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Revenue Recognition and the Impact for Business Valuations

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There are countless reasons to have a business valuation completed for your company—strategic planning, gift tax reporting purposes, divorce, shareholder or partnership disputes, and the list goes on.

For an appropriate business valuation to be performed, it is important to understand the new revenue recognition standards and the effect it may have on your company's accounting practices.

New Revenue Recognition Guidance

In May 2014, the Financial Accounting Standard's Board (FASB) issued ASC 606, which creates a model for recognizing revenue from contracts with customers. The objective of ASC 606 is to improve the comparability of revenue recognition practices across industries.

The new model has a five-step process for recognition:

- Identify the contract with the customer
- Identify the performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations
- Recognize revenue when (or as) the entity satisfies the performance obligation

This guidance is effective for ***annual reporting periods beginning after December 15, 2018 for private companies***, while public companies had a deadline to implement for annual reporting periods beginning after December 15, 2017.

Impact on Business Valuation

In general, a change in accounting practices will not make a company more or less valuable. However, as a company transitions to the new revenue recognition standard, there may be shifts or delays based on the timing of revenue recognition. Significant timing changes may distort a business valuation if the metrics used do not take these shifts into consideration.

Both the income- and market-based approaches utilized in business valuations are predicated on what a hypothetical buyer is willing to pay based on a company's expected earnings and cash flows. During the year of adoption, a company's revenues (and resultant earnings) may look very different from historical results based solely on the new accounting practice (and not a change in the company's performance). This variability is further compounded by behaviors in the marketplace in the form of ever-changing market multiples. For example, there may be challenges associated with identifying reliable market comparables based on the timing of those comparables' adoption of the new standard.

Additionally, net working capital and EBITDA (earnings before interest, taxes, depreciation and amortization) may fluctuate as a result of the changes to revenue and corresponding changes to accounts receivable and the way the company records costs (under the matching principle).

It is also worth noting that the five-step process above uses the word "contracts," which can include written, verbal or even implied agreements. A company may find it necessary to re-evaluate how contracts are written or communicated with customers, which could impact cash flow by adding various costs (e.g. restructuring contracts, costs associated with resources to understand and implement, tax implications, etc.).

A company's understanding and implementation of the new revenue recognition standard will help ensure the execution of an accurate business valuation. It is important for both management and the valuation analyst to be aware of revenue timing changes and their impact of the valuation process.

Do you have questions about the impact of the new revenue recognition standard and how it relates to business valuation or other **valuation-related matters**? Please contact Ashley DeCress at 440-449-6800 or **adecress@skodaminotti.com**.