In depth

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Accounting for acquired contract assets and contract liabilities

What's inside

At a glance

On October 28, the FASB issued guidance that requires contract assets and contract liabilities (i.e., deferred revenue) acquired in a business combination to be recognized and measured by the acquirer on the acquisition date in accordance with ASC 606, *Revenue from Contracts with Customers*. Generally, this new guidance will result in the acquirer recognizing contract assets and contract liabilities at the same amounts recorded by the acquiree.

Under current US GAAP, contract assets and contract liabilities acquired in a business combination are recorded by the acquirer at fair value. The new guidance creates an exception to the general recognition and measurement principles of ASC 805, *Business Combinations*.

The new guidance should be applied prospectively and is effective for calendar year public business entities in 2023 and all other calendar year entities in 2024, including interim periods within those years. Early adoption is permitted, including in interim periods, for any financial statements that have not yet been issued.

Key provisions

On October 28, 2021, the FASB issued ASU No. 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*. The new guidance in this update affects all entities that enter into a business combination within the scope of ASC 805-10.

Under the new guidance (ASC 805-20-30-28), the acquirer should determine what contract assets and/or contract liabilities it would have recorded under ASC 606 (the revenue guidance) as of the acquisition date, as if the acquirer had entered into the original contract at the same date and on the same terms as the acquiree. The recognition and measurement of those contract assets and contract liabilities will likely be comparable to what the acquiree has recorded on its books under ASC 606 as of the acquisition date. The FASB acknowledged that there will likely be an increase in the acquired contract liabilities balance as a result of the new guidance, resulting in a corresponding increase in the subsequent revenue recognized by the acquirer. The revenue recorded by the acquirer post-acquisition will now more closely align with the acquiree's revenue recognition prior to the acquisition, as well as the acquirer's revenue recognition on similar contracts entered into after the acquisition. However, there may be differences, as described further below.

ASC 606 provides guidance on when certain assessments and estimates should be made (i.e., at contract inception or on a recurring basis). ASU 2021-08 states that the acquirer should make those assessments as of the dates required by ASC 606. Accordingly, the acquirer should evaluate the performance obligations, transaction price (e.g., significant financing considerations), and relative standalone selling price at the original contract inception date or subsequent modification dates (unless certain practical expedients are applied—see Practical expedients). The acquirer should then assess the measure of progress (for performance obligations satisfied over time) or timing of control transfer (for performance obligations satisfied at a point in time) compared to the amount of consideration received (or receivable) to determine the amount of contract asset or contract liability as of the acquisition date. The acquirer should also consider an estimate of variable consideration (subject to the constraint described in ASC 606-10-32-11 through ASC 606-10-32-13, or the exception for sales- or usage-based royalties described in ASC 606-10-55-65) as of the acquisition date. As noted in section 33.3.4 of our Financial Statement Presentation guide, while the amounts are calculated based on individual performance obligations, a single net contract asset or contract liability should be determined for each acquired revenue contract. See our Revenue Recognition guide for further guidance on these calculations and estimates.

The Board noted in paragraph BC33 of the Basis for Conclusions that the accounting under the new guidance is not simply a “carryover” basis of the acquiree’s books and records. For example, the acquirer has to consider the reasonableness of the application of ASC 606 by the acquiree. Further, if the acquirer’s accounting policies differ from those of the acquiree (e.g., applying the practical expedient for a significant financing component when the time between performance and payment is less than one year), the acquirer’s policies are required to be applied.

The new guidance generally results in the amount of revenue recognized by the acquirer subsequent to the acquisition date to be the same as the amount that would have been recognized by the acquiree absent the business combination, or that would be recognized for identical contracts entered into by the acquirer. However, as the Board noted in paragraphs BC33 and BC43 of the Basis for Conclusions, there may be differences due to the recording of off-market contract assets or liabilities (see discussion on off-market contracts in Other intangible assets or liabilities) as well as differences arising from:

- situations when the acquiree has not applied ASC 606 (e.g., prepared financial statements under IFRS, statutory reporting requirements, or other financial reporting frameworks);
- differences in the acquirer’s and acquiree’s revenue recognition accounting policies;
- differences in estimates between the acquirer and acquiree (e.g., estimates of variable consideration or measure of progress); or
- errors in the ASC 606 accounting of the acquiree prior to the business combination.

