

# Deferred Revenue Valuation for Accounting Standards Codification (ASC) 805

## INTRODUCTION

Much of the valuation literature pertaining to ASC 805 has focused on the valuation of different intangible assets. It is important to remember ASC 805 requires the valuation of both acquired assets as well as liabilities. In assessing the fair values of liabilities, many current liabilities have carry values that reasonably reflect the cost to settle the liability. Also, many longer-term liabilities such as debt have interest rates that frequently approximate market rates, or the obligations may become due and payable as a result of a transaction. As a result, their fair values approximate their face values. Deferred revenue represents a liability that more often than not has a fair value that differs from its face value. This article provides an overview of the accounting for deferred revenue in the normal course of a business' operations and in the event of a business combination. We also discuss the valuation of deferred revenue, provide a valuation example, and highlight certain areas that require significant judgment.

## GENERAL ACCOUNTING FOR DEFERRED REVENUE

Deferred revenue is a liability that reflects an enterprise's obligation to provide goods or services to customer(s) at a future date(s). Deferred revenue results when a firm receives payment for a good or service but has not yet provided that good or service to the customer. Depending on the expected term for payment, deferred revenue can be a current and/or long-term liability of a firm. Deferred revenue is recorded as a liability in an amount that offsets the asset received (cash), which is reflected on the asset side of the balance sheet. The deferred revenue liability is reduced (and rev-

enue recognized) as the obligation is fulfilled or cancelled. Classic examples of deferred revenue include magazine and other subscriptions and the purchase of gift cards. A variety of arrangements relating to the license of software may result in deferred revenue. Other transactions will also lead to deferred revenue.

Outside of an ASC 805 setting, the amount of deferred revenue on a balance sheet is dependent on accounting rules that do not require reporting the fair value of the remaining obligation. The "traditional" accounting model for deferred revenue is not based on "fair value." The deferred revenue liability equals the amount that will eventually be recognized as revenue when the appropriate revenue recognition criteria are met.

### Deferred Revenue Valuation in a Business Combination

In a business combination, acquired assets and liabilities are measured at fair value. Deferred revenue related to remaining performance obligations (goods or services) is an acquired liability. If there is no performance obligation, there would not be a deferred revenue liability. Measurement of deferred revenue requires:

- Identifying all performance obligations
- Estimating the costs required to fulfill the performance obligation
- Estimating a profit factor associated with the costs to fulfill

### Accounting Implications of Deferred Revenue Valuation in a Business Combination

In the context of a business combination, appraisers should understand the accounting impact of deferred revenue on a firm's acquisition date and future balance sheets and income statements.



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As deferred revenue represents a liability on the balance sheet, when the deferred revenue obligation is satisfied, the buyer will recognize revenue on its future income statements. Given this, a potential bias to overvalue deferred revenue liabilities could be present. Higher deferred revenue balances will lead to higher future revenue and net income and increases in retained earnings and the book value of shareholders' equity.

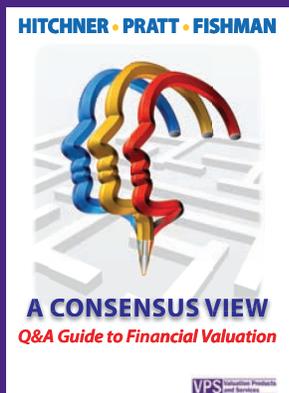
At the acquisition date, a higher deferred revenue liability would lead to a higher goodwill balance. The higher goodwill balance will lead to a potentially greater risk of goodwill impairments in the future. For firms that have elected to amortize goodwill, the initial increase in the goodwill balance will lead to higher amortization expenses that will ultimately offset the initial increase in book equity.

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## expert TIP

Deferred revenue represents a liability that more often than not has a fair value that differs from its face value.

