MEMO

Issue No. Issue Summary No. 1

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Project Issue No 18-A, Recognition under Topic 805 for an Assumed Liability in a Revenue Contract

Stage Initial Deliberations

Issue(s) Issue 1 - Recognition for an assumed liability in a revenue contract

Education topics on measurement for an assumed liability in a revenue contract in a business combination

Memo Purpose

1. The purpose of this memo is to assist the Task Force in addressing an accounting issue related to the application of the recognition guidance in Topic 805, Business Combinations, to a revenue contract acquired in a business combination after the acquirer has adopted Topic 606, Revenue from Contracts with Customers. This memo will also provide the Task Force with additional topics for discussion related to measuring an assumed liability in a revenue contract in a business combination. No standard-setting is expected on these measurement topics. However, those discussion points will serve as educational information to increase stakeholder awareness about questions that may arise in measuring such assumed liabilities.

* The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.
2. The staff will ask the Task Force the following questions:

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<th>Questions for the Task Force</th>
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<tr>
<td>1. Which concept does the Task Force believe should be used to determine whether a liability assumed in a revenue contract with a customer acquired in a business combination represents an identifiable liability that is recognized in the business combination (Issue 1)?</td>
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<td>2. Does the Task Force agree with the staff's view on the two measurement topics, which will serve as educational information to stakeholders (Topics #1 and #2)?</td>
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<td>3. Does the Task Force want to use a prospective transition with an option to use a modified retrospective transition, as described by the staff, or a different transition method for the proposed amendments on Issue 1?</td>
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<td>4. What transition disclosures does the Task Force want entities to provide when initially applying the proposed amendments on Issue 1?</td>
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**Background**

3. On March 28, 2018, the Board added this project to the EITF agenda to address the recognition of a revenue contract with a customer that is acquired in a business combination after an entity has adopted Topic 606 (Issue 1). The Board added this project because of the diverse views on how an entity would apply the guidance in Topic 805 to a revenue contract accounted for under Topic 606. Based on stakeholder outreach, some believe that the concept of a legal obligation should be used to determine whether deferred revenue is recognized in a business combination while others believe the concept of a performance obligation in Topic 606 should be used. The goal of this project is to narrow that diversity so that acquisitions occurring after Topic 606 is effective are consistently accounted for using the same concept for recognition.

4. The Board also directed the EITF to provide educational information on measurement topics that may arise from the application of Topic 606 to a business combination. One topic was brought up by a Board member during the discussion at the March 28, 2018 Board meeting (Topic #1) and another topic was raised to the staff and was presented to the Board at the March 28, 2018 Board meeting (Topic #2).
Issue 1 – Recognition for an assumed liability in a revenue contract

Overview

5. Topic 606 changed the accounting requirements in Topic 605, Revenue Recognition, for revenue contracts. As a result, Issue 1 relates to how an entity should apply Topic 805 to an acquired revenue contract that is accounted for under the new revenue guidance in Topic 606. To understand this issue, it is helpful to understand how an entity applies Topic 805 to a revenue contract accounted for under Topic 605 and to understand the changes that the guidance in Topic 606 made to Topic 605.

6. Consider the following fact pattern to illustrate Issue 1:

   Company A acquires Company B on July 1, 2018. Company B meets the definition of a business. Company B’s operations include the licensing of intellectual property (IP) to its customers. As of the acquisition date, one of the in-process license arrangements included in the set is the following:

   - Company B licensed the rights to use its IP (for example, a character image) to Customer X for two years. The license is non-exclusive (that is, Company B may license the IP to other customers).
   - The contract term is from January 1, 2018, to January 1, 2020.
   - Assume that Company B owns the IP underlying the license arrangement and the IP is included in the acquired set.
   - Company A has adopted Topic 606 as of January 1, 2018.

7. Under Topic 605 Company B would have recognized the $30 million upfront payment as revenue at the point in time when the license is delivered. (Some entities may have recognized revenue over time for these types of arrangements because diversity in practice exists.) See journal entries below under Topic 605.

   **Contract inception (1/1/18)**
   
   Dr. Cash 30  
   Cr. Revenue 30

   Generally, under Topic 605, the $30 million upfront payment is recognized as revenue at the point in time when the license term begins.

   **Balance Sheet of Acquiree at bus comb (7/1/18)**
   No receivable and no deferred revenue/contract liability related to the contract
8. Under Topic 606, Company B concludes that it has licensed symbolic IP. Therefore, it recognizes revenue when the customer has the right to access and benefit from the license over the contract term (that is, $3.75 million per quarter). See journal entries below under Topic 606.

**Contract inception (1/1/18)**

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<tr>
<th>Dr. Cash</th>
<th>Cr. Deferred Revenue</th>
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Under Topic 606, if the license is symbolic IP, the upfront fee is recorded as deferred revenue and recognized over the period the customer is able to use and benefit from the right to access the IP over the contract term.

**Revenue recognition prior to bus comb (6/30/18)**

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<tr>
<th>Dr. Deferred Revenue</th>
<th>Cr. Revenue</th>
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<td>7.5</td>
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The $30 m. upfront fee is recognized as revenue over the two-year term (that is, $3.75 m./quarter)

**Balance Sheet of Acquiree at bus comb (7/1/18)**

- Receivable - $0
- Deferred Revenue - $22.5 m

9. As illustrated by the example, the change in accounting requirements for licenses in Topic 606 results in a deferred revenue amount recorded on the balance sheet of Company B at the business combination date that would not have been recognized on the balance sheet had the revenue contract been accounted for under Topic 605. As a result, diverse views have emerged in practice on how Company A would evaluate that deferred revenue for recognition in the business combination after Topic 606 is adopted. Practitioners have shared the following two alternatives with the staff:

  a) **Alternative A: Legal Obligation** – A Company recognizes a contract liability only for its legal obligation to the customer as of the acquisition date because Topic 606 did not consequentially amend Topic 805 and current practice is to use the legal obligation concept.

