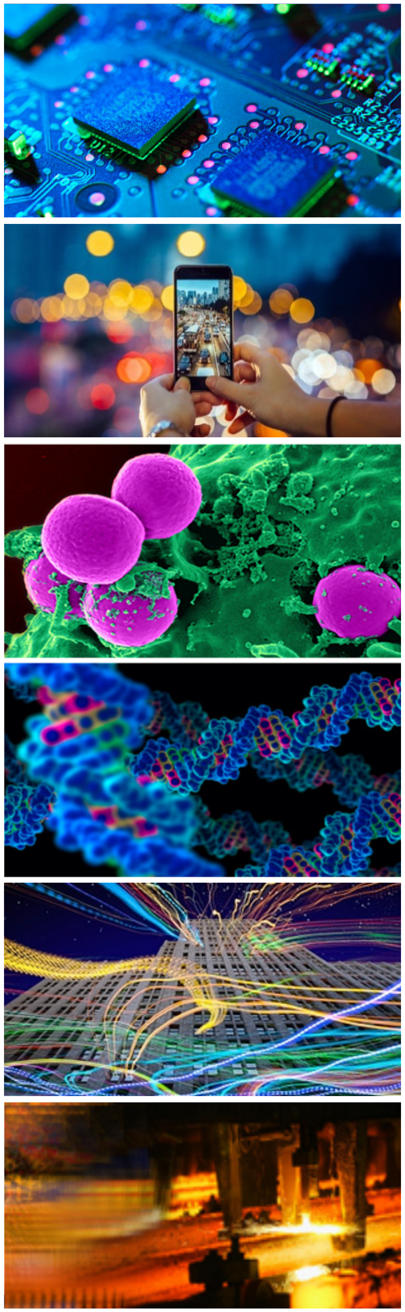

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Financial Valuation and Advisory Services

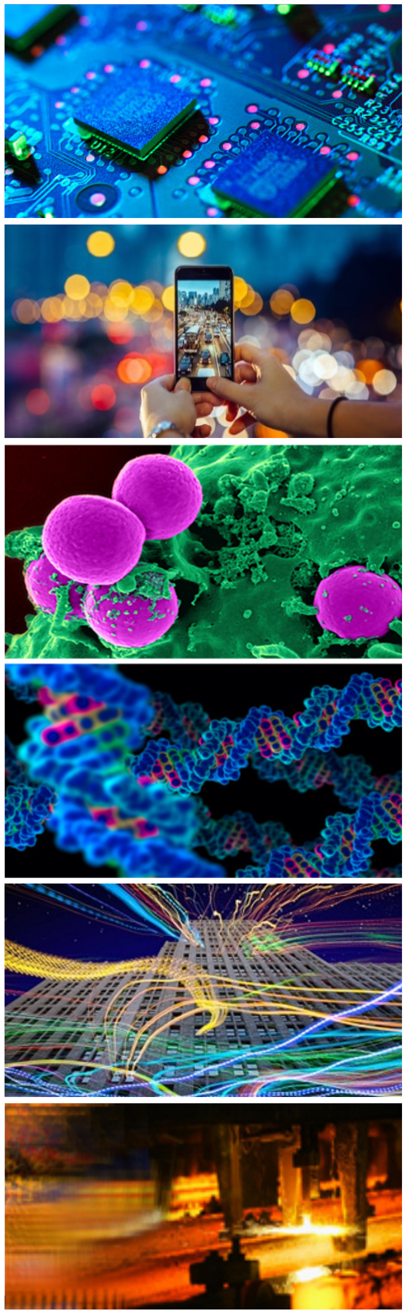
Deferred Revenue Valuation Under ASC 805

Business Valuation Resources Webinar

July 27, 2017

Agenda

- New Accounting Standard for Revenue Recognition
- Deferred Revenue under GAAP
- Valuation of Deferred Revenue
- Advanced Topics
- Mandatory Performance Framework Requirements
- Deferred Revenue for Tax Reporting
- Q&A



New Accounting Standard – ASU 2014-09: Revenue from Contracts with Customers

Revenue Recognition - *Revenue from Contracts with Customers* (ASC Topic 606)

- For some firms and industries, revenue recognition is straightforward. In other cases, revenue recognition is more challenging. **Factors that increase complexity** of revenue recognition include:
  - Customer contracts with **multiple deliverables** to customer
  - **Delays in timing of delivery** of product(s) and/or service(s)
- In May 2014, FASB released *Revenue from Contracts with Customers* (Topic 606) which changes revenue recognition guidance. IASB release of IFRS 15, *Revenue from Contracts with Customers*, has similar guidance.
- Key Points
  - New standard is far less prescriptive
  - US GAAP and IFRS are “largely” converged for revenue recognition.

Revenue Recognition Effective Dates

- US GAAP effective dates:
  - Public Companies: Fiscal years beginning after December 15, 2017
  - Non-Public and Non-Profits: Fiscal years beginning after December 15, 2019
  - Early adoption allowed as of original public company effective date (fiscal years beginning after December 15, 2016)
- IFRS effective date for updated IFRS 15:
  - January 1, 2018. Early adoption is allowed. Check for possible differences by country.

Revenue Recognition – Revision to ASC 606

- While some aspects of the new standard are similar to existing GAAP, other aspects represent **significant changes in revenue recognition principles**
- Viewed as a **"principles-based standard"** for recognizing revenue that can be applied to all contracts with customers to transfer goods, services, or non-financial assets, **except contracts within the scope of other standards** (such as **leases, insurance contracts, certain financial instruments, guarantees**, and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers)

Revenue Recognition – Steps Required to Recognize Contract Revenues per ASC 606

- ASC 606 provides **principles based guidance** for the recognition of contract revenues.
  - **Step 1 – Identify Contract(s) with Customers**
  - **Step 2 - Identify Performance Obligation(s) (“PO”)**
  - **Step 3 - Determine Transaction Price(s) for Each Performance Obligation**
  - **Step 4 - Allocate Total Transaction Price to Each Performance Obligation**
  - **Step 5 – Recognize Revenues Pursuant to ASC 606**
- Contracts with multiple elements may have several different performance obligations.

Revenue Recognition – Single vs. Multiple Element Contracts

- Customer contracts may have single or multiple elements.
- A "simple" magazine subscription where payment is received in advance would represent a single element contract.
- Complex contracts between business entities (aerospace and defense contracts, complex software license agreements, numerous others) will have multiple elements.
- **Multiple element contracts increase complexity of revenue recognition and deferred revenue valuation in the context of a business combination**.

Revenue Recognition – Performance Obligations

- Customer contracts can include a range of possible performance obligations. “Completion” of a performance obligation will lead to revenue recognition.
- **Criteria for determining separate performance obligations is “distinctness”.**
- A good or service (or bundle of goods or services) is distinct if both of the following criteria are met
  - The customer can **benefit from the good or service either on its own or together with other resources** that are readily available to the customer.
  - The entity’s promise to transfer the good or services to the customer is **separately identifiable** from other promises in the contract.

Revenue Recognition – Types of Performance Obligations

- Types of Performance Obligations include:
  - Current product
  - Future product upgrades
  - Installation
  - Training
  - Customer service and support
  - Future product discount (if specific (unique) to a contract)
  - Financing component (Influenced by length of time between satisfaction of performance option and when customer pays for the goods or services).
  - Gift cards
  - Other

Revenue Recognition – Types of Performance Obligations

- An **option in a contract** to acquire additional goods or services gives rise to a performance obligation only if it **provides a material right to the customer that it would not have received without entering into the contract**.
- Performance obligations include:
  - Promises within a contract to deliver goods / services
  - Promises implied by customary business practices

Revenue Recognition – Determining Revenue for Different Performance Obligations (“PO”)

- For customer contracts with multiple performance obligations, the revenues for each PO should reflect **stand-alone selling prices for each distinct performance obligation**.
- The **relative revenues from the different PO are used to allocate the overall contract price to different performance obligations.**
- Contracts with multiple elements may include discounts from the prices if elements were purchased individually rather than in a multiple element arrangement
- Example:
  - Bundled price for obligations A and B $100
  - Separate prices of $80 for A and $40 for B
  - “Pro forma” price of $66.7 for A and $33.3 for B