Under the new guidance, ASC 805-20-30-28 states the acquirer should measure the contract assets and contract liabilities of the acquired contract as if the acquirer originated the contract and then subsequently followed the guidance in ASC 606. Therefore, estimates (e.g., measurement of progress to completion) should be determined from the perspective of the acquirer, which may differ from the amounts recorded on the acquiree's books immediately prior to the business combination (for example, due to a different cost structure of the acquirer or expected synergies arising from the acquisition).

Initial accounting: contract assets

Under ASU 2021-08, the acquirer will recognize a contract asset if the acquiree has already transferred goods or services to a customer but has not yet received (or is not yet due) payment as of the acquisition date and the right to consideration is conditioned on something other than the passage of time. A contract asset differs from a receivable because the right to consideration is conditioned on something other than the passage of time (e.g., the transfer of additional goods or services).

We believe accounting under the new guidance will generally be consistent with current practice for contracts with fixed payment terms. However, if the future payments are variable, the amounts recognized on the acquisition date under the new guidance may be lower than the fair value amounts recorded under current guidance because of certain principles of ASC 606 (e.g., the constraint on variable consideration). It may also be lower when the contract is a license of functional intellectual property in exchange for sales-based royalties. In this case, no amount of the future variable consideration can be recognized as a contract asset under ASC 606-10-55-65 until the underlying sales occur.

No contract asset would be recognized at the acquisition date under the new guidance for variable consideration that cannot be recognized under ASC 606 at that time, and any subsequent consideration received (or recognizable under ASC 606) would be recognized as revenue in the post-acquisition period. The FASB indicated that the estimated cash flows subject to the variable consideration constraint or the exclusion of sales- or usage-based royalties could still be included in the valuation of the customer-related intangible assets associated with the contract in acquisition accounting. See Example 1 in the Appendix for an illustration.

Initial accounting: contract liabilities and impact on goodwill

ASC 606 defines a "contract liability" as an obligation to transfer goods or services to a customer when the entity has already received consideration (or the amount is due) from the customer. Currently, many entities recognize a contract liability in a business combination only if a legal obligation is present by reference to the guidance in EITF 01-3, *Accounting in a Business Combination for Deferred Revenue of an Acquiree* (which was not codified in ASC 805 but is often considered in practice). Under the new guidance, the acquirer should apply the definition of a performance obligation in ASC 606 to determine whether to recognize a contract liability. As described in ASC 606-10-25-16, a performance obligation includes not only legal and explicitly stated obligations in a contract, but also those that may be implied by an entity's customary business practices, published policies, or specific statements. See RR 3.6.2 for further discussion.

Under ASU 2021-08, the acquirer will recognize a contract liability if the customer has provided consideration to the acquiree (or the acquiree has a receivable from the customer), but the acquiree has not yet fully transferred the related goods or services to the customer (i.e., the acquiree has an unsatisfied performance obligation).

Acquirers will also apply the provisions of ASC 606 to calculate the amount of such contract liability (instead of using fair value under current guidance). As a result, entities will likely record a higher amount of contract liabilities on the acquisition date as compared with current US GAAP. As noted in paragraph BC41 of the Basis for Conclusions, the FASB believes that the related offset arising from application of this guidance would generally be recorded to goodwill. After adoption of ASU 2021-08, the amount of identifiable net assets recorded in acquisition accounting will be lower (due to the higher amount of contract liabilities), resulting in a higher goodwill balance.