In the example above, Company A does not have a legal obligation to perform any specific actions related to maintenance and/or support of the IP underlying the license over the remaining term of the arrangement. The obligation to maintain and/or support the IP over the license term is an implied obligation because there are no explicit obligations stated in the contractual arrangement; therefore, no obligation is recognized in the business combination.

  b) **Alternative B: Performance Obligation** – A Company recognizes a contract liability if it has a performance obligation to the customer as of the acquisition date based on Topic 606. In the example above, Company A has a performance obligation to provide the customer with a right to access the IP and an obligation to maintain and/or support the IP under the acquired in-process license arrangement.
Staff Research

Accounting Guidance

**Topic 805**

10. Topic 805 provides the accounting guidance for business combinations. In applying the acquisition method in Topic 805, the acquirer recognizes identifiable assets and liabilities assumed in a business combination and measures those assets and liabilities at fair value. The recognition criteria for an identifiable asset or liability to be recognized in the business combination is that it must meet the definition of an asset or liability in the FASB Concepts Statements. Specifically, paragraphs 805-20-25-1 and 25-2 provide the recognition guidance for identifiable assets and liabilities:

   805-20-25-1 As of the acquisition date, the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 805-20-25-2 through 25-3.

   805-20-25-2 To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements*, at the acquisition date. For example, costs the acquirer expects but is not obligated to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree’s employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its postcombination financial statements in accordance with other applicable generally accepted accounting principles (GAAP). [Emphasis added.]

**Concepts Statement 6**

11. Issue 1 is focused on the recognition of deferred revenue as a liability in a business combination. Because the guidance in Topic 805 refers to FASB Concepts Statement No. 6, *Elements of Financial Statements*, the staff considered the current definition of liability in CON 6. CON 6 currently defines liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”

12. The definition clarifies that present obligations is broader than legal obligations. A footnote to the definition states that “It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth *(Webster’s New Work Dictionary*, p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 37-40).”

13. CON 6 goes on to provide, in paragraph 36, characteristics of liabilities as follows:

   A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future
transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. … although most liabilities rest generally on a foundation of legal rights and duties, existence of a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability if for other reasons the entity has the duty or responsibility to pay cash, to transfer other assets, or to provide services to another entity.

**EITF Issue 01-3**

14. EITF Issue No. 01-3, “Accounting in a Business Combination for Deferred Revenue of an Acquiree,” provided specific guidance on the accounting for deferred revenue in a business combination. Issue 01-3 required that the acquiring entity should recognize a liability related to the deferred revenue of an acquired entity only if that deferred revenue represents a legal obligation assumed by the acquiring entity (a legal performance obligation as described in Issue 01-3) and the amount assigned to that liability is its acquisition date fair value.

15. Issue 01-3 provided specific guidance on determining when a liability for deferred revenue should be recognized by the acquirer in a business combination and therefore would have addressed Issue 1. However, Issue 01-3 was superseded by FASB Statement No. 141 (revised December 2007), *Business Combinations*, which did not include specific guidance on the recognition of deferred revenue as an identifiable liability assumed in a business combination nor a reason why the guidance in Issue 01-3 was superseded. Rather, FAS 141(R) was primarily a convergence project with the IASB and only pointed to the definition of a liability in CON 6 (that guidance is now codified in paragraph 805-20-25-2 as described above). The staff’s understanding is that the Board at the time did not intend to significantly change practice and that the principles in Issue 01-3 are still used in practice. See Appendix A, which provides additional discussion on the evolution of the guidance in Topic 805.

**Topic 606**

16. In May 2014, the FASB issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* (Update 2014-09 or Topic 606, including subsequent Updates), which provides a single comprehensive accounting model on revenue recognition for contracts with customers. During deliberations for Topic 606, business combination accounting was not a significant topic of discussion or deliberation. Generally, the Board’s view was that Topic 606 should not change business combination accounting and, therefore, Topic 606 did not consequentially amend Topic 805. Recollection of those events was confirmed by former FASB staff and International Accounting Standards Board (IASB) staff involved in the joint project.

17. In researching the archived project files for Topic 606, the staff identified a comment letter response to the 2011 Exposure Draft that requested clarification on the interaction between the proposed revenue guidance and business combination accounting. However, the questions raised by the
respondent were not the same as the issues in this memo. In addressing the comment letter received, Board Memo 172, which was issued July 12, 2013, stated that the staff believed that the Board did not intend to change the accounting for business combinations in the joint revenue project, and, therefore, the staff believed it was not necessary to revise the Codification as a result of the respondent’s requests.

18. Topic 606 establishes the definition of performance obligation as “a promise in a contract with a customer to transfer to the customer either: (a) a good or service (or a bundle of goods or services) that are distinct, or (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.” In addition, paragraph 606-10-25-16 states the following:

606-10-25-16 A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the promised goods and services identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are implied by an entity’s customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer.

19. The Board further explained that a performance obligation does not need to be legally enforceable in paragraphs BC32 and BC87 of Update 2014-09:

BC32. Although there must be enforceable rights and obligations between parties for a contract to exist, the Boards decided that the performance obligations within the contract could include promises that result in the customer having a valid expectation that the entity will transfer goods or services to the customer even though those promises are not enforceable (see paragraph BC87).

BC87. The Boards also noted that the implied promises in the contract do not need to be enforceable by law. If the customer has a valid expectation, then the customer would view those promises as part of the negotiated exchange (that is, goods or services that the customer expects to receive and for which it has paid). The Boards noted that absent this guidance developed by the Boards, an entity might recognize all of the consideration in a contract as revenue even though the entity continues to have remaining (implicit) promises related to the contract with the customer.

20. Therefore, once Topic 606 is adopted, a question arises about whether the definition of performance obligation under Topic 606 should be used to determine the identifiable liabilities that are assumed in a business combination and, therefore, recognized on the acquirer’s balance sheet, or whether the definition of a legal obligation should continue to be used. Under the Topic 606 definition of a performance obligation, an entity that is acquired in a business combination may have a deferred revenue balance related to a revenue contract on its balance sheet after adoption of Topic 606 that previously would not have existed had the revenue contract been accounted for under Topic 605 (as illustrated in the previous example). When the acquirer is evaluating which identifiable assets and liabilities to recognize as part of the business combination in accordance with paragraphs 805-20-25-
1 through 25-2, the balance sheet of the acquiree may now include a contract liability under Topic 606. This change highlights Issue 1.

**GAAP in Other Jurisdictions – IFRS Interaction**

21. Because the business combination project was a joint project, the guidance in Topic 805 and IFRS 3, *Business Combinations*, is largely converged. There are some differences between the two standards, such as those relating to the definition of *control*, accounting for contingencies, and accounting for noncontrolling interests.

