FINANCIAL ACCOUNTING STANDARDS BOARD

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July 23, 2018

TO: MEMBERS OF THE FASB EMERGING ISSUES TASK FORCE

Included are the final minutes of the June 7, 2018 meeting of the FASB Emerging Issues Task Force (EITF).

On June 27, 2018, the Board ratified the Task Force consensus on Issue 17-A on cloud computing arrangements and the consensuses-for-exposure on Issue 18-A on revenue contracts assumed in a business combination. Subsequent to that ratification, the Task Force decided that Issue 18-A warranted further consideration at a future EITF meeting. The final Accounting Standards Update for Issue 17-A is expected to be posted to the FASB website by the end of the third quarter.

The next regular EITF meeting is scheduled for September 27, 2018. The extra EITF meeting date reserved for July 19, 2018 was not utilized.

Please call or email me if you have any questions.

Sincerely,

Jason Bond

FASB Practice Fellow

FINANCIAL ACCOUNTING STANDARDS BOARD

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Emerging Issues Task Force
Meeting Minutes
June 7, 2018

MINUTES OF THE JUNE 7, 2018 MEETING
OF THE FASB EMERGING ISSUES TASK FORCE

Location: FASB Offices
401 Merritt 7
Norwalk, Connecticut

Thursday, June 7, 2018
Starting Time: 8:30 a.m.
Concluding Time: 2:30 p.m.

Task Force Members Present:
Susan M. Cosper (Chairman)
Kimber K. Bascom
Paul Beswick
James G. Campbell
Terri Z. Campbell
Alexander M. Corl
Lawrence N. Dodyk
Bret Dooley
Mark LaMonte (by telephone)
Ashwinpaul C. (Tony) Sondhi (by telephone)
Robert Uhl
Eric West
Jonathan Wiggins (SEC Observer)
James A. Dolinar (FinREC Observer)
Yan Zhang (PCC Observer) (by telephone)

Task Force Members Absent:
None

Others at Meeting Table:
Russell G. Golden, FASB Chairman
James L. Kroeker, FASB Vice Chairman
Christine A. Botosan, FASB Board Member
Marsha L. Hunt, FASB Board Member
R. Harold Schroeder, FASB Board Member
Marc A. Siegel, FASB Board Member
Gary R. Buesser, Incoming FASB Board Member (effective July 1, 2018)
Thomas J. Faineteau, EITF Coordinator
Jason C. Bond, FASB Practice Fellow
Amy J. Park, FASB Practice Fellow
Chiara Gilioli, FASB Assistant Project Manager

Mary S. Mazzella, FASB Senior Project Manager
Chandy C. Smith, FASB Senior Investor Liaison
Jenifer J. Wyss, FASB Supervising Project Manager
John W. Schomburger, FASB Postgraduate Technical Assistant
John P. Stansel, FASB Postgraduate Technical Assistant

ADMINISTRATIVE MATTERS

- The EITF Chair welcomed Mr. Eric West, Amazon.com Inc., as the newest member of the Task Force.

- The EITF Chair announced that Mr. Carl Kampel has stepped down as a member of the Task Force effective as of the January 18, 2018 EITF meeting. The Chair thanked Mr. Kampel for his service.

- The EITF Chair announced that Jason C. Bond, FASB Practice Fellow, has been appointed to the position of EITF Coordinator replacing Thomas J. Faineteau, FASB Practice Fellow, effective with the conclusion of this meeting. The Chair thanked Mr. Faineteau for his contribution.

- The EITF Coordinator noted that there are now three active Issues on the EITF agenda.

- The EITF Coordinator announced that any consensus or consensus-for-exposure reached at this meeting will be considered by the Board for ratification at the June 27, 2018 Board meeting.

- The EITF Coordinator announced that a future communication would be made about whether to retain the next regular EITF meeting scheduled for September 27, 2018, and whether to utilize the July 19, 2018 "Extra" EITF meeting date.

FASB Staff Announcement on Issue 15-F

Codification Reference: Topic 230, Beneficial Interests in Securitization Transactions

Topic: Unsolicited Comment Letter (*Accounting Standards Update 2016-15*)

The FASB staff presented an unsolicited comment letter pertaining to Accounting Standards Update No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* (resulting from EITF Issue No. 15-F, “Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments"), and requested feedback from the Task Force. The Task Force members concluded that no new information was presented in the letter that had not been considered during the Task Force’s redeliberations of Issue 15-F.

DISCUSSION OF AGENDA TECHNICAL ISSUES

Issue No. 17-A

Title: Customer's Accounting for Implementation, Setup, and Other Upfront Costs (Implementation Costs) Incurred in a Cloud Computing Arrangement That Is Considered a Service Contract

Dates Discussed: July 20, 2017; October 12, 2017; January 18, 2018; June 7, 2018

Background

1. In April 2015, the FASB issued Accounting Standards Update No. 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement*, to help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement (CCA) by providing guidance for determining when the arrangement includes a software license. Examples of CCAs include software as a service (SaaS), platform as a service, infrastructure as a service, and other similar hosting arrangements.

2. If a CCA includes a license to internal-use software, then the software license is accounted for by the customer in accordance with Subtopic 350-40. This generally means that an intangible asset is recognized for the software license and, to the extent that the payments attributable to the software license are made over time, a liability also is recognized. If a CCA does not include a software license, the entity should account for the arrangement as a service contract. This generally means that the fees associated with the hosting element (service) of the arrangement are expensed as incurred.

3. During the comment period and after the issuance of Update 2015-05, several stakeholders requested that the Board provide additional guidance on the accounting for costs of implementation activities performed in a CCA that is a service contract. Those stakeholders observed that there currently is diversity in practice because there is no directly applicable GAAP guidance, and therefore entities have looked to various areas of the Codification for additional guidance.

4. On May 10, 2017, the Board decided to add a narrow scope Issue to the EITF's agenda to address a customer's accounting for costs of implementation activities performed in a CCA that is a service contract.

Issues

5. The following issues were included in Issue Summary No. 4, dated May 24, 2018, and were discussed at the June 7, 2018 EITF meeting and prior meetings.

- Issue 1: Accounting for Implementation Costs Incurred in a CCA That Is Considered a Service Contract
- Issue 2: Amortization Period
- Issue 3: Definition of Implementation Costs
- Issue 4: Scope of the Issue
- Issue 5: Analogy to Other Service Contracts

Issue 6: Disclosures
Issue 7: Transition
Issue 8: Transition Disclosures
Issue 9: Effective Date and Early Adoption

Prior EITF Discussion

Issue 1: Accounting for Implementation Costs Incurred in a CCA That is Considered a Service Contract

6. At its July 20, 2017 meeting, the Task Force considered the following four alternatives to account for costs for implementation activities incurred in a CCA that is considered a service contract:

> **Alternative A**—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Recognized as an Expense When Incurred.
>
> **Alternative B**—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Recognized as an Asset or an Expense When Incurred on the Basis of Existing GAAP (Topic 340, Subtopic 350-40, Topic 360 Subtopic 720-45).
>
> **Alternative C**—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Accounted for the Same as Implementation Costs Associated with a Software License.
>
> **Alternative C^1**—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Accounted for Based on Topic 360.

7. Task Force members did not express support for Alternative A or Alternative C^1, and, accordingly, the discussion focused on Alternative B and Alternative C and the differences between those two alternatives.

