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Understanding revenue recognition issues while performing due diligence for health care services companies

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Allexian would like to thank Claudine Cohen, Principal, Transaction Advisory Services, Grant Thornton LLP, for writing this month,s newsletter.

Given the growing number of M&A transactions in the health care services sectors in recent months, performing strong financial due diligence is essential for buyers and sellers to have accurate valuations. However, when performing financial due diligence for health care services companies, revenue recognition can be a high-risk area. There are recurring issues that may have a significant impact on valuation when purchase price is computed on an EBITDA multiple.

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It may not be practical to use pro-forma historical financial information due to limitations around record-keeping and maintenance of data, a common occurrence in founder-owned companies. Although the historical information is always relevant in determining the pricing of a transaction, the buyer may have no option but to understand the future projections and financial modeling, and benchmark these against the historical business model to ensure that there have been no major changes. This will provide the acquirer with a level of comfort. Since the financial projections are modeled using base data and revenue/cost drivers, they can be used to correct past errors in order and ensure the underlying assumptions are accurate.

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It is not uncommon for companies providing health care services to earn income from several revenue streams, some of which may be contingent on future performance. This creates complexities around revenue recognition, especially where there are multiple elements in a contract.

Prior to recognizing revenue, four criteria must be met:

- Persuasive evidence of an arrangement, that is, there is a contractual agreement between the client and service provider
- Delivery has occurred or services have been rendered
- Collectability is reasonably assured and there is no indication that payments from customers will not be received or will not continue in the future
- The seller's price to the buyer is fixed or determinable

A summary of some common revenue arrangements is set out below:

Fixed-fee arrangements - Revenue on these fixed-fee arrangements should be recognized as services are performed and as deliverables are completed, similar to the percentage of complete methodologies used in construction contracts.

Full-service arrangements - A Company has the ability to tailor and alter each agreement specific to its customers, needs. The contract may include both a fixed- and variable-fee element (multiple-element deliverables). For instance, one may set a fixed fee for ongoing retainer-type services, which are administered based on a fixed number of hours. Revenue is recognized pro-rata to the hours or volumes on a percentage-completion basis.

For other services, there is no set fee and the customer may be charged based on volumes/units. This arrangement works well for both parties as it requires no upfront commitment and allows the customer to pay as they benefit from the services. For the service provider, there is more upside potential, as the fee increases as volumes increase.

Revenue recognition for full service arrangements is a little more challenging. How does one determine the overall revenue over the life of a contract that may extend three to five years? Estimating the volumes over a contract life based on historical experience may appear to be a reasonable proxy to apply to current contracts. However, from a US GAAP perspective, this is not considered acceptable as the entire consideration is unknown, and can vary widely based on the specifics of the customer and the nature of the revenue stream. As a result, revenue should not be recognized according to the percentage-completion method. This is notwithstanding that services may be performed many months in advance of revenue being earned. Once revenue is generated, it may be recognized based on actual volumes, an agreed-upon fee per unit, or any other acceptable accounting methodology. Costs associated with the contract should be deferred and amortized on a straight-line basis over the contact term.

While the above accounting treatment does not impact the actual cash flow, it can have significant EBITDA implications, which may impact the buyer,s valuation, purchase price and working capital calculations.

Case Study

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As former CEOs we assist health care companies with planning and execution.

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Company A performs services for Customer B including supply change optimization and pharmacy benefit management (PBM) procurement and contracting services for a large corporate client, thereby allowing the client to gain control over drug costs. Revenue is earned on a fee-per-unit basis based on the number of prescriptions being fulfilled. The contract with Customer B is for a period of five years. Company A began performing services relating to the contract from month one, with the first prescriptions being fulfilled in month 15. Company A recognized revenue from month one, based on estimated units to pass through the system over the five-year period, using historical data.

In terms of US GAAP revenue recognition criteria, this was incorrect, as the revenue was not fixed or determinable from the contract outset. Instead, Company A should have recognized revenue to the extent that actual prescriptions were fulfilled. Any costs incurred by Company A until such time prescriptions were fulfilled should have been capitalized and amortized over the period of the contract.

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