# DEFERRED REVENUE ACCOUNTING

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**Abstract**

*Torosyan and Razani[1] said that the Tax Cuts and Jobs Act amended Sec. 451 to allow accrual-basis taxpayers to defer recognizing income until it is considered in their applicable financial statements. This rule eliminates some book-tax timing differences regarding unearned revenue, also known as deferred revenue. 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. A risk problem with deferred revenue in purchase accounting is the tendency for it to vanish during mergers or acquisitions. During the deal, deferred revenue must be recorded at fair value according to GAAP. 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.*

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

## 1. Introduction

Private equity (PE) and venture capital (VC) firms record an increase in activity in the transaction settlement area, including acquisitions or business combinations. It is good to know the accounting rules for such transactions, as they have a significant impact on the financial statements of the companies they have acquired.

Upon completion of a business acquisition, the purchaser will complete the acquisition accounting as part of the entity's financial statement reporting requirements in accordance with the generally accepted accounting principles (GAAP) of the United States. An essential and often omitted element of this process is the accounting of deferred income in the accounting of purchases. I will supplement with useful tips for companies to better perceive deferred income and how to avoid common mistakes that could complicate the accounting of acquisitions.

Torosyan and Razani said in 2019, that the Tax Cuts and Jobs Act amended Sec. 451 to allow accrual-basis taxpayers to defer recognizing income until it is considered in their applicable financial statements. This rule eliminates some book-tax timing differences regarding unearned revenue, also known as deferred revenue. 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. A risk problem with deferred revenue in purchase accounting is the tendency for it to vanish during mergers or acquisitions. During the deal, deferred revenue must be recorded at fair value according to GAAP. 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.

An important issue to be known is when the company acquired had advance billed its customers but had not yet received the cash.

## 2. Deferred revenue concept

The deferred revenue is considered a liability because it has not yet been earned. The product or service is still owed to the customer. When the product or service is delivered, the value of deferred revenue liability decreases and would become revenue on the company's income statement.

From an accounting point of view, cash is deferred rather than immediate income. Then, deferred income is a credit (right) entry, reported on the credit (right) side of the balance sheet, below the taxpayer's

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[1] Torosyan, Andy A. and Razani, Shahab, *The Cost of Deferred Revenue* (July 1, 2019). Available at SSRN: https://ssrn.com/abstract=3435401 or http://dx.doi.org/10.2139/ssrn.3435401.

liabilities, and equity accounts are considered to improve net worth.

Using GAAP, the acquiree would have registered a receivable and deferred revenue only if the company had the right to invoice and receive payment in advance and the billings were made. Then the acquiree's deferred revenue would be subject to the haircut. The acquiree had advance billed and the customer was not obligated under the contract to pay such advance billing. My opinion is the deferred revenue and accounts receivable would be netted and there is no haircut on the deferred revenue in purchase accounting. When we have additional consideration when there are advance billing customers close to an acquisition. At this situation, we have an impact on future revenue recognition.

In actual law, taxpayers receive cash but not pay tax on it because the cash is deemed deferred revenue. When a taxpayer writes an option or sells stock short the taxpayer receives cash, but the cash is not considered gain or loss until the option is obtained or until the short sale stock is changed.

We give the following examples.

Example 1: Firm X

Basic income Statement of Target

| | | |
|---|---|---|
| Revenue | $ 100,000 | 100.0% |
| COGS | 75,000 | 75.0% |
| Gross Profit | 2,500 | 25.0% |
| SG&A Expense | 1,500 | 15.0% |
| EBIT | 1,000 | 10.0% |

**Example 2. Cash-method corporation:** Firm T provides software services. In year 1, Customer L pays firm T $10,000 for the right to use its software for the next four years. It costs firm T $800 per year to maintain its software per customer. Under the cash method of accounting, firm T recognizes $10,000 of revenue, matching the cash collected, and recognizes $800 of expense in year 1. The net income under the cash method would be $9200 and, in years 2 through 4, firm T incurs losses totaling $2,400. The total net activity over the five years would be $7000 of net income.

**Example 3. Accrual-method corporation:** Using the same facts from Example 2, except, we apply the accrual method for firm T. Firm T records a debit to cash and a credit to unearned revenue upon the receipt of $10,000 cash. This establishes an asset on the balance sheet and a corresponding liability. The liability shows that the obligation to the customer has not been completed. In many cases, depending on the terms of the underlying contract, customers may even have the right to a full cash refund if they do not collect what they were promised. In year 1, an entry must be made to recognize the revenue earned for the period by making a debit to deferred revenue of $2,000 and a credit to revenue. regardless of whether firm T uses the cash or accrual method, the total net income over the four years is $7,000.

Torosyan and Razani said that $1,406,789 was paid by the Prairie Farmer Publishing Co. to Pierce Corp. in 1957, in cash to acquire its assets. The obligation of Pierce Corp. was took by Prairie to publish its Wallaces' Farmer and Iowa Homestead newspaper and agreed to carry out the terms of all subscription contracts in force as of the date of closing for the unexpired subscriptions. Then, the $436,359 was considered as an adjustment to the cash paid by Prairie. Then, that amount was paid more in cash by Prairie to Pierce Corp. if Pierce Corp. paid off the reserves before closing.

