FASB Emerging Issues Task Force

Issue No. 04-11

Title: Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor

Document: Issue Summary No. 1*

Date prepared: November 3, 2004

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Date previously discussed: None

Previously distributed EITF materials: None

References:

FASB Statement No. 141, *Business Combinations* (FAS 141)

FASB Statement No. 143, *Accounting for Asset Retirement Obligations* (FAS 143)

FASB Concepts Statement No. 6, Elements of Financial Statements (CON 6)

FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (CON 7)

AICPA Statement of Position 97-2, *Software Revenue Recognition* (SOP 97-2)

EITF Issue No. 02-17, "Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination" (Issue 02-17)

EITF Issue No. 01-3, "Accounting in a Business Combination for Deferred Revenue of an Acquiree" (Issue 01-3)

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* **The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.**

Background

1. FAS 141 requires that an acquiring enterprise allocate the cost of an entity acquired in a business combination to the individual assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. In some cases, the balance sheet of an acquired entity immediately before the acquisition date includes deferred revenue.

2. Issue 01-3 provides the following guidance:

> …the acquiring entity should recognize a liability related to the deferred revenue of an acquired entity only if that deferred revenue represents a legal obligation[1] assumed by the acquiring entity (a legal performance obligation).
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> The Task Force noted that a legal obligation to provide goods, services, the right to use an asset(s), or some other consideration to a customer(s) would be examples of a legal performance obligation assumed by the acquiring entity. The Task Force also noted that an acquired entity might have deferred recognition of revenue because it is (or may be) obligated to grant the customer future concessions, as would be the case under a general right of return under Statement 48 or a price protection provision. The Task Force noted that the acquiring entity should recognize a liability if it has assumed a legal obligation to provide such concessions.
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> The Task Force noted that there are circumstances in which the deferred revenue of an acquired entity does not represent a legal performance obligation and, therefore, should not be recognized by the acquiring entity as a liability when the business combination is recorded. Examples of such circumstances are included in Exhibit 01-3A (Examples 1-4). [Not included herein.]
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> The Task Force observed that in accordance with Statement 141, when the acquirer recognizes a legal performance obligation related to a revenue arrangement of an acquired entity, the amount assigned to that liability should be based on its fair value at the date of acquisition.
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> [1]The Task Force observed that a legal obligation could arise from contractual provisions or from consumer rights in the relevant legal jurisdiction.

3. As required by FAS 141 and Issue 01-3, the amount assigned to a legal obligation related to deferred revenue in a business combination should be based on its fair value at the date of acquisition. The fair value of deferred revenue in a business combination generally is not readily available and, accordingly, in practice, the fair value of an assumed liability (which must arise

from a legal performance obligation) related to deferred revenue is estimated based on the direct cost of fulfilling the obligation plus a normal profit margin thereon. Also, in practice, the normal profit margin is limited to the profit margin on the costs to provide the product or service (that is, the fulfillment effort). That profit margin excludes any profit associated with the selling effort because the acquiree completed the selling effort before the acquisition date. That approach is consistent with the guidance contained in paragraph 75 of CON 7, which states, in part:

> When using present value techniques to estimate the fair value of a liability, the objective is to estimate the value of the assets required currently to (a) settle the liability with the holder or (b) transfer the liability to an entity of comparable credit standing.

4. In the software industry, postcontract customer support (PCS) is an element that typically requires deferral of revenue in software licensing arrangements. The definition of PCS in the glossary to SOP 97-2, includes the following:

> The right to receive services (other than those separately accounted for as described in paragraphs 65 and 66 of this Statement of Position) or unspecified product upgrades/enhancements, or both, offered to users or resellers, after the software license period begins, or after another time as provided for by the PCS arrangement. Unspecified upgrades/enhancements are PCS only if they are offered on a when-and-if-available basis. PCS does not include the following:
>
> - Installation or other services directly related to the initial license of the software
> - Upgrade rights as defined in this Statement of Position
> - Rights to additional software products
>
> PCS may be included in the license fee or offered separately…
>
> The right to receive services and unspecified upgrades/enhancements provided under PCS is generally described by the PCS arrangement. Typical arrangements include services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades/enhancements developed by the vendor during the period in which the PCS is provided. PCS arrangements include patterns of providing services or unspecified upgrades/enhancements to users or resellers, although the arrangements may not be evidenced by a written contract signed by the vendor and the customer.

