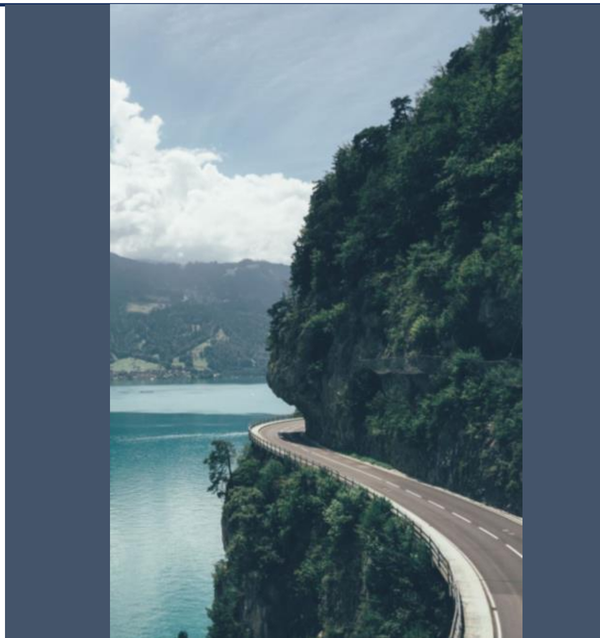

ASC 805 Deferred Revenue

Pre- & Post-ASU 2021-08 treatment

Notification to reader

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Summary

This discussion examines the pre- and post-Accounting Standards Update No. 2021-08, *Business Combinations – Accounting for Contract Assets and Contract Liabilities from Contracts with Customers* ("ASU 2021-08") treatment for contract assets and contract liabilities, or deferred revenue, in relation to Accounting Standards Codification 805, *Business Combinations* ("ASC 805").

Under legacy ASC 805, the general measurement principle in ASC 805-20-30-1 explains that an acquirer must initially measure all assets acquired and liabilities assumed, with limited exceptions, at their acquisition date fair values in accordance with Accounting Standards Codification 820, *Fair Value Measurement* ("ASC 820"). Accordingly, U.S GAAP required contract liabilities to be measured at fair value prior to the adoption of ASU 2021-08. In contrast, ASU 2021-08 provides a recognition and measurement exception from fair value for contract assets and contract liabilities. As such, contract assets and contract liabilities are to be recognized and measured by the acquirer on the acquisition date in accordance with ASC 606, Revenue from Contracts with Customers, instead of being measured at the acquisition-date fair value.

When contemplating and formulating ASU 2021-08, the Financial Accounting Standards Board ("FASB") observed that stakeholders indicated it was unclear how an acquirer should evaluate whether to recognize a contract liability from a revenue contract with a customer assumed in a business combination after ASC 606 is adopted.

- Some stakeholders stated that an entity should use the definition of performance obligation introduced by ASC 606 to determine whether a contract liability from a revenue contract with a customer is a liability assumed that is recognized in the business combination.

- Other stakeholders indicated that ASC 606 did not amend the guidance in ASC 805 and stated that an entity should continue to use a legal obligation concept when applying the guidance in ASC 805.

Additionally, the basis for conclusions[1] to ASU 2021-08 indicates the following regarding recognition similarities and differences for revenue contracts prior to and after the adoption of ASU 2021-08:

> *The Board [FASB] decided that an entity should use the definition of performance obligation as defined in [ASC] Topic 606 to determine whether to recognize a contract liability from a revenue contract with a customer that is acquired in a business combination at the acquisition date.*
>
> *An entity should evaluate whether it has a contract liability from a revenue contract that is assumed in a business combination if the acquiree has been paid (or consideration is due) for goods or services promised in the contract for which control has not been transferred to the customer (that is, an unsatisfied performance obligation) …*
>
> *The Board [FASB] indicated that in many situations in which an acquired revenue contract has been paid upfront before the business combination, the recognition conclusion under a [ASC] Topic 606 performance obligation would be the same as current practice if the acquirer used the legal obligation as the recognition criterion. However, the Board acknowledged that there may be circumstances in which the recognition conclusion could be different, such as for licenses of symbolic intellectual property or goods or services that are provided as a customary business practice because an entity is not legally obligated to perform in those situations.*

The potential benefits of adopting ASU 2021-08 include:

- *The complexity and effort required in accounting for acquired customer contracts may be reduced.*

