Modifying Your Due Diligence Approach as a Result of the New Revenue Recognition Standard

Is your company ready? Leverage lessons learned to be better prepared.

Background

The FASB and IASB issued their converged revenue recognition standard (ASC 606 and IFRS 15, respectively) with the objective to improve the area of financial reporting based upon the nature, amount, timing, and uncertainty of revenue and cash flows.

Dealmakers will need to reassess how they evaluate targets, negotiate, and structure their deals. The new revenue recognition standard could impact inputs to current valuation models, including EBITDA and other performance metrics, such as reconciling between GAAP net income and FCF to meet internal and external reporting requirements. In addition to valuation models, the standard could have a significant effect on tax planning, management compensation, due diligence, debt covenants, earn-out mechanisms, and exit strategies. Private companies will need to consider the appropriate adjustments to valuation models to incorporate the effects of the new standard by January 2019 (for annual periods beginning after December 15, 2018). Privately held companies have an advantage right now, as they can learn from the experiences of public companies that were required to adopt and implement the standard beginning in January 2018.

In the pages following, we have provided insights to help you prepare as you look to assess your deal opportunities from a financial and operational standpoint. Not only will there be immediate deal impacts as noted above, but, in addition, the cost and effort to adopt the new rules can be significant depending on several factors. If the buyer needs to shoulder the burden, they should evaluate this as part of the deal.

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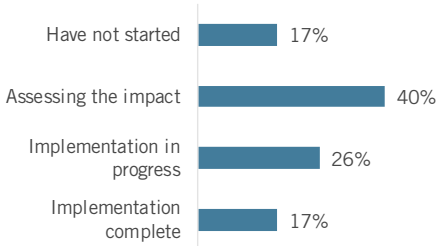
Overview

The new revenue recognition rules have been in effect for U.S. public companies throughout 2018, and the impacts on revenue, income, and EBITDA for certain companies and industries are now transparent, giving a leg up for sponsors and private companies to better assess the impacts on their deals. Certain components of revenue are largely accelerated for companies in the technology and pharma industries, whereas revenue has been deferred for certain companies in the construction and business services industries. Each company and industry has its own facts and circumstances, and, in some cases, the pattern of recognition has not changed at all. Accordingly, acquirers should consider the impacts of the changing models now as they look at prospective deals.

Dealmakers are in a period of flux thanks to the change in revenue models and the staggered timing of adoption and implementation between private and public companies. Public companies have largely transitioned to the new standard, although full-year results are not yet available. Also, most companies have used the modified retrospective transition approach, meaning that 2018 figures are not comparable to prior years, since those prior-year figures have not been restated. In contrast, private companies have not yet transitioned to the new standard and will start phasing in adjusted numbers throughout 2019. These multiple layers of mismatch between revenue reporting can create havoc and uncertainty in deal models as well as create additional effort and focus around the diligence process in understanding the current (and future) revenue and cash flow performance of an acquisition target.

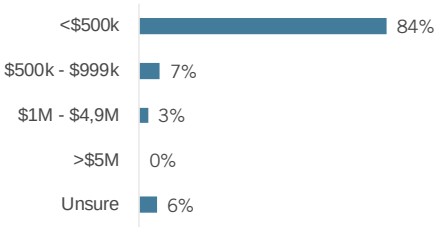
Question: *Which of the following best describes your company's status in adopting the new revenue* standards?

Non-Public Companies



Question: *What level of total incremental costs did you incur or do you expect to incur to implement the new revenue standards?*

