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# Deal Flash!

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# Revenue Is Revenue, Right? Under SAB 101, The Answer Is Not Always Apparent.

*In December, 1999, the SEC issued Staff Accounting Bulletin 101 (SAB 101) which specifies when companies can recognize revenue. This was in no small part in response to the SEC's concerns about quality of earnings, first voiced over two years ago. While intended simply to summarize and clarify existing rules, many believe SAB 101 fundamentally alters the "revenue landscape." SAB 101 affects sales, the most basic of corporate transactions, often delaying when companies can record revenue in their financial statements, even if they have collected the cash.*

*While the accounting impact of SAB 101 has been discussed in other quarters, we explore its potentially profound impact on the M&A process. Because it can affect valuation, EBITDA and quality of earnings, SAB 101 influences how companies assess acquisition targets and portfolio company performance. It makes thorough diligence paramount, especially on privately held and overseas targets not subject to the new rule, and further complicates the IPO process for non-US registrants. SAB 101 could reduce the cash flow-predicting power of GAAP earnings, and—because it may dilute earnings and the value of an acquirer's stock—diminish a company's ability to consummate a deal using its stock as currency.*

## The Action

SAB 101 specifies that revenue from a sale is earned and should be recognized when:

- A sales arrangement exists,
- Delivery has occurred,
- The price is fixed or determinable, and
- Collection is reasonably assured.

**Sounds simple, but it's not.** These criteria are in many cases stricter than the practices certain industries have followed for years, and their adoption has led to some high profile earnings restatements. Under SAB 101 form, in some respects, trumps substance, and seemingly insignificant contract provisions can defer revenue, as the following examples illustrate.

**Upfront fees:** The SEC staff views upfront fees for services delivered over a specified time period to be additional payment for those services. Even if non-refundable, such fees generally should be recognized over the term of the sales agreement, and not when payment is received. Where fees are refundable, they should not be recorded until refund rights expire, unless companies have trend data and a large enough sample from which to accurately project how many customers are likely to exercise refund rights.

**Customer acceptance clauses**: The SEC assumes that clauses giving customers a right to test products or obtain additional services from the seller, prior to accepting a product, are bargained-for terms. Hence the seller can't recognize revenue until the customer signs off, or the clause lapses.

**Contingent income:** If all or part of the fee a company receives for its services depends on the buyer's meeting performance criteria (i.e., when an ad agency's fee is contingent on the client's meeting a sales target), those criteria must be met before the company can record the contingent portion of the fee as revenue, even if meeting the criteria is virtually assured.

**Multi-phased deliverables:** The SEC does not consider an item delivered until the buyer has full use of it. Thus, when a company delivers a product or service in stages, such that the undelivered items are essential to the functionality of the delivered items, it must defer revenue from the first item delivered until it is fully functional. Following the same logic, companies cannot front-load revenue from services that require set-up activities—even though such costs are incurred upfront. Instead, they must recognize this revenue over the service period, which is generally the term of the contract.

It should be noted that certain businesses lie outside the scope of SAB 101 including leasing operations, industries that use contract accounting, and software companies, which are governed by specific rules that form the basis of SAB 101.

## The Impact

There are several ways in which SAB 101 will affect how companies value, assess and finance deals, as well as overall M&A strategy.

### Valuation Considerations

***Since revenue growth is becoming a more important valuation metric in many industries, will lower revenues drive down deal multiples?*** The market questions the ability of more traditional companies to raise earnings if they lack meaningful topline growth. If lower revenues (and EPS) drive down multiples, companies may alter business practices by eliminating things like customer acceptance clauses, in order to minimize the impact of the new rule and make a target more likely to command a higher price. On the other hand, if SAB 101 adversely affects the value of an acquirer, it may limit its ability to consummate deals using its shares as acquisition currency.

***Will a reduction in the cash flow-predicting power of GAAP earnings make them less relevant when valuing acquisition targets?*** Many market participants believe that cash flow drives valuation and that GAAP earnings are useful only if they accurately predict cash flow. Since SAB 101 specifies that the receipt of cash does not necessarily equal immediate revenue, we can expect that as companies are required to defer more revenue, GAAP earnings will deviate further from cash flow, reducing their predictive capability and thus their relevance in valuing enterprises.

