Accounting for Deferred Revenue Liabilities in Post–Business Combination Statements

By Josef Rashty and John O'Shaughnessy

Recent developments in generally accepted accounting principles (GAAP) for business combinations have, among other things, expanded the application of fair value accounting. It is important to understand the impact of the business combination guidelines on the treatment of post–business combination accounts. The discussion below deals specifically with deferred revenue liabilities in post–business combination accounts in the acquirer's financial statements. The focus is mostly on software companies; however, many of these concepts translate easily to other industries as well.

Deferred revenue liabilities that had been recognized by the acquiree or the acquirer on their pre-combination balance sheets do not necessarily qualify as deferred revenue liabilities in the acquirer's post-combination financial statements. An acquirer should determine whether the liability recognized by the acquiree represents a post–business combination performance obligation, and, if so, the fair value of such deferred revenue liabilities should be reflected in the financial statements. The guidance on this subject is covered in FASB's Accounting Standard Codification (ASC) Topic 805, *Business Combinations*.

Statement of Financial Accounting Standards (SFAS) 141(R), *Business Combinations*, was issued in December 2007, effective for annual reporting periods beginning after December 15, 2008. Paragraph 20 of SFAS 141(R) (ASC 805-20-30-1) requires that the "acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values." This applies to deferred revenue, which is often an assumed liability in post–business acquisition, provided legal obligations exist to perform the related services. This guidance is part of the convergence effort that attempts to make U.S. GAAP compatible with International Financial Reporting Standards (IFRS).

Prior to the issuance of SFAS 141(R), Emerging Issues Task Force (EITF) Issue 01-3, *Accounting in a Business Combination for Deferred Revenue of an Acquiree*, provided guidance in this area. SFAS 141(R) superseded EITF 01-3, but it did not change the general guidance. Both guidelines require 1) the fair value estimate at the time of acquisition and 2) the recognition of liability when performance obligation exists.

Deferred Revenue Liability and Performance Obligations

An acquiree records deferred revenue liabilities in its financial statements for a variety of reasons. Deferred revenues could represent upfront payments for services or products that have not yet been delivered, or payment for delivered goods or services sold as part of a multiple-element arrangement that cannot be accounted for separately from undelivered items included in the same arrangement. For example, the acquiree may not have vendor-specific objective evidence (VSOE) under ASC 605-25-30-8 to be able to recognize the revenues associated with different elements separately in a multiple-element arrange-

ment contract. (VSOE refers to the price charged for a deliverable in a multiple-elements arrangement when sold separately.)

An acquirer, however, reflects the acquiree's deferred revenue at fair value post–business combination, as long as it represents obligations to provide products or services to customers. There are cases in which an acquiree has recorded deferred revenue liabilities but the acquirer does not necessarily have any obligation to deliver any goods and services. For example, the acquiree might have recorded a revenue transaction as deferred revenue, because the transaction has not met the revenue recognition criteria for a reasonable assurance in collectability or lack of VSOE. In these scenarios, the acquirer does not have any performance obligation related to deferred revenue liability of the acquiree, and as a result it will not record any deferred revenue liability in post–business combination financial statements.

Fair Value Measurement of Deferred Revenue Liabilities

The acquirer should record liabilities for the deferred revenues based on the fair value of the obligation on the acquisition date. This amount could very well be different from the amount previously recognized by the acquiree. The deferred revenue that an acquiree has recognized as a liability generally represents the cash that it has received and does not necessarily reflect the fair value at the time of acquisition. The fair value of deferred revenue liabilities for an acquirer is generally the amount that an acquirer is willing to pay to a third party to assume such liabilities.

There are two different methods to determine the fair value of deferred revenue liabilities. The first method is called the bottom-up approach, and an alternative method is referred to as the top-down approach.

According to the bottom-up approach (the accounting literature has also referred to this method as the "cost build-up approach"), the deferred revenue liability is measured as: 1) direct costs, 2) any incremental costs (such as overhead), 3) a reasonable profit margin, and 4) any additional premium for price variability. The direct and incremental costs are related to the remaining performance obligation subsequent to the merger and not any upfront expenses that were incurred prior to the business combination. A reasonable profit margin would be the profit that a market participant would expect to earn for the completion of the activities related to the deferred revenue liabilities.

