PARTNERS BEYOND BOUNDARIES

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FAIR VALUATION OF DEFERRED REVENUE AND LEASES

In an M&A transaction, acquirers have certain expectations on the future revenue and earnings potential of their targets. There are instances, where they also acquire the liability to service revenue for which cash has already been received. Similarly, acquirers also takeover contracts entered by the target pre-acquisition. The obligation to service the revenue recorded in the target's books and the contracts may or may not be at market participant rates and this results in the creation of either an asset or a liability.

Deferred revenue and lease contracts are examples of such transactions, the valuations of which are discussed in this newsletter.

DEFERRED REVENUE

Deferred revenue represents an obligation to provide products or services to a customer when payment has been received in advance and delivery or performance has not yet occurred. Such performance obligation must be fair valued as a part of the purchase price allocation.

Deferred revenue most commonly arises in the following situations:

- Post-contract service arrangements
- Customer deposits
- Multi-year arrangements
- Collection of dues
- Subscription services

VALUATION OF DEFERRED REVENUE

Fair value of deferred revenue reflects the fair value of the obligation to service the same. Thus, the key point in valuation of deferred revenue is identification of the performance obligation which is addressed extensively by accounting standards on revenue recognition. The key inputs in the valuation of deferred revenue include a reversal schedule of the deferred revenue in the books of the target as well as the market participant costs and margins to service the identified performance obligation.

The most prominently used approaches for determining the fair value of deferred revenue are:

Bottom-up approach: The bottom-up approach values deferred revenue based on the "incremental" costs to be incurred by the acquirer post acquisition, to fulfil the obligation. The bottom-up approach estimates fair value as the present value of direct and indirect costs related to service the obligations, plus an assumed operating margin.

It is pertinent to note that the incremental costs to service the obligation as well as the assumed operating margin are based on market participation assumptions, in line with the characteristics of fair value outlined in fair value standards[1]

Top down approach: An alternate valuation approach is the top-down approach. This approach begins with the deferred revenue balance and involves subtracting previously incurred costs along with the estimated profit margins on the same. The residual value reflects the incremental costs to be incurred by the acquirer to service the deferred revenue along with the profit margin on the same. Like the bottom up approach, the elements that are adjusted should reflect a market participant assumption.

[1]ASC 820: Fair value measurements and Disclosures issued by Financial Accounting Standards Board
IFRS 13: Fair value measurement issued by International Accounting Standards Board
Ind AS 113: Fair value measurement issued by Ministry of Corporate Affairs, India

As opposed to the bottom-up approach, the top-down approach is less frequently used in practice. However, it is widely used to value deferred revenue arising out of remaining post-contract customer support for licensed software.

ILLUSTRATIONS

- **Bottom-up approach**

Particulars	Notes	Deferred revenue to be serviced on			Total
		December 2020	June 2021	December 2021	
Deferred revenue balance		100	150	250	500
Direct costs (estimated as a % of revenue) (A) *Direct costs as a % of revenue*	1	15.0 *15%*	22.5 *15%*	50.0 *20%*	87.5
Indirect costs (estimated as a % of revenue) (B) *Indirect costs as a % of revenue*	2	10.0 *10%*	15.0 *10%*	37.5 *15%*	62.5
Total direct and indirect costs (C = A + B)		25.0	37.5	87.5	150
Operating profit (estimated as a % of total cost) (D)	3	6.0 *24%*	9.0 *24%*	21.0 *24%*	36.00
Total estimated cost of servicing deferred revenue plus margin (C + D)		31	46.5	108.5	186
Present value factor @ 10%		0.91	0.87	0.83	
Present value of total estimated cost of servicing deferred revenue plus margin		28.21	40.46	90.06	
Sum of present value of total estimated cost of servicing deferred revenue plus margin					158.72

Notes

1. Received from the management; assumed to reflect a market participant's behaviour.
2. Received from the management; assumed to reflect a market participant's behaviour.
3. Taken as a median of the operating margins of comparable companies; back calculated to reflect it as % of the cost.

