



Financial Reporting

Beware of Disappearing Revenue in an Acquisition

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Buying a technology company? Be careful – an accounting rule might dramatically reduce your company's revenue in periods after the acquisition.

These days, it seems as if everyone wants to be a technology company – or to merge with one. Global merger-and-acquisition (M&A) activity through December 2015 was at a record high, with acquisition activity in the technology sector at the highest level on record. Unfortunately, the euphoria of acquiring a company can end abruptly – when the buyer realizes it will never get a chance to recognize a significant portion of the acquired company's pre-acquisition deferred revenue.

At this point, rational people may ask a reasonable question: How does buying a company cause it to have less revenue from operations?

A rule in GAAP can cause recently acquired entities to have substantially less revenue in the periods immediately following the acquisition. This article explains the rule and the steps buyers can take to mitigate its impact after a merger or acquisition.

The Issue

Some companies collect upfront payments from customers for goods and services that will be delivered in the future. These entities recognize deferred revenue – a liability – on each period's balance sheet. This liability generally represents cash received or amounts billed for services not yet rendered by the entity. As the entity provides services, the liability is reduced and revenue is recognized on the entity's income statement for the period.

The technology sector is full of companies that encounter this situation, and it is the sector most often affected by the rule, both in frequency and impact. Consider the following scenario:

Example: *Software Inc. is an entity that provides its customers access to a proprietary database of information. Software Inc. sells annual plans, whereby customers typically pay \$120, in advance, for one year of access to Software Inc.'s proprietary database. The incremental cost of providing access to each additional customer is effectively zero; the proprietary database has been created and does not require additional customization or other effort from Software Inc. to meet customers' needs.*

Where Did the Revenue Go?

The short answer to this question is that the revenue that would have been recognized, except for the effects of this purchase accounting rule, is never recorded. As an example, assume a software-as-a-service entity received an upfront payment of \$80 from a customer on Jan. 1, and the company records that payment as deferred revenue. In ordinary circumstances, the company would recognize \$80 of revenue when revenue recognition criteria are met (usually as the services are performed). Now assume that on Jan. 2, the entity is acquired. As a result of this purchase accounting rule, the entity revalues its deferred revenue to \$30. The entity will now recognize post-acquisition revenue of \$30 as the services are performed. The balance of the pre-acquisition deferred revenue of \$50 will never be recognized as revenue by the entity in any post-acquisition period.

In the example, Software Inc. would recognize \$120 of cash and deferred revenue on the first day of the contract. Software Inc. would then recognize \$10 per month of revenue from this customer over each month of the one-year service period. For example, if the customer's subscription started on Jan. 1, at the end of April, Software Inc. would have recognized \$40 of revenue in its income statement for the four months that ended April 30 and have \$80 of deferred revenue on its April 30 balance sheet.

In the ordinary course of business, a financial statement user would expect Software Inc. to have \$80 of revenue over the next eight months (May through December). But what happens if Software Inc. underwent a change in control and was required to apply business combination accounting rules on May 1?

As part of the purchase accounting, the deferred revenue would be adjusted to fair value, which would be minimal on the acquisition date.

When accounting for a business combination, liabilities (and assets) are generally recognized at fair value on the acquisition date (FASB ASC Paragraph 805-20-30-1). On May 1, the fair value of this deferred revenue would be minimal. As a result, the \$80 of revenue that – under normal circumstances – would have been recognized from May to December will not be fully recognized by Software Inc. As part of the purchase accounting, the deferred revenue would be adjusted to fair value, which may be somewhere between \$0 and \$80 – most likely closer to \$0. As a result, the postacquisition revenue would be much less than the original \$80 in deferred revenue.

The Broader Issue

This issue can affect any entity acquired in a business combination that normally has deferred revenue – including technology companies and many service and telecommunications businesses. Many companies in these industries receive upfront customer payments and have low costs associated with incremental services to additional customers or subscribers. Accordingly, this rule affects entities in these industries more often and more severely than it does entities in other industries.

The effect of lower revenue in periods after the acquisition date can be dramatic. Some businesses, especially technology companies, typically collect all or a substantial portion of customer payments in advance of services. This can result in a “lost year,” a year when revenue reported in the 12 months following the acquisition is lower than in a normal operating year for the business.

The extent of the period of lower revenue depends on the duration of typical revenue services. Companies with multiyear plans (such as a company selling a two- or three-year subscription) may see lower amounts of revenue for several years following the acquisition date.