The less frequently used top-down approach, on the other hand, relies on market indicators to estimate the expected revenues for deferred revenue obligations. Under this approach, the acquirer measures the fair value of the obligation based on the estimated selling price for the products and services, minus any selling effort and profit thereon.

The acquirer should also consider the "unit of accounting" in certain multiple-element arrangements when measuring the fair value of deferred revenues. For example, a software company provides one-year maintenance or post-contract services (PCS) to its customers, and, as part of this arrangement, provides unlimited bug fixes, telephone support, and unspecified software upgrades and enhancements. The acquirer has the following two alternatives:

- The unbundled unit of accounting measures the fair value of each element separately and on its own. Under this approach, the when-and-if-available upgrades are not considered performance obligations, because there is no contractual obligation on the part of the vendor to deliver such products.
- Based on the guidance in ASC 985-605 (formerly Statement of Position 97-2, *Software Revenue Recognition*) the entire PCS arrangement would be considered as the lowest level of a unit of accounting. Under this view, the fair value of the deferred PCS revenue equals all the costs expected to be incurred (i.e., the costs of providing support services and bug fixes as well as the cost of developing upgrades and enhancements), plus a normal profit margin.

Generally, both views are acceptable, as long as they are applied in a consistent manner.

Fair Value Measurement of Reacquired Rights

An acquirer may reacquire a right that it had previously granted to an acquiree. One example might be rights to the acquirer's technology under a technology license agreement for a certain period of time, for an upfront fee and certain amount of royalties. In post–business combination accounting, the acquirer usually recognizes such reacquired rights as intangible assets separate from goodwill (ASC 805-20-25-14). When an acquirer reacquires a previously granted right, it should recognize and measure its fair value based on the remaining life of the contract without taking into account any expected renewals or extensions. Paragraph 55 of IFRS 3, *Business Combinations*, contains similar guidance.

Valuation of reacquired rights, unlike other assets that are based on market participation assumptions, is based on the estimated cash flows over the remaining life of the contract (ASC 805-20-30-20).

The acquirer should record liabilities for the deferred revenues based on the fair value of the obligation on the acquisition date.

Therefore, there could be a difference between the values derived from market participation assumptions ("at market" value) and fair values estimated based on cash flows. This difference ("off market" value) makes a reacquired right favorable or unfavorable from the acquirer's perspective. As a result, the fair value of a contract consists of an off-market element in addition to an inherent at-market element.

ASC 805-10-55-20 and 21 require that an acquirer should recognize a gain or loss for the effective settlement of a preexisting relationship based on the lesser of the following:

- The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. If the acquirer has previously recognized an amount related to the reacquired right, the settle-

ment gain or loss related to the preexisting relationship should be adjusted for the previously recognized amount.

- The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If this amount is less than the amount mentioned above, the difference should be included as part of the business combination accounting.

Paragraphs 17 and 18 of a November 2010 International Accounting Standards Board (IASB) staff paper confirm that the above wording mirrors paragraph B52 of IFRS 3(www.ifrs.org/NR/rdonlyres/F98BBE13-7C2E-416E-973B-2FC95DF07629/0/1011obs15IFRS3Effectivesettlementofapreexistingrelationship.pdf). The argument in this guidance is that a business combination does not extinguish the relationship between the acquirer and acquiree per se, but rather settles what is the off-market portion of the relationship.

The value assigned to the reacquired rights should exclude any amounts recognized as a settlement gain or loss and would be limited to the value associated with the remaining contractual terms and current market terms. Therefore, the amount of any settlement gain or loss should not affect the measurement of the fair value of any intangible asset related to reacquired rights.

