FASB Changes: The Impact and How to Prepare
(for Private Equity Firms and their Portfolio Companies)

Revenue Recognition
And
Lease Accounting
Today’s Speakers

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Big Thinking. Personal Focus.
Agenda

• Why private equity should pay attention to the new rules
• Revenue recognition
  – Overview of standard
  – Effective dates
  – Impacts to private equity decision making
• Lease Accounting
  – Overview of standard
  – Effective dates
  – Impacts to private equity decision making
• Things to consider doing now
• Questions and answers
Potential Impact to Private Equity

• Two standards could materially change the financial reporting of nearly all businesses

• May change the way you evaluate a business including key ratios and metrics used today

• May have impact to:
  – EBITDA
  – Debt covenants
  – Compensation arrangement
  – Benefit arrangements
  – Restricted stock and other equity issuances
  – Earn-out provisions
  – Investment in new technology and infrastructure
  – Portfolio company internal control processes
Revenue Recognition
Revenue Recognition

Key Provisions:

- Removes industry specific guidance and creates a commonly used set of rules

- Increases comparability across entities, industries and capital markets

- Provides a robust framework for addressing revenue issues (5-step model)

- Provides more relevant information to financial statement users through improved disclosure requirements
## Revenue Recognition

<table>
<thead>
<tr>
<th></th>
<th>Non-public entities</th>
<th>Public entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective Date</td>
<td>2019</td>
<td>2018</td>
</tr>
<tr>
<td>Transition type</td>
<td>Full retrospective</td>
<td>OR Modified retrospective</td>
</tr>
<tr>
<td>Years to be “restated” in transition</td>
<td>2018</td>
<td>2016 &amp; 2017</td>
</tr>
<tr>
<td>Early adoption permitted?</td>
<td>Yes, but not earlier than 2017</td>
<td></td>
</tr>
</tbody>
</table>
5-Step Model

Step 1 - Identify contracts with a customer
Step 2 - Identify the performance obligations in the contracts
Step 3 - Determine the transaction price
Step 4 - Allocate the transaction price to the separate performance obligations
Step 5 - Recognize revenue when the entity satisfies each performance obligation
# Disclosure Requirements

## About the Contracts
- Disaggregation of revenue
- Contract balances
- Information about performance obligations
- Price allocated to remaining performance obligations

## Significant Judgements
- Timing of satisfaction of performance obligations
- How the transaction price and amounts allocated to performance obligations are determined

## Assets Recognized
- Assets recognized from costs to obtain or fulfill a contract
## Impacts Vary by Industry

<table>
<thead>
<tr>
<th>Industry</th>
<th>Step 1</th>
<th>Step 2</th>
<th>Step 3</th>
<th>Step 4</th>
<th>Step 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engineering &amp; Construction</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Healthcare</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Hospitality &amp; Retail</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
<tr>
<td>Software &amp; Technology</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
<td>●</td>
</tr>
</tbody>
</table>
Impacts to Private Equity Decision Making

Software & Technology:

- Elimination of software specific guidance
- Concept of multiple-element arrangements remains, however evaluation and conclusions may change
- Timing of software revenue may be accelerated with elimination of vendor-specific objective evidence of fair value rules
- Variable revenue amounts (milestone payments, penalties, etc.) are now estimated, rather than deferred until uncertainty is resolved
- Timing of revenue related to IP license fees could change based on current practices
Impacts to Private Equity Decision Making

Hospitality & Retail:

• Typical point-of-sale (POS) transactions generally not impacted

• A portion of POS revenue could be deferred if coupled with:
  – Customer incentives (coupons, BOGOs, free products, etc.)
  – Loyalty programs

• The timing of revenue related to licensing and royalty fees may changed, based on current practices

• The timing and amount of gift card breakage (the amount of unused gift cards forfeited) could changed under the new rules
Impacts to Private Equity Decision Making

Manufacturing Industry:

• Manufactures who build to customer specification will see higher impact than other manufactures