Non-Public Companies



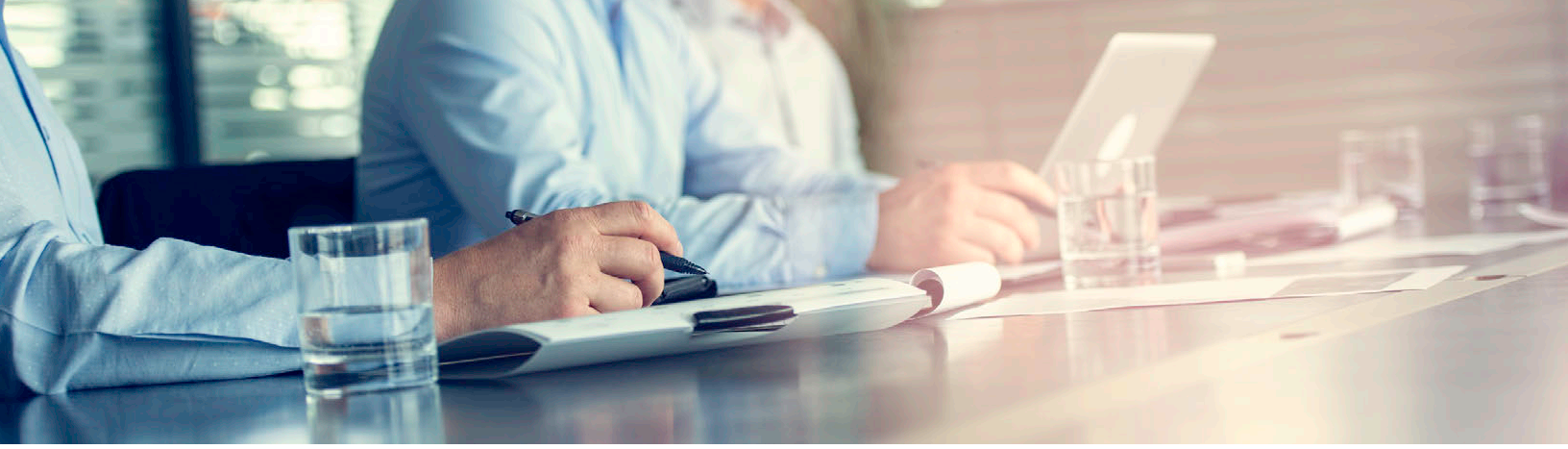
Source: PwC Accounting Change Survey, May 2018

Learnings: Advantage Sponsors

Several of our private company clients and the sponsor community are starting to assess the impact of the new standard in their deals, and the window to do so is approaching rapidly as required adoption nears in 2019. This is largely because private companies have not ramped up their transition efforts until recently, and, thus, it is hard to model in the deal impacts accordingly. Private company sellers have started preparing and analyzing these changes as they craft their story in going to market; however, their potential buyers are largely playing catch-up. Fortunately, our public company strategic acquirers have given us a head start on deal issues and opportunities to consider. As we have been working with our clients, we have gleaned a few notable diligence areas of focus as follows:

> **Impacts to key diligence items should help potential buyers evaluate strengths and weaknesses in the target company's operations.**

Focus Area	Our Insight
Varied Payment Terms Selected industries impacted: Retail and Healthcare	Many private firms have grown to know their customers intimately over the years and may have established custom payment arrangements. These arrangements may include variable consideration, the seller financing a significant portion of the transaction price, agreeing to receive noncash consideration, and being offered material amounts of rebates and sales discounts. All of these situations require special attention upon adopting ASC 606.
Material Rights Selected industries impacted: Manufacturers/Industrials, Technology (subscription-based businesses)	Businesses will be required to take a hard look at their legacy sales practices, particularly when customers are given options to acquire additional goods or services. An option that provides a customer with a future discount on goods or services might be a material right, which, under ASC 606, is considered a promise embedded in a current contract that should be accounted for as a separate performance obligation.
Principal vs. Agent Selected industries impacted: Financial services (brokerages), Media (distributors), Retail (wholesalers)	The new revenue standard also provides updated guidance on how to differentiate between whether an entity is a principal or an agent. This distinction has a key top-line impact during diligence procedures, as it will dictate if revenues are presented gross or net of costs in the financial statements. Being able to accurately identify whether an entity is acting in a principal or agent capacity can materially impact common sizing analysis of the P&L as well as return metrics such as asset turnover.
Cost Deferral Selected industries impacted: All	Upon adopting the new revenue guidance, companies must now capitalize the incremental costs of obtaining a contract with a customer (e.g., sales commissions and related costs, etc.) and amortize over the contract life rather than full expensing up front. Not only will this defer these costs over time, but the amortization of these costs will now also be a potential add-back to EBITDA or Adjusted EBITDA certain sellers may attempt to employ and could impact deal models and diligence procedures where these costs are significant.
Evolved Guidance Selected industries impacted: All	We have found that many privately held companies with limited reporting obligations have only had to assess their revenue under select portions of industry-specific guidance over time. Now that there is one unified standard that is principles and judgement based, each company and their buyers have the opportunity to reestablish their revenue policies and elections optimally upon transition.
Public Competitor Insights	Public company competitors that have already adopted ASC 606 in 2018 for fiscal years beginning after December 15, 2017, have had to provide disaggregated revenue insights along with a summary of impacts to both balance sheet and income statement line items. These impacts to key diligence items, such as accrued receivables, deferred revenue liabilities, primary and secondary revenue streams, and deferred costs, should help potential buyers evaluate strengths and weaknesses in the target company's operations.