8. In evaluating Alternatives B and C, the Task Force discussed the extent to which multiple elements of implementation costs incurred in a CCA would need to be separated for accounting purposes. The staff noted that under Alternative B, the implementation costs would likely require a more detailed breakout than under Alternative C in order to appropriately apply Topic 340, Other Assets and Deferred Costs; Topic 360, Property, Plant, and Equipment; Subtopic 350-40, Internal-Use Software; and Subtopic 720-45, Business and Technology Reengineering. One Board member observed that Alternative C also requires separation of multiple elements, and, therefore, such a feature does not distinguish Alternative B from Alternative C. One Task Force member also observed that allocation guidance between multiple element arrangements exists in GAAP (for example, in Subtopic 350-40), although it may not address all aspects (for example, when elements are considered to be distinct). During the discussion, a parallel to Topic 606, Revenue from Contracts with Customers, was also discussed. Specifically, certain members of the Task Force

discussed the possible application of the notion of "distinct" goods or services to CCAs that are considered service contracts for purposes of contract bifurcation under both Alternatives B and C.

9. Some Task Force members supported Alternative B because it relies on existing GAAP and is consistent with both the decisions reached in Update 2015-05 and the definition of an asset under FASB Concepts Statement No. 6, *Elements of Financial Statements*. However, other Task Force members expressed reservations with Alternative B, which they perceived as potentially resulting in a different accounting outcome for identical costs depending on who performs the service. For example, some Task Force members believed that certain implementation costs incurred by the hosting provider (vendor) would be expensed over the life of the contract if considered not to be distinct from the hosting service, while those same costs would be expensed as incurred if the work is performed internally or by a third-party consultant.

10. Some Task Force members supported Alternative C. Those Task Force members considered CCAs that are considered services to be economically similar to CCAs that include a software license. Some Task Force members also noted that a customer in a CCA that is considered a service has an asset; it is the "right-to-use" an asset even though that asset is serviced and maintained by an external party. Some Task Force members also preferred Alternative C because it would produce consistent accounting outcomes for implementation costs regardless of who performs the work. However, some Task Force members expressed concerns with Alternative C, noting that it would require revisiting and undoing the prior decisions reached in Update 2015-05. An FASB staff member also observed that a CCA that is considered a service contract is not economically similar to a "right-to-use" software license because the vendor still must perform throughout the term of the CCA in order for the customer to benefit from the arrangement. Several Task Force members also expressed concerns with Alternative C because (a) the guidance in Subtopic 350-40 is perceived as outdated, and (b) there are already practice issues associated with applying the guidance in Subtopic 350-40 to software licenses. They noted that applying the same guidance to implementation costs of a CCA that is considered a service might not reduce diversity in practice.

11. The Task Force directed the FASB staff to perform additional research (focusing on Alternatives B and C) to assist the Task Force in reaching a tentative conclusion on Issue 1. The following potential research areas were outlined by the FASB staff:

a. Analyze the issues that exist in practice for applying the guidance in Subtopic 350-40 to software licenses, and whether those issues would exist when applied to a CCA that is considered a service contract.
b. Build new examples for CCAs that are considered service contracts, with implementation activities that include additional complexities such as multiple-service providers (vendors, consultants).
c. Explore whether Alternative B could be improved to avoid different accounting outcomes depending on who performs the implementation work.
d. Evaluate whether any other model outside of Subtopic 350-40 could be applied to a CCA that is considered a service contract.

e. Explore whether a conceptual basis similar to Topic 842, Leases, could be applied, whereby a right-of-use asset is recognized even though control does not pass to the customer (similar to an operating lease).
f. Consider how to separate the elements of a contract to determine the appropriate accounting treatment.

12. At its October 12, 2017 meeting, the Task Force continued its discussion of Issue 1 and considered three alternatives to account for the costs incurred for implementation activities in a CCA that is considered a service contract. Those alternatives included Alternative B and "Original" Alternative C as presented at the July 20, 2017 meeting. The FASB staff clarified the application of Alternative B to address concerns raised by some Task Force members at the July meeting. The FASB staff also proposed to simplify the application of Alternative B by including specific guidance based on Topic 606 to determine whether an activity is distinct from the hosting service (rather than referencing Topic 606 to make that determination) for the residual activities for which there is no existing GAAP guidance. The FASB staff also introduced a revision to Original Alternative C in response to feedback received at the July meeting and based on outreach performed subsequent to that meeting (Revised Alternative C).

Alternative B—Residual Approach Utilizing Guidance in Topic 606 (or Another Model) to Determine What Is Distinct.

Original Alternative C—Implementation Costs Associated with a CCA That Is Considered a Service Contract Would Be Accounted for the Same as Implementation Costs Associated with a Software License.

Revised Alternative C—All Hosting Arrangements (as Defined in the Master Glossary) Are within the Scope of Subtopic 350-40

13. The Task Force first discussed Revised Alternative C, which would require an entity to identify a software element in all of its hosting arrangements, as defined in the Master Glossary of the Codification, and that software element would be within the scope of Subtopic 350-40. Since the software element would be within the scope of Subtopic 350-40, it would be capitalized and the implementation costs to get that software element ready for its intended use and that are capitalizable under Subtopic 350-40 also would be capitalized as part of the cost of the software element. A liability would be recognized for the present value of any fees in the CCA related to the software element that are not paid at contract commencement. Revised Alternative C would address the inconsistencies between Original Alternative C and Update 2015-05 by proposing new amendments that would change the conclusions in Update 2015-05. The discussion included presentation on the income statement, which the FASB staff confirmed would be a noncash operating expense (characterized as amortization). One Task Force member and one Board member questioned whether the term *hosting arrangement*, as defined in the Master Glossary, would cause some hosting arrangements to fall out of the scope of Revised Alternative C because that definition uses the term *license*. They therefore suggested updating the definition of hosting arrangement to avoid any unintended scope restrictions. One Task Force member noted that executory contracts that have a minor software element in the contract might be within the scope of Revised Alternative C, and, accordingly, that Revised Alternative C might have unintended

consequences related to executory contracts in general. When comparing Revised Alternative C with Original Alternative C, some Task Force members also discussed the executory nature of hosting arrangements and how there is a lack of well-defined accounting guidance for executory contracts. Some Task Force members and one Board member noted that Revised Alternative C would treat CCAs like leases under Topic 842, but that Topic specifically scopes out leases of intangible assets from its guidance. A Task Force member and a Board member therefore questioned whether other intangible assets should be addressed if the Task Force proposes to treat CCAs like leases.

14. The Task Force then discussed Alternative B, and, in particular, the simplified approach proposed by the staff for determining whether implementation activities are distinct from the hosting service for the residual activities for which there is no existing GAAP guidance. Rather than referring to Topic 606, the proposed simplified approach would provide explicit guidance that would be used to determine whether an implementation activity is distinct from the cloud service provider's hosting service. One Task Force member noted that there would be limited circumstances in which services performed by a third party would be determined not to be distinct under the simplified approach. Some Task Force members questioned the potential outcome of capitalizing as a prepaid asset the costs for customization activities when the activity is performed by a third-party other than the cloud service provider. Another Task Force member expressed concerns with the application of the simplified approach, noting that a vendor using the guidance in Topic 606 could reach a conclusion that is different from the conclusion that a customer would reach by applying the simplified approach in Alternative B when determining whether an element of a contract is distinct. Other Task Force members noted that Original Alternative C and Revised Alternative C also would not result in symmetry in accounting between a customer and a vendor, and that, therefore, symmetry might not be a critical factor when evaluating Alternative B.

