KPMG LLP
345 Park Avenue
New York, N.Y. 10154-0102

Telephone +1 212 758 9700
Fax +1 212 758 9819
Internet www.us.kpmg.com

April 29, 2019

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: Invitation to Comment: *Measurement and Other Topics Related to Revenue Contracts with Customers under Topic 805* (File Reference No. 2019-200)

Dear Technical Director:

We appreciate the opportunity to comment on the Invitation to Comment, *Measurement and Other Topics Related to Revenue Contracts with Customers under Topic 805*. We have also commented separately on the related proposed ASU, *Revenue from Contracts with Customers—Recognizing an Assumed Liability*, which was issued concurrently with the ITC. Both of these documents are based on the EITF's deliberations on Issue No. 18-A.

After evaluating the decisions reached in EITF Issue No. 18-A and observing inconsistent accounting outcomes that may arise depending on the timing of payments in a contract, we recommend that the FASB require a single model for all revenue contracts acquired in a business combination, regardless of whether they are in an asset position or a liability position on the acquisition date.

Related to the specific issues addressed in the ITC:

- We support an approach consistent with the general principle that payment terms should not affect the subsequent amount of revenue recognized by the acquirer for a revenue contract acquired in a business combination.
- When estimating the fair value of a performance obligation using a bottom-up (i.e. cost plus margin) approach, we believe that contributory asset charges should be included for all assets, both tangible and intangible, required to fulfill that performance obligation.

Appendix A describes our proposed approach for accounting for revenue contracts acquired in a business combination, which is consistent with these principles and which we believe would:

- provide more comparable financial information across entities;
- balance the accounting requirements and principles of Topics 805 and 606; and
- be operational.

Appendix B provides our answers to the questions in the ITC.

* * * * * * * * * *

If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com, David Elsbree Jr. at (212) 909-5245 or delsbree@kpmg.com or Nick Burgmeier at (212) 909-5455 or nburgmeier@kpmg.com.

Sincerely,

KPMG LLP

KPMG LLP

KPMG

Appendix A – An Approach for Accounting for Contracts with Customers Acquired in a Business Combination

After evaluating EITF Issue No. 18-A, we are aware of practices that we believe lead to inconsistent financial reporting.

- The payment terms of contracts acquired in a business combination affect the amount of revenue recognized by the acquirer after the acquisition. Acquirers often recognize more revenue for the post-acquisition fulfillment effort when the payments are in arrears than they do when payments were received by the acquiree in advance even though the fulfillment effort is the same.
    - For contracts paid in arrears, acquirers generally recognize all of the post-acquisition contractual payments (other than those already recognized as receivables or contract assets) as revenue.
    - For contracts with payments received by the acquiree in advance of performance and before the acquisition date, acquirers revalue the acquiree's deferred revenue (contract liability) to fair value, which results in recognizing less post-acquisition revenue than an otherwise identical contract paid in arrears.
- Certain deferred revenue liabilities (contract liabilities) are being valued at an amount that we believe is less than the price that a market participant would demand to assume the unfulfilled performance obligations under the contract, by excluding certain contributory asset charges. This practice results in significantly less revenue in the post-acquisition period compared with an otherwise identical contract paid in arrears, e.g. licenses of symbolic intellectual property.

In considering these issues, we concluded that it is necessary to develop a holistic approach to accounting for revenue contracts acquired in a business combination that is:

- consistent with the principle that the payment terms of a contract should not affect the amount of revenue an acquirer recognizes after a business combination;
- consistent with the principles of Topics 805 and 606; and
- operational.

We believe the approach that we describe herein meets these criteria. All references to the 'expected remaining net contractual payments' exclude amounts already recognized as receivables.

<u>Scope</u>

The proposed approach would apply to all of an acquiree's contracts with customers that meet the criteria for a contract in Section 606-10-25. Other contracts to which the Topic 606 model is applied would also be in scope. See our response to Question 4 in our comment letter on the proposed ASU.

Arrangements not meeting those criteria would continue to be accounted for under Topic 805.