22. In general, however, the accounting for recognizing and measuring assets and liabilities in a business combination is similar under both standards. Under Topic 805, the acquiring entity recognizes assets and liabilities that meet the definitions in CON 6. Under IFRS 3, the acquiring entity recognizes assets and liabilities that meet the definitions provided in the IASB’s *Framework for the Preparation and Presentation of Financial Statements*.\(^1\) The definitions from the respective frameworks are as follows:

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<th>IASB</th>
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<td><strong>Asset</strong></td>
<td>Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.</td>
<td>An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.</td>
</tr>
<tr>
<td><strong>Liability</strong></td>
<td>Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.</td>
<td>A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.</td>
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23. Under both standards, the assets acquired and liabilities assumed are measured at fair value on the acquisition date.

24. The FASB and the IASB also issued a joint standard for revenue recognition under Topic 606 and IFRS 15, *Revenue Recognition*. Both standards apply the same core accounting model; however, there are some differences in several specific topics, such as the collectability threshold, interim disclosure requirements, and impairment loss reversal. The performance obligation definition, however, is the same for both standards, that is, a promise in a contract with a customer to transfer to

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\(^1\) The IASB released the *Conceptual Framework for Financial Reporting* in March of 2018, which supersedes the previous Framework noted above and includes amendments to the existing conceptual definition of a liability. Under the IASB’s new Conceptual Framework, a liability is defined as a present obligation of the entity to transfer an economic resource as a result of past events. Although the new Conceptual Framework was issued in March 2018, IFRS 3 will continue to apply the definitions in the old Conceptual Framework until the IASB completes an assessment of the consequences of the new definitions to IFRS 3.
the customer either (a) a good or service (or a bundle of goods or services) that is distinct or (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

25. The FASB issued Accounting Standards Update No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, to clarify the guidance on licensing. The IASB made amendments to IFRS 15 that were not the same as the amendments in Update 2016-10. One difference relates to symbolic licenses. Accordingly, there may be situations under IFRS 15 in which revenue may be recognized at a point in time for symbolic IP licenses when the entity will not undertake subsequent activities that significantly affect the ability of the customer to obtain benefit from the IP during the license period. (However, this is expected to be uncommon, for example, a license for the logo of a sports team that no longer plays like the Brooklyn Dodgers.) Under Topic 606, revenue for all licenses of symbolic IP is recognized over time.

26. Before the issuance of both IFRS 3 and IFRS 15, the IASB did not have substantial guidance regarding business combinations and revenue recognition. The legal obligation concept previously included in Issue 01-3 did not previously exist in IFRS guidance. When IFRS 3 was issued, the business combination guidance in IFRS became much more robust and thorough. GAAP before the issuance of Topic 606 had much more revenue recognition guidance, albeit industry-specific and issue-specific, than the IASB’s pre-IFRS 15 guidance. The issuance of IFRS 15 resulted in a greater change to the IFRS guidance because of the limited guidance that previously existed.

Stakeholder Feedback

27. The staff performed outreach with revenue recognition and business combination specialists from eight accounting firms and the IASB staff.

28. The staff considered whether to do user outreach on Issue 1 and the timing of that outreach. In discussing the issue with the FASB’s senior investor liaisons, the staff concluded that user outreach at this time may not be overly meaningful for the following reasons:

a) The issue relates to very technical accounting and an analyst or user evaluating a business combination most likely will not focus on this level of detail to be able to provide meaningful feedback.

b) Because users will be more focused on the potential effect on financial reporting and the information they will have, it is difficult to determine what the financial reporting impact of the issue is because it is focused on the recognition of a liability and not the fair value measurement of the liability.
The staff plans to conduct some limited user outreach to validate the above working assumptions discussed with the senior investor liaisons during the June Investor Advisory Committee meeting and during the exposure period.

**Accounting Firms**

29. The accounting firms consistently described that when an entity applies Topic 805 in current practice to a revenue contract acquired in a business combination that the acquirer has accounted for under Topic 605, entities continue to use the legal obligation criteria in Issue 01-3 to recognize liabilities related to deferred revenue, even though that guidance has been superseded. Although FAS 141(R) superseded that guidance, the accounting firms asserted that they believe it was not the FASB’s intent to change the practice of how entities were accounting for deferred revenue in business combinations. The staff thinks that this may be because the notion of a legal obligation is mentioned in the footnote to the liability footnote in CON 6 and that FAS 141(R) did not offer reasoning as to why Issue 01-03 was superseded.

30. Feedback from the accounting firms on Issue 1 indicated that there is diversity in views with approximately half of the accounting firms supporting Alternative A (legal obligation) and half supporting Alternative B (performance obligation). Two of the Big Four accounting firms recently published interpretive guidance on Issue 1. One publication states that following the adoption of Topic 606, the firm believes that an acquirer should apply the definition of a performance obligation in Topic 606 to determine whether it has assumed a performance obligation (Alternative B); however, it notes that there may be some diversity in practice. The other publication does not offer a conclusion on the matter and instead describes the differing views (Alternative A and Alternative B) that exist once Topic 606 has been adopted.

31. Those who supported Alternative A to retain the current practice of using the legal obligation definition to define the liabilities that should be recognized in a business combination for a revenue contract highlighted the following reasons:

   a) Topic 606 did not amend Topic 805; therefore, current business combination practice should not be modified based on the adoption of the new revenue recognition guidance. Because Topic 606 did not consequentially amend Topic 805, several firms stated that, absent explicit guidance to use the Topic 606 definition in Topic 805, it would be inappropriate to use the Topic 606 definition. They believe that it was not the Board’s intent to change business combination accounting and practice with the issuance of the new revenue guidance.

   b) The definition of a performance obligation is generally grounded in legal enforceability. Therefore, the Topic 606 definition of a performance obligation should not be different from a legal obligation (current practice). Several firms pointed to guidance surrounding the
identification of a contract in Topic 606, which states that a contract is an agreement between two or more parties that creates enforceable rights and obligations and that enforceability of the rights and obligations in a contract is a matter of law. The performance obligation has a legal characteristic because it exists in a contract that has enforceable rights and obligations. Therefore, Topic 606’s definition of a performance obligation generally should not be significantly different from a legal obligation identified in a business combination. They acknowledged that there may be situations in which the two may not be the same (that is, if a customary business practice is identified as a separate performance obligation), but they believe that the Topic 606 definition of a performance obligation generally should not change the legal obligation used in practice.

