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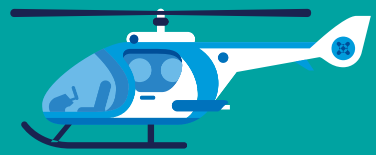

Defining Issues®

EITF reaches consensus-for-exposure on contract liabilities in business combinations

September 28, 2018

EITF reaches consensuses-for-exposure on contract liabilities in business combinations and development costs of episodic TV series.

Applicability

- **Recognizing contract liabilities in business combinations**[1] – All companies that assume a contract liability in a business combination after adopting ASC 606.[2]
- **Episodic television series**[3] – All companies in the film production and distribution industry that produce or license content.

Key facts and impacts

On September 27, the EITF reached a consensus-for-exposure to align the criteria for recognizing contract liabilities assumed in a business combination with the definition of a performance obligation in ASC 606. The EITF also directed the FASB staff to prepare a discussion paper with an invitation to comment on related measurement issues to be issued contemporaneously with the consensus-for-exposure.

The EITF also reached a consensus-for-exposure related to the accounting for development costs of episodic television series, which would align the cost capitalization model for films and episodic content. The consensus-for-exposure would also clarify how those development costs are amortized and evaluated for impairment. Both consensuses-for-exposure are subject to ratification by the FASB.

Contract liabilities in a business combination

EITF 01-3[4] provided specific guidance that deferred revenue (i.e. a contract liability) should be recognized in a business combination only if it was a legal obligation. Although EITF 01-3 was superseded, the recognition threshold of a legal obligation has continued to be applied to recognize contract liabilities in practice.

ASC 606 established a definition of a performance obligation for revenue recognition.[5] Questions have arisen about whether the ASC 606 definition of a performance obligation should be used to determine whether an acquirer should recognize a contract liability assumed in a business combination **or** whether the definition of a legal obligation should continue to be used. This could be a significant issue in acquisitions of entities that license symbolic IP, but its applicability would not be limited to such entities.

[1] EITF Issue No. 18-A, Recognition under Topic 805 for an Assumed Liability in a Revenue Contract

[2] ASC 606, Revenue from Contracts with Customers

[3] EITF Issue No. 18-B, Improvements to Accounting for Episodic Television Series

[4] EITF Issue No. 01-3, Accounting in a Business Combination for Deferred Revenue of an Acquiree

[5] ASC 606-10-20

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Example – Contract liability in a business combination

ABC Corp. acquires DEF Corp. in a business combination on July 1, 2018. DEF's business includes the licensing of intellectual property (IP) to its customers. DEF owns the IP, which is included in the acquired set in the business combination.

One of the license agreements acquired in the business combination follows.

- DEF licensed the rights to use a cartoon character image (symbolic IP) to Customer XYZ for a period of 10 years. The contract term is from January 1, 2018, through December 31, 2027.
- XYZ paid DEF $20 million on January 1, 2018, for the entire license term.
- DEF adopted ASC 606 as of January 1, 2018.

ASC 606 indicates that the license of symbolic IP is a performance obligation that is satisfied over time (the license term).

DEF's closing balance sheet on June 30, 2018 includes a contract liability of $19 million related to the agreement with XYZ (total consideration of $20 million less $1 million recognized as revenue in the first 6 months of the 10-year license term).

The EITF's consensus-for-exposure would require ABC to recognize a contract liability in the business combination accounting for the revenue arrangement. The liability would be measured at fair value, which would depend on the perspective about whether DEF has already provided the character images to XYZ.

Conversely, if the payment terms in this example changed so DEF's closing balance sheet did not include a contract liability recognized under ASC 606, then no liability would be recognized under the EITF's consensus-for-exposure.

Under the legal obligation approach currently applied in practice, no liability would be recognized in either scenario (i.e. regardless of the timing of the cash flows or recognition of a contract liability).

The EITF also reached a consensus-for-exposure that it is not appropriate for an acquirer to use carry-over basis to measure a contract liability in a business combination. Rather, the measurement should reflect the fair value of the obligation that is assumed in the business combination.

During previous discussions in June 2018, the EITF had decided that:

- the fair value measurement of the liability should consider the related assets that were obtained in the acquisition; and
- the payment terms should not affect the amount of revenue an acquirer recognizes for an assumed revenue contract after a business combination.