New GAAP for Revenue Recognition

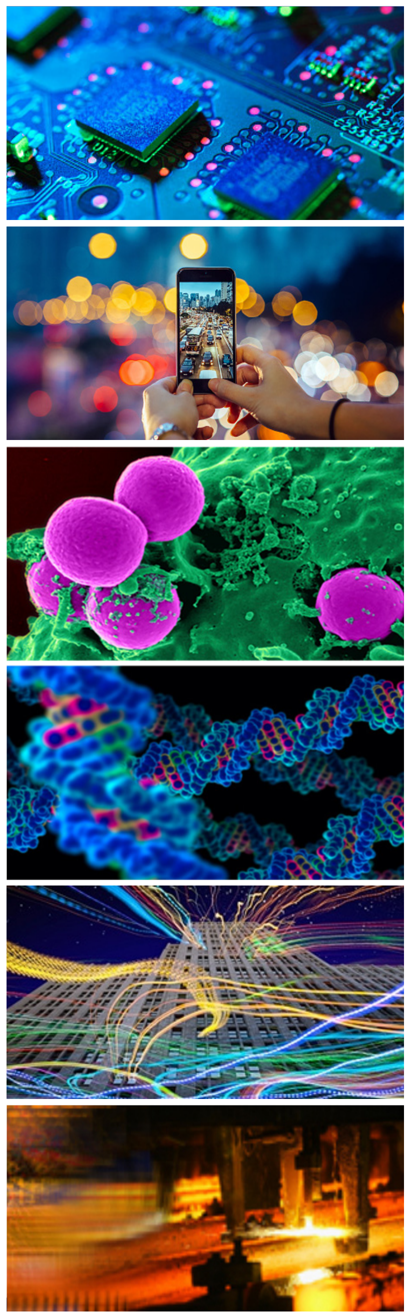
- New standard refers to “contract liabilities” rather than “deferred revenue”
- Deferred revenue (contract liabilities) will still be recorded
  - Concept remains the same
  - Amounts could differ
  - Circumstances could differ
- New standard also results in “contract assets”
  - Asset arises when vendor has satisfied a performance obligation but does not yet have an unconditional right to consideration (account receivable = unconditional right to consideration)
    - Example: Vendor must satisfy another performance obligation before it may invoice the customer

Revenue Recognition Key Provisions

- Special consideration of licenses
- Determine if a license is a **“sales type” or “lease type” license**
  - For **“sales type**” licenses, **revenue is recognized up-front**
  - For **“lease type”** licenses, revenue is recognized **over time**
- “Lease type” licenses are characterized by:
  - Licensor’s activities significantly affect the IP
  - Licensee will be directly exposed to the effects
  - Those activities are not a good or service being provided to the licensee

New Revenue Standard - Impacts

- **Potential revenue acceleration** for some firms (VSOE (vendor specific objective evidence) rule changes). This suggests **less deferred revenue** on target company books
- Impacts of new standard on
  - Public company metrics
  - Earn-outs
  - Debt covenants
- Revenue standard adoption and prior year “restatements”
  1. Full retrospective (restating all prior periods presented)
  2. Modified retrospective (recognize cumulative effect of initially applying the standards as an adjusted to R/E account)
  - Source” The new revenue recognition standard How will it affect Tech sector M&A deals” PwC, US Technology Deals Insights Q3 2016, October 2016



Deferred Revenue under U.S. GAAP

Deferred Revenue - Introduction

- Concept: Obligation to provide goods or services to customer arising from receipt of payment
  - Recorded as liability on balance sheet
  - Liability reduced (and revenue recognized) when obligation is fulfilled or cancelled
- Classic examples of deferred revenue
  - Subscription for magazine or satellite radio
  - Purchase of gift card
  - Customer is invoiced prior to delivery
    - Customer payment = "deferred revenue" until goods or services are provided

Deferred Revenue - Examples

- **Subscriptions**

  At the time of sale, vehicle owners purchasing or leasing a vehicle with a subscription to our service typically receive between a three and twelve month prepaid subscription. Prepaid subscription fees received from certain automakers are recorded as deferred revenue and amortized to revenue ratably over the service period which commences upon retail sale and activation. [Liberty Media Corp]

- **Gift cards**

  Proceeds from the sale of gift cards are recorded as deferred revenue at the time of sale and recognized as income when the gift card is redeemed by the holder or the likelihood of redemption becomes remote (gift card breakage) and the Company determines there is no legal obligation to remit the value of the unredeemed gift cards to governmental agencies. [Del Frisco's Restaurant Group, Inc]

- **Goods not delivered**

  Deferred revenue is recorded when the manufacturing process is complete and customers are invoiced prior to physical delivery of the product. [Northwest Pipe Co]

Deferred Revenue – Accounting Drivers

- Not all deferred revenue results from delayed delivery
- Deferred revenue arises whenever revenue recognition criteria have not been met
  - Four basic criteria for revenue recognition…
    - Persuasive evidence that an arrangement exists
    - Delivery has occurred/services rendered
    - Selling price is fixed or objectively determinable
    - Collectibility is reasonably assured
  - But lots of "nuances"
    - Rights of return
    - Multiple deliverables
    - Sell in vs sell through

Deferred Revenue – Accounting Drivers *(cont'd)*

- Typical journal entry:

  Debit (Dr) Cash $100

  Credit (Cr) Deferred Revenue $100

- Cash received from (or invoice sent to) customer cannot be recorded as current period revenue because accounting criteria for recognition of revenue have not been met
  - Sometimes no services/goods have been delivered
  - Sometimes some goods/services have been delivered
  - Other times, delivery has occurred
- Amount deferred is dependent on accounting rules, not value of remaining obligation

DR - Example of Accounting "Nuance"* from SEC Filing

"In 2007, the Company began shipping Apple TV and iPhone. For Apple TV and iPhone, the Company indicated it *may* from time-to-time provide *future unspecified features* and *additional software products* free of charge to customers... As such, the Company's policy is to **defer the associated revenue and cost of goods sold at the time of sale, and recognize both on a straight-line basis over the currently estimated 24-month economic life of these products**, with any loss recognized at the time of sale..." [*emphasis added*]

Apple (units and $ in thousands)	2009	2008	2007
iPhones Units Sold	20,731	11,627	1,389
iPhones Revenues Recognized	$6,754,000	$1,844,000	$123,000
Deferred Revenue**	$14,790,000	$7,882,000	$2,240,000
Consolidated Revenues	$36,537,000	$32,479,000	$24,006,000

* Effective 2010, new accounting rule narrowed the circumstances where this nuance applies.

** Deferred revenue includes *all* products and services for which revenue is deferred and is not limited to Apple TV and iPhone products.

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DR - More Nuanced Examples from SEC Filings

- ***Sell-through method***

  When a **right of return exists**, contractually or implied, the Company recognizes revenue on the sell-through method. Under this method, revenue is not recognized upon delivery of the inventory components. Instead, the **Company records deferred revenue upon delivery and recognize revenue when the inventory components are sold through to the end user**. [Flux Power Holdings, Inc]

- ***Rights of return***

  Certain product sales are made to retailers under agreements allowing for a right to return unsold products…. [R]ecognition of revenue on all sales to these retailers is deferred until the right of return expires, the product is sold to a third party or a provision for returns can be reasonably estimated based on historical experience. [Generex Biotechnology Corp]

- ***Standalone value***

  The Company's license agreements can provide for upfront license fees, maintenance payments, and/or substantive milestone payments… Upfront nonrefundable fees associated with license and development agreements where the Company has continuing involvement that does not meet the requirement of a separate deliverable are recorded as deferred revenue and recognized over the estimated service period. [Integral Technologies, Inc.]

