# Invitation to Comment

Issued: February 14, 2019
Comments Due: April 30, 2019

# Measurement and Other Topics Related to Revenue Contracts with Customers under Topic 805

Comments should be addressed to:

Technical Director
File Reference No. 2019-200

Financial Accounting Standards Board

**Notice to Recipients of This Invitation to Comment**

The Board invites feedback on all matters in this Invitation to Comment before developing an Exposure Draft of a proposed Accounting Standards Update related to measurement and other topics related to revenue contracts with customers under Topic 805, Business Combinations. This Invitation to Comment is being issued concurrently with a related proposed Accounting Standards Update, *Business Combinations (Topic 805): Revenue from Contracts with Customers—Recognizing an Assumed Liability* (File Reference No. 2019-300). We request comments by April 30, 2019, by one of the following methods:

- Emailing comments to director@fasb.org, File Reference No. 2019-200 or
- Sending a letter to "Technical Director, File Reference No. 2019-200, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

All comments received are part of the FASB's public file and are available at www.fasb.org.

A copy of this Invitation to Comment is also available at www.fasb.org.

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FASB FINANCIAL ACCOUNTING STANDARDS BOARD®

# Invitation to Comment

# Measurement and Other Topics Related to Revenue Contracts with Customers under Topic 805

February 14, 2019

Comment Deadline: April 30, 2019

## CONTENTS

Page Numbers


Purpose of This Invitation to Comment ....... 1
Background ....... 1–2
Overview of This Invitation to Comment ....... 2
Chapter 1—Payment Terms and Their Effect on the Subsequent Revenue Recognized ....... 3–24
Chapter 2—Costs to Fulfill a Performance Obligation in Measuring the Fair Value of a Contract Liability for a Revenue Contract under Topic 805 ....... 25–37

## Purpose of This Invitation to Comment

The purpose of this Invitation to Comment (ITC) is to solicit feedback about measurement and other topics related to revenue contracts with customers under Topic 805, Business Combinations, that were identified by the Emerging Issues Task Force (EITF) during its consideration of EITF Issue No. 18-A, "Recognition under Topic 805 for an Assumed Liability in a Revenue Contract" (Issue 18-A). This ITC is being issued concurrently with the related proposed Accounting Standards Update, *Business Combinations (Topic 805): Revenue from Contracts with Customers—Recognizing an Assumed Liability* (the proposed Update), which resulted from decisions reached by the EITF on Issue 18-A. The proposed Update solicits feedback about what the implications of finalizing the proposed amendments on the recognition of a contract liability from a revenue contract with a customer acquired in a business combination would be without finalizing amendments on measurement and other topics that are discussed in this ITC.

## Background

The FASB staff received two questions about the application of the guidance in Topic 805 to deferred revenue after the adoption of Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* (Update 2014-09 or Topic 606, including subsequent Updates), which provides a single comprehensive accounting model on revenue recognition for a contract with a customer (hereinafter referred to as a revenue contract). Before the adoption of Topic 606, in practice, a liability for deferred revenue was generally recognized in an acquirer's financial statements if it represented a legal obligation. The issuance and adoption of Topic 606 raised a question about whether a liability for deferred revenue in a business combination should be recognized on the basis of the legal obligation concept or whether the concept of a performance obligation included in Topic 606 should be applied. A second question raised was how to measure the fair value of a contract liability (for example, deferred revenue) from a revenue contract acquired in a business combination after the adoption of Topic 606.

On March 28, 2018, the Board added Issue 18-A to the EITF agenda to address the recognition of a revenue contract with a customer that is acquired in a business combination after an entity has adopted Topic 606. The Board also requested that the EITF provide educational information on measurement topics that may arise in a business combination after the adoption of Topic 606.

At the June 2018 EITF meeting, the Task Force reached a consensus-for-exposure on Issue 18-A that would require that an entity use the Topic 606 performance obligation definition in determining whether an assumed contract liability from a revenue contract represents a liability that is recognized in a business combination at the acquisition date. During the discussion on recognition, Task Force members decided that the timing of payment of consideration (or

payment terms) should not affect the subsequent amount of revenue recognized by the acquirer related to the acquired revenue contract. The Task Force also decided to amend the *FASB Accounting Standards Codification*® to include measurement guidance and reached a consensus-for-exposure that an acquirer would consider the assets and liabilities in the acquired set when determining the fair value of an assumed contract liability.

Before the expected issuance of a proposed Update, Task Force members identified potential unintended consequences of their decisions on payment terms and the acquired set measurement concept.

At the September 2018 EITF meeting, the Task Force affirmed its consensus-for-exposure that an acquirer should recognize a liability assumed in a business combination from a contract with a customer if that liability represents an unsatisfied performance obligation under Topic 606 for which the acquiree has received consideration (or the amount is due) from the customer (that is, a contract liability). Most Task Force members also continued to express the view that the timing of payment of consideration (or payment terms) should not affect the subsequent amount of revenue recognized by the acquirer related to the acquired revenue contract. The Task Force discussed different alternatives for the recognition and measurement of an assumed liability from a revenue contract in a business combination to address the potential unintended consequences of the decisions reached at the June 2018 EITF meeting, but the Task Force determined it needed additional feedback from stakeholders. Therefore, the Task Force recommended that the Board direct the staff to issue an Invitation to Comment to solicit input about measurement and other topics related to revenue contracts acquired in a business combination.

## Overview of This Invitation to Comment

This ITC includes two chapters, one for each of the two major issues discussed by the Task Force at its September 2018 meeting. Each chapter includes a summary of the financial reporting issue and some of the approaches that the Board or the Task Force could consider in responding to the issue. Neither the Board nor the Task Force has expressed a preliminary view about how to respond to each issue. The approaches are included in this ITC to help stakeholders understand the potential effect of including explicit guidance in the Codification on the two issues. The Board and the Task Force also are interested in feedback about any other approaches that they should consider.

# Chapter 1—Payment Terms and Their Effect on the Subsequent Revenue Recognized

## Background

1.1 At the June 2018 EITF meeting, the Task Force considered whether the timing of the payment of consideration (or payment terms) should affect the amount of subsequent revenue recognized by an acquirer related to an acquired revenue contract. The Task Force tentatively concluded that payment terms should not affect the amount of subsequent revenue recognized by an acquirer in a business combination. Task Force members decided that it would be inappropriate for two acquired revenue contracts with identical performance obligations and different payment terms to result in different amounts of post-acquisition revenue for the acquirer. For example, if two revenue contracts with identical performance obligations were acquired and the only difference was that one contract required payment of the total consideration upfront while the other contract required payment over the contract term, the Task Force determined that the revenue recognized related to those contracts after the business combination should be the same for both contracts.

1.2 Prior to the expected issuance of a proposed Update, some Task Force members identified potential unintended consequences of including guidance about payment terms in the Codification. The Task Force decided that the implications of issuing guidance on payment terms should be further considered to determine whether the accounting result would be operable. The Task Force discussed the unintended consequences of including payment terms guidance (as described in paragraphs 1.3 and 1.4) at its September 2018 meeting, and some Task Force members indicated that, in practice today, the payment terms of contracts acquired in a business combination affect the amount of subsequent revenue recognized by an acquirer. The Task Force recommended that the Board solicit feedback on the issue through the issuance of this ITC.

## Potential Alternatives

1.3 Most Task Force members agreed that on a conceptual basis, the subsequent amount of revenue recognized by an acquirer for contracts with identical performance obligations should be the same. However, some Task Force members indicated that proposed guidance stating that payment terms of an acquired revenue contract should not affect the subsequent amount of revenue recognized by an acquirer could significantly change practice for some entities. For example, in order to have the same amount of revenue recognized after the business combination for a contract that requires payment over the contract term and for a contract that requires an upfront payment, an acquirer may need to recognize an identifiable asset

for the contract that requires payment over the contract term for the fair value of future consideration expected to be received that is in excess of the fair value of the unsatisfied (or partially unsatisfied) performance obligation. That would differ from the approach generally applied in practice today whereby that value is included in a customer-related intangible asset (or another asset) under Topic 805. Another Task Force member suggested that guidance on payment terms would not significantly change practice because the value of the identifiable asset that would need to be recorded would be captured as an identifiable asset today (although its classification may be different).

