FASB issues ASU

New ASU affects revenue recognized following business combinations

October 29, 2021

The FASB provided an exception to fair value measurement for revenue contracts acquired in business combinations.

Applicability

ASU 2021-08, Accounting for Contract Assets and Contract Liabilities from Contracts with Customers

Entities with business combinations after adopting Topic 606, Revenue from Contracts with Customers.

Fast facts, impacts, actions

ASU 2021-08 requires an acquirer in a business combination to recognize and measure contract assets and contract liabilities (deferred revenue) from acquired contracts using the revenue recognition guidance in Topic 606. Under this 'Topic 606 approach', the acquirer applies the revenue model as if it had originated the contracts. This is a departure from the current requirement to measure contract assets and contract liabilities at fair value.

Under current practice, measuring deferred revenue at fair value typically results in a 'haircut' (or reduction) to the deferred revenue balance the acquiree had recorded before the acquisition. The 'haircut' causes the acquirer to recognize less revenue than the acquiree would have absent an acquisition.

Another outcome of the current practice is that the contractual timing of payments in otherwise similar contracts affects the amount of post-acquisition revenue recognized by the acquirer. For example, more revenue is recorded for contracts paid in arrears than contracts that are prepaid before the acquisition, even when the acquirer's post-acquisition performance is the same.

The ASU's 'Topic 606 approach' eliminates the 'haircut' and narrows the differences caused by the timing of payments. The FASB expects the elimination of the 'haircut' (and resulting higher deferred revenue balances) will generally result in a corresponding increase to goodwill. Therefore, acquisitions that have significant deferred revenue are expected to have more post-acquisition GAAP revenue and profit for the acquirer than under the fair value approach.

The ASU may be early adopted (see Effective dates and transition) in any interim period. However, when early adopted it must be applied retrospectively to all business combinations that have occurred since the beginning of the annual period that includes the interim period of adoption.

Action: Entities that wish to early adopt in an interim period need to evaluate business combinations consummated from the beginning of the year of adoption and potentially recast previously recorded business combinations to comply with the new requirements.

Background

Topic 805 generally requires assets and liabilities acquired in a business combination to be measured at fair value. However, historically there has been no specific guidance on the recognition and measurement of contract assets and contract liabilities (deferred revenue) arising from acquired revenue contracts.

A contract asset represents an entity's right to consideration in exchange for goods or services the entity has transferred to the customer and that is conditioned on something other than the passage of time. A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration.

The FASB issued ASU 2021-08 to address diversity and inconsistency related to (1) recognition of an acquired contract liability and (2) how payment terms affect the acquirer's post-acquisition revenue. Further, the FASB received feedback from users of financial statements that the practice of accounting for acquired revenue contracts at fair value (particularly the 'haircut' on deferred revenue) does not provide useful information, is challenging to understand and reduces comparability between the pre-acquisition and post-acquisition periods.

Recognition of contract liabilities (deferred revenue)

Due to the lack of specific business combination guidance, in practice, acquirers typically have recognized deferred revenue only when they have a remaining legal obligation to fulfill. They then measure the deferred revenue at fair value, which typically results in a 'haircut' in the amount of the deferred revenue that the acquiree had recorded.

When Topic 606 introduced the concept of performance obligations, it became unclear whether deferred revenue (contract liabilities) should be recognized based on the existence of acquired, unfulfilled performance obligations instead of acquired legal obligations. Under the normal workings of Topic 606, a contract liability or deferred revenue is recognized if the entity receives consideration before it fulfills its remaining performance obligations. Performance obligations are not limited to legal obligations and can be the result of customary business practices, policies or other specific statements that are implied at contract inception. Therefore, the definition used in a business combination would affect whether a liability is recognized.

Timing of payments

Under the pre-ASU fair value approach, the timing of contractual payments often affects the amount of the acquirer's post-acquisition revenue. For example, a contract that was paid entirely upfront generally results in less post-acquisition revenue than an otherwise identical contract paid over time. This is because the deferred revenue 'haircut' in the prepaid contract reduces the amount of post-acquisition revenue while the fair value of an at-market contract paid over time results in a customer-related intangible asset that, when amortized, typically does not affect post-acquisition revenue.

Key provisions of ASU 2021-08

To address the issues identified, ASU 2021-08 requires acquirers to use Topic 606 to determine how to recognize and measure a contract liability. This Topic 606 approach aligns the recognition of a contract liability with the definition of performance obligation. In addition, measurement under Topic 606 will eliminate any deferred revenue 'haircut'. The FASB indicated the increase in the contract liability will generally result in an offsetting increase to goodwill. This will result in more post-acquisition GAAP revenue and profit for many contracts in a contract liability position.

Example: Higher deferred revenue

ABC Corp. enters into a two-year service contract on January 1, Year 1, that is satisfied ratably over time with Customer. ABC concludes the contract does not have a significant financing component. Customer pays ABC the full contract price on contract inception (January 1, Year 1). DEF Corp. acquires ABC on January 2, Year 1 before any performance under the contract.

Assume the following facts:

Contract price	$1,000
Expected fulfillment cost	750
Selling effort plus a reasonable profit	100*
Acquisition date fair value of contract liability and performance obligation	900

*This represents the costs ABC incurs to enter into the contract with Customer (plus a margin), which in this simplified example represents the difference between the contract price and the fair value of the contract on the acquisition date.

The following compares the recording of the contract liability on acquisition and the revenue recorded by the acquirer DEF in the periods subsequent to the acquisition.