- **Top-down approach**

Particulars	Notes	Deferred revenue to be serviced on			Total
		December 2020	June 2021	December 2021	
Deferred revenue balance (A)		100	150	250	500
Previously incurred direct costs (B) Previously incurred indirect costs (C)	1 2	28.0 23.0	46.0 37.0	72.0 63.0	146.0 123.0
Total direct and indirect costs (D = B + C)		51.0	83.0	135.0	269.0
Operating profit (estimated as a % of total cost) (E) *Operating profit as a % of total cost*	3	12.2 *24%*	19.9 *24%*	32.4 *24%*	64.6
Undiscounted value of deferred revenue (A - D - E)		36.8	47.0	82.6	166.4
Present value factor @ 10%		0.91	0.87	0.83	
Present value of deferred revenue		33.4	40.8	68.3	
Sum of present value of deferred revenue					**142.5**

Notes

1. Received from the management.
2. Received from the management.
3. Taken as a median of the operating margins of comparable companies; back calculated to reflect it as % of the cost.

Deferred revenue: Important considerations

- An important adjustment when estimating the fair value of deferred revenue is to adjust the prospective financial information used for fair valuation of intangibles using income approach related methodologies (e.g. relief from royalty, multi-period excess earnings method etc.). The PFI include revenue for which cash has already been received and thus needs to be adjusted to avoid double counting. This involves subtracting from the PFI, the carrying value of deferred revenue as well as the costs associated with them.
- The appropriate discount rate for determining the fair value of deferred revenue shall encompass only the opportunity cost of the money utilised towards the incremental costs of servicing the deferred revenue, rather than the entire risk-return trade-off for the entity as a whole. The rationale for doing so is that the uncertainty of revenue is absent, since deferred revenue has already been invoiced and/or collected.
- The bottom up approach of valuation entails addition of a market participant profit margin to the costs expected to be incurred. Thus, it essentially requires converting the profit margin which is on revenue to a mark-up which considers cost as the base.
- The valuation of deferred revenue is on a pre-tax basis.
- The fair valuation of deferred revenue can be seen as a haircut adjustment to its carrying value. Although, the revenues have not disappeared, the expenses already incurred prior to the acquisition date have been matched with the pre-acquisition revenues, causing the need for the downward adjustment.

Favourable/unfavourable lease contracts

A lease agreement to which the target company is a party, that is termed different than the market rates will be either advantageous or disadvantageous to the entity. Such a benefit or disbenefit results in an intangible asset/liability to arise.

The valuation of favourable/unfavourable lease contracts is most commonly warranted in cases where an entity has several leases at multiple locations. The leases may pertain to office properties, factory premises etc. For instance, a pharmaceutical company may have multiple locations on lease for its corporate head office, branch offices and factory premises spanning across different countries around the world. These contracts are required to be assessed vis-à-vis existing market terms for similar properties to assess whether it is an asset or a liability.

The fair value of a lease contract pertains to its advantage/disadvantage over and above prevailing market rates. The market lease rates may represent the median of the prevailing lease rates of properties in the immediate neighbourhood of the similar type and quality. Over the contractual life of the leases, growth in the market lease rates must be considered.

If the contractual rent payable on an assumed lease is below the market rent, the acquirer should record an asset, referred to as a favorable lease, equal to present value of the difference between the contractual rental rate and the market rate at the date of acquisition. A liability is recognized if the market rate is below the contractual rent payable.

ILLUSTRATION

The valuation of favourable/unfavourable lease contracts can be depicted with the help of an example as follows:

Particulars	2019	2020	2021	2022
Lease rent per market	50	53	57	61
Lease rent per contract	51	53	55	57
Favourable/(Unfavourable) lease	**(1)**	**0**	**2**	**4**
Present value factor @ 10%	0.91	0.83	0.75	0.68
Present value of Favourable/(Unfavourable) leases	(0.91)	0.00	1.50	2.73
Total present value to be recognised as an intangible asset				**3.33**

Per ASC 805-20-25-12, *"Regardless of whether the acquiree is the lessee or the lessor, the acquirer shall determine whether the terms of each of an acquiree's operating leases are favorable or unfavourable compared with the market terms of leases of the same or similar items at the acquisition date. The acquirer shall recognize an intangible asset if the terms of an operating lease are favourable relative to market terms and a liability if the terms are unfavourable relative to market terms"*

Usually, lease contracts acquired as a part of a business combination relate to lease rent payable by the acquiree for the locations taken on lease. In some cases, however, the acquiree may have rented out some of its own properties or even subleased some locations. Such contracts which generate rental income should also be considered when valuing lease contracts

A fair valuation analysis can be exempted in situations where the residual contractual period is insignificant or where the contract has been recently completed or renewed.

CONCLUSION

Vis-à-vis valuation methodologies applicable to other intangibles assets, fair valuation of deferred revenue and lease contracts is forthright. As the market participant assumption plays an important role in the valuation analysis, identifying appropriate market participants plays a critical role in the valuation analysis.

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