Reporting entities will need to consider the impact of this outcome when assessing goodwill balances for impairment subsequent to an acquisition. For example, when contract liabilities are recognized for a contract to license symbolic intellectual property over a period of time with an upfront payment (as illustrated in Example 3 in the Appendix) and additional goodwill is recognized, there is initially no net impact from the new guidance on the net book value of the acquired business. However, as those contract liabilities are recognized into revenue post-acquisition, the net book value increases, which could create challenges for subsequent goodwill impairment tests under ASC 350 unless the fair value of the business increases during that time. In particular, if the goodwill is included in a standalone reporting unit upon acquisition, an entity will need to consider events or circumstances that could more likely than not reduce the fair value of the reporting unit below its carrying amount between annual tests (i.e., triggering events). This may be less critical for goodwill that is subsumed into an existing reporting unit at the acquirer to the extent there is an existing cushion between the reporting unit's fair value and its carrying amount.

Scope

ASU 2021-08 applies to contract assets and contract liabilities acquired in a business combination. It also applies to other contracts that apply the provisions of ASC 606, including contract liabilities from the sale of nonfinancial assets within the scope of ASC 610-20, *Other Income--Gains and Losses from the Derecognition of Nonfinancial Assets.* Additionally, the new guidance could apply to other arrangements that apply the provisions of ASC 606 either directly or by analogy, such as those accounted for under ASC 808, *Collaborative Arrangements.*

The new guidance does not impact:

- other assets or liabilities that may arise from contracts with customers, such as refund liabilities,
- assets related to upfront payments to customers,

- capitalized costs to obtain or fulfill a contract (as described in ASC 340-40), or
- inventory acquired in a business combination used to fulfill such contracts.

Refund liabilities should continue to be recorded at their fair value in acquisition accounting. For considerations on upfront payments to customers, see Upfront payments made by the acquiree to its customer. Costs to obtain or fulfill contracts incurred by the acquiree do not meet the definition of an asset to the acquirer and therefore would not be recognized by the acquirer in a business combination. However, the impact arising from these costs may effectively be incorporated in the value of customer-related intangible assets recognized in acquisition accounting.

The new guidance also does not address inventory acquired in a business combination. Therefore, inventory acquired in a business combination will continue to be recorded at fair value in accordance with ASC 805. As a result, while the new guidance will align reported amounts of revenue in the periods before and after the acquisition, there may still be a disconnect when describing the impact of an acquisition on gross margins.

Asset acquisitions

The new guidance addresses the recognition and measurement of contract assets and contract liabilities acquired in a business combination. It does not address asset acquisitions (i.e., a transaction in which assets acquired or liabilities assumed do not meet the definition of a business). Accordingly, we believe an entity that acquires contract assets or liabilities in an asset acquisition will follow the cost accumulation model set forth in ASC 805-50. This results in the cost being allocated to acquired assets and liabilities based upon their respective fair values in accordance with ASC 805-50-30-3.

Equity method investments

Equity method investments are not directly within the scope of the new guidance. However, as described in ASC 323-10-35-13, when an entity acquires an equity method investment, any difference between the investor's cost basis and its share of the investee's net assets should be accounted for as if the investee were a consolidated subsidiary. In practice, that means that the investor performs an acquisition accounting-like allocation to determine its share of the underlying net assets of the investee in order to calculate its "basis differences" for subsequent recognition. We believe an investor would apply the new guidance in ASU 2021-08 when performing such calculations.

Other considerations

The new guidance is an exception to the fair value model in business combination accounting and only applies to acquired contract assets and contract liabilities. The FASB considered but ultimately did not expand the scope to additional topics. Consequently, certain topics are not addressed and entities will need to apply judgment to these areas, as described in the following sections.

Other intangible assets or liabilities

During deliberations, the FASB decided not to include any specific guidance on other intangible assets or liabilities, including off-market contracts. The Board concluded that there is existing guidance that requires recognition of various customer-related intangible assets, as well as assets or liabilities for off-market contracts with favorable or unfavorable terms. While there is no specific discussion of the impact of the new guidance on such intangibles, the Board noted in paragraph BC38 of the Basis for Conclusions that entities should continue to apply existing guidance to such assets or liabilities.