15. The Task Force considered the accounting implications of each alternative. One Board member noted that the objective of the Issue, when it was added to the EITF's agenda, was to align the accounting for implementation costs for hosting arrangements. Another Board member noted that the criterion set forth in paragraph 350-40-15-4A about the right to take possession of the software might not be substantive and that, therefore, the accounting for CCAs currently might be based on form rather than substance. That Board member observed that what was important was to align the accounting for transactions that are economically similar. Some Task Force members preferred Revised Alternative C to Original Alternative C because they noted few (if any) instances in GAAP in which implementation costs are capitalized without an associated asset. Although one Task Force member noted that Revised Alternative C would introduce complexity into the accounting for implementation costs, which could be avoided by prescribing a simpler approach, some Task Force members noted that the application of Revised Alternative C would not result in any appreciable increase in complexity when compared to Original Alternative C, particularly if the Task Force were to permit entities not to separate the hosting service from the software element of a CCA. Some Task Force members also noted that while Original Alternative C would eliminate the difference in accounting for implementation costs, it would not eliminate all differences in accounting between arrangements that are considered economically similar. It also was noted that Revised Alternative C was the only alternative that would align the accounting for CCAs that are considered service contracts with that of on-premise software licenses.

16. Ultimately, the Task Force reached a tentative conclusion to align the accounting for CCAs, wherein all CCAs would include a software element that would be within the scope of Subtopic 350-40 (that is, Revised Alternative C).

17. The Task Force then discussed whether to revise the guidance in Subtopic 350-40 to address the concerns raised at the July 20, 2017 meeting that the guidance in Subtopic 350-40 is outdated and that applying that same guidance to costs to implement a CCA would not reduce diversity in practice. Based on the feedback obtained through outreach performed subsequent to the July meeting, there were no significant challenges identified that would arise in applying the guidance in Subtopic 350-40 for the accounting for costs to implement a CCA, and, accordingly, the Task Force decided not to add guidance in Subtopic 350-40 for those implementation costs. However, one Task Force member suggested an amendment to the title of Subtopic 350-40 to more clearly indicate that CCAs would fall within the guidance of that Subtopic.

18. The Task Force also discussed the practical questions under Revised Alternative C related to the capitalization of the software element of a hosting arrangement, such as how to consider renewal and termination options, what discount rate to use, and how to account for variable payments. The Task Force discussed the extent of the guidance in Topic 842 that would apply if the Task Force were to permit use of the leases guidance by analogy to CCAs. The FASB staff clarified that only specific aspects of the guidance in Topic 842 would apply if the Task Force were to permit use of the leases guidance by analogy to CCAs. For example, a customer in a CCA would apply the guidance in Topic 842 by analogy for the accounting of variable payments or for the evaluation of extension or termination options included in the arrangement, but the customer would not be required to assess lease classification, nor would the customer be required to provide all disclosures included in Topic 842. The staff also clarified that implementation costs would not be accounted for as initial direct costs under Topic 842.

19. Some Task Force members supported analogizing to certain aspects of Topic 842, but other Task Force members and some Board members preferred obtaining a better understanding of how practice currently applies the guidance in Subtopic 350-40 to on-premise software licenses before determining whether analogizing to Topic 842 is necessary. The Task Force also requested that the staff perform additional research on how certain aspects of Topic 842 would apply to the accounting for hosting arrangements. For example, one Task Force member observed that the guidance about discount rates in Topic 842 would not apply to the software element of a hosting arrangement because, under Topic 842, the incremental borrowing rate is determined on a collateralized basis. While the staff proposed an analogy to a finance lease, one Board member also questioned whether an analogy should be made to an operating lease. Accordingly, the following areas of research were identified by the Task Force and Board members:

a. Determine whether there currently is diversity in practice in accounting for on-premise software under Subtopic 350-40, including how entities assess variable payments, discount rates, and renewals for internal-use software.
b. Determine how the accounting for on-premise software under Subtopic 350-40 may change if an analogy to (or alignment with) Topic 842 were to be made for hosting arrangements.

c. Evaluate whether the capitalized software element of a hosting arrangement is more appropriately analogized to an operating lease or finance lease.
d. Analyze the disclosure requirements in Topic 842 and assess whether any of those requirements would be applicable to hosting arrangements.

20. The Task Force decided not to provide guidance about separation of elements in a CCA because that question is beyond the scope of this Issue.

21. At its January 18, 2018 meeting, the Task Force reached a consensus-for-exposure that would require an entity to capitalize implementation costs of a hosting arrangement that is a service contract using the guidance in Subtopic 350-40 on internal-use software. The accounting for the hosting fees associated with the hosting arrangement would not be affected by this consensus-for-exposure and, accordingly, would be expensed as the service is performed.

22. In reaching its consensus-for-exposure, the Task Force noted that an entity may incur significant costs when implementing a hosting arrangement that is a service contract, which may indicate a future benefit to the entity beyond the period over which the implementation services are performed. In a service contract, while the right to receive the service and the obligation to pay for the service as the service is performed are not recognized on the balance sheet, the Task Force observed that certain costs to implement the hosting arrangement enhance the right to receive the related service. Accordingly, the Task Force decided that the implementation costs of a hosting arrangement that is a service contract could be attached to the service contract and, therefore, could be capitalized as an asset and recognized over a period longer than the period over which the implementation services are provided. That is, those capitalized costs, while not representative of an asset on a standalone basis, result in an increase in future benefits to be received under the hosting arrangement, thus resulting in an asset related to the service contract. While overall, the Board and Task Force members believe that it is important that guidance be developed in a manner in which the outcome is both relevant to investors' needs and responsive to preparers' ability to apply the guidance, some Task Force members weighed the expected costs and expected benefits differently in determining the consensus-for-exposure and its interaction with the FASB conceptual framework. In determining the consensus-for-exposure, the Task Force decided that it represents a practical solution that addresses the original concern that was raised to the Task Force and that it was responsive to the unique characteristics of hosting arrangements that are service contracts.

23. The Task Force noted that implementation costs capitalized under the amendments in the proposed Update relate to the rights and obligations embedded in a hosting arrangement (which are not recognized separately as assets and liabilities) for which the entity has the right to use and that this is similar to other contract-related assets. For example, under Subtopic 340-40 on other assets from contracts with customers, costs that relate to a specific contract and that are expected to be recovered are recognized as an asset if they generate or enhance resources of the entity that will be used in fulfilling the contract in the future. This guidance results in the capitalization of costs that cannot be capitalized in accordance with other GAAP and that are not added to the measurement of another asset. They merely generate a resource for the entity. The Task Force believes that the result of the implementation costs of a hosting arrangement generates a resource for the entity that is used in connection with the hosting arrangement.

24. In discussing the accounting for implementation costs incurred in a hosting arrangement that is a service contract, the Task Force considered other alternatives, including an alternative that would have resulted in recognizing an asset for both the costs incurred to implement the hosting arrangement and the right to use the software embedded in the hosting arrangement based on the premise that the hosting arrangement provides an economic resource to the customer irrespective of ownership or location of the software. A few Task Force members preferred that alternative. They noted that under Subtopic 350-40, costs associated with implementation activities are not capitalized as a separate or standalone asset. Instead, the software is the identified asset, and costs of implementation activities are added to the measurement of that asset. Those Task Force members also believe that this alternative is consistent with the FASB conceptual framework. Those Task Force members noted that in the absence of an asset to which implementation costs can be added, the implementation costs incurred in a hosting arrangement that is a service contract are like costs incurred in other transactions that, while expected to provide economic benefits in future periods, are not recognized as an asset but rather are expensed as incurred (for example, training costs or business process reengineering costs). However, other Task Force members noted that that alternative also had conceptual limits (for example, it treated the transaction as economically different from how a vendor accounts for the transaction under Topic 606 on revenue from contracts with customers). The Task Force ultimately rejected that alternative. In doing so, the Task Force also considered the general lack of support by preparers and users during outreach. Initial outreach with users indicated that they generally preferred implementation costs to be expensed as incurred and that they also preferred software and related implementation costs of internal-use software to be expensed as incurred, but they saw an argument for capitalizing the implementation costs of a hosting arrangement that is a service contract. In addition, some Task Force members were concerned that accounting for hosting arrangements that are service contracts like leases may have unintended consequences because intangible assets are not in the scope of Topic 842 on leases. Some Task Force members also noted that the alternative would be beyond the scope of the issue given to the Task Force.

