Changes to accounting for revenue contracts in a business combination

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1. Summary and background

The overall principles used to recognize and measure assets and liabilities acquired in a business combination in accordance with the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 805, *Business Combinations*, results in the following:

- Only recognizing assets acquired and liabilities assumed in the accounting for a business combination that meet the definitions of assets and liabilities in paragraphs 25 and 35 of FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6)
- Measuring identifiable assets acquired and liabilities assumed at fair value

While ASC 805 includes various exceptions to these recognition and measurement principles, prior to October 2021, there were no exceptions related to recognizing and measuring assets and liabilities for acquired customer contracts within the scope of ASC 606, *Revenue from Contracts with Customers*. When ASC 606 was issued as part of Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, neither that ASU nor several subsequently issued ASUs amending ASC 606 included conforming amendments to ASC 805 related to accounting for customer contracts acquired in a business combination.

With the implementation of ASC 606, which only recently became fully effective for all entities, the question was raised with respect to whether a contract liability (i.e., deferred revenue) should be recognized based on the underlying legal obligation (as was done prior to ASC 606) or the underlying performance obligation as that concept is used in ASC 606. In addition, questions were raised about the measurement of the contract liability recognized in a business combination. These questions centered around use of the legal obligation's fair value under ASC 805, which often resulted in the buyer recognizing a contract liability in an amount less than (and in some cases, significantly less than) the contract liability recognized by the target prior to the acquisition under ASC 606 (for additional information, see Section 10.6.4.1 and Example 10-3 in our publication, A guide to accounting for business combinations [our business combinations guide]). Both the recognition and measurement questions were raised to the FASB, and a project ultimately was added to its agenda. In October 2021, this project culminated in the FASB's issuance of ASU 2021-08*, Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*.

To understand the effects of ASU 2021-08, it is important to understand what constitutes a contract asset and contract liability under ASC 606:

- A contract liability arises under ASC 606 when the customer's performance is greater than that of the entity (i.e., the consideration paid by the customer plus any amount recognized as a receivable is greater than the revenue recognized for the promised goods or services transferred to the customer).
- A contract asset arises under ASC 606 when the entity's performance is greater than that of the customer (i.e., the revenue recognized for the promised goods or services transferred to the customer is more than the consideration paid by the customer or recognized as a receivable).

Adoption of ASU 2021-08 may change the manner in which the buyer in a business combination recognizes and measures contract assets and contract liabilities related to acquired customer contracts as follows:

Before adoption of ASU 2021-08	After adoption of ASU 2021-08
The buyer should recognize contract assets and contract liabilities at their fair values. However, we believe there is diversity in practice that results in the recognition of contract liabilities based on the fair value of either: (a) the legal	The buyer should recognize and measure contract assets and contract liabilities based on the guidance in ASC 606 (except when one of the measurement practical expedients provided in ASC 805-20-30-29 has been elected).

Before adoption of ASU 2021-08	After adoption of ASU 2021-08
obligation (using the definition of a liability in paragraph 35 of CON 6) or (b) the performance obligation (using the definition in ASC 606-10-25-14).	

The adoption of ASU 2021-08 also may affect the amount of revenue recognized after the acquisition date. In some cases, measuring a contract liability under ASC 606 in the accounting for a business combination will result in the recognition of a higher contract liability than the contract liability that would have been recognized had it been measured at its fair value as was required before the adoption of ASU 2021-08. As a result, all other things being equal in these cases, the buyer likely will recognize more post-acquisition revenue after its adoption of ASU 2021-08 than it would have recognized before its adoption of ASU 2021-08.

The following additional information about the amendments made by ASU 2021-08 to ASC 805 is provided in the remainder of this white paper:

- Scope of the ASU
- Recognition and measurement of contract assets and contract liabilities in the accounting for a business combination
- Required disclosures
- Effective date of the ASU and transition

Additional information about recognizing customer-contract-related assets and liabilities acquired in a business combination other than those within the scope of ASC 606 is provided in Section 10.6 of our business combinations guide. Additional information about recognizing revenue from contracts with customers under ASC 606 is provided in our publication, A guide to revenue recognition.

2. Scope

The guidance in ASU 2021-08 applies to the recognition and measurement of contract assets and contract liabilities related to customer contracts within the scope of ASC 606 that are acquired in a business combination. The guidance also applies to other acquired contracts accounted for in accordance with ASC 606, such as contracts within the scope of ASC 610-20, *Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets*, and certain parts of collaborative agreements within the scope of ASC 808, *Collaborative Arrangements*. While the focus of this white paper is on acquired customer contracts, it is important to keep in mind that the same guidance applies to other contracts accounted for in accordance with ASC 606.

