

# Technical Line

FASB – final guidance

## A closer look at the new guidance on accounting for revenue contracts acquired in a business combination

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### What you need to know

- ▶ The new guidance requires entities to apply ASC 606 to recognize and measure contract assets and contract liabilities from contracts with customers acquired in a business combination.
- ▶ This generally will result in companies recognizing contract assets and contract liabilities at amounts consistent with those recorded by the target.
- ▶ While the guidance is not industry specific, the number of in-process revenue contracts and the significance of adoption may vary by industry and the facts and circumstances of the contracts acquired.
- ▶ For public business entities, the guidance is effective for fiscal years beginning after 15 December 2022, and interim periods therein. For all other entities, it is effective for fiscal years beginning after 15 December 2023, and interim periods therein. Early adoption is permitted.

### Overview

The new **guidance**<sup>1</sup> issued by the Financial Accounting Standards Board (FASB or Board) changes how an entity accounts for revenue contracts it acquires in a business combination.

The changes require entities to apply Accounting Standards Codification (ASC) 606<sup>2</sup> to recognize and measure contract assets and contract liabilities from contracts with customers in a business combination, creating another exception to the general recognition and measurement

principle of ASC 805.<sup>3</sup> 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 under ASC 820<sup>4</sup> on the acquisition date.

The FASB issued the guidance in response to questions raised by stakeholders about whether an acquirer in a business combination should apply the concept of a performance obligation introduced by ASC 606 when determining whether to recognize a contract liability for the target's revenue contracts. Previously, an acquirer recognized deferred revenue under the "legal obligation" approach, consistent with the superseded guidance from the Emerging Issue Task Force (EITF) in EITF 01-3, *Accounting in a Business Combination for Deferred Revenue of an Acquiree*, which was generally considered more limited in scope than the definition of a performance obligation.

Stakeholders had also raised questions about how an acquirer should measure a target's contract assets and liabilities from revenue contracts. They noted that applying the subsequent measurement provisions of ASC 606 could be challenging if a revenue contract that contains variable consideration or contingent payment terms (e.g., sales-based royalties) is measured at fair value on the acquisition date. Measuring contract liabilities in a business combination at fair value often results in total revenue that is lower than would have been recognized under that contract had it not been acquired in a business combination.

The Board also observed that the measurement of acquired revenue contracts at fair value can result in acquirers recognizing different amounts of post-combination revenue for two contracts with the same performance obligations, depending on the contractual timing of payments.

Accounting Standards Update (ASU) 2021-08 improves the comparability for the recognition and measurement of revenue contracts acquired in a business combination by addressing when an acquirer should recognize a contract asset or contract liability and how the contract asset and contract liability should be measured. The ASU also improves the comparability between revenue contracts acquired in a business combination and those originated by an acquirer.

This publication addresses key accounting and financial reporting implications of the new guidance and provides examples to help entities apply it.

## Key considerations

### Scope

ASU 2021-08 applies to all contract assets and contract liabilities in a business combination that result from (1) contracts with customers accounted for under ASC 606 and (2) other contracts to which the provisions of ASC 606 apply.

The FASB said in the Background Information and Basis for Conclusions that the guidance does not apply to contract-based intangible assets and liabilities, deferred costs under ASC 340-40,<sup>5</sup> or other assets and liabilities that may be recognized under ASC 606. That is because the Board believed that the scope of the ASU as issued addresses the objective of providing consistency in revenue for acquired revenue contracts between the pre- and post-acquisition periods.<sup>6</sup>

The out-of-scope components continue to be accounted for at fair value at the acquisition date unless another recognition and measurement exception applies. Entities will need to consider any possible effects of the measurement exception for contract assets and liabilities on their fair value measurement of other intangible assets (e.g., cash flows for which a contract asset is not recognized in accordance with ASC 606 at the acquisition date will likely be captured in the fair value measurement of another intangible asset).

Scope includes:	Scope excludes:
<ul style="list-style-type: none"> <li>▶ Contract assets as defined by ASC 606</li> <li>▶ Contract liabilities as defined by ASC 606</li> <li>▶ Contract assets and liabilities that arise from other contracts to which the provisions of ASC 606 apply (e.g., contract liabilities that arise from the sale of nonfinancial assets that are in scope of ASC 610-20<sup>7,8</sup> and contract liabilities that may arise from certain collaborative arrangements that are in the scope of ASC 808<sup>9,10</sup>)</li> </ul>	<ul style="list-style-type: none"> <li>▶ Receivables under ASC 310<sup>11</sup> and ASC 326-20<sup>12</sup></li> <li>▶ Contract-based intangible assets and liabilities, such as customer relationships and contracts with off-market terms<sup>13</sup></li> <li>▶ Deferred costs under ASC 340-40</li> <li>▶ Other assets and liabilities that may be recognized under ASC 606, such as refund liabilities and upfront payments to customers</li> </ul>

### Components of acquired revenue contracts

An acquired contract with a customer may consist of the following components (which also represent the elements of value):

- ▶ An asset (e.g., a receivable or contract asset under ASC 606) for the target's right to consideration for transferring a promised good or service to a customer before the business combination
- ▶ A liability (e.g., a contract liability under ASC 606) for a target's obligation to transfer goods or services to a customer for which the target has received consideration (or an amount of consideration is due) from the customer before the business combination
- ▶ A customer relationship intangible asset
- ▶ An intangible asset for the inherent or in-place value of the contract (i.e., the price a market participant is willing to pay for an at-market contract, often referred to in practice as contract backlog)
- ▶ An intangible asset or liability to the extent that the terms of the contract are not "at market" at the acquisition date (generally referred to as the off-market component)

### Contract assets

When an entity transfers a promised good or service to a customer, it has earned a right to consideration from the customer and, therefore, has an asset. This asset may represent a conditional or unconditional right to consideration.