DR - More Nuanced Examples from SEC Filings

- ***Collection not reasonably assured***

  Deferred revenue is primarily comprised of **maintenance and other service revenues for which payment has been received and for which services have not yet been performed**. Revenue is also deferred in situations where **collection of the receivable at the time of shipment is not reasonably assured**. In situations where collection of the receivable is not reasonably assured, the inventory is expensed upon shipment and the revenue is deferred and recognized as the cash is received. [Analogic Corp]

- ***Customer acceptance***

  In situations with multiple deliverables, revenue is recognized upon the delivery of the separate elements to the customer and when the **Company receives customer acceptance** or is otherwise released from its customer acceptance obligations… When goods or services have been delivered to the customer but all conditions for revenue recognition have not been met, the Company defers revenue recognition until customer acceptance and records the deferred revenue and/or deferred costs of sales in deferred profit on the Consolidated Balance Sheet. [Lam Research Corp]

Deferred Revenue - Measurement

- For initial recording of deferred revenue (not in an ASC 805 context), typically measured based on **amount received or invoiced**
  - Sometimes amount represents an allocated portion of total consideration
    - Allocation might be based on vendor's stand alone selling price, third party's stand alone selling price, management's best estimate of stand along selling price, vendor specific objective evidence of fair value (VSOE) in software, or other measures
- However, amount deferred is dependent on accounting rules, not necessarily the value of remaining obligation
- **Accounting model is not based on "fair value**"
  - Deferred amount = amount that will eventually be recognized as revenue when the appropriate recognition criteria are met

DR - Additional Examples from SEC Filings

- ***Set-up fees***

  Subscription-based and transaction-based contracts generally include the delivery of software, access to our database through a hosted service, upfront fees for the implementation and set-up activities necessary for the client to use/access the software and maintenance. Under a subscription arrangement, we consider delivery of software, access to the hosted database and maintenance to be a combined unit of accounting and recognize related revenues at the end of each month upon the completion of the monthly service. A transaction-based fee represents a payment for the right to use the software, access to the hosted database and maintenance. We consider the fee to be fixed and determinable only at the time actual usage occurs, and, accordingly, we recognize revenue at the time of actual usage. Implementation services and set-up activities are necessary for the client to receive services/software. We defer up-front fees billed during the implementation/set-up phase and recognize such revenues on a straight-line basis over the estimated customer life. Recognition of this deferred revenue will commence upon the start of the monthly service. Implementation and set-up costs that are direct and incremental to the contract are capitalized and amortized on a straight-line basis over the estimated customer life.[Solera Holdings Inc.]

DR - Additional Examples from SEC Filings

- ***Post-contract customer support based on Vendor Specific Objective Evidence of Fair Value (VSOE)***

  Datawatch software products are generally sold in multiple element arrangements which may include software licenses, professional services and customer support…The VSOE of fair value of the services and customer support is based on the amounts charged for these elements when sold separately... Customer support is typically provided under a maintenance agreement which provides technical support and rights to unspecified software maintenance updates and bug fixes on a when-and-if available basis. Revenue from customer support services is deferred and recognized ratably over the period of support (generally one year). Such deferred amounts are recorded as part of deferred revenue in the Company’s accompanying consolidated balance sheets. The Company has established VSOE of fair value for the majority of its customer support based on stated renewal rates only if the rate is determined to be substantive and falls within the Company’s customary pricing practices. VSOE of fair value for sales through the Company’s distribution channel was established using the bell-shaped curve method. VSOE calculations are updated and reviewed quarterly. [Datawatch Corp]

DR - Additional Examples from SEC Filings

- ***Frequent Flyer Miles Awarded In Conjunction with a Flight***
- United has a frequent flyer program that is designed to increase customer loyalty. Program participants earn mileage credits ("miles") by flying on United and certain other participating airlines…Miles can be redeemed for free …, discounted or upgraded air travel and non-travel awards. The Company records its obligation for future award redemptions using a deferred revenue model…In the case of the sale of air services, the Company recognizes a portion of the ticket sales as revenue when the air transportation occurs and defers a portion of the ticket sale representing the value of the related miles as a multiple-deliverable revenue arrangement. [United Continental Holdings, Inc.]
- The Company uses the incremental cost method to account for the portion of our frequent flyer liability incurred when AAdvantage and Dividend Miles members earn mileage credits by flying ... The Company has an obligation to provide future travel when these mileage credits are redeemed and therefore has recorded a liability for mileage credits outstanding… The liability for outstanding mileage credits is valued based on the estimated incremental cost of carrying one additional passenger. Incremental cost primarily includes unit costs incurred for fuel, food, and insurance as well as fees incurred when travel awards are redeemed on partner airlines…No profit or overhead margin is included in the accrual of incremental cost. [American Airlines Inc]

DR - Additional Examples from SEC Filings

- ***Biotech upfront payments***

  …[T] he Company determined that its licenses lacked stand-alone value and were combined with other elements of the arrangement and any amounts associated with the license were deferred and amortized over a certain period, which the Company refers to as the Company's period of substantial involvement. The determination of the length of the period over which to defer revenue is subject to judgment and estimation and can have an impact on the amount of revenue recognized in a given period. Historically the Company's involvement with the development of a collaborator's product candidate has been significant at the early stages of development, and lessens as it progresses into clinical trials. Also, as a drug candidate gets closer to commencing pivotal testing the Company's collaborators have sought an alternative site to manufacture their products, as the Company's facility does not produce pivotal or commercial drug product. Accordingly, the Company generally estimates this period of substantial involvement to begin at the inception of the collaboration agreement and conclude at the end of non-pivotal Phase II testing. The Company believes this period of substantial involvement is, depending on the nature of the license, on average six and one-half years. Quarterly, the Company reassesses its periods of substantial involvement over which the Company amortizes its upfront license fees and makes adjustments as appropriate. In the event a collaborator elects to discontinue development of a specific product candidate under a development and commercialization license, but retains its right to use the Company's technology to develop an alternative product candidate to the same target or a target substitute, the Company would cease amortization of any remaining portion of the upfront fee until there is substantial preclinical activity on another product candidate and its remaining period of substantial involvement can be estimated. In the event that a development and commercialization license were to be terminated, the Company would recognize as revenue any portion of the upfront fee that had not previously been recorded as revenue, but was classified as deferred revenue, at the date of such termination. [Immunogen Inc]

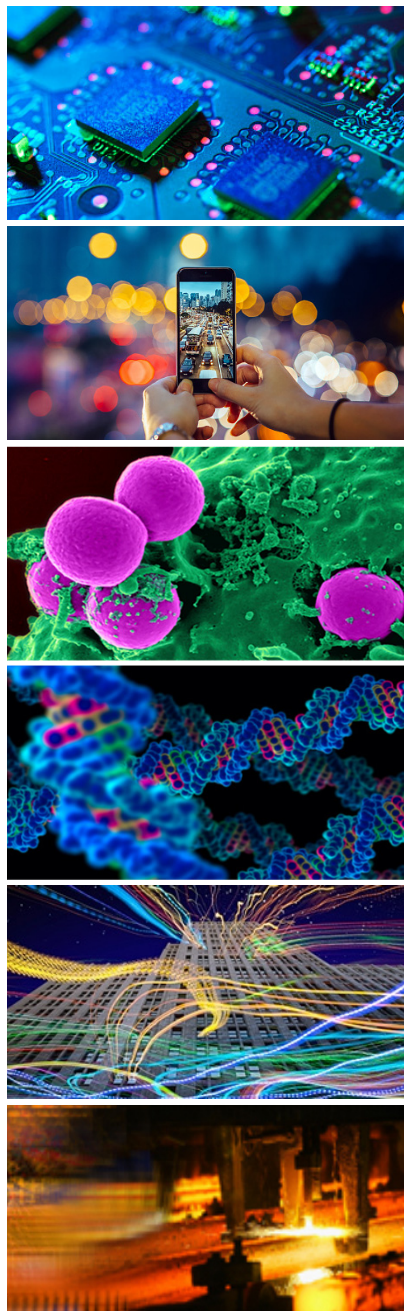
Deferred Revenue – General Insights from Apple, Inc. September 28, 2013 Form 10-K

- Deferred revenue is very significant for certain firms. Key info for Apple:
  - Revenues $170.9 billion
  - Net Income $37.0 billion
  - Total Assets $207.0 billion
  - Equity $123.5 billion
  - Deferred Revenue
    - Current - $7.4 billion
    - Non-current - $2.6 billion
- The Company records deferred revenue when it receives payments in advance of the delivery of products or the performance of services. This includes amounts that have been deferred for unspecified and specified **software upgrade rights** and **non-software services** that are attached to hardware and software products. The Company sells **gift cards** redeemable at its retail and online stores, and also sells gift cards redeemable on the iTunes Store for the purchase of digital content and software. The Company records deferred revenue upon the sale of the card, which is relieved upon redemption of the card by the customer. Revenue from AppleCare service and support contracts is deferred and recognized over the service coverage periods. AppleCare service and support contracts typically include extended phone support, repair services, web-based support resources and diagnostic tools offered under the Company's standard limited warranty.

Deferred Revenue Overview – Other Public Company Deferred Revenue Observations

- For certain industries and firms, deferred revenue has a significant impact on financial statements.