At the 2005 AICPA National Conference on Current SEC and PCAOB Developments (www.sec.gov/news/speech/spch120505bkr.htm), SEC staffer Brian K. Roberson indicated that the fair value of reacquired rights should be estimated as if the registrant were purchasing a right that it previously did not own. SEC staff acknowledge that valuation of reacquired rights is difficult, as the rights often are not transacted on a stand-alone basis.

At the 2006 AICPA National Conference on Current SEC and PCAOB Developments (www.sec.gov/news/speech/2006/spch121106jbu.htm), SEC staffer Joseph B. Ucuzoglu specifically identified in-process revenue contracts as examples of executory contracts that should be recognized as unfavorable contract liabilities, to the extent that the terms of the contracts are less favorable than the terms that could be realized in the current market. Conversely, even though not directly discussed by SEC staff, an in-process revenue contract with terms favorable to the acquirer on the acquisition date should be recognized as favorable contract assets in post–business combination reporting.

Example

Entity A (acquirer) acquires Entity T (acquiree, or target). Assume that they both develop and sell computer software programs. At the time of the acquisition, the following deferred revenue liabilities were reflected in the acquiree and acquirer's financial statements:

1. Entity T sold a license agreement prior to acquisition for $1,000 and is not reasonably sure that it can collect the fee, because the customer is facing financial difficulties. Management plans to recognize this amount as revenue on a cash basis upon collection. Entity T reflected $1,000 in its deferred revenue liabilities prior to acquisition.
2. Entity T had agreed to extensively modify one of its programs for a customer. The modifications were complete at the time of acquisition, but the customer did not sign the acceptance form until two days after the acquisition date. The selling price of the software program was $500, and the amount of the modifications on a cost-plus basis was an additional $300. The customer paid Entity T $800 prior to acquisition, and Entity T reported this amount in its deferred revenue liabilities.
3. Entity T has a commitment to provide professional services for $200. Entity T received $200 from the customer prior to acquisition but has not performed any part of these services prior to acquisition. Entity T expects to complete such services one month after acquisition. Entity T recognized $200 in its deferred revenue liabilities.
4. Entity T has deferred $100 in cash received for training services (as part of the transaction in 2 above) because it did not have VSOE for it. All training services were completed to the satisfaction of the customer prior to the acquisition.
5. Entity T has a $2,000 deferred revenue for PCS at the time of acquisition.
6. Entity A sells a license to Entity T to embed the software in the products that Entity T sells to its customers. Entity A provides Entity T with a "gold disk" for the unlimited deployment of licenses for the two-year duration of contract. Entity A receives a payment of $1,200 at inception and a royalty fee based on each product sale to Entity T customers. Entity A does not have VSOE for the transaction and records the cash receipt as a deferred revenue liability and amortizes it ratably over the next two years. The balance of deferred revenue liability at the time of acquisition was $600. Entity T, on the other hand, recorded the transaction as an advance payment and amortized it based on the number of units sold. The balance of advance payment at the time of acquisition was $500.

The first two columns of the *Exhibit* reflect the effects of the above information in Entities T and A's financial statements prior to the business combination.

The post–business combination column (the last column) of the Exhibit reflects the following additional information regarding the fair value of the deferred revenue liabilities in the post–business combination financial statements of Entity A:

EXHIBIT
Deferred Revenue Liabilities

	Entity T at Acquisition	Entity A at Acquisition	Post–Business Combination
1	$1,000	$ –	$ –
2	800	–	–
3	200	–	100
4	100	–	–
5	$2,000	–	$500
6	–	$500	–

1. Entity A will not recognize any deferred revenue liabilities post-combination because it does not have any performance obligation.
2. Entity A will not recognize any deferred revenue liabilities post-combination because it does not have any performance obligation.
3. Entity A has used the bottom-up approach to determine the fair value of deferred liabilities for professional services and estimated it to be $100.
4. Entity A will not recognize any deferred revenue liabilities post-combination because it does not have any performance obligation.
5. Entity A has used the bottom-up approach and considered the whole PCS arrangement as a unit of accounting to arrive at the fair value of the PCS arrangement, and has estimated it to be $500.
6. Entity A has determined that the fair market value of the license agreement at the time acquisition was $1,500. This fair market value consists of $600 at-market (based on market participants' estimates) and $900 off-market components (based on the excess of fair value derived from cash flow estimates over at-market values; $1,500 – $600). The off-market component is favorable to Entity T and unfavorable to Entity A, as royalty rates have increased considerably in comparable markets since the initiation of the contract. The contract does not have any cancellation clause or any minimum royalty payment requirements.