• Variable revenue amounts (volume discounts, penalties, right of return, etc.) are now estimated, rather than deferred until uncertainty is resolved

• Narrow-scope example of how timing of revenue could change:
  – Manufacturer who builds to customer specifications
  – Has right to collect payment for work completed to date
  – Today: recognize revenue at point-in-time
  – Under new rules: recognize revenue over-time as work is performed
Key Revenue Recognition Take-Aways

• For nonpublic companies, 2018 will be initially reported under the current rules, then “restated” and presented again under the new rules in 2019
• Positive news: one commonly used set of rules moving forward
• Negative news: impact of changes vary by industry, case-by-case analysis will be needed
• The overall amount of revenue recognized will typically not change, however the timing of when its recognized may
• If timing is going to change, make sure you know when and by how much – could impact transaction decision making
• Implementation of the new rules could require new investment in current portfolio companies
• Consider how you evaluate new investments in the future, including historical comparisons and valuation model adjustments
Lease Accounting
Lease Accounting

Key Provisions:

• Substantially all long-term operating leases will now have a right-of-use asset and lease liability on the balance sheet

• Expense recognition will generally not substantially change

• Effective date is for the year ended December 31, 2020 for non-public entities

• This change could impact debt covenant calculations and other performance measures
Scope and Definition of a Lease

• The new standard applies to leases of all identified assets except:
  – Leases of inventory, assets under construction, intangible assets and biological assets, including timber
  – Leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources (including the intangible right to explore for those resources and the rights to use the land)

• A contract is or contains a lease if it conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration
Scope and Definition of a Lease (Cont.)

Lease and Non-Lease Components

• Many contracts contain leases (lease components) and agreements to purchase or sell other goods or services (non-lease components)
  – Non-lease components are identified and accounted for separately under other applicable Generally Accepted Accounting Principles (GAAP)
  – Maintenance activities, and equipment service charges are considered non-lease components

Lease Term and Lease Payments

• Lease term includes any non-cancelable periods
  – Reasonably certain is a high threshold for including optional periods (e.g., options to extend or terminate a lease)
  – Reasonably certain = reasonably assured

| Fixed payments, including in-substance fixed payments | Exercise price of a purchase option* | Payments for penalties for terminating the lease** | Variable lease payments that depend on an index or rate | Residual value guarantees – amounts probable of being owed (lessees only) |

* Include only if reasonably certain of exercise
** Include unless reasonably certain not to be exercised
Lease Classification - Operating vs. Finance

• At lease commencement, a lessee and a lessor classify a lease using the following criteria:
  – The lease transfers ownership of the underlying asset to the lessee by end of the lease term
  – The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
  – The lease term is for the major part of the remaining economic life of the underlying asset*
  – The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset
  – (New criterion) The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of lease term

• Short-term lease exemption

* Not applicable for leases that commence at or near the end of the underlying asset’s economic life
# Lessee Accounting

## Lessee Recognition and Measurement

<table>
<thead>
<tr>
<th></th>
<th><strong>Finance lease</strong></th>
<th><strong>Operating lease</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial recognition and measurement</strong></td>
<td>Initially measure the right of use (ROU) asset (^1) and lease liability at the present value of the lease payments not yet paid</td>
<td><strong>Initial measurement of ROU asset also includes the lessee’s initial direct costs and prepayments made to the lessor less lease incentives received from the lessor</strong></td>
</tr>
<tr>
<td><strong>Subsequent measurement – lease liability</strong></td>
<td>Use the effective interest method using the discount rate determined at lease commencement (^2) to recognize interest expense and reduce the lease liability for the payments made</td>
<td>Measure the lease liability at the present value of the remaining lease payments using the discount rate determined at lease commencement (^2)</td>
</tr>
<tr>
<td><strong>Subsequent measurement – ROU asset</strong></td>
<td>Amortize the ROU asset, generally on a straight-line basis, over the shorter of the lease term of its useful life; and record any impairment of the ROU asset</td>
<td>Measure the ROU asset at the amount of the lease liability and adjust for cumulative prepaid or accrued rents (i.e., uneven rent payments), any lease incentives received, lessee initial direct costs; and record any impairment of the ROU asset</td>
</tr>
</tbody>
</table>
| **Income statement effect** | Generally “front-loaded” expense  
Interest expense and amortization expense are recorded and presented separately | Generally straight-line expense  
A single lease expense is recognized |