5. Issue Summary No. 1 (April 4, 2001) and Issue Summary No. 1, Supplement No. 1 (revised January 9, 2002) for Issue 01-3 included discussion of whether an acquiring entity should recognize a liability for a conditional performance obligation including "when-and-if-available upgrades" assumed in a business combination (Category 8 in the Issue Summary and Issue 3 in the Supplement); however, the final consensus in Issue 01-3 does not specifically address that question.[1] As a result, diversity in practice exists as to whether a customer's right to receive unspecified upgrades/enhancements on a "when-and-if-available" basis under a PCS arrangement should be recognized as a legal performance obligation and measured at fair value.

6. Deferred PCS revenue often is significant for a software company as a result of the revenue recognition criteria in SOP 97-2. Further, the effect on the estimated fair value of an assumed PCS liability in a business combination can vary significantly depending on whether an entity includes the costs attributed to future research and development activities expected to be incurred to develop unspecified product upgrades/enhancements and a fulfillment margin on those activities. For example, if an entity only includes phone support and error fixes (and a fulfillment margin thereon) in its measurement of the fair value of the liability for deferred PCS revenue, the deferred revenue liability, and resulting effect on the future earnings of the combined entity, likely would be small. In contrast, if an entity includes research and development activities for unspecified product upgrades/enhancements (and a fulfillment margin thereon) in its measurement of the fair value of the liability for deferred PCS revenue, the deferred revenue liability likely would be significantly larger than if the entity only included phone support and error fixes in its estimate of fair value and, therefore, would have a greater effect on the future earnings of the combined entity.

7. This Issue applies to software licensing arrangements for which the PCS element has been deferred because the related PCS services have not been performed, rather than arrangements for which revenue has been deferred based on other facts and circumstances. This Issue only

[1] During the research of Issue 01-3, the FASB staff learned that the obligation to provide when-and-if-available upgrades were often referred to as "constructive obligations" by entities because they believed that they had an obligation to their existing customer base to perform the research and development. Those entities believed that failure to perform the research and development would impact their existing customer relationships, thus impacting future sales. The guidance in Issue 01-3 for recognizing a legal obligation is more restrictive than the recognition of a constructive obligation as outlined in FAS 143 and CON 6. Accordingly, if the legal criterion in Issue 01-3 is met, any related constructive obligation is inherently recognized.

addresses the recognition of a legal performance obligation related to PCS in a business combination and does not address the measurement of the assumed obligation at fair value.

8. Based on an informal survey of certain constituents, it appears that they have not performed additional procedures (for example, obtaining legal determination letters) in order to assess whether a PCS arrangement, and, more specifically, when-and-if-available upgrades, represents a legal obligation since the issuance of Issue 01-3. A majority of constituents surveyed appear to assess the notion of legal obligation for the PCS agreement as a whole, whereas the remaining constituents appear to evaluate each individual element of the PCS arrangement separately.

Accounting Issues and Alternatives

Issue 1: The unit of account that should be considered when recognizing the fair value of deferred PCS revenue in a business combination.

View A: Each element of the PCS arrangement should be evaluated separately for purposes of assessing whether each element individually represents a legal obligation that should be recognized and measured at fair value.

9. Proponents of View A believe that a PCS arrangement is comprised of multiple elements (for example, phone support, error fixes, and when-and-if-available upgrades) which must be separately assessed for recognition and measurement as part of the purchase price allocation. Proponents reference the guidance in paragraph B99 of FAS 141, which states in part "…the Board affirmed the basic principle set forth in Opinion 16 that the cost of an asset group should be allocated to the **individual** assets (or assets and liabilities) that make up the group on the basis of their fair values" (emphasis added). They note that when allocating the cost of an acquired entity in a business combination, other arrangements are bifurcated between each of the elements for purposes of determining fair value. They believe that this is evidenced by paragraph 11 of Issue 02-17, which indicates that each of the elements of a contract should be valued individually, stating, in part, that:

The Task Force observed that implicit in the consensuses reached in Issues 1, 2, and 3 is the fact that a customer contract and the related customer relationship may represent two distinct intangible assets.

10. Once the elements of the arrangement have been identified, View A supporters believe that, although the acquiring entity has assumed a legal obligation to deliver upgrades/enhancements if they are subsequently developed, there is no legal obligation to develop the upgrades. They believe the term "legal obligation" as defined in the accounting literature supports the notion that an entity should not reflect future development costs and the related fulfillment margin in the fair value assigned to deferred PCS revenue in a business combination. Issue 01-3 provides the following discussion of a legal obligation:

> The Task Force noted that a legal obligation to provide goods, services, the right to use an asset(s), or some other consideration to a customer(s) would be examples of a legal performance obligation assumed by the acquiring entity.
>
> [1] The Task Force observed that a legal obligation could arise from contractual provisions or from consumer rights in the relevant legal jurisdiction.

