involved with the implementation effort. Additionally, the documentation of the basis for those judgments will be important, and estimates must be updated throughout the term of the contract.

Increased judgments and estimates also will require increased processes, controls and documentation, as well as potentially significant changes to existing information technology (IT) systems. Further, there may be a need for new IT solutions to capture, track and aggregate the information that must be recorded and disclosed in accordance with the requirements in the new guidance (e.g., data migration issues, recasting of historical transactions, the maintenance of two sets of books for the same timeframe, etc.). Designing, developing and testing the necessary system modifications could take many months to complete, especially since custom software development generally will be required. Remember that new processes and controls also may be necessary to capture the costs to fulfill a contract if such costs had not been capitalized under the existing standards.

Some additional challenges middle-market companies may experience when implementing ASC 606 include the following, among others:

- **The need to analyze contracts in detail** – Contracts will need to be analyzed to determine the appropriate revenue recognition treatment under the new guidance. It is critical that both standard and unique contracts be reviewed for terms and conditions that may be relevant for recognizing revenue under the new standard (e.g., performance obligations, transaction pricing, contingencies, related costs for obtaining and fulfilling the contract, etc.). Legal interpretation may be needed in some cases to determine when a contract exists. Training likely will be required for anyone involved in negotiating or reviewing contracts. This includes sales representatives, account managers, legal professionals, executives and others (i.e., not only accounting/finance people).

- **The impact on the financial statement audit** – Keep in mind that your external auditors will need to review and test your documentation related to contract reviews, revenue stream analysis, significant estimates (e.g., standalone selling price for performance obligations), updated procedures (e.g., to assess collectability), financial statement disclosures and much more.

- **Income tax implications** – There is the potential for new temporary differences or the re-measurement of existing temporary differences, and the income tax impacts associated with the adoption of the new standard must be disclosed. Also, consideration should be given to potential tax accounting method changes for revenue recognition and related matters. Approval from taxing authorities may be required, so it is prudent to discuss the implementation of ASC 606 with your tax advisors.

- **The impact on financial metrics, key performance indicators and capital structure** – The new standard can impact revenue, EBITDA, working capital ratios, debt-to-equity ratios and financial covenants. For example, a change in ratios can cause a company to be out of compliance with debt agreements. Companies should consider how such impacts may affect external stakeholders, such as lenders and potential acquirers. A concern for some private companies is the need to be compliant with ASC 606 in the quarter following the acquisition if the company were to be acquired by a calendar-year public company during 2018.

- **Budgeting for post-adoption periods** – ASC 606 could change internal financial results, and this would need to be quantified as part of the company’s budgeting process.
What are the opportunities associated with implementation of ASC 606?

The silver lining in this grey cloud of challenges can be seen in the opportunities presented with the adoption of ASC 606, such as potential improvements to existing systems/processes. Implementation involves a review of existing order-to-cash and procure-to-pay processes, which could result in process improvements, including automation of manual processes. Also, coordination of legal, finance, IT, tax and operations for application of the standard can produce operational benefits.

Another area of opportunity when implementing ASC 606 is the ability to alter contractual terms and pricing strategies going forward to achieve the desired revenue model. Contract terms that are either ambiguous or have unfavorable revenue recognition implications can be modified in the pre-adoption period if identified early in the process. Discounting practices and pricing strategies also should be reviewed and monitored. Changes can be made prospectively based on the desired business goals and revenue model. Marketing offers can be developed in a manner that eliminates undesirable implicit performance obligations or timing of revenue recognition. For example, a coupon for 20 percent off a next purchase offered to a customer may be considered a reward for a prior purchase, which may have significant accounting impacts.

Are there any additional challenges or opportunities for middle-market private equity funds?

In the middle market, private-equity-fund ownership of companies is significant. When implementing ASC 606, there are both challenges and opportunities for private equity funds and their portfolio companies. The most obvious challenges occur because of the number of portfolio companies in need of assistance with the implementation, while the most obvious opportunity is the potential for economy of scale in the implementation process. Potential challenges also may arise in the need to implement the standard quickly due to an impending acquisition by a public company.

We encourage private equity funds to start the implementation process by first determining the impact of the standard on each portfolio company, and then prioritizing the implementation of the standard at the various portfolio companies by assessing factors such as:

- Similar impacts of the standard
- Competency of the portfolio company management team
- Size and complexity of operations
- Geographic focus (i.e., international vs. domestic)
- Reporting needs and timing, considering matters such as time to liquidity

Resources available at each portfolio company also will be a factor. The fund may be able to train select resources, and then leverage them across the portfolio companies.

How can a private company be in a position to efficiently adopt ASC 606?

Adopting ASC 606 will be a time-consuming process for most entities. It is important to start by understanding the impact of the new standard and how pervasive the requisite changes will be. It will be helpful to develop a comprehensive change-management project plan, such as the following, to guide implementation of the new standard:

- Assess the impact of the new standard in order to design and implement an appropriate plan. This phase of the plan typically would include:
  - Comparing historical revenue recognition accounting policies and practices to the new requirements
- Analyzing the various ways in which products and services are sold to customers and then selecting a representative sample of contracts from each revenue stream to review. It is important that this sample be comprehensive so as to cover nonstandard terms, custom contracts, potential implicit goods/services (i.e., items outside of the written contract), etc.
- Determining the impacts of the new standard on the accounting for commission plans and direct costs to fulfill a contract as such costs may need to be capitalized under the new requirements
- Assembling a cross-functional team to consider the business-related impact of adopting ASC 606 (e.g., effects on budgets, income taxes, compensation plans, loan covenants, etc.)
- Identifying new data to be tracked and retained for revenue recognition and the related required disclosures; communicating related requirements to IT
- Assessing accounting policy elections under the new standard
- Discussing the impact with external auditors. It is wise to discuss with your auditors the plans for ASC 606 implementation sooner rather than later.

- Develop the necessary technology and implementation strategy by:
  - Evaluating business requirements against viable technology vendors
  - Determining the implementation timeline and budget
  - Developing a strategy for recast of historical financial information and a strategy for migrating the accounting for contracts in progress to the new requirements
  - Developing a strategy for aggregating the necessary information related to the capitalization of costs
  - Determining the necessary changes to internal control over financial reporting

- Implement changes required, which among other actions, could include:
  - Performing a “deep dive” review of a larger sample of contracts for each revenue stream
  - Drafting accounting policies to ensure revenue streams are evaluated properly under ASC 606
  - Drafting necessary transition and ongoing disclosures
  - Reporting on the progress of the implementation to external auditors and those charged with governance on a regular basis during the project’s duration
  - Testing selected sample contracts and related internal controls for appropriate accounting under ASC 606

Information regarding the new guidance in ASC 606 is available in RSM’s Revenue Recognition Resource Center. If you have questions about the new guidance or its implementation, don’t hesitate to contact an RSM representative.