

EITF ABSTRACTS

Issue No. 97-15

Title: Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination

Dates Discussed: March 18-19, 1998; May 21, 1998

References: FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*
FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
FASB Statement No. 141, *Business Combinations*
FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
APB Opinion No. 16, *Business Combinations*

ISSUE

A purchase business combination agreement may contain a provision in which the purchaser agrees to pay cash or some other form of consideration to the seller at a future date if the securities issued to effect the combination are not worth a specified amount at some future date. In some situations, the purchase agreement may include an arrangement for the purchaser to issue additional consideration to the seller that guarantees a minimum value or security price at a future date that is less than the value or security price at the date such securities are issued (a "below-market guarantee"). The following example illustrates a below-market guarantee.

Example 1: Assume Company A acquires Company B for 100,000 shares of Company A stock, which is valued at \$10 per share at the date of acquisition. In the purchase

agreement, Company A agrees that if its share price is below \$8 one year after the combination, then Company A will issue additional shares to make up the deficiency below \$8 per share. In substance, Company A guarantees that the *total consideration* to be issued in the business combination will have a *minimum value* of \$800,000 in 1 year (which is less than the \$1,000,000 value of the consideration issued at the date of acquisition).

In other situations, the purchase agreement may include an arrangement for the purchaser to issue additional consideration to the seller based on security prices at a future date in which the amount of additional consideration to be issued is limited so that the total value of all consideration to be issued is not determinable at the date of the acquisition. That is, the contingency arrangement is based on security prices and does not result in a guarantee of the minimum value of the total consideration, but, rather, provides for additional consideration to be issued should the value of the shares originally issued be less than a target value. The following examples illustrate these types of contingency arrangements.

Example 2: Assume Company A acquires Company B for 100,000 shares of Company A stock, which is valued at \$10 per share at the date of acquisition. In the purchase agreement, Company A agrees to issue 25,000 additional shares if the price of Company A stock is \$16 or less per share 3 years from the date of acquisition. The number of additional shares issuable falls from 25,000 to zero as the share price increases from \$16 to \$20 per share. In substance, Company A is obligated to issue additional consideration for the acquired business if the original consideration is worth less than the \$2,000,000 target value in 3 years.

Example 3: Assume Company A acquires Company B for 100,000 shares of Company A stock, which is valued at \$10 per share at the date of acquisition. In the purchase

agreement, Company A agrees to issue 250,000 additional shares if the price of Company A stock is \$4 or less per share 3 years from the date of acquisition. The number of additional shares issuable falls from 250,000 to zero as the share price increases from \$4 to \$20, with the total fair value of the additional shares to be issued limited to \$1,000,000 at the date issued. In substance, Company A is obligated to issue additional consideration for the acquired business if the original consideration is worth less than the \$2,000,000 target value in 3 years.

Example 4: Assumed Company A acquires Company B for 100,000 shares of Company A stock, which is valued at \$10 per share at the date of acquisition. In the purchase agreement, Company A agrees to issue 25,000 additional shares if the price of Company A stock is \$8 or less per share 3 years from the date of acquisition. The number of additional shares issuable falls from 25,000 to zero as the stock price increases from \$8 to \$10. In substance, Company A is obligated to issue additional consideration for the acquired business if the original consideration is worth less than the \$1,000,000 target value in 3 years.

Paragraph 79 of Opinion 16 provides that, in general, the issuance of additional securities or distribution of other consideration at resolution of contingencies based on security prices does not change the recorded cost of an acquired entity. Paragraphs 81 and 82 specify the appropriate accounting when the contingency agreement represents a guarantee that the price of the securities issued unconditionally will be maintained or a higher security price will be achieved at a later date. Under paragraphs 81 and 82, the securities issued unconditionally at the date of the combination are recorded at the guaranteed amount as the cost of the acquired company. That amount represents the entire purchase price including contingent consideration. [Note: See STATUS section.]

It is not clear how the provisions of paragraphs 81 and 82 of Opinion 16 apply to the types of arrangements discussed above. Application of the guidance in paragraphs 81 and 82 either is not possible or, as in the case of a below-market guarantee, could produce anomalous results.

The issues are:

1. How contingent consideration based on a future security price should be recorded when the contingency arrangement based on security prices guarantees a future security price that is below the price of such securities at the date of the combination
2. How contingent consideration based on a future security price should be recorded when the contingency arrangement based on security prices does not result in a guarantee of the minimum value of the total consideration.