It is important to note that ASU 2021-08 only added exceptions to the general recognition and measurement principles in ASC 805 for contract assets and contract liabilities related to acquired customer contracts. In other words, ASU 2021-08 did not change the accounting guidance in ASC 805 otherwise applicable to recognizing and measuring other assets and liabilities related to customer contracts acquired in a business combination, including the following:

- Accounts receivable (see Sections 10.3 and 10.6.2 of our business combinations guide)
- Inventory (see Section 10.7 of our business combinations guide)
- Refund liabilities that do not meet the definition of contract liabilities and an asset for related returned inventory (see Section 7.3.6 of our revenue recognition guide)
- Backlog intangible assets (see Section 10.6.2 of our business combinations guide)

- Off-market contract intangible assets (above market) or liabilities (below market) (see Section 2.1 in this white paper and Section 10.6.2 of our business combinations guide)
- Customer relationship intangible assets (see Sections 10.6.2 and 10.6.3 of our business combinations guide)

In addition, ASU 2021-08 did not change how deferred costs of the target related to either of the following should be treated by the buyer in the accounting for a business combination:

- Fulfillment costs and costs to obtain a customer contract within the scope of ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers* (see Chapter 13 of our revenue recognition guide)
- Upfront payments to a customer for which the target either (a) has not or will not receive a distinct good or service from the customer or (b) has not received a purchase commitment from the customer (see Section 7.5 of our revenue recognition guide)

For example, a target may have deferred costs related to obtaining a customer contract under ASC 340-40. As discussed in Section 10.6.7 of our business combinations guide, we believe those deferred costs should not be recognized by the buyer in the accounting for the business combination because they do not meet the definition of an asset in CON 6. We also believe this continues to be the appropriate accounting after the adoption of ASU 2021-08.

2.1 Indirect effects of ASU 2021-08 on the recognition of off-market contract intangible assets and liabilities

While ASU 2021-08 does not address the accounting for off-market contract intangible assets or liabilities, we believe the change in how contract assets and contract liabilities are recognized in the accounting for a business combination could have an indirect effect on how off-market contract intangible assets and liabilities are recognized. For example, prior to its adoption of ASU 2021-08, an entity may have included the fair value of an off-market contract intangible asset or liability for an acquired customer contract in the fair value of the contract liability recognized for that contract. After the adoption of ASU 2021-08, the contract liability no longer is measured at fair value, which means the entity will need to separately consider whether an off-market contract asset or liability should be recognized, and if so, the amount that should be recognized. This is similar to considering whether an intangible asset or liability should be recognized for an operating lease that has favorable or unfavorable terms compared to market that was acquired in a business combination in which the acquiree is the lessee (see Section 10.13.2.2 and Section 10.13.3.3 of our business combinations guide).

3. Recognition and measurement of contract assets and contract liabilities in a business combination

3.1 Initial accounting

ASU 2021-08 adds both a recognition exception and a measurement exception to ASC 805 for contract assets and contract liabilities acquired in a business combination. These exceptions require such assets and liabilities to be recognized and measured in accordance with ASC 606, as if the buyer itself had originated the related customer contracts. In other words, the exceptions require the recognition of contract assets and contract liabilities at the amounts that would have resulted from the buyer applying ASC 606 to the acquired customer contract since its origination. As such, to the extent ASC 606 requires an assessment or judgment to be made at contract inception, upon contract modification or on a recurring basis, the buyer's measurement of contract assets and contract liabilities should reflect those assessments or judgments of the buyer as of when they were otherwise required to be made under ASC 606. However, the following measurement practical expedients are available for election by the buyer on an acquisition-by-acquisition basis:

- When a customer contract has been modified prior to the acquisition date, the buyer may base the following on the terms of the contract as of the acquisition date (instead of the origination and subsequent modification dates):
  - Identification of the performance obligations in the contract and whether they have been satisfied;
  - Determination of the transaction price; and
  - Allocation of the transaction price to the performance obligations.
- The buyer may use the acquisition-date standalone selling prices for the performance obligations in the customer contract (instead of the origination-date standalone selling prices) when allocating the transaction price to the performance obligations in the contract.

If the buyer elects to apply one or both practical expedients to its accounting for an acquisition, the practical expedient(s) must be consistently applied to *all* customer contracts acquired in that acquisition.