<u>Unit of Account</u>

The unit of account would be the contract, which we believe is consistent with the principle in Subtopic 805-20 that an acquirer should recognize separately from goodwill all assets acquired and liabilities assumed. Each revenue contract usually represents either an asset or a liability, depending on the relationship between the fair values of the acquiree's rights and obligations under the contract on the acquisition date, similar to a derivative contract (such as an interest rate swap) acquired in a business combination. This approach is also consistent with Topic 606, which uses the contract as the unit of account for presenting contract assets and liabilities, for evaluating whether a contract exists under Step 1 and for determining the transaction price in Step 3.

In current practice, many acquirers aggregate customer relationships and backlog intangible assets into meaningful groups to be recognized as a single asset. Similarly, under our proposal, a portfolio approach comparable to that described in paragraph 606-10-10-4 could be used to determine whether contracts acquired in a business combination could be grouped for recognition and measurement purposes.

Initial Recognition and Measurement

In our proposed approach, the fair value of an acquired revenue contract would be calculated at the acquisition date as the difference between:

- the fair value of the expected remaining net contractual payments; and
- the fair value of the remaining unsatisfied or partially satisfied performance obligation(s).

The net of these amounts reflects either what a market participant would pay to acquire a contract (when the fair value of the remaining contractual payments exceeds its fulfillment costs plus a reasonable margin) or what an entity would need to pay a market participant to assume the remaining obligation(s) (when the fair value of the remaining net contractual payments is less than its fulfillment costs plus a reasonable margin).

Therefore, under our proposed approach, an acquirer would recognize an asset when the fair value of the remaining contractual payments exceeds the fair value of the remaining performance obligations. Likewise, the acquirer would recognize a liability when the fair value of the remaining unsatisfied performance obligation exceeds the fair value of the remaining contractual payments.

Any contract asset or liability the acquiree had recognized would effectively be replaced by the asset or liability recognized under this approach. Similarly, the acquirer would not need to recognize a favorable (unfavorable) asset (liability) because our proposed approach already takes that concept into account.

Fair value of the net contractual payments

The fair value of expected remaining net contractual payments would be measured using the principles in Topic 820 and Concepts Statement 7.

Fair value of remaining unsatisfied or partially unsatisfied performance obligations

The fair value of the remaining unsatisfied or partially satisfied performance obligations would be measured under the principles in Topic 820, using either a top-down or bottom-up approach, as described in the ITC.

We believe that the top-down and bottom-up approaches described in the ITC are appropriate valuation approaches. Practically, we believe the top-down approach approximates the stand-alone selling price of the remaining performance obligation at the acquisition date less an amount that reflects the selling effort plus a reasonable profit margin thereon. Many entities have stand-alone selling price information readily available for their performance obligations that could be used as the starting point under a top-down approach. When the contract has multiple remaining performance obligations, the entity would need to consider the selling price of the bundle to account for discounts a market participant would provide for the bundle.

If a bottom-up approach is used, an acquirer would use market participant assumptions about the costs to fulfill the remaining unfulfilled or partially unfulfilled performance obligations related to the profit margin a market participant would expect on the remaining fulfillment effort. We believe that a market participant would include a contributory asset charge for all operating assets, whether tangible or intangible, required to fulfill the remaining performance obligations.

Subsequent Accounting

The subsequent accounting will need to address (1) the accounting for the asset or liability and (2) differences between the amount of consideration to which the entity is ultimately entitled and the fair value of the expected net contractual payments at the acquisition date.

We believe the asset (liability) recognized in acquisition accounting should be recognized in the income statement as a reduction of (increase to) post-acquisition revenue.

Guidance will be necessary to address how to account for the differences between the recorded net asset or liability and the actual cash flows. At a minimum, differences will arise because the cash flows, when received, will be undiscounted while the fair value of the cash flows are discounted. Other differences can arise due to different outcomes on credit risk and, for more complex arrangements, variable consideration, than was estimated in determining the fair value. We believe there is more than one potentially acceptable approach to the subsequent accounting for these differences.