Company	Microsoft		Cisco		PeopleSoft		Oracle	
FYE	6/30/2013		7/27/2013		12/31/2013		5/31/2014	
Revenue	$ 77,800		$ 48,600		$ 2,267		$ 38,275	
Net Income	$ 21,900		$ 10,000		$ 85		$ 10,955	
Deferred Revenue								
- Current	$ 20,600	92.0%	$ 9,300	68.9%	$ 589	83.1%	$ 7,269	94.7%
- Non-current	1,800	8.0%	4,200	31.1%	120	16.9%	404	5.3%
- Total	$ 22,400	100.0%	$ 13,500	100.0%	$ 709	100.0%	$ 7,673	100.0%
Total Assets	$142,400		$101,200		$ 4,225		$ 90,344	
Equity	$ 78,900		$ 59,100		$ 2,859		$ 47,447	
Deferred Revenue (Current) as % of								
Revenue	26.5%		19.1%		26.0%		19.0%	
Net Income	94.1%		93.0%		692.9%		66.4%	
Total Assets	14.5%		9.2%		13.9%		8.0%	
Equity	26.1%		15.7%		20.6%		15.3%	



Valuation of Deferred Revenue for ASC 805

Deferred Revenue and ASC 805 - Introduction

- **In a business combination, acquired liabilities are measured at fair value**
- Deferred revenue related to **remaining performance obligations** (goods or services) is an acquired liability
  - Requires **identifying all performance obligations**, recorded AND unrecorded
  - Requires understanding why deferred revenue was recorded
    - Collectibility not reasonably assured? Possible returns? Pending customer acceptance? Future defined goods or services? Future undefined goods or services (when-if-available unspecified software or unspecified upgrades)? Bundled services (maintenance, phone support and 'bug fixes')?
  - Requires **defining the remaining performance obligation**
  - Requires acknowledging that some "revenue" will never be recognized, not by seller, not by buyer

Valuation - Fair Value under ASC 805 Often Differs from Book Value

- Under ASC 805, the fair value of acquired deferred revenue typically differs from its reported book value.
- **Upon initially 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**.
- 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.**

Valuation – Fair Value Methodology

- For ASC 805, the FV of deferred revenue should be based on:
  - **Costs of the remaining activities** to be performed after the acquisition
  - **Profit factor** associated with remaining activities
- Methods used to determine the FV of deferred revenue include:
  - **Bottom-up approach** – Build-up of costs to be incurred and associated profit to be earned
  - **Top-down approach** – Start with deferred revenue balance and deduct previously incurred expenses and the associated profit requirement
- Both approaches are consistent with GAAP. One or both may be applicable depending on the availability of adequate information.
- Valuation of deferred revenue **under ASC 805 typically results in a reduction to the book value** of deferred revenue (some expenses have likely already been incurred – i.e., selling expenses).

Valuation – Valuation Process for Deferred Revenue

1. Determine type(s) and balance(s) of deferred revenues
2. Determine whether bottom-up and/or top-down approach will be applied
3. Develop "general" expense and profit assumptions
   a) Confirm whether target company financial information is consistent with market participant perspective (If available, assess buyer or guideline company data)
   b) Assess whether entity, reporting unit or function specific revenue, expense and profit estimates should be used ***(Key Item)***
4. Determine previously and to be incurred expenses ***(Key Item)***
5. Calculate profit adjustment (mark-up) factor(s) and develop value indication ***(Key Item)***
6. Assess timing of fulfillment and calculate pre-tax discount rate, if needed

Valuation – Actual and Pro Forma Income Statements

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%		
Pro Forma Income Statement					
	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%

- Simplified income statement used to highlight concepts.

Valuation – Sample Income Statement
Allocation of Profit to Various Business Activities

Allocation of Profit						
						Allocated Profit as % of Revenues
	- Previously Incurred COGS	-		0.0%		0.0%
	- To Be Incurred COGS	7,000		77.8%		7.8%
	COGS		7,000		77.8%	
	- Previously Incurred SG&A	500		5.6%		0.6%
	- To Be Incurred SG&A	1,500		16.7%		1.7%
	SG&A Expense		2,000		22.2%	10.0%
	Total Costs		$9,000		100.0%	

- The 10% EBIT margin is allocated among the previously and to be incurred expense categories. The allocated profit figures will be carried to the valuation calculation.

Valuation – Deferred Revenue Valuation Top-Down and Bottom-Up Approaches

- Top-down and bottom-up approaches should reconcile.
- Bottom-up approach may be more intuitive and readily explained.

Top Down Approach					
Deferred Revenue at Acquisition Date	$ 2,000		100.0%		
Less: Previously Incurred COGS	-	0.0%		X	$ 2,000
Less: Previously Incurred SG&A	100	5.0%		X	$ 2,000
Less: Profit on P.I. COGS	-	0.0%		X	$ 2,000
Less: Profit on P.I. SG&A	11	0.6%		X	$ 2,000
Fair Value of Deferred Revenue	$ 1,889		5.6%		
			94.4%		
Bottom-Up Approach					
To Be Incurred COGS	$ 1,400		70.0%	X	$ 2,000
Plus: To Be Incurred SG&A	300		15.0%	X	$ 2,000
Plus: Profit on To Be Incurred COGS	156		7.8%	X	$ 2,000
Plus: Profit on To Be Incurred SG&A	33		1.7%	X	$ 2,000
Fair Value of Deferred Revenue	$ 1,889		94.4%		

Bottom-up Approach – Form of Calculation

- The bottom-up approach calculates fair value as:
  - Direct and incremental costs to fulfil the legal performance obligation
  - Plus: Reasonable *profit (or mark-up)* associated with costs incurred to service the obligation.
  - Equals: FV of deferred revenue.
- Costs incurred (and related profit earned) prior to the business combination are not included as they were already incurred.
  - Examples of previously incurred costs may include up-front selling and marketing costs, training costs, and recruiting costs.

Bottom-up Approach – Direct Costs

- 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" which should therefore be included in the FV estimation of the deferred revenue obligation but others do not.
- Treatment on of overhead and certain fixed costs direct and incremental depends on the facts and circumstances.
  - The ultimate decision regarding which costs to include 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.
- **Costs should be on a pre-tax basis and the profit mark-up should be on a pre-tax basis**.

Bottom-up Approach – Profit Mark-Up Factor

- Mark-up (measured as a % of cost) is not the same as a profit margin (measured as a % 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.
- Mark-up = Normal profit margin / (1-Normal profit margin)

Bottom-up Approach – Reasonable Profit

- A reasonable profit reflects a market participant's profit, as opposed to specific attributes of the target company or the buyer.
  - i.e. what a market participant or hypothetical transferee would charge to assume the remaining performance obligation.
- Reasonable profit should reflect the valuation date market profit mark-up (instead of historical or projected) on the specific component of the deferred revenue balance (or similar services/products).
- If deferred revenue is recent and target operations were stable, there may not be sufficient basis to expect the mark-up factor from subject data to not reflect a market participant level.
- No mark-up should be included for elements of service/product process that were completed prior to the business combination.
  - Services already provided have a 100% “haircut” in the FV adjustment (i.e., no remaining balance).

Bottom-up Approach – Example

- **Mark-up Based on Operating Profit Margin**

Book value of deferred revenue	\$120 million	As reported

- **Bottom-up Calculation:**

COGS to be incurred	\$60 million	Provided by Management
<u>Operating expenses - G&A</u>	<u>+ \$20 million</u>	Provided by Mgmt
Total costs to be incurred	\$80 million	
Operating profit margin	20%	For remaining functions
Operating expense mark-up	25%	Convert profit margin to mark-up = (.2 / (1-.2)
FV of deferred revenue	\$100 million	

(\$80 million of costs to be incurred plus profit mark-up of \$20mm (\$80mm times 25%))

Adjustment to book value for DR	(\$20 million)	= \$120mm - \$100mm

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Top-down Approach - Overview

- General elements of the Top-down Approach are:
  - Market price (book value of deferred revenue)
  - Less: Costs previously incurred
  - Less: Profit mark-up on previously incurred costs
  - Equals: FV of deferred revenue

- Market price (book value) presumably reflects an appropriate allocation to the performance obligation at time of original recognition.
- One issue for concern is whether a multiple element arrangement involved a discount from unbundled selling prices for different performance obligations.

