The Association of Accountants and Financial Professionals in Business

May 13, 2019

Mr. Shayne Kuhaneck
Acting Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

File Reference No. 2019-200 and No. 2019-300

Dear Mr. Kuhaneck:

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views on:

(1) the Financial Accounting Standards Board's (FASB or Board) Proposed Accounting Standards Update (Proposed ASU) – *Business Combinations (Topic 805): Revenue from Contracts with Customers— Recognizing an Assumed Liability (a consensus of the FASB Emerging Issues Task Force)*, and

(2) Invitation to Comment (ITC) – *Measurement and Other Topics Related to Revenue Contracts with Customers under Topic 805*.

The IMA is a global association representing over 130,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The Committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

The Committee observes that the topics raised in the Proposed ASU and in the ITC (collectively, Accounting for Customer Contracts in Business Acquisitions) are complicated and intertwined. Their resolution could have broad implications on multiple aspects of accounting and valuation in business acquisitions, as well as subsequently as the acquiror applies Topic 606 to the acquired entity's contracts with customers. The Committee concluded that addressing recognition issues in the Proposed ASU separately from measurement and other issues included in the ITC is not practical, and in fact could hinder development of a meaningful approach and resolution of these broad issues. The Committee feels that separate issuance of the guidance in the proposed ASU is not likely to significant help in resolving the existing inconsistencies in how companies address the issues of Accounting for Customer Contracts in Business Acquisitions. Additionally, the separate issuance will necessitate two separate implementation exercises, increasing the costs for preparers, and likely creating confusion in the accounting community.

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Consequently, the Committee does not support issuance of the Proposed ASU without simultaneously releasing guidance applicable to measurement aspects of Accounting for Customer Contracts in Business Acquisitions.

Recommended Approach – Scope Exception

The Committee debated the issues and the alternatives included in the Proposed ASU and the ITC over the course of multiple meetings. While different views were discussed, the Committee members converged to a predominant belief that the issues pertinent to the Accounting for Customer Contracts in Business Acquisitions would be best addressed by adding a scope exception to the provisions of ASC 805-20-25-16 and the corresponding guidance in ASC 805-20-30-11 and 30-12. The Committee's rationale for advocating this approach is included at the end of this letter.

Under the recommended scope exception, any assets and liabilities arising from contracts with customers would be excluded from the general recognition and measurement guidance in Topic 805 unless they are in the scope of other accounting literature or are not separable from other assets and liabilities recognized in the business acquisition. Instead, acquiring entities would recognize and measure such excluded assets and liabilities, both initially upon closing of the acquisition and subsequently, based on the provisions of Topic 606 or Topic 340-40. Entities would recognize and measure such assets and liabilities upon closing of the acquisition in a manner similar to that applicable upon adoption of Topic 606 and Topic 340-40, as described in ASC 606-10-65-1(d)(2), including the practical expedient in ASC 606-10-65-1(f)(4) if desired (with the resulting net debit or net credit included in acquisition accounting).

The Committee believes the scope exception should be extended to (a) contracts that do not meet the criteria in ASC 606-10-25-1 to constitute contracts with customers as of the acquisition date, but are expected to meet those criteria at a later date; and (b) contracts that are required to be accounted for using recognition and measurement provisions of Topic 606 – such as contracts in the scope of Topic 610-20 – or for which the entity elects to analogize to the recognition and measurement provisions of Topic 606. This may apply, for example, to certain contracts in scope of Topic 808, government grants, etc.

As noted above, the recommended scope exception would not apply to assets and liabilities that are in the scope of other accounting literature. Examples include (a) costs incurred to fulfil a contract with a customer, if capitalized under Topic 330, Topic 350-40, Topic 360, or other applicable literature, and (b) accounts receivable, if in scope of Topic 310. Such assets and liabilities would fall under the general recognition and measurement provisions of Topic 805. The scope exception would also not apply to amounts that are not separable from other assets and liabilities recognized in the business acquisition. An example is contract origination activities performed by the acquired entity, if part of a separately-recognized customer-related intangible asset.

The Committee observes that under this recommended approach, entities will generally recognize the same amount of revenue on contracts with customers following the closing of the acquisition regardless of the timing of payment by customers.

