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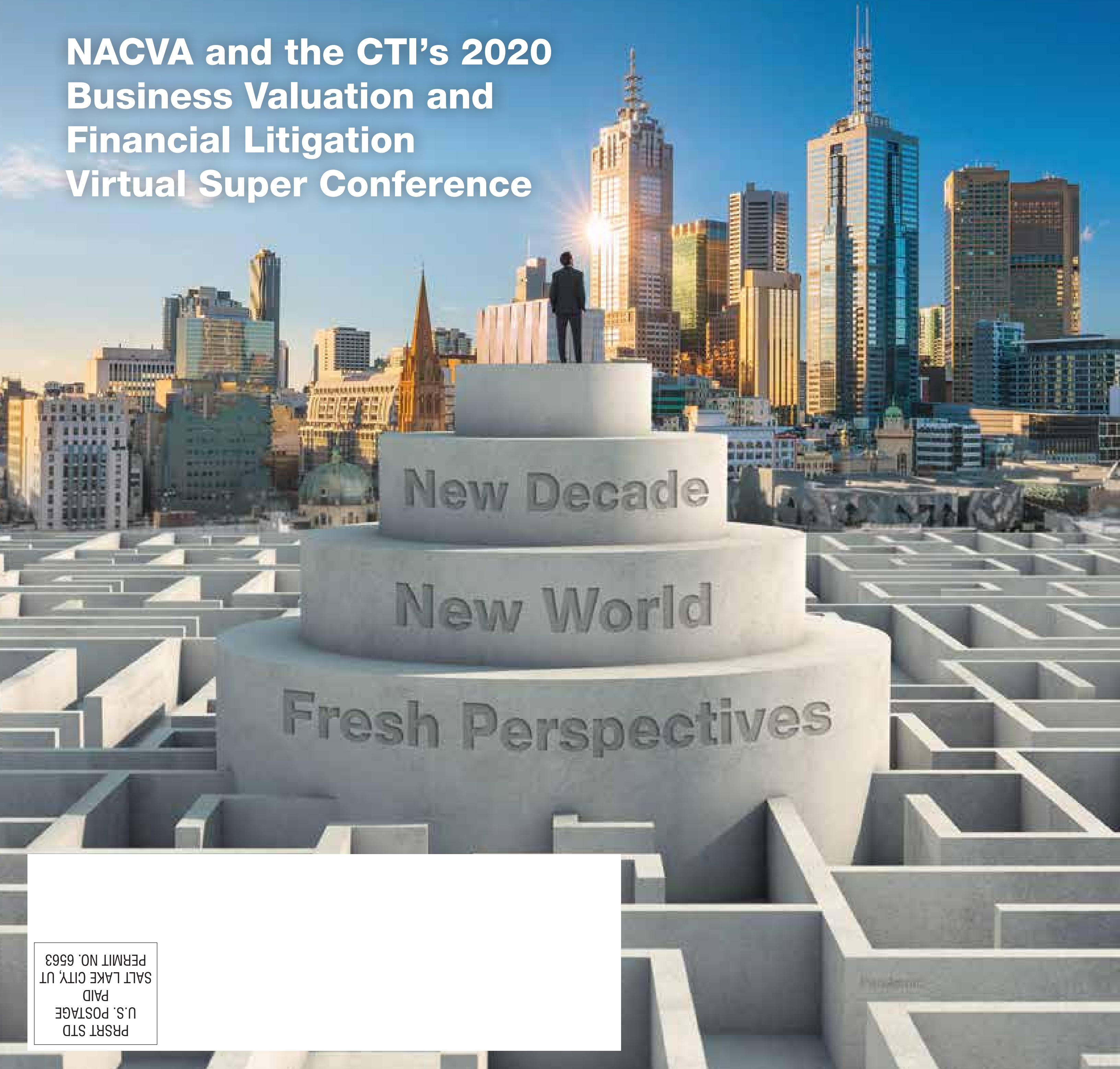

The New Revenue Accounting Standard: Impact on Economic Damages Analyses

By Ralph Nach, CPA and Michael D. Pakter, CPA, CVA, MAFF

In the January/February 2020 issue of *The Value Examiner,*[1] we explored the impact on business valuation of the new Revenue Recognition Accounting Standard (the Standard) issued jointly by the U.S. Financial Accounting Standards Board (FASB) and the UK-based International Accounting Standards Board (IASB). The purpose of this article is to continue educating readers by examining the Standard's impact on financial analyses prepared in connection with economic damages engagements and by discussing the factors that damages experts should consider when performing these engagements.

