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FASB proposes changes to accounting for revenue contracts in a business combination

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KPMG reports on the FASB's proposed ASU[1], which would change accounting for revenue contracts acquired in a business combination.

Applicability

All entities that enter into a business combination after adopting Topic 606, Revenue from Contracts with Customers.

Key facts and impacts

The proposed ASU would provide an exception to the general fair value principles in Topic 805, Business Combinations, by requiring an entity to recognize and measure contract assets and contract liabilities (deferred revenue) in a business combination under a 'Topic 606 approach'. Under the Topic 606 approach, instead of applying fair value principles under Topic 805 to measure these assets and liabilities, an entity would apply the revenue model in Topic 606. This proposal generally would result in the acquirer recognizing the contract asset or liability balances in the acquiree's US GAAP financial statements. The FASB expects these changes to increase the contract liabilities balance recorded by an acquirer and corresponding post-acquisition revenue.

The proposed ASU would not change the requirement to recognize and measure at fair value other assets or liabilities from revenue contracts with customers, such as customer-related or contract-based intangible assets (e.g. backlog or favorable contract intangibles) or unfavorable contract liabilities.

Background

The proposed ASU arose from a FASB project to address (1) when to recognize a contract liability in a business combination and (2) whether payment terms should affect the amount of post-acquisition revenue recognized.

Recognition of contract liability

Topic 805 generally requires assets and liabilities acquired in a business combination to be measured at fair value but currently does not include specific guidance on the recognition and measurement of a contract asset or contract liability (also referred to as deferred revenue). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration. A contract asset represents an entity's right to consideration in exchange for goods or services the entity has transferred to the customer and that is conditioned on something other than the passage of time.[2]

1 Proposed ASU, Accounting for Contract Assets and Contract Liabilities from Contracts with Customers, December 15, 2020 (Proposed ASU).

2 Subtopic 606-10 Glossary.

Due to this lack of specific guidance, in practice, entities typically recognize deferred revenue only if a legal obligation exists at the acquisition date. The deferred revenue is then measured at fair value, which typically results in a 'haircut' or reduction in the amount of the deferred revenue that the acquiree had recorded. However, when Topic 606 introduced the concept of performance obligations, it became unclear whether deferred revenue (contract liabilities) should be recognized based on the existence of acquired, unfulfilled performance obligations instead of acquired legal obligations.

Under the normal workings of Topic 606 (outside of a business combination), a contract liability or deferred revenue is recognized if the entity receives consideration before it fulfills its remaining performance obligations. A performance obligation goes beyond a legal obligation and can be the result of customary business practices, policies or other specific statements that are implied at contract inception. Therefore, basing the recognition threshold for contract liabilities on the existence of unfulfilled performance obligations could result in the recognition of more contract liabilities in business combinations.

Timing of payments

Under the current practice described above, the timing of contractual payments can affect the amount of revenue recognized post-acquisition. For example, a contract that was paid entirely upfront generally results in less post-acquisition revenue than an otherwise identical contract paid in proportion to revenue recognized. This is because the deferred revenue is adjusted to fair value, generally resulting in a haircut that affects the amount of post-acquisition revenue, but an at-market contract paid in proportion to revenue recognized does not have a fair value adjustment (because there is no contract asset or liability) that affects post-acquisition revenue.

Proposed guidance

To address the issues identified, the FASB proposed an exception to the general recognition and measurement principles in Topic 805. This exception would require contract assets and liabilities to be recorded based on the principles in Topic 606 instead of fair value. However, the Board is not proposing any incremental guidance on the accounting for other assets or liabilities that arise from customer contracts.

The FASB also did not propose guidance that would require the acquirer to record contract cost assets associated with incremental costs to obtain a contract or fulfillment costs under Subtopic 340-40, Other Assets and Deferred Costs. Consequently, we believe the acquirer would not apply Subtopic 340-40 because the costs to acquire the contracts are accounted for in the customer-contract and customer-related intangible assets.

The Topic 606 approach explained

Under the Topic 606 approach, an acquirer would measure and recognize contract assets or liabilities from contracts with customers using Topic 606's five-step revenue model, which is based on the existence of performance obligations. The acquirer would apply the entire five-step revenue model to each acquired contract to determine if it must recognize a contract asset or liability as of the acquisition date. In contrast, under current practice an entity generally only records a liability if there is a remaining legal obligation (which may be different from a performance obligation) and measures it at fair value.

The FASB expects these changes to increase the amount of deferred revenue recorded by an acquirer and corresponding post-acquisition revenue. That is because recognizing a contract liability at fair value usually results in a haircut to the balances measured under the Topic 606 approach. The FASB received feedback from users of financial statements that such effects on acquired revenue contracts do not provide useful information, are challenging to understand and reduce comparability between the pre-acquisition and post-acquisition periods.[3]

[3] Proposed ASU, BC18.

