Josef Rashty, CPA, Ph.D. (candidate) has received his master's in accounting from Oklahoma State University and provides consulting services in Silicon Valley, Calif. He can be reached at jrashty@josefrashty.com.

Deferred revenue liabilities in business combinations: An exception to fair value accounting

By Josef Rashty, CPA, Ph.D. (candidate)

In October 2021, FASB issued ASU 2021-08, Accounting for Contract Assets and Contract Liabilities from Contracts with Customers. This ASU requires an acquirer in a business combination to recognize and measure acquired contract assets and acquired contract liabilities (usually recorded as deferred revenues) using revenue recognition guidance in ASC 606, Revenue from Contracts with Customers, as if it had originated the contracts. The objective of this guidance is to provide comparability after and before business combination by providing consistent recognition and measurement guidance for revenue contracts with customers.

This article explicates recognition and measurement of contract assets and contract liabilities that an acquirer has obtained in a business combination pursuant to ASC 606 under the ASU 2021-08 guidance.

Background information

FASB did not have any specific guidance on the recognition and measurement of contract assets and contract liabilities (deferred revenues) arising from business combinations, but companies followed provisions of ASC 805, Business Combinations, and measured these assets and liabilities at fair value. The objective of ASU 2021-08 is to improve accounting practices for the acquired revenue contracts and address the diversity and inconsistencies in practice.

Definitions

Contract assets represent a company's right to consideration for goods and services that it has already transferred to customers and, unlike accounts receivable, is conditioned on something other than passage of time.

Contract liabilities, on the other hand, are a company's obligations to provide and transfer goods and services to customers for which it has received considerations.

Existing guidance

The acquirer recognizes a deferred revenue liability only to the extent that the deferred revenue represents an obligation assumed by the acquirer (i.e., obligation to provide goods, services or the right to use an asset or some other concession or consideration given to a customer). Thus, the fair value of deferred revenue liability after acquisition is based on the fair value of the obligation that an acquirer assumes at the acquisition date, and that may differ from the liability that acquiree had recognized prior to acquisition.

As a result, under the existing guidance, companies measure deferred revenues of acquirees at fair value that typically results in a "haircut" (or reduction) to the amount of deferred revenues in post combination balance sheet. (An acquirer generally records more revenues for acquiree's contracts that are paid in arrears than prepaid contracts.)

Companies often use the valuation technique from the perspective of a market participant that owes the liability for the acquisition of deferred revenues after a business combination. This approach requires an entity to determine the fair value that a market participant pays to another market participant to assume the deferred revenue obligations.

ASU 2021-08 guidance

The objective of this ASU is to eliminate diversity in practice. Since prior to this guidance, some companies were recognizing contract liabilities as a legal obligation to transfer goods and services, whereas the others were recognizing them based on the definition of performance obligation under ASC 606.

ASU 2021-08 requires that an acquirer measures contract assets or contract liabilities in accordance with ASC 606 on revenue from contracts with customers (ASC 805-20-30-27). Thus, an acquirer measures contract assets and contract liabilities in a business combination as if the acquirer had originated the acquired contract (ASC 805-20-30-28).

Practical expedient

The following practical expedients are available when applying paragraphs ASC 805-20-30-27 through 30-28 at the acquisition date (ASC 805-20-30-29):

- Modification expedient, an acquirer may reflect the aggregate level of all modifications that occurred prior to the acquisition when identifying the satisfied and unsatisfied performance obligations.
- Stand-alone selling price expedient, an acquirer may determine the standalone selling price at the acquisition date (instead of the contract inception date) of each performance obligation in the contract.

The acquirer shall apply these expedients on an acquisition-by-acquisition basis. Each practical expedient that is elected shall be applied consistently to all contracts in a business combination (ASC 805-20-30-30).

Effective dates and transition requirements

Public business entities (PBE) adopt the ASU for fiscal years beginning after Dec. 15, 2022, including interim periods within those fiscal years.

All other entities adopt the ASU for fiscal years beginning after Dec. 15, 2023, including interim periods within those fiscal years.

Companies should apply the ASU prospectively to business combinations occurring on or after the effective date of the guidance.