A Brief Recap

In our previous article, we reviewed the Standard (ASC 606) in some detail, and we will not repeat that discussion here. A summary follows below.

The Standard is now part of U.S. and international financial reporting standards (U.S. GAAP and IFRS, respectively, and GAAP collectively).[2] All reporting companies—both public and private—are now required to have implemented the Standard pursuant to staggered implementation dates. The Standard applies to all publicly traded and privately held businesses and not-for-profit organizations, exempting only federal, state, and local governmental entities.[3]

Unlike legacy GAAP, which contains prescriptive rules that apply to various specialized industries, the Standard is based on the premise that the industry in which an entity operates should not influence the portrayal of its revenues in its financial statements. The new model is industry agnostic and intended to be universally applied in all industries regardless of whether there were formerly specialized carve-outs or industry-specific rules.[4]

ASC 606 establishes a core principle—that revenue is to be recognized as the price that a seller expects to receive from its customer in exchange for the transfer of control of promised products or services—and supplements that principle with a five-step process for implementing it.[5] It also provides for capitalization as "contract assets" of two types of contract-related costs: the incremental costs to acquire contracts and the costs to fulfill contracts.[6]

The new model departs from current practice in several significant ways:[7]

- It eliminates specialized industry carve-outs. To facilitate adoption of a universal rule for revenue recognition, FASB rescinded virtually all its prior specialized industry guidance.
- It emphasizes transfer of control. The trigger for revenue recognition is changed from an emphasis on delivery and transfer of the risk of loss and rewards of ownership to an emphasis on transfer of control from the seller to its customer that enables the customer to direct the use of the asset and obtain benefits from the asset.

1 Ralph Nach, CPA and Michael D. Pakter, CPA, CVA, MAFF, "The New Revenue Accounting Standard: Major Impacts on Business Valuation," *The Value Examiner* (January/February 2020): 6–14.

2 FASB Accounting Standards Update (ASU) 2014-09, which added a new Topic 606 to the FASB Accounting Standards Codification® (ASC) and International Financial Reporting Standard (IFRS) No. 15. The U.S. standard is often referred to as ASC 606, and its international counterpart is referred to as IFRS 15. While they closely resemble each other, there are certain differences between the two standards that should be taken into account in financial analyses.

3 ASC 606-10-15-1 provides that the new guidance applies to all entities. However, ASC 105-10-15-1 specifies that the ASC "...applies to financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP)."

4 ASC 606-10-15-1.

5 Under ASC 606-10-05-4, the five-step process is as follows: (1) identify the contract with the customer; (2) identify the distinct performance obligations in the contract; (3) determine the transaction price, that includes, if applicable, both fixed consideration and variable consideration; (4) allocate the transaction price to the performance obligations using relative standalone selling price; and (5) if a performance obligation is satisfied over a period, recognize revenue as the seller satisfies the performance obligation or, if the performance obligation is satisfied at a point in time, recognize revenue when the seller transfers control to the customer.

6 The balance sheet may also present contract liabilities representing customer payments made in advance of seller performance, subsequently amortized on a systematic basis. Unamortized balances should be evaluated for impairment.

7 For a detailed discussion of these differences, *see* Nach and Pakter, "The New Revenue Accounting Standard," 8–11 (see n. 1).