If an entity must transfer other goods or services in the contract before it is entitled to payment from the customer, the right is conditional and presented as a contract asset. In contrast, if nothing other than the passage of time is required before payment of consideration is due, the right to consideration is unconditional. An entity that has an unconditional right to receive consideration from the customer accounts for it as a receivable and presents it separately from its contract assets. Refer to section 10 of our Financial reporting developments (FRD) publication, [\*Revenue from contracts with customers \(ASC 606\)\*](#), for more guidance on distinguishing between a contract asset and a receivable.

Upon adoption of the ASU, an acquired contract asset is measured in accordance with ASC 606 at the acquisition date. When the contract consideration is fixed, the amount an acquirer recognizes as a contract asset at the acquisition date is more likely to approximate the amount it would recognize at fair value under ASC 805 before adoption of the ASU.

However, when the contract consideration is variable and has been constrained or the sales- and usage-based exception for licenses of intellectual property is applied, the amount an acquirer recognizes as a contract asset at the acquisition date is generally lower than the amount it would recognize at fair value under ASC 805 before adoption of the ASU. This results in an acquirer recognizing more revenue post-acquisition than it would before it adopted the ASU. Consider the following example:

#### **Illustration 1 – Sales-based royalty exception**

Target enters into a 15-year arrangement with a customer for a perpetual, exclusive license to commercialize a compound on 1 January 20X2. This compound is approved by the Food and Drug Administration (FDA). The license requires the customer to pay a sales-based royalty of 5% of its gross sales associated with the compound. The contract does not contain any additional performance obligations. Target transfers the compound to the customer on 1 January 20X2.

The customer's estimated gross sales associated with the compound are \$200 million a year. Target applies the sales-based royalty exception and recognizes revenue when sales occur.

Acquirer purchases Target, which is a business, on 2 January 20X2.

#### **Analysis**

Acquirer does not recognize a contract asset on the acquisition date because it continues to apply the sales-based royalty exception. Acquirer recognizes revenue when the customer's sales occur. The cash flows from the estimated sales associated with the compound are included in the measurement of the acquired intangible asset. Acquirer estimates the fair value of the cash flows associated with the remaining royalties to be \$150 million and recognizes an intangible asset in that amount. Acquirer subsequently amortizes the intangible asset on a straight-line basis over the useful life of the asset, unless the pattern in which the asset is consumed can be reliably determined.<sup>14</sup>

#### **How we see it**

The requirement to measure acquired contract assets in accordance with ASC 606 may not affect the amount of goodwill recognized in a business combination. That is because the acquirer continues 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 intangible assets recognized in the business combination.

#### **Contract liabilities**

A target may have recognized a liability in its preacquisition financial statements for a future obligation to transfer goods or services to a customer for which it has received consideration (or the amount is due) from the customer. For example, a liability could represent upfront payments for goods and services that have yet to be delivered.

The acquirer recognizes a contract liability (e.g., deferred revenue) related to the performance obligations, as defined under ASC 606, that it assumes if the target has received consideration (or the amount is due) from the customer.

When applying the definition of a performance obligation under ASC 606 as of the acquisition date, the acquirer identifies the remaining promised goods and services in a contract with a customer and evaluates whether the goods and services it must provide to a customer in the future are an assumed performance obligation for which the target has received consideration

The requirement to measure acquired contract assets in accordance with ASC 606 may not affect the amount of goodwill recognized in a business combination.

(or for which the customer is required to remit consideration). A promised good or service is a performance obligation if it is both capable of being distinct and is distinct in the context of the contract. A performance obligation may be created based on a customer's reasonable expectations and may include promises that are implied by an entity's customary business practices or industry norms. See chapter 4 of our FRD, [\*Revenue from contracts with customers \(ASC 606\)\*](#), for additional guidance on identifying performance obligations in a contract with a customer.

Remaining performance obligations as of the acquisition date are measured by applying ASC 606. Measuring a contract liability under ASC 606 will likely result in the recognition of an amount higher than what would have been recognized using a fair value measurement. A primary reason for this difference is that the fair value measurement of a contract liability is often based on the remaining costs to be incurred by the combined company to satisfy the remaining performance obligations in the arrangement plus a reasonable profit margin. The fair value measurement excludes any profit that would otherwise be included in the transaction price related to the target's selling effort.

Any contract liability recognized at the acquisition date is derecognized as the combined company performs and satisfies the remaining performance obligation(s). Higher contract liability amounts recognized at the acquisition date result in increased revenue in the post-combination period(s).

The following example illustrates how an acquirer recognizes and measures a contract liability in a software arrangement after adoption.

#### **Illustration 2 – Contract liability acquired – PCS**

Target enters into a two-year arrangement on 1 January 20X2 to provide a term-based software license and two years of post-contract customer support (PCS) to a customer in exchange for an upfront fee of \$300,000. Target has determined that the contract contains two performance obligations: (1) the software license and (2) the PCS. Based on the standalone selling prices (SSP), Target allocates \$240,000 (80%) of the total transaction price to the license and \$60,000 (20%) to the PCS.

Target recognizes \$240,000 in revenue on 1 January 20X2 related to the software license. Target determines that time elapsed is an appropriate measure of progress and recognizes \$60,000 in revenue from PCS ratably over the two-year contract period.

Acquirer purchases Target, which meets the definition of a business, on 1 January 20X3. Acquirer and Target use the same method for estimating SSP.

#### **Analysis**

After the Acquirer performs an assessment of the Target's ASC 606 accounting (discussed below), Acquirer recognizes a contract liability of \$30,000 ( $\$60,000/\text{two-year contract period}$ ) related to the partially satisfied performance obligation for the PCS on the acquisition date. Revenue related to the PCS is recognized ratably over the remaining contractual term of one year. A contract liability related to the term-based software license is not recognized because that performance obligation was satisfied before the acquisition. Any customer-related intangible asset would be recognized at fair value in accordance with ASC 805 and amortized over the useful life of the asset.