Under one approach, the amount of post-acquisition revenue recognized for each contract would be fixed at the acquisition date fair value of the unsatisfied (or partially unsatisfied) performance obligations. A difference between (a) the consideration to which the combined entity is entitled after the acquisition date and (b) the fair value of the expected remaining net contractual payments at the acquisition date would be recorded as other operating income or expense.

A second approach would recognize as post-acquisition revenue the remaining transaction price determined under Topic 606, plus (minus) the net liability (asset) recognized at the acquisition date. Changes in variable consideration would result in an adjustment to revenue. There are multiple ways to achieve this outcome depending on how the asset or liability is classified (see Question 1.4). For example, the asset could be amortized against revenue akin to a favorable intangible asset or it could be treated like a contract asset. Either way, the net revenue recognized would be the same.

The first approach would ensure that the acquirer recognizes the same amount of post-acquisition revenue regardless of payment terms. That outcome would be ensured because a difference between (a) the consideration to which the combined entity is entitled after the acquisition date and (b) the fair value of the expected remaining net contractual payments at the acquisition date (e.g. due to discounting) would be classified as other operating income or expense. In contrast, those differences, which arise because of payment terms, would be classified as revenue under the second approach.

We believe either approach would be an improvement over current practice, because the post-acquisition revenue recognized would be more comparable across transactions, even within an entity, than it is today. While the first approach may achieve a desired outcome of payment terms not affecting the amount of revenue recognized, it may be operationally more challenging when there is variable consideration. Some consider the differences between the contractual payments after the acquisition date and the fair value of those payments at the acquisition date to be attributable to post-combination performance and believe they should be classified as revenue, because that is factored into what a market participant would pay (or demand to receive as compensation) to acquire (or assume) the contract.

Under either approach, we believe a portfolio approach could be used if the relevant criteria are met.

Acquired contract with no unfulfilled performance obligation

For contracts with unresolved variable consideration and with no remaining performance obligations to be fulfilled by the acquirer after the acquisition date (e.g. a license of functional intellectual property transferred before the acquisition date with usage-based royalties due after the acquisition date), the variable consideration received after the acquisition date would be recorded as an offset to the asset recognized in the business combination. Differences between the cash received and asset recognized would be classified as other operating income or expense. Because the performance obligation was satisfied before the acquisition date, these royalties would not be revenue of the combined entity.

Why is this approach practical?

We do not believe that the proposed approach would require significantly more effort to account for a business combination than the approach used in practice. Currently, preparers use the same contractual net cash flows to value an acquiree's contracts, but include the value within customer-related intangible assets, mainly as customer backlog. Our proposed approach reclassifies the backlog asset and a favorable (unfavorable) asset (liability) from intangible assets into a separate identifiable asset/liability.

Allowing acquirers to aggregate contracts into meaningful groups using a portfolio approach also helps preparers simplify the accounting. Preparers who have adopted Topic 606 already apply paragraph 606-10-10-4 to group similar contracts in the portfolio approach for determining revenue.

Appendix B – Responses to Questions for Respondents

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?

We believe that generally the timing of payments should not affect the amount of post-acquisition revenue the acquirer recognizes.

However, rather than stating the principle by reference to the payment terms, we recommend stating that each acquired revenue contract should be recognized at its fair value to be consistent with the principles of Topics 805 and 606. The fair value of a revenue contract is the difference between the fair value of the expected remaining net contractual payments and the fair value of the remaining unfulfilled (or partially unfulfilled) performance obligations at the acquisition date. Depending on how the differences between (a) the consideration to which the combined entity is entitled after the acquisition date and (b) the fair value of the expected remaining net contractual payments at the acquisition date are classified, payment terms could affect the amount of post-acquisition revenue recognized due to variable consideration and discounting in a present value calculation. See Appendix A and Question 1.8 for further discussion of the post-acquisition accounting.

We are not aware of other accounting outcomes applied in practice for different payment term scenarios that are not illustrated in the ITC.

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)?

Yes, we recommend that an acquirer recognize an asset or a liability for each acquired revenue contract that is separate from other customer-related intangible assets. As described in Appendix A, using the contract as the unit of account in our suggested approach would result in recognizing a single asset or liability for each acquired contract. That single asset or liability would replace the contract asset (liability), the favorable (unfavorable) contract intangible asset (liability) and the backlog asset that an acquirer recognizes under current GAAP for each acquired contract but would be separate from a customer relationship intangible asset.