Issue 2: Amortization Period

25. At the July 20, 2017 EITF meeting, the FASB staff recommended providing guidance on the amortization period to the extent that the existing guidance is not sufficient (generally for a prepaid asset). The staff recommended that the amortization period under Alternative B of Issue 1 include the noncancelable hosting contract term plus any expected renewal periods. The staff did not recommend providing amortization period guidance under Alternative C of Issue 1 considering that guidance exists in Subtopic 350-40.

26. Task Force members who expressed a view on Issue 2 generally were supportive of the staff recommendation. One Task Force member recommended that an entity should continually reassess the useful life of the asset (for example, based on changes in expectations of renewal option exercises or based on whether the entity continues to expect to benefit from the asset during the renewal periods). Another Task Force member asked whether the staff recommendation took into consideration expectations of renewals of a CCA that does not include contractual rights to renew. That Task Force member also observed that it would be useful if the staff were to provide guidance about how to evaluate renewal options so that practitioners know how to apply the guidance (for

example, by providing a threshold above which renewal periods would be included in the useful life of the asset). An FASB staff member clarified that the staff's recommendation was based on options to renew that are included in the contract, not based on expectations of future renegotiations and renewals. There also was a discussion between some Task Force members and Board members about whether prepaid assets would arise under the application of Alternative C.

27. At the January 18, 2018 meeting, the Task Force also reached a consensus-for-exposure to require entities to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement, which would include renewal options that are reasonably certain to be exercised. The Task Force believes that including reasonably certain renewals to determine the period over which the costs should be expensed would represent the expected period of benefit of the enhanced right that is expected to be realized from the hosting arrangement. The Task Force also believes that this is reasonably consistent with the period over which capitalized costs are recognized as an expense for implementation costs of hosting arrangements that contain a license. The Task Force also decided that an entity would record the expense related to the implementation costs in the same line item in the statement of income as the fees for the hosting arrangement (and, accordingly, the amortization expense related to those implementation costs would not be presented along with depreciation or amortization expense related to property, plant, and equipment, and intangible assets). This is because the asset recognized for the implementation costs is recognized only as a result of enhancing the value of the hosting service, which itself is not recognized as an asset. Thus, although the implementation costs are recognized as a standalone asset, the future benefit derived from that asset is linked to the benefit derived from the hosting service, which is expensed as incurred.

Issue 3: Definition of Implementation Costs

28. At its October 12, 2017 meeting, the Task Force decided not to provide a definition or description of implementation costs within Subtopic 350-40. While one Task Force member observed that adding a description of the different types of implementation costs could be helpful, the Task Force generally agreed that there was no need to include a definition or description of implementation costs because Subtopic 350-40 already has appropriate guidance that entities can apply. One Task Force member also noted that there is no significant diversity in practice today related to identifying implementation costs.

Issue 4: Scope of the Issue

29. At its January 18, 2018 meeting, the Task Force reached a consensus-for-exposure to amend the definition of *hosting arrangement* to remove the reference to licensing. The Task Force noted that the definition of hosting arrangement uses the phrase "licensing of software," which would potentially limit the number of arrangements to which the guidance in the amendments in the proposed Update would apply because many hosting arrangements do not provide the customer with a license to the underlying software. In addition, the Task Force discussed whether to add guidance to limit the scope of the proposed amendments to service contracts in which the hosting arrangement is more than minor. The purpose of that guidance would be to reduce the costs of implementing internal controls over financial reporting related to analyzing all service arrangements to determine whether a hosting arrangement, as defined in the Master Glossary, is

included in the service arrangement. While the Task Force decided not to add guidance to limit the scope of the proposed amendments, the Task Force decided to obtain feedback on the issue.

Issue 5: Analogy to Other Service Contracts

30. The Task Force discussed and decided to remain silent on whether an entity may apply the guidance in the amendments in the proposed Update by analogy to other transactions and activities. The Task Force noted that explicitly disallowing an analogy to Subtopic 350-40 would not be effective because the guidance in the proposed amendments is based, in part, on an analogy to the guidance in Subtopic 340-40. If the Task Force decided to disallow an analogy to Subtopic 350-40, an entity could still analogize to Subtopic 340-40 on the same basis as the proposed Update. Some Task Force members also believe that few, if any, arrangements are similar to hosting arrangements. As a result, there may not be many transactions for which an entity would attempt to analogize to Subtopic 350-40.

Disclosures

31. The Task Force reached a consensus-for-exposure to add disclosure requirements that would apply to implementation costs of all transactions within the scope of Subtopic 350-40, not just hosting arrangements that are service contracts. The amendments in the proposed Update would require certain qualitative and quantitative disclosures about costs incurred to implement internal-use software or hosting arrangements. The intent of these disclosures would be to provide users with information about the type and amount of implementation costs capitalized as well as information about the subsequent measurement of those costs. The Task Force decided that the new disclosures would be required for all transactions within the scope of Subtopic 350-40 to create consistency between the information provided for internal-use software and hosting arrangements.

Transition

32. The Task Force did not propose an effective date for the guidance in the amendments in the proposed Update. Consequently, the Task Force will take into consideration the comments received from the exposure of the document before determining when the proposed Update would be effective.

33. The Task Force reached a consensus-for-exposure to allow entities to choose between prospective transition and retrospective transition when adopting the guidance in the amendments in the proposed Update. Under prospective transition, an entity would apply the proposed guidance to hosting arrangements entered into, renewed, or materially modified after the effective date. The prospective transition approach is based on whether a hosting arrangement is entered into (or materially modified or renewed) after the effective date, and not whether implementation costs are incurred after the effective date. The Task Force understands that the benefits of retrospective transition may not justify the costs because the effect of retrospective application may not be significant for many entities. However, the Task Force saw no reason to prohibit an entity from retrospectively applying the proposed amendments, and an entity with significant implementation costs during the comparative periods of the financial statements in which the entity adopts the

proposed amendments may believe that retrospective application provides more useful information. The Task Force discussed potential challenges of implementing the proposed guidance in situations in which an entity is incurring costs to implement a hosting arrangement that already exists upon the proposed Update's ultimate effective date. However, in-process implementation costs would be capitalized only if the entity elects retrospective transition.

34. The Task Force reached a consensus-for-exposure to require different transition disclosure requirements depending on the transition method elected. For prospective transition, an entity would disclose the nature of and reason for the accounting change, the transition method, and a qualitative description of the financial statement line items affected by the change. For retrospective transition, the disclosure requirements at transition would include all of the requirements for prospective transition plus quantitative information about the effects of the accounting change. The Task Force decided that the benefits of requiring quantitative disclosure of the effect of the proposed amendments for prospective transition would not justify the costs. The transition disclosures would be in lieu of those required in paragraphs 250-10-50-1 through 50-3.

Current EITF Discussion

Issue 1: Accounting for Implementation Costs Incurred in a CCA That Is Considered a Service Contract

35. The Task Force reached a consensus that requires an entity to capitalize implementation costs of a hosting arrangement that is a service contract using the guidance in Subtopic 350-40. The accounting for the hosting fees associated with the hosting arrangement is not affected by this consensus and, accordingly, the hosting fees are expensed as the service is provided.

