

To the Point

FASB – final guidance

FASB issues guidance on accounting for revenue contracts acquired in a business combination

The new guidance addresses the recognition and measurement of contract assets and contract liabilities acquired in a business combination.

What you need to know

- ▶ The FASB issued final guidance that requires companies to apply ASC 606 to recognize and measure contract assets and contract liabilities from contracts with customers acquired in a business combination. This creates an exception to the general recognition and measurement principle in ASC 805.
- ▶ This generally will result in companies recognizing contract assets and contract liabilities at amounts consistent with those recorded by the acquiree immediately before the acquisition date.
- ▶ The guidance clarifies that companies should apply the definition of a performance obligation in ASC 606 when recognizing contract liabilities assumed in a business combination.
- ▶ For public business entities, the guidance is effective for fiscal years beginning after 15 December 2022 and interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after 15 December 2023 and interim periods within those fiscal years. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) issued **final amendments**¹ to Accounting Standards Codification (ASC) 805, *Business Combinations*, that create an exception to the general recognition and measurement principle for contract assets and contract liabilities from contracts with customers acquired in a business combination.

Under this exception, an acquirer applies ASC 606, *Revenue from Contracts with Customers*, to recognize and measure contract assets and contract liabilities on the acquisition date. 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.

The FASB issued the Accounting Standards Update (ASU) in response to questions from stakeholders about whether an acquirer should recognize a contract liability based on the remaining performance obligation under ASC 606² and how an acquirer should measure contract assets and liabilities. In particular, stakeholders had said 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.

Key considerations

The ASU applies to all contract assets and contract liabilities acquired in a business combination that result from contracts accounted for under the principles in ASC 606, including those in the scope of ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*. The ASU does not affect the accounting for customer or contract-related intangible assets recognized in a business combination. It also does not apply to other assets or liabilities that may be recognized under ASC 606, such as refund liabilities or up-front payments to customers, or costs incurred by an acquiree to obtain a contract with a customer in the scope of ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.

Initial accounting

Contract assets

An entity that acquires a contract in the scope of the ASU recognizes 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 on something other than the passage of time (e.g., future performance).

When future payments are fixed, the amount an acquirer recognizes as a contract asset measured under ASC 606 generally approximates the amount it would recognize at fair value under ASC 805 before adoption of the ASU. 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 ASU is generally lower than fair value.

How we see it

We generally don't expect the requirement to measure acquired contract assets in accordance with ASC 606 to affect the amount of goodwill recognized in the business combination. That is because the acquiring entity 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 customer-related intangible assets recognized in the business combination.

Contract liabilities

The ASU requires an entity that acquires a contract with a customer to 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.

The new guidance is intended to reduce diversity in practice. Some companies have been recognizing contract liabilities when they have a legal obligation to transfer goods and services under a revenue contract, while other companies have been recognizing them 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 will likely result in the acquirer in a business combination recording an amount that is higher than what it would have recognized using a fair value approach before adoption. That is 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 because a market participant is not expected to incur them to fulfill the remaining unsatisfied performance obligation.

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 of revenue recognized should be consistent with the amount the acquiree would have recognized if it hadn't been acquired.

The ASU aligns the business combination accounting with the subsequent accounting for contract assets and liabilities under ASC 606.

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 about diversity in practice resulting from the lack of additional measurement guidance 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.

The ASU aligns the business combination accounting with the subsequent accounting for contract assets and liabilities under ASC 606. The Board said this will improve the quality of financial information reported to users of financial statements and reduce the cost and complexity of accounting for acquired revenue arrangements after a business combination.

Other considerations

The Board said the amendments would generally result in an acquirer recognizing contract assets and contract liabilities in a business combination at amounts that are consistent with those reported by the acquiree immediately before the acquisition date. However, these amounts may differ when the acquirer cannot assess or rely on the acquiree's ASC 606 accounting, such as 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, (2) the acquiree does not follow US GAAP or (3) the acquirer determines that there was an error in the acquiree's pre-combination accounting under ASC 606.³

Practical expedients

The ASU provides two practical expedients for acquirers to use when they either aren't able to assess or rely on the acquiree's ASC 606 accounting or do not have the historical data or expertise to analyze that accounting. All entities can apply the expedients, which address (1) contracts that were modified before the acquisition and (2) the determination of the standalone selling price. If an entity elects any of the practical expedients, it applies them on an acquisition-by-acquisition basis and consistently applies them to all contracts with customers acquired in the business combination. The Board said it does not expect the use of practical expedients to be widespread. An entity must disclose any of the expedients it elects to apply and, if reasonably possible, a qualitative assessment of the estimated effect of applying the expedients.

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 available in any interim period regardless of whether a business combination occurs in that period.

The amendments should be applied prospectively; however, an entity that elects to early adopt in an interim period should apply the amendments to all business combinations that occurred during the fiscal year that includes that interim period.

How we see it

An entity that elects to early adopt the guidance is required to apply it to all acquisitions that occur during the fiscal year of adoption, even those for which the measurement period closed before the entity adopted the guidance. The contract assets and contract liabilities previously measured at fair value would be revised and measured as of the acquisition date in accordance with ASC 606. In addition, an entity will need to consider the effect on post-combination revenue for business combinations that occurred earlier in the year of adoption.

Endnotes:

- ¹ ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*.
- 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 Basis for Conclusions (BC) 31 and BC33 from ASU 2021-08.

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