  After the adoption of the new standard, the acquirer's accounting for acquired revenue contracts may be significantly less complex and may require less effort in instances when the acquiree had properly

[1] BC27 through BC29 of ASU 2021-08

applied ASC 606 and there are no material differences in the acquiree's and acquirer's revenue recognition policies. However, the measurement and recognition of acquired contract assets and assumed contract liabilities on the acquisition date should be accounted in accordance with ASC 606 as if the acquirer had originated the contract. As a result, there may be instances where contract assets and contract liabilities recorded by the acquirer may differ from the balances recognized by the acquiree in the preacquisition period. For instance, if the acquirer uses a time-based measure of progress (e.g., straight-line) but the acquiree uses an input-based measure of progress (e.g., cost-to-cost percentage of completion) for similar contracts, the acquirer's accounting for acquired contract assets and assumed contract liabilities may differ from the acquiree's accounting.

Additionally, the new standard provides certain practical expedients, such as being able to estimate standalone selling prices as of the acquisition date and reflect the aggregate effect of modifications that occur prior to the acquisition date for certain measurements, including identifying satisfied and unsatisfied performance obligation. These practical expedients may also result in the differences in an acquirer's acquisition date accounting when compared to the acquiree's preacquisition accounting.

- *The acquirer will generally record more revenue in the postacquisition period.*

  Prior to the adoption, the requirement to measure assumed contract liabilities at fair value generally resulted in the acquirer recognizing less revenue during the postacquisition period as a result of the fair value adjustment. Upon acquisition, the adjustment and reduction of acquired deferred revenues to their acquisition date fair value is informally referred to as the deferred revenue "haircut".

- *Consistent application of GAAP for acquired revenue contract and arrangements.*

  The amendments in ASU 2021-08 provide specific guidance on recognition and measurement for contract assets and contract liabilities related to acquired revenue from contracts with customers, resulting in consistent application of GAAP for revenue contracts. For instance, otherwise similar revenue arrangements with differences in payment terms, such as upfront subscription payments versus periodic subscription payments, typically resulted in the acquirer recognizing different amount of revenue in the postacquisition period as a result of the fair value adjustment.

- *Reporting and disclosing the impact of the acquisition to users of financial information.*

  As a result of the adoption of ASU 2021-08, issuers are generally expected to incur less costs and complexity in communicating and disclosing the impact of the acquisition to the users of the issuer's financial information.

  In the basis of conclusions to ASU 2021-08, FASB indicated that investors often attempted to reverse these types of fair value adjustments to analyze an entity after the acquisition as fair value adjustments may have reduced comparability between the preacquisition and postacquisition periods, disrupting the ability to predict future cash flows and revenue.[2] Additionally, issuers may have reported such fair value adjustments as part of non-GAAP disclosures or supplemental financial information to enhance comparability in periodic reporting and normalize results of the combined company, absent the fair value adjustment to deferred revenue. Preparers also often received questions from users of financial information and regulators and incurred additional costs and complexity to maintain records that adjust revenue by reversing out the effects of the fair value adjustments in order to report and explain those revenue adjustments to users.[3]