Although there is no change in the guidance for intangible assets and liabilities, there could be differences in application as a result of the new guidance. For example, historically, the off-market terms of a favorable or unfavorable contract were often subsumed into the fair value calculations of the deferred revenue amounts in acquisition accounting. Under the new guidance, which requires recording the contract liability in acquisition accounting based on the contractual terms of the arrangement, we believe that there may be more instances when separate intangible assets or liabilities will need to be recognized for such off-market terms.

Subsequent to recognition, we generally believe the amortization of an off-market intangible asset or liability should be recorded to revenue as an adjustment to the pricing terms of the contract.

Entities will also need to be careful in how they incorporate the impact of the new guidance into their valuation of other intangible assets in acquisition accounting. While those fair values should not change as a result of the new guidance, the acquirer will need to consider how to incorporate working capital amounts that will change under the new guidance into its intangible asset valuation models. Additionally, while post-acquisition revenue (and therefore projections of future operating results) will change as a result of applying the new guidance, the future cash flows will not. Acquirers should ensure that future cash flows are appropriately included or excluded when determining the fair value of other intangible assets acquired. For example, an acquiree may have licensed symbolic intellectual property and received an upfront payment from its customer. While the acquirer will now record a contract liability and post-acquisition revenue on this contract, the valuation of the underlying intellectual property intangible asset should exclude the effects of such revenue, as it is non-cash.

Upfront payments made by the acquiree to its customer

An entity may make an upfront payment to a customer to incentivize the customer to sign a contract. Under ASC 606, payments to a customer are recorded as a reduction of revenue, unless they reflect payment for a distinct good or service. If paid upfront, depending on assessments of recoverability, such amount may be deferred and recognized against subsequent revenue generated from that customer.

Upfront payments made by the acquiree to its customers are not within the scope of the new guidance. Accordingly, we believe that entities should continue to apply their existing approach subsequent to adoption of ASU

2021-08. Such deferred assets do not reflect separate assets to be recognized in acquisition accounting. The impact of an upfront payment made by an acquiree to its customer is generally included by the acquirer as part of the valuation of the customer relationship intangible asset in acquisition accounting. In essence, the upfront payment helped to obtain the future cash flows associated with the customer contract. The acquirer generally records the amortization of this intangible asset as an expense.

However, if the acquirer negotiated and/or directed the acquiree to make the upfront payment to a new customer in contemplation of the business combination, the payment should be viewed to be for the benefit of the acquirer/combined entity post-acquisition, and the subsequent amortization should be recorded as a reduction of revenue. This is consistent with the guidance originally issued in EITF 01-3. While this guidance was superseded and not codified in ASC 805, we believe it is consistent with the guidance in ASC 805-10-55-18 related to transactions that should be accounted for separate from the business combination, and the guidance in ASC 606 related to payments to customers.

Loss contracts

Contracts assumed in a business combination may give rise to assets or liabilities based on favorable or unfavorable contract terms. In limited circumstances, the acquirer may acquire contracts for which the acquiree had determined that the total costs to complete the contract exceed the total consideration to be received from the customer (i.e., loss contracts), and for which the acquiree recorded a loss accrual. A question arises as to how loss contracts should be recorded in acquisition accounting under the new guidance.

The scope of the new guidance only addresses contract assets and contract liabilities under ASC 606; loss contracts are addressed under other US GAAP, such as ASC 605-35 on construction-type contracts or ASC 605-20 on separately priced extended warranty contracts. Therefore, we do not believe that loss contracts are subject to the new guidance. We believe the related unfavorable element of a loss contract would generally be subsumed into an off-market contract liability. As part of the off-market contracts calculation, the unfavorable element would be based on fair value using market participant assumptions about the prevailing market terms for such goods or services (i.e., follow ASC 805), rather than simply using the acquiree's cost estimates (ASC 605). Subsequently, the off-market liability would be amortized in future periods with the related offset generally recorded as an adjustment to of revenue (see Other intangible assets or liabilities).

