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How Does the Revenue Recognition Standard Affect Private Equity Firms?

AUDIT, PRIVATE EQUITY, PROFESSIONAL SERVICES
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The creation and adoption of the Financial Accounting Standards Board's (FASB) Codification Section 606, *Revenue from Contracts with Customers*, (ASC 606) is one of the most significant changes to the Codification that has occurred over the past several years. Private equity firms are in a unique situation because the adoption of ASC 606 will not only have an effect on the portfolio companies within the fund, but also the fund itself.

Each portfolio company will need to evaluate the five-step model. Depending on the facts and circumstances of the portfolio company, the timing of revenue may significantly change. Portfolio companies that have historically recognized revenue at a point in time may start to recognize revenue over time and vice versa.

A change in timing of revenue could have multiple effects, including but not limited to effects on debt covenants, attraction to potential purchasers, anticipated Earnings Before Income, Taxes, Depreciation, and Amortization (EBITDA), and more. Most portfolio companies measure their financial results using EBITDA; therefore, if there is a sudden fluctuation in EBITDA between periods, especially in the period of acquisition, conversations should occur with potential users of the financial statements.

One may ask, how will ASC 606 affect the valuation of the fund? Depending on how the fund values its portfolio companies, a change in revenue recognition could have a significant effect on the valuation of the fund. For example, if an EBITDA multiple is used, or a discounted cash flow model, or a comparable company analysis, any fluctuation in revenue could have a direct effect on the valuation of the fund.

Depending on how the partnership agreement is written, there could be additional effects including the allocation of profits and losses. The timing of revenue recognition has a direct effect on the amount of profits available for allocation, which in turn can have an effect on the carried interest calculation and therefore any clawback provisions.

In addition, the allocation of management fees should be reviewed. If management fees are waived or offset and carried forward to a future period, ASC 606 will be applicable.

As private equity funds are looking for potential acquisitions or soliciting potential acquirers, ASC 606 will have an impact. If potential acquisitions or sales occur during the transition period, fund managers should be alert when reviewing

comparative financial information.

In addition, contingent consideration is a topic that occurs in most acquisitions with private equity firms. Fund partners, deal teams, and management of portfolio companies should remain alert as to how contingent considerations could fluctuate with the adoption of ASC 606.

For example, contingent consideration is usually based on a revenue or EBITDA target. These targets were more than likely based on guidance in place prior to the implementation of ASC 606. Depending on how significant of a transition ASC 606 has on the portfolio company, the targets may be met more quickly. This should be considered when budgeting cash flows.

ASC 606 will have an effect on all industries; however, private equity funds and portfolio companies have unique effects that should be considered.

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