EITF DISCUSSION

The Task Force reached a consensus that:

1. In the case of a below-market guarantee (whether that guaranteed minimum value is stated in or implied by the contingency arrangement), the consideration issued unconditionally at the date of the combination should be recorded at fair value at the date of acquisition.¹ The payment or issuance of any additional consideration resulting from the guarantee would not change the recorded cost of the acquisition. In Example 1 above, the purchase price would be \$1,000,000 (100,000 shares issued unconditionally at \$10 per share). [Note: See STATUS section.]
2. In the case of a contingency arrangement based on security prices that does not result in a guarantee of the minimum value of the total consideration, the cost of the acquisition should be recorded at an amount equal to the maximum number of shares that could be issued multiplied by the fair value per share at the date of acquisition,² but should not exceed the target value (that is, the lowest total value at which additional consideration would not be required to be issued) of the consideration issued at the date of acquisition if that amount is limited (whether that target value is stated in or implied by the contingency arrangement). That is, the cost of the acquisition should be recorded at an amount equal to the lower of the

¹Issue No. 99-12, "Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination," provides additional guidance for determining what date should be used to value marketable equity securities issued to effect a business combination accounted for using the purchase method.

²Refer to footnote 1.

target value and the maximum number of shares that could be issued multiplied by the fair value per share at the date of acquisition. The payment or issuance of any additional consideration resulting from the contingency would not change the recorded cost of the acquisition. In Example 2, the purchase price would be \$1,250,000 (the lower of 125,000 maximum shares that could be issued at \$10 per share and the target value of \$2,000,000). In Example 3, the purchase price would be \$2,000,000 (the lower of 350,000 maximum shares that could be issued at \$10 per share and the target value of \$2,000,000). In Example 4, the purchase price would be \$1,000,000 (the lower of 125,000 maximum shares that could be issued at \$10 per share and the target value of \$1,000,000).

STATUS

Statement 133 was issued in June 1998 and was amended by Statements 137, 138, and 149. The effective date for Statement 133, as amended, is for all fiscal quarters of all fiscal years beginning after June 15, 2000.

The instrument in this Issue may be a hybrid instrument that contains an embedded derivative subject to the provisions of paragraph 12 of Statement 133 for the holder. Under Statement 133, if the option is indexed to the issuer's stock, the option (related to receiving contingent consideration) would be clearly and closely related to the host contract (an equity instrument of the issuer) and therefore not separately accounted for by the issuer or holder. Additionally, from the issuer's standpoint, the exclusions provided by paragraphs 11(a) and 11(c) would be applicable. Contingent consideration discussed in this Issue would continue to be subject to the consensus in Issue 97-15 if not subject to Statement 133.

Statement 141, which supersedes Opinion 16, was issued in June 2001. Paragraphs 79, 81, and 82 of Opinion 16 have been carried forward without reconsideration in paragraphs 27, 29, and 30 of Statement 141. Statement 141 does not impact any of the consensus reached in this Issue.

Interpretation 45, which was issued in November 2002, requires a guarantor to recognize, at inception of the guarantee, a liability for the obligation undertaken in issuing the guarantee. The Interpretation also elaborates on the disclosures to be made by a guarantor. Paragraph 3 of that Interpretation identifies the characteristics of guarantees that are addressed by that Interpretation. Paragraph 7(c) provides an exemption from the initial recognition and initial measurement requirements for provisions in a business combination to pay contingent consideration (as addressed in Statement 141), and paragraph 7(d) of the Interpretation provides an exemption from its initial recognition and initial measurement requirements for obligations that would be reported as equity under GAAP. However, those provisions are still subject to the Interpretation's disclosure requirements. Interpretation 45 does not impact any of the consensus reached in this Issue.

Statement 150 was issued in May 2003 and is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of a nonpublic entity. Statement 150 establishes standards for issuer's classification and measurement of certain financial instruments with characteristics of both liabilities and equity and requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances).

When recognized, a financial instrument within the scope of Statement 150 that was issued as consideration (whether contingent or noncontingent) in a business combination is classified pursuant to the requirements in that Statement. Statement 150 applies to certain freestanding financial instruments that are settleable by issuance of a variable number of the issuer's equity shares, which may include certain instruments in this Issue. However, the instruments in this Issue may be hybrid instruments that contain embedded derivative features and, if so, Statement 150 does not apply to them. That is because,

under paragraph 15, Statement 150 does not apply to features embedded in a financial instrument that is not a derivative in its entirety.

No further EITF discussion is planned.