The recognition of a contract liability in the accounting for a business combination generally increases the amount of goodwill recognized, while the recognition of a contract asset may or may not affect the amount of goodwill recognized (it will depend on the facts and circumstances because the recognition of a contract asset may affect the amount recognized for another customer-contract-related asset with the net effect on goodwill being zero). However, the effects of recognizing contract assets and contract liabilities on goodwill only captures one piece of the overall effects of accounting for customer contracts acquired in a business combination. As discussed earlier in Section 2, the buyer may need to recognize other assets and liabilities related to customer contracts acquired in a business combination, including accounts receivable, refund liabilities, backlog intangible assets, off-market contract intangible assets or liabilities, and (or) customer relationship intangible assets. Only after considering all of the customer-contract-related assets and liabilities that should be recognized in the accounting for a business combination does the buyer get a complete picture of the effects of the customer contract on the amount of goodwill recognized.

When a business combination is treated as a taxable transaction (see Section 11.4.1.1 of our business combinations guide), the contract assets and contract liabilities recognized under ASC 805 likely would create a temporary difference for which deferred income taxes should be recognized. Given the complexities involved in the accounting for the income tax effects of a business combination, we recommend the buyer seek the assistance of a tax specialist to help with that accounting. For additional information about the accounting for income taxes in a business combination, see Section 11.4 of our business combinations guide.

The examples in Section 3.3 illustrate the initial accounting under ASC 606 for contract assets and contract liabilities recognized in the accounting for a business combination.

3.1.1 Using the target's contract assets and contract liabilities recognized and measured in accordance with ASC 606

If the target has not applied ASC 606 (i.e., it does not prepare financial statements in accordance with U.S. generally accepted accounting principles), the amounts it has recognized at the acquisition date related to its customer contracts should not be used by the buyer in its accounting for the business combination. If the target has applied ASC 606, the contract assets and contract liabilities recognized by the target as of the acquisition date generally should be used by the buyer for purposes of its accounting for the business combination after incorporating the adjustments that may result from considering the following questions:

- *Has the target made any errors in its application of ASC 606?* The degree of complexity involved in accounting for customer contracts under ASC 606 varies based on a number of factors, including the complexity of an entity's customer contracts. As the complexity increases, so too may the possibility for errors.

- *Are there differences in the judgments and estimates used by the target in applying ASC 606 to its contracts compared to the judgments and estimates that would be used by the buyer in applying ASC 606 to those same contracts?* Examples of judgments and estimates that may differ between the buyer and target are those involved in determining the amount of variable consideration to include in the transaction price, determining standalone selling prices for performance obligations and measuring progress toward the complete satisfaction of a performance obligation satisfied over time (see Section 7.3, Section 8.2 and Section 9.3 of our revenue recognition guide, respectively).
- *Has the target elected different accounting policies and practical expedients under ASC 606 compared to those elected by the buyer?* ASC 606 provides various accounting policies and practical expedients that may or may not be elected by an entity. Each of these create the potential for the buyer and target to have made different elections.

If the answer to one or more of these questions is "yes," for purposes of its business combination accounting, the buyer would not be able to use the contract assets and contract liabilities recognized by the target as of the acquisition date without making the necessary adjustments (e.g., correcting the errors made by the target, using the buyer's judgments and estimates instead of the target's and [or] conforming the target's ASC 606 elections with those of the buyer).

Central to correctly answering the questions in this section is the buyer having an in-depth understanding of the target's application of ASC 606. To gain this in-depth understanding, the buyer should have processes and controls in place to evaluate the target's application of ASC 606 prior to the buyer accounting for its acquisition of the target.

3.1.2 Fair value considerations related to non-ASC 606 customer-contract-related assets and liabilities

As discussed in Section 3.1, ASU 2021-08 only addresses the accounting for contract assets and contract liabilities recognized in accordance with the provisions of ASC 606 and does not change the guidance in ASC 805 otherwise applicable to recognizing and measuring other assets and liabilities related to customer contracts acquired in a business combination. Those non-ASC 606 customer-contract-related assets and liabilities continue to be (a) recognized when they meet the definition of an asset or liability in CON 6 and (b) measured at their fair values.