[2] BC20 through BC21 of ASU 2021-08

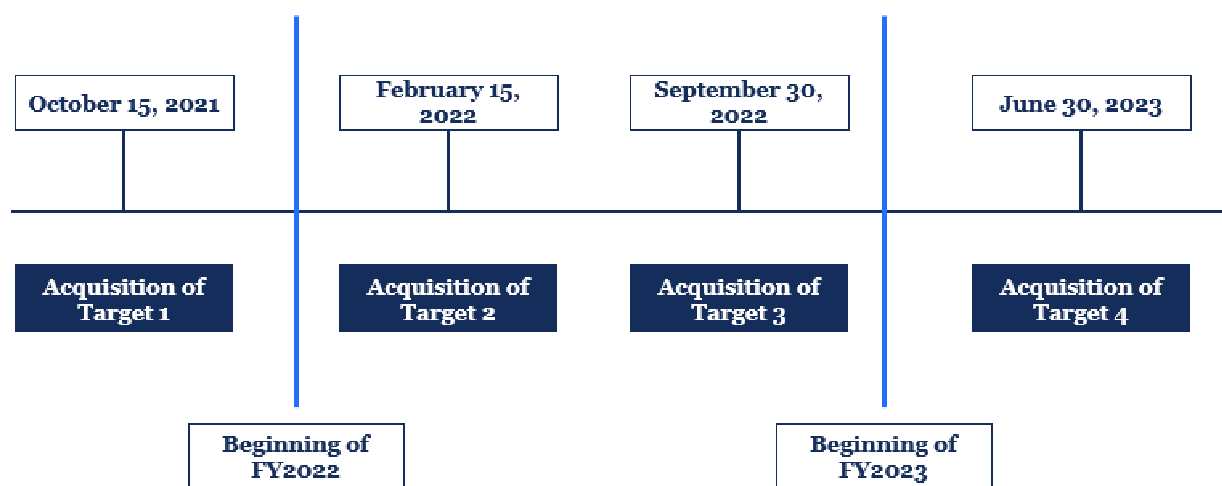
[3] BC22 of ASU 2021-08

Adoption and effective dates

The effective dates and transition methods are as follows:

Issuer Type	Effective date and Transition Methods
Public business entities (PBEs)	Fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. The amendments included in the new standard should be applied prospectively to business combinations occurring on or after the effective date of the new standard. Early adoption of the amendments is permitted, including adoption in an interim period. An entity that early adopts in an interim period should apply the amendments (1) retrospectively to all business combinations for which the acquisition date occurs on or after the beginning of the fiscal year that includes the interim period of early application and (2) prospectively to all business combinations that occur on or after the date of initial application.
Other entities	Fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. The transition methods for non-PBEs are the same transition methods for PBEs.

For example, Company A, a PBE with December 31 fiscal year, had the following acquisitions:



- If Company A had adopted the standard as of the Target 2 acquisition date, Company A would apply the new standard as part of acquisition accounting for this acquisition and any acquisitions which may occur thereafter.

- If Company A had not adopted the standard as of the acquisition date for Target 2 but adopted the new standard as part of acquisition accounting for Target 3, Company A would apply the new standard in acquisition accounting for Target 3.

  Additionally, Company A would retrospectively apply the new standard for acquisition of Target 2. Since Company A had recognized revenue based on the fair value of Target 2's contract assets and contract liabilities before adopting the new standard, Company A would have to adjust the revenue previously recognized to reflect the amount of revenue that should have been recognized if Target 2's contract assets and contract liabilities were recognized under ASC 606 as of the acquisition date.

- If Company A had not early adopted the standard in the fiscal year ended December 31, 2022, Company A would have to apply the new standard in its acquisition accounting for Target 4. In this instance, Company A is not permitted to retrospectively apply the new standard for acquisition of Target 2 or Target 3.

- Company A is not permitted to retrospectively apply the new standard for acquisition of Target 1 in any of the adoption scenarios above.

Scope

The ASU only applies to contract assets and contract liabilities, as defined in ASC 606, from contracts with customers and other contracts to which the provisions of ASC 606 apply. The scope of the ASU excludes the following assets and liabilities relating to acquired customer contracts:

- Receivables under Accounting Standards Codification 310, Receivables and Accounting Standards Codification, Subtopic 326-20, Financial Instruments—Credit Losses—Measured at Amortized Cost
- Contract-based intangible asset and liabilities, such as customer relationships, backlog and contracts with off-market terms.
- Deferred costs in scope of Accounting Standards Codification Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers.
- Other assets and liabilities that may be recognized under ASC 606. Examples of these may include refund liabilities or upfront payments to customers.

The FASB, however, indicated that intangible assets associated with off-market terms in acquired customer contracts may also impact the subsequent revenue recognition by the acquirer, even if intangible assets arising out of customer contracts are not directly within the scope of the ASU. In certain circumstances, an acquirer should recognize the amortization expense for such intangible assets as a reduction in revenue.

Deferred Revenue treatment under ASC 805, prior to adoption of ASU 2021-08

Under current business combination guidance,[4] contract assets and contract liabilities (deferred revenue) acquired in a business combination are recorded by the acquirer at fair value.

The measurement of an assumed obligation related to deferred revenue is at fair value at the date of acquisition, pursuant to the guidance in ASC 820. ASC 820 defines fair value as the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

In general, there are two methods used in practice for measuring the fair value of the assumed deferred revenue obligation.