1.4 Task Force members noted that the addition of guidance on payment terms could raise other issues and questions about the recognition and measurement of customer-related intangible assets under Topic 805 that may need to be addressed. However, they noted that guidance about payment terms likely would not affect the total income related to a revenue contract over its life (or customer relationship period). For example, if an entity recognized more revenue after a business combination under today's practice because the entity was not paid upfront, it also likely would recognize a larger customer-related intangible asset in the business combination and amortize that intangible asset into income. If an entity recognized less revenue after the business combination because of guidance on payment terms, the entity likely would recognize a smaller customer-related intangible asset in the business combination and amortize that into income. In either case, the ultimate amount of income for that contract likely would be the same, although the margin in each period and income statement presentation could differ significantly.

## *Arrangements That Have Payments Made at Different Times*

1.5 The staff developed the following scenarios to illustrate the potential financial reporting effects of including guidance on payment terms in the Codification for arrangements with different payment terms. The scenarios assume the consensus-for-exposure in the related proposed Update is finalized. For each scenario, the staff illustrates two accounting outcomes:

a. If GAAP were to remain silent on the effect of payment terms
b. If GAAP were to state that payment terms should not affect the subsequent amount of revenue recognized by the acquirer.

1.6 The outcome in each scenario that illustrates the accounting if GAAP were to remain silent on the effect of payment terms shows one way in which an entity may account for an acquired revenue contract in a business combination by recognizing revenue for cash received after the business combination for services performed after the business combination. However, diversity in practice exists in how an entity accounts for a contract

liability assumed in a business combination and the amount of revenue an entity recognizes after a business combination, which could be significantly different from the accounting if GAAP were to state that payment terms should not affect the subsequent amount of revenue recognized by the acquirer.

1.7 For simplicity, the scenarios do not include the consideration of other customer-related intangible assets that may be recognized in a business combination. Those customer-related intangible assets would be amortized and would affect the total income from the related revenue contract so that the income from the related revenue contract over the life of the contract would be the same under either outcome (discussed in paragraph 1.4). The scenarios assume all contracts are "at market" and also ignore income taxes and discounting for simplicity.

## Scenario 1: Upfront payment of all consideration

1.8 On January 1, 20X6, Company B entered into a two-year service contract that is satisfied ratably over time with Customer X. Customer X paid Company B the full contract price at the contract origination date (January 1, 20X6). Company A acquires the outstanding shares of Company B on January 2, 20X6. Assume the following for this scenario:

| | |
|---|---|
| Contract Price | $1,000 |
| Expected Cost of Fulfillment | 750 |
| Selling Effort plus a Reasonable Profit on Selling Effort | 100* |
| Acquisition-Date Fair Value of Contract Liability and Performance Obligation | 900† |

*This represents the costs Company B incurred to enter into a contract with Customer X before the business combination plus a reasonable profit on those costs.

†In this simplified example, the difference between the contract price and the acquisition-date fair value of the contract liability and performance obligation is assumed to be the selling effort plus a reasonable profit on the selling effort (using a top-down method), but there could be other reasons for the difference in practice. The fair value of the contract liability and performance obligation also could be determined using a bottom-up method in which the performance obligation is measured on the basis of the fulfillment costs required to satisfy the unsatisfied performance obligation, plus a reasonable profit on those costs. Under this method, the selling effort would not be included in those costs because they were incurred before the business combination. Theoretically, the fair value derived under either a top-down or bottom-up method should be similar.

### *Outcome 1A: If GAAP were to remain silent on the effect of payment terms*

1.9 Company B recognized a contract liability of $1,000 for the cash received at the contract origination date. Company A recognizes a contract liability of $900 (its fair value) at the acquisition date, which represents the fair value of the unsatisfied performance obligation for which it has been paid. Company A recognizes the contract liability of $900 as part of the allocation of the acquisition-date fair value of the consideration transferred in the business combination. Company A records the following journal entries for each of the annual periods ending December 31, 20X6, and 20X7:

| | | |
|---|---|---|
| Contract liability | 450 | |
| Revenue | | 450 |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

### *Outcome 1B: If GAAP were to state that payment terms should not affect the subsequent amount of revenue recognized by the acquirer*

1.10 Company B recognized a contract liability of $1,000 for the cash received at the contract origination date. Company A recognizes a contract liability of $900 (its fair value) at the acquisition date, which represents the fair value of the unsatisfied performance obligation for which it has been paid. Company A recognizes the contract liability of $900 as part of the allocation of the acquisition-date fair value of the consideration transferred in the business combination. Company A records the following journal entries for each of the annual periods ending December 31, 20X6, and 20X7:

| | | |
|---|---|---|
| Contract liability | 450 | |
| Revenue | | 450 |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

## Scenario 2: Partial upfront payment of consideration

1.11 On January 1, 20X6, Company B entered into a two-year service contract that is satisfied ratably over time with Customer X. Customer X paid Company B half of the contract consideration ($500) at the contract origination date (January 1, 20X6) and will pay the other half of the contract consideration ($500) on January 1, 20X7. Company A acquires the

outstanding shares of Company B on January 2, 20X6. Assume the following for this scenario:

| Contract Price | $1,000 |
|---|---|
| Expected Cost of Fulfillment | 750 |
| Selling Effort plus a Reasonable Profit on Selling Effort | 100* |
| Acquisition-Date Fair Value of Contract Liability | 450 |
| Acquisition-Date Fair Value of Performance Obligation | 900† |

*This represents the costs Company B incurred to enter into a contract with Customer X before the business combination plus a reasonable profit on those costs.

†In this simplified example, the difference between the contract price and the acquisition-date fair value of the performance obligation is assumed to be the selling effort plus a reasonable profit on the selling effort (using a top-down method), but there could be other reasons for the difference in practice. The fair value of the performance obligation also could be determined using a bottom-up method in which the performance obligation is measured on the basis of the fulfillment costs required to satisfy the unsatisfied performance obligation, plus a reasonable profit on those costs. Under this method, the selling effort would not be included in those costs because they were incurred before the business combination. Theoretically, the fair value derived under either a top-down or bottom-up method should be similar.

### *Outcome 2A: If GAAP were to remain silent on the effect of payment terms*

1.12 Company B recognized a contract liability of $500 for the cash received at the contract origination date. Company A recognizes a contract liability of $450 (its fair value) at the acquisition date, which represents the fair value of the unsatisfied performance obligation for which it has been paid. Company A recognizes the contract liability of $450 as part of the allocation of the acquisition-date fair value of the consideration transferred in the business combination. Company A records the following journal entries for the annual period ending December 31, 20X6:

| | | |
|---|---|---|
| Contract liability | 450 | |
| Revenue | | 450 |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

1.13 Company A records the following journal entries for the annual period ending December 31, 20X7:

| | | |
|---|---|---|
| Cash | 500 | |
| Revenue | | 500 |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

### *Outcome 2B: If GAAP were to state that payment terms should not affect the subsequent amount of revenue recognized by the acquirer*

1.14 Company B recognized a contract liability of $500 for the cash received at the contract origination date. Company A recognizes a contract liability of $450 (its fair value) at the acquisition date, which represents the fair value of the unsatisfied performance obligation for which it has been paid. Company A also recognizes an identifiable asset of $50 for the fair value of the future consideration expected to be received that is in excess of the fair value of the unsatisfied performance obligation, which in this case represents the portion of the selling effort and related reasonable profit for which the customer has not paid. Company A recognizes the contract liability of $450 and identifiable asset of $50 as part of the allocation of the acquisition-date fair value of the consideration transferred in the business combination. (The recognition of an identifiable asset of $50 would affect the valuation of any contract backlog intangible asset recognized to avoid double counting.) Company A records the following journal entries for the annual period ending December 31, 20X6:

| | | |
|---|---|---|
| Contract liability | 450 | |
| Revenue | | 450 |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

1.15 Company A records the following journal entries for the annual period ending December 31, 20X7:

| | | |
|---|---|---|
| Cash | 500 | |
| Revenue | | 450 |
| Identifiable asset | | 50* |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

*In this simplified example, the identifiable asset is reduced as cash is collected from the customer. How the identifiable asset is derecognized depends on the nature of the identifiable asset recognized. The Board does not have a preliminary view on the nature of the identifiable asset. Further discussion of the nature of the identifiable asset is included in paragraphs 1.32 through 1.51. In addition, question 1.4 asks respondents about views on the nature of the identifiable asset.