The Committee considered the interaction between the issues of Accounting for Customer Contracts in Business Acquisitions and the premise underlying valuation of assets of the acquired entity used in satisfying the entity's performance obligations to customers. Examples of such assets include a backhoe used in a contract to dig a ditch, a building subject to a lease contract, and both functional and symbolic intellectual property licensed to a customer. The Committee believes the acquirer should record upon acquisition the fair value of all assets controlled by the acquired entity. Fair value should be determined consistent with how the entity determines what it controls. As stipulated by ASC 606-10-55-50 and 55-62, control of the right to access the entity's intellectual property (including all symbolic intellectual property) is transferred over time. Therefore, at any point in time during the license term, the entity retains control of access to its intellectual property as pertains to the future periods, even if such property is encumbered with a binding contract (i.e., a license) requiring the entity to transfer such control to a customer in the future. The Committee believes this approach should apply regardless of whether the asset controlled by the entity represents a backhoe, a building, or right to access intellectual property in the future. This view is consistent with the "second view" as discussed in paragraph 2.14 of the ITC.

Alternative Approach

While the above recommended approach was the predominant view among the Committee members, several members expressed a preference for an approach similar to one of the approaches in the ITC. That approach was also an acceptable alternative to some of the members who supported and preferred the Committee's recommended approach. Under this alternative approach, entities would record contract liabilities at an amount that excludes the value attributable to the selling effort undertaken by the acquired entity.

Consistent with the view in the recommended approach, the fair value of the assets used to transfer performance obligations underlying the acquired contract liabilities would be determined under the premise based on transfer of control. Thus, the fair value of intellectual property the access to which is transferred over time (including all symbolic intellectual property) would be determined regardless of whether such intellectual property is encumbered with binding contracts (such as licenses to access) transferring control over a portion of the future economic benefits to a third party. Likewise, the fair value of the related contract liabilities would include amortization (or rental) of such asset over the remaining term of the license. In other words, this alternative approach supports the view described in paragraph 2.13 (and the related "second view" in paragraph 2.14) of the ITC.

All members who prefer (or accept) this alternative approach concluded that conceptually, if this approach is adopted, the timing of payments by customers should not impact the amount of revenue recognized by the acquirer subsequent to the acquisition (i.e., such revenue conceptually should not include the value attributable to the acquired entity's selling effort). However, some of these members do not believe this concept can be meaningfully translated into practice. According to these members, benefits to financial reporting are not enough to justify the incremental costs to determine the value of the asset that this approach would necessitate and the unavoidable disruption to existing valuation practices for customer-related intangibles. In addition, these members observe that implementing this approach is likely to encounter practical challenges that go beyond those the broad accounting community is skilled at addressing.

Other Questions

Most of the Committee members do not believe additional disclosures would be required to address recognition of balances related to Customer Contracts in Business Acquisitions. The existing disclosure requirements in ASC 805-20-50-1(c), as well as the general disclosure requirements in ASC 235-10-50-1 and 50-3, and, for SEC registrants, requirements to disclose significant accounting estimates and assumptions required by SEC Release 33-8350, are sufficient.

We do agree that the prospective transition method would be appropriate to adopt any eventual guidance on Accounting for Contracts with Customers in Business Acquisitions.

Recommended Scope Exception Approach – Rationale

The Committee's recommendation of a scope exception for balances associated with contracts with customers is rooted in deep conceptual differences between Topic 606 and Topic 805. We believe it is likely these differences and the related challenges prevented the Emerging Issues Task Force (EITF) from reaching a consensus in its deliberations. Under Topic 805, assets and liabilities are generally recognized upon acquisition at fair value. Although certain fair value considerations underlie the accounting framework in Topic 606, overall it is not a standard based on fair value.

Assets and liabilities recorded under Topic 606 reflect the transaction price determined as of a point in time, allocated using certain principles to individual units of account known as performance obligations, as adjusted for the contractual rights to consideration in existence at that time. In many instances, the transaction price and the amounts allocated to individual performance obligations or rights to consideration are not reflective of the fair value of either the contract as a whole or the individual units of account (i.e., performance obligations) as of any relevant point in time. Further, the net contract asset or contract liability related to a particular contract in many instances would not correspond to any specific performance obligation, as contractual payment streams are often not specific to individual performance obligations. As a result, ASC 606-10-45-1 requires entities to report a single net position (i.e., either a contract asset or a contract liability) for each contract with a customer. Effectively, for balance sheet reporting purposes, the contract in aggregate serves as the unit of account. This single net position is derived from a calculation, the key inputs into which are not fair value measures, and thus in many instances would not reflect the fair value of the contract.

Under Topic 805, fair value of executory contracts is typically addressed as part of the valuation of intangible assets. Entities may also record assets or liabilities representing off-market contract elements (also known as favorable or unfavorable contracts). Contracts with customers also have inherent value which is captured as "backlog". If an executory contract with a customer is the single unit of account for balance sheet purposes (i.e., the approach used in Topic 606), and if the fair value concept is to be applied to this unit of account, it would logically need to be determined in a manner consistent with that for any other executory contract. This approach would be different from any approaches illustrated in the ITC and would also result in significant changes to existing practice. We do not advocate this approach as it is not likely to produce meaningful information for users, in addition to being cumbersome for both preparers and auditors.

