FASB Emerging Issues Task Force

Issue No. 09-4

Title: Seller Accounting for Contingent Consideration

Document: Issue Summary No. 1*

Date prepared: May 21, 2009

FASB Staff: Homant (ext. 359)/Inzano (ext. 364)

EITF Liaison: Jay Hanson

Date previously discussed: None

Previously distributed EITF materials: None

References:

FASB Statement No. 5, *Accounting for Contingencies* (Statement 5)

FASB Statement No. 141 (revised 2004), *Business Combination* (Statement 141(R))

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement 133)

FASB Statement No. 160, *Noncontrolling Interest in Consolidated Financial Statements* (Statement 160)

AICPA Accounting Research Bulletin No. 51, Consolidated Financial Statements (ARB 51)

IAS 39, *Financial Instruments: Recognition and Measurement* (IAS 39)

---

* **The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presented to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Background

1. Statement 141(R) requires that a buyer recognize the acquisition-date fair value of contingent consideration, as defined by Statement 141(R), as part of the consideration transferred to the seller in exchange for the acquiree. In addition, Statement 141(R) requires a buyer to remeasure contingent consideration classified as an asset or liability to its fair value through current period earnings (or other comprehensive income if the arrangement is a hedging instrument) each reporting period.

2. While Statement 141(R) does not provide guidance on seller accounting for a business combination, Statement 160, which was issued concurrent with Statement 141(R), amends the guidance in ARB 51, to provide the seller's accounting for the deconsolidation of a subsidiary. In the event that a parent ceases to have a controlling financial interest in a subsidiary (including the sale of a subsidiary) and deconsolidation is required, paragraph 36 of ARB 51 requires that the gain or loss recognized upon deconsolidation of a subsidiary be measured as the difference between (a) the *fair value of any consideration received*, (b) the fair value of any retained noncontrolling investment in the former subsidiary at the date the subsidiary is deconsolidated, (c the carrying amount of any noncontrolling interest in the former subsidiary at the date the subsidiary is deconsolidated, and (d) the carrying amount of the former subsidiary's assets and liabilities. Therefore, Statement 160 requires initial measurement at fair value of contingent consideration received. However, Statement 160 does not address subsequent measurement requirements for the seller's right to additional consideration received in the deconsolidation of a subsidiary.

Accounting Issues and Alternatives

Issue 1: Whether the seller should subsequently remeasure contingent consideration that is not accounted for as a derivative, at fair value through current period earnings.

View A: Subsequently remeasure contingent consideration to fair value through current period earnings.

3. Consistent with the buyer's accounting in Statement 141(R), View A proponents believe that a seller in the deconsolidation of a subsidiary should subsequently measure contingent consideration at fair value through current period earnings. Proponents of View A believe that the rationale provided by the Board in Statement 141(R) for requiring a buyer to continually remeasure contingent consideration equally applies to sellers.

4. In paragraph B349 of Statement 141(R), the Board acknowledges that most contingent consideration arrangements are financial instruments and that many meet the definition of a derivative instrument. Statement 141(R) deleted the scope exception in paragraph 11(c) of Statement 133 related to a buyer's accounting for contingent consideration. Paragraph B355 of Statement 141(R) discusses the Board's conclusion that "in concept, all liabilities for contingent consideration should be accounted for similarly," and that all "liabilities for contingent payments not accounted for as derivative instruments should also be remeasured at fair value after the acquisition date." Proponents of View A believe that this argument also applies to the subsequent accounting for a seller's rights to additional consideration in a business combination. Because all contingent consideration arrangements should be accounted for alike and because most are financial instruments, proponents of View A believe that an asset recognized for the right to future consideration in a business combination should also be remeasured to fair value subsequent to the date of acquisition.

5. In addition, proponents of View A believe that a remeasurement model that requires all changes in fair value to be reflected in earnings will result in entities reporting economic gains and losses immediately, thus improving financial statement transparency. Measuring assets and liabilities, specifically financial instruments, at fair value provides more current information about a financial instrument, provides better information about the current wealth of an entity than any other single measure, and provides users with information so that they can assess the entity's prospects for future cash flows.

6. Opponents of View A contend that the Board's decision in Statement 141(R) to require a buyer to subsequently measure contingent consideration arrangements to fair value through current period earnings was an exception made specific to buyers. Because of the inherent

difficulty in subsequently measuring the fair value of contingent consideration, opponents of View A believe that a seller should follow another model that does not require remeasurement at fair value each reporting period.

7. Opponents of View A also believe, consistent with the Board, that contingent consideration received in a business combination is a financial instrument. However, from the seller's view, the right to future consideration usually results in an asset that has similar characteristics of a receivable financial instrument, which is not typically remeasured to fair value through current period earnings each reporting period under current GAAP unless the fair value option is elected. These opponents believe that the accounting consequences for similar assets should be the same.

View B: Do not subsequently remeasure contingent consideration to fair value through current period earnings; account for the contingent consideration received in accordance with Statement 5.

8. Proponents of View B believe that no specific guidance exists requiring a seller to subsequently measure contingent consideration at fair value through current period earnings (unless the contingent consideration arrangement meets the definition of a derivative pursuant to Statement 133).

9. Further, proponents of View B contend that it is not practical for a seller to continually measure contingent consideration at fair value unless required by other applicable GAAP. In many cases, it will be difficult for a seller to determine the fair value of contingent consideration subsequent to the date of acquisition, especially when a seller does not have access to the appropriate information that is necessary to measure the fair value of contingent consideration on a continual basis. Examples of those situations are when the contingent consideration is based on earnings or other performance targets of the former subsidiary and no contractual provisions were included that provide the seller with access to detailed financial information.