## Scenario 3: Payment of consideration over time as performance occurs

1.16 On January 1, 20X6, Company B entered into a two-year service contract that is satisfied ratably over time with Customer X. Company A acquires the outstanding shares of Company B on January 2, 20X6. As of January 2, 20X6, Customer X has paid no consideration for the contract. Assume the following for this scenario:

| | |
|---|---|
| Contract Price | $1,000 |
| Expected Cost of Fulfillment | 750 |
| Selling Effort plus a Reasonable Profit on Selling Effort | 100* |
| Acquisition-Date Fair Value of Performance Obligation | 900† |

*This represents the costs Company B incurred to enter into a contract with Customer X before the business combination plus a reasonable profit on those costs.

†In this simplified example, the difference between the contract price and the acquisition-date fair value of the performance obligation is assumed to be the selling effort plus a reasonable profit on the selling effort (using a top-down method), but there could be other reasons for the difference in practice. The fair value of the performance obligation also could be determined using a bottom-up method in which the performance obligation is measured on the basis of the fulfillment costs required to satisfy the unsatisfied performance obligation, plus a reasonable profit on those costs. Under this method, the selling effort would not be included in those costs because they were incurred before the business combination. Theoretically, the fair value derived under either a top-down or bottom-up method should be similar.

*Outcome 3A: If GAAP were to remain silent on the effect of payment terms*

1.17 Company A does not recognize a contract liability at the acquisition date because Company B did not receive consideration (and no amount was due) from the customer before the acquisition date. Company A records the following journal entries for the annual period ending December 31, 20X6:

| | | |
|---|---|---|
| Cash | 500 | |
| Revenue | | 500 |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

1.18 Company A records the following journal entries for the annual period ending December 31, 20X7:

| | | |
|---|---|---|
| Cash | 500 | |
| Revenue | | 500 |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

*Outcome 3B: If GAAP were to state that payment terms should not affect the subsequent amount of revenue recognized by the acquirer*

1.19 Company A does not recognize a contract liability at the acquisition date because Company B did not receive consideration (and no amount was due) from the customer before the acquisition date. Company A recognizes an identifiable asset of $100 for the fair value of the future consideration expected to be received that is in excess of the fair value of the unsatisfied performance obligation, which in this case represents the selling effort and related reasonable profit for which the customer has not paid. Company A recognizes the identifiable asset of $100 as part of the allocation of the acquisition-date fair value of the consideration transferred in the business combination. (The recognition of an identifiable asset of $100 would affect the valuation of any contract backlog intangible asset recognized to avoid double counting.) Company A records the following journal entries for the annual period ending December 31, 20X6:

| | | |
|---|---|---|
| Cash | 500 | |
| Revenue | | 450 |
| Identifiable asset | | 50* |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

1.20 Company A records the following journal entries for the annual period ending December 31, 20X7:

| | | |
|---|---|---|
| Cash | 500 | |
| Revenue | | 450 |
| Identifiable asset | | 50* |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

*In this simplified example, the identifiable asset is reduced as cash is collected from the customer. How the identifiable asset is derecognized depends on the nature of the identifiable asset recognized. The Board does not have a preliminary view on the nature of the identifiable asset. Further discussion of the nature of the identifiable asset is included in paragraphs 1.32 through 1.51. In addition, question 1.4 asks respondents about views on the nature of the identifiable asset.

## Comparison of the post-acquisition revenue of Company A in Scenarios 1–3

1.21 In Scenarios 1 through 3, Company A acquires Company B on January 2, 20X6, and the acquisition-date fair value of the remaining performance obligation is the same ($900). The only difference between Scenarios 1 through 3 is the timing of payment of the consideration for the acquired revenue contract. The following table illustrates the differences in the post-acquisition revenue for Company A in each scenario under Outcome A (one possibility, if GAAP were to remain silent on the effect of payment terms) and Outcome B (if GAAP were to state that payment terms should not affect the subsequent amount of revenue recognized by the acquirer):

| | Scenario 1 Payment All Upfront | Scenario 2 Partial Payment Upfront | Scenario 3 Payment over Time |
|---|---|---|---|
| Outcome A<br><br>GAAP remains silent | 900 | 950 | 1,000 |
| Outcome B<br><br>GAAP includes guidance on payment terms | 900 | 900 | 900 |

1.22 If Company A does not recognize an identifiable asset at the acquisition date, the consideration received by Company A (after the acquisition date) that is in excess of the fair value of the unsatisfied performance obligation will be recognized as additional revenue, which is what happens in practice today for some entities (as demonstrated in Outcome A). As explained in paragraph 1.4, the ultimate amount of income for the related contract likely would be the same if additional revenue is recognized after the business combination because a larger customer-related intangible asset likely would be recognized and subsequently amortized into income.

## Scenario 4: Partial performance by acquiree without payment of consideration

1.23 On January 1, 20X6, Company B entered into a two-year service contract that is satisfied ratably over time with Customer X. Company A acquires the outstanding shares of Company B on July 1, 20X6. Therefore, Company B satisfied 25 percent of the contract as of the acquisition date. As of July 1, 20X6, Customer X has paid no consideration for the contract, and Company A determines that a receivable should not be recognized because it does not have an unconditional right to payment. Assume the following for this scenario:

| Contract Price | $1,000 |
|---|---|
| Selling Effort plus a Reasonable Profit on Selling Effort | 100* |
| Expected Remaining Cost of Fulfillment | 562.5 |
| Acquisition-Date Fair Value of the Remaining Performance Obligation | 675† |
| Acquisition-Date Fair Value of the Contract Asset | 250‡ |

*This represents the costs Company B incurred to enter into a contract with Customer X, which occurred before the business combination, plus a reasonable profit on those costs. In this simplified example, the selling effort is assumed to be recovered over the term of the contract with the customer.

†In this simplified example, the difference between 75 percent of the contract price and the acquisition-date fair value of the performance obligation is assumed to be 75 percent of the selling effort plus a reasonable profit on the selling effort (using a top-down method), but there could be other reasons for the difference in practice. The remaining 25 percent of the selling effort ($25) is included in the acquisition-date fair value of the contract asset. Therefore, $225 of the contract asset relates to Company B's fulfillment of the performance obligation as of the acquisition date and $25 of the contract asset is attributed to the efforts of Company B before the business combination. The fair value of the performance obligation could be determined using a bottom-up method in which the performance obligation is measured on the basis of the fulfillment costs required to satisfy the unsatisfied performance obligation, plus a reasonable profit on those costs. Under this method, the selling effort would not be included in those costs because they were incurred before the business combination. Theoretically, the fair value derived under either a top-down or bottom-up method should be similar.

‡For simplicity, assume the contract asset reflects Company A's conditional right to consideration for the portion (25 percent) of the contract satisfied as of the acquisition date ($250). Company A does not have any right to consideration for the remaining 75 percent of the contract price ($750) as of the acquisition date.

### *Outcome 4A: If GAAP were to remain silent on the effect of payment terms*

1.24 Company B recognized a contract asset of $250 for performance completed through the acquisition date. Company A recognizes a contract asset of $250 on the acquisition date as part of the allocation of the acquisition-date fair value of the consideration transferred in the business combination. Company A records the following journal entries for the annual period ending December 31, 20X6:

| | | |
|---|---|---|
| Cash | 500 | |
| Contract asset | | 250 |
| Revenue | | 250 |
| Cost of sales | 187.5 | |
| Payable | | 187.5 |

1.25 Company A records the following journal entries for the annual period ending December 31, 20X7:

| | | |
|---|---|---|
| Cash | 500 | |
| Revenue | | 500 |
| Cost of sales | 375 | |
| Payable | | 375 |

### *Outcome 4B: If GAAP were to state that payment terms should not affect the subsequent amount of revenue recognized by the acquirer*

1.26 Company B recognized a contract asset of $250 for performance completed through the acquisition date. Company A recognizes a contract asset of $250 on the acquisition date. Company A also recognizes an identifiable asset of $75 for the fair value of the future consideration expected to be received that is in excess of the fair value of the unsatisfied performance obligation and the contract asset, which in this case represents the portion of the selling effort and related reasonable profit for which the customer has not paid and for which a contract asset has not been recognized. Company A recognizes the contract asset of $250 and identifiable asset of $75 as part of the allocation of the acquisition-date fair value of the consideration transferred in the business combination. (The recognition of an identifiable asset of $75 would affect the valuation of any contract backlog intangible asset recognized to avoid double counting.) Company A records the following journal entries for the annual period ending December 31, 20X6:

| | | |
|---|---|---|
| Cash | 500 | |
| Contract asset | | 250 |
| Revenue | | 225 |
| Identifiable asset | | 25* |
| Cost of sales | 187.5 | |
| Accounts payable | | 187.5 |

1.27 Company A records the following journal entries for the annual period ending December 31, 20X7:

| | | |
|---|---|---|
| Cash | 500 | |
| Revenue | | 450 |
| Identifiable asset | | 50* |
| Cost of sales | 375 | |
| Accounts payable | | 375 |

*In this simplified example, the identifiable asset is reduced as cash is collected from the customer. How the identifiable asset is derecognized depends on the nature of the identifiable asset recognized. The Board does not have a preliminary view on the nature of the identifiable asset. Further discussion of the nature of the identifiable asset is included in paragraphs 1.32 through 1.51. In addition, question 1.4 asks respondents about views on the nature of the identifiable asset.