36. In reaching this consensus, the Task Force noted that an entity may incur significant costs when implementing a hosting arrangement that is a service contract, which may indicate a future benefit to the entity beyond the period over which the implementation services are performed. In a service contract, while the right to receive the service and the obligation to pay for the service as the service is provided are not recognized on the balance sheet, the Task Force observed that certain costs to implement the hosting arrangement enhance the unrecognized right to receive the related service. Accordingly, the Task Force decided that the implementation costs of a hosting arrangement that is a service contract could be attached to the service contract and, therefore, should be capitalized as an asset and recognized over a period longer than the period over which the implementation services are provided. That is, those capitalized costs, while not representative of an asset on a standalone basis, result in an increase in future benefits to be received under the hosting arrangement, thus resulting in an asset related to the service contract. While overall the Board and Task Force members concluded that it is important that guidance be developed in a manner in which the outcome is both relevant to investors' needs and responsive to preparers' ability to apply the guidance, some Task Force members weighed the expected costs and expected benefits differently in determining the consensus and its interaction with the FASB conceptual framework. In determining the consensus, the Task Force decided that it represents a practical solution that addresses the original concern that was raised to the Task Force and that it is responsive to the unique characteristics of hosting arrangements that are service contracts.

37. The Task Force noted that implementation costs capitalized under the amendments in the Update resulting from this Issue relate to the rights and obligations embedded in a hosting arrangement (which are not recognized separately as assets and liabilities) for which the entity has the right to use and that this is similar to other contract-related assets. For example, under Subtopic 340-40 on other assets and deferred costs for contracts with customers, costs that relate to a specific contract and that are expected to be recovered are recognized as an asset if they generate or enhance resources of the entity that will be used in fulfilling the contract in the future. This guidance results in the capitalization of costs that cannot be capitalized in accordance with other GAAP and that are not added to the measurement of another asset. They merely generate a resource for the entity. The Task Force concluded that the result of the implementation costs of a hosting arrangement generates a resource for the entity that is used in connection with the hosting arrangement.

Issue 2: Amortization Period

38. The Task Force also reached a consensus to require entities to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangement, which includes customer renewal options that are reasonably certain to be exercised and all contractual renewal options controlled by the vendor. The Task Force concluded that including reasonably certain renewals to determine the period over which the costs are expensed represents the expected period of benefit of the enhanced right that is expected to be realized from the hosting arrangement. The Task Force also concluded that this is reasonably consistent with the period over which capitalized costs are recognized as an expense for implementation costs of hosting arrangements that contain a license.

39. The Task Force decided to require entities to record the expense related to the implementation costs in the same line item in the statement of income as the expense for fees for the hosting arrangement (and, accordingly, the amortization expense related to those implementation costs should not be presented along with depreciation or amortization expense related to property, plant, and equipment and intangible assets if such depreciation or amortization is presented separately from its functional classification), to present the capitalized implementation costs in the same line item in the statement of financial position as a prepayment of the fees for the associated hosting arrangement, and to classify the cash flows from capitalized implementation costs in the same manner as the cash flows for the fees for the associated hosting arrangement. This is because the asset recognized for the implementation costs is recognized only as a result of enhancing the value of the hosting service, which itself is not recognized as an asset. Thus, although the implementation costs are recognized as a standalone asset, the future benefit derived from that asset is linked to the benefit derived from the hosting service, which is expensed as incurred.

40. The Task Force reached a consensus to clarify how to account for impairment and abandonment of capitalized implementation costs for a hosting arrangement that is a service contract by requiring an entity to apply the guidance in Subtopic 350-40 (which references the impairment model in Subtopic 360-10 on property, plant, and equipment). The Task Force decided that applying the same impairment model to both internal-use software (which includes the costs to implement that developed or acquired software) and capitalized implementation costs of a hosting arrangement that is a service contract should reduce complexity for preparers because

capitalized implementation costs of a hosting arrangement that is a service contract and internal-use software may be included in the same asset group for impairment purposes. The Task Force also decided to clarify that an entity is required to evaluate the capitalized implementation costs of each module or component of a hosting arrangement that is a service contract for abandonment. This decision is consistent with the Task Force's decision to amortize separately the capitalized implementation costs of certain modules or components of a hosting arrangement that is a service contract. In the Task Force's view, it should reduce potential diversity in practice as to when impairment losses are recognized and how to account for the abandonment of capitalized implementation cost assets. The amendments in the Update resulting from this Issue related to abandonment require that a loss be recorded for capitalized implementation costs that no longer provide a future benefit in cases in which a module or component is no longer used while the core hosted software continues to be used.

Issue 3: Definition of Implementation Costs

41. The Task Force decided that there was no need to provide a definition of the term implementation costs. The Task Force observed that adding a description of the different types of implementation costs could be helpful but decided it was not necessary because Subtopic 350-40 already has appropriate guidance that entities currently apply in practice.

Issue 4: Scope of the Issue

42. The Task Force reached a consensus to amend the definition of *hosting arrangement* in the Master Glossary to remove the reference to licensing and the requirement that the software application resides on the vendor's or a third party's hardware. The Task Force noted that the definition of hosting arrangement used the phrase *licensing of software*, which would have potentially limited the number of arrangements to which the guidance in the amendments in the Update resulting from this Issue applies because many hosting arrangements do not provide the customer with a license to the underlying software. The Task Force also noted that the key characteristic in a hosting arrangement is that the customer does not have possession of the software at the date of the evaluation of the scope of Subtopic 350-40; it is not where the software resides at that date.

43. The Task Force discussed whether to add guidance to limit the scope of the amendments to service contracts in which the hosting arrangement is more than minor. The purpose of that guidance was to reduce the costs of implementing internal controls over financial reporting related to analyzing all service arrangements to determine whether a hosting arrangement, as defined in the Master Glossary, is included in the service arrangement. The Task Force decided not to propose guidance to limit the scope of the amendments but asked respondents to the proposed Update to provide feedback on the issue. While some respondents indicated that clarifying the guidance on scope would be beneficial, most respondents indicated that it was not necessary. Paragraph 350-40-30-4 (as amended in the Update resulting from this Issue) provides guidance on separating multiple elements in an arrangement, and paragraph 105-10-05-6 states that the provisions of the Codification need not be applied to immaterial items. Therefore, the Task Force concluded that existing guidance sufficiently addresses the issue and decided not to provide guidance to limit the

scope of the amendments resulting from this Issue to service contracts in which the hosting arrangement is more than minor.

Issue 5: Analogy to Other Service Contracts

44. Although the Task Force intended for the scope of the amendments in the Update resulting from this Issue to be narrowly applied to implementation costs of hosting arrangements that are service contracts, the Task Force discussed and decided to remain silent on whether an entity may apply the guidance in those amendments by analogy to other transactions and activities. The Task Force noted that explicitly disallowing an analogy to Subtopic 350-40 would not be effective because the guidance in the amendments in the Update resulting from this Issue is based, in part, on an analogy to the guidance in Subtopic 340-40. If the Task Force decided to disallow an analogy to Subtopic 350-40, an entity could still analogize to Subtopic 340-40 on the same basis as the guidance in the amendments in the Update resulting from this Issue. Some Task Force members also believe that few, if any, arrangements are similar to hosting arrangements. As a result, there may not be many transactions for which an entity would attempt to analogize to Subtopic 350-40.