The following example illustrates how an acquirer recognizes and measures a contract liability related to symbolic intellectual property (IP) after adoption of ASU 2021-08.

### Illustration 3 – Contract liability acquired – symbolic IP

Target enters into a 20-year arrangement with a customer to market and sell consumer packaged goods using the Target's brand on 1 January 20X2. The license arrangement requires the customer to pay an upfront fee of \$10 million on 1 January 20X2.

The license to use the Target's brand represents symbolic IP because it does not have significant standalone functionality since its utility is derived from the Target's ongoing or past support (e.g., activities that support the value of a brand name). Target determines that time elapsed is an appropriate measure of progress, and therefore, the initial upfront payment is recognized ratably under ASC 606 as the Target satisfies the performance obligation over the 20-year term.

Acquirer purchases Target, which is a business, on 1 January 20X5.

#### Analysis

While the Target may have no legal obligation other than to allow for the continued use of its brand over the license term, the Acquirer records a contract liability of \$8.5 million based on the remaining performance obligation at acquisition date as if it had originated the license arrangement. Acquirer recognizes revenue related to the symbolic IP ratably over the remaining contractual term of 17 years. There are no future cash flows associated with the license arrangement, and the contract liability recorded will result in more goodwill being recognized in the business combination than would have been recognized before adoption of the new guidance. This is because a substantially smaller contract liability would have been recognized using a fair value measurement given the lack of future cash outflows associated with the contract.

Under the guidance, an increase in contract liabilities will result in a higher amount of goodwill recognized in a business combination.

### How we see it

The guidance eliminates the complexity of determining the fair value of contract liabilities and may result in higher balances for contract liabilities acquired in a business combination. The FASB acknowledged that an increase in contract liabilities under the guidance will result in a higher amount of goodwill recognized in a business combination.

While the amendments may also result in more post-combination revenue being recognized by the acquirer, the amount should generally be consistent with the amount the target would have recognized if it hadn't been acquired. During the FASB'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.

### Acquirer's assessment of the target's ASC 606 accounting

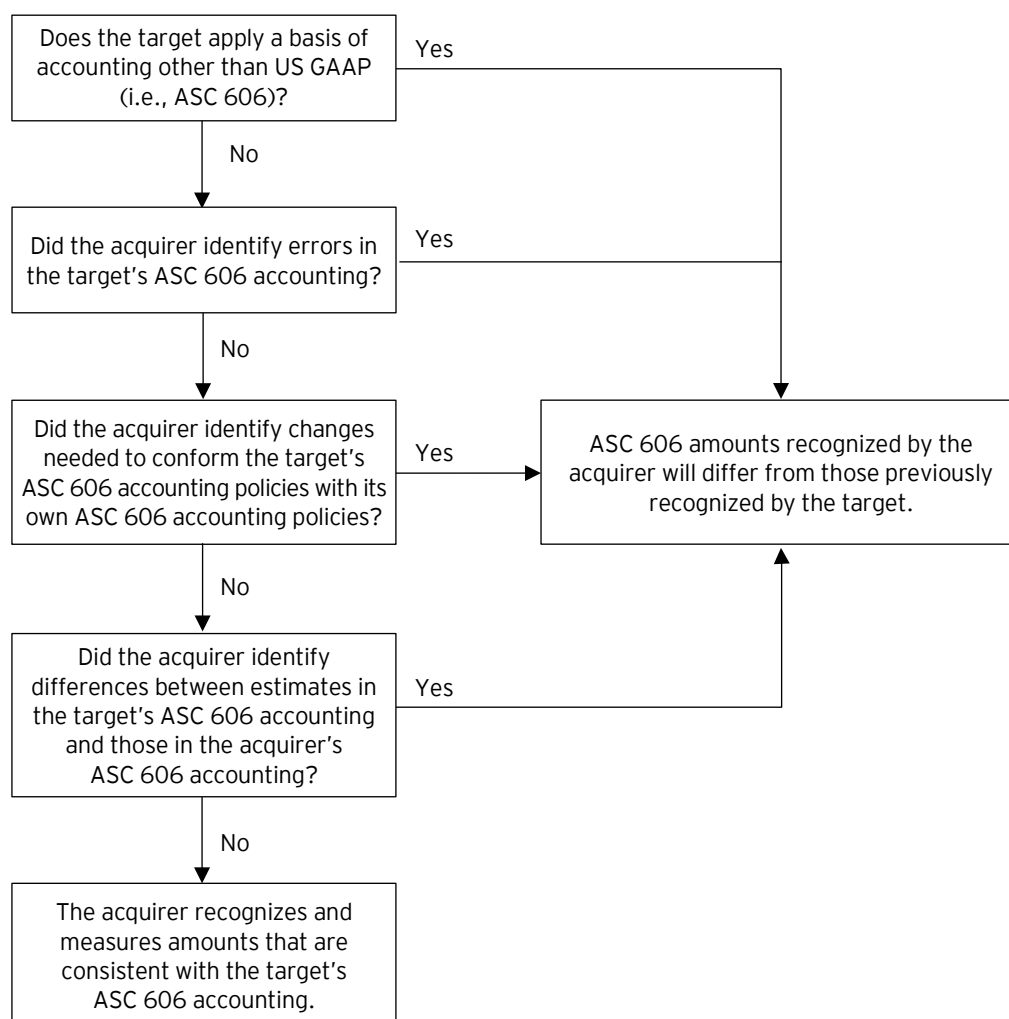
While the new guidance requires that an acquirer account for the acquired contract under ASC 606 as if it had originated the acquired contract, the FASB said in the Basis for Conclusions in the ASU that the "acquirer would assess the acquiree's accounting" under ASC 606. If, based on this assessment, an acquirer determines that the target's ASC 606 accounting is well documented and supported, it may recognize the acquired contract assets and contract liabilities in the business combination at amounts that are consistent with those reported by the target

immediately before the acquisition date (i.e., it carries over the target's accounting related to those revenue contracts). For purposes of this publication, "carry over" means the acquirer recognizes and measures amounts that are consistent with the target's ASC 606 accounting.

