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Mr. Shayne Kuhaneck
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File Reference No. 2019-200
Financial Accounting Standards Board
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30 April 2019

Re: Invitation to comment, Measurement and Other Topics related to Revenue Contracts with Customers under Topic 805 (File Reference No. 2019-200)

Dear Mr. Kuhaneck:

We appreciate the opportunity to provide feedback on the Invitation to comment, *Measurement and Other Topics related to Revenue Contracts with Customers under (Topic 805)* (the ITC), issued by the Financial Accounting Standards Board (FASB or Board).

We have carefully considered the topics discussed in the ITC and believe the matters raised are likely the result of a lack of measurement guidance related to revenue contracts with customers acquired in a business combination. We believe that the Board has an opportunity to comprehensively address all the matters raised in the ITC in a manner that is practical for financial statement preparers to apply, results in a financial reporting outcome that reflects the economics of the acquisition and provides users with decision-useful information to evaluate trends.

In this letter, we recommend an approach that we believe would improve the consistency and comparability of financial reporting. We also respond to the questions posed in the ITC in the Appendix to this letter.

In addition, we recommend that the Board move forward with its Proposed Accounting Standards Update, *Business Combinations (Topic 805): Revenue from Contracts with Customers – Recognizing an assumed liability (a consensus of the FASB Emerging Issues Task Force)*. We believe doing so would reduce the diversity in practice that currently exists when an entity recognizes a contract liability from a contract with a customer that is acquired in a business combination and is in the scope of Accounting Standards Codification (ASC) 606.

Our recommendation

We recommend that the Board consider amending ASC 805 to provide an exception to the general fair value measurement principle for contract assets and contract liabilities arising from a contract with a customer that is acquired in a business combination and is in the scope of ASC 606. Under this exception, an acquirer would carry over the accounting applied by the acquiree pursuant to ASC 606. We refer to this approach as the carryover approach.¹

We also recommend that the Board state explicitly in any new guidance which transactions the exception would apply to and which transactions it would not apply to. We believe this exception should apply to all arrangements in the scope of ASC 606 and to arrangements in which the recognition and measurement principles of ASC 606 are applied under the guidance in other subtopics (e.g., ASC 610-20). In this letter, we explain how we think applying this approach would affect both the acquirer's accounting for a business combination and the amount of revenue the acquirer recognizes after the business combination.

Initial measurement

When an acquirer obtains control of a business, the acquirer identifies and separately recognizes the assets it has acquired and the liabilities it has assumed that are separately identifiable and meet the recognition principles in ASC 805. A revenue contract acquired in a business combination may give rise to the separate recognition of a contract asset or liability, as defined, in ASC 606, in addition to certain contract-related intangible assets.²

Contract liabilities

Under our recommendation, an acquirer would record a contract liability on its opening balance sheet in the same amount as the acquiree recorded on its closing balance sheet to reflect consideration received (or the amount due) from its customer in advance of satisfying its obligation to transfer goods or services to that customer.

We acknowledge that, under this approach, the acquirer would likely record a contract liability that is larger than the liability it would recognize using the fair value approach. That's because the costs (and related profit) of certain activities the acquiree performed before the acquisition date would be included in the carryover amount but not in a fair value measurement.³ That is, a fair value measurement

¹ This assumes that the target's application of ASC 606 was appropriate.

² The other components of value of an acquired contract with a customer may include a customer relationship intangible asset (reflecting the future benefit to be received by the acquirer from future contracts with that customer), a contract backlog intangible asset (reflecting the future benefit to be received by the acquirer from the existing contract with that customer (i.e., the inherent or in-place value associated with outstanding purchases or sales orders)) and an off-market component intangible asset or liability (reflecting the value attributable to the terms of the contract that are not "at market" at the acquisition date).

³ We believe that these activities primarily relate to the cost of selling and marketing efforts incurred to obtain the contract, plus a "normal" profit margin on that effort.

would generally be determined using a cost buildup approach that would reflect only the remaining costs to satisfy the performance obligation, plus a reasonable profit margin on those costs.