Top-down Approach – Example

1. Market price	
Book value of deferred revenue	$120 million
Selling price	$120 million
2. Costs – previously incurred	
Selling price	$120 million
Selling expense	x 13%
Selling cost	$16 million
3. Profit mark-up on costs (i.e., selling effort)	
Selling cost/effort	$16 million
Operating profit	20%
Operating expense mark-up	25%
Profit on selling effort ($16mm times 25%)	$4 million
4. Fair value of deferred revenue	
Book value of deferred revenue	$120 million
Less: Selling effort already performed	- $16 million
Less: Profit on selling effort	- $ 4 million
FV of deferred revenue	$100 million

Deferred Revenue – Cost to Fulfill

- ASU 2009-5, *Measurement of Liabilities,* indicates liabilities are valued at "the **price paid to transfer a liability** in an orderly transaction between market participants at the measurement date"
- Fair value of DR should reflect the **costs a market participant buyer** of the obligation would incur to satisfy the DR obligation as well as a **reasonable profit margin** for their efforts
- Question arises as to inclusion of costs in DR valuation. Market participants may factor in costs that an acquirer of the DR will not have to expend in cash when satisfying the obligation (i.e. sunk cost of the seller, created technology, right of ownership of assets needed to satisfy the obligation, etc).

Deferred Revenue – Cost to Fulfill *(cont'd)*

- May result in smaller differences between fair value and DR book values than current accepted approaches
- Considers that the obligation is to deliver the underlying asset/service and NOT just the delivery of the asset/service
- Considers that the **DR obligation can be discharged separately from the underlying business**
- Considers costs that the acquirer will never cash outlay – typically, asset access rights (e.g. software license)
- Increased asset fair value to reflect "hypothetical" asset access cash inflows; fair value is based on the actual cash costs to be expended to satisfy the DR obligation
- Constraint is selling price less selling costs to resign contract giving rise to DR (inclusive of reasonable mark-up)

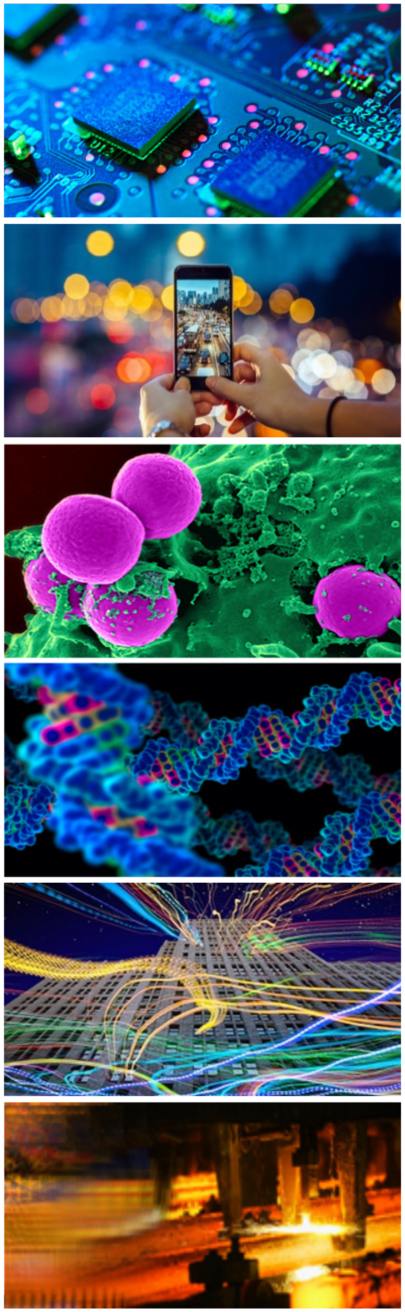
Deferred Revenue – Costs to Fulfill - Example

- **Example from the film broadcasting industry**
- Company A owns the rights to distribute a film.
- Company B paid Company A $1,000 for the exclusive right to air the film.
- Company A records $1,000 DR liability.
- Company A's cost to fulfill the obligation is $10 and represents the cost pushing an uplink. (Content is already owned.) A reasonable profit to deliver the content is $2.
- Company A is acquired. The fair value conclusion from two different perspectives are as follows:

Deferred Revenue – Cost to Fulfill - Example

Comparison of Deferred Revenue Valuations				
		Existing Buyer		**Third-Party Buyer**
[1]	Cash Costs post deal to satisfy obligation	$ 10		$ 10
[2]	Plus: Profit on Costs	2		2
[3]	Plus: Costs to obtain underlying content	0		900
	Fair Value	$ 12		$ 912
Notes:				
[1]	Assumed			
[2]	Assumed			
[3]	Existing buyer reflects no incremental content cost to existing owner			
	Third-party buyer reflects need to acquire content rights in order to license.			

- Significant difference in assumptions related to inclusion of content cost in valuation.
- A third-party market participant would consider the cost to obtain content right needed to satisfy the obligation.
- If this issue arises, may wish to consult with auditor early in process



Advanced Topics

Advanced Topics - Bundled Services Top-down Approach and Market Price

- Market price for multiple element contracts may reflect a discount
- Prices if sold separately
  - Software license $80
  - Software support $20
- Price of bundle $90
- Market price of the separate elements would presumably be pro rated to reflect a bundled transaction
  - Software license $90 * 80% = $72
  - Software support $90 * 20% = $18

Advanced Topics - Bundled Services, Top-down Approach and Market Price *(cont'd)*

- The market price, if available, is used. Market price reflects the actual value of the different services
- However, when multiple products and/or services are sold in a single bundle, Vender Specific Objective Evidence (VSOE) is often applied.
  - VSOE occurs in a multiple element arrangement.
  - It governs how a company that licenses, sells, leases or otherwise markets its products (i.e., software) must recognize the revenue.
- VSOE is the price the company charges when selling the same product separately.
  - Some believe a top-down approach would be the most appropriate approach if reliable VSOE is available (provides market evidence).

Vendor Specific Objective Evidence

- **Vendor-specific objective evidence** (VSOE) is a method of revenue recognition that enables companies to **recognize revenue on specific items on a multi-item sale** based on evidence specific to a company that the product has been delivered.
- The AICPA Accounting Standards Executive Committee instituted SOP 97-2. A company selling software with a package including installation and a one-year maintenance contract can only record the sale on a deferred basis and earnings are recognized over the term of the maintenance contract. Based on VSOE, allocation **occurs by splitting the fee amongst the products and related element**s – which is the price established by the vendor for the **separate sale of each element** and are able to recognize some of the revenue at delivery. This allows companies that sell items that have software licenses, support contracts and hardware items recognizing the revenue of the hardware items on delivery, and the software license or support contract based on the fulfillment of the time the contract it is related to.

Advanced Topics – Steps 2 and 3 Financial Data to Use Market Participant

- A market participant must be capable of fulfilling the obligation and ideally is a pure-play comparable company, similar to the bottom-up approach.
  - If comparable provides multiple products / services, income statement would need to be disaggregated by function
    - Information may not be available
    - Undue cost and burden concerns
- When there is a lack of market participant information and there is no evidence that a market participant would make different assumptions, the target company's information may be used.
- Given nature of disclosures, identification of comparable market participant information could be challenging.

Advanced Topics – Measurement of Direct Costs

- EITF Issue No. 04 – 11,*Accounting in a Business Combination for Deferred Post Contract Support Revenue of a Software Vendor*, provides for use of direct costs. Determination of direct costs is a potential area for divergence in practice
- Certain industries such as software, pharmaceuticals, healthcare and others have a relatively high degree of indirect costs such as R&D, advertising and other indirect costs as a percentage of total costs.

Advanced Topics – Profits for Different Functions

- Profit to include in valuation of deferred revenue reflects the remaining costs to fulfill the revenue
- Some question as to whether sales function vs. the fulfillment function would have the same profit margins
- Transfer pricing studies prepared for tax reporting purposes can possibly be a source of different profit mark-ups on cost or profit margins as a percent of revenue
  - Concern regarding number of different functions provided
  - Reconciliation challenges if separate estimates used
  - Undue cost and burden issues possible
- Limited guidance available on this topic

Advanced Topics – Step 7 and 8 Discount Rate

- There is **limited guidance on when deferred revenue should be adjusted for time value of money**.
- When deferred revenue is a **non-current liability, present value adjustments should be applied**.
- Deferred revenue fair value should reflect the perspective of a third party willing to assume the liability.
- **Deferred revenue discount rate should consider**:
  - Valuation on a **pre-tax basis** (valuation of a liability)
  - Valuation of a **liability** rather than an asset
  - **Time period** until obligation satisfied
- 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 fulfil the obligation.
- A **credit-adjusted risk-free rate may be a good starting point**, with any premiums or discounts applied accordingly

Deferred Revenue and Customer Relationships - Introduction

- Valuations of deferred revenue (liability) and customer-related intangibles (asset) (or technology if valued using an MPEEM) need to be assessed for consistency.
- Future revenues for an entity include:
  - Existing customers
    - Deferred revenue (if any)
    - Order backlog
    - Customer contract and/or relationship
  - New customers
- As cash for certain customer services has already been received, valuation model for customers needs to reflect this consideration. Cash received should be adjusted out of projected revenues.
- The cash received is reflected by the deferred revenue balance before any valuation adjustments.