The fair value of certain non-ASC 606 customer-contract-related assets may be based on future (i.e., post-acquisition) cash flow estimates. While cash flow estimates for a customer contract are unaffected by ASU 2021-08, using ASC 606 as a basis to measure contract assets after the adoption of ASU 2021-08 could result in certain future cash flows being included or excluded from the measurement of the contract assets. As such, when it comes to estimating the fair value of certain non-ASC 606 customer-contract-related assets recognized in the accounting for a business combination, the buyer should consider whether (a) all appropriate future (i.e., post-acquisition) cash flows have been taken into consideration in estimating the fair value of non-ASC 606 customer-contract-related assets and (b) no future cash flows have been double counted in the overall accounting for the business combination. With respect to (a), the buyer should consider whether future cash flows expected from a customer contract that have not been reflected in the measurement of a contract asset due to the provisions of ASC 606 (such as those that exclude sales- and (or) usage-based royalties [see Example 3-1] or constrained variable consideration from contract assets) have been taken into consideration (as appropriate) in determining the fair value of a non-ASC 606 customer-contract-related intangible asset (such as a customer relationship intangible asset). With respect to (b), the buyer should consider whether future cash flows expected from a customer contract that have been reflected in the measurement of a contract asset due to the provisions of ASC 606 (such as those expected cash payments that are included in the measurement of the contract asset recognized in Example 3-4 because the entity's performance exceeds the customer's performance) have not been taken into consideration in determining the fair value of a non-ASC 606 customer-contract-related intangible asset (such as a customer relationship intangible asset).

In addition, using ASC 606 as a basis to measure contract liabilities after the adoption of ASU 2021-08 could result in certain contract liabilities being recognized in the accounting for the business combination for which there are no associated future cash flows required to satisfy the liability. Because only future (i.e., post-acquisition) cash flows should be taken into consideration in estimating the fair value of other intangible assets (e.g., customer relationship intangible assets, intellectual property intangible assets), the future revenues from contract liabilities for which there are no associated future cash flows should not be included in estimating the fair value of those other intangible assets (see the “Note” in Example 3-3).

Given the complexities involved in identifying the non-ASC 606 customer-contract-related assets and liabilities that are acquired in a business combination and measuring those assets and (or) liabilities at fair value, we strongly recommend that the buyer seek the assistance of a valuation specialist to help with those identification and measurement activities.

3.2 Subsequent accounting

Both before and after the adoption of ASU 2021-08, ASC 606 is used to subsequently account for contract assets and contract liabilities recognized in the accounting for a business combination. After the acquisition-date accounting is complete, application of ASC 606 to these assets and liabilities does not affect the business combination accounting, and whether revenue is affected depends on the facts and circumstances. The examples in Section 3.3 illustrate the subsequent accounting under ASC 606 for contract assets and contract liabilities recognized in the accounting for a business combination.

3.3 Examples

The following examples do not provide a comprehensive description of all terms, facts or circumstances that could affect the accounting for the license agreements or construction contracts under ASC 606, nor do they provide the comprehensive analysis performed by Target or Buyer when accounting for the agreements under ASC 606. For an in-depth discussion of the guidance in ASC 606 related to the accounting for customer contracts that include a license of intellectual property, and comprehensive examples illustrating application of that guidance, see Chapter 10 of our revenue recognition guide. In-depth discussion of the guidance in ASC 606 that could affect the accounting for construction contracts is provided throughout our revenue recognition guide. Examples in that guide illustrating the application of certain concepts to construction contracts include Example 6-7, Example 7-6, Example 7-21, Example 9-4, Example 9-5, Example 9-7, Example 9-10 and Example 12-2.

Example 3-1: Customer contract for the license of functional intellectual property in which all of the consideration is a sales-based royalty

Facts

On November 30, 20X3, Target enters into a three-year license agreement with Customer. The agreement meets the definition of a contract in ASC 606-10-25-2 and meets the contract existence criteria in ASC 606-10-25-1. Under the terms of the agreement, Customer has the right to use the formula for one of Target’s drug compounds (Formula X) in the production of a pharmaceutical product (Product Z). There are no other promised goods or services in the agreement. Target provides Formula X to Customer on November 30, 20X3. Customer is obligated to pay Target 20% of the sales proceeds related to Product Z on a monthly basis. There is no other consideration payable between Target and Customer, and Customer does not have a refund right.

Target is acquired by Buyer on December 1, 20X4. For ease of illustration, Target’s receivable for the sales-based royalty due from Customer for its sales of Product Z prior to the acquisition has been ignored. Target has no other assets or liabilities related to its license agreement with Customer on its balance sheet as of the acquisition date.

How does Target account for the license agreement with Customer prior to its acquisition?

Based on applying the guidance in ASC 606 to the terms of the contract and related facts and circumstances, Target accounts for the contract with Customer as follows prior to its acquisition:

- Treats the license as a right to use intellectual property, which is a performance obligation satisfied at the point in time Formula X is provided to Customer on November 30, 20X3.
- Recognizes the sales-based royalty under the license agreement as Customer sells Product Z, which results in Target not having a contract asset recorded at November 30, 20X4 despite Target's performance being greater than that of Customer as of that date (i.e., Target has completed its performance by providing Formula X, while Customer has not completed making all of the payments required under the contract). (This accounting treatment results from Target's application of the sales- and (or) usage-based royalty exception in ASC 606-10-55-65 to 55-65B, which prohibits recognition of the sales- and (or) usage-based royalty as revenue or a contract asset in this situation until the subsequent sale or usage occurs.)