Accordingly, using the carryover approach to measure a contract liability would generally result in more post-combination revenue than using a fair value method. Under the carryover approach, an entity would continue to measure any intangible assets (or liabilities) related to the revenue contract at fair value, including a liability associated with contract terms that are unfavorable when compared to market terms. We acknowledge that if the Board were to provide this measurement exception for contract liabilities, the amount of goodwill recognized in a business combination could increase. This would be the case if the Board doesn't also issue guidance stating that an entity should increase an intangible asset that is also recognized as part of the acquired contract, for the difference between the fair value of the contract liability and its carrying amount.

Contract assets

If the acquiree recorded a contract asset because it had already transferred goods or services to a customer but had not yet received payment (because the acquiree's right to payment is conditional), the acquirer would reflect the same contract asset on its opening balance sheet that the acquiree reflected on its closing balance sheet immediately before the business combination. If the amount of consideration to be received in the future is fixed,⁴ we would generally expect the carrying amount to approximate the amount an acquirer would recognize as a contract asset measured at fair value under ASC 805 today. Because an entity would continue to measure the other components of value that comprise an acquired revenue contract at fair value, the sum of all assets and liabilities recognized will equate to an amount that reasonably approximates fair value as a whole.

However, if the consideration promised under the contract is variable and the acquiree excluded certain cash inflows from the contract asset amount recognized on its balance sheet before the business combination because it constrained the estimate of variable consideration when determining the transaction price,⁵ the carrying amount of the contract asset may be lower than an amount measured at fair value. This is because a fair value measurement generally considers the present value of expected future cash flows from the perspective of a market participant.

When an acquirer measures the other components that comprise the acquired revenue contract (e.g., a contract backlog intangible) at fair value, it would still need to verify that all cash flows have been appropriately considered (i.e., cash flows have not been omitted or double counted) to make sure that the sum of all relevant assets and liabilities recognized equates to an amount that reasonably approximates fair value as a whole. Accordingly, we would expect that, in most instances, applying a

⁴ "Fixed" in this case means that the consideration expected to be received under the contract is not determined to be variable under ASC 606.

⁵ As stated in BC214 of the Basis for Conclusions of ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, the guidance first requires an entity to estimate the consideration to which it expects to be entitled and then determine whether it is probable that a significant revenue reversal will not occur when the uncertainty associated with the variable consideration is resolved.

carryover approach to contract assets would not affect the amount of goodwill recognized in a business combination.

Subsequent measurement

The acquirer would subsequently remeasure and derecognize any assumed contract liability or acquired contract asset pursuant to ASC 606. An offsetting entry generally would be recorded to revenue, accounts receivable or cash. The primary benefit of adopting a carryover approach is that it would align the subsequent accounting for contract assets and contract liabilities with ASC 606, as discussed in more detail below.

As previously stated, we acknowledge that if a contract liability is recognized at its carryover basis, the acquirer would recognize revenue and profit for the portion of the liability attributable to the acquiree's pre-combination performance. However, we would expect this revenue and profit, most often associated with the sales and marketing effort of the acquiree, to be minor relative to the total cost to fulfill the remaining performance obligation(s) in an acquired contract (and many acquired contracts are short-term in duration).

We believe this approach would result in a financial reporting outcome that would provide meaningful information that is easy for financial statement users to understand. Preparers could also operationalize the approach without incurring excessive cost or expending undue effort.

Reasons for our recommendation

We believe a carryover approach would provide better overall alignment with the revenue accounting model and produce high-quality financial information for users of the financial statements. This is consistent with one of the central objectives the Board highlighted when it issued ASC 606. Revenue trends reported during the periods after a business combination would more closely resemble the information reported by the acquiree in the pre-combination period, allowing investors to compare the results as they seek to understand and predict the long-term future performance of the combined entity.

In addition, we understand that entities may disclose non-GAAP performance measures that include certain adjustments to GAAP earnings (loss) to remove the effects of some of the measurement differences identified in purchase accounting. We believe that a carryover approach may reduce the frequency of certain non-GAAP adjustments.

