Understanding How Revenue Recognition Impacts M&A Transactions

By Ashley DeCress, CPA

During the course of financial due diligence for a potential acquisition, there are a plethora of areas to review and consider. One very important area in particular is the reporting of revenue by the target company. Because acquisitions are often priced based on earnings (which are a direct result of revenues), it is essential to understand how a business recognizes revenues and if its process is appropriate and consistent within its industry.

The following areas frequently impact the way in which a buyer may look at a potential transaction:

1. Cash vs. Accrual Basis of Accounting

Under accrual basis accounting, revenues are recorded when they are earned regardless of when the money is received. The cash basis, on the other hand, records revenue when cash is received (and expenses when cash is paid). Although GAAP (Generally Accepted Accounting Principles) financial statements require companies to use accrual accounting, many small and middle-market businesses operate under the cash basis for various reasons (e.g., small or no accounting department exists within the business, it's more easily understandable, it allows for more simplified entries).

If a company uses cash basis accounting, this means it will not report receivables or payables, which can impact profitability, EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), working capital, etc. When performing a due diligence engagement, the cash basis may not fairly reflect the true profitability of a business year after year. Furthermore, the target company's financial results may not be consistent with the industry, which is important for pricing the deal. For example, say your business pays an annual fee of $6,000 in June for a one-year subscription. Under the cash basis, the month of June will reflect a higher expense level than all other months ($6,000 of expense is recorded in June, and $0 is recorded in the rest of the year). Under the accrual basis, the $6,000 is evenly spread over the 12 months the subscription is utilized ($500/month).

Additionally, a trailing twelve-month period may pick up additional expenses or not capture an expense, which could create a distorted view of the financials.

2. FOB Shipping Point and FOB Destination

FOB shipping point and destination indicate the point that the title of the goods transfers from the seller to the buyer. FOB shipping point transfers to the seller when placed in delivery, whereas FOB destination transfers to the seller once the goods reach the seller. These milestones, depending on the contract between the buyer and the seller, are frequently utilized in the recognition of revenue.

From a due diligence perspective, it is important to understand if the company is applying its selected method consistently. If not, there may be revenue cutoff issues from one period to another, resulting in distorted revenue results. It is also essential to understand if the company's revenue recognition policies are followed each month or less frequently (e.g. quarterly or annually). For example, if a business has an FOB destination agreement with a customer and the goods are shipped on the last day of the month, but not delivered until the following month, they should not be relieved from inventory until the goods have been delivered to the destination because risk of loss still resides with the seller until delivery. If the company does not consistently apply this method on a monthly basis, financial adjustments may be necessary.

3. Percentage of Completion

Percentage of completion is a common accounting method in the construction industry, which recognizes revenue and expenses of long-term contracts as a percentage of work completed during the period.

One potential diligence issue is that this method is susceptible to misuse in the interest of boosting short-term results (e.g., a project is actually only 10 percent complete but reported as 80 percent complete so that revenues are inflated in the current period). Revenues and expenses that are accounted for in an incorrect period could skew profitability and create unreliable numbers. Understanding the appropriateness of estimates historically and the review process of the company's WIP (Work-in-Process) schedule will help to better understand if revenue and expenses are being recognized correctly.

As discussed above, due diligence procedures can be designed to evaluate the consistency of application of accounting methods, cut-off between periods, accrual accounting, etc. In addition, as the new revenue recognition standard (ASC 606, as discussed here) moves into effect, the issue of revenue recognition will be crucial in evaluating potential deals.

If your business, or the business you are looking to purchase, has not adopted the new standard, you should assess the implementation costs to be incurred as well as the time and resources needed. It is also important to look at how the new model will affect contracts with customers or shifts in pricing or marketing strategies. These changes may impact performance metrics, working capital adjustments, EBITDA or even earnouts and debt covenants.

Do you have questions about revenue recognition and how it relates to due diligence or other transaction advisory-related matters? Please contact Ashley DeCress, CPA, at 440-449-6800 or adecress@skodaminotti.com .