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**VALUATION FOR ASC 805 REPORTING**

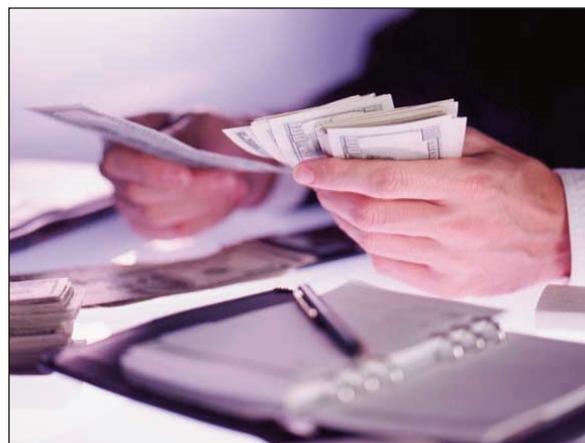
Under ASC 805, the fair value (FV) of acquired deferred revenue typically differs from its reported book value prior to the acquisition. Upon recording deferred revenue (prior to a business combination), the book value of deferred revenue is initially equal to the cash consideration received. This includes payment by the buyer for all efforts incurred to obtain the sale and ultimately deliver the goods and/or services. The deferred revenue liability is adjusted as revenue is earned (i.e., products/services are provided). In contrast, the FV of deferred revenue under ASC 805 is based on costs required to fulfill the deferred revenue obligation plus a mark-up on those costs.

Conceptually, there are two methods available to determine the FV of deferred revenue, including:

- Bottom-up approach – Total of costs to be incurred plus associated profit to be earned
- Top-down approach – Start with deferred revenue balance and deduct previously incurred expenses and the associated profit from the previously incurred expenses

Both approaches are consistent with generally accepted accounting principles (GAAP). One or both may be applicable depending on the availability of adequate information. As deferred revenue represents a liability, the bottom-up approach would seem to more closely reflect the accounting guidance provided for the valuation of deferred revenue.

We previously noted the valuation of deferred revenue under ASC 805 typically results in a reduction to the book value of deferred revenue. This occurs as some expenses have already been incurred— selling and marketing expenses are the most obvious examples. Other expenses may



have also been incurred as well. Conceptually, profits associated with these previously incurred efforts would also have been “earned.”

**Steps in Valuation Process**

The general process for the valuation of deferred revenue includes:

1. Determine types and balances of deferred revenue
2. Determine whether bottom-up and/or top-down approach will be applied (as previously noted, the bottom-up approach is more intuitive and more frequently applied)
3. Develop expense and profit assumptions consistent with a market participant perspective
4. Determine previously incurred and to-be-incurred expenses
5. Calculate profit adjustment (mark-up) factor on expenses to be incurred (bottom-up approach) and develop value indication
6. Assess timing of fulfillment and calculate pre-tax discount rate, if needed

The bottom-up approach calculates fair value as:

**Costs to fulfill the legal performance obligation**  
**Plus: Reasonable profit (or mark-up) associated with costs incurred to service the obligation**  
**Equals: Fair value of deferred revenue**

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## FINANCIAL VALUATION - Fair Value/Financial Reporting, continued

### Simple Example

A simple example will highlight the key concepts associated with deferred revenue valuation.

An acquired firm has an income statement as set forth below (all items are believed to approximate a market-participant perspective).

### Basic Income Statement of Target

Revenue	\$ 10,000	100.0%
COGS	7,000	70.0%
Gross Profit	3,000	30.0%
SG&A Expense	2,000	20.0%
EBIT	\$ 1,000	10.0%

Consistent with the guidance, the appraiser, in conjunction with management, has developed estimates of previously incurred and to-be-incurred expenses. For example, all cost of goods sold is "to-be-incurred." Selling, general, and administrative expenses consist of certain previously and certain "to-be-incurred" items.

### Pro Forma Income Statement - Previously and To-Be-Incurred Expenses

Revenue		\$ 10,000		100.0%
- Previously Incurred	-		0.0%	
- To Be Incurred	7,000		70.0%	
COGS		7,000		70.0%
Gross Profit		3,000		30.0%
- Previously Incurred	500		5.0%	
- To Be Incurred	1,500		15.0%	
SG&A Expense		2,000		20.0%
EBIT		\$ 1,000		10.0%

The top-down approach starts with the total deferred revenue balance and subtracts from this amount previously incurred expenses and previously earning profit as follows:

### Top-Down Approach

Deferred Revenue at Acquisition Date	\$ 2,000			100.0%
Less: Previously Incurred COGS	-	\$ 2,000	X	0.0% = -
Less: Previously Incurred SG&A	100	\$ 2,000	X	5.0% = 100
Less: Profit on P.I. COGS	-	\$ 2,000	X	0.0% = -
Less: Profit on P.I. SG&A	11	\$ 2,000	X	0.6% = 11
Fair Value of Deferred Revenue	\$ 1,889			5.6%
				94.4%