### Comparison of the post-acquisition revenue of Company A in Scenario 4

1.28 In Scenario 4, Company A acquires Company B on July 1, 20X6, and the acquisition-date fair value of the remaining performance obligation is $675. Post-acquisition revenue under Outcome A (one possibility, if GAAP were to remain silent on the effect of payment terms) would be $750, whereas post-acquisition revenue under Outcome B (if GAAP were to state that payment terms should not affect the subsequent amount of revenue recognized by the acquirer) would be $675. The amount of revenue recognized under Outcome A exceeds the amount of revenue recognized under Outcome B by the amount of consideration received by Company A (after the acquisition date) that is in excess of the acquisition-date fair value of the remaining performance obligation and the contract asset.

## *Other Concerns about Guidance on Timing of Payment*

1.29 Task Force members raised concerns that guidance on payment terms could significantly change practice by affecting the time and effort needed to account for a business combination because an entity may need to evaluate whether an identifiable asset needs to be recorded for each revenue contract to comply with the potential payment terms guidance, whereas that analysis is often performed at the customer level or a higher level under today’s practice. Another stakeholder suggested that because the value of the identifiable asset that may need to be recorded under the payment terms guidance would be captured as an identifiable asset today

(although its classification may be different), an acquirer's evaluation would not significantly change.

1.30 Some Task Force members also highlighted the potential effect of any proposed guidance on the accounting for sales-based royalties (or other variable consideration). Those Task Force members indicated that an entity with a sales-based royalty may be required to estimate the amount of the royalty it expects to receive and recognize that amount as an identifiable asset on the date of the business combination because payment terms should not affect the amount of revenue recognized by the acquirer after the business combination. Those Task Force members indicated that some entities recognize revenue for sales-based royalties received after a business combination. They also indicated that additional guidance would need to be provided on how to update the estimate of the identifiable asset for the actual amount of sales-based royalties received. These concerns related to contingent payment terms are further discussed in paragraphs 1.52 through 1.55.

1.31 The FASB staff performed outreach with other stakeholders on this issue and received diverse views about whether payment terms should affect the subsequent amount of revenue recognized. Additionally, those stakeholders expressed concerns similar to the Task Force members' concerns about the implications of the proposed guidance on current practice.

## *Recognition of Contract-Related Assets in a Business Combination*

1.32 Topic 805 requires that an acquirer in a business combination recognize identifiable assets, liabilities assumed, and any noncontrolling interest in the acquiree separately from goodwill. To qualify for recognition in a business combination, an identifiable asset or liability assumed must meet the definition of an asset or liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*, at the acquisition date. Concepts Statement 6 defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" and liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events" (footnote references omitted). In addition, the identifiable asset acquired or liability assumed must have been exchanged in the business combination rather than in a separate transaction between the entities. Limited exceptions to the Topic 805 recognition principle exist for assets and liabilities arising from contingencies, income taxes, employee benefits, indemnification assets, and leases (upon the effective date of Accounting Standards Update 2016-02, *Leases (Topic 842)*, and subsequent Updates).

1.33 Topic 805 requires identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree to be recognized and measured at their acquisition-date fair values. Exceptions to the Topic 805 general measurement principle exist for income taxes, employee benefits, indemnification assets, reacquired rights, share-based payment awards, assets held for sale, and certain assets and liabilities arising from contingencies, leases (upon the effective date of Update 2016-02 and subsequent Updates), and purchased financial assets with credit deterioration (upon the effective date of Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*).

1.34 Accounting for an acquired revenue contract in a business combination may result in the recognition of multiple assets at the acquisition date, including customer-related intangible assets (for example, a contract backlog asset, a customer relationship asset, or an "off-market component" [not discussed in this ITC]), a financial asset (receivable), or a contract asset.

1.35 As illustrated in the scenarios, an acquirer may need to recognize an identifiable asset for contracts that require payment over time to have the same amount of revenue recognized after the business combination as a contract that requires an upfront payment. The recognition of that asset likely would change practice for entities and raise questions about the nature of the identifiable asset recognized. Task Force members expressed different views about the nature of the identifiable asset that would need to be recognized to result in the same amount of revenue after acquisition for contracts with different payment terms. Specifically, Task Force members considered whether the recognition of a financial asset is more appropriate than recognition as an intangible asset. Some viewed the recognition of a financial asset as not being intuitive when the acquiree has not provided a good or service, while others stated that a financial asset would better reflect the underlying economics of the contract.

1.36 The guidance relevant to the various types of assets that may be recognized for an acquired revenue contract in a business combination is discussed in paragraphs 1.37 through 1.50 along with the reasons why the identifiable asset that may need to be recognized to have the same amount of revenue recognized regardless of payment terms may be viewed as those types of assets. The subsequent measurement of those types of assets also is discussed in paragraphs 1.39, 1.46, and 1.49. Topic 805 generally requires that an acquirer subsequently measure and account for assets acquired and liabilities assumed in a business combination in accordance with other applicable GAAP. However, Topic 805 provides guidance for a limited number of specific items in a business combination including: reacquired rights, assets and liabilities arising from contingencies, indemnification assets, and contingent consideration. Topic 805 does not provide guidance

about the subsequent measurement of customer-related intangible assets, contract assets, or financial assets.

## Customer-related intangible assets

1.37 The Master Glossary of the Codification defines *intangible assets* as "assets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill.)" Paragraph 805-20-25-10 requires that an acquirer recognize "separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable."

1.38 Under Topic 805, an asset is separable if it is capable of being separated or divided from the acquired entity and sold, transferred, or exchanged for value, either individually or together with a related contract, asset, or liability. This would be the case even if the acquirer does not intend to sell, transfer, or exchange the asset. An asset meets the contractual-legal criterion if it arises from contractual or other legal rights, regardless of whether those rights are separable. The provisions of Topic 805 may result in the recognition of assets and liabilities that were not previously recognized by the acquiree before the business combination. The implementation guidance in Topic 805 provides examples of customer-related intangible assets that meet either the separability criterion or the contractual-legal criterion, which are discussed in paragraphs 1.41 through 1.43 and include customer lists, order or production backlog, customer contracts and related customer relationships, and noncontractual customer relationships.

1.39 Customer-related intangible assets recognized separately from goodwill are subsequently amortized over their useful life under Topic 350, Intangibles—Goodwill and Other. Outreach with stakeholders indicated that there is diversity in practice in how entities amortize customer-related intangibles; however, most entities do not amortize customer-related intangible assets directly to revenue.

1.40 The identifiable asset that may need to be recognized for an acquirer to recognize the same amount of revenue for an acquired revenue contract regardless of payment terms may be similar in nature to a customer-related intangible asset because it is an asset that lacks physical substance and relates to the acquiree's efforts incurred to obtain the revenue contract. However, subsequently amortizing a customer-related intangible asset would not result in the same amount of revenue recognized for contracts with different timing of payment unless the amortization of the customer-related intangible asset reduces revenue. Even in that case, the amortization pattern (for example, straight-line) may result in a different

amount of revenue recognized in each period and the useful life may not be the same as the contract period if the period of economic benefit of the customer-related intangible asset differs from the term of the contract. Therefore, the subsequent measurement of a customer-related intangible asset may not result in an outcome in which the identifiable asset would offset the consideration received in excess of the fair value of the performance obligation.

