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Understanding and evaluating deal considerations in the health care information technology enabled services sector

This issue explores certain operational, financial, and tax due diligence and structuring issues that private equity investors should consider when making investments in health care information technology-enabled service companies.

Financial accounting

Revenue recognition—Like many technology companies, those providing technology-enabled health care solutions may have complex arrangements and provisions that are subject to complicated revenue recognition rules and practices, including the appropriate treatment of multiple elements such as set-up, software licenses, hardware and professional services. Due to the complexity in contracts and authoritative revenue recognition guidance as well as the judgment required, companies are often challenged in correctly accounting for revenue and deferred revenue. In particular, they often incorrectly recognize revenue upfront for items that may need to be deferred (e.g. over the contractual period or the estimated customer life), which can significantly impact the historical quality of earnings.

Focused diligence should be performed by accounting professionals to read contract terms, understand the Target's revenue recognition practices, its impact on financial statements and the one-time versus recurring nature of revenue streams.

Hosting arrangements—Cloud computing and other hosting arrangements are growing sectors in the technology industry that offer customers online access to a

multitude of Web-based hardware and software solutions. This delivery model is increasing in popularity since (i) for customers, it allows for payments over the term of the arrangement compared to software ownership, which may require significant upfront costs, and (ii) for vendors, it allows for consistent recurring cash flows. Vendors that offer customers access to software in a cloud environment, known as software-as-a-service (SaaS), face challenges in developing an appropriate revenue recognition accounting policy under existing GAAP. While access to SaaS arrangements is generally provided to customers on a subscription basis, additional implementation, training and other consulting services are often provided to customers in bundled arrangements, which can further complicate the recognition of revenue arising from such arrangements. In many cases, SaaS arrangements are not within the scope of software revenue and should be accounted for as a service arrangement. Up-front fees related to services that do not have stand-alone value are typically deferred and recognized over the period in which they are earned, which may be over the estimated customer relationship period that may extend beyond the initial contract term. These arrangements should also be analyzed for compliance with state sales tax requirements, which can impact EBITDA.

Cash flows and valuation—GAAP revenues do not normally reflect cash flows due to the requirement to defer certain revenue. This can result in significant differences in timing between customer billing and payments compared to revenue recognition. As a result, current period GAAP earnings are sometimes converted and analyzed on a billings basis by adjusting for the change in deferred revenue. In addition, analysis of renewal rates, the timing of renewals and customer churn is important to understanding the quality of earnings.

Deferred revenue—The nature of deferred revenue, expected roll-out and the related cost to service the obligations are important to evaluate. Variation in practice exists for how this liability is treated in purchase price adjustment mechanisms in the transaction agreements (e.g. all or a portion is treated as debt, as part of net working capital or not included at all), depending on the nature of the balance. To avoid dispute with sellers late in the deal process, it is recommended that this point is brought up early in the deal negotiations. Debt treatment is generally the most advantageous for a buyer, especially in a cash-free debt-free transaction where the cash portion of deferred revenue may have already been collected by the seller and for which the buyer will likely have to service the obligation. Some variations to treating the full deferred revenue as debt may be to consider only the non-current portion or the cost to service this obligation post-close. In addition, deferred revenue in technology businesses is often subject to a significant haircut as part of acquisition accounting for the opening balance sheet, which requires adjustment to fair value based on the cost to service the obligation plus a reasonable margin. This has the effect of reducing GAAP revenue for a period after close. This should be considered for modeling and debt covenant purposes.

Software capitalization—The capitalization of internal costs related to the development of software follows specific rules that vary depending on whether the software is to be used for internal use (i.e. software never sold) or marketed for sale. These capitalization rules are often incorrectly interpreted by companies; including the capitalization of costs associated with maintenance projects which should be expensed. In general, the development costs for software to be marketed is only capitalizable after the achievement of technological feasibility (which is typically near the end of the development process), while development costs for internal use software may be capitalized earlier. Valuation models should consider the cash outflow of the capitalized internal costs either as a reduction to EBITDA or included in capital expenditures.

Revenue recognition project—The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) initiated a joint project to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRS. The standard is still in draft form, but is expected to be issued in May/June 2014 with an effective date in 2017 (with alternate transition methods). The new standard may change the current accounting for certain companies depending on their circumstances and private equity clients may want to consider and consult their advisors on how this may impact a portfolio company's financial statements and its valuation upon exit.

Tax structuring and diligence

Deferred revenue—An accrual method taxpayer may account for advance payments using the deferral method, whereby such taxpayer may defer the recognition of advance payments to an immediately succeeding tax year if the revenue is also deferred for financial reporting purposes. It is important during due diligence to evaluate whether the target is deferring too much income for tax purposes as this could create historical income tax risk to a buyer. Subsequently, if such taxpayer is a party to a transaction, the terms of its contracts and the structure of the deal will likely dictate the seller's and the buyer's tax consequences. In a stock acquisition, for example, accounting methods generally carryover and a buyer could be forced to recognize "dry" taxable income in a post-closing tax period if the target uses the deferral method. As such, it is important to know whether a target uses the deferral method in order to analyze "debt-like" items and project future cash taxes. In deemed and actual asset

acquisitions, for example, the purchase price allocation may generally dictate the seller's and buyer's tax consequences and may prevent a buyer from recognizing "dry" taxable income in a post-closing tax period, but may accelerate the recognition of deferred revenue to the sellers. As such, it is important to analyze deferred revenue early in the deal process to manage sellers' expectations.

Medical device excise tax—Certain tech-enabled tools, including certain types of software applications, are classified and regulated as medical devices. If these tech-enabled tools are listed with the FDA, they could fall within the definition of a taxable medical device. As such, sales may be subject to the medical device excise tax. Therefore, during due diligence, it is important to analyze whether the medical devise excise tax applies, whether any historic exposure exists, whether EBITDA is impacted and whether a target's projections accurately incorporate the tax.

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