If a market participant were to acquire a third party's revenue contract in a stand-alone transaction, it would either:

- pay the third party to acquire the contract (if the fair value of the remaining net contractual payments exceeds the fair value of the remaining unfulfilled or partially unfulfilled performance obligations under the contract), recognize an asset for that payment, and reduce the amount of revenue subsequently recognized under the contract by that asset (because it effectively bought that revenue); or
- receive a payment from the third party to assume the contract (if the fair value of the remaining unfulfilled or partially unfulfilled performance obligations exceeds the fair value of the remaining net contractual payments), recognize a liability for the payment received, and add that liability to the amount of revenue recognized under the contract (because it received additional compensation from the third party to do so).

We believe the accounting for revenue contracts acquired in a business combination should be broadly consistent with the accounting that would apply if the acquirer bought the revenue contract in a stand-alone transaction.

We do not support measuring the contract liability on the basis of Topic 606, because that would be inconsistent with the fair value model under Topic 805 and would not reflect the amount a market participant would pay (or receive) to acquire a contract in a stand-alone transaction. Our proposed approach in Appendix A considers how to value the identifiable asset/liability.

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?

Yes, we believe applying the contract as the unit of account is operational. If the acquiree has a large number of revenue contracts, we believe a portfolio approach similar to that identified in paragraph 606-10-10-4 could enhance practicability, as discussed in Appendix A.

Paragraph 805-20-55-22 requires acquirers to recognize a backlog intangible asset for in-place contracts. In practice, preparers use the same estimates of net contractual cash flows to value an acquiree's contracts as would be used to value the identifiable asset. However, they generally aggregate that value within customer-related intangible assets. Recognizing an identifiable asset results in reclassifying the backlog asset and a favorable (unfavorable) asset (liability) from intangible assets into a separate identifiable asset (liability).

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?

Yes, the identifiable asset meets the definition of an asset. Paragraph 25 of 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." To the extent that the fair value of the acquirer's rights exceeds the fair value of the acquirer's obligations under an acquired revenue contract, that contract meets the definition of an asset. As noted in our response to Question 1.3, paragraph 805-20-55-22 requires acquirers to recognize that asset and classify it as a backlog intangible asset.

We believe the unit of account should be each individual revenue contract. We believe this approach is consistent with Topics 805 and 606. When using the entire contract as the unit of account to recognize a single asset or liability, we believe that an asset meets the definition of a contract-related intangible asset. As previously noted, this asset is effectively the combination of the backlog asset and a favorable (unfavorable) contract intangible asset (liability). We are not as concerned with the classification of the asset as long as the asset subsequently affects revenue, not expense.

We also believe that, as a practical approach, acquirers should be allowed to aggregate certain acquired revenue contracts. We think the existing portfolio approach guidance in paragraph 606-10-10-4 would be appropriate for that purpose and has the benefit of being consistent with the existing guidance for accounting for revenue contracts.

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?

Generally no, because the backlog asset would be subsumed into the identifiable asset. However, if the scope of the new guidance on accounting for revenue contracts in business combinations is limited to arrangements that meet the definition of a contract in Topic 606 (as we recommend in Appendix A), an acquiree may have some arrangements with customers for which it would continue to be appropriate to recognize a backlog asset (e.g. a wholly unperformed contract for which each party has a unilateral right to terminate without compensation under paragraph 606-10-25-4).

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

Yes. We believe the Board would need to provide guidance on the subsequent accounting for the identifiable asset, to ensure that reductions to that asset are recognized as a reduction of revenue as the entity satisfies performance obligations under the contract after the acquisition date. Additionally, the Board should provide guidance on how an asset or liability recognized should be incorporated into the post-acquisition revenue accounting. See Appendix A for additional discussion related to subsequent accounting.

We also believe an impairment model would be needed for the identifiable asset. Guidance on an impairment model should be consistent with how the Board determines the asset classification.