- The first method, commonly referred to as the cost build-up approach.
    - The obligation is measured as the directly related incremental costs to fulfill the remaining legal obligation and adding a reasonable profit margin. The profit margin is also often referred to as the mark-up in practice. The profit margin used in the valuation of deferred

[4]EITF 01-3: Accounting in a business combination for deferred revenue of an Acquiree. In the basis of conclusion (BC4 through BC5), FASB indicates that Issue 01-3 required that an acquiring entity recognize a liability related to the deferred revenue of an acquired entity only if that deferred revenue represented a legal obligation assumed by the acquiring entity (a legal performance obligation as described in Issue 01-3) and the amount assigned to that liability was its acquisition date fair value. Additionally, FASB observed that stakeholders indicated that practice generally continued to apply the concepts in Issue 01-3, including using the legal obligation concept, to determine whether an entity should recognize a liability assumed related to deferred revenue of an acquired entity accounted for under Topic 605, Revenue Recognition. As observed above, stakeholders and issuers had indicated that prior to adoption of ASU 2021-08, there was no prescriptive guidance regarding whether the acquirer should consider assumed liabilities for customer contracts from the perspective of a performance obligation or a legal obligation after the acquirer's adoption of ASC 606.

revenue represents the profit that a market participant would require to earn in exchange for assuming the obligation from the transferring party.

    - The sum of the cost to fulfill the remaining legal obligation and the mark up is used as the estimate for the amount that would be required to be paid to transfer the obligation related to deferred revenue in an orderly transaction between market participants at the measurement date, consistent with how ASC 820 defines fair value.

- The second method is to measure the obligation by the use of market information or data about the amount of revenues an entity would earn in a transaction to provide the remaining legal obligations under the contract, less the cost of the selling effort already been performed by the acquiree prior to the acquisition date and the profit margin on that selling effort.

- Through either method, an entity should perform the fair value analysis from the perspective of a market participant.

The requirement to measure deferred revenue based on an identification of legal obligations and at fair value typically results in a deferred revenue "haircut" resulting in the acquirer recording a lower deferred revenue balance than the acquiree's book value.

For instance, assume acquiree had a deferred revenue balance of $100 for an arrangement where the customer had prepaid an annual subscription fee of $120. Assuming the underlying performance obligation is a stand-ready obligation that is going to be satisfied continuously during the 12-month term, the revenue for the related arrangement is recognized ratably over the 12-month subscription term under ASC 606. The fair value of the deferred revenue balance is determined to be $50, representing a 50% reduction, or "haircut" from the acquiree's book value.

The acquirer would recognize $50 ratably over the remaining 10-month period, not the $100 which the acquiree had recorded prior to the acquisition, as a result of the legacy requirement to measure the balance at fair value under ASC 805.

Deferred Revenue treatment under ASC 805, ASU 2021-08

ASU 2021-08

ASU 2021-08 provides an exception to the historical treatment of the general recognition and measurement principles under ASC 805 for contract assets and contract liabilities related to acquired customer contracts in a business combination. As such, acquired contract assets and assumed contract liabilities are not required to be measured at fair value after the adoption of the new standard. Instead, these will be measured and recognized pursuant to the principles of ASC 606.

The measurement of acquired contract assets and assumed contract liabilities under the ASU is premised on the notion that the accounting by the acquirer should be done as if the acquirer had originated the contract with the customer. ASC 606 specifies when certain assessments and estimates should be made as of contract inception or on a recurring basis. At the acquisition date, the acquirer should make those assessments as of the dates required by ASC 606. In the basis of conclusions of, the FASB observed that the amendments in ASU 2021-08 do not alter the timing of these judgments and estimates required by Topic 606.[5] Accordingly, an acquirer should assess and/or determine judgments as of both the contract inception date (or modification date in circumstances in which the contract had been previously modified) and the acquisition date for recurring estimates.

The ASU, however, provides for certain practical expedients relating to certain assessments and estimates, including a practical expedience permitting an acquirer to determine standalone selling prices at the acquisition date rather than at the contract inception date as otherwise required by ASC 606. As an example,

[5] BC32 of ASU 2021-08.

an acquirer would identify the performance obligations that exist in an acquired customer contract, assuming it was not modified in the preacquisition period, as of the contract inception date under the assumption that the acquirer had originated the customer contract. In contrast, an acquirer is permitted to estimate the transaction price and standalone selling prices as of the acquisition date.

