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To the Point

FASB — proposed guidance

FASB proposes guidance for revenue contracts acquired in a business combination

The proposal would resolve questions about when to recognize a contract liability in a business combination.

What you need to know

- The FASB proposed amendments to ASC 805 that would require companies to apply ASC 606 to recognize and measure contract assets and contract liabilities relating to contracts with customers they acquire in a business combination.
- At the acquisition date, companies would assess how the acquiree applied ASC 606 to determine the amounts to recognize for acquired revenue contracts. This would generally result in companies recognizing contract assets and contract liabilities at amounts consistent with those recorded by the acquiree.
- Requiring companies to apply ASC 606 would create an exception to the guidance in ASC 805 that generally requires assets and liabilities acquired in a business combination to be accounted for at fair value.
- The proposal also would clarify that companies should apply the definition of a performance obligation in ASC 606 when determining whether to recognize a contract liability in a contract with a customer in a business combination.
- Comments are due by 15 March 2021.

Overview

The Financial Accounting Standards Board (FASB or Board) proposed amendments to Accounting Standards Codification (ASC) 805, *Business Combinations*, that would create an exception to the general recognition and measurement principle for contract assets and

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contract liabilities from contracts with customers acquired in a business combination. Under this exception, an acquirer would apply ASC 606, *Revenue from Contracts with Customers,* to recognize and measure contract assets and contract liabilities on the acquisition date.

In issuing the proposal, the FASB is addressing questions raised by stakeholders about the accounting for revenue contracts with customers that are acquired in a business combination.[1]

ASC 805 generally requires the acquirer in a business combination to recognize and measure the assets it acquires and the liabilities it assumes at fair value on the acquisition date, with certain exceptions. ASC 805 currently does not provide an exception for acquired contract assets or contract liabilities (i.e., deferred revenue) from contracts with customers.

Stakeholders have questioned whether an acquiring entity should recognize a contract liability based on the remaining performance obligation under ASC 606.[2] They also questioned how the entity should apply the subsequent measurement provisions in ASC 606 to contract assets recognized at fair value in a business combination, noting that this may be challenging when revenue contracts contain variable consideration or contingent payment terms (e.g., sales-based royalties).

Key considerations

The proposed amendments would apply to all contracts accounted for under ASC 606 that are acquired in a business combination, including those in the scope of ASC 610-20, *Gains and Losses from the Derecognition of Nonfinancial Assets*, when that guidance requires an entity to apply the principles in ASC 606. The proposal would not affect the accounting for customer or contract-related intangible assets recognized in a business combination.

Initial accounting

Contract assets

An entity that acquires a contract in the scope of the proposal would recognize a contract asset on the acquisition date if it determines that the acquired entity has already transferred goods or services to the customer under the contract but has not yet received payment because the acquiree's right to consideration is conditional.

When future payment is fixed, the amount an acquirer recognizes as a contract asset measured under ASC 606 generally approximates the amount the acquirer would recognize at fair value under ASC 805 today. When the contract consideration is variable and the acquirer applies either the constraint on variable consideration or the sales and usage-based exception for licenses of intellectual property, the amount recognized under the proposal would generally be lower than fair value.

How we see it

We generally expect that applying the provisions in ASC 606 to measure acquired contract assets would not affect the amount of goodwill recognized in the business combination. That is because the acquiring entity would continue to verify that all cash flows related to the contract have been appropriately considered (i.e., not omitted or double counted) when determining the fair value of customer-related intangible assets recognized in the business combination.

Contract liabilities

Under the proposal, an entity that acquires a contract with a customer would recognize a contract liability if it determines that the acquired entity has an unsatisfied performance obligation, and the acquiree has received consideration (or the amount is due) from the customer. This guidance would reduce the diversity in practice that exists today. Certain companies recognize contract liabilities when they have a legal obligation to transfer goods and services under a revenue contract. Other companies may recognize contract liabilities based on the definition of a performance obligation under ASC 606, which is broader than an obligation that is legally enforceable.

Measuring a contract liability under ASC 606 would likely result in the acquirer in a business combination recording an amount that is higher than what it would recognize using a fair value approach under today's guidance. That's because transaction prices determined under ASC 606 typically consider the costs (and related profit) an entity incurs to obtain the contract (i.e., the selling and marketing activities performed by the acquiree before the business combination), but these costs are not considered in the fair value measurement of an assumed contract liability under ASC 805 because a market participant is not expected to incur them to fulfill the remaining unsatisfied performance obligation.

The proposal would align the business combination accounting with the subsequent accounting for contract assets and liabilities under ASC 606.

How we see it

The proposed guidance would eliminate the complexity associated with determining the fair value of contract liabilities and may result in higher contract liability balances. The Board acknowledged that an increase in contract liabilities under the proposed guidance would result in a higher amount of goodwill related to the business combination.

While the proposal also would result in more post-combination revenue being recognized by the acquirer than it would recognize under today's guidance, the amount of revenue recognized would be consistent with the amount the acquiree would have otherwise recognized without the business combination. During the Board's outreach, investors stated that making the post-acquisition reporting of cash flows and revenue comparable to the pre-acquisition reporting would provide information that is more decision-useful about the combined company after the acquisition.

Subsequent accounting

ASC 805 generally requires an entity to subsequently measure and account for assets acquired and liabilities assumed in accordance with other relevant US GAAP (e.g., ASC 606 for contracts with customers that are acquired in a business combination).

Stakeholders had expressed concerns that diversity in practice could develop if additional measurement guidance was not provided because ASC 606 does not address changes in estimates or derecognition of contract assets or contract liabilities that are initially measured at fair value in a business combination.

Under the proposal, the business combination accounting would be aligned with the subsequent accounting for contract assets and liabilities under ASC 606. The Board believes this would improve the quality of financial information reported to users of financial statements and also reduce the cost and complexity of accounting for acquired revenue arrangements after a business combination.

Other considerations

The Board said the proposal would generally result in an acquirer recognizing contract assets and contract liabilities in a business combination at amounts that are consistent with those reported in the acquiree's financial records immediately before the acquisition date. However, these amounts may differ when (1) the acquirer and acquiree apply different revenue recognition accounting policies, and the acquirer concludes that it is appropriate to conform the acquiree's accounting policy to its own on the acquisition date,[3] (2) the acquirer determines that adjustments arising from changes in estimates as of the acquisition date are required or (3) the acquirer determines that there was an error in the acquiree's pre-combination accounting under ASC 606.

Effective date and transition

An effective date will be determined after the Board considers stakeholder feedback on the proposal. The guidance would be applied prospectively, and early adoption would be permitted. An entity that elects to early adopt the guidance in an interim period would have to apply it to all business combinations that occur during the annual period that includes that interim period.

Endnotes:

1 This proposal originated from Emerging Issues Task Force (EITF) Issue 18-A, *Recognition under Topic 805 for an Assumed Liability in a Revenue Contract*, which focused on when to recognize a contract liability in a business combination.

2 Acquirers historically recognized deferred revenue if they determined that they had a legal obligation to transfer goods or services under a revenue contract consistent with the guidance in EITF 01-3, *Accounting in a Business Combination for Deferred Revenue of an Acquiree*.

3 When the acquirer and acquiree follow different acceptable accounting alternatives under US GAAP, the acquirer may conform the accounting policies of the acquiree to its own policies in its consolidated financial statements after a business combination.

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