32. Those who supported Alternative B to use the definition of performance obligation in Topic 606 when recognizing liabilities in a business combination for a revenue contract highlighted the following reasons:

a) The current practice of using a legal definition of a performance obligation is outdated because Issue 01-3, which established that guidance, was superseded. Additionally, Topic 805 does not define obligation, other than the CON 6 liability definition. Because another area in GAAP now defines performance obligation, they asserted that it is appropriate to use this codified definition consistently in GAAP (that is, the performance obligation definition should be used not only for revenue recognition but also for business combinations related to revenue contracts with customers). Proponents of this view asserted that using current and recently codified guidance (that is, Topic 606) is more appropriate than using superseded guidance (that is, Issue 01-3).

b) Because of differences in revenue recognition between Topic 605 and Topic 606 in certain instances, Topic 606 may result in liabilities on an acquiree’s books that were not previously recognized under Topic 605 at the time of the business combination. Therefore, because an entity potentially could be measuring deferred revenue that it otherwise would not have measured in a business combination in which the acquiree accounted for the revenue contract under Topic 605, the new definition of a performance obligation would be more applicable in recognizing deferred revenue.

c) One firm stated that there is either an implicit or explicit liability if at the acquisition date there is an outstanding performance obligation because the entity could be sued for failing to complete the performance obligation (that is, a liability exists because there is an obligation to complete the performance obligation). Therefore, that firm believes that the Topic 606 performance obligation also is a legal obligation.

33. Some firms also indicated that the financial reporting outcome may not be significantly different between using a legal obligation definition and using a Topic 606 performance obligation definition...
because Topic 805 requires a recognized liability to be measured at fair value and the fair value of the Topic 606 performance obligation potentially may be minimal or zero. However, some firms indicated that recognition of a liability would result in some fair value assigned to the recognized liability, even if that fair value may be relatively small. In addition, in situations in which the Topic 606 performance obligation is a legal obligation, the outcome will be the same under both alternatives.

**IASB Staff Feedback**

34. The IASB staff indicated that the IASB has not received questions similar to Issue 1 and there have not been discussions by the IASB on the issue.

**Conceptual Framework**

35. Since the guidance in paragraph 805-20-25-2 refers to the concept statement definitions for recognition, the staff analyzed both alternatives under the conceptual framework and believes that both are acceptable interpretations of the guidance in paragraph 805-20-25-2 and CON 6. The content in the Conceptual Framework is meant to be a starting point for Board analysis and is not designed to provide specific answers to the accounting issues faced by the Board. The definitions of assets and liabilities are clearly stated, but the items that meet those definitions are not settled by the Conceptual Framework.

36. The CON 6 definition of liability explicitly includes both legal obligations and non-legal obligations, which for the latter CON 6 describes as equitable and constructive obligations. However, the discussion of equitable and constructive obligations in the current Framework is tenuous and there is no clear indication of how to evaluate these obligations other than that they should be considered. Specifically, paragraph 40 of the Conceptual Framework notes "The line between equitable or constructive obligations and obligations that are enforceable in courts of law is not always clear, and the line between equitable or constructive obligations and no obligations may often be even more troublesome because to determine whether an entity is actually bound by an obligation to a third party in the absence of legal enforceability is often extremely difficult." Accordingly, the two alternatives presented above appear to be acceptable interpretations of the overall guidance in paragraph 805-20-25-2 and CON 6.

37. Although EITF 01-03 preceded FAS 141(R), the Task Force at that time made the determination that liabilities related to deferred revenue should only be recognized in a business combination if they are legal obligations. Stated another way, the Task Force, at the time, concluded that in the circumstances discussed, an entity was not obligated to sacrifice assets in the future absent being legally bound to do so, which is not an inconsistent interpretation of CON 6.

38. The Board, in their standards-level deliberations for Topic 606, determined that certain performance obligations related to deferred revenue are liabilities due to the implications of an entity's customary
business practices or published policies and therefore should be recognized. The rationale used in
Topic 606 regarding becoming obligated due to customary business practices or published policies is
consistent with how constructive obligations are described in CON 6.

39. The FASB staff also is considering potential changes to the definition of assets and liabilities in the
Concepts Statements in the Conceptual Framework – Elements project. Decisions reached by the
Board in the future on the conceptual framework definitions could affect the recognition in business
combinations. In addition, the IASB recently completed its project to amend its framework definitions
of assets and liabilities, however those changes do not affect IFRS 3 until at least 2020.

Staff Analysis and Recommendation for Issue 1

40. The staff has analyzed the two alternatives on determining what definition should be used to
recognize identifiable liabilities related to a revenue contract acquired in a business combination after
Topic 606 is adopted. The staff did not identify any additional alternatives that would narrow the
diversity in views.

   Alternative A: Legal obligation.
   Alternative B: Topic 606 performance obligation.

Alternative A: Legal Obligation

41. Under Alternative A, the acquiring company would use the legal obligation concept that was
established in Issue 01-3 to recognize a liability related to a revenue contract acquired in a business
combination. Even though the guidance was superseded, proponents of Alternative A assert that this
is the most appropriate way to view a business combination (that is, from the perspective of the
buyer, what rights and obligations has the buyer legally acquired and assumed). Alternative A is a
subset of the CON 6 definition of a liability because that definition includes a footnote reference that
says the definition is broader than a legal obligation. Therefore, a legal obligation would represent a
liability in CON 6 and as explained in paragraph 37, Alternative A can be viewed as an interpretation
consistent with the guidance in paragraph 805-20-25-2.

42. Proponents of Alternative A argue that Topic 606 did not consequentially amend Topic 805 and
therefore, they assert that it was not the Board’s intent to change practice for business combination
accounting because of the new revenue guidance. Moreover, proponents of Alternative A assert that
it is not appropriate to change and use the Topic 606 definition absent standard setting because
Topic 805 was not amended. Because current practice applies the legal obligation concept,
proponents of Alternative A assert that application should continue for business combinations after
Topic 606 is effective.
43. In addition, proponents of Alternative A have concern about the potential ability to “buy” revenue through a business combination if a legal obligation view is not used because the acquirer would have a liability that will get recognized as future revenue without having a legal obligation to perform. That is, Alternative A would result in the least amount of deferred revenue recognized in a business combination because it represents the narrowest of the two alternatives. Therefore, supporters of Alternative A challenged Alternative B that results in more revenue for the acquirer after the business combination date. The staff thinks that this concern about “buying revenue” may relate to stakeholder’s different views about licensing in general. That is, during the revenue project many stakeholders, as well as Board members, had differing views on the economics of a licensing arrangement, an entity’s performance, and whether revenue should be recognized at a point in time or over time. To make the guidance more operable, the guidance includes a rule that symbolic revenue should always be recognized over time. That is because there is a presumption that an entity needs to support and maintain a license, and thus the entity is satisfying the performance obligation over the licensing period. Therefore, a view that the entity can buy revenue and not perform later contradicts the guidance in Topic 606 that presumes an entity performs by supporting and maintaining the license.