While the acquirer may carry over the target's ASC 606 accounting, the acquirer is ultimately responsible for the contract asset and liability amounts reported under ASC 606 in connection with the business combination.

The Board also acknowledged that there may be circumstances in which the acquirer cannot carry over the target's ASC 606 accounting. The flowchart below provides a roadmap for entities to follow as they determine whether they are able to recognize and measure the acquired contract assets and liabilities that are consistent with the target's ASC 606 accounting.

### Assessment



Making this assessment will require judgment and will likely require changes to an acquirer's business combination processes. These changes include additional or revised internal controls to execute the assessment of the target's ASC 606 accounting and may also include additional or revised internal controls to address the risks of material misstatement related to the recognition and measurement of contract assets and contract liabilities as of the acquisition date. The nature, extent and precision of the additional or expanded controls will depend on the acquirer's evaluation of risks related to both the performance of the assessment and the ASC 606 accounting for the acquired contract assets and liabilities.

Considerations for the acquirer in performing the assessment of the target's ASC 606 accounting may include:

- ▶ Financial reporting framework of the target (e.g., US GAAP, IFRS, local statutory framework)
- ▶ How the target applied ASC 606 to the acquired contracts (e.g., the target's accounting policies and how those policies were applied to the in-process acquired revenue contracts)
- ▶ The nature of the target's revenue contracts (e.g., long-term contracts, including variable consideration and the application of the constraint)

Understanding the target's internal control over financial reporting may help an acquirer determine the nature and extent of both the processes it needs to have in place for the assessment and the procedures it needs to perform in the assessment. An acquirer that determines, based on its assessment, that it cannot carry over the target's ASC 606 accounting for some or all of the target's contracts with customers must reevaluate the target's ASC 606 accounting at the acquisition date. This will require the acquirer to have the appropriate processes and procedures to implement ASC 606 accounting as of the acquisition date as if the acquirer was applying ASC 606 to the acquired contracts as of contract inception.

The acquirer will also have to retain reasonable support for its internal control assessment, when applicable, and documentation of the design of the controls is an integral part of reasonable support. Generally, we would expect management's support and documentation to be more robust as the assessed risk of material misstatement increases.

### How we see it

Acquirers will need to carefully assess the target's ASC 606 accounting to determine whether it can carry over the target's ASC 606 accounting. This will impact the acquirer's processes and procedures related to business combinations.

### *Reevaluating target estimates*

ASC 606 provides guidance about judgments and estimates that an entity must make when accounting for revenue contracts with customers. ASC 606 requires an entity to make certain of those judgments and estimates at the contract inception date, such as identifying performance obligations and estimating SSP. Other estimates must be made on a recurring basis, such as estimates of variable consideration and an entity's measure of progress toward satisfying its performance obligations.

When the acquirer determines that it cannot carry over a target's ASC 606 accounting because of differences in estimates, the acquirer will reevaluate one or more of a target's estimates, including those determined at contract inception and those updated on a recurring basis. The acquirer could elect one or both of the available practical expedients discussed later in this publication.

An acquirer that determines it cannot carry over the target's ASC 606 accounting for some or all of the target's contracts with customers must reevaluate the target's ASC 606 accounting at the acquisition date.



The following example illustrates a difference between the target and the acquirer's estimation of SSP for a contract.

#### **Illustration 4 – Difference in measuring SSP estimates**

Target enters into a two-year arrangement on 1 January 20X2 to provide a perpetual software license and two years of PCS to a customer in exchange for an upfront fee of \$300,000. Target has determined that the contract contains two performance obligations: (1) the software license and (2) the PCS. Based on the SSP, Target allocates \$240,000 (80%) of the total transaction price to the license and \$60,000 (20%) to the PCS.

Target recognizes \$240,000 in revenue on 1 January 20X2 related to the software license. Target determines that time elapsed is an appropriate measure of progress and recognizes \$60,000 in revenue from PCS ratably over the two-year contract period.

Acquirer purchases Target, which meets the definition of a business, on 1 January 20X3. Acquirer and Target use different acceptable methods to estimate SSP. Acquirer assesses the Target's ASC 606 accounting and determines that the Acquirer's estimation of SSP is more reasonable because it believes certain observable inputs should be weighted differently. Instead of allocating 80% (\$240,000) of the total transaction price to the license and 20% (\$60,000) to the PCS, Acquirer allocates 70% (\$210,000) of the transaction price to the license and the remaining 30% (\$90,000) to PCS.

#### **Analysis**

Acquirer recognizes a contract liability of \$45,000 (\$90,000/two-year contract period) on the acquisition date. The \$30,000 decrease to the transaction price allocated to the software license would not be recognized at the acquisition date because that performance obligation was satisfied before the acquisition. Revenue related to the PCS is recognized ratably over the remaining contractual term of one year. Any customer-related intangible asset is recognized at fair value in accordance with ASC 805 and amortized over the useful life of the asset.

The following example illustrates when the estimated revenue from the acquired revenue contract is updated on a recurring basis by both the target before acquisition and the acquirer after acquisition.

#### **Illustration 5 – Target acquired with trailing commissions**

Target, an insurance broker, executes a contract with Company A, a health insurance provider, on 1 January 20X0. Target receives an initial fee of \$100 when a consumer buys an insurance policy from Company A. In addition, Target receives "trailing commissions" from Company A of \$50 whenever one of those consumers renews a policy.

Target has a large pool of historical data about consumer renewal patterns, given its significant experience with similar contracts. Target noted that the amount of consideration is highly susceptible to factors outside its influence, and the uncertainty could stretch out over multiple years. However, it also has significant experience with similar types of contracts, and its experience has predictive value.

