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Changes in revenue recognition guidance

It’s game time. Is your M&A team ready?

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The clock is ticking on adoption of the new revenue accounting standard. The implications for M&A are here and are real. Deal teams should understand the financial and operational implications and adjust their diligence, modeling, and integration playbooks accordingly.

Background

In May 2014, the FASB and IASB issued a new revenue recognition standard - Revenue from Contracts with Customers (ASC 606 and IFRS 15, respectively), replacing nearly all existing revenue guidance under U.S. GAAP and IFRS. The objective is to improve comparability across businesses, industries, and markets through a principles-based model.

> **This is arguably the most significant accounting change in recent history. It will affect most companies' financial statements, processes and controls—with certain industries and companies impacted more than others.**

It will also impact your next deal—with implications on your diligence approach, your model and your integration and value creation plan. Before exploring these in further detail, here's a brief summary of how the new standard impacts a company's ěnancial statements, followed by where companies stand in the adoption continuum.

Revenue could be accelerated (in many cases) or deferred (in some cases), resulting in a different revenue proële and potentially increased earnings volatility.

Certain revenue-related costs, such as set-up costs and sales commissions, will be capitalized on the balance sheet and amortized over (or beyond) the contract period. This creates a dislocation between GAAP and cash costs.

Additional qualitative and quantitative disclosures are required, making revenue and revenue-related costs more transparent.

Greater judgment may be required, which may affect the quality of earnings in subtle but important ways.

For many companies, operational impacts associated with adoption will be signiěcant. New ěnancial and operational data must be tracked and analyzed to support policy elections, estimates, and more complex disclosures. This will likely require signiěcant enhancements to IT systems, controls, and processes. GAAP-driven metrics underlying incentive plans may need to be re-evaluated.

State of readiness

Although these new rules have been discussed for years, the effective date is fast approaching. The new standard becomes effective January 1, 2018 for calendar-year-end public companies and January 1, 2019 for calendar-year-end private companies. Early adoption on January 1, 2017 is permitted.

Implementation can take several months or longer and can come with signiĕcant ĕnancial cost, particularly if IT systems are impacted. Many private companies have not yet begun the time-intensive process of assessing the effects and complying with the new standard. In our 2016 survey, almost 80 percent of respondents said they were still assessing the potential impact of the new standard or, in some cases, had not yet begun an assessment. They described facing resource constraints, competing priorities, and a reluctance to commit the required budget.

Implications on your next deal

For your next deal, consider that these changes may impact the target's ĕnancial performance and operations soon after you take ownership. This will affect how you carry out diligence, model future performance, and plan for integration or exit. Here are four steps you can take to increase your success.

1 Augment your deal team and diligence game plan accordingly.

Do not assume that your next target has completed an adequate assessment or begun its implementation. This places a higher burden on deal teams to evaluate the implications.

- Your deal team's capabilities may need to be augmented to ensure the right people are asking the right questions. And they'll need to do this analysis in a highly coordinated manner (see Exhibit 1).
- A more in-depth technical accounting and operational analysis will be required when performing integrated business diligence.
- When evaluating targets who have completed their assessments and are in the implementation phase, a new level of attention should be placed on key policy elections, judgments, and applied estimates. The principles-based standard may introduce additional management judgment and diversity in application. Buyers will need to evaluate key elections made by the target, compare them with their own, and align as necessary.
- Diligence ĕndings should be clearly linked to your Day-1 readiness efforts and integration plan.

Exhibit 1: Key questions for target management in your next deal

Has target management performed an impact assessment of the new revenue standard?

What are the key ĕnancial statement impacts and broader operational impacts?

Who is leading the effort and to what extent have your auditors reviewed key accounting positions taken?

Does the company have the right amount and caliber of resources needed to complete the assessment and implementation in time?

Has a transition method of adoption been chosen and, if so, what factors were considered? What is your plan for compliance with dual reporting requirements upon adoption?

What new estimates will be made in recognizing revenue and have you designed relevant controls to address the initial judgment and any required revisions?

Can your IT systems and chart of account structure handle the greater level of detail required?

What are your next steps in the implementation process?

How have you budgeted for the implementation effort and are those future costs reĜected in your forecast?

Beyond the challenges, what opportunities could result from adoption of the new standard?