When	Current practice			New ASU		
		Debit	*Credit*		*Debit*	*Credit*
Acquisition date	Goodwill	900		Goodwill	1,000	
	Contract liability		900	Contract liability		1,000
	To record contract liability at acquisition date fair value.			*To record contract liability using Topic 606.*		
Periods subsequent to the acquisition	Contract liability	900		Contract liability	1,000	
	Revenue		900	Revenue		1,000
	To record revenue and derecognize contract liability.			*To record revenue and derecognize contract liability.*		

The Topic 606 approach also narrows the differences caused by timing of payments. This is because the mechanics of Topic 606 generally result in the same amount of revenue regardless of the timing of payments for an otherwise similar contract.

Observation: While post-acquisition revenue will be the same regardless of the timing of contractual payments, timing of payments will still affect post-acquisition profit on acquired revenue contracts. This is because the FASB indicated the difference between fair value of a contract liability and the amount recorded under Topic 606 results in more goodwill (which is not amortized) and not a customer-related intangible asset.

The mechanics of the Topic 606 approach

To allow an acquirer to apply the Topic 606 approach, the ASU creates an exception to the general recognition and measurement principles in Topic 805. This exception requires contract assets and contract liabilities acquired in a business combination to be recognized and measured under Topic 606. Mechanically, the acquirer records a contract asset or contract liability for acquired revenue contracts as if it had originated the contract. This means the acquirer needs to apply its accounting policies, estimates and judgments to acquired revenue contracts to determine the appropriate amount to record.

For example, an acquirer would identify the performance obligations that exist in an acquired contract as of the contract inception date and estimate the transaction price as of the acquisition date. However, practically, in many cases the acquirer may be able to leverage the amounts recorded by the acquiree before the transaction if there are no material differences in the application of Topic 606.

Observation: The FASB observed that the Topic 606 approach is not the same as simply carrying over the acquiree's balances because there could be differences between the acquirer's and acquiree's accounting policies, estimates and judgments, and errors in the acquiree's accounting.

The FASB does not expect the ASU to increase the cost of accounting for acquired revenue contracts since the effort will shift from a fair value analysis to an analysis under Topic 606. However, the ASU includes practical expedients, as discussed below, to reduce costs in complex situations.

Action: The acquirer will need to gain an understanding of the acquiree's accounting policies to identify any inconsistencies with its own policies and assess the accuracy of the acquiree's accounting. In addition, the acquirer will likely need to expand or modify its business combination processes and controls to apply the Topic 606 approach at the acquisition date, which is different than the processes and controls required to measure revenue contracts at fair value.

Practical expedients

The FASB observed that applying Topic 606 to acquired contracts could be challenging in certain situations (e.g. acquiree did not prepare GAAP financials or there are complicated long-term contracts). Therefore, the ASU includes the following two practical expedients to reduce the cost in these scenarios.

— **Modification expedient:** the acquirer may reflect the aggregate effect of all modifications that occurred prior to the acquisition date when identifying the satisfied and unsatisfied performance obligations, determining the transaction price, and allocating the transaction price to the satisfied and unsatisfied performance obligations.

— **Stand-alone selling price expedient:** the acquirer may determine the stand-alone selling price at the acquisition date, instead of the contract inception date, of each performance obligation in the contract for the purposes of allocating the transaction price.

Entities are required to disclose the expedients used and discuss the effects they had on the financial statements.

Observation: Each practical expedient can be elected on a transaction-by-transaction basis. However, when elected for a particular transaction, a practical expedient must be applied consistently to all acquired revenue contracts.

Variable consideration and royalty recognition constraint applies

To apply Topic 606 to acquired contracts, the acquirer will need to apply the variable consideration and royalty recognition constraints to applicable contracts. Applying either constraint may preclude the acquirer from recognizing an acquisition date contract asset even when it expects the contract to generate positive future cash flows. If, or when, the variable amounts become unconstrained in the post-acquisition period, the variable amounts would affect post-acquisition revenue. Nevertheless, the constrained cash flows would still be factored into the valuation of other customer-related intangible assets (e.g. backlog asset).

ASU applies to any contract that applies the provisions of Topic 606

The ASU primarily addresses the accounting for contract assets and contract liabilities from acquired customer revenue contracts. However, the amendments also apply to contract assets and contract liabilities from other contracts to which the provisions of Topic 606 apply, such as contract assets or liabilities from contracts in the scope of Subtopic 610-20, Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets.

Observation: In current practice, many times the off-market terms of contracts are factored into the fair value of a customer-related intangible asset (e.g. backlog) or contract liability. Because a contract liability is no longer measured at fair value, the acquirer may need to recognize an incremental asset or liability compared to what it would have recognized in current practice.

Other customer-related assets and liabilities

The ASU does not affect the existing guidance and accounting for other acquired assets or liabilities that may arise from acquired customer contracts such as refund liabilities, customer-related intangible assets (e.g. backlog assets and customer relationships) and/or intangible assets or liabilities from off-market contracts. The FASB decided not to change the accounting for these assets or liabilities and an acquirer will continue to recognize and measure these assets or liabilities in accordance with the general principles in Topic 805.

Observation: The ASU creates a difference between US GAAP and IFRS for revenue contracts acquired in a business combination. Therefore, entities that prepare financial statements under both US GAAP and IFRS will need to track differences for acquired revenue contracts.

Effective dates and transition

The amendments in this ASU are applied to business combinations occurring on or after the effective date of the amendments.

	SEC registrants	Other entities
Annual periods – Fiscal years beginning after	December 15, 2022	December 15, 2023
Interim periods – In year of adoption	Yes	Yes
Early adoption permitted?	Early adoption is permitted, including adoption in an interim period. If early adopted, the amendments are applied retrospectively to all business combinations for which the acquisition date occurred during the fiscal year of adoption.	

Contributing authors

Nick Burgmeier, Megan Hearn

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