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Show Me the Money – And Start With Your Revenue!

(Or, an Introduction to New Revenue Recognition Rules and the Effect on Lenders)

Technology lenders, asset based lenders, commercial lenders and factors always pay close attention to a borrower's revenue line – obviously the revenue line is critical for determining the income of the company and the amount and quality of the accounts receivable and contracts receivable collateral that will be available to secure a line of credit or loan. Many deals involving companies in Silicon Valley now peg advance rates to revenue formulas or, alternatively, contain loan covenants that use the monthly or quarterly revenue numbers as key factors in the formulas for calculating compliance. Against this backdrop the Financial Accounting Standards Board issued ASC 606, which significantly changes the way a number of companies will recognize revenue in the future.** Although full implementation is still a few years out, the action begins in 2016 and may affect a lender's credit analysis and the covenants and requirements in loan agreements. More is said about these points below.

ASC 606 and Changes in Revenue Recognition

Revenue recognition is presently a heavily rules driven process which can, depending on the accounting standards used, lead to different reporting results. In an attempt to narrow the differences between US GAAP reporting and IFRS revenue standards, ASC 606 was issued. It seeks to establish a principles-based approach to recognizing revenue using a multi-step process and will require companies to more clearly identify performance obligations under contracts, show how the contract price relates to the required activities under the contract and explain the assumptions being used in recognizing or deferring revenue in various accounting periods. ASC 606 requires a significant amount of additional disclosure by management, allowing bankers and analysts reviewing financial information to assess the revenue recognition principles utilized by different companies. Company management will exercise more judgment over the process but will need to explain itself.

Complete implementation of the new reporting requirements under ASC 606 is scheduled for 2018 financial reports for public companies and 2019 financial reports for private companies. However, companies will also have to look back and restate revenues consistent with ASC 606 principles for prior years beginning with 2016.

The Takeaways – the Potential Effects of the Changes in Revenue Recognition

So what does this mean to the lender? The pending implementation of ASC 606 potentially means material changes in revenue reporting by new and existing borrowers. Depending on the type of business, the effects on the lender may include the following:

- For growth companies with contract revenue, reported revenue is expected to adjust upward, at least initially, while deferred revenue diminishes, which means advance rates or financial covenants may need to be adjusted accordingly. A lender will need to understand how changes in a company's recognition of revenue will affect the income statement and balance sheet on a case-by-case basis. If ASC 606 is going to have a material impact on a borrower, it inevitably means that more in-depth analysis of management's underlying assumptions concerning future revenue will be required as management will have more latitude to make these determinations.

- If a loan extends into 2019 (2018 for public companies), lenders will want to consider whether the loan documents executed prior to that time need to include adjustments to loan covenants or advance rates to reflect the changes in revenue recognition. As many credit facilities are structured to mature in 1-2 years, this will become a larger issue as the implementation dates get closer.

- The increased data collection, accounting costs and disclosures required of the company may materially impact the borrower's administrative expense line. Lenders will want to determine what effect this might have on the company's profitability and related effects on cash flow and any loan agreement financial covenants.

- Is the borrower on top of this? Company disclosures about the expected impact of ASC 606 are required going forward. Initially a company may be able to simply say it is evaluating the impact but that position can only be taken for a limited period of time.

Because revenue recognition is so critical in measuring the well-being of any business, the pending changes resulting from ASC 606 are beginning to get attention. If a lender determines a company is likely to experience a material impact in revenue reporting, the lender can begin to pro-actively plan whether any changes in the management of the credit are needed.

*** The author is indebted to Rick Brounstein of CFO Network LLC for introducing him to ASC 606 and the issues potentially created by this new standard. The contents of this article, however, are solely the responsibility of the author.*