Practical expedients

ASU 2021-08 provides certain practical expedients to the acquirer in a business combination. These are designed to provide relief for circumstances when the acquirer is unable to assess or rely on the acquiree's accounting under ASC 606. In this case, the Board observed that the acquirer would effectively have to adopt ASC 606 for the acquiree's revenue contracts, and therefore provided a similar practical expedient as was applicable to the initial adoption of ASC 606. This practical expedient permits an acquirer to utilize the terms that exist as of the latest modification of a contract to determine the performance obligations and transaction price.

In addition, a second practical expedient in the new guidance relates to the timing of determining the standalone selling prices in order to allocate the transaction price to the performance obligations in the contract. This practical expedient permits an acquirer to determine the standalone selling prices at the acquisition date, rather than at the contract inception date as otherwise required by ASC 606. The FASB indicated that the purpose of this practical expedient is to alleviate circumstances in which it would be onerous for the acquirer to go back to the contract inception date if the acquiree lacks sufficient information or did not previously prepare financial statements in accordance with US GAAP.

An acquirer can elect to apply either or both of these practical expedients on an acquisition-by-acquisition basis. If practical expedients are elected for a particular acquisition, they should be applied to all revenue contracts associated with that acquisition. However, different elections can be made for different acquisitions.

Disclosures

The new guidance does not require any additional transaction-specific disclosures for acquisitions, or any transition disclosures. Entities should continue to apply the existing disclosure requirements in ASC 805 and ASC 606. These include:

- disclosures of the recorded value of significant assets acquired and liabilities assumed (ASC 805-20-50-1(c)),
- revenue and earnings associated with the acquired business (ASC 805-10-50-2(h)),
- an explanation of the changes in the contract asset and the contract liability balances during the reporting period due to business combinations (ASC 606-10-50-10), and
- the amount of transaction price allocated to unfulfilled performance obligations (ASC 606-10-50-13).

If an entity elects any of the practical expedients provided in the new guidance, the entity should disclose the expedients that have been used. Additionally, a qualitative assessment of the estimated effect of applying each of the expedients should be disclosed to the extent reasonably possible.

Divergence from IFRS

Currently, ASC 805 and IFRS 3 state that the assets acquired and liabilities assumed generally should be recognized and measured at fair value on the acquisition date. The new guidance creates a difference between US GAAP and IFRS, as under US GAAP, contract assets and contract liabilities acquired in a business combination will now be recognized and measured in accordance with ASC 606, largely based on their contractual terms. This may create additional accounting complexities on cross-border transactions between entities applying both US GAAP and IFRS for different reporting purposes (e.g., a foreign subsidiary of a US parent acquires a business and recognizes the transaction in its statutory financial statements under IFRS, while the US parent recognizes the transaction in its consolidated financial statements under US GAAP).

Effective dates and transition

The new guidance is effective for public business entities[1] for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all other entities, the new guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years.

Entities should apply the new guidance in ASU 2021-08 on a prospective basis to all business combinations with an acquisition date on or after the effective date. The acquisition date under ASC 805 is when the acquirer obtains control of the acquiree.

Early adoption is permitted, including in an interim period, for any period for which financial statements have not yet been issued. However, adoption in an interim period other than the first fiscal quarter requires an entity to apply the new guidance to all prior business combinations that have occurred since the beginning of the annual period in which the new guidance is adopted.

While this ensures consistency in the accounting for all business combinations that occurred during the annual period, it creates operational complexities. For example, if a calendar-year entity adopts ASU 2021-08 in the fourth quarter of 2021, the new guidance would need to be applied to any business combinations that occurred since January 1, 2021. If there were business combinations that occurred in earlier interim periods of 2021, entities would need to determine and record the related impacts on revenue, income taxes, net income, earnings per share, goodwill and related impairment analyses, and segments, among other areas, if material. This would also result in an entity needing to recast comparative quarterly data in future filings, if material.

