The Intersection of ASC 606 and ASC 805: Recognition and Measurement of Assumed Contract Liabilities in a Business Combination

by Scott Ehrlich and Eliza Ong (Mind the GAAP, LLC)
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As companies, both public and private, adopt the new guidance in ASC Topic 606, *Revenue from Contracts with Customers*, certain unexpected practice issues have begun to emerge. One situation involves how to recognize and measure a contract liability – sometimes referred to as "deferred revenue" – assumed in a business combination after the acquirer has adopted ASC 606.

Performance vs legal obligation

Prior to ASC 606, an acquiring entity in a business combination generally recognized a liability for the deferred revenue of an acquired entity only if that deferred revenue represented a *legal obligation* assumed by the acquirer.

However, ASC 606 introduced the concept of *performance obligation*. A performance obligation can be more expansive than a legal obligation. For instance, a performance obligation can include customary business practices or other implied promises in a contract that aren't necessarily legally enforceable.

To demonstrate, assume that at the beginning of the year, Target enters into a contract to provide a software license to its customer for an up-front fee. The contract does not explicitly obligate Target to provide postcontract customer support (PCS). Nonetheless, Target has a business practice of providing PCS to its customers for a period of one year. Under ASC 606, the contract has two performance obligations – transferring a software license as well as PCS. However, the contract has just the one legal obligation to transfer the software license.

Now suppose that Acquirer purchases Target in a business combination a few months after the customer contract commences. At that moment, Target has a partially unsatisfied ASC 606 performance obligation related to its business practice of providing PCS for a year after transferring a license. The question is whether in applying business combination accounting under ASC Topic 805, Acquirer should recognize an assumed contract liability for the unsatisfied performance obligation (PCS). Remember – the commitment to provide PCS is not legally enforceable, meaning that it may not have been recognized as an assumed liability in a business combination that occurred before ASC 606 was issued.

The FASB has issued a proposed Accounting Standards Update that, if adopted, would require that an acquirer "recognize a liability assumed in a business combination from a contract with a customer *if that liability represents an unsatisfied performance obligation under Topic 606 for which the acquiree has received consideration (or the amount is due) from the customer*". Therefore, the FASB has proposed to link the recognition of a contract liability assumed in a business combination to the performance obligation notion in ASC 606. Comments on this proposed ASU are due April 30, 2019.

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Valuation challenges

In a business combination, acquired assets and liabilities (including contract liabilities) are generally measured at fair value, based on the principles of ASC 820, *Fair Value Measurement*. The challenge in measuring the fair value of contract liability is that there is typically no observable prices for identical liabilities in active markets. As such, the measurement is generally performed using a valuation technique.

Prior to the effective date of ASC 606, one common valuation technique on measuring assumed deferred revenue obligations was a "cost plus margin" method. Under this method, the acquirer would measure the liability based on the estimated cost of fulfilling any remaining obligations, plus a typical profit margin that a market participant would demand for fulfilling the obligation.

Employing a cost plus margin method could have the effect of reducing the amount of revenues the combined company reported post-acquisition. Returning to our previous software example, it's likely that the costs associated with performing the remaining PCS obligations under the contract are probably fairly minimal at the time of acquisition. After all, it probably won't take much effort to answer a one-off technical question over the remaining performance period. So if a contract liability were recognized, its value would be quite small under the cost plus margin method. And when the liability is subsequently derecognized, the resulting revenues would also be small – likely less than what Target would have recognized had it not been acquired.

The FASB has issued a separate Invitation to Comment (ITC) around measurement of any contract liability recognized in a business combination. The ITC solicits feedback around a number of issues including whether payment terms should affect the measurement of an assumed contract liability and what costs should be included in a fair value measurement. The FASB staff make no recommendations on these and other questions, and are seeking input on these challenging valuation questions. Comments on the ITC are also due April 30, 2019.