2 Adjust your model and consider impacts on deal economics.

The new standard primarily impacts the timing of revenue recognition and can impact the amount of revenue that will be recognized. As such, deal teams need to consider various impacts on their model, deal structures, and negotiations.

§ Certain elements of customer arrangements that were once deferred for accounting purposes could now qualify for earlier recognition (or vice versa). This could impact growth rates, the relationship between EBITDA and cash flow, and comparability across periods. It could also introduce a new degree of volatility and may reduce forward visibility as some ratable accounting models are disrupted.

§ Your model should address new working capital dynamics as deferred revenue balances decline and new deferred cost accounts and unbilled receivable accounts are established.

§ Changes in the timing of revenue may affect the calculation and financial reporting for income taxes and other types of taxes. This could impact your tax accounting methods, temporary differences in your income tax provision, transfer pricing strategies, and presentation of sales or excise tax.

§ Additional capital expenditures and run-rate costs should be reflected to address future implementation needs. Similarly, consider the risk that certain planned cost synergies may need to be delayed as members of target management are needed for extended periods to assist with implementation.

§ The transitional impacts of adoption itself should be considered along with the desired adoption approach, including any revenue or costs that may "disappear" or "reappear" in transition and the resulting impacts on comparability.

§ Beyond the model, earn-out structures, ongoing compensation plans, and covenants linked to GAAP performance may be impacted.

3 Revisit your integration and value creation playbook.

Where a target stands in its implementation efforts and the impacts on operations can directly affect your integration and value creation plan.

For corporate buyers:

Depending on the timing and extent of integration, teams will need to prepare for added complexity and disruption.

Your existing integration efforts and playbook could be challenged by a new three-way dynamic – integrating the acquired company, addressing its implementation, and carrying out your own implementation – potentially all at once. Altogether, this could change your own adoption approach.

The implications on the finance function and demands on the broader business are clear. If issues arise post-deal, the ability to close the books could be at risk (especially for transactions subject to SEC Rule 3-05 of Regulation S-X disclosures).

Many companies are adopting the new revenue standard using the modified retrospective approach (cumulative catch-up on adoption). Parallel reporting under both legacy and new GAAP is required in the year of adoption, placing further stress on integration.

If the buyer plans to adopt under the full retrospective method, consider the target's readiness to have potentially two years of historical financial statements restated and audited under the new standard.

Gaps remain between IFRS and U.S. GAAP in certain areas of revenue recognition (e.g., licensing, sales taxes, shipping and handling charges, among others). This lack of convergence adds complexity for cross border transactions.

Enhanced communication with stakeholders and analysts is needed to build consensus on non-recurring implementation costs, operational impacts, and performance comparability across periods.

For private equity investors:

Post-deal implementation efforts and costs will be on your time and your dime.

Costs will likely increase during and following implementation (e.g., increased costs for people, systems, controls, and the audit).

Revenue or EBITDA-based metrics and definitions in debt covenants may be impacted by the new standard.

Depending on the adoption method, financial statement comparability and trending data will need to be addressed in future refinancing efforts and selling materials as you prepare for exit.

For IPO exit scenarios, consider the timing and level of effort associated with the IPO under the new standard, inclusive of updating management's forecast for the road show. To comply with SEC rules, companies planning an IPO in the year of adoption that elect the full retrospective method may be required to restate an additional year of financials (e.g., calendar year 2015 for a calendar year SEC registrant adopting on January 1, 2018).

4 Leverage the upside potential.

Beyond the challenges for companies and deal teams, the new revenue standard can present opportunity.

- Previously deferred revenue for accounting purposes could be accelerated (or "lost" through equity) upon adoption, particularly for many software companies that deferred license revenue due to an absence of vendor-specific objective evidence (VSOE).
- Product and sales teams could have greater flexibility with product and service bundling, pricing models, the use of customer inducements, and guidance on development roadmaps.
- Enhanced automation can drive efficiencies and create new data sets that can be used to improve top-line analytics. This can drive greater operational insights into the company's unit economics and performance.
- Implementation may be an opportunity to improve underlying systems for companies with control deficiencies or manual processes related to revenue recognition.
- For companies with control deficiencies or manual processes related to revenue recognition, this may be an opportunity to improve underlying systems and processes.