> **Multiples and models based on trailing 12 months' data could have a mix of old and new revenue figures to deal with.**

How to Pay the Piper

Certainly these changes will cause buyers to reevaluate how they want to negotiate and structure both payments to the sellers as well as go-forward compensation to the target's employees. Sponsors and private companies, in particular, use common purchase price mechanisms such as earn-outs, which are inherently tied to revenue or other profit measures derived therefrom. What will the results of the business look like after acquisition upon adoption of the new standards? What terms can be negotiated to safeguard any irregularities or shifts in metrics in order to protect both buyer and seller?

Also, key employees typically have incentive programs that are tied to the performance of the business. Deal teams who are evaluating bonus programs or stock award agreements through diligence should take note of any potential changes that may change deal models, projections of the business, and ultimately cash that will be distributed to employees. Until companies fully adopt the new rules, buyers may want to think about structuring purchase mechanisms and incentive arrangements differently in order to avoid the uncertainty that will come along with the new revenue standard.

Stuck in the Middle With You

During the transition years of 2018 and 2019, adopting the requirements of ASC 606 will play havoc with trying to tell a meaningful story over an extended period of time on buyers and sellers. Both the buyer and seller may have to run two sets of books or models under the old and new standards in order to accommodate for the transition. In addition, the buyer community will need to become comfortable with offering prices based upon revenue or EBITDA multiples for a period of time that may not historically align with the market or industry. Multiples and models based on trailing 12 months' data, for example, could even have a mix of old and new revenue figures to deal with. While the valuation of a company shouldn't theoretically be impacted by these changes, consideration should be taken to normalize the figures in order to obtain a consistent analysis.

> **Revenue could be accelerated to a pre-transaction period due to the adoption of ASC 606, but deferred to the post-transaction period for tax accounting purposes.**

And Finally...Taxes

There are also tax considerations related to the adoption of ASC 606. The modification of revenue recognition for GAAP purposes without a corresponding change to revenue recognition for tax purposes creates a timing difference. These timing differences, which should be recorded as deferred tax assets/liabilities, could impact the tax considerations for a transaction. For example, revenue could be accelerated to a pre-transaction period due to the adoption of ASC 606, but deferred to the post-transaction period for tax accounting purposes. Under this scenario, a target company's revenue would be increased without a corresponding reduction for income taxes, thus providing the buyer with the benefit of the revenue but leaving the buyer with the income tax burden. Identifying these additional tax costs will add an additional layer of complexity to the tax due diligence process.

In May 2018, the IRS issued Rev. Proc. 2018-19, which provides that taxpayers can automatically change their tax accounting method to more closely mirror the requirements of ASC 606. However, the guidance only applies to the year in which a taxpayer adopts ASC 606. If the election to change the tax accounting method is not made in the same year as the adoption of ASC 606, the process to conform tax and GAAP revenue recognition is more arduous. If target companies are in industries impacted by ASC 606, buyers should understand the target's plan to conform tax accounting to GAAP.

Act Now

Perhaps an overlooked consideration as private companies transition and dealmakers are assessing the transaction is this: Is the target ready? The cost and effort to adopt the new rules can be significant, depending on several factors. If the buyer needs to shoulder this burden, they should evaluate this as part of the deal, as underestimating the new standard's implications may lead to a disadvantaged negotiation position, deal value leakage, or both. There are also tax and real cash implications resulting from adopting ASC 606. Buyers would be wise to perform extended financial and tax diligence procedures to ensure their projected return on investment gets off on the right start.

Houlihan Lokey's Transaction Advisory Services professionals are ready to stand side-by-side in helping buyers and sellers think through these matters in order to best optimize deal value for all involved.

HOULIHAN LOKEY'S INTEGRATED APPROACH TO SERVING CLIENTS

Houlihan Lokey's Transaction Advisory Services practice has a dedicated advisory team—Accounting & Financial Reporting (AFR)—that helps our clients navigate today's uncertain and complex dealmaking and strengthen their reporting functions. AFR partners with other Houlihan Lokey practices, such as Tax & Financial Reporting (TFR), Dispute Resolution Consulting, Financial Restructuring, and Corporate Finance (CF), to bring our clients an integrated approach so that they can quickly respond to issues or concerns directly impacting negotiations.

Want to know more about our Accounting & Financial Reporting Advisory Services? **Please visit us at HL.com.**

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