The FASB issued an Invitation to Comment on the measurement of contract liabilities and other topics related to the accounting for revenue contracts acquired in a business combination, along with a proposal that would clarify when contract liabilities should be recognized. The proposal would clarify that the definition of a performance obligation in ASC 606 should be applied when determining whether a contract liability in a contract with a customer should be recognized in a business combination. The FASB also asked stakeholders whether any final guidance should address both the recognition and measurement topics. Comments on both documents are due by 30 April 2019.

Overview

The Financial Accounting Standards Board (FASB or Board) issued an Invitation to Comment (ITC) on the measurement of contract liabilities and other topics related to the accounting for revenue contracts acquired in a business combination, along with a proposal that would clarify that entities should use the definition of a performance obligation in Accounting Standards Codification (ASC) 606 to determine when contract liabilities should be recognized.

The proposed Accounting Standards Update (ASU), which is based on a consensus-for-exposure of the Emerging Issues Task Force (EITF), is intended to address questions raised by stakeholders about how an entity that has adopted the new revenue guidance in ASC 606 should account for contract liabilities in a business combination.
The EITF discussed but was not able to reach a consensus on the topic of measurement and asked the FASB to issue an ITC seeking feedback from stakeholders about measurement and other topics related to acquired revenue contracts.

In the proposal, the FASB also asks stakeholders to comment on the implications, if any, of finalizing the recognition guidance before any guidance on measurement or other topics that may result from feedback it receives in response to the ITC.

**Key considerations**

**FASB proposal on recognition**

While ASC 805 requires the acquirer in a business combination to recognize and measure the liabilities it assumes at fair value (with certain limited exceptions), it does not provide guidance on recognizing and measuring contract liabilities (i.e., deferred revenue). Absent such guidance, acquirers historically have recognized deferred revenue if they determined that they had a legal obligation to transfer goods or services to a customer under a revenue contract.

When the new revenue standard was issued, it defined a performance obligation in the Codification for the first time, and the definition is broader than an obligation that is legally enforceable. Because the FASB did not amend ASC 805 to refer to performance obligations when it issued ASC 606, stakeholders questioned whether they should recognize a contract liability in an acquired revenue contract when they have an unsatisfied performance obligation under ASC 606 or an unsatisfied legal obligation.

The proposed ASU would require an acquiring entity to recognize a contract liability from a contract with a customer if it determines that the acquired entity has an unsatisfied performance obligation based on the definition in the new revenue standard, and the acquiree has received consideration (or the amount is due) from the customer.

The proposed amendments would be applied prospectively to business combinations that occur on or after the effective date.

**How we see it**

Using the definition of a performance obligation in ASC 606 to determine when to recognize contract liabilities in a business combination may, in certain instances, result in the recognition of more contract liabilities because that definition is broader than a legal obligation.

**Invitation to Comment on measurement**

In the ITC, the Board seeks stakeholders’ views on two topics: whether the timing of payments related to an acquired revenue contract should affect the amount of revenue an acquirer recognizes after a business combination and what types of costs expected to be incurred to fulfill a performance obligation should be included in the fair value measurement of a contract liability. It also discusses possible approaches the Board or the EITF could consider to clarify the guidance in areas where diversity in practice may exist.

**Timing of payments**

Most EITF members agreed that, conceptually, the amount of revenue recognized by an acquirer for two contracts with identical unsatisfied performance obligations should be the same, regardless of the timing of payments. Certain EITF members, however, noted that making that a requirement could change practice for some entities and could raise questions about the recognition and measurement of customer-related intangible assets. Therefore, the ITC seeks input on whether the timing of payments related to an acquired revenue contract should affect the amount of revenue the acquirer recognizes after a business combination.
In doing so, the ITC presents several hypothetical scenarios in which an entity acquires the same service contract as part of a business combination and has an identical unsatisfied performance obligation, but the timing of payments differs (e.g., payments made at contract inception, payments made as performance occurs).

The ITC describes situations in which the timing of payments might affect the amount of revenue an acquirer recognizes. In the situations in which it is determined that the timing of payments should not affect the amount of revenue an acquirer recognizes, the ITC explores whether and what type of identifiable asset should be recognized at the acquisition date. Today, there is diversity in practice in whether entities separately identify and recognize such an asset. The scenarios focus on revenue recognition because the total amount of income recognized by the acquirer post-acquisition likely wouldn’t be affected by any guidance provided on the timing of payments.

Stakeholders are invited to comment on whether guidance on payment terms would improve the usefulness and comparability of financial statements, among other things. The ITC also explores whether the FASB should issue guidance on contingent payments for acquired revenue contracts involving sales-based royalties and variable consideration.

Considering the costs to fulfill when measuring the fair value of a contract liability

The ITC also seeks input on what types of costs expected to be incurred to fulfill a performance obligation should be included in the fair value measurement of a contract liability that would be recognized under the proposal. The Board acknowledges that diversity in practice may exist, and the ITC lays out several examples to highlight the different views.

How we see it

The issues addressed in the ITC apply to all entities that acquire revenue contracts in a business combination. We encourage entities to carefully consider the questions raised in the ITC and share their views, especially entities that frequently acquire revenue contracts in business combinations because they are likely to be affected by any guidance the Board may develop after receiving feedback on the ITC.

Endnotes:

1 Invitation to Comment, Measurement and Other Topics Related to Revenue Contracts with Customers under Topic 805.
2 Proposed ASU, Business Combinations (Topic 805), Revenue from Contracts with Customers – Recognizing an Assumed Liability, a consensus of the FASB Emerging Issues Task Force.
3 ASC 606, Revenue from Contracts with Customers.
4 The concept of a legal performance obligation is leveraged from previously existing guidance in EITF 01-3, Accounting in a Business Combination for Deferred Revenue of an Acquiree.