As a result, Accounting for Contracts with Customers in Business Acquisitions presents one of those challenging situations where a transaction transitions from one accounting topic to another and there is a conflict between the accounting concepts underlying the two topics. Although this conflict was present even prior to the adoption of Topic 606, it became more pronounced as Topic 606 includes detailed principles of how to address various aspects of contracts with customers, including introducing the concept of contract assets and a single unit of account reporting on the balance sheet.

Conflicts between concepts within different accounting topics cannot be resolved without a compromise. The ITC contemplates several variations of one approach towards resolution, attempting to apply fair value considerations (Topic 805 concepts) to individual elements of a contract with a customer, such as "unsatisfied performance obligation for which [the entity] has been paid". This approach is inconsistent with the single unit of account concept used in Topic 606 for balance sheet purposes. The result also may not represent true fair value, unless a substantial valuation exercise is performed, because in many instances it will likely be derived from an allocation of the transaction price, with deviations from fair value potentially present in both the transaction price and the allocation process. We note also that "unsatisfied performance obligation for which [the entity] has been paid" is not a unit of account under Topic 606. It is also questionable whether determining its fair value is even a meaningful or possible exercise. The ITC itself identifies some of the resulting unavoidable challenges, for example, how to assess variable consideration, including that representing sales- and usage-based royalties. True fair value determinations would require making estimates of all these amounts, which is beyond the ongoing requirements of Topic 606, as allowed by ASC 606-10-50-14 and 50-14A. However, allowing similar exemptions in the context of acquisition accounting will inevitably produce a result that is not fair value-based.

Further, Topic 606 provides detailed approaches entities use to account for different types of performance obligations throughout the lifecycle of a contract with a customer. It addresses topics such as changes in transaction price and the resulting impact on its allocation to performance obligations; contract modifications; contract continuation (when options with material rights are exercised); breakage (unexercised rights); vendor and customer options or obligations to repurchase (return) goods and services; timing of measurement of noncash consideration; contract cutoff (i.e., when a contract with a customer is deemed to exist for Topic 606 purposes); and other. This results in a carefully-thought out but very complex framework. Resetting the contract assets (liabilities) to an extraneous amount representing the fair value of either the contract as a whole or its individual elements upon acquisition will likely create significant disruptions in how entities apply Topic 606 framework subsequently. Many questions are likely to arise and do not have intuitive answers or meaningful ways to be resolved.

Consequently, the Committee reached its predominant view that the most reasonable approach to resolve the conflict between the accounting concepts in Topic 805 and Topic 606 is to allow a scope exception within Topic 805 for contracts with customers. Although this recommended approach does not result in fair value accounting upon acquisition, the alternative approaches as discussed in the ITC would likely also not result in recording of the true fair value of the contracts, especially if the analysis is performed at a unit of account level that is inconsistent with Topic 606. On the other hand, our recommended approach avoids many practical complexities that would arise from trying to couple the fair value reset of contract assets (liabilities) with subsequent accounting that would apply the detailed approaches required under Topic 606.

While our recommended approach will result in entities recognizing revenue that is arguably attributable to the acquired entity's selling effort, the Committee observes that the alternative approaches (as contemplated in the ITC) also suffer from this drawback. For example, most of the selling effort for any contracts executed shortly after the acquisition likely was undertaken prior to the acquisition. Likewise, for recurring customers the selling effort for future contracts may not be separable from execution on prior contracts. The value of these efforts incurred prior to the acquisition is embedded in goodwill and customer relationship intangible assets recorded upon acquisition, and therefore would not reduce the acquirer's revenue. Applying different accounting treatment to the value of the selling effort solely based on the

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timing of when the vendor and the customer execute the agreement effectively means that such value only arises when the agreement is executed, which can be used as an accounting convention, but is not a business reality.

Additionally, we believe that users of the financial statements are better informed by entities reporting post-acquisition revenue that is also indicative of future performance, i.e. has not been reduced by the value of the pre-acquisition selling effort.

The Committee notes that transactions or balances that tend to cross multiple accounting periods and are in scope of other accounting pronouncements that establish a comprehensive accounting framework are often granted scope exception from the fair value provisions of Topic 805 for similar reasons. Examples of such transactions include income taxes, employee benefits, leases under Topic 842 and share-based payment awards. We believe it is appropriate to allow the same treatment for balances arising from contracts with customers.

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

Sincerely,

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Institute of Management Accountants
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