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FASB FLASH REPORT

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FASB Clarifies Accounting for Contract Assets and Contract Liabilities in a Business Combination

Summary: The FASB issued ASU 2021-08[1] ("Update") to require an acquirer to recognize and measure contract assets and contract liabilities acquired in a business combination in accordance with revenue recognition guidance as if the acquirer had originated the contract. That is, such acquired contracts will not be measured at fair value. The Update is available **here** and is effective for public companies in fiscal years starting after December 15, 2022. Early adoption is permitted.

BACKGROUND

Under existing guidance in ASC 805, a company that acquires a business recognizes the fair value of the acquired assets and assumed liabilities on the acquisition date. Prior to adoption of ASC 606[2], a deferred revenue liability was generally recognized in an acquirer's financial statements only if it represented a legal obligation. The revenue standard's new definition of a performance obligation generated questions about whether an acquirer should recognize a contract liability based on the performance obligation concept or the legal obligation concept. Stakeholders also requested additional guidance on measuring revenue contracts acquired in a business combination.

1 Business Combinations (Topic 805), Accounting for Contract Assets and Contract Liabilities from Contracts with Customers

2 Revenue from Contracts with Customers

MAIN PROVISIONS

The Update clarifies that an acquirer should apply ASC 606 principles when recognizing and measuring contract assets and contract liabilities assumed in a business combination, as if the acquirer itself had originated the contract. That is, a contract asset or liability should be recognized based on the definition of a performance obligation and measured based on its transaction price rather than its fair value at the acquisition date. This will generally result in an acquirer recognizing and measuring acquired contract assets and contract liabilities consistent with how they were recognized and measured in the acquiree's financial statements.

> **BDO Insight:** In many cases, the amount of deferred revenue recorded in a business combination under the ASU will be significantly higher than amounts recorded under a fair value approach under prior U.S. GAAP.

The amendments apply to contracts with customers and other contracts to which ASC 606 principles apply, such as contract liabilities resulting from the sale of nonfinancial assets under ASC 610-20[3].

It is important to note that the amendments do not change the accounting for other acquired assets and liabilities that may arise from revenue contracts, including customer-related and contract-related intangible assets such as customer relationship assets and backlog assets. Those assets and liabilities will continue to be accounted for at fair value as required by ASC 805.

In certain circumstances, an acquirer may not be able to rely on the acquiree's application of ASC 606, for example when errors were identified in the acquiree's accounting or when the acquiree's accounting policies do not conform to those of the acquirer. Therefore, the acquirer will independently apply the provisions of ASC 606 to record those acquired contracts.

The Update provides several practical expedients that an acquirer can elect if they are required to reassess revenue contracts as of the acquisition date, including:

- The option to reflect the aggregate effect of all modifications prior to acquisition date when (1) identifying satisfied and unsatisfied performance obligations, (2) determining the transaction price, and (3) allocating the transaction price to satisfied and unsatisfied performance obligations, and
- The option to determine standalone selling price at the acquisition date.

An entity's use of practical expedients must be disclosed.

3 Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets

EFFECTIVE DATES AND TRANSITION

The Update is effective for public companies in fiscal years starting after December 15, 2022, including interim periods therein. All other entities are required to apply this Update in fiscal years starting after December 15, 2023, including interim periods therein. The Update is to be applied prospectively to all business combinations occurring on or subsequent to the adoption date.

Early adoption, including adoption in an interim period, is allowed. Should a company decide to adopt the Update during an interim period, the company must adopt the Update on

1. A retrospective basis for all business combinations occurring on or after the start of the fiscal year of adoption and
2. Prospectively beginning on the date of adoption.

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