Additionally, paragraph 2 of FAS 143 provides the following definition of a legal obligation:

> As used in this Statement, a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel.[3]
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> [3] *Black's Law Dictionary*, seventh edition, defines *promissory estoppel* as, "The principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment."

11. Proponents of View A believe that although the acquired entity has a legal obligation to perform under the contract if upgrades/enhancements are developed, whether or not development occurs is within the entity's control. Consequently, the acquiring entity can, at its discretion, avoid the future sacrifice of assets by ceasing any and all R&D efforts directed at upgrades/enhancements.

12. Under View A, the fair value of the deferred PCS revenue liability recorded in purchase accounting would generally equal the cost of providing support services and error corrections (that is, bug fixes), plus a fulfillment margin thereon. Development costs and the related fulfillment margin would not be included in the fair value of the deferred PCS revenue liability, unless this element was deemed to represent a legal obligation.

View B: The PCS arrangement in its entirety represents the unit account for purposes of assessing whether a legal obligation has been assumed.

13. Proponents of View B believe that the entire PCS arrangement represents an assumed legal obligation in a business combination and, accordingly, the agreement as a whole should be measured at fair value. They believe that the notion of a single arrangement is consistent with the definition of PCS included in SOP 97-2, which is:

> The right to receive services… or unspecified product upgrades/enhancements, or both, offered to users or resellers, after the software license period begins, or after another time as provided for by the PCS **arrangement**. [Emphasis added.]

14. Paragraph 124 in the Basis for Conclusions of SOP 97-2 further expands upon this definition, stating, in part, that:

> An **obligation** to perform PCS is incurred at the inception of a PCS **arrangement** and is discharged by delivering unspecified upgrades/enhancements, performing services, or both over the period of the PCS arrangement. The **obligation** also may be discharged by the passage of time. [Emphasis added.]

15. Additionally, paragraph 9 of SOP 97-2 addresses multiple elements arrangements as follows:

> Software arrangements may provide licenses for multiple software deliverables (for example, software products, upgrades/enhancements, PCS, or services), which are termed multiple *elements*.

Based on the above guidance, proponents believe that it is clear under SOP 97-2 that a PCS arrangement is a **single** element of a multiple arrangement and, therefore, the PCS arrangement is already the lowest unit of account. They believe the fact that phone support, error fixes, and when-if-available-upgrades are rarely sold as separate elements further supports the view that PCS is a single arrangement. Additionally, they note that paragraph 124 in the Basis for Conclusions of SOP 97-2 implies that the requirement to perform under a PCS arrangement represents a single obligation.

16. View B supporters believe that the acquiring entity has assumed a legal obligation under the contractual terms of the PCS arrangement and should record the fair value of this liability in a business combination. Many View B supporters believe that all costs expected to be incurred (that is, both the costs of providing support services and error corrections and the costs of developing product upgrades/enhancements) and the fulfillment margin thereon should be included in estimating the fair value.

17. Some View B supporters note that the fair value of the obligation would include the acquiring entity's assessment of the likelihood of nonperformance occurring. They note that the continuing development of upgrades/enhancements of software products and the PCS arrangement may often be assessed as probable of occurring because those actions may be necessary to achieve the planned growth of the acquired business.

18. Further, some View B proponents point to the tentative decisions reached by the Board in its Purchase Method Procedures project (Phase II) to measure at fair value all preacquisition contingencies that meet the definition of a liability and that were part of the purchase price of the acquisition. That measurement of fair value would incorporate the probability of occurrence and proponents believe that in many instances, the value of the deferred revenue of an acquiree at the date of acquisition would closely approximate fair value (assuming the impact of the time value of money is not significant). They note that as currently drafted, the issuance of a final Statement on Phase II (currently anticipated to be effective January 1, 2006 for calendar year companies) would nullify both Issue 01-3 and any consensus reached herein. That possibility was considered by the EITF Agenda Committee at its August 20, 2004 meeting. However, due

to the diversity in practice and the estimated timing of Phase II, the Agenda Committee believed the Issue should be addressed by the Task Force.