Issue 6: Disclosures

45. The Task Force reached a consensus that the existing disclosures in paragraph 350-40-50-1 are sufficient to provide information to users about implementation costs of a hosting arrangement that is a service contract, supplemented by a description of the nature of an entity's hosting arrangements that are service contracts. The Task Force concluded that those disclosures will provide users with information about the type and amount of implementation costs capitalized as well as information about the subsequent measurement of those costs. The proposed Update would have required several new disclosures for hosting arrangements that are service contracts. Those disclosures would have been applied to other transactions within the scope of Subtopic 350-40, not just hosting arrangements that are service contracts. A majority of respondents did not support applying those proposed disclosures to internal-use software. The Task Force decided not to finalize those proposed disclosures, except for the requirement to disclose the nature of an entity's hosting arrangements that are service contracts, because the disclosure requirements for internal-use software already provide sufficient and similar information for all transactions within the scope of Subtopic 350-40.

Issue 7: Transition

46. The Task Force reached a consensus to allow entities to choose between prospective transition and retrospective transition when adopting the guidance in the amendments in the Update resulting from this Issue. Under prospective transition, an entity applies the guidance to any costs for implementation activities performed after the date of adoption. The Task Force decided that a prospective transition approach based on costs for activities performed after the date of adoption will result in increased comparability among entities for the treatment of any implementation costs incurred after the date of adoption. Otherwise, two entities that enter into hosting arrangements that require a long implementation period could have different accounting for the costs for several years if, for example, one entered into a hosting arrangement shortly before the adoption date and one entered into a hosting arrangement shortly after the adoption date. The Task Force understands

that the benefits of retrospective transition may not justify the costs because the effect of retrospective application may not be significant for many entities. However, the Task Force saw no reason to prohibit an entity from retrospectively applying the amendments in the Update resulting from this Issue, and an entity with significant implementation costs during the comparative periods of the financial statements in which the entity adopts the amendments in the Update resulting from this Issue may believe that retrospective application provides more useful information.

<u>Issue 8: Transition Disclosures</u>

47. The Task Force reached a consensus to require different transition disclosure requirements depending on the transition method elected. For prospective transition, an entity is required to disclose the nature of and reason for the accounting change, the transition method, and a qualitative description of the financial statement line items affected by the change. For retrospective transition, the disclosure requirements at transition include all of the requirements for prospective transition plus quantitative information about the effects of the accounting change. The Task Force decided that the benefits of requiring quantitative disclosure of the effect of the amendments in the Update resulting from this Issue for prospective transition do not justify the costs. The transition disclosures are in lieu of those required in paragraphs 250-10-50-1 through 50-3.

<u>Issue 9: Effective Date and Early Adoption</u>

48. The Task Force decided that the amendments in the Update resulting from this Issue should be effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. For all other entities, the amendments are effective for all fiscal years beginning after December 15, 2020, and all interim periods beginning after December 15, 2021. Early adoption is permitted, including adoption in an interim period.

Board Ratification

49. At its June 27, 2018 Board meeting, the Board ratified the consensus reached by the Task Force on this Issue and directed the staff to draft a final Update reflecting the consensus for vote by written ballot.

Status

50. No further EITF discussion is planned.

Issue No. 18-A

Title: Recognition Under Topic 805 for an Assumed Liability in a Revenue Contract

Date Discussed: June 7, 2018

Background

1. Topic 805 provides guidance on the accounting for business combinations. In applying the acquisition method in Topic 805, an acquirer recognizes identifiable assets acquired and liabilities assumed in a business combination and generally measures those assets and liabilities at fair value. Paragraph 805-20-25-2 provides further guidance on the recognition criteria. It states that for an identifiable asset or liability assumed to be recognized in a business combination, it must meet the definition of an asset or liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Concepts Statement 6 defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." The definition in Concepts Statement 6 also clarifies that a present obligation is broader than a legal obligation.

2. EITF Issue No. 01-3, "Accounting in a Business Combination for Deferred Revenue of an Acquiree," provided specific guidance on the accounting for deferred revenue in a business combination. Issue 01-3 required an acquiring entity to 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. Issue 01-3 was superseded by FASB Statement No. 141 (revised 2007), *Business Combinations,* which did not include specific guidance on the recognition of deferred revenue as a liability assumed in a business combination. Rather, Statement 141(R) referenced the definition of a liability in Concepts Statement 6 (that guidance is now codified in paragraph 805-20-25-2).

3. Although Statement 141(R) superseded the guidance in Issue 01-3, stakeholders indicated that practice generally continued to apply the concepts in Issue 01-3, including use of 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.

4. In May 2014, the FASB issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606),* which provides a single comprehensive accounting model on revenue recognition for contracts with customers. Among other things, Topic 606 defined a performance obligation as "a promise in a contract with a customer to transfer to the customer either: (a) a good or service (or a bundle of goods or services) that is distinct or (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer." Distinct goods or services may not be explicitly stated in the contract and can include goods or services that are implied by an entity's customary business practices, which do not need to be legally enforceable.

5. Stakeholders have indicated that after Topic 606 is adopted, there is diversity in views on how an acquirer would evaluate revenue contracts with customers in a business combination. Some

stakeholders believe that an entity should use the Topic 606 performance obligation definition to determine whether a liability in a revenue contract is a liability assumed that is recognized in the business combination, and other stakeholders believe that an entity should continue to use the legal obligation concept when applying the guidance in Topic 805.

6. On March 28, 2018, the Board added a narrow scope Issue to the EITF agenda to reduce the diversity that might arise when evaluating whether to recognize a liability from a revenue contract with a customer that is acquired in a business combination after an entity has adopted Topic 606. In addition, stakeholders have indicated that questions may arise under Topic 606 about measurement of revenue contracts with customers in a business combination. The Board asked the EITF to also consider those measurement issues.

Issues

7. The following issues were included in Issue Summary No. 1, dated May 24, 2018:

Issue 1: Recognition for an Assumed Liability in a Revenue Contract
Issue 2: Measurement for an Assumed Liability in a Revenue Contract in a Business Combination.

8. Issues 1 and 2 were discussed at the June 7, 2018 EITF meeting.

Current EITF Discussion

<u>Issue 1: Recognition for an Assumed Liability in a Revenue Contract</u>

9. The Task Force reached a consensus-for-exposure that would require an entity to use the Topic 606 performance obligation definition to determine whether an assumed contract liability from a revenue contract with a customer represents a liability assumed that is recognized in a business combination at the acquisition date. An entity would evaluate whether it has a liability for a revenue contract that is assumed in a business combination because the acquiree has a contract liability (that is, it has been paid for goods or services that have not been transferred to the customer). The acquirer would not recognize a liability for goods or services that have not been transferred to the customer and for which no payment has been received, except in cases in which the acquiree has recognized a receivable.

10. In reaching this consensus-for-exposure, the Task Force considered both the Topic 606 performance obligation concept and the superseded legal obligation concept as potential alternatives. The Task Force discussed the use of the legal obligation concept alternative in current practice before the adoption of Topic 606 and observed that Topic 606 did not consequentially amend Topic 805, which requires that a liability recognized in a business combination meet the definition of a liability in Concepts Statement 6. The Task Force rejected that alternative because it believes that the use of the definition of performance obligation better aligns with current guidance already included in the Codification and would be consistent between both Topic 606 and Topic 805 (that is, for the identification of an obligation for a revenue contract). In addition, the Task Force also observed that the Topic 606 performance obligation concept may be less complex to apply and is more consistent with the definition of a liability in Concepts Statement 6.