After its adoption of ASU 2021-08, how does Buyer account for Target's license agreement with Customer in its accounting for the business combination?

Buyer reviews Target's accounting for its license agreement with Customer under ASC 606 and concludes:

- Target has not made any errors in its application of ASC 606 to the agreement.
- In applying ASC 606 to the agreement, Buyer would use the same judgments and estimates that were used by Target.
- There are no accounting policy or practical expedient elections made by Target under ASC 606 that would affect its accounting for the agreement (i.e., there are no accounting policy or practical expedient elections made by Target that need to be conformed with Buyer's elections).

Based on this analysis, Buyer concludes it should not recognize a contract asset related to the license agreement with Customer in its accounting for the business combination on December 1, 20X4, which is consistent with Target's accounting for the agreement prior to its acquisition.

While Buyer does not recognize a contract asset for the future sales-based royalties it expects to receive from Customer, those sales-based royalties should be considered in determining the fair value of any non-ASC 606 customer-contract-related intangible assets recognized related to the license agreement in the accounting for the business combination, such as a customer relationship intangible asset.

How does Buyer recognize revenue for the license agreement with Customer after the acquisition date?

Buyer recognizes revenue for the license agreement with Customer each month based on the sales-based royalty it is due to receive related to Customer's sales of Product Z.

Example 3-2: Customer contract for software and PCS that includes both upfront and ongoing payments

Facts

On November 30, 20X3, Target enters into a three-year contract with Customer. The agreement meets the definition of a contract in ASC 606-10-25-2 and meets the contract existence criteria in ASC 606-

10-25-1. Under the terms of the contract, Customer has the right to use Target's software and receive post-contract customer support (PCS) from Target for three years. There are no other promised goods or services in the contract. Customer is obligated to pay Target $1 million on November 30, 20X3 and $200,000 on November 30, 20X4 and November 30, 20X5. There is no other consideration payable between Target and Customer, and Customer does not have a refund right. On November 30, 20X3, Target provides the software to Customer and Customer pays $1 million to Target. In addition, on November 30, 20X4, Customer pays $200,000 to Target.

Target is acquired by Buyer on December 1, 20X4. Buyer determines that Target's contract with Customer is at market (neither favorable nor unfavorable) as of the acquisition date.

Customer pays $200,000 to Buyer on November 30, 20X5.

How does Target account for the contract with Customer prior to its acquisition?

Based on applying the guidance in ASC 606 to the terms of the contract and related facts and circumstances, Target accounts for the contract with Customer as follows prior to its acquisition:

- Treats the software and PCS as separate performance obligations
- Determines the transaction price is $1.4 million
- Allocates $800,000 of the transaction price to software and $600,000 of the transaction price to the PCS (based on their respective standalone alone selling prices)
- Treats the software as a right to use intellectual property, which is a performance obligation satisfied at the point in time the software is provided to Customer
- Treats the PCS as a performance obligation ratably satisfied over the three-year term of the contract

The following represents Target's accounting for the revenue associated with satisfying the software performance obligation as of November 30, 20X3:

	Debit	Credit
Cash	$1,000,000	
Contract liability		$200,000
Revenue		800,000

The following represents the net effects of Target's accounting for the revenue associated with satisfying the PCS performance obligation over time for the 12 months ending November 30, 20X4:

	Debit	Credit
Cash	$200,000	
Revenue		$200,000

As of the date it is acquired, Target has a contract liability of $200,000 on its books related to its contract with Customer.

After its adoption of ASU 2021-08, how does Buyer account for Target's contract with Customer in its accounting for the business combination?

Buyer reviews Target's accounting for its contract with Customer under ASC 606 and concludes:

- Target has not made any errors in its application of ASC 606 to the contract.
- In applying ASC 606 to the contract, Buyer would use the same judgments and estimates that were used by Target.

- There are no accounting policy or practical expedient elections made by Target under ASC 606 that would affect Target's accounting for the contract (i.e., there are no accounting policy or practical expedient elections made by Target that need to be conformed with Buyer's elections).

Based on this analysis, Buyer concludes it should recognize a contract liability of $200,000 related to Target's contract with Customer in its accounting for the business combination on December 1, 20X4, which is consistent with Target's accounting for the contract prior to its acquisition.

How does Buyer account for the contract with Customer after the acquisition date?