An acquirer may assess how the acquiree applied ASC 606 to determine what to record for the acquired revenue contracts to achieve the recognition and measurement principles of the ASU. For instance, the acquiree would have recognized a contract liability for the remaining, unsatisfied performance obligations in accordance with ASC 606 when a revenue contract was paid fully upfront prior to an acquisition. This assessment may result in the acquirer recognizing contract assets and contract liabilities at the same amounts recorded by the acquiree, and a separate fair value assessment is not required under ASC 820. This accounting would be contingent on accounting policies and estimates aligning under ASC 606 for the acquirer and acquiree, acquiree having historically appropriately applied US GAAP, and there being no errors identified related to the acquiree's preacquisition ASC 606 accounting.

In the basis of conclusions,[6] the FASB indicated that the differences between contract assets and contract liabilities recorded by an acquirer and those recorded by the acquiree before the acquisition generally would result from:

- Differences in the acquirer's and acquiree's revenue recognition accounting policies and the resulting change to the acquiree's policies.
- Differences in estimates derived in applying the principles of ASC 606 between the acquirer and acquiree.
- Errors in the ASC 606 accounting of the acquiree.

As an example, there may be differences in contract assets and contract liabilities recorded by the acquirer when compared to those of the acquiree's preacquisition balances if the acquirer uses a time-based measure of progress (e.g., straight-line) but the acquiree uses an input-based measure (e.g., cost-to-cost percentage of completion).

Two practical expedients are available for acquirers to use when they are either not able to assess or rely on the acquiree's ASC 606 accounting or do not have the historical data or knowledge to analyze an acquiree's accounting. The practical expedients are as follows:

1) The acquirer would adopt ASC 606 for the acquiree's revenue contracts that were modified during the pre-acquisition period using the latest modified terms of the contract as of the acquisition date to determine performance obligations and transaction price.
2) Permits the acquirer to determine the standalone selling prices at the acquisition date, rather than at the contract inception date as otherwise required by ASC 606.

Our observation

While the adoption of ASU 2021-08 may significantly reduce complexity and effort required by the acquirer in accounting for assumed contract liabilities in certain transactions, the new standard may also add complexity and effort required by the acquirer in certain transactions.

The complexity and effort required to determine the appropriate contract asset and contract liability balances may be significant for private company acquisitions, especially if these companies have experienced significant growth in periods leading to the acquisition, have no to little documentation on formal revenue recognition policies and have not been audited previously.

[6] BC33 of ASU 2021-08.

In our experience, it is not uncommon for smaller private companies to not have adopted ASC 606 and/or have no to little documentation on formal accounting policies under ASC 606. As a result, the acquirer may have to effectively adopt ASC 606 for the acquiree for the first time as part of the acquisition accounting.

As part of the due diligence phase, an acquirer and an acquirer's management team can take several steps to further understand potential gaps in the acquiree's revenue recognition practices and policies to better prepare for acquisition accounting and integration of the acquiree for accounting purposes. These steps include, but are not limited to, the following:

- Understand acquiree's revenue recognition policies and identify gaps or misalignments when compared to the acquirer's accounting policies for similar revenue arrangements.
- Understand acquiree's document retention practices and policies to ensure that the acquirer's accounting team will have sufficient access to acquired customer contracts in order to assess terms and conditions of acquired customer contracts and related ASC 606 considerations.
- Understand the quality of acquiree's information and data for revenue arrangements, including whether acquiree has reliable data on standalone selling prices (SSP) and other estimates, such as usage-based revenue arrangements or arrangements involving variable consideration.

In theory, the acquiree's revenue recognition policies should not directly impact the fair value measurement for assumed contract liabilities as revenue recognition practices should not impact the cash flows, including the costs relating to fulfilling the remaining obligation, associated with the assumed customer contract liabilities and related obligations. However, acquiree's revenue recognition policies may have had an impact on acquirer's accounting for assumed contract liabilities in practice, even prior to adoption of ASU 2021-08. For instance, acquiree may have incorrectly recognized too much or too little in revenue prior to the acquisition date. As a result, the acquirer may not have been fully aware of the magnitude of the remaining obligations, resulting in the fair value measurement not incorporating all the assumptions that a market participant would use in the fair value measurement of such obligations.

Illustrative Examples

<u>Example 1 – Software-as-a-Service (SaaS) contract for one-year term with an upfront payment</u>

Company A acquires Company B on December 31, 20X2 in a transaction accounted for as a business combination. Company A and Company B had adopted ASC 606 prior to the acquisition date. The fiscal year-end for both Company A and Company B is December 31.