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

Yes, we believe guidance consistent with the principle that the payment terms should not affect the amount of subsequent revenue recognized by the acquirer would improve the comparability and consistency of financial information across entities.

However, as indicated in our response to Question 1.1, we would not describe the principle by reference to the payment terms.

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?

One approach to accounting for variable consideration after the acquisition date would be to recognize in other operating income or expense (rather than in revenue) the difference between the amount of consideration to which the combined entity is ultimately entitled and the fair value of the consideration included in the measurement of the contract at the acquisition date. This approach would fix post-acquisition revenue at an amount equal to the fair value of the unfulfilled (or partially unfulfilled) performance obligations at the acquisition date. Accordingly, this approach would be most consistent with the principle that the payment terms should not affect the amount of post-acquisition revenue recognized by the acquirer.

Alternatively, post-acquisition adjustments to variable consideration could be presented as an adjustment to revenue. We believe acquirers generally follow this approach today, and it may be more practical to apply.

We believe there are merits to both approaches. Regardless of the approach the FASB chooses, we believe that additional guidance on this subject will be necessary, and that examples may also be helpful.

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?

For consistency with the principles in Topic 805, we believe that an acquired revenue contract should be measured at fair value on the acquisition date, without regard to the sales- and usage-based royalty exception or the constraint on variable consideration. Accordingly, the fair value of the expected remaining net contractual payments would be based on market participant assumptions about the likelihood that variable consideration, including sales- and usage-based royalties, will become due and be collected when the underlying contingency is resolved. The fair value of the revenue contract is the difference between the fair value of the expected remaining net contractual payments and the fair value of the unfulfilled performance obligations.

We note that recognizing an identifiable asset at fair value does not change the amount of variable consideration in the contract in the post-acquisition period. Guidance may be necessary to address how the constraint in Topic 606 interacts in the post-acquisition period with the asset or liability recognized in the business combination.

A sales- or usage-based royalty associated with a performance obligation satisfied over time will continue to be recognized using the exception that applies to those royalties in Topic 606. As noted in our response to Question 1.8, a difference between the amount of the royalty and the fair value of the estimated royalty stream that is included in the measurement of the contract at the acquisition date could be presented either as revenue or as other operating income or expense.

A sales- or usage-based royalty collected after the acquisition date associated with a performance obligation satisfied at a point in time before the acquisition date will be applied against the identifiable asset, and an excess or shortfall (or impairment) should be recognized in other operating income or expense. Because the performance obligation was satisfied before the acquisition date, these royalties would not be revenue of the combined entity.

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?

The appropriate impairment model to be applied to the identifiable asset depends on the Board's decision about the nature of that asset. For example, if the Board concludes that an identifiable asset is an intangible asset, the impairment model in Topic 360 for long-lived assets that are held and used should be applied.

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?

We believe an entity should include contributory asset charges for all tangible and intangible assets required to fulfill a performance obligation when estimating the fair value of that performance obligation using a bottom-up approach. We believe a market participant would include all relevant contributory asset charges when determining the price that it would be willing to pay (or would demand to receive) when acquiring a revenue contract in a stand-alone transaction. Accordingly, we believe including these charges in the determination of the price is consistent with the definition of fair value in Topic 820, that is, "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

We believe that it is widely accepted that contributory asset charges related to tangible assets required to fulfill a performance obligation should be included in a bottom-up fair value estimate for that performance obligation. As indicated in paragraph 2.15 of the ITC, the point of debate seems to be whether contributory asset charges related to intangible assets required to fulfill a performance obligation should be considered when estimating the fair value of that performance obligation. However, we can think of no reason why intangible assets should be treated differently from tangible assets when estimating the fair value of the performance obligation.

In EITF Issue No. 18-A, the EITF reached a consensus-for-exposure that an acquirer should use the definition of a performance obligation in Topic 606 to determine whether to recognize a contract liability acquired in a business combination. We agree with the EITF's consensus-for-exposure on EITF Issue No. 18-A, and believe the definition of a performance obligation should also be applied to identify the remaining obligations (and to measure them) in all revenue contracts acquired in a business combination, not just those in a liability position at the acquisition date. Therefore, we believe a contributory charge should be considered in determining the fair value of all contracts with unfulfilled performance obligations.