However, the EITF decided to remove these requirements from its consensus-for-exposure and instead directed the FASB staff to draft a discussion paper with an invitation to comment on these issues to inform future discussions. The consensus-for-exposure and the discussion paper will be issued concurrently.

KPMG observation

The EITF considered an example showing how to determine the fair value of a contract liability for a license of symbolic IP. The example indicated that the license includes two distinct activities (providing the IP and supporting the IP) and specified that the fair value of the contract liability would include only those costs to support the IP incurred after the business combination date.

Applied to the example above, ABC would assume that a market participant would not need to license the character images from the owner to fulfill the contract obligation.

However, the EITF did not reach a consensus about whether the valuation approach in the example would be an appropriate fair value measure in the example circumstances. As a result, the EITF decided not to include this example in the consensus-for-exposure. It is possible that it will be included in the discussion paper, along with an alternative view that ABC should include those costs in measuring the fair value of the obligation. This view would likely result in a significantly higher fair value for the contract liability and therefore more revenue recognized by the acquirer after the acquisition.

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KPMG observation	
The discussion paper will ask constituents whether the EITF should specify that payment terms in a revenue contract should not affect the amount of revenue the acquirer recognizes after a business combination. Stakeholders have previously said that if this requirement were added, then additional guidance would be needed related to the recognition of specific customer or contract-related assets in a business combination.	In the example above, consider an alternative scenario in which XYZ was required to pay $2 million at the end of each year during the 10-year license term, instead of the entire $20 million on January 1, 2018. In this alternative example, there would not be a contract liability under ASC 606. Consequently, ABC likely would recognize more revenue after the business combination because it would be based on the actual cash flows received rather than the fair value measurement of the contract liability.

Episodic television series

There have been significant changes in the production and distribution models in the media and entertainment industry since the accounting guidance for the film industry[6] was originally issued. For example, the internet has continued to expand the distribution channels for content with the emergence of streaming services and content library subscriptions (e.g. Netflix, Hulu, Amazon Prime).

The FASB created a working group of preparers, accounting firms and investors to discuss issues for consideration related to the financial reporting for this industry. The EITF discussed input from the working group related to the guidance for capitalizing production costs and their amortization and impairment.

At the September 27, 2018 meeting, the EITF reached a consensus-for-exposure on issues related to the accounting for costs incurred to develop episodic television (TV) content.

The proposed guidance would align the requirements for episodic TV content with the guidance that applies to films in certain respects. This would include the removal of restrictions on the capitalization of production costs for episodic television content. The following table includes a summary of the issues addressed in the consensus-for-exposure.

Transition and effective date

The consensus-for-exposure would require a prospective transition method. Under this method, companies would apply the proposed guidance to all costs incurred on or after the effective date.

Episodic TV series – Summary of EITF consensus-for-exposure	
Cost capitalization	Align the cost capitalization guidance for episodic content with the guidance for films by removing the content distinction. This would remove the existing constraint on capitalization based on contracted revenue in the initial and secondary markets because no constraint exists for film production costs.
Amortization	Current industry guidance on amortization of capitalized film costs using the individual-firm-forecast method would be retained. However, in the absence of revenue that is directly related to a film, a requirement to review and revise estimates of the remaining use of the film each reporting period would be added. Any changes in estimated use would be accounted for prospectively.

[6] ASC 926-20, Entertainment—Films, Other Assets—Film Costs

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Episodic TV series – Summary of EITF consensus-for-exposure	
Impairment	The unit of account for evaluating capitalized film or licensing costs for impairment would be the 'film group', defined by the lowest level of identifiable cash flows. For companies with predominantly indirect revenue at an individual title level (e.g. content library subscription services), this may be at the entire library level and may rarely, if ever, result in an impairment. The proposed guidance would require writing off capitalized costs of individual films that are abandoned prior to release or removed from a service offering (i.e. library). Additional examples of changes in circumstances or events that indicate the potential for an impairment at the individual film or film group levels would be provided. The impairment models for licensed and produced content would be aligned to the current fair value model used for produced content. This would eliminate the net realizable value model required for licensed content in existing guidance.[7]
Presentation and disclosure	The existing specific classification requirements (i.e. current and noncurrent) for capitalized costs of produced and licensed content would be removed. The disclosure requirements for these two types of content would be generally aligned. Disclosures related to the method and expected amounts of amortization of capitalized development and licensing costs would be required.

[7] ASC 920-350, Entertainment—Broadcasters, Intangibles—Goodwill and Other

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