### *Order or production backlog*

1.41 Paragraph 805-20-55-22 states, "An order or production backlog arises from contracts such as purchase or sales orders. An order or production backlog acquired in a business combination meets the contractual-legal criterion even if the purchase or sales orders are cancelable." Therefore, the value recognized in an order or production backlog asset is attributable to the future benefit to be received from unfulfilled contracts acquired in a business combination.

1.42 Backlog may be recognized and measured separately from a related customer relationship due to differences in their future economic benefit and useful lives. Paragraph 805-20-55-25 indicates, "Consequently, if an entity has relationships with its customers through these types of contracts [contracts that give rise to order or production backlog], the customer relationships also arise from contractual rights and therefore meet the contractual-legal criterion" (see paragraph 1.43 for customer relationships that arise from contractual rights). Therefore, the value attributed to the backlog should be excluded from the measurement of the customer relationship asset to avoid double counting the future benefit related to that contract.

### *Customer contracts and related customer relationships*

1.43 Under Topic 805, customer relationship assets arise from establishing relationships with customers through contracts. A customer contract and the related customer relationship may be two separate intangible assets because the pattern of economic benefit and useful lives of the assets may differ. A customer relationship exists because of the entity's access to information about the customer and the existence of communication channels between the entity and the customer. Examples in Topic 805 illustrate that customer relationship assets arising from the contractual-legal criterion are recognizable even if a contract is cancelable or not in existence at the acquisition date. The guidance also indicates that discretion exists regarding the appropriate unit of account for contracts and related customer relationships due to the nature of the relationship and interdependency of cash flows.

## Contract assets

1.44 Update 2014-09 added the term *contract asset* to the Master Glossary of the Codification and defined it as, "an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance)." For an entity to recognize a contract asset, it must have transferred goods or services to a customer. However, the receipt of consideration from the customer is conditional upon future performance or some other event. For example, an entity would recognize a contract asset when it has satisfied some, but not all, of the performance obligations in the contract, and it has a right to payment only after it satisfies all of the performance obligations in the contract. The element of the definition that makes it conditional on something other than the passage of time distinguishes a *contract asset* from a *financial asset* (discussed in paragraphs 1.48 through 1.50).

1.45 A private company alternative in paragraphs 805-20-25-29 through 25-33 states that for purposes of applying that alternative, contract assets are not considered to be customer-related intangible assets. Therefore, contract assets cannot be subsumed into goodwill and companies must analyze whether contract assets are identifiable as of the acquisition date.

1.46 When an entity satisfies the conditions necessary to be entitled to payment, the contract asset would become a financial asset, which subsequently would be derecognized when consideration is received from the customer.

1.47 The identifiable asset that may need to be recognized for an acquirer to recognize the same amount of revenue for an acquired revenue contract regardless of payment terms may possess some characteristics of a contract asset because the entity has performed selling efforts that the consideration from the customer will compensate for, but that consideration is conditional on the acquirer transferring goods and services; therefore, it is not a financial asset. The recognition of a contract asset would result in the same amount of revenue recognized for contracts with different timing of payment because the consideration received in excess of the fair value of the performance obligation would offset the contract asset directly. However, a contract asset generally represents a right to payment for the exchange of goods and services, and, in this case, the acquired entity had not transferred any goods or services to the customer.

## Financial assets

1.48 The Master Glossary of the Codification defines a *financial asset* as follows:

> Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:
>
> a. Receive cash or another financial instrument from a second entity
> b. Exchange other financial instruments on potentially favorable terms with the second entity.

1.49 A common example of a financial asset related to a revenue contract is a trade receivable, which conveys an unconditional right to receive cash from a second entity (therefore, the ultimate receipt of cash is not contingent on the occurrence of a future event other than the passage of time). A financial asset recognized in a business combination generally would be subsequently derecognized upon the receipt of consideration from a customer.

1.50 The identifiable asset that may need to be recognized for an acquirer to recognize the same amount of revenue for an acquired revenue contract regardless of payment terms may possess some characteristics of a financial asset because the acquired entity has performed selling efforts that the consideration from the customer will compensate for. The recognition of a financial asset would result in the same amount of revenue recognized for contracts with different timing of payment because the consideration received in excess of the fair value of the performance obligation would offset the financial asset directly. (This type of derecognition is illustrated in Outcome B of Scenarios 2 through 4.) However, a right to receive consideration from the customer may not be present at the acquisition date, which is inherent to the nature of a financial asset.

## Interaction of an identifiable asset that may need to be recognized to result in the same amount of revenue and other customer-related intangible assets

1.51 The various types of customer-related intangible assets are interrelated, which can result in issues in practice when recognizing and measuring the assets. An entity also would need to evaluate how the recognition of the identifiable asset that may need to be recognized to result in the same amount of revenue after the acquisition affects the recognition and measurement of other customer-related intangible assets. For example, if an identifiable asset is recognized to result in the same amount of revenue recognized after the acquisition, an entity would not consider the cash flows

related to that asset when measuring the other customer-related intangible assets (that is, to avoid double counting the cash flows).

## Topic-Specific Questions

**Question 1.1:** Should the timing of payments affect the subsequent amount of revenue recognized by the acquirer? Why or why not? Are there other accounting outcomes applied in practice for the different payment terms scenarios that are not illustrated?

**Question 1.2:** If the timing of payments should not affect the subsequent amount of revenue recognized by the acquirer, would an acquirer need to recognize an identifiable asset separate from other contract-related assets and liabilities, as illustrated in the scenarios? Why or why not? Are there other approaches that should be considered (for example, measuring a contract liability on the basis of Topic 606 instead of Topic 805)?

**Question 1.3:** Would the recognition of an identifiable asset for each contract be operational? Are there alternative approaches that would make this more practical to apply?

**Question 1.4:** Would that identifiable asset meet the definition of an asset?

a. If so, is the identifiable asset a financial asset, a customer-related intangible asset, or a contract asset? Please explain your view.
b. Should the unit of account of the asset be each contract, each customer, or a group of contracts for similar customers?

**Question 1.5:** Would an entity still need to consider whether to recognize an order or production backlog if guidance requires the recognition of an identifiable asset that results in the same amount of revenue recognized by the acquirer after acquisition for contracts with different payment terms? Why or why not?

**Question 1.6:** Would additional guidance on subsequent measurement be needed for the identifiable asset?

**Question 1.7:** Would guidance on payment terms improve the usefulness and comparability of financial information provided to users?

## Contingent Payment Terms Considerations

1.52 Some Task Force members expressed concerns about the effect of including in the Codification payment terms guidance on transactions when payment is contingent on future events, such as sales-based or usage-based royalty arrangements. Task Force members indicated that language stating that payment terms should not affect the subsequent amount of revenue recognized may result in an entity with sales-based royalties or variable consideration estimating the amount of expected consideration and recording that amount as a receivable on the acquisition date.

1.53 Some entities may recognize sales-based royalties received after a business combination as revenue under current practice. That is because Topic 606 provides specific guidance for the revenue recognition of sales-based and usage-based royalties. Paragraph 606-10-55-65 states,

> Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14 [guidance on constraining estimates of variable consideration and including that amount in the transaction price], an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:
>
> a. The subsequent sale or usage occurs.
> b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

1.54 Under the general constraint of estimates of variable consideration in paragraphs 606-10-32-11 through 32-14, an entity includes an estimated amount of variable consideration in the transaction price to the extent that it is probable that a significant reversal in the amount of cumulative revenue will not occur when the uncertainty associated with the variable consideration is subsequently resolved. An entity updates that estimate at the end of each reporting period.

1.55 Including guidance in the Codification that states that payment terms should not affect the subsequent amount of revenue recognized by an acquirer raises questions as to how an entity would apply existing guidance in Topic 606 to contingent payment terms (see paragraphs 1.53 and 1.54) in a business combination and whether additional guidance would be needed. One view is that any guidance on payment terms would not apply to arrangements with variable consideration or sales-based or usage-based royalties because there is specific guidance in Topic 606 on the timing of revenue recognition for such arrangements. Another view is that any payment terms guidance would apply to contingent payments, so an entity would need to estimate the fair value of the future consideration to be received and recognize that amount as an identifiable asset on the date of the business combination. The second view may raise additional questions about how to update the estimate of the identifiable asset for actual variable consideration or sales-based royalties received and how to derecognize the asset so that payment terms would not affect the subsequent amount of revenue recognized by the acquirer of a sales-based royalty arrangement.

## Topic-Specific Questions

**Question 1.8:** Should contingencies related to the amount of consideration to be received affect the subsequent amount of revenue recognized by the acquirer? Are there other variable payment arrangements that should result in a different conclusion?