11. The Task Force indicated that in most situations the recognition conclusion under either a Topic 606 performance obligation alternative or a legal obligation alternative would be the same, but the Task Force acknowledged that there may be circumstances in which the recognition conclusion could be different, such as for symbolic licenses or goods or services that are provided as a customary business practice because the entity is not legally obligated to perform in those situations. For situations in which the Topic 606 performance obligation does not represent a legal obligation, the Task Force noted that in many cases the fair value measurement of the performance obligation may be minimal or zero because of the nature of the activity or activities that the acquirer would be performing. See the discussion on measurement considerations in paragraphs 13 through 18.

12. The Task Force also considered whether the timing of the payment of consideration or payment terms should affect the amount of revenue recognized by the acquirer related to the acquired revenue contract.

<u>Issue 2: Measurement for an Assumed Liability in a Revenue Contract in a Business Combination</u>

13. In addition to the recognition issue, stakeholders indicated that questions may arise after the adoption of Topic 606 about how to determine the fair value of a contract liability when applying the acquisition method. As a result, at its March 28, 2018 meeting, the Board directed the Task Force to consider the following measurement issues to provide educational information to stakeholders:

a. May the acquirer determine the fair value of a contract liability recognized in the business combination using the amount as determined by the acquiree in its revenue accounting (that is, a carryover basis)?
b. Should the acquirer consider the other assets and liabilities in the acquired set when determining the value of a contract liability acquired in a business combination?

14. The Task Force reached a consensus-for-exposure on the first measurement question that it would be inappropriate for an acquirer to default to using a carryover basis (that is, recording the liability on the acquirer's balance sheet equal to the amount of deferred revenue on the acquiree's balance sheet immediately preceding the business combination date) when measuring an assumed liability in a revenue contract because that would be inconsistent with the measurement guidance in Topic 805. The measurement principle in paragraph 805-20-30-1 states that an acquirer must measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values. That principle exists for all assets and liabilities acquired in a business combination under Topic 805, with some exceptions that are specified in that Topic. The Task Force noted that an exception to the fair value measurement principle in Topic 805 is not necessary for an assumed liability in a revenue contract acquired in a business combination.

15. In determining the fair value of a contract liability acquired in a business combination, the Task Force noted that the acquirer would measure the fair value of the remaining or unfulfilled performance obligation, as defined under Topic 606, that it has assumed from the acquiree. In determining the fair value of the unfulfilled performance obligation, the acquirer would consider

only activities the acquirer will perform after the business combination that directly relate to the acquired contract. That is, it would not consider the overall activities the acquirer would undertake irrespective of the acquired contract or activities already performed by the acquiree that the acquirer would not perform.

16. The second measurement question focuses on what should be included in the fair value measurement and not how an entity would determine fair value. The Task Force noted that how to measure those costs is covered in the guidance in Topic 820, Fair Value Measurement, and is outside the scope of this Issue.

17. The Task Force considered two potential alternatives to determine the fair value of an assumed contract liability:

a. *Consider the assets and liabilities in the acquired set*. This alternative would consider assets included in the acquired set when measuring the fair value of a contract liability recognized in a business combination. For example, if a contract liability is recognized in a business combination for an in-process license arrangement, the measurement of that contract liability would not assume that the acquirer would have to obtain the related intellectual property in order to perform under the acquired contract because that intellectual property was included in the acquired set. This would result in a "net" valuation of the liability as opposed to including an amount for the value of the intellectual property in both the asset and liability.
b. *Do not consider the other assets and liabilities in the acquired set.* This alternative would consider the contract liability in isolation from any related asset needed to satisfy the performance obligation in the acquired contract even if the asset was included in the acquired set. For example, if a contract liability is recognized in a business combination for an in-process license arrangement, the measurement of that contract liability would assume that the acquirer would have to obtain the underlying intellectual property in order to perform under the acquired contract. This would result in gross measurements of the asset and the liability on the balance sheet.

18. The Task Force reached a consensus-for-exposure that an acquirer would consider the assets and liabilities in the acquired set when determining the fair value of an assumed contract liability because ignoring an asset in the acquired set that is necessary to fulfill the liability would not be appropriate when the asset and liability have been acquired and assumed, respectively, together. The Task Force indicated that a buyer generally would not assume an obligation in a business combination to perform under a contract without also purchasing the asset needed to fulfill that contract. Therefore, the Task Force noted that it would be appropriate to value that obligation after considering the related asset. In reaching this consensus-for-exposure, the Task Force indicated that it would not want to allow an acquirer to recognize higher revenue after a business combination because of a valuation technique used to measure a contract liability.

<u>Transition</u>

19. The Task Force did not propose an effective date for any proposed amendments resulting from this Issue. Consequently, the Task Force will take into consideration the comments received on any proposed amendments before determining when those amendments would be effective.

20. The Task Force reached a consensus-for-exposure that would require that an entity apply the proposed amendments prospectively to all business combinations that occur after the proposed amendments are effective. The Task Force indicated that allowing a choice between prospective transition or modified retrospective transition would result in unnecessary costs and added complexity for preparers particularly because the Task Force noted that the financial reporting outcome resulting from the proposed amendments should not be materially different from current practice. In reaching this consensus-for-exposure, the Task Force also considered previous amendments to Topic 805, which generally followed a prospective transition method.

Transition Disclosures

21. The Task Force also reached a consensus-for-exposure not to require any transition disclosures in the period of adoption because the Task Force believes that the disclosures would not provide incremental information that would be useful to users of financial statements and therefore would result in unnecessary costs for preparers.

Board Ratification

22. At its June 27, 2018 Board meeting, the Board ratified the consensus-for-exposure reached by the Task Force on this Issue and directed the FASB staff to draft a proposed Update reflecting the consensus-for-exposure for vote by written ballot.

Status

23. Task Force members identified potential unintended consequences of the decisions reached at the June 7, 2018 meeting when reviewing a draft of the proposed Update. Therefore, individual Task Force members recommended that the Issue be further discussed by the Task Force prior to the issuance of the proposed Update. The Issue will be discussed at a future EITF meeting.

Issue No. 18-B

Title: Improvements to Accounting for Episodic Television Series

Date Discussed: June 7, 2018

Background

1. Subtopic 926-20, Entertainment—Films—Other Assets—Film Costs, includes guidance that originated from AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films,* issued in 2000. Subtopic 926-20 provides two capitalization models, one for films and one for episodic content. Production costs for films are fully capitalized but production costs for episodic television series are subject to a constraint. That constraint specifies that capitalized costs cannot exceed the amount of revenue contracted for each episode until an entity can establish estimates of secondary market revenue. This distinction was established to address the risks inherent in producing episodic content through deficit funding arrangements, which often had a high risk of failure. In those arrangements, the licensing fee paid by the initial network exhibiting the show did not cover production costs and most revenues were generated in the secondary market upon syndication. Therefore, the current accounting guidance precludes an entity from capitalizing all production costs related to episodic television content until it can support the expectation that the series will make it to syndication to recover those production costs and potentially earn a return.

2. Since the issuance of the guidance in SOP 00-2, the entertainment industry has experienced significant changes to its production and distribution models that were not contemplated when that guidance was developed. For example, the internet has introduced new distribution channels and new participants into the industry with different business models and indirect revenues, such as subscription-based services.

3. As a result, the Board added an Issue to the EITF agenda to consider the cost capitalization guidance for episodic television series in Subtopic 926-20 and, specifically, whether financial reporting under the current model is still relevant given the changes in the media and entertainment industry. The Board also requested that the Task Force consider whether any changes made to the cost capitalization guidance as a result of this Issue would require changes to the amortization, impairment, and disclosure requirements in Subtopic 926-20.