Even though most of the consideration Target will be entitled to is uncertain and depends on the actions of third parties (i.e., whether consumers renew), Target determined it can estimate a minimum amount of variable consideration for which it is probable that a significant reversal of cumulative revenue will not occur. Assuming that the Target's performance was complete for brokering the health insurance policy upon a consumer's initial signing of the policy on 1 January 20X0, Target recognized the initial \$100 fee that was received from Company A plus \$150 (the minimum amount related to future renewals that is not constrained).

Acquirer acquires Target, which is a business, on 2 January 20X0.

### Analysis

Target recognized an estimated amount of revenue (\$250) upon the execution of the consumer's health insurance policy with Company A that includes the amount it expects to be entitled to receive for renewals of that policy. Before the acquisition date, Target received the initial fee of \$100 but none of the "trailing commissions" of \$150 from Company A. Accordingly, Target had a \$150 contract asset recorded immediately before the acquisition date.

At the acquisition date, Acquirer assesses the Target's ASC 606 accounting for the contract with Company A as if it originated the contract. Acquirer considers (1) the expected revenue of \$250 recognized by Target from contract inception through the acquisition date and (2) its best estimate of expected revenue based on its experience with similar types of contracts. Acquirer determines that the total expected revenue of \$250 is consistent with what it would have recorded if it had originated the contract. Acquirer determines it can carry over Target's accounting and recognizes a contract asset in the amount of \$150, consistent with Target.

At each future reporting period, Acquirer will reassess its estimate of expected revenue from future policy renewals in accordance with ASC 606, including the variable consideration constraint. It will recognize increases or decreases to revenue from any changes to the estimate of policy renewals. In addition, Acquirer will recognize amortization expense related to the customer-related intangible asset that was recorded at the acquisition date.

### How we see it

An acquirer may determine that it cannot carry over the target's ASC 606 accounting based on differences between estimates of the target and acquirer. Determining under which circumstances an acquirer cannot carry over the target's accounting based on differences in estimates will require significant judgment. The acquirer's assessment of the target's accounting will need to consider the reasonableness of prior estimates made by the target. Differences in estimation between the acquirer and target may occur more often in circumstances where the acquirer has significant experience in the target's industry and the acquired contracts require more estimation (e.g., long-term, significant variable consideration).

### ***Accounting for contracts with customers in a business combination that have performance obligations that are satisfied over time***

Revenue for some contracts may be recognized over time as the entity transfers control of the promised goods or services to the customer. ASC 606 requires the use of measures of progress that focus solely on the entity's performance in transferring control of the goods or services. When a performance obligation is satisfied over time, two types of methods can be used to measure progress under the contract: an input method and an output method. An entity should select a single measure of progress for each performance obligation that depicts the entity's performance in transferring control of goods or services promised to a customer.

Before adoption of the ASU, acquired contracts with performance obligations satisfied over time are recognized at fair value based on the amount of effort remaining for the combined company to satisfy the remaining performance obligations. This results in a reset of the measure of progress as of the acquisition date, and the arrangement is effectively considered to be a new contract for the remaining performance obligations as of the acquisition date.

After adoption of the ASU, an acquirer should measure progress toward completion as if it originated the contract. The measure of progress as of the acquisition date should include effort expended by the target before the acquisition. For example, an acquirer would use the actual costs the target incurred before the acquisition date plus the estimate of costs it will incur to complete the remaining work required under the contract to measure progress toward completion as of the acquisition date. Any difference in the measure of progress will be reflected as an adjustment to the contract asset or liability balance under purchase accounting.

In the post-combination period, the acquirer would continue to update the measure of progress for the acquired contract under ASC 606. We believe the acquirer would use the measure of progress established in the business combination updated for any post-combination effort expended on that contract and adjusted for any changes in the estimate of costs to complete under ASC 606.

The following example illustrates an entity's considerations when acquiring a long-term construction contract in a business combination after adoption of the ASU.

#### **Illustration 6 – Acquisition of long-term construction contract**

Target enters into a contract with a municipality to construct a tunnel on 1 January 20X1 for total consideration of \$1,000,000. The construction is expected to take five years to complete and is considered a single performance obligation satisfied over time. Target determines that the contract does not include a significant financing component, and the municipality pays for the contract as certain milestones are achieved. Target uses an input method to determine the measure of progress based on costs incurred compared with total estimated costs to complete construction of the tunnel.

Acquirer acquires Target, which is a business, on 1 January 20X3. Target estimates the contract to be 40% complete at the acquisition date based on the input-method measure of progress (total cost incurred as of 1 January 20X3 by Target of \$320,000 over total estimated cost to complete of \$800,000). Target recognizes \$400,000 (40% x \$1,000,000) in revenue and received \$200,000 in payments from the municipality as of the acquisition date.

Target recognizes a contract asset of \$200,000 (\$400,000 - \$200,000) at the acquisition date (and not a receivable) since all future payments to Target are conditioned upon achieving a future milestone in the project. Target determined it was appropriate to include the \$200,000 estimate of variable consideration associated with the milestone payment in the transaction price (i.e., the variable consideration was not constrained).

#### **Analysis**

Acquirer determines that its estimate of the costs to complete the construction of the tunnel is \$700,000 (\$320,000 of costs incurred through 1 January 20X3 and Acquirer's estimate of \$380,000 to complete the tunnel), which is lower than Target's total estimated cost to complete. Acquirer has a more favorable cost structure than Target due to Acquirer's purchasing power. Acquirer estimates that the construction of the tunnel is 46% complete as of 1 January 20X3.

Acquirer recognizes a contract asset of \$260,000 (46% x \$1,000,000, less \$200,000 in payments received as of the acquisition date) at the acquisition date. This is \$60,000 greater than the contract asset previously recognized by Target and will result in \$60,000 less revenue in the post-combination period.

For a performance obligation satisfied over time, an acquirer should measure progress toward completion as if it originated the contract.