Initial measurement

We believe that allowing entities to use the carryover approach would be consistent with the Board's decision to provide the sales-based royalty exception to the measurement principle in ASC 606. In the Basis for Conclusions of ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*, the Board noted that, for licenses of intellectual property for which the consideration is based on a customer's sales or usage, an entity cannot reasonably estimate the consideration to which it expects

to be entitled in exchange for transferring goods or services.⁶ The Board ultimately decided to provide the exception because entities would otherwise report amounts that would not be relevant or useful to users of the financial statements. We believe that requiring entities to apply a fair value approach for units of account derived from the transaction price (i.e., contract assets and contract liabilities) simply because they were acquired in a business combination would be inconsistent with the Board's earlier decision on the sales-based royalty exception.

Under the carryover approach, the total future cash flows associated with acquired revenue contracts would be appropriately captured in a customer-related intangible asset and the carrying amount of the contract asset, and the FASB wouldn't have to provide additional guidance on the subsequent accounting under ASC 606 (see discussion below).

If the FASB retains a fair value measurement principle for contract assets, we believe diversity in practice could develop regarding the determination of the fair value of contract assets recognized in a business combination. That is, because ASC 805 does not provide guidance on the measurement of contract assets that include variable consideration, we believe some entities may include the fair value of future cash flows related to variable consideration (which were appropriately excluded from the transaction price and corresponding contract asset pursuant to ASC 606) in the fair value of the customer-related intangible rather than an ASC 606 contract asset. Therefore, if the FASB retains a fair value measurement principle for contract assets, we believe the FASB should provide additional guidance to clarify which unit of account (e.g., contract asset or customer-related intangible asset) should reflect the fair value adjustment associated with variable consideration.

Subsequent measurement

If the FASB retains a fair value measurement principle, we believe the Board would need to consider developing additional guidance to address the subsequent accounting for revenue contracts acquired in a business combination. Should the Board provide additional guidance, it may lead to more complexity and result in revenue contracts acquired in a business combination being accounted for differently from contracts the entity enters into after the business combination. Preparers would also need to enhance their internal controls to address the increased risk associated with the subsequent accounting for acquired revenue contracts. We believe this could be complex and costly for many entities.

Contract assets and contract liabilities are subject to the general requirement in ASC 805 that an entity subsequently measure and account for assets acquired and liabilities assumed in accordance with other relevant GAAP. However, ASC 606 does not address changes in estimates or derecognition of contract assets or contract liabilities measured at fair value in a business combination. Entities that

⁶ In BC415 of the Basis for Conclusions of ASU 2014-09, the Board considered intellectual property licensing arrangements where a substantial amount of the consideration promised in the contract is variable, it is paid over a long period of time and it varies on the basis of factors that are outside the control of both the entity and the customer (i.e., a royalty payment that varies based on a customer's subsequent sales or usage). The Board indicated that it would not be useful for an entity to recognize a minimum amount of variable consideration upon contract inception in these situations because significant adjustments would inevitably be required in subsequent periods as the significant uncertainty is resolved. Consequently, the Board decided that "for a license of intellectual property in which the consideration is based on the customer's subsequent sales or usage, an entity should not recognize any revenue for the variable amounts until the uncertainty is resolved."

acquire revenue contracts in a business combination may conclude that it would be appropriate to apply the guidance in ASC 606 to account for changes in the transaction price after the acquisition date.⁷ However, applying this guidance to a contract asset recognized at fair value upon acquisition could be difficult and could lead to diversity in practice, in particular for contracts that include variable consideration subject to constraint.

For example, assume that an acquirer had constrained the estimate of variable consideration when it recognized a contract asset before a business combination. If the contract asset is recognized at fair value in the business combination, additional guidance may be necessary to address how to account for subsequent changes in variable consideration. Depending on the level of uncertainty associated with the variable consideration to be received in the future, changes in transaction price in subsequent reporting periods could have a significantly different accounting effect from entity to entity. The potential conflict in measurement guidance between ASC 805 and ASC 606 is even more pronounced when an entity applies the sales-based royalty exception, which precludes an entity from recognizing revenue (or a contract asset) before the sales or usage occurs.

Our recommendation is broadly consistent with the views the Board described in the Background Information and Basis for Conclusions of ASU 2016-02, *Leases (Topic 842)*,⁸ where it said it decided that an acquirer should not be required to measure lease assets and lease liabilities at fair value because the benefits of doing so would not justify the cost and difficulty of operationalizing the approach.