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\(^1\) Initial measurement of ROU asset also includes the lessee’s initial direct costs and prepayments made to the lessor less lease incentives received from the lessor  
\(^2\) As long as a reassessment has not occurred.
Lessee Accounting Example - Difference in Expense Recognition

A lessee enters into a five-year agreement to make the following payments each year:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100,000</td>
</tr>
<tr>
<td>2</td>
<td>$150,000</td>
</tr>
<tr>
<td>3</td>
<td>$200,000</td>
</tr>
<tr>
<td>4</td>
<td>$250,000</td>
</tr>
<tr>
<td>5</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

The organization assumes a 7% discount rate for the calculation of the present value of the future payments. There are no renewal periods, purchase options, or other factors to take into consideration for the initial measurement of the present value of future lease payments.

Calculation of the present value of future lease payments = $792,353
Lessee Accounting Example - Difference in Expense Recognition (Cont.)

The example below shows the subsequent accounting and impact to the expense recognition for each lease:

**FINANCE LEASE**

<table>
<thead>
<tr>
<th>Year</th>
<th>(V) Cash Flow</th>
<th>ROU Asset</th>
<th>Lease Liability (A)</th>
<th>(W) Interest Expense</th>
<th>(X) Amortization Expense (R)</th>
<th>(W) + (X) Total Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>-</td>
<td>$792,353</td>
<td>$792,353</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1</td>
<td>$100,000</td>
<td>633,882</td>
<td>747,818</td>
<td>$44,535</td>
<td>55,465</td>
<td>213,996</td>
</tr>
<tr>
<td>2</td>
<td>150,000</td>
<td>475,411</td>
<td>650,165</td>
<td>97,563</td>
<td>52,347</td>
<td>210,818</td>
</tr>
<tr>
<td>3</td>
<td>200,000</td>
<td>316,940</td>
<td>496,677</td>
<td>154,488</td>
<td>46,512</td>
<td>202,996</td>
</tr>
<tr>
<td>4</td>
<td>250,000</td>
<td>158,469</td>
<td>280,374</td>
<td>215,303</td>
<td>34,697</td>
<td>193,161</td>
</tr>
<tr>
<td>5</td>
<td>300,000</td>
<td>-</td>
<td>-</td>
<td>280,374</td>
<td>19,626</td>
<td>178,996</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000,000</td>
<td></td>
<td>$792,353</td>
<td></td>
<td>$207,647</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

A - The effective-interest method is used to calculate the lease liability, regardless of the type of lease.

B - Amortization is on a straight-line basis (similar to other nonfinancial assets).

C - For operating leases, only straight-line lease expense is recognized each year.