10. Proponents of View B believe that the right to future consideration usually results in an asset with similar characteristics of a receivable financial instrument, which is not typically

remeasured to fair value through current period earnings each reporting period. These proponents believe that similar assets should be accounted consistently, resulting in contingent consideration being recognized at its initial fair value and tested for impairment in accordance with paragraph 8 of Statement 5. Increases in the value of the contingent consideration would also be accounted for in accordance with Statement 5 as a gain contingency.

11. Paragraph 8 of Statement 5 requires an estimated loss from a loss contingency to be accrued by a charge to income if both of the following conditions are met:

> a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
> b. The amount of loss can be reasonable estimated.

12. Opponents of View B believe that the remeasurement model required in Statement 141(R) for contingent consideration should also be applicable to sellers. Thus, the seller should remeasure contingent consideration to its fair value through current period earnings each reporting period. Opponents also believe that fair value provides more useful information to users of financial statements.

13. In addition, opponents of View A note there are situations in which the contingent consideration may result in the seller being required to record a liability. Opponents believe that a fair value measurement most faithfully represents this obligation.

14. Finally, opponents of View B do not believe that practicability of a fair value measurement is a sufficient basis for determining whether an asset or liability should be subsequently measured to fair value. In fact, opponents of View B point to the fact that the Board rejected that argument when determining whether contingent consideration should be initially measured at fair value on the date of acquisition. In paragraph B347 of Statement 141(R), the Board acknowledged the difficulty in measuring the fair value of contingent consideration arrangements. However, the Board concluded that "to delay recognition of, or otherwise ignore,

assets or liabilities that are difficult to measure would cause financial reporting to be incomplete and thus diminish its usefulness in making economic decisions." While this reference is from the perspective of the buyer, proponents of View A believe that the same argument applies to subsequent measurement of contingent consideration from the perspective of the seller.

Issue 2: What the required disclosures of seller contingent consideration should be.

Disclosure

15. The FASB staff recommends that the following disclosures be made in annual financial statements for which the seller has a right to additional consideration received in a business combination. This disclosure could be required regardless of the Task Force's conclusion on Issue 1.

> For each annual reporting period after the disposal until the seller collects, sells, or otherwise loses the right to a contingent consideration asset, the seller shall disclose the following information for each material right to additional consideration received:
>
> i. Amount recognized as of the date the seller deconsolidates the subsidiary
> ii. Description of the arrangement and the basis for determining the amount of consideration
> iii. Any change in the recognized amounts, including any differences arising upon settlement
> iv. Any changes in the range of outcomes and reasons for those changes.
>
> If rights to individually immaterial arrangements for additional consideration are material in the aggregate, the information required above shall be disclosed in the aggregate.

Transition and Effective Date

16. The effective date of Statement 141(R) and Statement 160 was for fiscal years beginning after December 15, 2008. If the Task Force reaches a consensus-for-exposure at the June 18, 2009 EITF meeting, a final abstract for this Issue would most likely be issued around October 1,

2009. The staff believes that a consensus on this Issue should be effective for new transactions as soon as possible, given that the effective date of Statement 141(R) and Statement 160 has passed.

17. The Task Force is also being asked what transition should be required for a consensus reached in this Issue.

View A: A consensus should be effective immediately for new transactions. For all other transactions, a consensus should be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2009. The consensus would require retrospective application to deconsolidation transactions for which the transaction date was on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier application by an entity that has previously adopted an alternative accounting policy is permitted.

18. View A proponents believe that many entities may not be able to implement the change in the interim period after the issuance of this Issue. However, they believe that some entities may wish to early adopt. View A opponents believe that early adoption should not be permitted as it may reduce the comparability between different reporting entities.

View A': A consensus should be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2009. The consensus would require retrospective application to deconsolidation transactions for which the transaction date was on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier application by an entity that has previously adopted an alternative accounting policy is not permitted.

19. This view is the same as View A; however, it would not require immediate adoption for new transactions. Proponents believe that View A' allows for the benefit of consistency and comparability for all future transactions and does not result in non-comparability in an annual reporting period. View A' opponents believe that there is generally a lack of comparability

between entities' accounting for asset acquisitions and business combinations as each transaction is unique and therefore a lack of comparability should not be persuasive.

View B: A consensus should be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2009. The guidance in this Issue shall be applied to contingent consideration initially received on or after the effective date of Statement 160. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before initial application of this Issue and the amounts recognized in the statement of financial position at initial application of this Issue. Earlier application by en entity that has previously adopted an alternative accounting policy is not permitted.

20. This view requires the guidance to be adopted through a cumulative effect. View B proponents note that if the Task Force reaches a tentative consensus for View A of Issue 1 that it could require entities who had not previously been remeasuring contingent consideration at fair value through earnings to attempt to determine the fair value of the contingent consideration for prior periods. These opponents believe that the information required to determine the fair value of the contingent consideration in an earlier period may not be available and therefore believe that cumulative effect adoption would be preferable.

International Convergence

21. It is the staff's belief that seller contingent consideration is subsequently remeasured to fair value through current period earnings under IAS 39.

Interaction with Other Board Agenda Projects

22. If the contingent consideration meets the definition of a financial instrument, it may be within the scope of the Board's Financial Instruments: Improvements in Recognition and Measurement project. However, that project does not yet have a defined scope. This Issue is does not appear to be within the scope of any other FASB projects.