THE FAIR VALUE OF DEFERRED REVENUE

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Abstract

Deferred income has been recognized by the acquiring entity or by the acquirer on their balance prior to the combination. During the deal, deferred revenue must be recorded at fair value according to GAAP . The amount of these deferred income liabilities should be reflected in the financial statements. Recommendations on this topic are covered in the FASB Coding Accounting Standard (AUC) Topic 805, Business Combinations. This rule eliminates some book-tax timing differences regarding unearned revenue, also known as deferred revenue. It is known that the Financial Accounting Standards (SFAS) 141 (R), Business Combinations, was issued in December 2007, in force for the annual reporting periods from 15 December 2008. Since then, paragraph 20 of SFAS 141 (R) (AUC 805- 20-30-1) requires that "the acquirer must measure the identifiable assets acquired, the assumed liabilities and any uncontrolled interest in the entity acquired at fair value at the date of acquisition". The guidelines impose two facts: estimating the fair value at the time of acquisition and recognizing liability when the obligation to perform exists. These deferred income debts that were recognized by the acquired entity or by the acquirer on their pre-combination balance sheets do not appear as deferred income liabilities in the post-business period of the acquirer combined financial statements. Performance obligations and fair market values affect the value of deferred income debts that an acquirer would recognize in post-business combination accounting. Thus, the combined income from the post-business combination of companies is significantly lower than total revenue between the two companies if they didn't have been merged. Moreover, the rights regained it doesn't just interact with the deferred amount income liabilities and income during the period post-combination business period, but influences revenue through additional expenses or income.

Keywords: *deferred revenue, liability, fair value, accounting, purchase accounting, acquisition accounting, private venture, venture equity.*

1. Introduction

Developments in generally accepted accounting principles (GAAP) for business combinations have, among other things, evolved the application of fair value accounting. It is important to know the impact of the business combination guidelines on the tendencies of post-business combination accounts.

This is based on what it will cost to deliver the service or goods. The cost is less than the amount that was received for it. When the deferred revenue is adjusted down in purchase accounting, there is a sum that never gets recorded as revenue in the future. We notice, for a supplementary consideration, when there are advance billing customers close to an acquisition this situation has an impact on future revenue recognition.

Let us talk about the deferred debt receivables in the post-business combination accounts in the financial statements of the acquirer. Now we will focus mainly on software companies; however, many of these concepts are easily translated into other industries.

The sheets do not necessarily qualify as deferred income liabilities in the acquirer's post-combined financial statements. An acquirer must determine whether the debt recognized by the acquired entity is a post-combination performance obligation.

Payment made to a buyer for an unearned income account is gross income for the buyer for tax purposes, which is eligible for deferral. The buyer is also required to capitalize the costs of servicing the contracts corresponding to the uncollected revenue, as these are paid as debts incurred in the transaction.

The sheets do not necessarily qualify as deferred income liabilities in the acquirer's post-combined financial statements. An acquirer must determine whether the debt recognized by the acquired entity is a post-combination performance obligation. If so, the amount of these deferred income liabilities should be reflected in the financial statements. Recommendations on this topic are covered in the FASB Coding Accounting Standard (AUC) Topic 805, Business Combinations.

Acquisitions or business combinations represent activities in the transaction settlement area of private equity (PE) and venture capital (VC) firms record that are increase. It must be known that transactions have a significant impact on the financial statements of the companies they have acquired.

It is critical to properly phrase the language in purchase agreements dealing with the tax treatment of deferred revenue accounts to support avoid surprises after closing, whether the adviser signifies the buyer or the seller in an M&A transaction. The treatment of unearned revenue can have a material impact not only

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on taxes, revenue recognized by the seller, and revenue recognized by the buyer, but also on the value of the working capital target in M&A transactions. Buyers and sellers should be wise to work together and get more certainty to their intended tax treatment for unearned revenue for purposes of both tax and target working capital.

Taxpayers can defer income recognition based on how the income is recognized in their applicable financial statements. The new rules provide that accrual-method taxpayers receiving advance payments have to recognize them as gross income in the year of receipt unless the taxpayer makes an election to defer the income.

During mergers or acquisitions, deferred revenue in purchase accounting is to be vanished.

2. Fair Value and Deferred Revenue Liabilities

An acquired company records deferred income passive for several reasons. Deferred income represents advance payments for services or products that have not yet been delivered. Deferred income is payments for goods or services delivered sold as part of a multiple item arrangement that cannot be accounted for separate from items not delivered in the same arrangement. For example, the acquired entity does not have objective specific vendor evidence (VSOE) according to the AUC 605-25-30-8 to be able to observe income associated with various items separately in a multi-item arrangement contract.

An acquirer will reflect deferred income of the entity acquired at fair value post-business combination, if represent obligations to supply the products or customer service. In cases in which an acquired entity records deferrals income debt and not the acquirer they necessarily have a delivery obligation any goods and services. For example, the acquired entity has recorded an income transaction as deferred income, and the transaction did not reach revenue recognition criteria for reasonable assurance of collectibility or lack of VSOE. Thus, the acquirer does not force to execute a deferred income liability of the acquired entity. So no one will register deferred income in the post-operative period combined financial statements.