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The bottom-up approach is presented as follows:

**Bottom-Up Approach**

To-Be-Incurred COGS	\$ 1,400	=	\$ 2,000	X	70.0%
Plus: To-Be-Incurred SG&A	300	=	\$ 2,000	X	15.0%
Plus: Profit on To-Be-Incurred COGS	156	=	\$ 2,000	X	7.8%
Plus: Profit on To-Be-Incurred SG&A	33	=	\$ 2,000	X	1.7%
Fair Value of Deferred Revenue	\$ 1,889				94.4%

**VALUATION ISSUES**

Consistent with most valuations, a variety of issues require careful consideration. A few of these include:

**Overhead Allocation-** Allocation of overhead costs is an area where practice varies. Some consider overhead costs such as rent and general and administrative expenses to be “direct and incremental costs” that should be included in the FV estimation of the deferred revenue obligation, but others do not. Treatment of overhead and certain direct and incremental fixed costs depends on the facts and circumstances. The ultimate decision is driven by which costs market participants would include. For example, if a market participant would include certain direct overhead in its pricing, then those costs should be considered.

**Determination of Profit Mark-Up-** If a bottom-up method is used, then the profit allocation represents a mark-up on costs. Mark-up (measured as a percent of cost) is not the same as a profit margin (measured as a percent of revenue). A profit margin can't be directly applied because the analysis is based on costs, not revenues. Therefore, a mark-up on direct and incremental costs must be used. The simple formula for transforming a profit margin to a mark-up factor follows:

$$\text{Mark-up} = \frac{\text{Normal profit margin}}{(1 - \text{Normal profit margin})}$$

Previous example  $.10 / (1 - .10) = 11.1\%$

**Profit Factor** - Profit levels for different business functions is another area of divergence in practice in deferred revenue valuation. The profit to include

in valuation of deferred revenue reflects the remaining costs to fulfill the revenue. Some question whether the sales function vs. the fulfillment function would have the same or different profit margins. There is limited guidance available on this topic at present.

**Tax Treatment-** As deferred revenue is a liability rather than an asset, the costs should be estimated on a pre-tax basis and the profit mark-up should also be on a pre-tax basis.

**Discount Rate Application-** There is limited guidance on when deferred revenue should be adjusted for the time value of money. When deferred revenue is a current liability, a time value adjustment may have a very modest impact on the value of the deferred revenue. When deferred revenue is a non-current liability, present value adjustments will become more important. Deferred revenue fair value should reflect the perspective of a third party willing to assume the liability.

**Discount Rate Development-** As deferred revenue is a liability, any discount rate should reflect an appropriate discount rate for a liability. As a liability, a deferred revenue discount rate should consider valuation on a pre-tax basis. The discount rate should reflect the risk associated with the liability; therefore it is likely to be the performance or default risk of the business to fulfill the obligation. A credit-adjusted risk-free rate may be a good starting point, with any premiums or discounts applied accordingly.

**Multiple Element Arrangements-**

Multiple element arrangements represent another area that leads to complexities in deferred revenue valuation. In many instances, the market price for multiple element contracts may reflect a discount. As an example, if sold separately, a software license might cost \$80 and software support \$20. The price for the sale of the bundle may well be \$90. The market price of the separate elements would presumably be pro-rated to reflect a bundled transaction as follows:

<b>Software license</b>	<b>\$90 * 80% = \$72</b>
<b>Software support</b>	<b>\$90 * 20% = \$18</b>

**Deferred Revenue and Customer Relationships Valuation-**

There are a variety of complexities associated with the valuation of customer-related assets when deferred revenue is present. These issues are discussed in the exposure draft on the valuation of customer-related assets. Appraisers should be aware of these issues and models should appropriately reflect the guidance and the facts at hand.

**CONCLUSION**

Many appraisers continue to focus on ASC 805 as being focused on estimating the fair value of the assets of an acquired business enterprise. While many companies do not have deferred revenue balances, certain industries such as software development and licensing frequently have deferred revenue liabilities and the balances can be significant. While a simple example of deferred revenue valuation is presented, deferred revenue valuations can be quite complex. 