Company B had originated a contract with Customer X on July 1, 20X2. Pursuant to the terms of the contract, Customer X has access to Company's B's cloud-based HR and payroll management platform. Customer X had paid $1,200 as a nonrefundable upfront payment in exchange for 12 months of access to the platform.

Company B had determined that the contract consisted of a single, stand-ready performance obligation and recognizes revenue ratably over the 12-month term with cumulative recognized revenue of $600 as of the acquisition date. Accordingly, Company B had a remaining contract liability of $600 as of the acquisition date, representing the difference the upfront payment of $1,200 and recognized revenue of $600.

<u>Company A's (acquirer) accounting prior to adoption of ASU 2021-08</u>

For purposes of the fair value measurement, Company A estimates that the aggregate costs to fulfill the obligation is $200, consisting of customer support costs, hosting fees and other costs directly related to fulfilling the remaining obligation. Additionally, Company A estimates that a market participant would expect to earn a normalized profit margin of $30 for assuming the obligation to fulfill the remainder of the services and goods related to the contract liability, representing a mark-up of 15% on the costs related to fulfilling such obligation. Based on these assumptions, Company A estimates that the fair value of the assumed contract liability is $230 and records $230 as an assumed contract liability as part of acquisition accounting.

	20X3
Revenue that would have been recognized by the acquiree	$600
Total cost to fulfill services (obligation)	$200
Plus: profit mark-up	$30
Profit mark-up as a % of Total costs to fulfill obligation	*15%*
Fair value of deferred revenue	**$230**
Haircut to deferred revenue ($)	(370)
Haircut (%)	62%
Deferred revenue, post-haircut	230

For illustrative purposes, the liability is not discounted to present value. A market participant may presumably, however, consider discounting the liability to present value for purposes of the fair value measurement as the costs to fulfill the obligation are incurred over the remaining contractual term. Accordingly, the implied cash flows for fulfilling the obligation would also be incurred over time instead of at a single point time by a market participant

Company A's (acquirer) accounting after the adoption of ASU 2021-08

As part of Company A's accounting for the acquisition, Company A assessed Company B's accounting policies under ASC 606. Company A did not observe differences in accounting policies between Company A and Company B. Additionally, Company A did not observe any errors in Company B's accounting for the assumed contract liability. Accordingly, Company A records a contract liability of $600 as part of acquisition accounting.

Based on Company A's assessment, the contract does not have favorable or unfavorable aspects. In the basis of conclusions to ASU 2021-08, the FASB observed that certain intangible assets and liabilities (favorable or unfavorable contracts) would be recognized if the acquired revenue contract contains identified off-market terms or conditions, which limits the ability for an entity to acquire revenue contracts with favorable conditions and not depict those conditions in the financial statements.[7]

Differences in Company A's accounting prior to and after adoption of ASU 2021-08

	Assumed contract liability	**Revenue recognized by acquirer in postclose period**
Prior to adoption of ASU 2021-08	$230	$230
After adoption of ASU 2021-08	$600	$600

If Company A had adopted ASU 2021-08 as of the acquisition date, Company A would recognize an assumed contract liability of $600 as part of the acquisition accounting. In contrast, Company A would recognize an assumed contract liability of $230 if it had not adopted ASU 2021-08 as of the acquisition date.

[7] BC42 of ASU 2021-08

All else held equal, this would generally imply that goodwill recognized for the acquisition would also be higher after the adoption of ASU 2021-08 due to Company A having recognized an incremental $370 in contract liabilities which would reduce acquired net assets.[8]

Additionally, Company A would recognize $600 in revenue in the postclosing period after the adoption of ASU 2021-08 compared to $230 prior to the adoption of ASU 2021-08. In the basis of conclusions to ASU 2021-09, the FASB acknowledged that the expected increase in contract liabilities in a business combination will result in an increase in the subsequent revenue recognized by an acquirer.[9]

Example 2 – Software-as-a-Service (SaaS) contract for three-year term with annual upfront payments

Company A acquires Company B on December 31, 20X2 in a transaction accounted for as a business combination. Company A and Company B had adopted ASC 606 prior to the acquisition date. The fiscal year-end for Company A and Company B is December 31.