We believe the carryover approach would align the accounting principles for revenue contracts an entity enters into and those it acquires in a business combination, increasing comparability. We believe our recommendation would improve a financial statement users' understanding of revenue contracts acquired in a business combination.

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We would be pleased to discuss our comments with the Board or its staff at your convenience.

Very truly yours,



⁷ Paragraph ASC 606-10-32-43 states that "an entity shall allocate to the performance obligations in a contract any subsequent changes in the transaction price on the same basis as at contract inception [...] Amounts allocated to a satisfied performance obligation shall be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes."

⁸ Paragraph BC416 of ASU 2016-02.

Appendix – Responses to questions in the ITC

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 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 or 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?

As previously discussed, we believe a carryover approach would provide better overall alignment with the revenue accounting model and produce high-quality financial information for users of the financial statements. Revenue trends reported during the periods after a business combination would more closely resemble the information reported by the acquiree in the pre-combination period, allowing investors to compare the results as they seek to understand and predict the long-term future performance of the combined entity.

We do not believe that ASC 805 should be amended to state that the timing of payment of consideration related to an acquired revenue contract should not affect the subsequent amount of revenue recognized. We understand why the Emerging Issues Task Force agreed that, in principle, the timing of payments should not affect post-combination revenue. However, we believe that providing guidance stating that

the timing of payments shall not affect the subsequent amount of revenue recognized would not improve the usefulness and comparability of financial information and would be impracticable for preparers to apply. If the FASB followed our recommendation and provided guidance requiring entities to use the carryover approach, the timing of payments generally would not affect the amount of revenue recognized after a business combination (except when there is variable consideration).

We are concerned that guidance requiring entities to record an identifiable asset as a way to make sure that the timing of payments does not affect the amount of revenue recognized by the acquirer after the business combination would be burdensome and difficult to apply. We acknowledge that the recognition of an identifiable asset may result in a highly precise financial reporting outcome from a revenue perspective. However, given that the component of value attributable to selling effort is likely captured in an intangible asset and amortized into income today, we believe that separate balance sheet classification and presentation would provide only limited benefit to users of the financial statements and could make financial statements more difficult to understand.

When measuring the fair value of intangible assets, valuation specialists likely consider the future cash inflows to be received by the acquirer from the customer attributable to an acquiree's selling effort either at a customer level, or at a contract portfolio level. Identifying these cash flows on a contract-by-contract basis, as contemplated in the scenarios described in the ITC, would likely require a lot of effort. The Board has indicated that assessing cash flows at the contract level may be challenging and not cost beneficial in other circumstances. For example, the Board provided guidance in ASC 310-30 that allows an acquiring entity to aggregate impaired loans that have common risk characteristics into one or more pools at the time of acquisition if the acquirer believes that it is probable that, on an individual loan basis, it will not collect the remaining contractual payments as a result of credit deterioration since the loan was originated. The loan pool then becomes the unit of account for recognition, measurement and disclosure purposes.

We believe that if the Board were to require recognition of an identifiable asset to account for the acquiree's selling effort, it would also need to provide guidance to address the nature of the asset and its classification on the balance sheet. Guidance would also be needed on the subsequent measurement and derecognition of the asset that includes explicit unit of account guidance that is operational. We are concerned that, if these issues are not addressed, diversity in practice would increase in several areas of financial reporting.

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?

As discussed above, we believe the Board should consider providing an exception to the general fair value measurement principle in ASC 805 and require that acquirers recognize contract assets and contract liabilities using the carrying amounts of the acquiree determined under ASC 606. Under this approach, an acquirer would continue to apply the guidance in ASC 606 relative to measurement constraints in a manner that is consistent with the method previously applied by the acquiree. Please refer to the “reasons for our recommendation” section of this letter, where we discuss the complexities that we believe exist with respect to acquired contracts that involve variable consideration and contingent payment structures.

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?

Question 2.3: Should the performance obligation definition 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?

We agree that diversity exists in practice today with respect to which types of costs incurred to fulfill a performance obligation an entity includes in the fair value measurement of a contract liability, and we generally would expect contributory charges to be included in a fair value measurement. However, as discussed above, we are recommending that the Board consider providing an exception to measuring contract liabilities and contract assets at fair value.