- It changes the unit of accounting. Under existing GAAP, most sellers record revenue as being earned concurrently with the issuance of an invoice to the customer. The focus of the Standard is on customers; contracts with those customers; modifications to existing contracts; performance obligations; costs to obtain and fulfill contracts; and the related amortization and, if applicable, impairment of those costs.
- It redefines transaction price. Transaction price under the previous standard was required to be both fixed and determinable. Under ASC 606, transaction price is a broader concept that encompasses additional elements.
- It introduces variable consideration. ASC 606 requires the inclusion of estimated variable consideration as a part of the transaction price at contract inception.
- It introduces a significant financing component. Subject to certain exceptions and practical expedients, contracts that contain provisions for extended payment terms or customer prepayments are generally required to reflect a portion of the transaction price as interest income or interest expense by adjusting the transaction price to discounted present value.
- It requires analysis of principal versus agent. ASC 606 concerns itself with gross reporting of revenue versus net reporting of revenue.
- It creates differences between GAAP and income tax reporting. Many of the changes made by ASC 606 may not be permissible for income tax purposes for some or all taxpayers.
- It considers licenses of intellectual property. ASC 606, as amended, sets forth a separate model to apply to transactions between sellers or licensors of intellectual property and their customers or licensees.
- It calls for re-estimation of prior period estimates. ASC 606 requires a substantial number of management estimates to be made at contract inception and further requires management to revise these estimates prospectively each time interim or annual financial statements are prepared.
- It requires extensive new disclosures. ASC 606 establishes an overarching objective—to inform financial statement users about the nature, amount, timing, and uncertainty associated with revenue and cash flows—and five categories of required disclosures designed to meet that objective.

Impact on Economic Damages Analysis

Economic damages may involve lost profits, lost earnings or earning capacity, property damages, and the like. Typically, an award of monetary damages is designed to put a plaintiff in the position it would have occupied but for a defendant's wrongdoing. Damages should be calculated with a reasonable degree of certainty, have a causal link to the defendant's wrongdoing, and not be speculative.

A dispute's outcome may depend on the effective determination (or rebuttal) of economic damages and, in turn, the proper measurement of revenue levels or trends.[8] Accordingly, obtaining a complete and detailed understanding of a subject or comparable company's revenues is essential to properly determining economic damages—either for a plaintiff's use or a defendant's rebuttal.

As a result of the new Standard, damages experts will need to carefully consider the comparability of revenue data between subject and peer companies; between periods in which the Standard is effective and periods in which legacy GAAP was effective; between revenues and costs of revenues; between aggregated and disaggregated data; or between tax-exempt and non-exempt companies. It is important to understand how the Standard was implemented, as it provides for certain alternatives (referred to as "practical expedients") that management can elect to use. Damages experts may now need to consider identifying contracts, invoice dates, transaction pricing, discounts, rebates, refunds, rights of return, and other forms of variable consideration when those items previously were not relevant to economic damages determinations. It may be necessary for a damages expert to determine gross versus net reporting of revenues and to account separately for significant financing components.

Depending on the facts and circumstances, a damages expert may need to obtain a sufficient understanding of an enterprise's contracts with its customers, the underlying performance obligations, and the transaction prices allocated to those performance obligations. If the engagement involves comparing subject and comparable companies; comparing current and prior periods; comparing periods before and after the date of harm; comparing tax-exempt and non-exempt companies; or comparing actual and budgeted data, the damages expert may need to obtain the aforementioned understanding in order to make accurate comparisons.

Damages experts, again depending on the facts and circumstances, may need to obtain an understanding of

8 In most but not all instances, this article uses "revenues" throughout, including where the reader may expect to see "sales," unless in quoted text. Similarly, for "cost of revenues" versus "cost of sales."

contract-related costs—between companies, periods, or budgets, or before and after harm. Aspects of such contract-related cost analysis may already be embedded into economic damages calculations when, for example, incremental costs[9]—such as direct labor, direct materials, sales commissions, and similar contract-related costs—are applied to "but for" revenue analyses.

The Standard introduces an additional wrinkle when the comparable company or prior period recognized contract assets and then amortized them on a systematic basis consistent with the pattern of transfer of products or services to customers. The damages expert may encounter even greater analytical challenges if the subject or comparable company adopted the Standard during the period being analyzed or when the adoption dates differ between comparable entities.

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Damages experts may need to assess the Standard's impact on publicly available metrics, industry studies, or business intelligence research, and determine how that impact affects reported trends in industry growth and profitability data. As the Standard rescinds virtually all prior specialized industry guidance, damages experts may be required to take additional care when analyzing construction contractors, franchisors, software, or similar companies where legacy U.S. GAAP applied specialized accounting rules to the determination of their revenue.