44. In the fact pattern in paragraph 6, Company A would not recognize a contract liability for the deferred revenue balance on Company B’s balance sheet for the in-process license arrangement if it believes that it does not have a legal obligation to provide support and/or maintain the IP during the license period. In current practice, there is diversity in views on whether Company A would have a legal obligation to continue to provide the right to access the IP through the license. Those who believe that there is no legal obligation assert that Company B already provided the license prior to the business combination. However, those who believe that Company A still has a legal obligation to provide access to the IP, assert that the value of that obligation is zero. Therefore, regardless of whether the right to access the IP is a legal obligation, the end financial reporting outcome would be the same.

**Alternative B: Topic 606 Performance Obligation**

45. Under Alternative B, the acquiring company would use the Topic 606 definition of a performance obligation to recognize a liability related to a revenue contract acquired in a business combination. Because the Board concluded in Topic 606 that an entity has a performance obligation to support and maintain the IP throughout the license period for symbolic licenses (See BC57 in Update 2016-10), Topic 606 determines that a liability does exist in the application of paragraph with 805-20-25-2. If an acquiree’s balance sheet includes a deferred revenue balance for a performance obligation it is required to complete, then the acquiring company would recognize the fair value of that liability at the acquisition date.
46. Proponents of Alternative B assert that because GAAP has defined a performance obligation in the context of revenue contracts through Topic 606, this authoritative guidance should be used as opposed to a legal obligation concept that originated from guidance that was superseded.

47. In the fact pattern in paragraph 6, Company A would recognize a contract liability at the fair value of the performance obligation on Company B’s balance sheet for the in-process license arrangement. Under this view, Company A has acquired an obligation to continue to provide access to its IP through the license and an ongoing obligation to support and maintain that IP. Opponents of Alternative B note that the Board acknowledged in its basis for conclusions in Update 2016-10 that for symbolic licenses there may be cases in which there is no ongoing obligation. In fact, the Board considered an alternative under which an entity could override the over-time recognition if it was reasonably certain it would undertake no additional activities to support or maintain the IP during the license period. The Board ultimately rejected this override for simplicity purposes and to reduce complexity in applying the guidance. Therefore, there could be situations with symbolic licenses in which the entity has no further obligation to support or maintain the IP and, therefore, would not meet the CON 6 definition but would be required to recognize a liability under Alternative B.

Staff Recommendation

48. The staff recommendation is Alternative B, using the Topic 606 performance obligation definition. The staff believes that the use of codified GAAP is more appropriate than superseded guidance and that the codified guidance should be consistently applied (that is, the identification of an obligation for a revenue contract should not be different because of a business combination). The staff also notes that the definition of performance obligation is broader than a legal obligation concept and includes constructive obligations. The staff notes that the measurement of the liability by the acquirer in the acquisition accounting likely will be different than the measurement of the performance obligation by the acquiree in the revenue accounting because Topic 805 requires fair value measurement for a business combination (see Topic 1 below). However, the staff believes the recognition of a liability should not be different. For situations where the Topic 606 performance obligation may not represent a legal obligation, the staff believes that the fair value measurement of the performance obligation may be minimal or zero because it would only consider the incremental costs to support or maintain the IP that directly relates to the acquired contract and would not consider the overall activities that the entity would undertake to support and maintain its brand irrespective of the acquired contract.

49. The staff also believes that Alternative B may be less complex to apply for recognition purposes because it does not require a legal analysis, although this could be offset by the necessity to measure additional performance obligations under this alternative. Additionally, Alternative B would reduce diversity in practice more so than Alternative A because, similar to today, there may be different
conclusions on legal obligation (such as determining whether a customary business practice rises to the level of a legal obligation).

50. The staff does not object to Alternative A because the staff believes that the arguments for Alternative A do have merit, especially the fact that Topic 606 did not consequentially amend Topic 805 and the view that the Board did not intend to change business combination accounting when developing the new revenue guidance.

51. The staff acknowledges that in most situations the recognition conclusion under both alternatives and current guidance may be the same. However, the staff is aware of situations in which the conclusion could be different under the two alternatives. The symbolic license example provided in paragraph 6 is one example. Another situation in which the recognition conclusion may be different is when Topic 606 separately identifies a performance obligation related to a customary business practice that the entity is not legally obligated to provide based on the terms of the contract.

52. The staff recommends the following draft language for the proposed amendment on Issue 1 if the Task Force reaches consensus on the staff recommendation:

>Recognizing Particular Assets Acquired and Liabilities Assumed

>> Revenue From Contracts with Customers

805-20-25-15B The acquirer shall recognize a contract liability from a contract with a customer that is assumed in a business combination as an identifiable liability if that contract liability represents a performance obligation under Topic 606 and shall measure the contract liability using the measurement principle in paragraph 805-20-30-1.

Education Topics on Measurement for an Assumed Liability in a Revenue Contract in a Business Combination

53. When the Board added the project to its technical agenda for the EITF on Issue 1, the Board also acknowledged that there may be education that could be provided to stakeholders on measurement-related questions for revenue contracts acquired in a business combination after Topic 606 has been adopted. This acknowledgment was primarily due to the possibility that more contracts would be recognized as assumed liabilities under business combination accounting when compared to current GAAP if the Task Force supports Alternative B. For example, a question was raised as part of the staff’s pre-agenda research that was presented to the Board as part of the agenda prioritization board meeting about costs to fulfill an ongoing performance obligation. In addition, during the agenda prioritization meeting, the Board discussion included a question on carry-over basis. The staff has considered these two questions and have provided a staff view described below for the EITF’s consideration. The staff intends to include the staff’s view and feedback from the EITF on these topics in the basis for conclusions of the proposed Update on Issue 1 for broader education. In addition, the meeting minutes for the EITF’s discussion on these topics will also be available for public education.
**Topic #1: Carry-over basis and measuring the fair value of a Topic 606 performance obligation**

**Question**

54. If the Task Force concludes in Issue 1 that the definition of a *performance obligation* in Topic 606 should be used to recognize a liability for a revenue contract acquired in a business combination (Alternative B), may the acquirer determine the fair value of that liability using the amount as determined by the acquiree in its revenue accounting (that is, a “carry-over” basis)? Said differently, can the deferred revenue on the acquirer’s balance sheet have the same basis and measurement as the deferred revenue on the acquiree’s balance sheet at the business combination date?