The following represents the net effects of Buyer's accounting for the revenue associated with satisfying the PCS performance obligation over time for the 12 months ending November 30, 20X5:

	Debit	Credit
Cash	$200,000	
Revenue		$200,000

The following represents Target's accounting for the revenue associated with satisfying the PCS performance obligation over time for the 12 months ending November 30, 20X6:

	Debit	Credit
Contract liability	$200,000	
Revenue		$200,000

What if Buyer determines as of the acquisition date that Target's contract with Customer is favorable compared to market by an amount of $10,000 (and Buyer has not elected the private-company intangible asset alternative)?

For the same reasons noted earlier, Buyer would conclude it should recognize a contract liability of $200,000 related to Target's contract with Customer in its accounting for the business combination on December 1, 20X4. In addition, Buyer would conclude it should separately recognize an off-market contract intangible asset of $10,000 for the favorable position of the contract. Buyer concludes this intangible asset should be derecognized ratably over the remaining two years of the contract with Customer.

Example 3-3: Customer contract for the license of symbolic intellectual property in which all of the consideration is paid upfront

Facts

On November 30, 20X3, Target enters into a three-year license agreement with Customer. The agreement meets the definition of a contract in ASC 606-10-25-2 and meets the contract existence criteria in ASC 606-10-25-1. Under the terms of the agreement, Customer has the right to use Target's cartoon mascot for three years. There are no other promised goods or services in the agreement. Customer is obligated to pay Target $1.2 million on November 30, 20X3. There is no other consideration payable between Target and Customer, and Customer does not have a refund right. On November 30, 20X3, Target provides Customer with access to its cartoon mascot, and Customer pays $1.2 million to Target.

Target is acquired by Buyer on December 1, 20X4. Buyer determines that Target's contract with Customer is at market (neither favorable nor unfavorable) as of the acquisition date.

How does Target account for the license agreement with Customer prior to its acquisition?

Based on applying the guidance in ASC 606 to the terms of the license agreement and related facts and circumstances, Target treats the license as a right to access intellectual property that is satisfied over time on a ratable basis, which results in Target recognizing revenue of $400,000 per year over the three-year term of the agreement.

The following represents Target's accounting for the $1.2 million received from Customer on November 30, 20X3:

	Debit	Credit
Cash	$1,200,000	
Contract liability		$1,200,000

The following represents Target's accounting for the revenue associated with the license agreement for the 12 months ending November 30, 20X4:

	Debit	Credit
Contract liability	$400,000	
Revenue		$400,000

As of the date it is acquired, Target has a contract liability of $800,000 on its books related to its license agreement with Customer ($1,200,000 initial balance − $400,000 derecognized in the 12 months ending November 30, 20X4).

After its adoption of ASU 2021-08, how does Buyer account for Target's license agreement with Customer in its accounting for the business combination?

Buyer reviews Target's accounting for its license agreement with Customer under ASC 606 and concludes:

- Target has not made any errors in its application of ASC 606 to the agreement.
- In applying ASC 606 to the agreement, Buyer would use the same judgments and estimates that were used by Target.
- There are no accounting policy or practical expedient elections made by Target under ASC 606 that would affect Target's accounting for the agreement (i.e., there are no accounting policy or practical expedient elections made by Target that need to be conformed with Buyer's elections).

Based on this analysis, Buyer concludes it should recognize a contract liability of $800,000 related to Target's license agreement with Customer in its accounting for the business combination on December 1, 20X4, which is consistent with Target's accounting for the agreement prior to its acquisition.

Note: When determining the fair value of the intangible asset for the cartoon mascot that should be recognized in the accounting for the business combination, the future revenue from the contract liability of $800,000 recognized for Target's license agreement with Customer should not be considered because there are no future cash flows associated with that liability.

How does Buyer account for the license agreement with Customer after the acquisition date?

The following represents Buyer's accounting for the revenue associated with the license agreement for the 12 months ending November 30, 20X5 and November 30, 20X6:

	Debit	Credit
Contract liability	$400,000	
Revenue		$400,000

Example 3-4: Customer contract with a single performance obligation satisfied over time and progress payments made over the contract's term

Facts

On November 30, 20X3, Target enters into a contract with Customer to build a building. The agreement meets the definition of a contract in ASC 606-10-25-2 and meets the contract existence criteria in ASC 606-10-25-1. Under the terms of the contract, Customer is required to make progress payments of $400,000 on May 31, 20X4, November 30, 20X4 and May 31, 20X5 and a final payment of $800,000 when Target completes construction of the building, which is expected to be on or about November 30, 20X5. There is no other consideration payable between Target and Customer, and Customer does not have a right of return. Customer pays Target $400,000 on May 31, 20X4 and November 30, 20X4.