For businesses that have an incremental cost associated with providing service to each customer (e.g., the delivery of newspapers or magazines), the acquisition-date value of the deferred revenue may approximate or exceed the prior carrying amount. The deferred revenue balance would be adjusted to fair value; ordinarily, this is the amount that an independent third party would be paid to assume the obligation. Typically, this would be calculated as the present value of the cash flows that the entity requires to satisfy its customer contract, plus a reasonable margin that a third party would be willing to accept to assume this liability. Except in very unusual circumstances, this would still reduce the reported amount of deferred revenue immediately after the business combination because most entities charge a greater amount for their services than the underlying cost of providing those services. Consequently, even these types of entities wind up with lower revenue in periods after an acquisition than they would have if the acquisition had not occurred.

Usually, each customer contract subsequent to the acquisition date is not subject to a fair value adjustment. For example, for a Software Inc. customer who signs up for service on May 2, the company would recognize the customer's \$120 fee over the next 12 months as the service is provided.

In Brief

- Merger-and-acquisition activity was on the rise at the end of 2015, but companies must be aware of the potential to lose revenue after an acquisition because of business combination rules.
- The potential for a loss of revenue is most common in the technology sector, but the issue can affect any entity acquired in a business combination that normally has deferred revenue.
- The length of time for potential lower revenue depends on the company being acquired. For example, entities selling multiyear subscriptions could see lower revenue for several years after an acquisition.
- Buyers that are aware of the business combination rule can mitigate the impact of the potential loss of revenue by taking several actions, including notifying and negotiating with creditors so that financial covenants in debt agreements are adjusted.

Aware and Prepared

In the short term, buyers cannot change GAAP. However, buyers that are aware of the rule can take a few actions, detailed below, to mitigate its impact. Karen O'Byrne, CPA, CGMA, is the CFO and COO of Modernizing Medicine Inc., a technology company that specializes in developing cloud-based, specialty-specific software solutions for healthcare providers. She has extensive experience with buying and selling software companies. She advises careful review of revenue projections for any acquisition target and, in particular, a review of deferred revenue's impact on those projections. "Whenever a target organization's revenue projections depend on a waterfall from deferred revenue, we ensure they are appropriately adjusted for the effects of this quirky rule," O'Byrne said.

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Here are specific considerations when buying a business with a significant deferred revenue balance:

Financial Covenants in Debt Agreements

Many credit agreements require the borrower to meet minimum financial targets. One example is a minimum fixed-charge coverage ratio (which normally approximates the amount by which the entity's earnings exceed interest, principal payments on debt, and other payments usually determined by the lender). Another common example is a covenant requiring the borrower to achieve a minimum amount of earnings before interest, taxes, depreciation, and amortization (EBITDA). A recently acquired entity that is affected by this GAAP rule might report lower "earnings" than normal. Consequently, the entity may have achieved lower fixed-charge coverage ratios and lower EBITDA in the periods immediately following the acquisition.

Beyond these examples, other types of common financial covenants can be affected by this rule. Management of entities that are affected by the rule should negotiate with creditors so that financial covenants in debt agreements are adjusted to reflect the accounting anomaly. Either the financial covenants can be adjusted to "add back" the purchase accounting adjustment related to deferred revenue or they can be based on the entity's financial statements after consideration of the purchase accounting adjustment.

Compensation Arrangements

Some entities may have compensation arrangements with sales personnel or other employees that are based on the amount of revenue or earnings that the entity reports. The effect of this rule may unintentionally leave these employees with financial performance targets that are nearly impossible to achieve. This could result in the elimination of the incentive for the employees to work toward the financial target. Management of entities affected by this rule should review compensation arrangements – they may need to adjust the performance targets to reflect the lower amount of expected GAAP revenue.

IT Systems and Internal Controls

Most IT systems will continue to capture the pre-acquisition deferred revenue because these systems are normally integrated with the customer's account. As a result, IT systems may need to be adjusted to account for the complexity associated with this adjustment. Alternatively, the accounting group may need to work with IT to ensure that the correct amount of revenue and deferred revenue can be calculated each reporting period after the acquisition.

These steps will not replace the revenue an acquired entity “loses” as a result of this accounting rule. However, by taking the steps described here, buyers can focus on running the acquired business instead of wasting time dealing with the unintended consequences of the rule.





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