**Question 1.9:** Should an acquirer continue to apply the sales and usage-based royalty constraint or variable consideration constraint guidance in Topic 606 as part of a business combination to an acquired revenue contract in which one or more performance obligations have been satisfied before the acquisition?

**Question 1.10:** How should an entity subsequently measure and derecognize the asset that would result if contingencies related to the amount of consideration to be received do not affect the subsequent amount of revenue recognized by the acquirer?

## Interaction with Other FASB Projects

1.56 Topic 805 provides a private company accounting alternative to simplify the accounting for identifiable intangible assets in a business combination. Paragraph 805-20-25-30 states that if the alternative is elected,

> . . . an acquirer shall not recognize separately from goodwill the following intangible assets:
>
> a. Customer-related intangible assets unless they are capable of being sold or licensed independently from other assets of a business
> b. Noncompetition agreements.

1.57 The FASB is working on a project to consider the subsequent accounting for goodwill and the accounting for certain identifiable intangible assets. The scope of that project includes the possible expansion of the private company accounting alternative noted in the previous paragraph. The FASB plans to issue another Invitation to Comment to obtain formal input from stakeholders on that project. Feedback received or decisions made as part of that project could affect the way in which the Board addresses the issues discussed in Chapter 1 of this ITC. Stakeholders should monitor developments related to that project.

# Chapter 2—Costs to Fulfill a Performance Obligation in Measuring the Fair Value of a Contract Liability for a Revenue Contract under Topic 805

## Background

2.1 Stakeholders indicated to the Board that questions may arise after the adoption of Topic 606 about the fair value measurement of a contract liability from a revenue contract acquired in a business combination assuming the concept of a performance obligation is applied. As explained in paragraphs 2.3 through 2.5, the primary question raised focuses on *what* costs should be included in the fair value measurement and not *how* an entity would determine fair value. Stakeholders noted that *how* to measure those costs is addressed by the guidance in Topic 820, Fair Value Measurement. Therefore, the Board added the question about what costs to fulfill a performance obligation should be included in the fair value measurement of a contract liability assumed in a business combination to the EITF Agenda as part of Issue 18-A.

2.2 The measurement principle in paragraph 805-20-30-1 states that an acquirer in a business combination must measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values. That principle exists for all assets and liabilities acquired in a business combination under Topic 805, with certain exceptions. There is no specific guidance or exception related to the measurement of contract liabilities from revenue contracts.

## How to Measure a Contract Liability under Topic 820

2.3 In determining the fair value of a contract liability acquired in a business combination under Topic 820, an acquirer should measure the fair value based on market participant assumptions. Under Topic 820, the fair value measurement assumes that a liability would remain outstanding, and it would be transferred to a market participant who would be required to fulfill the obligation. If a quoted price for the transfer of an identical or a similar liability is not available, which would be common for contract liabilities, valuation techniques would be applied to determine the fair value. There are two common methods in practice that are used to measure the fair value of a contract liability. One acceptable method would be a present value technique that takes into account the future cash outflows that a market participant would expect to incur in fulfilling the obligation plus a reasonable profit margin that a market participant would require for performing the activities to fulfill the obligation (a bottom-up method). Another acceptable technique is to utilize a market price for the contract on the basis of the goods or services to be provided and deduct any costs (plus a reasonable

profit margin on those costs) that were incurred before the business combination (a top-down method). Theoretically, the fair value of a contract liability derived under either method should be similar.

2.4 Some of the costs that would be incurred to fulfill a performance obligation can be easily identified (for example, direct costs). Those costs clearly would be included in the measurement of fair value. For other types of costs, there may be diversity in practice about whether the costs are included. Consider the following example of a service arrangement that utilizes an asset to fulfill the performance obligation to the customer. In a contract to dig a ditch, an entity will need to use a backhoe for five hours and incur labor hours of an employee to fulfill the performance obligation to dig the ditch. The contract does not require the entity to transfer a physical asset to the customer. If the contract to dig a ditch is acquired as part of a business combination and the customer paid for the service upfront, then the acquirer would recognize a contract liability for the services it is required to provide. To determine the fair value of the contract liability, a market participant would consider all the costs associated with fulfilling the performance obligation. The cost of labor clearly would be included in the fair value measurement of the liability, but it is possible some may question what costs should be included related to the backhoe, particularly if the backhoe is owned by the acquirer after the business combination. In this case, a market participant likely would consider the costs related to the use of the backhoe to fulfill the unsatisfied performance obligation (and not the full cost to purchase a backhoe) to determine the price at which the liability could be transferred (that is, its fair value). In summary, if an asset is required to fulfill an unsatisfied performance obligation, then the cost of the use of that asset (that is, a contributory charge or contribution value) would be added to the costs used to determine the fair value of the performance obligation in many cases.

2.5 If a contributory charge is included in determining the fair value of a contract liability, then the cash flows related to the use of that asset would not be deducted from the cash flows used to determine the acquisition-date fair value of the underlying asset. Therefore, the fair value of the contract liability is higher because of the contributory charge for the use of the related asset, but the fair value of the underlying asset is not affected (that is, the requirement to use the asset [or a similar asset] to fulfill the contract does not result in a decrease in its fair value). In other words, the fair value of the underlying asset is determined as if it was unencumbered by any contractual obligations.

## Measurement of an Operating Lease Contract in a Business Combination

2.6 The fair value of assets that are subject to leases also are measured on an unencumbered basis under paragraph 805-20-30-5. Topic 805 provides a specific requirement for an acquirer to measure the fair value of an asset subject to an operating lease separately from the lease contract. That is, the fair value of an asset should be the same regardless of whether it is subject to an operating lease. Because the underlying asset is measured on an unencumbered basis, leasing arrangements associated with the asset are measured independently of the asset. If the acquiree is the lessor of an operating lease, the acquirer may recognize various assets and liabilities as part of the business combination, including assets based on the value of "in-place" leases and favorable leases and liabilities based on unfavorable leases. For an operating lease arrangement in which all the consideration is paid upfront, the lessor would recognize a liability that reflects the value of using the underlying asset for the term of the lease (which likely would be included as part of an unfavorable lease liability). The use of the underlying asset for the term of the lease would be considered by a market participant in determining the fair value of the remaining obligation of the lessor, even if the right to use the underlying asset already has been provided.

2.7 Topic 805 does not provide guidance on how to measure other assets that may be subject to contractual obligations similar to leases. For example, paragraph 805-20-30-5 states that patents and intangible assets are examples of assets that could be subject to an operating lease, but the staff notes that those assets would be more likely subject to a license than a lease.

## EITF Discussion

2.8 When the Task Force discussed how to measure the fair value of a contract liability, it focused on how to measure the fair value of a contract liability for an in-process arrangement for a license to symbolic intellectual property that was acquired in a business combination after the adoption of Topic 606. That is because Topic 606 provides specific guidance on how to recognize revenue for licenses and because the agenda request submitted by an accounting firm used that fact pattern. In that fact pattern, the acquiree was paid upfront and had delivered the right to access the license to the customer before the business combination. Topic 606 requires an entity to recognize revenue from a license to symbolic intellectual property over time, so the acquiree had recorded a contract liability before the business combination. The revenue contract was then acquired in a business combination.

2.9 The FASB staff performed outreach with valuation and business combination accounting specialists to gather information about the fair value measurement of liabilities in a business combination to prepare for the discussion with the Task Force. Those specialists stated that the process used to value the identified assets and liabilities assumed should not change based on the adoption of Topic 606. They noted that they assess the cash flows of the business at the acquisition date, and those cash flows would not be affected by the accounting method used to recognize revenue (that is, the cash flows will not change on the basis of whether they are accounted for under Topic 605 or Topic 606).

2.10 The Task Force discussed the activities and costs that should be included in the measurement of the contract liability. Some Task Force members indicated that only the activities and related costs that would be incurred by the acquirer after the acquisition should be considered in the measurement of the fair value of the contract liability. Other Task Force members indicated that a contributory charge for the use of the underlying asset should be included in the measurement of the contract liability, similar to the measurement of an unfavorable lease liability in a business combination for an operating lease contract that has been paid for upfront (see paragraph 2.6).