**OPERATING LEASE**

<table>
<thead>
<tr>
<th>Year</th>
<th>(V) Cash Flow</th>
<th>ROU Asset</th>
<th>Lease Liability (A)</th>
<th>(Y) Lease Expense (C)</th>
<th>(Z) Reduction in Liability</th>
<th>(Z) + (Y) - (V) Reduction in ROU Asset</th>
<th>Difference in Expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>-</td>
<td>$792,353</td>
<td>$792,353</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1</td>
<td>$100,000</td>
<td>647,818</td>
<td>747,818</td>
<td>$200,000</td>
<td>$44,535</td>
<td>$144,535</td>
<td>$13,936</td>
</tr>
<tr>
<td>2</td>
<td>150,000</td>
<td>500,165</td>
<td>650,165</td>
<td>200,000</td>
<td>97,653</td>
<td>147,653</td>
<td>10,818</td>
</tr>
<tr>
<td>3</td>
<td>200,000</td>
<td>345,677</td>
<td>495,677</td>
<td>200,000</td>
<td>154,488</td>
<td>154,488</td>
<td>3,983</td>
</tr>
<tr>
<td>4</td>
<td>250,000</td>
<td>180,374</td>
<td>280,374</td>
<td>200,000</td>
<td>215,303</td>
<td>165,303</td>
<td>(6,832)</td>
</tr>
<tr>
<td>5</td>
<td>300,000</td>
<td>-</td>
<td>-</td>
<td>200,000</td>
<td>280,374</td>
<td>180,374</td>
<td>(21,905)</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000,000</td>
<td></td>
<td>$1,000,000</td>
<td>$792,353</td>
<td>$792,353</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>
Effective Date and Transition

- Standard is applied as of the beginning of the earliest comparative period presented in the financial statements.
- Lessees and lessors are required to adopt the new standard using a modified retrospective transition approach.
  - Certain transition relief is available.
- Certain disclosures are required in accordance with ASC 250, *Accounting Changes and Error Corrections*.

*Public business entities, not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an-over-the-counter market, and employee benefit plans that file or furnish financial statements with or to the SEC.*

<table>
<thead>
<tr>
<th>Effective date for calendar-year companies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public business entities and certain other entities</strong></td>
</tr>
<tr>
<td>2019 and interim periods within that year</td>
</tr>
</tbody>
</table>
Effective Date and Transition (Cont.)

• All entities may elect to apply all of the following practical expedients (elected as a package and applied to all leases) not to reassess:
  – Whether contracts are or contain leases
  – Lease classification
  – Initial direct costs (i.e., whether those costs would have qualified for capitalization under the new leases standard)

• All entities can also elect for all leases to (1) use hindsight in determining the lease term when considering lease options to extend or terminate the lease and to purchase the underlying asset and (2) assess impairment of ROU assets
  – Election could be made separately or in conjunction with the package of practical expedients above
Significant Items Relevant to Private Equity Organizations

- Debt covenant calculations could be impacted
  - Be sure to discuss with banks early & be aware of the definitions within debt agreements (i.e. what qualifies as debt)

<table>
<thead>
<tr>
<th>Metric</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage Ratio</td>
<td>Debt/Equity</td>
</tr>
<tr>
<td>Current Ratio</td>
<td>Current Assets/Current Liabilities</td>
</tr>
<tr>
<td>Debt to EBITDA</td>
<td>Debt/EBITDA</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>Net Income/Total Assets</td>
</tr>
</tbody>
</table>

- Due to early adoption being allowed, organizations could adopt at different dates, causing difficulties in comparability and benchmarking
Significant Items Relevant to Private Equity Organizations (Cont.)

• Significant money and time will be spent in getting ready for this change

• Potential Change in Business and Economic Decisions – Lease-versus-buy decisions

• No significant change to EBITDA expected
Things To Consider Doing Now
Are Your Portfolio Companies Ready?

• Internal task force
• Education
• Internal control design
• Impact on IT and softwares
  – Schneider Down’s internally developed lease software solution simpLEASE Accounting
• Communication with all stakeholders
• Inventory of leases
• Assess all revenue streams for potential impacts
• Apply new rules to contracts within scope
• Parallel revenue schedules and aggregation of information needed for disclosure
Is Your PE Firm Ready?

• Education
• Evaluation of impacts to each industry
• Analysis of impact to EBITDA, year-by-year
• Impact to pre- and post-deal actions
• Legal review of contracts
• Evaluation of debt agreements and covenants
Questions & Answers

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Private equity firms face a number of issues from increased regulations and oversight to an ever-changing market with limited investment opportunities. With increasing pressures to show returns, you should consider engaging our experienced business advisors to work with you throughout the lifecycle of your fund and portfolio investments.