**Strategic Considerations**

***Will companies revise e-business strategies?*** Many established companies are expanding e-business operations as an engine of future growth. These investment-intensive ventures are most likely to be hurt by the new rule, especially if they depend on long-term sales contracts. Management may find selling its story to investors and backers a challenge, if the deferral of revenues further reduces the ability of these expansion efforts to yield near-term revenue or earnings growth.

***Will companies have to reconsider portfolio company exit and financing strategies?*** Financial buyers should assess the impact of SAB 101 on portfolio companies, particularly those targeted for a near-term exit into the U.S. public markets. If the new rule adversely affects a portfolio company, the owner may be better off targeting foreign or privately held firms not subject to the rule. Longer term, financial buyers must carefully assess the impact of this standard on their investment horizon and financing strategies. All things being equal, under SAB 101, portfolio companies will likely take longer to report positive earnings, making an early exit unattractive or even impossible in some cases. This delay make cause financial buyers to demand a higher return on "plain vanilla" common or preferred stock investments, or increase their reliance on mezzanine securities, convertibles, debt and other complex instruments.

***Will vendors continue to use creative financing structures to minimize risk?*** Cash-strapped companies in industries saddled with significant capital expenditure requirements often require their suppliers to provide or arrange for financing for large purchases. Vendors often use securitization and other off-balance sheet structures to minimize their risk on such deals. However, such arrangements can significantly delay revenue recognition, particularly if the supplier lacks a history of providing extended payment terms. Under the new rule, vendors should ask themselves whether the benefits derived from selling to cash-poor customers outweigh the revenue growth and EPS impact of SAB 101. If they do, vendors should carefully structure customer financing offerings to protect revenue.

**Target Evaluation Concerns**

***How will SAB 101 affect deal pricing?*** Companies that price deals based on multiples of revenue, EPS or EBITDA must determine how SAB 101 affects each of these measures, and whether it should change the price or the multiple paid. The answer depends in part on whether the buyer is making a long-term buy, or planning an exit, such as an IPO or sale to a US public company, that will require SAB 101-compliant financials. This will determine the scope of diligence. For example, specialists familiar with the new rule should scrutinize contracts for customer rights that could delay revenue recognition, such as acceptance clauses, hidden side letters and deferral provisions.

I***s a dual standard being created?*** Since SAB 101 affects only US public companies, an acquirer assessing a private or overseas target should perform extensive diligence on its revenue to determine whether it would be different if SAB 101applied. As it is fair to assume that companies will not adopt SAB 101 unless they have to, investors/acquirers should use diligence to bridge the gap with US public companies when appropriate.

In addition, guidance on revenue recognition available from International Accounting Standards (IAS) and other national standard setters outside the U.S is not nearly so comprehensive as SAB 101. How will these standard setters respond? Will the SEC accept filings that present reconciling items from IAS or home country GAAP to US GAAP for revenue?

***Disappearing revenue.*** When cash is received, but the criteria for revenue recognition are not met, a liability—deferred revenue—is established, which is converted to sales as soon as the criteria are met. When a company is acquired in a purchase acquisition, all of its assets and liabilities are recorded at fair value. The fair value of deferred revenue is generally the remaining costs the company will incur in order to earn the revenue. This is often a small percent of the total amount deferred. The net result is that neither the target, nor the acquirer ever records these deferred revenues as sales. SAB 101 will exacerbate this effect by generally causing targets to defer more revenue. Principals who must use purchase accounting should consider this impact when modeling transactions and managing market expectations. This is not a concern on leveraged recapitalization or pooling deals.

## Conclusion

SAB 101 presents challenges to companies struggling to cope with the realities of public disclosure. Assessing the impact of SAB 101 on a target requires a thorough understanding of how the company does business, and the contractual terms governing its transactions with customers. Acceptance clauses, upfront fees, access charges, and delivery of multi-phased products will often delay revenue recognition until the customer signs off.

Although companies were required to implement SAB 101 last year, this is not a one-time issue. The SEC will be reviewing filings in 2001 and, in the process, provide additional guidance. The Emerging Issues Task Force plans to issue further guidance later this year, as companies grapple with unique fact patterns, and the economy continues to spawn new business models that are not contemplated in current GAAP. Stay tuned.

***Deal Flash!*** provides late-breaking news on regulatory developments that affect the deal community. ***Deal Flash!*** is a publication of the Transaction Services Group of PricewaterhouseCoopers, which includes over 700 professionals in 13 US cities. For more information, contact one of the deal structuring professionals listed below


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