2.11 The Task Force indicated that any decision made on the measurement of the contract liability in the fact pattern presented could affect other arrangements that are similar to a contract for a license to symbolic intellectual property. Those arrangements include service contracts in which an asset is required to fulfill the service, hosting arrangements, indefeasible right-of-use arrangements, and leasing contracts. In many of these types of arrangements, there is an underlying asset that is provided to the customer to use for a period of time, which is often described as a right to use or a right to access the asset.

## Potential Alternatives

2.12 Similar to the views expressed by certain Task Force members, the view supported by some stakeholders is that an entity should only include the costs of activities required to fulfill the performance obligation that an acquirer must perform after the date of the business combination when measuring the fair value of a contract liability. Under this view, the fair value of a contract liability for a license to symbolic intellectual property would not include the cost of the underlying intellectual property (or the cost of using the intellectual property), regardless of whether the intellectual property was also acquired. That is because those stakeholders assume the intellectual property is delivered to the customer by the acquiree before the business combination, thus the acquirer has no ongoing obligation related to the license except for its obligation to maintain and support the underlying intellectual property and not to limit the customer’s contractual use of the

intellectual property. The acquirer would not be required to deliver the intellectual property to the customer again after the business combination. This view acknowledges that a license to symbolic intellectual property grants the customer a right to access the entity's intellectual property, which is satisfied over time as the entity fulfills its promise to the customer. However, that promise consists of two activities (see paragraph 2.20): granting the customer rights to use and benefit from the entity's intellectual property and supporting or maintaining the intellectual property. In summary, the fair value of the contract liability under this view would only include the incremental costs of the activities to support and maintain the underlying intellectual property for that specific contract, which may be minimal.

2.13 Other stakeholders support a view in which an entity should include a contributory charge for the use of the underlying asset as well as the costs of activities that an acquirer must perform after the date of the business combination in measuring the fair value of the contract liability. Those stakeholders note that a market participant would consider the cost of the use of an underlying asset in measuring the fair value of the obligation because the use of an asset generally diminishes the value of that asset. This view is similar to how operating lease contracts are accounted for in a business combination, as described in paragraph 2.6. This view acknowledges that a license to symbolic intellectual property is a single performance obligation in which the licensor has granted the customer a right to access the underlying intellectual property. This promise is not fulfilled upfront, so the acquirer must consider the cost of granting access to the intellectual property throughout the term of the license. In summary, the fair value of the contract liability under this view would include a contributory charge for the use of the asset plus the incremental costs of the activities to support and maintain the underlying intellectual property. The fair value in this view likely would be closer to the value of the contract liability recorded by the acquiree before the business combination.

## *Effect on the Fair Value of the Underlying Asset*

2.14 Under the first view, the fair value of the underlying intellectual property would be lower than the fair value of the underlying intellectual property under the second view if the acquirer determines that the realizable value of the intellectual property is reduced each time it is licensed. That is, under the first view the underlying intellectual property would be valued on an encumbered basis, and a market participant would consider that part of the overall value of the intellectual property as already having been realized. However, some stakeholders do not believe that the realizable value of all (or at least certain types of) intellectual property is significantly reduced by granting licenses to the intellectual property. Under the second view, the fair

value of the underlying intellectual property would be estimated on an unencumbered basis, and a market participant would consider all cash flows attributable to the asset irrespective of the fact that part of the cash flows already has been realized. Conceptually, the second view would be consistent with the treatment of the underlying asset in an operating lease as discussed in paragraph 2.6.

### *Comparing Alternatives with Other Arrangements*

2.15 The two views differ on whether a contributory charge should be included in the fair value of the contract liability. Topic 805 provides specific guidance on how to account for leases, and stakeholders generally agree that a contributory charge should be included in measuring the fair value of a contract liability for a service contract that requires the acquirer to use an asset to fulfill the obligation (for example, a contract to dig a ditch). However, stakeholders do not agree on whether a contributory charge should be included for other types of arrangements in which revenue is recognized over time, including licenses to symbolic intellectual property, hosting arrangements, and indefeasible right-of-use arrangements.

2.16 As described in paragraphs 2.10 and 2.13, some stakeholders compare those types of arrangements to operating leases. Other stakeholders note that a lease of a tangible asset is different from a license of intellectual property because an entity can continue to license intellectual property for the same period to additional customers even after it has been licensed to the first customer, unless it is an exclusive license, but a lessor cannot continue to lease the same asset for the same period after the asset has been leased. Furthermore, some stakeholders may question whether a contributory charge should be included in the measurement of a liability for an operating lease contract absent the specific guidance in Topic 805.

2.17 Paragraphs 2.18 through 2.32 describe the Codification guidance for licenses of intellectual property, leasing arrangements, hosting arrangements, and indefeasible right-of-use arrangements, and why the obligation in those contracts is fulfilled over time versus at a point in time. In some cases, the Board’s basis for those decisions (as detailed in the related basis for conclusions for the specific guidance) is also included. The objective of including the guidance is to help respondents to this ITC evaluate whether the underlying economics of the arrangements are similar and determine whether a contributory charge should be included for some, all, or none of these arrangements. In addition, the guidance may inform respondents about whether there is an unsatisfied performance obligation if an entity acquired the contract in the middle of the arrangement.

## Licensing of Intellectual Property under Topic 606

2.18 To determine whether a performance obligation that is a license to intellectual property (or a single performance obligation that includes a license to intellectual property) is satisfied over time or at a point in time, an entity must consider whether the license provides the customer with a right to access the entity's intellectual property throughout the license period (satisfied over time) or a right to use the entity's intellectual property as it exists at the point in time when the license is granted (satisfied at a point in time).

2.19 To help make this determination, an entity should consider the nature of the underlying intellectual property. Topic 606 classifies intellectual property as either of the following:

a. **Functional intellectual property**. Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality.
b. **Symbolic intellectual property**. Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities.

2.20 Topic 606 indicates that a license to functional intellectual property generally provides a customer with the right to use the intellectual property whereas a license to symbolic intellectual property provides a customer with the right to access the intellectual property. Topic 606 further notes that a customer's ability to derive benefit from a license to symbolic intellectual property depends on the entity continuing to support or maintain the intellectual property, and, therefore, it consists of a promise to both:

a. Grant the customer rights to use and benefit from the intellectual property
b. Support or maintain the intellectual property.

2.21 The basis for conclusions of Accounting Standards Update No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing,* which provides additional clarifications to Topic 606's guidance on licensing, lists brands, team or trade names, logos, and franchise rights as examples of symbolic intellectual property. The basis for conclusions also explains that because

symbolic intellectual property does not have significant standalone functionality, the utility of it to a customer is largely dependent on the entity supporting or maintaining that intellectual property (for example, a license to a sport's team name and logo typically will have limited residual value if the team stops playing games).

## Leasing Arrangements under Topic 842

2.22 A lease is a contract that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. In reaching the conclusions in Topic 842, the Board considered why leases are different from service contracts for the lessee and described those differences in the basis for conclusions of Update 2016-02. Additionally, in the basis for conclusions, the Board compared the rights and obligations of a lessee and lessor to the rights and obligations of a licensee and licensor.

2.23 The Board indicated that leases generally give rise to different rights and obligations than service contracts. This is because in a lease the lessee continues to benefit throughout the lease term from the lessor's performance, at lease commencement, of making the underlying asset available for use by the lessee. The Board noted that a lessee benefits in substantially the same manner as a licensee. That is, a licensee also continues to benefit from a license to intellectual property throughout the license term from the licensor's performance (making the intellectual property available), which occurs at the start of the license period. When a lessor makes available the underlying asset for use by the lessee at the commencement date, the lessor has fulfilled its obligation to transfer the right to use that underlying asset to the lessee even if it has other obligations that require continuing performance under the contract.

2.24 The Board contrasted the leasing arrangement with a typical service contract in which the customer obtains economic benefits from the service only as the supplier performs the service. The supplier's performance to date often does not continue to benefit the customer throughout the remaining service term. If it does, it is likely because the service has created an asset for the customer, which the customer typically recognizes.

2.25 Not all Board members at the time Update 2016-02 was issued agreed with that distinction for all leases, specifically operating leases. Those Board members observed that operating leases are similar in some respects to many service contracts. For example, in Example 2 of Subtopic 842-10, an airport operator has conveyed a right to use some portion of its space (but not a specified portion) at the inception of the arrangement, and the customer's obligation to pay the airport operator is conditional on the continued access to space owned by the airport operator. However, this arrangement would not be considered a lease under Topic 842. In

substance, this arrangement is very similar to the economics of a lease, but it is not accounted for as such.