Example: Higher deferred revenue

ABC Corp. entered into a two-year service contract on January 1, Year 1, that is satisfied ratably over time with Customer. ABC concluded the contract does not have a significant financing component. Customer paid ABC the full contract price on contract inception (January 1, Year 1). DEF Corp. acquires ABC on January 2, Year 1 before any performance under the contract.

Assume the following facts.

Contract price	$1,000
Expected fulfillment cost	750
Selling effort plus a reasonable profit	100*
Acquisition date fair value of contract liability and performance obligation	900

*This represents the costs ABC incurred to enter into the contract with Customer (plus a margin), which, in this simplified example, represents the difference between the contract price and the fair value of the contract on the acquisition date.

The following compares the recording of the contract liability on acquisition and the revenue recorded by the acquirer in the periods subsequent to the acquisition.

Current practice	Topic 606 approach
DEF records $900 contract liability (fair value of unsatisfied performance obligation) at the acquisition date	DEF records $1,000 contract liability (contract liability under Topic 606) at the acquisition date

DEF would record the following journal entries for each of years ending December 31, Year 1 and Year 2.

Current practice	*Debit*	*Credit*
Contract liability	450	
Revenue		450
To derecognize the contract liability and recognize revenue.		

Topic 606 approach	*Debit*	*Credit*
Contract liability	500	
Revenue		500
To derecognize the contract liability and recognize revenue.		

Topic 606 approach not the same as carryover basis

Generally, the Topic 606 approach would result in the acquirer recording the same contract asset or liability recorded in the acquiree's US GAAP financial statements. However, the FASB noted that the Topic 606 approach is not always the same as directly carrying over the acquiree's balances because there could be differences between the acquirer and acquiree's accounting policies, differences in estimates between the acquirer and acquiree, and application errors by the acquiree, or the acquiree may prepare financial statements under other financial reporting frameworks such as IFRS® Standards.[4] Therefore, the acquirer would need to gain an understanding of the acquiree's accounting policies and estimation processes to identify any differences and assess the accuracy of the acquiree's accounting. If differences in policies and estimates are identified, the acquirer would need to reperform the Topic 606 accounting to record the appropriate balance at the acquisition date.

4 Proposed ASU, BC28.

Observation: Different processes and controls will be needed

While the Topic 606 approach may result in the acquirer ultimately recording the same amounts the acquiree has recorded, the acquirer still needs to evaluate all of the acquired contracts under its own accounting policies to determine the amount (or absence) of a contract asset or liability. Further, an acquirer needs to have appropriate processes and controls over the amounts recorded under the Topic 606 approach instead of simply relying on the controls the acquiree had in place.

The controls for the Topic 606 approach likely would be different from the controls an acquirer may have in place under current practice to account for these amounts at fair value. However, the acquirer would still need its existing processes and controls to determine the fair value measurements of other assets or liabilities from revenue contracts with customers, such as customer-related or contract-based (e.g. backlog or favorable contract intangibles) or unfavorable contract liabilities.

Entities are required to apply the full Topic 606 revenue model from contract inception

Under the Topic 606 approach, the acquirer would apply the entire five-step revenue model to acquired contracts, which could require significant judgments and estimates. For example, an acquirer would need to estimate the stand-alone selling price to allocate the transaction price to each performance obligation as of contract inception, estimate variable consideration subject to the variable consideration constraint, and estimate the progress toward completion of a performance obligation satisfied over time. Further, the acquirer would need to apply modification accounting to all modifications since contract inception.

Observation: Topic 606 approach challenges

The requirement for the acquirer to apply the full five-step revenue model using its own accounting policies and estimation processes may be challenging – especially when the acquiree has a significant volume of long-term contracts. For example, an acquirer may:

- need access to several years of the seller's historical accounting records;
- have to apply modification accounting each time the contract was modified between the contract inception and the acquisition date (which could include multiple modifications); and
- have to estimate the stand-alone selling price using the acquirer's specific assumptions at contract inception.

An acquirer may need to consider the need for information about these long-term contracts to evaluate the accounting under the Topic 606 approach during due diligence.

Variable consideration and royalty recognition constraint applies

In addition to the variable consideration constraint, acquirers may also need to apply the royalty recognition constraint when applying the full five-step revenue model under the Topic 606 approach.[5] Applying either constraint could prohibit the acquirer from recognizing a contract asset even when it expects the contract to generate positive future cash flows. Nevertheless, the FASB observed that the constrained cash flows would still be factored into the valuation of other customer-related intangible assets (e.g. backlog asset) and subsequently amortized into the income statement.[6] If or when the variable amounts become unconstrained in the post-acquisition period, they would be recorded as revenue. However, we understand that typically, in current practice, the amortization of a backlog assets is recorded as an expense instead of as contra-revenue.