The accounting for the combined entity, post-combination, would be as follows:

- Entity A would recognize a settlement loss on the reacquired rights equal to the amount that agreement is unfavorable (i.e., the $900 off-market component). This off-market component is related to the below-market revenue-based royalty that Entity T pays to Entity A. Entity A, however, reduces this amount by the amount of deferred revenue liability that is outstanding at the time of acquisition (i.e., $400). Therefore, Entity A recognizes a settlement loss of $500 ($900 – $400). Entity A reflects $900 in its purchase accounting journal entry, which ultimately impacts goodwill. Entity A will not recognize any portion of the $400 deferred revenue as revenue in its post–business combination accounting.
- Entity A will record the remaining value (i.e., the at-market value) of the reacquired rights at $600 as an intangible asset, separate from goodwill, and will amortize it ratably over the next year. The $500 advance payment that Entity T has recorded pre–business combination will not get transferred to Entity A; it will be replaced by $600 (based on the SEC requirement that the fair value of reacquired rights should be estimated as if the registrants were purchasing a right that it previously did not own). The difference between $600 (at-market value) and $500 (the balance of unamortized advance payments) will be reflected in goodwill.

Performance obligations and fair market values impact the amount of deferred revenue liabilities that an acquirer would recognize in post–business combination accounting.

Recent Developments

FASB recently issued EITF Issue 08-01, *Revenue Arrangements with Multiple Deliverables*, which amends certain provisions of ASC 605-25 (Accounting Standards Update [ASU] 2009-13). This guidance is effective for arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010; early adoption is permitted. ASU 2009-13 is not applicable to software companies, but other technology companies and cloud-based computing arrangements are within the scope of this ASU. This guidance made two significant changes to the following: the determination of unit of accounting, and the allocation of transaction consideration to identified units of accounting. ASU 2009-13 allows companies to account for delivered items as a separate unit of accounting if the delivered item has value to the customer on a standalone basis. It also allows the use of third-party evidence and a best estimate of the selling price if VSOE is not available. The adoption of this guidance could accelerate revenue recognition and, as a result, reduce the amount of deferred revenue liabilities.

On June 24, 2010, FASB and the IASB jointly issued an exposure draft that supersedes all prior guidance in revenue recognition issues arising from contracts with customers. This guidance will impact revenue recognition in both software companies and other industries. The proposed treatment may significantly affect how software companies determine what elements can be accounted for separately, particularly software licenses. This guidance will impact the deferred revenue liabilities, which are the mirror image of recognized revenues. It is expected that FASB and the IASB will jointly issue a converged revenue recognition standard in 2011, with an effective date in 2014 or 2015.

Revenues May Be Affected

Deferred revenue liabilities that had been recognized by the acquiree or the acquirer on their pre-combination balance sheets do not necessarily qualify as deferred revenue liabilities in the acquirer's post–business combination financial statements. Performance obligations and fair market values impact the amount of deferred revenue liabilities that an acquirer would recognize in post–business combination accounting. As a result, the revenues of the combined companies' post–business combination may be significantly lower than the total revenues of the two companies if they would not have been merged. Furthermore, reacquired rights will not only impact the amount of deferred revenue liabilities and revenues during the post–business combination period—they may also impact the earnings through additional expenses or income, as illustrated above. ❑

Josef Rashty, CPA, *has had managerial positions in several publicly held technology companies in the Silicon Valley region of California. He can be reached at jrashty@sfsu.edu.* ***John O'Shaughnessy, PhD, CPA (inactive)*** *is an accounting professor at San Francisco State University. He can be reached at joshaun@sfsu.edu.*