Also, any contract-related intangible asset or liability recognized at the acquisition date relating to the off-market or contract backlog components is amortized over the remaining term of the contract. Any customer relationship intangible asset is amortized separately over its remaining useful life. As previously stated, these components are not in the scope of ASU 2021-08 and continue to be recognized at fair value.

### **Out-of-scope components**

The components of acquired revenue contracts discussed below are examples of components not in the scope of the ASU.

#### ***Refund liabilities***

A target may have received consideration that it will need to refund to the customer in the future because the consideration is not an amount to which the target will ultimately be entitled to under the contract. A refund liability generally does not represent an obligation to transfer goods or services in the future. We believe that a refund liability does not typically meet the definition of a contract liability.

When an acquirer concludes that a refund liability is not a contract liability, it recognizes the acquired refund liability as of the acquisition date at fair value in accordance with the principles of ASC 820.

#### ***Costs incurred by a target to obtain a contract with a customer***

A target may have recognized an asset in its preacquisition financial statements for the incremental costs it incurred (and expects to recover) to obtain a contract with a customer in accordance with ASC 340-40 (e.g., capitalized sales commissions). Because the acquirer has not obtained a probable future economic benefit, we do not believe these costs qualify for separate asset recognition by the acquirer in a business combination. The cash flows that the acquirer expects to receive in the future to recover these costs may affect the valuation of other assets recognized as part of the related acquired customer contract (e.g., a customer-related intangible asset or contract backlog asset).

#### ***Contract-based intangible assets and liabilities***

Under ASC 805, intangible assets acquired in a business combination in connection with the acquisition of contracts with customers are required to be measured at fair value.

Economically, the recognition and fair value measurement of an intangible asset represent the benefit that the acquirer is expected to realize by acquiring an already existing intangible asset as compared to creating the intangible asset organically. This “make” versus “buy” decision affects the price that buyers and sellers would pay to acquire a business that includes this intangible asset.

The intangible components of value of an acquired contract with a customer are commonly measured as follows:

- ▶ Customer relationship intangible asset – measured as the expected present value of future cash flows available from future contracts with that customer
- ▶ Contract backlog intangible asset – measured as the value derived under the income approach based on the present value of expected future cash flows available from the existing contract, net of cash flows associated with contract assets and receivables
- ▶ Off-market component intangible asset (or liability) – measured as the present value of the amount by which the current contract terms deviate from what a market participant could achieve on the acquisition date

An important aspect of valuing an acquired contract with a customer is to verify that all components of value have been considered (that is, none of the components of value have been omitted or double counted) and appropriately reflected in the measurement.

#### ***Upfront payments to customers***

A target may have made an upfront payment to a customer in anticipation of future purchases. At the time of payment, the target accounts for the consideration paid or payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the target.<sup>15</sup> When payments to customers are not in exchange for a distinct good or service and the target expects to generate future revenue associated with the payment, a target generally defers the upfront payment by recognizing an asset, separate from any contract asset or contract liability recorded, and reducing revenue as the related goods or services (or as expected related goods or services) are transferred to the customer.

In an acquisition, an acquirer would not continue to recognize a separate asset under ASC 606 for the upfront payment to the customer. However, the acquirer should carefully consider the facts and circumstances associated with the upfront payment when determining the fair value of the customer-related intangible asset, including whether the upfront payment results in an off-market component of the contract. After the acquisition date, the acquirer may recognize the amortization expense for the intangible asset as a reduction in revenue or as additional cost of goods sold, depending on the nature of the asset.

#### **Other considerations**

##### ***Significant financing component***

For some transactions, the timing of the receipt of consideration does not match that of the transfer of goods or services to the customer (e.g., the consideration is prepaid or is paid after the services are provided). When the customer pays in arrears, the entity is effectively providing financing to the customer. Conversely, when the customer pays in advance, the entity has effectively received financing from the customer.

The Board explained in the Basis for Conclusions of ASU 2014-09 that, conceptually, a contract that includes a financing component includes two transactions – one for the sale of goods and/or services and one for the financing. Accordingly, the Board decided to require entities to adjust the amount of promised consideration for the effects of financing only if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing.<sup>16</sup>

When an entity acquires a contract that includes a significant financing component, after adoption of the ASU, the post-combination revenue and interest related to the significant financing component that are recognized by the combined company should be the same as those that would have been recognized by the target if the business combination had not occurred.<sup>17</sup>

##### ***Measurement period***

Contract assets and contract liabilities acquired in a business combination will be subject to the measurement period provided in ASC 805. If the measurement period for an acquisition is open, the entity may report provisional amounts for contract assets and contract liabilities acquired in a business combination as of its financial reporting date. The acquirer discloses that the amounts recognized are provisional and discloses the information that the acquirer has arranged to obtain but has not yet received. In this case, the acquirer may be waiting for appropriate support to assess the target's ASC 606 accounting before it can say that the measurement period is complete for the contract assets and contract liabilities acquired.

If the acquirer records any adjustments to provisional amounts recognized, it must perform a careful evaluation of those amounts to determine whether the potential adjustment is the result of information that existed as of the acquisition date or whether the potential adjustment is the result of events occurring after the acquisition date.

### How we see it

Significant judgment will be required when evaluating whether the measurement period is open for acquired revenue contracts. Even though the measurement period is available for the recognition and measurement of acquired contract assets and liabilities in a business combination, an acquirer is required to apply ASC 606 to those acquired revenue contracts during the post-combination period.

It will be important for an acquirer to understand the items that it has not yet obtained for purposes of its acquisition date recognition and measurement and how those items relate to its ongoing revenue recognition. For example, the acquirer may be required to obtain certain information about acquired contracts to continue applying ASC 606 during the post-combination period (e.g., total costs incurred as of the end of the reporting period) that may also provide resolution to certain information necessary to identify and measure contract assets and liabilities as of the acquisition date.

All entities can apply the practical expedients to acquired revenue contracts in a business combination.