Deferred Revenue and Customer-Related Intangibles - Adjustment to Expenses

- If the **existing customer revenues are adjusted downward** by the **gross** deferred revenue, then **expenses should also be adjusted**.
  - Deferred revenue on the credit side of the balance sheet (i.e., a separate unit of account).

Deferred Revenue References in Valuation Guidance – Contributory Asset Charge

- 2.2.07 If an entity has deferred revenue, this liability may or may not be included as a component of the working capital that is then used as the basis for a CAC. Whether to include or exclude the deferred revenue as a component of the working capital will depend on how the PFI was developed. **If the revenue component of the PFI was developed on an accrual basis, then it likely would be appropriate to include the deferred revenue as a component of working capital.** The Working Group believes that **deferred revenue should be included in working capital on a normalized basis if deferred revenue is a part of an entity's ongoing operation.** The Working Group also believes that, in such a circumstance, the level of accrued deferred revenue included in net working capital for purposes of calculating the CAC should reflect an entity's ongoing operations and be consistent with the PFI, as opposed to a level reflecting a "one-time" adjustment of the fair value of any legal performance obligation that would arise in a business combination accounting setting.

Business Combinations Guide – Deferred Revenue and Customers

- If deferred revenues exist at the time of the business combination, and intangible assets are valued using the income approach (e.g., RFR or MEEM), then **adjustments may be required to the PFI if it was prepared on an accrual basis**. This will **eliminate any revenues reflected in the PFI that have already been received by the acquiree** (i.e., the **acquired cash includes the deferred revenue amount**). If the excess earnings method is used, the expenses and required profit on the expenses that are captured in the valuation of the deferred revenue valuation are also eliminated from the PFI. However, **if cash based PFI is used** in the valuation and therefore acquired **deferred revenues are not reflected in the PFI, then no adjustment is required** in the valuation of intangible assets using the income approach.

Deferred Revenue Comments: Customer-Related Assets Guide

- 9.3.1 Deferred revenue is a liability (either current or non-current) that arises from the accounting for transactions in which a customer pays for goods or services in advance of the delivery of such goods or services and there is a remaining performance obligation. The undelivered performance obligation becomes a liability at the time of the transaction and is recognized as revenue once the performance obligation is fulfilled. Common examples are computer service contracts, software maintenance contracts, or other extended service contracts where the contract is paid at inception but the performance obligation will be delivered over the term of the contract, which causes the entity to defer recognition of revenue.

- 9.3.2 The presence of deferred revenue when valuing an intangible asset such as customer-related assets or technology-related assets can create the need for adjustments to the cash flows to ensure there is **not double counting**. Specifically, the valuation of the deferred revenue (which typically arises in a business combination or a goodwill impairment step two analysis) considers the costs to fulfill the performance obligation and the related profit on those efforts. It is important to **make sure that those costs and profits are not measured in another intangible asset** such as customer-related or technology-related assets so that the liability is not netted with an asset.

Deferred Revenue Comments: Customer-Related Assets Guide

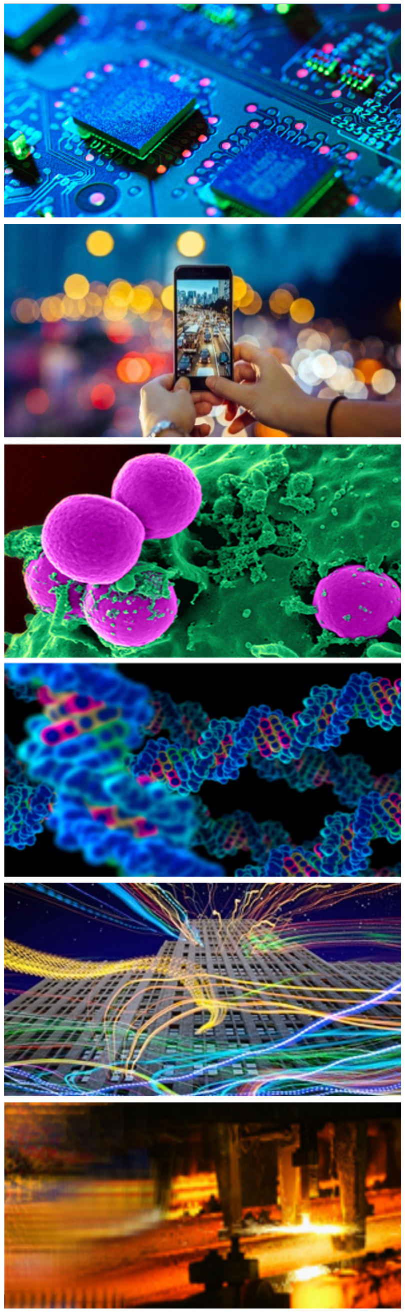
- 9.3.3 In most cases, the PFI prepared by management is developed on an **accrual basis**. In the presence of deferred revenue, this can create the **need for adjustments to be made because a portion of the projected revenue will have already been received in cash.** The Working Group believes there are generally three alternatives for making deferred revenue-related adjustments:
  - a. In Method 1, the accrual PFI can be **converted to a cash-basis** PFI. Using a cash-basis PFI would not require a need for any adjustments because revenue is not deferred in cash-basis accounting.
  - b. In Method 2, **adjust the accrual-based PFI in a MPEEM to exclude the book value of deferred revenue, and remove the fulfillment cost from the Cost of Goods Sold (COGS) and operating expenses**. By eliminating the deferred revenue and the fulfillment cost from the MPEEM, double counting is avoided**.[Also, exclude selling cost which was previously incurred.]**
  - c. In Method 3, in situations **where the amount of revenue from existing customers** that is deferred each year is expected to be relatively **consisten**t or the amount of revenue deferred each year is **minimal** as compared with total annual revenue, as a **practical expedient no adjustments for deferred revenue or related fulfillment expenses are made** in the customer-related asset valuation model. The timing impact on cash flows is considered to be de minimis.

Deferred Revenue Comments: Customer-Related Assets Guide

- 9.3.4 The Working Group believes that **Methods 2 and 3 are more practical expedients**, as converting accrual accounting PFI to cash basis may be a complex task. Key adjustments in Method 2 include:
  - a. **Projected revenue should represent revenue from future sales only** (i.e., revenue that has not yet been received). Thus, the **amount of revenue that is deferred (book value) should be excluded from the MPEEM because it has already been received** and the **cost associated with fulfilling the performance obligation associated with the deferred revenue is valued as a liability**.
  - b. The cost of goods sold should be based on the revenue from future sales only.
  - c. The **working capital CAC** should reflect debt-free working capital, **including deferred revenue and the related cash**.

Advanced Topics - Information Request

- Is deferred revenue from a single or multiple element contract?
- If a multiple element contract, how did management originally allocate revenue to different performance obligations?
- Detailed listing of deferred revenue
  - Type of product / service
  - Source
  - Amount
  - Timing of receipt
  - Subscriptions paid in advance
- Profit and loss statements for business groups providing specific products or services with deferred revenue



Mandatory Performance Framework Requirements for Contract Liabilities Valuation

MPF – Contract Liabilities – Topic Overview

- A3.11.1 In a business combination, **a legal performance obligation may give rise to the recognition of an asset and a liability by the acquirer**. A **revenue arrangement may result in the assumption of a legal obligation to provide goods or services, requiring the recognition of both contract liabilities** and a customer related intangible asset. Therefore, the contract liabilities and acquired customer assets are recognized separately.
- Revenue arrangements to provide goods or services are often referred to as deferred revenue, unearned revenue, unearned income or other terms.