Company B had originated a contract with Customer X on July 1, 20X2. Pursuant to the terms of the contract, Customer X has access to Company B's cloud-based HR management platform for a three-year term. Customer X had paid $1,200 as a nonrefundable upfront payment representing the payment for the first 12 months of the contract. Additionally, Customer X is obligated to pay an additional $1,200 for each of the successive annual periods with each payment due at the beginning of the respective annual periods. The contract does not have unilateral early termination provisions, such as termination for convenience clauses.

Company B had determined that the contract consisted of a single, stand-ready obligation and recognized revenue ratably over the 36-month term with cumulative recognized revenue of $600 as of the acquisition date. Accordingly, Company B had a remaining contract liability of $600 as of the acquisition date, representing the difference between the payment of $1,200 for the first annual period and recognized revenue of $600.

Company A's (acquirer) accounting prior to adoption of ASU 2021-08

For purposes of the fair value measurement, Company A estimates that the aggregate costs to fulfill the obligation is $200, consisting of customer support costs, hosting fees and other costs directly related to fulfilling the obligation. Additionally, Company A estimates that a market participant would expect to earn a normalized profit margin of $30 for assuming the liability, representing a mark-up of 15% on the costs related to fulfilling the obligation. Based on these estimates, Company A estimates that the fair value of the assumed contract liability is $230 and records $230 as an assumed contract liability as part of acquisition accounting, similarly to Example 1.

Additionally, Company A would include the remaining contractual billings for the second and the third annual periods in its measurement of customer-related intangible assets, such as backlog.

Company A's (acquirer) accounting after the adoption of ASU 2021-08

As part of Company A's accounting for the acquisition, Company A assessed Company B's accounting policies under ASC 606. Company A did not observe differences in accounting policies between Company A and Company B. Additionally, Company A did not observe any errors in Company B's accounting for the assumed contract liability. Accordingly, Company A records a contract liability of $600 as part of acquisition

[8] Under ASC Topic 805, goodwill is generally calculated as the difference between consideration transferred and acquired net identifiable assets. As the adoption of ASU 2021-08 would generally result in the acquirer recognizing a higher balance for contract liabilities, this would generally reduce the balance of acquired net identifiable assets and also goodwill. FASB had indicated similarly in the basis of conclusion with BC41 stating, "The Board [FASB] believes that the corresponding increase to the acquired contract liabilities balance for those adjustments will generally be recognized in goodwill."

[9] BC42 of ASU 2021-08

accounting. Lastly, the contract does not have favorable or unfavorable terms based on Company A's assessment.

Differences in Company A's accounting prior to and after adoption of ASU 2021-08

	Assumed contract liability	Revenue recognized by acquirer in postclose period		
		20X3(i)	20X4	20X5
Prior to adoption ASU 2021-08	$230	$830	$1,200	$600
After adoption ASU 2021-08	$600	$1,200	$1,200	$600

(i) Calculated as of (i) revenue recognized from the contract liability as of the acquisition date plus (ii) $600, representing revenue recognized, on ratable basis, from July 20X3 through December 20X3 for the second annual period with a billing of $1,200.

Similar to Example 1, the contract liability, and postclosing revenue recognized by Company A would be higher after adoption of ASU 2021-08.

In the basis of conclusions to ASU 2021-08,[10] FASB acknowledge the following related to otherwise identical revenue arrangements with the exception of differing payment terms:

> *… Task Force members considered whether two acquired revenue contracts with identical performance obligations but with different payment terms would result in different amounts of postacquisition revenue for the acquirer. Most Task Force members indicated that, theoretically, the timing of payment should not affect the amount of revenue recognized by the acquirer after the acquisition for the acquired contract (other than perhaps because of a significant financing component). However, in current practice, a revenue contract that is paid upfront before the acquisition likely will result in different postacquisition revenue compared with an identical revenue contract that is paid over time after the acquisition.*
>
> *When a revenue contract is paid upfront, an acquirer recognizes an assumed contract liability at fair value when the acquiree has received consideration from the customer and there is still a remaining unsatisfied, or partially unsatisfied, obligation as of the acquisition date. The resulting fair value measurement will often be lower than the contract liability balance that is recorded by the acquiree … when a contract is paid over time as performance occurs, an acquirer likely would not analyze the specific revenue contract at the acquisition date because there would be no identifiable assets or liabilities assumed to measure at fair value for that contract (absent assumed intangible assets). Therefore, there is no contract-specific fair value adjustment, and an acquirer likely would subsequently recognize the same amount of revenue that the acquiree would have recognized if no business combination took place.*

Example 3 – Software-as-a-Service (SaaS) contract for three-year term with total contractual value paid upfront

Assume the same facts and circumstances as Example 2 with the exception that Customer X had paid the full contractual value of $3,600 for the three-year term at the inception of the contract. Accordingly, the remaining contract liability on the acquiree's books is $3,000 as of the acquisition date, representing the difference between the upfront payment of $3,600 and recognized revenue of $600.