*Pierce Corp. did not write down any of the reserves as gain on the sale on its 1957 income tax returns.*

*The Tax Court sided with the IRS and held that the assumption of the reserves by Prairie was the appropriate time for Pierce Corp. to recognize income. The Eighth Circuit accepted with the Tax Court that the reserves were includible in income because the seller's obligation to perform services had stopped. Even using GAAP matching principles, one can accept with this outcome. Pierce Corp. had got the cash, and it no longer was going to perform on the contract. The income deferral period would stop with the extinguishment of the obligation. We note that the recognition of income causes the reserve account for unearned revenue to become zero.*

*The Tax Court had refused Pierce Corp.'s argument to be allowed a deduction for the reduction in price caused by the reserves. This is acceptable outcome because a taxpayer would not be allowed to claim a deduction for a payment in which the taxpayer has not established basis for tax purposes. Taxpayers who donate their time for charitable work should not be allowed a deduction unless they recognize income for a salary. Then, the seller would not get a deduction unless it also admits the income associated with the obligation assumed by the buyer.*

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## 2.1. Deferred revenue in acquisition accounting

A risk problem with deferred revenue in purchase accounting is the tendency for it to vanish during mergers or acquisitions. During the deal, deferred revenue must be recorded at fair value according to GAAP. 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.

Managers have to be careful during diligence phases so that forecasted amounts of top-line revenue can be made accurately. If a deal received meaningful prepayments that have not yet been admitted in the acquiree's financial statements, this could have a significant impact on the sum of revenue recorded post-acquisition as all the deferred revenue does not survive in purchase accounting and therefore is not admitted as revenue in the future.

Other issue to be known of is when the company acquired had advance billed its customers but had not yet received the cash.

One way to avoid some of the usual pitfalls is to work with an accounting expert to review your liabilities and assets involving deferred revenue. Accounting providers must also help ensure any recent accounting standard changes – such as those recently decreed to revenue recognition accounting under ASC Topic 606 – implement to your situation, and advise you through this sometimes-complex step of the process.

Then, the contract with the "perpetual" subscribers gave the subscribers and their heirs the right to redeem nine-tenths of the price of the contract. Thus, the buyer had become directly obligated to incur a cost to the subscribers without any additional cash payment from them.

If the buyer was unable to perform, it would likely have to refund the balance to the subscriber. This obligation for the buyer was a reserve for a future expense and different from the unearned revenue balance that was used to track the seller's unrecognized income.

Properly, for tax purposes, the seller assumed income for the entire unearned revenue balance, and this was never in dispute.

The Eighth Circuit continued on to explain that the buyer's obligation to subscribers did not cease when the seller recognized revenue. Because the buyer and seller decreased the purchase price by the liability assumed, the seller was treated as making a payment to the buyer for the assumption of the subscription liability. This considered payment obtained in a deduction under Sec. 162 for the seller, but the court did not explain why the seller obtained a deduction without first creating basis in the deduction for tax purposes.

In some cases, the taxpayer may also postpone advance payments received for future goods or services.

The proposal treats uniformly the deferred income account as if it were cash received when the offsetting obligation terminates. Then, if is assumed, or is accomplished or when it is no longer appropriate for the revenue to be deferred. At very latest, the deferred revenue has to be closed into a revenue account at death or liquidation of the taxpayer. The cash must be income, sometimes a reduction of basis or cost, and sometimes a part of amount realized. The proposal builds a framework that does not propose substantive law on how then cash should be treated, but only insists that the closing of the deferred revenue account be treated as cash received.

Taxpayers have based on Rev. Proc. 2004-34 to defer the recognition of income for tax purposes on prepayments. In general, taxpayers could defer income from advance payments for tax purposes if they adopted the accrual method and deferred the income for financial reporting purposes. However, taxpayers generally cannot defer the income recognition beyond the year following the year of receipt.

As discussed above, the TCJA has changed Sec. 451 by effectively codifying the principles of Rev. Proc. 2004-34. 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.

The deferred income has to be recognized in the tax year following the year of receipt. The deferral is also speed up in a year in which the taxpayer ceases to exist.

One major obstacle is the GAAP treatment of unearned revenue in M&A transactions. Then, when a target company is acquired, the GAAP reporting period does not stop. The GAAP financials are center on the target company's financial performance without regard to who the owner is.

In a purchase, GAAP will need all assets acquired and liabilities assumed in a business combination to be recorded at their respective fair values. As a result, the target will standardize its gross margin, which will permit the target to recognize future revenue as the deferred revenue is earned subsequent to the acquisition date. GAAP will not need the seller to speed up revenue recognition when a company is sold, nor will it require the buyer to capitalize costs post-closing. This will build up book-tax differences, which must be carefully analyzed, documented, and tracked.

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 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.

## 3. Conclusions

A risk problem with deferred revenue in purchase accounting is the tendency for it to vanish during mergers or acquisitions. During the deal, deferred revenue must be recorded at fair value according to GAAP. 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.

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