### IFRS

While the ASU allows entities reporting under US GAAP to apply the recognition and measurement concepts under ASC 606 to acquired revenue contracts, IFRS 3<sup>18</sup> has not been similarly amended and requires entities to recognize and measure those revenue contracts at fair value on the acquisition date. This difference may cause additional accounting complexities for entities that report under both US GAAP and IFRS or are contemplating cross-border transactions.

For example, if an IFRS-reporting foreign subsidiary of a US entity acquires a business, the subsidiary would measure contract assets and liabilities for acquired revenue contracts at fair value in accordance with IFRS 3 for its statutory financial statements while the US entity would separately measure those contract assets and liabilities in accordance with ASC 606 in its consolidated financial statements.

### Practical expedients

The ASU provides two practical expedients for acquirers, and all entities can apply them.

The first practical expedient relates to contracts that were modified<sup>19</sup> before the acquisition. It allows the acquirer to reflect the aggregate effect of all modifications that occurred before the acquisition date, as of the acquisition date, when:

- ▶ Identifying the satisfied and unsatisfied performance obligations
- ▶ Determining the transaction price
- ▶ Allocating the transaction price to the satisfied and unsatisfied performance obligations

This expedient is similar to a practical expedient that the FASB previously provided for entities to ease the transition to ASC 606.

Consider the illustration below.

**Illustration 7 – Contract modification practical expedient**

Target enters into a contract with a customer to sell equipment for \$1 million and provide services for 10 years for \$20,000 annually. The equipment is delivered on 1 January 20X0, and the service contract commences at that time. The equipment and the service contract are separate performance obligations.

The contract is modified several times between contract inception and 20X5. The modifications extended the contract by 10 years and provided an additional piece of equipment for \$1 million. The additional equipment will be delivered in 20X7 and is a separate performance obligation.

Acquirer acquires Target on 1 January 20X6. Acquirer elects to apply the practical expedient on contracts that were modified before the acquisition.

Acquirer's total transaction price for the acquired modified contract at the acquisition date is \$2,400,000 [\$1 million (equipment) + \$1 million (equipment) + (20 years x \$20,000 (service))], which is the cumulative effect of all the contract modifications that occurred between contract inception and the acquisition date. The total transaction price is allocated to the two products and the service contracts based on the SSP of each performance obligation at the acquisition date.

The transaction price allocated to the second piece of equipment and the remaining unperformed services would be recognized when or as they are transferred to the customer.

The second practical expedient relates to the determination of SSP. ASC 606 allows for any reasonable estimation approach as long as it is consistent with the notion of an SSP, maximizes the use of observable inputs and is applied on a consistent basis for similar goods and services and customers. SSP is determined at contract inception under ASC 606, but the practical expedient allows the acquirer to determine SSP at the acquisition date instead of at contract inception.

An acquirer that elects to use this practical expedient as of the acquisition date should consider the guidance in ASC 606 for determining SSP as of the date of acquisition. This would include having the appropriate processes and procedures over the determination of the SSP estimates that are used in the acquirer's ASC 606 accounting for the acquired contracts. See section 6.1 of our FRD, *Revenue from contracts with customers (ASC 606)*, for a discussion on determining SSP.

Any entity can elect to apply the practical expedients on an acquisition-by-acquisition basis. If elected, the expedients must be applied consistently to all acquired contracts with customers in each acquisition.

**How we see it**

We believe the acquirer's implementation of ASC 606 for the acquired contracts will likely be similar to an initial adoption of ASC 606 in instances where the acquirer cannot carry over all of the target's accounting. The expedients provide relief in situations where the acquirer does not have appropriate data to evaluate the historical periods since contract inception. The Board has said that it does not expect the use of the practical expedients to be widespread.

## Disclosure considerations

The ASU does not require additional general or transition disclosures. The FASB determined that the disclosures required under ASC 805 and ASC 606 provide sufficient information for users of financial statements.<sup>20</sup> However, if the acquirer decides to elect a practical expedient in ASC 805-20-30-29, the acquirer should disclose:

- The expedients that have been used
- A qualitative assessment of the estimated effect of applying each of the expedients, to the extent reasonably possible<sup>21</sup>

## Effective date and transition

The ASU is effective for fiscal years beginning after 15 December 2022, and interim periods therein for public business entities (PBEs). For all other entities, it is effective for fiscal years beginning after 15 December 2023, and interim periods therein.

Early adoption is permitted for all entities, including adoption in an interim period. PBEs can early adopt the amendments for periods for which financial statements have not yet been issued, and all other entities can early adopt the amendments for periods for which the financial statements have not yet been made available for issuance. Further, early adoption is permitted in any interim period regardless of whether a business combination occurs in that period.

The guidance is applied prospectively. However, an entity that elects to early adopt must apply the amendments to all business combinations that occurred during the fiscal year that includes that interim period.

Further, an entity that early adopts the guidance cannot change the accounting for acquisitions that occurred in a prior annual period for which financial statements have already been issued.

An entity must apply the guidance to all acquisitions in its fiscal year of adoption, even those for which the measurement period closed before it adopted the guidance. For example, if an acquirer completed an acquisition earlier in its fiscal year of adoption and measured the contract assets and contract liabilities acquired at fair value, it must revise and remeasure the contract assets and contract liabilities retrospectively as of the acquisition date in accordance with ASC 606.

In addition, the acquirer needs to consider the effect on post-combination revenue. If it recognized revenue based on the fair value of the contract assets and contract liabilities before adopting the ASU, it has to adjust the revenue previously recognized to reflect the amount of revenue that should have been recognized if the contract assets and contract liabilities were recognized under ASC 606 as of the acquisition date.

Consider the illustration below.

### Illustration 8 – Early adoption of ASU 2021-08

Company A elects to early adopt the ASU in the fourth quarter of fiscal year 20X1. Company A acquired Company B in the fourth quarter of fiscal year 20X0, Company C in the first quarter of fiscal year 20X1, and Company D in the fourth quarter of fiscal year 20X1.