Because the Standard focuses on the transfer of control rather than the transfer of risk from seller to customer, "cutoff" issues (e.g., before-and-after distribution agreement terminations) may need additional attention concerning the terms of customer contract arrangements versus the more traditional invoice/delivery cutoff analyses under legacy GAAP.

Some economic damages determinations (e.g., resulting from breach of a distribution agreement) may require additional focus on contractually specified transaction price adjustments between sellers and customers, such as coupons, slotting fees, rebates, nonrefundable up-front fees, financing arrangements, rights of return, loyalty programs, and store credits. In the case of a publicly traded company, this information might be available in the notes to the annual financial statements, but in the case of a privately held entity, the more minimalist approach to required disclosures may require the damages expert to augment the financial statements using other information sources in order to perform necessary analyses.

The financial analysis underpinning economic damages engagements may require an evaluation of whether comparable companies, periods, or budgets involved gross or net reporting of revenues, which, in turn, may depend on an assessment of whether a party is the principal to the revenue-generating transaction or, alternatively, is acting in the capacity of an agent on behalf of another party. (Indeed, that may be a central disputed fact in the case.)[10]

Certain GAAP treatments under the Standard may not be permissible for income tax reporting purposes, so damages experts may need to consider whether there is an effect on the recognition of deferred income tax assets or liabilities. However, the impact may be limited if economic damages are determined on a pretax basis or if the subject company is a flow-through entity for federal income tax reporting purposes. An additional challenge may be encountered when the subject company data is provided solely in the company's income tax returns whereas the benchmark data is provided in the form of GAAP-compliant financial statements.

The Standard may impact the recognition or treatment of management estimates. It requires management to make a substantial number of estimates at the inception of the contract and to revise those estimates prospectively each time interim or annual financial statements are prepared for distribution to external users. This may add to the damages

9 Often called "saved costs" or "avoided costs" in certain economic damages engagements.

10 An agent reports revenue as the commission earned while the principal reports gross revenue and accounts for the agent's commissions as a selling expense.

expert's burden (and costs) in evaluating revenue trends between periods, between budgets and actual results, and between subject and comparable companies.

The extensive, expanded revenue disclosures required by the Standard should be of considerable assistance to damages experts, who likely will find a host of valuable new disclosures in adopting companies' financial statements, informing readers of the nature, amount, timing, and risks associated with revenues and cash flows. Experts may find new and useful data disaggregating revenues by geography, type of contract, market, distribution channel, product line, and timing of transfers, providing valuable insights for the development of the economic damages model.

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The availability of this information will be limited with respect to financial statements of privately held companies that are exempt from a substantial portion of these disclosures. In such cases, experts may be missing information necessary to benchmark comparable public companies and may need to analyze information from other sources to fully justify an assertion that the nondisclosing private company is comparable or not comparable to its public company counterpart.

Impact on Approaches and Modeling Techniques

The Standard may affect the following typical approaches used to derive revenues for lost profit analysis:

- **The "before-and-after approach."** Comparing the performance of the company before and after the alleged harmful acts may be affected by elimination of a special industry carve-out present in the before period but absent in the after period; by the trigger for revenue recognition changing to transfer of control; or by subsequent revisions in estimates made in the before period.
- **The "forecast approach."** Using sales forecasts of expected performance for the business or industry to evaluate the probable effect of harmful acts may be affected by the units of accounting, changes in estimates, or date of adoption of the Standard.
- **The "yardstick approach."** Comparing the harmed business to comparable but unharmed businesses or locations to assess "but for" results may be affected if these businesses do not recognize revenues in the same way at the same time.
- **The "market share approach."** Comparing the plaintiff's market share during the periods before and after the harm may be affected by changes in market share resulting solely from adoption of the Standard.

The Standard may affect various modeling techniques used in economic damages analyses. Consider, for example, the following description of the use of averaging in economic damages claims.

