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FASB Changes: The Impact and How to Prepare

(for Private Equity Firms and their Portfolio Companies)

Revenue Recognition

And

Lease Accounting

Today's Speakers

Joel Rosenthal, Shareholder

Business Advisory

Adam Goode, Sr. Manager

Revenue Recognition

Shane Gastecki, Manager

Lease Accounting

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

	Non-public entities	Public entities
Effective Date	2019	2018
Transition type	Full retrospective **OR** Modified retrospective	
Years to be "restated" in transition	2018	2016 & 2017
Early adoption permitted?	Yes, but not earlier than 2017	

5-Step Model

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

Disclosure Requirements

About the Contracts	Significant Judgements	Assets Recognized
• Disaggregation of revenue • Contract balances • Information about performance obligations • Price allocated to remaining performance obligations	• Timing of satisfaction of performance obligations • How the transaction price and amounts allocated to performance obligations are determined	• Assets recognized from costs to obtain or fulfill a contract

Impacts Vary by Industry

	Step 1	Step 2	Step 3	Step 4	Step 5
Engineering & Construction	●	●	●	●	●
Healthcare	●		●		
Hospitality & Retail		●	●	●	
Manufacturing		●	●		●
Software & Technology		●		●	●

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

	Finance lease	Operating lease
Initial recognition and measurement	Initially measure the right of use (ROU) asset [1] and lease liability at the present value of the lease payments not yet paid	
Subsequent measurement – lease liability	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	Measure the lease liability at the present value of the remaining lease payments using the discount rate determined at lease commencement [2]
Subsequent measurement - ROU asset	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	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
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

[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:

Year 1	$100,000
Year 2	$150,000
Year 3	$200,000
Year 4	$250,000
Year 5	$300,000

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.)

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

FINANCE LEASE

Year	(V) Cash Flow	ROU Asset	Lease Liability (A)	Principal	(W) Interest Expense	(X) Amortization Expense (B)	=(W) + (X) Total Expense
0	-	$792,353	$792,353	-	-	-	-
1	$100,000	633,882	747,818	$44,535	$55,465	$158,471	$213,936
2	150,000	475,411	650,165	97,653	52,347	158,471	210,818
3	200,000	316,940	495,677	154,488	45,512	158,471	203,983
4	250,000	158,469	280,374	215,303	34,697	158,471	193,168
5	300,000	-	-	280,374	19,626	158,469	178,095
Total	**$1,000,000**			**$792,353**	**$207,647**	**$792,353**	**$1,000,000**

OPERATING LEASE

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

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.

Effective Date and Transition

Effective date for calendar-year companies		
Public business entities and certain other entities*	**All other entities**	**Early adoption?**
2019 and interim periods within that year	2020 and interim periods in 2021	Yes

- 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.

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

Metric	Definition
Leverage Ratio	Debt/Equity
Current Ratio	Current Assets/Current Liabilities
Debt to EBITDA	Debt/EBITDA
Return on Assets	Net Income/Total Assets

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

- 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

Adam J. Goode, CPA
Audit Senior Manager
Schneider Downs & Co., Inc.
One PPG Place, Suite 1700
Pittsburgh, PA 15222
(412) 697-5411
agoode@schneiderdowns.com

Shane M. Gastecki, CPA
Audit Manager
Schneider Downs & Co., Inc.
One PPG Place, Suite 1700
Pittsburgh, PA 15222
(412) 697-5498
sgastecki@schneiderdowns.com