Creation of the actual fund, including structure, is just the beginning. Schneider Downs can assist with appropriate entity structure, tax advice and private equity fund audits. Other services we provide on an ongoing basis include due diligence, tax planning, investment valuation and operational efficiency.

Once you have identified a target, our dedicated due diligence team can provide you valuable insight by identifying value drivers, providing quality of earnings and working capital analysis, as well as uncovering potential liabilities and potential future earnings. Following a portfolio acquisition, our professionals can assist to ensure that any adjustments subject to your purchase agreement are documented and presented in a meaningful way. We also recognize that setting up the opening balance sheet can be complicated, and our team frequently provides assistance with accounting and valuation issues to ensure a smooth transition.

Our Audit and Assurance team – led by highly experienced shareholders at each step – can provide portfolio company audits. As issues are identified, we not only will communicate them to you, but also provide a comprehensive list of suggestions to improve the profitability of your investment. Similarly, we can assist in implementing any finding from our diligence, again with an eye toward enhancing profitability.

Building value in your investment during the holding period involves a team effort between ownership, management and your advisors. To that end, Schneider Downs delivers a wealth of thought leadership across the board, with services including tax, IT, process improvement and benefit planning. A more detailed menu of our services is included within this document.

Exiting from a portfolio company is where the rubber meets the road for a private equity firm. Our investment banking professionals at Schneider Downs Corporate Finance will identify buyers and markets for the investment. Other services include tax structuring and sell-side due diligence.
SERVICE CAPABILITIES

FINANCIAL DUE DILIGENCE SERVICES
Schneider Downs has a dedicated team of professionals to help minimize surprises and maximize transaction value. Services include:

- Quality of earnings analysis
- Working capital evaluation
- Balance sheet investigation
- Customer trends
- Unrecorded liability identification
- Payroll and benefits analysis
- Evaluation of accounting systems, controls and procedures
- Fraud risk assessments

AUDIT SERVICES
Portfolio companies encounter a myriad of audit considerations and accounting challenges unique to their structure. Schneider Downs audit professionals assist firms in managing issues immediately following a transaction and throughout the portfolio’s company’s lifecycle, including:

- Accounting for complex equity structures
- Assistance with developing and adhering to revenue recognition policies in compliance with US GAAP
- Accounting for business combinations, including accounting related to opening balance sheets
- Accounting for share-based compensation arrangements
- Evaluation of impairment of intangible assets
- Accounting for complex debt arrangements, including convertible debt issuances and debt issued with warrants
- Identification of internal control issues, and discerning and applying industry best practice

TAX SERVICES
Tax planning and structuring is essential for private equity firms, and Schneider Downs has the experience and in-depth knowledge to assist private equity firms with their tax issues. Our tax service offerings include:

TAX DUE DILIGENCE
- Confirmation of tax elections-Methods
- Confirmation of tax entity-Elections
- Evaluation of tax attributes NOLs, § 382, limitations, tax credits
- FIN 48 Assessments
- Assessment of intangibles and amortization
- Assessment of representations, warranties, indemnifications
- Evaluate exposures including apportionments, state and local tax compliance
- Confirmation of tax positions

TAX STRUCTURING
- Indemnification of tax advantages
- State and local economic development
- Entity planning
- Stock and asset purchases
- Asset purchases
- ESOPS
About Schneider Downs

Our Focus is You
As one of the 60-largest accounting and business advisory firms in the U.S., Schneider Downs can meet all your global needs with an integrated service team of specialists. We are committed to delivering innovative business solutions that result in breakthrough ideas, providing responsive service that is proactive and timely and adds value to your business and building a business partnership that is based on trust and personal relationships.

Schneider Downs’ global delivery service model incorporates the PrimeGlobal association of over 350 highly successful independent public accounting firms with a combined annual revenue of more than US$2.0 billion. PrimeGlobal’s independent member firms house a combined total of 2,200 partners, 17,000 employees, and 800 offices in 90 countries around the globe.