**Staff View**

55. The staff does not believe that it is appropriate for an acquirer to use a carry-over basis (that is, recording the liability on the acquirer’s balance sheet equal to the amount of deferred revenue on the acquiree’s balance sheet immediately preceding the business combination date) for measurement of an assumed liability in a revenue contract because this is inconsistent with the measurement guidance in Topic 805. The measurement principle in paragraph 805-20-30-1 states that an acquirer must measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values. This principle was established for all assets and liabilities acquired in a business combination as a result of FAS 141, with some exceptions that are specified in Topic 805. The staff does not believe that the Task Force decision on Issue 1 would impact the measurement principal in Topic 805 for the liability in question and does not believe that an exception to the fair value measurement principle in Topic 805 is appropriate for an assumed liability in a revenue contract acquired in a business combination.

56. At the March 28, 2018 meeting, Board members noted specifically that despite the need for standing-setting on Issue 1, the measurement principle in Topic 805 remains appropriate for those liabilities that are recognized irrespective of which alternative is reached in Issue 1. Certain Board members at that meeting also expressed their view that constituents should not confuse the recognition guidance with that of measurement, and potentially utilize a carry-over basis measurement. Accordingly, the staff's view is consistent with those Board members' discussion at that meeting. The staff views this topic relevant only if the Task Force decides on Alternative B on Issue 1. The staff believes that this measurement question is not relevant if the Task Force decides on Alternative A (legal obligation) because that alternative would retain practice prior to the adoption of Topic 606 and the fair value measurement principle.

57. In determining the fair value of a performance obligation acquired in a business combination, the staff believes that the acquirer would fair value the *remaining* obligation that it has assumed from the
acquiree from a Topic 606 perspective. In the example provided for Issue 1, Topic 606 establishes that Company B’s promise to Customer X is both (a) to grant Customer X rights to use and benefit from the IP, which includes making a copy of the underlying IP available for Company X’s use, and (b) to support or maintain the IP. At the date of the business combination (July 1, 2018), Company A has acquired Company B’s remaining obligations under the contract with Customer X. Since Company B has already provided Customer X with the right to access the IP by making a copy of the IP available for Customer X’s use, Company A only has acquired Company B’s remaining obligation to support or maintain the IP from the date of the business combination through the end of the contract term. In Company A’s acquisition accounting, Company A would only fair value this remaining obligation to support or maintain the IP using the fair value measurement principles in Topic 820.

58. In the example provided for Issue 1, the $22.5 million of deferred revenue on Company B’s balance sheet at the date of acquisition is the result of the over time accounting required by Topic 606 for symbolic licenses and, accordingly, the staff does not believe that the $22.5 million is representative of the fair value of the remaining obligation to support or maintain the IP. The staff believes that the value attributed to the remaining obligation to support or maintain the IP would be small compared to the value of obtaining the right to access the IP through delivery of the license because of the following:

a) The value attributed to supporting or maintaining the IP would only consider the incremental costs that directly relate to the acquired contract and would not consider the overall activities that the entity would undertake to support and maintain its brand irrespective of the acquired contract.

b) The value attributed to obtaining the right to access the IP through delivery of a copy of the IP has already been provided by Company B.

59. Another fact pattern could be the acquisition of a revenue contract in which the acquiree provides a customary business practice. Topic 606 considers the customary business practice to be a potential performance obligation under the contract even though the company may not be legally obligated to provide it (see paragraphs 18 and 19). Therefore, if a customary business practice has been identified as a performance obligation under Topic 606, the staff believes that an acquirer would include any remaining customary business practices in its fair value measurement of the assumed performance obligation in addition to any other remaining obligations it must perform in the contract.
Topic #2: Costs to fulfill a performance obligation in measuring the fair value of a contract liability for a revenue contract under Topic 805

Question

60. Should the direct costs to fulfill a performance obligation for a contract liability acquired in a business combination consider the other assets and liabilities in the acquired set when measuring the liability recognized by the acquirer?

Background

61. The question raised focuses on what costs should be included in the measurement and not on how an entity would fair value those costs. The staff believes that “how” to measure those costs would follow the guidance in Topic 820, Fair Value Measurement, and is not the scope of this question. In addition, the staff believes that this question is relevant regardless of the Task Force’s views on Issue 1.

62. The staff considered two views:

a) View A – When determining the fair value of an assumed liability, consider the assets and liabilities in the acquired set.

The direct costs to fulfill a performance obligation would consider assets that were included in the acquired set when measuring the fair value of a contract liability recognized in a business combination. For example, if a contract liability is recognized in the business combination for an in-process license arrangement, the measurement of that contract liability would not include the costs for a market participant to purchase the related IP because that IP was included in the acquired set. This would result in a “net” valuation of the liability as opposed to including an amount for the cost to obtain the IP in both the asset and liability.

b) View B – When determining the fair value of an assumed liability, do not consider the other assets and liabilities in the acquired set.

The direct costs to fulfill a performance obligation would be viewed in isolation from any related asset needed to complete the performance obligation even if the asset was included in the acquired set. For example, if a contract liability is recognized in the business combination for an in-process license arrangement, the measurement of that contract liability would include the costs for a market participant to purchase the related IP underlying the license. The cost to obtain ownership or access to the IP is considered a direct fulfillment cost necessary to fulfill the performance obligation. View B would apply the same logic and reasoning to the asset side and therefore most likely would result in grossing up the asset and the liability on the balance sheet.
63. See the table below for an illustration of both views for the example provided in Issue 1 with the following assumptions:

- The fair value of the IP is $1000 at the date of the business combination.
- The fair value of the cost to obtain a license for the IP to satisfy the contract to Customer X is $20 at the date of the business combination (that is, the amount another entity would charge for a new contract with a customer that has the same term as the remaining term of the contract that was acquired assuming the entity had to acquire the license for the IP).
- Under a legal obligation view for Issue 1, Company A concludes that there is no remaining legal obligation related to the contract with Customer X. Under a Topic 606 performance obligation view for Issue 1, Company A concludes that the fair value of the remaining obligation to Customer X to support or maintain the IP is zero.