After adoption of the ASU:

- Any contract assets and contract liabilities acquired in the acquisition of Company B continue to be recognized at fair value at the acquisition date. Because this acquisition occurred in the fourth quarter of fiscal year 20X0 in the fiscal year before adoption of the ASU, the provisions of the ASU do not apply to this acquisition.

An entity must apply the guidance to all acquisitions in its fiscal year of adoption, even those for which the measurement period closed before it adopted the guidance.



- ▶ Any contract assets and contract liabilities acquired in the acquisition of Company C are recognized in accordance with ASC 606 as of the acquisition date. Before adopting the ASU, Company A reflected the acquired revenue contracts at fair value at the acquisition date in its first-, second- and third-quarter financial statements. However, because Company A adopted the ASU in fiscal year 20X1, it must remeasure the acquired revenue contracts in accordance with ASC 606 at the acquisition date, which may also impact goodwill and other assets and liabilities recognized in purchase accounting. Further, Company A adjusts the revenue previously recognized by determining the amount of revenue that should have been recognized if the contract assets and contract liabilities were recognized under ASC 606 as of the acquisition date. The remeasured amounts are reflected retrospectively when presenting comparative financial information in future periods.
- ▶ Any contract assets and contract liabilities acquired in the acquisition of Company D are recognized in accordance with ASC 606 as of the acquisition date. Company A acquired Company D in the same quarter that Company A adopted the ASU.

### Application of ASU 2021-08 to a target's prior business combinations

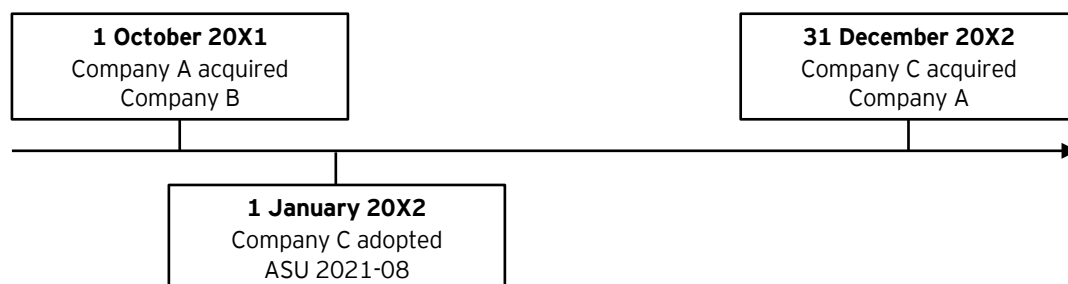
An acquirer may acquire a target that has previously acquired other businesses for which the target appropriately measured contract assets and liabilities at fair value before adoption of the ASU. In this situation, we believe the acquirer would recognize all acquired revenue contracts of the target in accordance with the ASU. That is, any contracts previously acquired by the target in a business combination that are still in process as of the acquisition date will be remeasured by the acquirer in accordance with ASC 606. In this circumstance, the acquirer would be unable to carry over the target's contract assets and liabilities related to those previously acquired contracts.

Consider the following example.

#### Illustration 9 – Revenue contracts acquired from Target's previous acquisition

Company A acquired Company B on 1 October 20X1 before adopting the ASU. Company A acquired contract assets and contract liabilities in the acquisition of Company B. Company A recorded the acquired contract assets and contract liabilities at fair value as of the acquisition date.

Company C adopted the ASU on 1 January 20X2 and subsequently acquired Company A on 31 December 20X2.



#### Analysis

Company C acquired contract assets and contract liabilities from Company A. Company A still had contract assets and contract liabilities acquired from Company B on its balance sheet as of 31 December 20X2. Company C measures all acquired contract assets and contract liabilities from Company A, inclusive of any remaining contract assets and liabilities from the Company B acquisition, in accordance with ASC 606, as if Company C had originated those acquired revenue contracts at the contract inception date.

## Endnotes:

- <sup>1</sup> ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*.
- <sup>2</sup> ASC 606, *Revenue from Contracts with Customers*.
- <sup>3</sup> ASC 805, *Business Combinations*.
- <sup>4</sup> ASC 820, *Fair Value Measurement*.
- <sup>5</sup> ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.
- <sup>6</sup> Basis for Conclusions (BC) 52 from ASU 2021-08.
- <sup>7</sup> ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*.
- <sup>8</sup> BC51 from ASU 2021-08.
- <sup>9</sup> ASC 808, *Collaborative Arrangements*.
- <sup>10</sup> We believe this also applies to instances where entities are in the scope of ASC 808 and apply ASC 606 by analogy.
- <sup>11</sup> ASC 310, *Receivables*.
- <sup>12</sup> ASC 326-20, *Financial Instruments – Credit Losses – Measured at Amortized Cost*.
- <sup>13</sup> BC38 from ASU 2021-08.
- <sup>14</sup> ASC 350-30-35-6.
- <sup>15</sup> ASC 606-10-32-25.
- <sup>16</sup> BC229 from ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*.
- <sup>17</sup> An acquirer may make other changes to contract assets and liabilities in instances where it does not carry over the target's accounting. Those changes could affect post-combination revenue and interest.
- <sup>18</sup> IFRS 3, *Business Combinations*.
- <sup>19</sup> Contract modifications may occur when parties to an arrangement agree to modify the scope or price (or both) of their contract. Once an entity determines that a contract has been modified, it needs to determine the appropriate accounting for the modification. Certain modifications are treated as separate standalone contracts, while others are combined with the original contract and accounted for in that manner. In addition, some modifications are accounted for on a prospective basis, and others are accounted for on a cumulative catch-up basis. Accordingly, an acquirer will also need to consider the effect of contract modifications when reevaluating prior estimates.
- <sup>20</sup> BC54 and BC55 from ASU 2021-08.
- <sup>21</sup> ASC 805-20-50-5.

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