2.26 The basis for conclusions of Update 2016-02 also notes that there was general agreement among stakeholders that a lessor generally would have nothing further to do after the delivery of the underlying asset other than to comply with the terms and conditions of the contract, which stakeholders did not view as meeting the definition of a liability. However, the lessor still must recognize revenue for some leases, such as operating leases or finance leases, over time because the Board decided that these leases grant different rights and impose different obligations on the lessee than sales of nonfinancial assets (for example, an operating lease does not effectively transfer control of the underlying asset to the lessee).

## Other Arrangements That Utilize Underlying Assets

### *Hosting Arrangements*

2.27 The pending content in the Master Glossary defines a *hosting arrangement* as follows: "In connection with accessing and using software products, an arrangement in which the customer of the software does not currently have possession of the software; rather, the customer accesses and uses the software on an as-needed basis."

2.28 Paragraph 606-10-55-54 notes that a hosting arrangement would be accounted for under the licensing guidance in Topic 606 if both of the following criteria are met:

a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

2.29 A hosting arrangement in which both criteria are met would be considered a functional license under Topic 606 and, therefore, the revenue for the license would be recognized at a point in time and the revenue for the hosting service would be recognized over time. A hosting arrangement that does not meet both criteria would be considered a service and its related revenue likely would be recognized over time under Topic 606, similar to other service contracts.

### *Indefeasible Right-of-Use Arrangements*

2.30 An indefeasible right-of-use arrangement is one in which a customer purchases a specified amount of capacity of a communications system (for example, a fiber optic cable). This type of arrangement may meet the definition of a lease or, if it does not, it would be a service contract, depending on the facts and circumstances of the contract.

2.31 Whether the arrangement meets the definition of an operating lease or is a service contract, the revenue for the arrangement will be recognized over time. Under the view that an entity should include only the costs of activities required to fulfill the performance obligation that an acquirer must perform after the date of the business combination when measuring the fair value of a contract liability, the distinction between an operating lease and service contract would result in different measurements of the liability to fulfill the remaining obligation in a business combination on the basis of the guidance in Topic 805 for operating leases mentioned in paragraph 2.6.

## Summary of the Guidance

2.32 Arrangements such as operating leases, licenses to symbolic intellectual property, nondistinct goods or services (such as hosting arrangements that do not meet certain criteria), and indefeasible right-of-use agreements are considered to have some ongoing involvement after delivery or transfer of the underlying asset, and, therefore, the pattern of revenue recognition is over time as the entity fulfills its obligation. However, Topic 805 includes specific guidance only for measuring the asset (and thereby the associated liability) underlying an operating lease.

## Topic-Specific Questions

**Question 2.1:** In what circumstances, if any, do you think an entity should include a contributory charge for the use of a related asset in measuring the fair value of a contract liability acquired in a business combination?

**Question 2.2:** If guidance is provided on how to measure the fair value of a contract liability assumed in a business combination, would additional guidance be needed on how to measure the fair value of related assets?

## Unit of Account Used in a Business Combination

2.33 The response to Question 2.1 could be informed by the unit of account used in a business combination (referred to as the unit of valuation). As described in the basis for conclusions of FASB Statement No. 141 (revised 2007), *Business Combinations*, which was subsequently codified in Topic 805, unit of valuation is the level at which an asset or liability is aggregated or disaggregated to determine what is being measured. There is limited

prescriptive guidance in Topic 805 and Topic 820 related to how to determine the unit of valuation. However, Topic 805 provides specific guidance on the unit of valuation for an asset subject to a lease (see paragraph 2.6), which prescribes that the unit of account in the Topic on leases (Topic 840 or Topic 842) should be the unit of valuation for Topic 805 for those arrangements.

2.34 The subsequent measurement of an arrangement after a business combination is required to be made in accordance with the underlying Topic for that type of arrangement (for example, Topic 606 for contracts with customers or Topic 842 for leasing arrangements). A benefit of prescribing a unit of valuation that is consistent with the unit of account of the underlying Topic is that it reduces the complexity of applying the subsequent measurement guidance to a different unit of account.

2.35 In the proposed Update resulting from Issue 18-A and issued concurrently with this ITC, the Task Force decided that an acquirer should recognize a liability assumed in a business combination from a contract with a customer if that liability represents one or more unsatisfied performance obligations under Topic 606 for which the acquiree has received consideration (or the amount is due) from the customer. The unit of account for presentation of contract assets and contract liabilities under Topic 606 is a contract. However, the unit of account for determining the amount of revenue to be recognized under Topic 606 is a performance obligation, which is a good or service (or bundle of goods and services) that is distinct (see paragraphs 2.39 through 2.41). A performance obligation is satisfied (and revenue is recognized) when or as control of the good or service is transferred to the customer, which may be at a point in time or over time. The revenue standard provides specific guidance on how to apply these principles to licenses to intellectual property (described in paragraphs 2.18 through 2.21).

## *EITF Discussion*

2.36 During the outreach performed as part of Issue 18-A, stakeholders indicated that current practice for the measurement of the fair value of a contract liability for a license to symbolic intellectual property would not consider the cost of the underlying intellectual property because the intellectual property had already been delivered to the customer by the acquiree before the business combination. This view is inconsistent with the unit of account used in Topic 606 for these types of arrangements because Topic 606 indicates that a license to symbolic intellectual property is a single promise, even though it consists of two activities (see paragraph 2.20): granting the customer rights to use and benefit from the entity’s intellectual property and supporting or maintaining the intellectual property.

2.37 Stakeholders indicated that these arrangements existed and were measured at fair value in a business combination before the adoption of Topic 606. They noted that the amendments in Topic 606 should not affect how valuation specialists identify the remaining activities necessary to fulfill a contractual obligation when measuring the acquisition-date fair value of that obligation under Topic 805. However, some Task Force members indicated that the unit of account under Topic 606 (that is, a performance obligation) should be used as the unit of valuation under Topic 805 because it would be used for purposes of identifying whether an assumed liability exists under the proposed Update resulting from Issue 18-A and issued concurrently with this ITC.

## *Potential Alternatives*

2.38 While discussing Issue 18-A, Task Force members expressed mixed views on whether the unit of account in Topic 606 should be used as the unit of valuation of a contract liability under Topic 805, specifically for licenses to symbolic intellectual property. Some Task Force members indicated that the unit of account in Topic 606 does not need to be used as the unit of valuation for Topic 805 because an entity is required to measure the fair value of the contract liability, which is the fair value of the remaining performance obligation (only a portion of the original performance obligation) for which the entity has been paid. Additionally, those Task Force members noted that the unit of account in Topic 606 is specific to the evaluation of the appropriate pattern of revenue recognition, which is a different objective than the unit of valuation in Topic 805. Those Task Force members noted that there are two activities within a license to symbolic intellectual property and they should be considered separately under Topic 805. Those Task Force members also supported the view that a contributory charge should not be included as part of the fair value of a contract liability for a license to symbolic intellectual property. Other Task Force members indicated that the unit of account under Topic 606 should be used as the unit of valuation under Topic 805 because it would be used for purposes of identifying whether an assumed liability exists under Topic 805 and there is less complexity when the unit of valuation in a business combination is consistent with the unit of account for general recognition and measurement purposes. In addition, that approach would be consistent with the unit of valuation guidance for leases under Topic 805 (that is, the unit of valuation under Topic 805 is the same as the unit of account under Topic 840 and Topic 842).

## *Topic 606: Identify the Performance Obligations in the Contract*

2.39 A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer. If an entity promises in a contract to transfer more than one good or service to the customer, the entity should account for each promised good or service as a performance obligation only if it is (a) distinct or (b) a series of distinct goods or services that are substantially the same and have the same pattern of transfer.

2.40 A good or service is distinct if both of the following criteria are met:

a. The good or service is capable of being distinct—the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer.
b. The promise to transfer the good or service is distinct within the context of the contract—the promise to transfer the good or service is separately identifiable from other promises in the contract.

2.41 A good or service that is not distinct should be combined with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. Refer to paragraphs 606-10-25-14 through 25-22 for related guidance.

## Topic-Specific Question

**Question 2.3:** Should the performance obligation unit of account used in Topic 606 for revenue recognition (for example, the unit of account for a license to symbolic intellectual property) be used as the unit of valuation in a business combination under Topic 805?