> The use of an average (or the mean) is a basic, but sometimes necessary, technique used in damages claims. Practitioners employ averages when they cannot obtain sufficient evidential matter that provides a more accurate or reliable mechanism for estimating a value. For example, average revenue growth over a historical period could offer the only reasonable means of estimating revenues during a but-for period where the resources needed to provide insight into market trends and the likely impacts of the adverse event are unavailable. Similarly, if useful data regarding cost trends are unavailable, practitioners can analyze averages across time, across an industry, or across operating units.[11]

Damages experts often justifiably use averages when analyzing stable, mature businesses with predictable growth patterns in revenues and costs. The use of averages might render the analysis of revenues misleading, especially when used as a benchmark in "but for" comparisons. Some damages experts compare a company's financial performance and share price to a stock market index, such as the Standard & Poor's (S&P) 500, to establish the relative effect of broader market variations for all market participants versus the

11 Elizabeth A. Evans, Phil J. Innes, and Daniel G. Lentz, "Damages Theories and Causation Issues," in *Litigation Services Handbook: The Role of the Financial Expert*, 6th ed., ed. Roman L. Weil, Daniel G. Lentz, and Elizabeth A. Evans (Hoboken, NJ: John Wiley & Sons, Inc., 2017), Section 4.5(a).

subject company's results. But the damages expert needs to justify the use of these indices as an appropriate mechanism of comparison or they will be no more defensible than basic averages in proving damages. In making these comparisons, the damages expert should keep in mind the differing effective dates for the Standard that applied to public and nonpublic enterprises. The Standard may affect the financial analyses of averaging by eliminating specialized industry carve outs during the averaging period; changing the trigger for revenue recognition from transfer of the risk of loss to transfer of control during the averaging period; or changing the unit of accounting, transaction prices, or variable consideration during the averaging period.

Perhaps the most significant challenge facing damages experts will be to understand the Standard's impact on analyses of comparable information or companies for engagements dependent on such comparisons. The Standard may have less impact if an expert uses discounted cash flow (DCF) modeling to determine business value or damages. Clearly, the expert will need to make a reasonable and appropriate determination of cash flows from revenues, which may or may not need to consider the impact, if any, of the new Standard. This problem can be avoided by using, as a starting point in lieu of revenues, the data provided in the subject or comparable companies' statements of cash flows and making any necessary adjustments thereto.

Attaining Reasonable Certainty

Courts generally require that lost profits and other economic damages be proven with reasonable certainty. Recent guidance emphasizes the critical role revenue plays in such damages analyses. For example, in a practice aid issued by the AICPA's Forensic and Valuation Services (FVS) Section,[12] the authors note that many lost profits claims include two key elements: an estimate of "but for" revenues (revenues that would have been earned but for the alleged bad act) and an estimate of revenue growth (how lost revenues would have grown over the applicable damages period).[13] "Given the centrality of revenue estimation and growth to the analysis of lost profits," they continue, "there is a robust body of case law that examines the expert's role in revenue and growth estimation."[14]

The practice aid concludes that "it is clear that the courts will exclude expert opinions that contain revenue and growth rate estimates not based upon accepted methodologies and approaches, and which are generally untethered from any meaningful analyses."[15] To avoid exclusion, experts should "conduct some sort of independent investigation or verification to ensure that the data [used] is both accurate and helpful to the court considering the disputed issues" and demonstrate that they have "gained a working familiarity with the borrowed data so that the expert can demonstrate the data's reliability. Blind adherence to data of unknown origin does not suffice in federal court."[16]

The Standard introduces new complexities that affect an expert's verification of and familiarity with data underlying revenue and growth rate estimates. As a result, the Standard may complicate the process of establishing economic damages with reasonable certainty. VE

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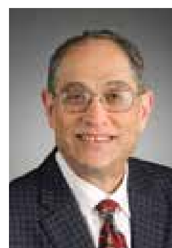

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12 AICPA FVS Practice Aid, *Attaining Reasonable Certainty in Economic Damages Calculations: Revenues, Costs, and Best Evidence* (Durham, NC: AICPA, 2018). Note: AICPA FVS practice aids are prepared by AICPA staff and volunteers and do not reflect official AICPA positions, nor establish standards or preferred practices. The AICPA's position is that the practice aids provide illustrative information on the subject matter.

13 Ibid., 11.

14 Ibid., 11.

15 Ibid., 28.

16 Ibid., 15, quoting Bruno v. Bozzuto's, Inc., 311 F.R.D. 124 (M.D. Pa. 2015).