<table>
<thead>
<tr>
<th>View A</th>
<th>IP = 1000 (FV of IP)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Liability = 0 (FV of remaining obligation)</td>
</tr>
<tr>
<td>Note: cost to obtain license is not included because View A considers the acquired asset.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>View B</th>
<th>IP = 1000 + 20 (FV of IP + cost to obtain license) = 1020</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Liability = 0 + 20 (FV of remaining obligation + cost to obtain license) = 20</td>
</tr>
<tr>
<td>Note: cost to obtain license is 20 because View B does not consider the acquired asset.</td>
<td></td>
</tr>
</tbody>
</table>

As shown in this illustration, the net cash flow of $1000 is the same for both View A and View B. The staff believes that the two views should only result in a difference in gross presentation of the asset(s) and liability.

**Staff View**

64. The staff recommends View A because ignoring an asset in the acquired set that is necessary to fulfill the performance obligation does not seem appropriate when the asset and performance obligation have been acquired together. For example, the license to the IP owned by the acquiree and the performance obligation are included in the same purchase agreement. A buyer would not purchase in a business combination an obligation to perform under a contract without also purchasing the asset needed to fulfill that contract. Therefore, it seems inappropriate to then value that obligation without considering the related asset. In addition, the staff has concerns about the ability to “buy” revenue in
a business combination through a valuation technique that results in higher contract liabilities and therefore future corresponding revenue for the buyer.

65. The staff performed outreach as part of our pre-agenda research with revenue recognition and business combination specialists from eight accounting firms. The accounting firms indicated that current practice for revenue contracts accounted for under Topic 605 is that entities fair value the identified liabilities based on a market participant perspective under Topic 820, Fair Value Measurement. In determining the fair value, the acquiring entity includes the costs that still exist to fulfill the performance obligation. For licenses, in measuring the fair value of the remaining obligation in a business combination, entities typically do not look at the IP underlying the license and the performance obligation in isolation and do not gross up the balance sheet by including the cost to purchase the IP for the license as a cost to fulfill the performance obligation. Instead, the IP is considered part of the acquired set and the cost to purchase the IP is not included from a market participant perspective in valuing the liability. Generally, the accounting firms supported a continuation of this practice (that is, View A).

66. The staff agrees with the feedback provided in outreach and does not believe that the issuance of Topic 606 should change the evaluation of what costs to include for measurement purposes because Topic 606 did not modify how to determine the fair value of assets and liabilities. Since the obligation and asset are purchased together, they should not be viewed in isolation and should not result in a gross up of the asset and liability and the ability to “buy” revenue from a business combination through the measurement of the asset and liability.

Transition and Disclosures for Issue 1

Transition - Staff Analysis and Recommendation

67. Since Issue 1 arises once Topic 606 is effective, the staff has identified two potential transition approaches considering interrelation with the effective dates of Topic 606:

   a) Modified retrospective transition – the proposed amendments would apply retrospectively to all business combinations that occurred after an entity’s adoption of Topic 606.

   b) Prospective transition – the proposed amendments would apply to all business combinations after the effective date of a final standard on this Issue (Effective Date)

68. Depending on the Effective Date the Board chooses, the Effective Date will impact the application of each of these transition methods. For the purposes of the staff analysis below, the staff has assumed an Effective Date in 2019 for public business entities and 2020 for non-public business entities. If the Board chooses an Effective Date in 2020 for public business entities, the considerations under each transition method will be slightly different.
69. Under a modified retrospective transition to the date of initial adoption of Topic 606, an entity would be required to restate the accounting for business combinations occurring since the date of initial adoption of Topic 606 through a cumulative-effect adjustment to retained earnings for business combinations occurring after Topic 606 is initially adopted and prior to the beginning of the earliest period presented in the financial statements. The staff notes that for this transition approach an entity would likely only record a cumulative-effect adjustment if it early adopted Topic 606 and completed a business combination in a period prior to the earliest comparative period presented (that is, prior to 1/1/18). The staff does not believe this represents a significant population of entities because only a handful of companies early adopted the guidance. Entities that did not adopt Topic 606 prior to the public business entity effective date would record the effects of business combinations occurring after the adoption of Topic 606 into earnings as part of the restatement of the comparative periods presented. For entities that have not adopted Topic 606, depending on the Effective Date for this Issue, there will be no cumulative-effect adjustment to the opening balance of retained earnings, since there will be no applicable transactions to restate.

70. The modified retrospective approach would enhance comparability but increase costs to an entity due to having to restate the accounting for business combinations (if the acquiree has identifiable liabilities related to a revenue contract) in the comparative period or periods. A potential additional complexity under this transition approach is the effect on the recorded balances of goodwill or intangible assets that were subject to previously completed impairment testing. However, subsequent adjustments to assets and liabilities recorded in an acquisition are not uncommon due to the one-year measurement period allowed by Topic 805. Although these proposed amendments would not result in measurement period adjustments, the staff notes that these concerns about complexity with the modified retrospective approach may not be significant.

71. Under a prospective transition for an entity that has adopted Topic 606 prior to the Effective Date, an entity would apply the proposed amendments to business combinations occurring on or after the Effective Date (unless early application is permitted, which will be determined during redeliberations after stakeholder feedback). The prospective transition approach would be less costly and less burdensome to apply than a retrospective transition because an entity would not need to restate the accounting for business combinations occurring since the initial adoption date of Topic 606. The prospective transition approach also would alleviate potential complexities under a retrospective approach for impairment testing.

72. Although prospective transition could produce less comparative information across periods, it is unclear whether the ultimate financial reporting impact will be different under each of the alternatives since Issue 1 is focused on recognition and not measurement. As described in paragraph 49, the fair value measurement of a liability recognized using the Topic 606 performance obligation alternative may be minimal or zero, which would not be substantially different from the financial reporting under a
legal obligation alternative. This reasoning also could mitigate the cost of the modified retrospective transition approach to preparers and make the benefits of the comparative information it would provide outweigh the costs. Therefore, the staff recommends the prospective transition method described in paragraph 71 with an option for an entity to apply the modified retrospective transition method.