MPF – Contract Liabilities – Documentation Requirements

- A3.11.4 The valuation professional, at a minimum, must document in writing within the work file, if applicable:

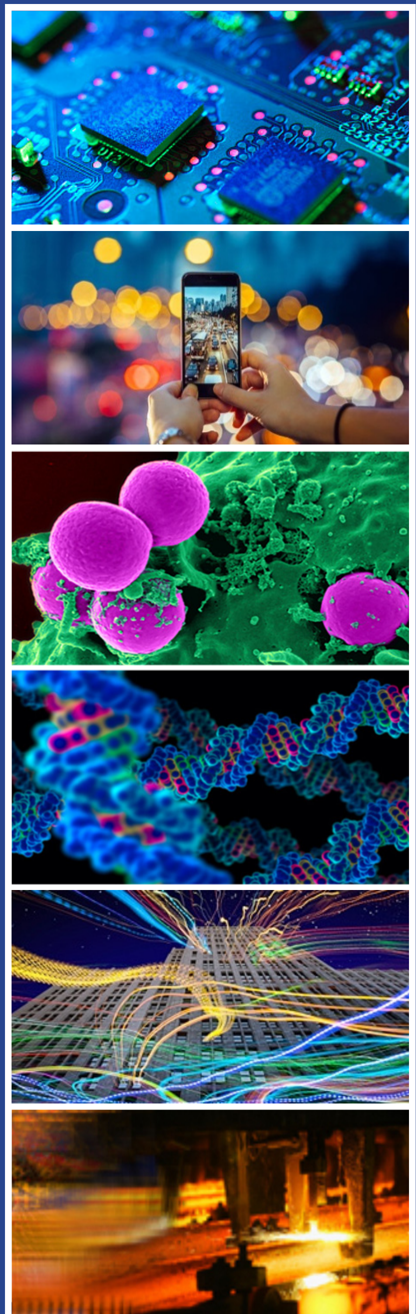
a. The **rationale for selecting** one of the two methods described previously [**top-down or bottom-up**] to value contract liabilities

b. When utilizing the **bottom-up** approach, clearly indicate **all the costs necessary to fulfill the contract liability and how the "normal" profit margin was estimated**

c. When utilizing the **top-down approach**, provide **market data sources and support for each assumption for related selling costs and profits** thereon

d. The **life of the contract liability** in case discounting is applied

e. The rationale for the **rate of return** used to estimate the fair value of the contract liabilities



Deferred Revenue for Tax Reporting

Revenue Recognition for Tax

- Under general tax principles, a **taxpayer must recognize revenue when it has a fixed right to receive the revenue** — which generally occurs the *earlier* of when it is due, paid, or earned — and the amount can be determined with reasonable accuracy.
  - Revenue generated from the **sale of goods** generally is earned when the benefits and burdens of ownership of the good passes to the customer, which could occur upon shipment, delivery, acceptance, or title passage.
  - Revenue generated from the **provision of services** generally is earned when performance of the required services (or divisible services) is complete.

Tax Impacts of Revenue Standard Changes

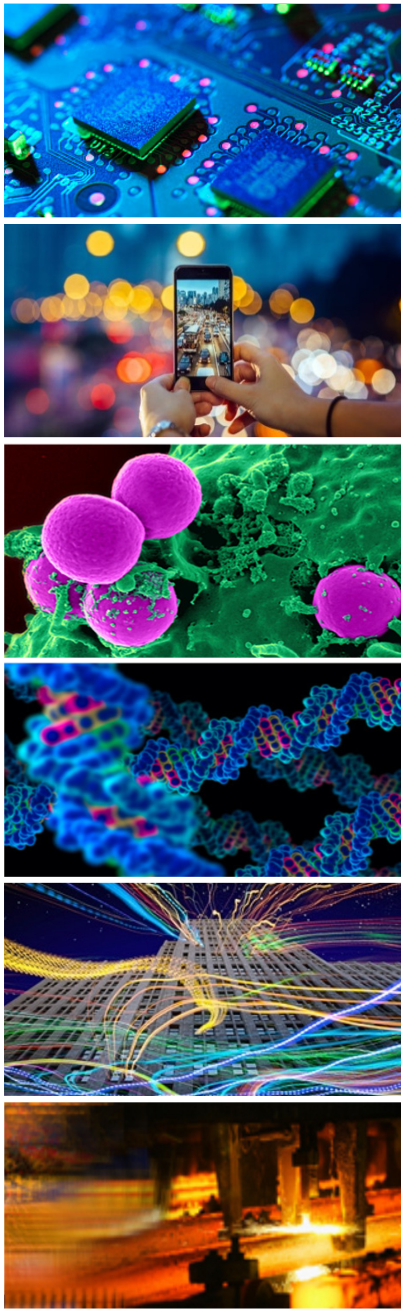
- Amounts that are due or paid before they are earned (known as advance payments) may be eligible for deferred recognition for tax purposes under specific provisions, such as the **Section 451** regulations for goods and integral services and **Rev. Proc. 2004-34** for goods, services, use of certain intellectual property, and other eligible payments, both of which allow limited tax deferral that cannot exceed the financial accounting deferral.
- **Generally no impact on cash taxes.** However, in certain circumstances, such as when a company receives advance payments, a change in the recognition of revenue for financial accounting purposes will affect tax recognition because the **tax deferral for advance payments cannot exceed the book deferral**.
- Most changes in the recognition of revenue for financial accounting purposes that result from the new standard likely will **affect only** the computation of a **book-tax difference** and the related **deferred taxes**.
- Source" New FASB, IASB revenue recognition rules could have significant US tax implications, PwC Tax Insights, June 3, 2014

Deferred Revenue – Tax Treatment

- **Tax guidance on treatment of deferred revenue in the context of a business combination is somewhat unclear**
- General rule – advance payments taxable upon receipt
- For tax purposes, deferred revenue occurs when recognition of advance payment in taxable income is deferred beyond the year of receipt
  - Examples include prepaid subscriptions, gift cards, layaway sales, membership fees, extended service, warranty plans
- Assumption of deferred revenue liability in asset acquisition causes deferral period to end
  - Ordinary income to seller upon closing
  - Seller entity to *equal, offsetting* deduction to reflect “payment” to Buyer to satisfy Seller’s performance obligation
- Source: Contingent Liabilities and Deferred Revenue in M&A Transactions, November 17, 2015, Daniel White, Cathryn Benedict, Bryan Cave LLP

Deferred Revenue –Tax Guidance

- "present law allows buyers and sellers discretion in choosing a tax method of accounting for deferred revenue liabilities in the context of a taxable asset acquisition. We understand that the government is considering issuing guidance that would provide for consistent tax treatment of the deferred revenue liability by buyers and sellers in taxable asset acquisitions."
- *Recommendations on the Tax Treatment of Deferred Revenue in Taxable Asset Acquisitions*, April 23, 2015 AICPA Letter to IRS, AICPA Deferred Revenue in Taxable Asset Acquisitions Task Force.
- Research suggests this guidance has not yet been released for discussion.



Appendix

Deferred Revenue References in Valuation Guidance – IPR&D Guide

- IPR&D guide – 6.39 "**if the revenue component of the PFI was developed on an accrual basis, then it likely would be appropriate to include the deferred revenue as a component of working capital**. Alternatively, one could remove from the PFI the deferred revenue and accrual-based expenses associated with generating that revenue. In addition to the consideration of a deferred revenue adjustment to the overall PFI, an adjustment to the required level of net working capital would also need to be considered. The key to any adjustment is to avoid either double-counting or undercounting any revenue, expense, or profit.
- 6.40 When assessing the required level of working capital, the valuation specialist would need to determine whether deferred revenue may be included as a component of working capital. When making this determination, it is import to understand the underlying accounting for revenue recognition. For example, in the software industry, . . . The valuation specialist would need to measure the fair value of the remaining legal performance obligation associated with the deferred revenue.

Deferred Revenue References in Valuation Guidance – Contributory Asset Charges Guide

- 2.2.07 If an entity has deferred revenue, this liability may or may not be included as a component of the working capital that is then used as the basis for a CAC. Whether to include or exclude the deferred revenue as a component of the working capital will depend on how the PFI was developed. **If the revenue component of the PFI was developed on an accrual basis, then it likely would be appropriate to include the deferred revenue as a component of working capital.** The Working Group believes that **deferred revenue should be included in working capital on a normalized basis if deferred revenue is a part of an entity's ongoing operation.** The Working Group also believes that, in such a circumstance, the level of accrued deferred revenue included in net working capital for purposes of calculating the CAC should reflect an entity's ongoing operations and be consistent with the PFI, as opposed to a level reflecting a "one-time" adjustment of the fair value of any legal performance obligation that would arise in a business combination accounting setting.

Extract from PwC Business Combinations Guide

- 7.6.4 – The **fair value of a deferred revenue liability typically reflects how much an acquirer has to pay a third party to assume the liability** (i.e., a transfer of the liability). **The acquiree's recognized deferred revenue liability at the acquisition date is rarely the fair value** amount that would be required to transfer the underlying contractual obligation.
- 7.6.4.1 - "there are two methods of measuring the fair value of a deferred revenue liability. The first method, commonly referred to as a **bottom-up approach**, measures the liability as the **direct, incremental costs to fulfill** the legal performance obligation, plus a **reasonable profit margin** if associated with goods or services being provided, and a **premium for risk associated with price variability**. **Direct and incremental costs may or may not include certain overhead items**, but should include costs incurred by market participants to service the remaining performance obligation related to the deferred revenue obligation. These costs do not include elements of service or costs incurred or completed prior to the consummation of the business combination such as upfront selling and marketing costs, training costs, and recruiting costs.