The acquirer will record debts for deferred income based on the fair the amount of the obligation at the date of acquisition.

This amount is different from the amount previously recognized by the acquiree. The deferred income that an acquired company has admitted is generally the cash that received and does not necessarily reflect the fair value at the time of purchase. The fair value of deferred income debts for an acquirer generally represents the amount that the acquirer pays a third party to assume such obligations.

Two different methods are known for determining the fair value of deferred income. The first method is called the bottom-up approach, and the second method is called top-down approach.

In the case of a bottom-up approach (The literature also referred to this method as “increasing costs approach”), the deferred income debt it is measured by direct costs, any incremental costs (such as overheads), a reasonable profit margin and any additional premium cost for price variability. In the case of the first two, we have the obligation of performance remaining after the merger and not everything in advance expenses incurred before business combination. A reasonable profit margin is the profit that a market participant earns for completion of activities related to deferred income debts.

In the case of the top-down method, the approach is based on market indicators to estimate expected revenues for deferred income obligations. Here, we notice that the acquirer measures the fair value of the obligation on the basis the estimated selling price for products and services, less any selling effort and profit on it.

The acquirer must also consider "Unit of account" in certain multi-item arrangements when measured the fair value of deferred income. Take, for example, a software company that offers one-year maintenance or post-contract (PCS) services for its customers. As part from this arrangement, the company offers unlimited bug fixes, telephone support and unspecified software upgrades and enhancements. The acquirer has the following two options:

- The accounting unit measures the fair value of each item separately and on its own. In this method, upgrades when and if available are not performance obligations considered, because there is no contractual obligation from the seller to deliver in this way products.
- Considering in ASC 985-605 (previous statement of position 97-2, Software Revenue Recognition) the whole the PCS arrangement would be considered fair the lowest level of an accounting unit. Deferred PCS fair value revenue is equal to all estimated costs (*i.e.* the costs of providing support services and bug fixes, as well as cost development of upgrades and enhancements), plus a normal profit margin.

In general, both methods are recognized as long as they are applied in a consistent manner.

An acquirer regains a right that he had previously given it to an acquirer. An example is the technology rights of the acquirer under a technology license agreement for a certain period of time, for an advance fee and a certain amount of royalties. In post-business

combination accounting, it is usually recognized the acquirer has rights acquired as intangible assets separate from goodwill (AUC 805-20-25-14). When an acquirer regains a previously granted right, it will recognize and measure the fair value on the basis of the remaining life of the contract without regard to consider any expected renewals or extensions. Para. 55 of IFRS 3, Business Combinations, contains similar guidelines.

Valuation of acquired rights compared to other assets that are based on market share assumptions represents estimated cash flows over the remaining life of the contract (ASC 805-20-30-20). Thus, there is a difference between values derived from market share assumptions ("at market value") and fair values based on cash flow. This difference ('out of market' value) shows an acquired right or something unfavorable from the perspective of the acquirer. We note that, the fair value of a contract consists of an element outside the market in addition to an element inherent in the market.

ASC 805-10-55-20 and 21 show that an acquirer must recognize a gain or loss for the effective settlement of a pre-existing relationship based on the lowest amount of the contract favorable or unfavorable from the perspective of the acquirer in comparison with prices for regular market transactions for identical or similar items. An acquirer must record debts for deferred income based on the fair value of the obligation on date of purchase.

The gain or loss on the pre-existing relationship is adjusted for the amount previously recognized. The amount of any settlement declared by the provisions of the contract is available counterparty whose contract is unfavorable. If this amount is less than the amount mentioned above, the difference must be included in the combined business accounting.

In para. 17 and 18 of November 2010 International Accounting Standards The Council's staff document (IASB) states that paragraph B52 of IFRS 3 (www.ifrs.org/NR/rdonlyres/F98BBE13-7C2E-416E-973B-2FC95DF07629 / 0 / 1011obs15IFRS3Effective settlement mentofapreexistingrelationship.pdf). A business combination does not stop the relationship between the acquirer and acquired in itself, but represents what it is the off-market part of the relationship.

The value assigned to the acquired rights any amounts recognized as a gain or loss on settlement and is limited to the associated value with the remaining contractual terms and current market conditions. Then, the amount of any gain or loss on settlement it must not affect the measurement the fair value of any related intangible asset to the acquired rights.

The acquirer must record debts for deferred income based the fair value of the obligation on date of purchase.

3. Conclusions

These deferred income debts that were recognized by the acquired entity or by the acquirer on their pre-combination balance sheets do not appear as deferred income liabilities in the post-business period of the acquirer combined financial statements.

Performance obligations and fair market values affect the value of deferred income debts that an acquirer would recognize in post-business combination accounting.

Thus, the combined income from the post-business combination of companies is significantly lower than total revenue between the two companies if they didn't have been merged. Moreover, the rights regained it doesn't just interact with the deferred amount income liabilities and income during the period post-combination business period, but influences revenue through additional expenses or income.

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