Accounting prior to adoption of ASU 2021-08

For purposes of the fair value measurement, Company A estimates that the aggregate costs to fulfill the obligation is $1,000, consisting of customer support costs, hosting fees and other costs directly related to fulfilling the obligation for the remaining contractual term of 2.5 years with the full contractual value paid upfront. Additionally, Company A estimates that a market participant would expect to earn a normalized

[10] BC12 through BC 13 of ASU 2021-08

profit margin of $150 for assuming the obligation to fulfill the remainder of the services and goods related to the contract liability, representing a mark-up of 15% on the costs for fulfilling the obligation. Based on these assumptions, Company A estimates that the fair value of the assumed contract liability is $1,150 and records $1,150 as an assumed contract liability as part of acquisition accounting.

	20X3	20X4	20X5	Total
Revenue that would have been recognized by the acquiree	$1,200	$1,200	$600	$3,000
Total cost to fulfill services (obligation)	$400	$400	$200	$1,000
Plus: profit mark-up	$60	$60	$30	$150
Profit mark-up as a % of total costs to fulfill obligation	*15%*	*15%*	*15%*	*15%*
Fair value of deferred revenue	**$460**	**$460**	**$230**	**$1,150**
Haircut to deferred revenue ($)	(740)	(740)	(370)	(1,850)
Haircut (%)	62%	62%	62%	62%
Deferred revenue, post-haircut	460	460	230	1,150

For illustrative purposes, the liability is not discounted to present value. A market participant would presumably, however, consider discounting the liability to present value for purposes of the fair value measurement as the costs to fulfill the obligation are incurred over the remaining contractual term. Accordingly, the implied cash flows for fulfilling the obligation would also be incurred over time instead of at a single point time.

Accounting after the adoption of ASU 2021-08

As part of Company A's accounting for the acquisition, Company A assessed Company B's accounting policies under ASC 606. Company A did not observe differences in accounting policies between Company A and Company B. Additionally, Company A did not observe any errors in Company B's accounting for the assumed contract liability. Lastly, Company A determined that the contract does not have a significant financing component. Accordingly, Company A records a contract liability of $3,000 as part of acquisition accounting.

Based on Company A's assessment, the contract does not have favorable or unfavorable terms.

Differences in Company A's accounting prior to and after adoption of ASU 2021-08

	Assumed contract liability	Revenue recognized by acquirer in postclose period		
		20X3	20X4	20X5
Prior to adoption ASU 2021-08	$1,150	$460	$460	$230
After adoption ASU 2021-08	$3,000	$1,200	$1,200	$600

In contrast to Example 2, revenue recognized by Company A in the postclosing period would be significantly lower in this example if Company A had not adopted ASU 2021-08 as a result of Customer X having had paid the full contractual value at the inception of the arrangement. As noted in Example 2, FASB acknowledged that prior to adoption of ASU 2021-08, a revenue contract that is paid upfront before the acquisition likely will result in different amounts post acquisition revenue recognized as compared with an identical revenue contract that is paid over time after the acquisition.

After adoption of ASU 2021-08, the payment terms of acquired customer contracts generally would not have an impact the amount of revenue recognized by the acquirer in the postclosing period. For instance, the

amount of revenue recognized by Company A is assumed to be the same in Example 2 and Example 3 after the adoption of ASU 2021-08.

This is consistent with the FASB's observations on the impact of ASU 2021-08. In the basis of conclusion to ASU 2021-08, [11] FASB stated the following:

> *The amendments in this Update [ASU 2021-08] generally align the accounting for acquired revenue contracts that were paid upfront before the acquisition and have an associated contract liability at the acquisition date with the current accounting for acquired revenue contracts that do not have an associated contract liability at the acquisition date …*

[11] BC41 of ASU 2021-08.