4. Given the industry-specific nature of this Issue, a working group was formed to assist the Task Force in understanding the industry, the relevant issues, and potential solutions. The working group had one meeting prior to the June 7, 2018 EITF meeting and contributed to the issues and solutions that were included in Issue Summary No. 1.

Issues

5. The following issues were included in Issue Summary No. 1, dated June 7, 2018:

Issue 1: Cost Capitalization
Issue 2: Amortization
Issue 3: Unit of Account for Impairment
Issue 4: Impairment Indicators

Issue 5: Model Used for Measuring Impairment under Subtopic 926-20 and Subtopic 920-350, Entertainment—Broadcasters—Intangibles—Goodwill and Other
Issue 6: Presentation and Disclosures
Issue 7: Transition
Issue 8: Transition Disclosures
Issue 9: Private Company Considerations.

6. At the June 7, 2018 EITF meeting, the Task Force discussed Issues 1 through 6. Issues 7 through 9 were not discussed and will be discussed at a future meeting.

Current EITF Discussion

Issue 1 – Cost Capitalization

7. Issue 1 is whether the capitalization model in Subtopic 926-20 for episodic television series is still relevant considering changes in the production and distribution models within the media and entertainment industry since the guidance was originally issued. Currently, the guidance in Subtopic 926-20 provides a capitalization model for episodic content that is different from the model for film; that is, production costs for episodic content are capitalized subject to a constraint based on contracted revenues in the initial and secondary markets, while film production costs are fully capitalized. At the June 7, 2018 meeting, the Task Force considered the following two alternatives for Issue 1:

> **Alternative 1A**—Align the cost capitalization guidance for episodic content with the guidance for films by removing the content distinction
>
> **Alternative 1B**—Maintain the current cost capitalization guidance for episodic content but provide an exception when the entity does not produce episodic content via a deficit-funding arrangement.

8. The Task Force reached a tentative conclusion to align the cost capitalization guidance for episodic content with the guidance for films by removing the content distinction (Alternative 1A). In reaching its tentative conclusion, the Task Force noted that over time, the current business models, monetization strategies, and risks associated with producing episodic content have become similar in nature to those for film content. The Task Force acknowledged that having two different cost capitalization models was more reflective of the business environment that existed when SOP 00-2 was developed because at that time the level of integration between studios and distribution channels was limited. The Task Force noted that today's environment offers more distribution channels for the initial distribution of episodic content compared with the environment that existed 20 years ago because it now offers online video distribution (OVD) streaming platforms, immediate access to international distribution channels, and direct-to-consumer (DTC) streaming platforms. The availability of these additional distribution channels significantly reduces a producer's risk of not being able to eventually recover all the initial production costs for episodic content. The Task Force observed that the current guidance no longer accurately reflects the economics of episodic content production considering those changes and therefore supports a single capitalization model for both types of content.

9. The Task Force noted that a single capitalization model would eliminate complexities in the application of current guidance for capitalization, including the challenges experienced by stakeholders in identifying initial and secondary markets and allocating indirect subscription-based revenues to individual series. The Task Force also noted that Alternative 1A was recommended by the working group and outreach participants during pre-agenda research.

Issue 2: Amortization

10. Issue 2 is whether additional guidance is necessary to apply the existing amortization requirements in Subtopic 926-20 to content with no direct revenue. Under Subtopic 926-20, entities are required to amortize their produced content by using the individual-film-forecast-computation method that requires an entity to estimate ultimate revenues. In the absence of revenues from third parties, entities are required to amortize their produced content in a manner that best reflects the use of that content. The Task Force considered the following two alternatives to resolve Issue 2:

> **Alternative 2A**—Maintain current industry guidance (no standard-setting is necessary)
>
> **Alternative 2B**—Amend the amortization guidance in Subtopic 926-20 to provide more prescriptive guidance on viewership and the use of amortization curves.

11. The Task Force reached a tentative conclusion on Alternative 2A to maintain current industry guidance. Based on feedback received from the working group, the Task Force noted that entities with no direct contracted revenue apply the amortization guidance in paragraph 926-20-35-2 by using viewership curves as an estimate of the use of a title. Viewership curves are established by pooling historical viewership data for different types or genres of content and are reviewed periodically.

12. In current practice, because paragraph 926-20-35-2 is generally applied consistently in a manner that best reflects the use of the content, the Task Force did not observe a need for amendments to the guidance or a need to provide more prescriptive guidance for entities with indirect revenues (for example, by explicitly requiring the use of viewership curves). Consistent with feedback from the working group, the Task Force noted that flexibility and judgment in the model is necessary to allow entities to amortize their content in the manner that they believe best represents the use for that content. For example, the Task Force was concerned that adding prescriptive guidance could prevent entities from adopting a different estimate of the use of a title if viewership no longer is the most relevant indicator.

Issues 3-5: Unit of Account, Impairment Indicators, and the Impairment Model

13. The Task Force discussed Issues 3 through 5 together because the three issues are interrelated and all relate to impairment. Issue 3, on unit of account, considers whether to address the challenges encountered by entities with no direct contracted revenue in performing the impairment test at the individual film level (for example, one alternative discussed is to apply the impairment model to the lowest level of identifiable cash flows, which may be a portfolio of content). Issue 4,

on impairment indicators, considers whether additional indicators are needed to evaluate the performance of a film after its release. Issue 5, which is on the impairment model, considers whether the same impairment model should be applied to both produced content in Subtopic 926-20 and licensed content in Subtopic 920-350, Entertainment—Broadcasters, Intangibles—Goodwill and Other.

14. The Task Force did not reach a tentative conclusion on any of these three issues. In discussing the unit of account for the impairment assessment, certain Task Force members acknowledged that a higher-level unit of account for impairment may not ever result in an impairment loss when the lowest level of identifiable cash flows is the entity's entire business. Therefore, the Task Force discussed whether certain impairment indicators should result in the reevaluation of the amortization calculation or the useful life of a film in situations in which an impairment loss is not required. The Task Force also noted that the proposed impairment indicators would be applied to individual films but, under one alternative, entities would determine whether an impairment loss is necessary at the lowest level of identifiable cash flows. Some Task Force members expressed concerns about utilizing a different unit of account for the impairment indicators than the determination of the need for an impairment loss. Certain Task Force members suggested that in the case of a producer with a large portfolio of films for which the unit of account is the entire portfolio of films, one impairment indicator likely would be met by at least one film each reporting period. As a result, the entire portfolio would need to be tested for impairment each reporting period, which would increase the cost of applying the guidance and limit the usefulness of the indicators. The Task Force also discussed whether a fair value or net realizable value impairment model for both Subtopic 920-350 and Subtopic 926-20 would be appropriate, with many Task Force members indicating that a fair value model would be appropriate.

15. No tentative conclusions were reached on impairment. Task Force members requested that the FASB staff work with the working group to discuss the operability of the proposed alternatives, changing the unit of account for impairment from an individual film level to a pooled level and how entities with different business models would determine the unit of account and evaluate the indicators. Some Task Force members generally supported the recommendations in Issue Summary No. 1 on these issues but noted that illustrative examples and feedback from the working group would be helpful to understand how the proposed solutions would be applied to different business models. The Task Force also asked the staff to work with the working group to provide additional feedback on how the impairment assessment would interact with the amortization guidance.

Issue 6: Presentation and Disclosures

16. The Task Force provided limited feedback on Issue 6 and requested that the FASB staff solicit feedback from the working group to assess the staff's proposed presentation and disclosures requirements.

Status

17. Further discussion is expected at a future EITF meeting.