Conclusion

The time is now to understand the wider implications of the new revenue recognition standard on M&A. The potential impacts on your next deal should be front and center – and they extend far beyond accounting. Communication of the new challenges and opportunities across your deal teams, business units and leadership is more important than ever.

Refer to Exhibit 2 for highlights of impacts by industry and KPMG's Web site for more in-depth publications regarding the new revenue standard.

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How KPMG can help

In our experience, best-in-class M&A teams seek to maximize purpose, advantage, and speed. Our world-class Deal Advisory and Strategy professionals help enable these attributes of deal success. KPMG does this with better people, a better approach and better deal technology. Visit our Web site at: kpmg.com/us/dealadvisory

Exhibit 2: Impact considerations by industry

Aerospace and defense

- For contractors following the series guidance, there may be an acceleration in the timing of revenue, cost, and margin recognition.
- Accounting for variable consideration, including award fees, claims, incentives, and penalties, may differ from today.
- Contractors that currently recognize revenue at a point in time may be required to recognize revenue over time.
- Revenue will be recognized earlier for many contractors that use the units-of-delivery method under current U.S. GAAP.

Consumer products

- Revenue may be reduced before an incentive offer is made based on a past practice of providing incentives to end customers.
- Most retrospective volume rebates will have similar accounting to today. However, revenue may be deferred for certain discounts on future purchases.
- Revenue upon sale to the distributor will be deferred for promises to provide the end customer with an additional good or service.
- Certain types of arrangements will experience a change in the timing of revenue recognition.
- Companies applying the sell-through method of accounting will likely experience an acceleration of revenue and cost recognition.

Engineering and construction

- New criteria for contract existence may affect the timing of revenue recognition.
- Performance obligations are the new unit of account, which may affect the timing of revenue and margins each period. Tracking costs at this level may make implementation more difĕcult.
- New criteria to determine accounting for variable consideration requires a change in perspective.
- Revenue may continue to be recognized over time for most construction contracts, but the timing and amount may change under the new standard.
- The timing for recognizing costs and revenue related to activities before the existence of a contract may change.

Freight and logistics

- Transportation companies may see a change in the timing of revenue recognition, speciĕcally those that currently recognize revenue when freight is delivered.
- Changes to principal versus agent guidance could lead to changes in a transportation company's accounting for and presentation of revenue.
- Most retrospective volume discounts will have similar accounting to today. However, revenue may be deferred for certain discounts on future purchases.

Healthcare providers

- Healthcare providers should consider the speciĕc facts and circumstances in determining whether and when an agreement with a patient creates legally enforceable rights and obligations.
- Healthcare providers will need to apply judgment to determine whether they have implicitly provided a price concession.
- Many healthcare providers will see signiĕcant decreases in the provision for bad debts under the new standard.
- A healthcare provider likely transfers control of in-patient healthcare services over time.

Manufacturers

- Manufacturers that produce goods speciĕcally for an individual customer based on that customer's design may see an acceleration in the timing of revenue and cost recognition.
- Certain types of arrangements will experience a change in the timing of revenue recognition based on when control transfers to the customer.
- Manufacturers in the scope of the series guidance may see an acceleration in the timing of revenue, cost, and margin recognition.
- The timing for recognizing cost and revenue related to activities prior to existence of a contract may change.
- Most retrospective volume rebates will have similar accounting to today; however, revenue may be deferred for certain discounts on future purchases.

Software and SaaS

- A software company's determination of the performance obligations in the contract, which is no longer contingent on VSOE, may accelerate software license revenue recognition compared with current U.S. GAAP.
- VSOE is no longer the only basis for allocating contract revenue in software arrangements.
- Distinct software licenses are recognized at the point in time when the software license is transferred to the customer. Whether or not the company has VSOE for undelivered elements (e.g., PCS or professional services) does not affect that conclusion.
- The timing of revenue recognition for software licenses combined with PCS or professional services (e.g., software and customization services) will be similar to today in most cases.
- The timing of revenue recognition for unspeciëed software updates or upgrades/ enhancements and professional services will be similar to today in most cases.
- Whether multiple contracts are combined for software and SaaS entities will be similar to current U.S. GAAP in most cases.

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