5 See KPMG Handbook: Revenue Recognition, section 10.11.

6 Proposed ASU, BC31.

Observation: Timing of payments still affects post-acquisition results

The FASB observed that in current practice, the timing of customer payments caused differences in the amount of post-acquisition revenue for otherwise similar contracts. To address this issue the Board chose the Topic 606 approach because it would often result in the same post-acquisition revenue regardless of the timing of payments. However, we believe the timing of payments would still have an effect on the post-acquisition income statement as follows.

— The FASB believes that the difference between a contract liability measured under the Topic 606 approach (i.e. where the timing of payments precedes the timing of revenue recognition) and fair value would result in more goodwill instead of an increase in customer-contract intangibles.[7] However, an otherwise identical contract with payments in proportion to revenue recognized would give rise to an amortizable intangible asset. Therefore, while the post-acquisition revenue may be the same for these two contracts, the contract in a liability position would result in higher GAAP net income because goodwill is not amortized.

— A contract with constrained variable consideration or subject to the royalty recognition constraint may preclude the acquirer from recognizing a contract asset. If an otherwise identical contract has fixed payments, or payments not constrained, a contract asset would be recognized, leading to less post-acquisition revenue. Therefore, the amount of post-acquisition revenue would be different in these situations.

We understand there is diversity in views on whether the entire difference between a contract liability measured at fair value and under the Topic 606 approach should result in an increase to goodwill. As a result, the FASB may need to clarify whether an acquirer is required to record the entire difference as an increase to goodwill.

Other customer-related or contract-based intangible assets or liabilities

The proposed ASU would not amend the guidance on customer-related or contract-based intangibles. Therefore, consistent with current practice, the acquirer may be required to record at fair value a backlog asset, favorable contract intangible asset or unfavorable liability.[8] The FASB also indicated that the amount of post-acquisition revenue could differ from what the acquirer would have recognized without the acquisition as a result of the amortization of an off-market asset or liability reducing or increasing revenue.[9]

Observation: Potentially more favorable intangible assets or unfavorable liabilities

There is limited guidance in Topic 805 on how to determine the fair value of a favorable contract intangible or unfavorable liability. In most cases, the off-market asset or liability arises because of changes in market terms between contract inception and the acquisition date. However, typically the objective in determining the off-market amount is to make the rate of return reflected in the post-acquisition financial statements equal to a market return for the acquirer's remaining performance.[10] Similarly the FASB indicated that an off-market asset or liability would result in post-acquisition revenue that reflects either the current market terms or current stand-alone selling prices of the remaining performance obligations in the acquired contract.[11]

Measuring a contract asset or liability under the Topic 606 approach could result in the post-acquisition financial statements being different than the market return for the acquirer's performance unless a favorable asset or unfavorable liability is recognized, even if the market terms did not change between contract inception and the acquisition date.

7 Proposed ASU, BC33.

8 Proposed ASU, BC29.

9 Proposed ASU, BC30.

10 2006 AICPA National Conference on Current SEC and PCAOB Developments, Speech by SEC Staff, Joseph Ucuzoglu.

11 Proposed ASU, BC30.

Consider the following example.

- ABC charges a one-time nonrefundable upfront fee to new customers for reimbursement of set-up activities that is deferred and recognized over the term of the contract.
- ABC does not charge a similar fee on the customer's renewals.
- ABC concludes that the renewal option does not provide a material right to the customer.
- Other than the upfront fee the new customer contract and renewal contract are identical.

Under the Topic 606 approach, if ABC were acquired there would be a recorded contract liability for the new contract but not for the renewal contract. For these two contracts, the acquirer's post-acquisition performance is identical but the net income recorded would be greater in the new contract because the contract liability increases post-acquisition revenue. Therefore, we believe some entities may conclude that an off-market asset should be recorded so that the post-acquisition financial statements reflect the appropriate rate of return. This effectively results in the entity applying the Topic 606 approach and fair value.

It may be necessary for the FASB to clarify how entities measure off-market assets or liabilities in revenue contracts in the final ASU to avoid diversity in practice. That is, the Board may need to clarify whether the determination is solely about the difference in market terms between contract inception and the acquisition date or whether the objective is to result in the post-acquisition income statement reflecting the net fair value of the acquired contract.

Effective dates and transition

The proposed ASU would be adopted prospectively for business combinations after the effective date. The FASB will determine the effective date after considering stakeholder feedback. Early adoption of the proposed amendments would be permitted.

Next Steps

Comments on the proposed ASU are due March 15, 2021.

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