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authoritative guidance should be used as opposed to a legal obligation concept that originated from guidance that was superseded.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 The staff believes that the use of codified GAAP is more appropriate than superseded guidance and that the codified guidance should be consistently applied (that is, the identification of an obligation for a revenue contract should not be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

<u>**>> Revenue From Contracts with Customers**</u>

<u>**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.</u>

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.

View A	IP = 1000 (FV of IP) Liability = 0 (FV of remaining obligation) *Note: cost to obtain license is not included because View A considers the acquired asset.*
View B	IP = 1000 + 20 (FV of IP + cost to obtain license) = 1020 Liability = 0 + 20 (FV of remaining obligation + cost to obtain license) = 20 *Note: cost to obtain license is 20 because View B does not consider the acquired asset.*

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.