Extract from PwC Business Combinations Guide (cont'd)

- The **reasonable profit margin should be based on the nature of the remaining activities and reflect a market participant profit**. If the profit margin on the specific component of deferred revenue is known, it should be used if it is representative of a market participant's normal profit margin on the specific obligation. If the current market rate is higher than the market rate that existed at the time the original transactions took place, the higher current rate should be used. The measurement of the fair value of a deferred revenue liability is generally performed on a pretax basis and, therefore, the normal profit margin should be on a pretax basis.
- An alternative method of measuring the fair value of a deferred revenue liability, commonly referred to as a **top-down approach**, relies on market indicators of expected revenue for any obligation yet to be delivered with appropriate adjustments. This approach starts with the amount that an entity market participant would receive in a transaction, less the cost of the selling effort (which has already been performed) including a profit margin on that selling effort. This **method is used less frequently, but is sometimes used for measuring the fair value of remaining post contract customer support (PCS) for licensed software**.

Extract from PwC Business Combinations Guide (cont'd)

- If deferred revenues exist at the time of the business combination, and intangible assets are valued using the income approach (e.g., RFR or MEEM), then **adjustments may be required to the PFI if it was prepared on an accrual basis**. This will **eliminate any revenues reflected in the PFI that have already been received by the acquiree** (i.e., the **acquired cash includes the deferred revenue amount**). If the excess earnings method is used, the expenses and required profit on the expenses that are captured in the valuation of the deferred revenue valuation are also eliminated from the PFI. However, **if cash based PFI is used** in the valuation and therefore acquired **deferred revenues are not reflected in the PFI, then no adjustment is required** in the valuation of intangible assets using the income approach.

EY Business Combinations Guide – 4.3.2

- . A **performance obligation assumed in a business combination might give rise to the recognition of one or more assets** (for potential future sales to the customer as well as a contract asset for future performance under the contract for which the customer has not already paid) and a liability by the acquiring company. For example, a single revenue arrangement may result in the assumption of a legal obligation to provide goods or services, requiring the recognition of a liability (deferred revenue), and of a customer related intangible asset. In such a situation, **acquired assets and assumed liabilities should be recognized separately (i.e., gross and not net**).
- When a legal performance obligation is assumed by the acquirer, the provision of goods or services required under the obligation would trigger derecognition of the deferred revenue liability recognized in the business combination and recognition of revenue in the statement of operations.

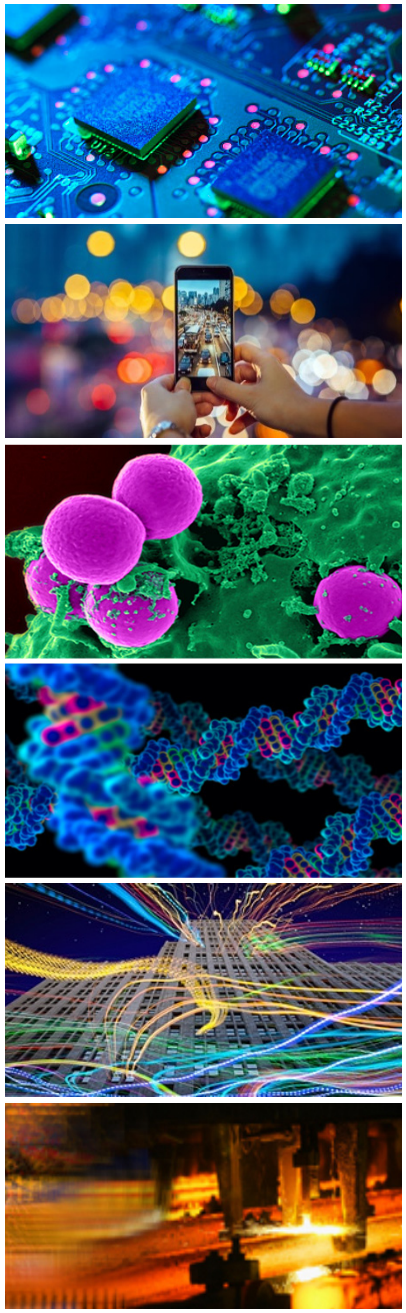
EY Business Combinations Guide (cont'd)

. The measurement of the assumed performance obligation should be at fair value at the date of acquisition, pursuant to the guidance in ASC 820. There are generally two acceptable methods of measuring the fair value of the assumed deferred revenue obligation. The first method is a **cost build-up approach**. The cost build-up approach is based on a market participant's estimate of the costs that will be incurred to fulfill the obligation plus a "normal" profit margin for the level of effort or assumption of risk by the acquirer after the acquisition date. The normal profit margin also should be from the perspective of a market participant and should not include any profit related to selling or other efforts completed prior to the acquisition date. The second and less frequently used method for measuring the fair value of an assumed deferred revenue obligation is by obtaining evidence from market information about the amount of revenues an entity would receive in a transaction to provide the

EY Business Combinations Guide (cont'd)

Remaining obligation under the contract, less the selling effort (which has already been performed by the acquiree prior to the acquisition date) and the profit margin on that selling effort. As noted previously, the normal profit margin should be from the perspective of a market participant. While market information, when available, generally provides the most reliable and best evidence of fair value, that information may be difficult to obtain for the remaining obligation under the contract.

Normally, we believe the fair value of an assumed performance obligation would be less than the amount recognized by the acquired entity in its pre acquisition financial statements.



Questions

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- Ray is a Managing Director in the Irvine, California office of Globalview Advisors. He has over 30 years of financial valuation expertise in the valuation of businesses, securities interests, and intangible assets.
- Ray has performed valuation projects for financial (both US GAAP and IFRS) and tax reporting, transactions, and litigation projects. In addition to performing valuations, Ray has extensive experience in the review of third-party and management prepared valuations.
- Ray has a wealth of experience in a wide range of industries. In recent years, much of his work has focused on technology and Internet firms. Other industries where he has significant project expertise include consumer products, entertainment and media, food services, health care, and manufacturing, in addition to early stage, rapid growth firms.
- Prior to joining Globalview Advisors in 2012, Ray was a Director in the Valuation Services Practice at PricewaterhouseCoopers LLP. He was also a Senior Manager in the Valuation Services Practice at KPMG LLP and KPMG Consulting, Inc., as well as a Manager at Arthur Andersen & Company.
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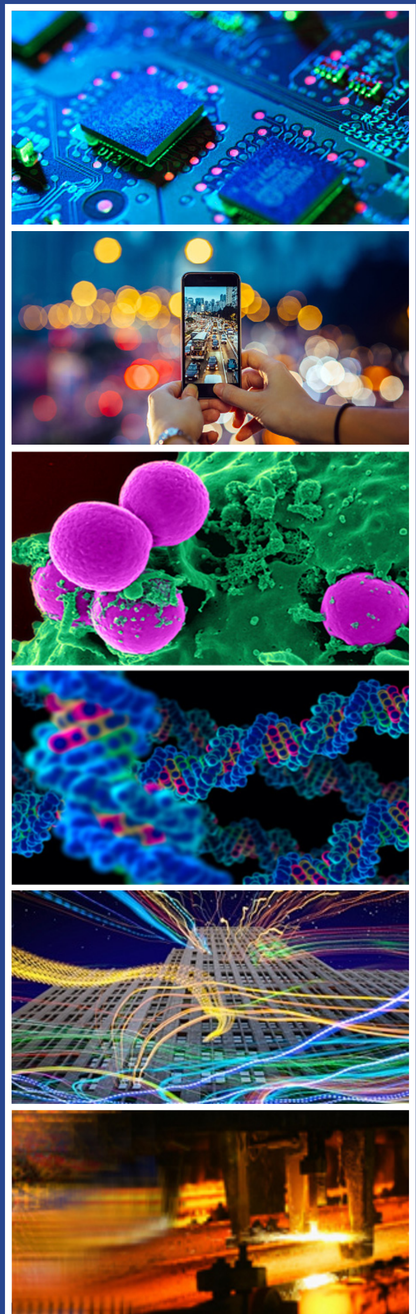

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