Recurring and Transition Disclosures – Staff Analysis and Recommendation

73. The staff believes that given the scope and potential amendments of Issue 1, there are no additional recurring disclosures that would be necessary. For transition disclosures, the staff recommends that the Task Force require disclosures in Subtopic 250-10, Accounting Changes and Error Corrections-Overall, which are applicable for a change in accounting principle. Specifically, if the Task Force requires the staff-recommended transition method (modified-retrospective), the staff would also recommend the disclosures in paragraphs 250-10-50-1 through 50-2 in the period of adoption. The staff does not believe that the cost to provide these disclosures would be significant. Appendix B includes the recommended disclosures.

74. If the Task Force requires prospective transition, the staff recommends that the Task Force also require the disclosures in paragraphs 250-10-50-1 through 50-2 except those requiring quantitative disclosures that would effectively require an entity to maintain two sets of accounting books solely in order to meet disclosure requirements. The staff does not think this would be cost-beneficial. Therefore, for prospective transition, the only disclosure requirements at transition would be the nature of and reason for the change in accounting principle, the transition method, and a qualitative description of the financial statement line items affected by the change.

Next Steps

75. If the Task Force can reach consensus on Issue 1 at the June 7, 2018 meeting and the Board subsequently ratifies the EITF’s consensus, then the staff estimates that a proposed Update could be issued in the third quarter of 2018.
Appendix A

Evolution of the Guidance in Topic 805

1. In understanding the guidance in Topic 805, the staff believes that it is useful to understand the origin of and basis for the guidance, particularly the guidance on identifiable liabilities. The guidance in Topic 805 was codified from Statement 141(R), which was issued in December 2007. That Statement was the FASB’s accounting standard resulting from a joint project by the FASB and the IASB. The IASB’s standard was issued in IFRS 3, Business Combinations (as revised in 2007). The basis for conclusions provides the reasoning behind the Boards’ decision to use the definition of an asset and liability in each Boards’ conceptual framework for recognition as follows.

B113. In determining whether an item should be recognized at the acquisition date as part of the business combination, the Boards decided that the appropriate first step is to apply the definitions of assets and liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements, or the IASB’s Framework, respectively.

B114. The Boards observed that in accordance with both Statement 141 and IFRS 3, and their predecessors and the related interpretative guidance, particular items were recognized as if they were assets acquired or liabilities assumed at the acquisition date even though they did not meet the definition of an asset or a liability. That practice was related to the previous emphasis on measuring the cost of (or investment in) the acquiree rather than the acquisition-date fair values of the assets acquired and liabilities assumed. For example, as discussed in paragraphs B365–B370, some expenses for services received in connection with a business combination were capitalized as part of the cost of the acquiree (and recognized as part of goodwill) as if they were an asset at the acquisition date. In addition, some future costs that an acquirer expected to incur often were viewed as a cost of the acquiree and recognized as if they were a liability at the acquisition date—expected restructuring costs were an example. The Boards concluded that the representational faithfulness, consistency, and understandability of financial reporting would be improved by eliminating such practices.

2. Statement 141(R) nullified Issue 01-3. One issue discussed in Issue 01-3 was whether the deferred revenue of an acquired entity represents a liability that should be recognized by the acquiring entity when the business combination is recorded and, if so, how the amount assigned to that liability should be measured. The Task Force reached a consensus that the acquiring entity should recognize a liability related to the deferred revenue of an acquired entity only if that deferred revenue represents a legal obligation assumed by the acquiring entity (a legal performance obligation), and the amount assigned to that liability is its acquisition date fair value. Examples included the legal obligation to provide goods, services, the right to use an asset, or some other consideration to a customer.

3. Issue Summary No. 1 of Issue 01-3 describes that revenue is recognized and, thus, deferred revenue is derecognized by the combined entity, based on a higher threshold compared to other changes in assets or liabilities, which is supported by CON 5.

4. The Issue Summary also provides additional background on the staff’s analysis presented to the Task Force, including several examples that discussed situations in which the entity acquired in a business
combination might have recognized deferred revenue before a business combination. One example described is the contractual requirement for additional performance, such as the requirement to deliver “when-and-if-available” items. The staff analysis in the Issue Summary acknowledged that when-and-if-available items do not represent legal obligations. However, this example was not included in the final EITF consensus. EITF Issue No. 04-11, “Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor,” which ultimately was dropped because the Task Force could not reach consensus, notes the following:

During the research of Issue 01-3, the FASB staff learned that the obligation to provide when-and-if-available upgrades were often referred to as “constructive obligations” by entities because they believed that they had an obligation to their existing customer base to perform the research and development. Those entities believed that failure to perform the research and development would impact their existing customer relationships, thus impacting future sales. The guidance in Issue 01-3 for recognizing a legal obligation is more restrictive than the recognition of a constructive obligation as outlined in FAS 143 and CON 6. Accordingly, if the legal criterion in Issue 01-3 is met, any related constructive obligation is inherently recognized.
Appendix B

Note: If the Task Force requires prospective transition, the disclosures would include the transition method, and exclude the quantitative disclosures below

Change in Accounting Principle

250-10-50-1 An entity shall disclose all of the following in the fiscal period in which a change in accounting principle is made:

a. The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable.

b. The method of applying the change, including all of the following:

1. A description of the prior-period information that has been retrospectively adjusted, if any.

2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted. Presentation of the effect on financial statement subtotals and totals other than income from continuing operations and net income (or other appropriate captions of changes in the applicable net assets or performance indicator) is not required.

3. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

4. If retrospective application to all prior periods is impracticable, disclosure of the reasons therefore, and a description of the alternative method used to report the change (see paragraphs 250-10-45-5 through 45-7).

c. If indirect effects of a change in accounting principle are recognized both of the following shall be disclosed:

1. A description of the indirect effects of a change in accounting principle, including the amounts that have been recognized in the current period, and the related per-share amounts, if applicable

2. Unless impracticable, the amount of the total recognized indirect effects of the accounting change and the related per-share amounts, if applicable, that are attributable to each prior period presented. Compliance with this disclosure requirement is practicable unless an entity cannot comply with it after making every reasonable effort to do so.

Financial statements of subsequent periods need not repeat the disclosures required by this paragraph. If a change in accounting principle has no material effect in the period of change but is reasonably certain to have a material effect in later periods, the disclosures required by (a) shall be provided whenever the financial statements of the period of change are presented.

250-10-50-2 An entity that issues interim financial statements shall provide the required disclosures in the financial statements of both the interim period of the change and the annual period of the change.