Additionally, Topic 606 specifies that licenses of symbolic intellectual property are performance obligations satisfied over a period of time, rather than at a point in time, because the licensor continuously grants access to the underlying intellectual property and supports that intellectual property over the entire license term. To be able to continue to grant access to the underlying intellectual property over the license term, a market participant acquiring a license contract as licensor must either (1) also acquire the underlying intellectual property, in which case the market participant would include a contributory charge in the price it would demand to recover a portion of the amortization of that asset plus a margin thereon or (2) rent the underlying intellectual property, in which case the market participant would include the rental charge in the price it would demand to assume the contract. We can see no difference between this fact pattern and similar fact patterns involving tangible assets.

Some examples may illustrate this point:

- We believe an exclusive license of symbolic intellectual property is most analogous to a contract that requires the use of a dedicated tangible asset to fulfill. In a contract that requires a dedicated tangible asset to fulfill (e.g. a contract to dig a ditch), a market participant acquiring the contract would include a contributory asset charge related to the backhoe necessary to dig that ditch. That charge would cover either (1) the depreciation expense for the period required to dig the ditch, plus a margin thereon, or (2) a rental charge for the period required to dig the ditch. Similarly, for an exclusive license of symbolic intellectual property (i.e. the underlying asset is dedicated to fulfilling a single contract), a market participant acquiring the contract also would include a contributory asset charge, consisting of either (1) the amortization expense for the period of the license, plus a margin thereon, or (2) a rental charge for the period of the license.

- We believe a non-exclusive license of symbolic intellectual property is most analogous to a contract that requires the use of a tangible asset to fulfill, where the tangible asset can be used to fulfill multiple customer contracts simultaneously. Fiber-optic cable is an example of that type of asset. A market participant acquiring a telecommunications contract for less than the full capacity of a fiber-optic cable would include a contributory asset charge for a portion of the depreciation expense during the term of the contract, rather than the entire depreciation expense during that period, because it expects to recover the remaining depreciation expense during that period through other customer contracts. Similarly, a market participant assuming the role of licensor in a non-exclusive license of symbolic intellectual property would include a contributory asset charge for only a portion of the amortization expense over the term of the license, because it also expects to recover the remaining amortization expense during that period through other non-exclusive licenses.

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?

Yes, additional guidance would be needed to clarify how to measure the fair value of related assets. As paragraph 2.14 of the ITC correctly points out, the valuation of the contract liability affects the valuation of the underlying asset. Not including a contributory asset charge in the valuation of a contract liability results in a lower fair value measurement of the underlying asset used to fulfill that liability. The net contractual cash flows that have already been collected are excluded from the cash flow projections used to estimate the fair value of the underlying asset. We believe that the resulting valuation of the underlying asset is an entity-specific valuation, because it takes into account the specific revenue contracts of the acquiree. This particularly affects the valuation of intellectual property assets because of the practice of not including a contributory asset charge in the valuation of the liability.

We believe it would be more consistent with the fair value principles and market participant view in Topic 820 to estimate the fair value of the underlying asset on an unencumbered basis, independent of the revenue contracts the acquiree has in place. This is similar to the approach required by paragraph 805-20-30-5 for valuing the leased asset in an acquiree lessor's operating lease. Accordingly, we recommend adding a similar paragraph to require assets that are used to fulfill the acquiree's revenue contracts, particularly intellectual property assets, to be valued on an unencumbered basis.

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?

No. We believe the contract should be the unit of account for measurement. One component of that measurement is the fair value of the unfulfilled or partially unfulfilled performance obligation(s) at the acquisition date. Revenue contracts with multiple performance obligations generally have an embedded discount, and we believe that the expectations of market participants about discounts that would be embedded in the value of such contracts should be reflected in their measurement. If each performance obligation were valued separately without considering the expectations of market participants about discounts, the acquirer could eventually recognize more revenue after the acquisition date than the acquiree would have recognized in the absence of the business combination.