Target is acquired by Buyer on December 1, 20X4. Buyer determines that Target's contract with Customer is at market (neither favorable nor unfavorable) as of the acquisition date.

Customer pays $400,000 to Buyer on May 31, 20X5, and on November 30, 20X5, Buyer completes construction of the building and Customer pays $800,000 to Buyer.

How does Target account for the contract with Customer prior to its acquisition?

Based on applying the guidance in ASC 606 to the terms of the contract and related facts and circumstances, Target accounts for the contract with Customer as follows prior to its acquisition:

- Treats construction of the building as a single performance obligation that is satisfied over time.
- Determines the transaction price is $2 million.
- Uses a cost-to-cost method to measure progress toward the complete satisfaction of the performance obligation to construct the building, which indicates that the construction is 55% complete at November 30, 20X4.

The following represents Target's accounting for the construction contract with Customer for the 12 months ending on November 30, 20X4:

	Debit	Credit
Cash	$800,000	
Contract asset	300,000	
Revenue ($2,000,000 × 55%)		$1,100,000

After its adoption of ASU 2021-08, how does Buyer account for Target's construction contract with Customer in its accounting for the business combination?

Buyer reviews Target's accounting for its contract with Customer under ASC 606 and concludes:

- Target has not made any errors in its application of ASC 606 to the contract.
- In applying ASC 606 to the contract, Buyer would use the same judgments and estimates that were used by Target. (See the last question in this example for a scenario in which Buyer would use a different measurement of progress toward the complete satisfaction of the performance obligation.)
- There are no accounting policy or practical expedient elections made by Target under ASC 606 that would affect Target's accounting for the contract (i.e., there are no accounting policy or practical expedient elections made by Target that need to be conformed with Buyer's elections).

Based on this analysis, Buyer concludes it should recognize a contract asset of $300,000 related to Target's construction contract with Customer in its accounting for the business combination on December 1, 20X4, which is consistent with Target's accounting for the contract prior to its acquisition.

How does Buyer account for the contract with Customer after the acquisition date?

The following represents Buyer's accounting for the revenue from the construction contract with Customer (and excludes Buyer's accounting for the related costs) for the 12 months ending on November 30, 20X5:

	Debit	Credit
Cash	$1,200,000	
Contract asset		$300,000
Revenue ($2,000,000 × 45%)		900,000

What if Buyer's acquisition-date estimate of the progress toward the complete satisfaction of the performance obligation to construct the building was different from Target's estimate?

Assume that Buyer's costs of construction are less than Target's costs because Buyer is able to obtain volume discounts from many of its suppliers that Target was not able to obtain from its suppliers. Further assume that, based on its cost estimates, Buyer would have estimated that construction of the building was 60% complete at the acquisition date. Using Buyer's estimate of 60% complete instead of Target's estimate of 55% complete would result in Buyer recognizing a contract asset of $400,000 related to the construction contract with Customer in its accounting for the business combination on December 1, 20X4 ([$2 million transaction price × 60% complete] − $800,000 cash received).

The following would represent Buyer's accounting for the construction contract with Customer for the 12 months ending on November 30, 20X5 when a $400,000 contract asset (instead of a $300,000 contract asset) was recognized in the accounting for the business combination:

	Debit	Credit
Cash	$1,200,000	
Contract asset		$400,000
Revenue ($2,000,000 × 40%)		800,000

4. Required disclosures

The incremental disclosures required by ASU 2021-08 only apply when the buyer has elected one or both of the measurement practical expedients discussed in Section 3.1. When that is the case, the buyer must disclose its election of the expedient(s), and if reasonably possible, a qualitative assessment of the effects of doing so.

As discussed in paragraphs BC54 and BC55 of ASU 2021-08, the FASB did not add any incremental disclosures beyond those applicable to the measurement practical expedients because they believed the existing disclosure requirements in ASC 606 and ASC 805 would provide sufficient information about contract assets and contract liabilities acquired in a business combination. Paragraph BC55 of ASU 2021-08 specifically mentions the following disclosure requirements in this context:

- For all entities, each major class of assets acquired and liabilities assumed
- For public entities (as defined in the Master Glossary of the ASC):
  - The post-acquisition-date revenue and net income attributable to the target that are included in the consolidated financial statements

- Supplemental pro forma consolidated revenue and net income for the current and prior period (if comparative financial statements are presented), as well as information about any material, nonrecurring adjustments related to the business combination that are reflected in the pro forma amounts
- Qualitative and quantitative explanation of what caused significant changes in the contract assets and contract liabilities during the reporting period (with business combinations being provided as an example of what could cause a significant change)
- With limited exceptions, the aggregate transaction price allocated to certain unsatisfied (or partially unsatisfied) performance obligations at the balance-sheet date and either a quantitative or qualitative description of when the buyer expects to recognize that amount as revenue

5. Effective date of the ASU and transition

ASU 2021-08 should be applied on a prospective basis and is effective:

- For *public business entities*, in fiscal years beginning after December 15, 2022, including interim periods therein. For example, ASU 2021-08 is effective for a calendar-year-end public business entity as of January 1, 2023.
- For *all other entities*, in fiscal years beginning after December 15, 2023, including interim periods therein. For example, ASU 2021-08 is effective for a calendar-year-end private company as of January 1, 2024.