The ASU allows early adoption of the guidance, including adoption in an interim period. However, the companies that adopt the ASU in an interim period should apply it retrospectively to all business combinations for which the acquisition date occurs on or after the beginning of the fiscal years that includes the interim period of early application. It is expected that many companies early adopt this ASU due to its favorable impact that it has in post-acquisition revenues.

Illustration

The following scenarios clarify the concepts that this article has discussed. They reflect that under the existing guidance, acquirers often receive a haircut in revenues and post lower revenues in comparison with ASU 2021-08:

First scenario

The acquiree has received a total cash consideration for $1,200 from a customer for one-year post-contract customer support (PCS) prior to its acquisition, which entitles the customer to when and if available upgrades and 24-hour telephone support. At the time of acquisition, there are six months left from the life of the contract.

After adoption of ASU 2021-08, the acquirer would recognize $600 (prorated six out of the 12-month contract) contract liability. This amount is based upon the original terms of the contract, the determination of the performance obligations and relative standalone selling prices of the performance obligation at the contract inception, and the progress to completion through the acquisition date. The acquirer would recognize this amount ratably over the next six months, as it provides the remaining PCS services.

Prior to adoption of ASU 2021-08, the acquirer would determine the fair value that a market participant pays to another market participant to assume the deferred revenue obligation. In this example, if the fair value of the PCS obligation is $220 ($200 cost of providing support for the remaining six months plus 10 percent industry accepted profit margin), it would result to a haircut of $380 ($600 less $220) that neither the acquirer nor the acquiree would recognize as revenue.

Second scenario

The acquiree has sold and delivered a software license for $10,000 to a customer but has not recognized any revenues since it is not probable that it can collect the consideration that it is entitled to in exchange for the goods or services that it has delivered. (ASC 606 defines probable as "likely to occur"—generally a threshold of at least 75 percent to 80 percent.) The acquiree has recorded the transaction in contra accounts prior to its acquisition.

The customer pays fully for the price of the software that it has acquired shortly after the acquisition.

After adoption of ASU 2021-08, the acquirer records a contract asset and an offsetting contract liability for $1,000 and after the receipt of payment from the customer, it records the payment as revenue.

Prior to adoption of ASU 2021-08, since the acquirer does not have any cost for fulfilling its obligation, it determines that the fair value of the of deferred revenue is nil. Therefore, this transaction results in a haircut of $1,000. However, at the time of acquisition it may reflect a value for the accounts receivable based on the probability of its collectability, as part of the acquisition with an offsetting entry to goodwill.

Third scenario

An acquiree enters into a sales-based royalty arrangement with a customer for a period of two years and delivers the intellectual property to the customer. The acquiree receives $1,000 royalty during the first year and expects the same amount of royalty during the second year. The company is acquired at the end of the first year of royalty arrangement.

ASC 606-10-55-65 has an exception for the recognition of revenue for usage-based royalties. It requires that companies do not record any revenues until usage occurs.

After adoption of ASU 2021-08, the acquirer would not record a contract asset related to this arrangement. However, it would record a customer-related intangible asset at fair value for $1,000 for anticipated future royalty with an offsetting entry to goodwill. It would also record revenues after receipt of payments for royalties from customer subsequent to acquisition and reflects amortization of customer-related intangible asset as an expense ratably over the year following the date of acquisition.

Prior to adoption of ASU 2021-08, since the acquirer does not have any cost for fulfilling its obligation, it determines that the fair value of the royalty revenue is nil, but the acquirer would record $1,000 as an estimate of royalties' receivable with an offsetting entry to goodwill at the time of acquisition. Subsequent to acquisition, it would reflect the receipt of royalties to offset the amount of royalties' receivable. Therefore, this transaction results in a haircut of $1,000 that neither the acquirer nor the acquiree would recognize as royalty revenue.

Conclusion

ASU 2021-08 allows an acquirer to apply ASC 606 guidance in business combinations, and thereby creates an exception to measurement and recognition of assets and liabilities that acquirer has acquired in a business combination. FASB issued this guidance to address diversity and inconsistencies related to recognition of contract assets and liabilities in business combinations. Many companies often report their acquisition-related revenue haircuts as part of their non-GAAP presentations; thus, adoption of this ASU may reduce the need for non-GAAP reporting of certain acquisition contracts. The author expects that many companies may early adopt this ASU since it reduces the amount of haircut and increases post-acquisition revenues.