No adjustment can be made to acquisitions that occurred in previous fiscal years, even if the "measurement period" described in ASC 805-10-25-14 is still open for such acquisition.

Appendix

The below examples illustrate certain common situations that may be most impacted by the new guidance.

Example 1 illustrates the accounting by an acquirer in a business combination in which the acquiree licensed functional intellectual property to a customer in exchange for royalties.

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[1] In this context, "public business entities" refers to the FASB's general master glossary definition of such entities, which includes otherwise nonpublic entities whose financial statements are included in another public entity's filing, such as for a "significant" acquired entity or equity method investee.

EXAMPLE 1

Pharmaceutical drug license

Company A is a pharmaceutical company. Company A acquires Company B in a business combination on January 1, 20X2. Company B, also a pharmaceutical company, previously licensed its approved oncology drug to Company Z on January 1, 20X1. The drug license arrangement has a term of five years with a 6% sales-based royalty paid by Company Z to Company B based upon Company Z's sales of the drug to third parties. Company B previously delivered the oncology drug intellectual property at the contract inception date and has no remaining performance obligations.

How should Company A account for the functional intellectual property drug license arrangement with Company Z in acquisition accounting?

Analysis

ASC 606-10-55-65 includes an exception for the recognition of revenue relating to licenses of intellectual property with sales- or usage-based royalties. Under this exception, royalty revenue is not recorded until the subsequent sale or usage occurs, or the performance obligation has been satisfied, whichever is later.

After adoption of ASU 2021-08, Company A would not record a contract asset in acquisition accounting related to this arrangement. Company A would record revenue subsequent to the acquisition date as the royalties are generated by Company Z. On the acquisition date, Company A would record a customer-related intangible asset at fair value (which likely contemplates anticipated future royalties that will be generated for Company A from Company Z) and reflect amortization of that intangible asset as an expense ratably over the useful life of the asset.

Example 2 illustrates the accounting by an acquirer in a business combination in which the acquiree licensed functional intellectual property and provides distinct services to a customer.

EXAMPLE 2

Software license with post-contract customer support

Company A provides a three-year, fixed-term software license to Company B on January 1, 20X1. Company B also receives post-contract customer support (PCS), which entitles Company B to "when and if available upgrades" that are developed by Company A. The total cash consideration paid at contract inception is $75 million. Company A determines the software license and PCS are separate performance obligations and allocates $60 million of the transaction price to the software license and $15 million to the PCS. Company A recognizes revenue allocated to the software license when the license term commences and recognizes the revenue allocated to PCS ratably over the three-year term.

Company C acquires Company A on January 1, 20X3. For the purpose of this example, any effects of significant financing are ignored and the price associated with PCS in the contract is still considered market pricing at the acquisition date.

How should Company C account for the software license and PCS arrangements with Company B in acquisition accounting?

Analysis

After adoption of ASU 2021-08, Company C would not record a contract asset or contract liability related to the software license, as the acquiree already received the cash and delivered the software. Company C would recognize a $5 million contract liability for the unsatisfied portion of the performance obligation for the PCS arrangement ($15 million less $10 million recognized for the first two years, as performance is two-thirds complete as of the acquisition date of January 1, 20X3). 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 contract inception, and the progress to completion through the acquisition date. This amount would be recognized as revenue over the next year post-acquisition as the remaining PCS service is provided to Company B.

Example 3 illustrates the accounting by an acquirer in a business combination in which the acquiree licensed symbolic intellectual property to a customer and had received an upfront payment from that customer prior to the acquisition date.

EXAMPLE 3

License of character images

Company A creates and produces early childhood educational programs, including a new animated television show. Company A grants a four-year exclusive license to Company B on January 1, 20X1 to use the images of the characters from the television show in exchange for an upfront payment of $80 million.