However, ASU 2021-08 may be adopted early in an annual or interim period, provided the financial statements for that period have not been issued (for public entities) or made available for issuance (for all other entities). If an entity elects to early adopt ASU 2021-08 in an interim period, it is required to apply the provisions of ASU 2021-08 to all business combinations for which the acquisition date occurred on or after the beginning of the fiscal year that includes that interim period, as well as all business combinations that occur on or after the early adoption date. We believe early adoption does not affect the accounting for business combinations that occurred in the prior fiscal year but for which the measurement period remains open in the fiscal year of adoption. In other words, we believe the accounting for those business combinations should be finalized by continuing to apply ASC 805 prior to the amendments made by ASU 2021-08.

Complexity may arise in the retrospective application of ASU 2021-08 to business combinations that occurred in earlier interim periods within the same fiscal year as the interim period in which the ASU is early adopted (which will be referred to as *earlier interim-period business combinations*). For example, the buyer would have applied the pre-ASU 2021-08 guidance to recognize and measure contract assets and contract liabilities for any customer contracts acquired in an earlier interim-period business combination. Retrospective application of ASU 2021-08 to this business combination would require the buyer to re-evaluate the contract assets and contract liabilities to recognize them in accordance with ASC 606, which likely would result in adjustments to the business combination accounting that occurred in the earlier interim period. These adjustments may affect more than just the amounts of contract assets, contract liabilities and (or) goodwill recognized in the business combination accounting. For example, the buyer should carefully consider whether any retrospective application adjustments to contract assets and contract liabilities would affect the amounts recognized for any non-ASC 606 customer-contract-related intangible assets or liabilities. In addition, retrospective changes to the amounts recognized in an earlier interim-period business combination likely would affect the income statement subsequent to the acquisition date. For example, an increase to a contract liability recognized in the accounting for the business combination typically would affect the amount of revenue recognized by the buyer subsequent to the acquisition date. These income statement effects should be taken into consideration in the retrospective application of ASU 2021-08 to earlier interim-period business combinations.

Example 5-1: Early adoption of ASU 2021-08

Facts

Private Company (PC) has a calendar year end and decides to early adopt ASU 2021-08 in the third quarter of 2022, for which it has not yet made its interim financial statements available for issuance. PC had one business combination in the first quarter of 2022 (Q1 2022 business combination), no business combinations in the second quarter of 2022 and one business combination in the third quarter of 2022 (Q3 2022 business combination). In addition, PC had one business combination in the fourth quarter of 2021 (Q4 2021 business combination) for which the measurement period related to accounting for the acquired customer contracts remains open in the third quarter of 2022. PC completed its accounting for the Q1 2022 business combination in the second quarter of 2022, which reflected its application of ASC 805 prior to the amendments made by ASU 2021-08. In this business combination, PC recognized a contract liability at its fair value on the acquisition date of $1 million. In remeasuring this contract liability as of the acquisition date under ASC 606, PC increases the contract liability to $4 million, which is appropriately consistent with the contract liability recognized by the target under ASC 606 as of the acquisition date.

Analysis

PC must retrospectively apply ASU 2021-08 to its Q1 2022 business combination and prospectively apply ASU 2021-08 to its Q3 2022 business combination. We believe PC’s Q4 2021 business combination is unaffected by its adoption of ASU 2021-08. In other words, we believe PC should finalize the accounting for its Q4 2021 business combination by continuing to apply ASC 805 prior to the amendments made by ASU 2021-08.

In retrospectively applying ASU 2021-08 to its Q1 2022 business combination, PC must increase the amount of the contract liability recognized from $1 million to $4 million. In doing so, PC should carefully consider which other amounts recognized in the accounting for the business combination should be adjusted (e.g., goodwill, any non-ASC 606 customer-contract-related intangible assets or liabilities). In addition, increasing the amount of the contract liability from $1 million to $4 million affects the amount of revenue recognized by PC subsequent to the acquisition date, which should be taken into consideration in the retrospective application of ASU 2021-08 to the Q1 2022 business combination.

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