The intellectual property (IP) underlying the license is symbolic IP because the character images do not have significant standalone functionality. The license is therefore a right to access IP and Company A recognizes revenue over time under ASC 606.

On January 1, 20X4, Company C acquires Company A in a business combination. There is one year remaining on the symbolic IP license arrangement between Company A and Company B, and to date Company A has recognized $60 million in revenue. For the purpose of this example, any effects of significant financing are ignored and the fee associated with the IP license is still considered market pricing at the acquisition date.

How should Company C account for this arrangement in acquisition accounting?

Analysis

After adoption of ASU 2021-08, Company C would record a contract liability in acquisition accounting based on what it would have recorded if Company C had entered into the original contract with Company B at the same date and on the same terms. As the license fee would be recognized over the four-year term of the license, Company C would record a contract liability in acquisition accounting for the remaining one-fourth of the license period that remains at the acquisition date of January 1, 20X4, or $20 million. This amount would be recognized as revenue by Company C in the one-year period subsequent to the acquisition. As the application of this guidance would not affect the fair value of the Company A IP acquired by Company C (because there are no cash inflows over the remaining license period), the offsetting amount associated with the contract liability for the license arrangement would be recorded as an increase to goodwill in acquisition accounting.

Note: the fair value of the intangible asset for the symbolic IP should consider that there will be no future cash flows associated with the licensed character images from Company B for the remaining term of the license arrangement, even though there will be future revenue recognized under this contract under the new guidance. Additionally, we believe that there is no customer relationship intangible asset to record in this situation, as there are no further cash flows to be received from the customer under the license arrangement subsequent to the acquisition date.

Example 4 illustrates the accounting by an acquirer in a business combination in which the acquiree entered into a long-term construction contract with a customer prior to the acquisition date, including how progress should be measured for that acquired in-progress performance obligation.

EXAMPLE 4

Long-term construction contract

Company A enters into an arrangement with Company B on January 1, 20X1 to construct a new office building for total consideration of $40 million, which is paid in various installments as certain defined milestones are met over the construction period. The construction of the facility is considered a single performance obligation under ASC 606 that is satisfied over time, and is expected to take approximately two years to complete. Company A concludes that the contract does not include a significant financing component and determines that the most appropriate measure of progress is an input method based on costs incurred as compared to total anticipated costs to complete the building.

On January 1, 20X2, Company C acquires Company A in a business combination. Based on the measure of progress, Company A estimates the contract to be 50% complete immediately before the acquisition and had recognized $20 million in revenue (50% x total consideration of $40 million) and received $18 million in payments from Company B through that date. Therefore, as of the acquisition date, Company A would have recognized a contract asset of $2 million under ASC 606 since payment of this amount is conditioned on something other than the passage of time.

However, on the acquisition date, Company C estimates that the performance obligation is 55% complete based on its assessment of the cost of the remaining post-acquisition performance obligation and Company C's cost structure (which differs from the cost structure of Company A due to Company C's greater purchasing power).

How should Company C account for this arrangement in acquisition accounting?

Analysis

The measure of progress for a performance obligation satisfied over time should reflect the reporting entity's performance in transferring control of goods or services. In a business combination, the acquirer should assess the measure of progress for a performance obligation satisfied over time (multiplied by the total consideration for the contract) compared to the amount of consideration received as of the acquisition date to determine the amount of contract asset or liability to record in acquisition accounting. Such calculations should reflect the acquirer's estimates associated with the acquired contract.

After adoption of ASU 2021-08, Company C would record a contract asset or contract liability in acquisition accounting based on what it would have recorded if Company C had entered into the original contract with Company B at the same date and on the same terms. Based on its measure of progress toward completion (55%) at the acquisition date, multiplied by the total contract consideration of $40 million, less the $18 million of payments received from Company B to date, Company C would record a contract asset of $4 million. Note that this differs from the $2 million contract asset that Company A would have recorded as of that date, due to differences in estimates between the companies.

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