FINANCIAL ACCOUNTING SERIES

EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: April 17, 2012
Comments Due: July 16, 2012

Business Combinations (Topic 805)

Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution

a consensus of the FASB Emerging Issues Task Force

This Exposure Draft of a proposed Accounting Standards Update of Topic 805 is issued by the Board for public comment. Written comments should be addressed to:

Technical Director
File Reference No. EITF-12C

Financial Accounting Standards Board
of the Financial Accounting Foundation

The *FASB Accounting Standards Codification*® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft and is requesting comments by July 16, 2012. Interested parties may submit comments in one of two ways:

- Emailing a written letter to director@fasb.org, File Reference No. EITF-12C
- Sending written comments to "Technical Director, File Reference No. EITF-12C, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

Do not send responses by fax.

All comments received are part of the FASB's public file. The FASB will make all comments publicly available by posting them to the online public reference room portion of its website.

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Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

The objective of this proposed Update is to address the diversity in practice about how to subsequently measure an indemnification asset for a government-assisted (Federal Deposit Insurance Corporation or National Credit Union Association) acquisition of a financial institution that includes a loss-sharing agreement (indemnification agreement). Accounting for a business combination requires that at each subsequent reporting date, an acquirer measure an indemnification asset on the same basis as the indemnified liability or asset, subject to any contractual limitations on that amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update would affect all entities that recognize an indemnification asset (in accordance with Subtopic 805-20, Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest) as a result of a government-assisted acquisition of a financial institution.

What Are the Main Provisions?

When a reporting entity recognizes an indemnification asset (in accordance with Subtopic 805-20) as a result of a government-assisted acquisition of a financial institution and subsequently a change in the cash flows expected to be collected on the indemnification asset occurs (as a result of a change in cash flows expected to be collected on the assets subject to indemnification), the reporting entity would be required to subsequently account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification. Any amortization of changes in value would be limited to the contractual term of the indemnification agreement (that is, the lesser of the term of the indemnification agreement and the remaining term of the indemnified assets).

How Would the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

The amendments in this proposed Update would clarify the applicable guidance for subsequently measuring an indemnification asset recognized as a result of a government-assisted acquisition of a financial institution. The Task Force believes that the proposed amendments would resolve current diversity in practice on the subsequent measurement of these types of indemnification assets.

When Would the Amendments Be Effective?

The proposed amendments would be applied prospectively to any new indemnification assets acquired and to changes in expected cash flows of existing indemnification assets arising from a government-assisted acquisition of a financial institution occurring on or after the date of adoption. Early adoption would be permitted. The effective date will be determined after the Task Force considers stakeholder feedback on the proposed Update.

How Do the Proposed Provisions Compare with International Financial Reporting Standards (IFRS)?

IFRS 3, *Business Combinations,* and U.S. GAAP contain the same subsequent measurement guidance for an indemnification asset—that the indemnification asset be subsequently measured on the same basis and subject to any contractual limitations on its amounts. However, the guidance under U.S. GAAP and IFRS for subsequent measurement of items subject to indemnification may not be fully aligned, which would result in differences in the subsequent measurement of the indemnification asset itself. For example, the subsequent measurement guidance for purchased credit-impaired assets is different under U.S. GAAP and IFRS. However, as part of the joint project on accounting for financial instruments, the Boards are deliberating changes to the credit impairment accounting model, which includes financial assets that are purchased at a discount attributable to credit quality. If the guidance under U.S. GAAP and IFRS converge, it may result in convergence of the subsequent measurement of any related indemnification asset recognized as a result of a government-assisted acquisition of a financial institution.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Question 1: When a reporting entity recognizes an indemnification asset (in accordance with Subtopic 805-20) as a result of a government-assisted acquisition of a financial institution and subsequently a change occurs in the cash flows expected to be collected on the asset subject to indemnification, do you agree that (a) the reporting entity should be required to account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification and that (b) any amortization of changes in value should be limited to the contractual term of the indemnification agreement (that is, the lesser of the term of the indemnification agreement and the remaining term of the indemnified assets)? If not, please explain those aspects of the requirement that you disagree with and why.

Question 2: Do you agree that the scope of this proposed Update should be limited to indemnification assets (in accordance with Subtopic 805-20) as a result of a government-assisted acquisition of a financial institution? If not, what other indemnification agreements have arisen in practice that the Task Force should consider for which there are concerns about the interpretations of the terms *on the same basis* and *contractual limitations* as referred to in paragraph 805-20-35-4?

Question 3: If you are a user of financial statements, would the amendments in this proposed Update affect your analysis? If so, please explain how.

Question 4: Do you agree that the proposed amendments should be applied prospectively to any new indemnification assets acquired and to changes in expected cash flows of existing indemnification assets occurring on or after the date of adoption? If not, please explain why.

Question 5: Do you agree that an entity should be permitted to early adopt the proposed amendments? If not, please explain why.

Question 6: How much time is needed to implement the proposed amendments?

Question 7: If the proposed amendments were to be applied either by (a) full retrospective application to all relevant prior periods (when FASB Statement No. 141 (revised 2007), *Business Combinations* [as codified in Topic 805], was initially adopted) by recording a cumulative-effect adjustment to beginning retained earnings for the earliest period presented or (b) recording the cumulative effect of the change to beginning retained earnings in the period of adoption for all arrangements existing at that date, how much time and effort would be necessary to implement the proposed amendments?

Question 8: The proposed amendments would apply to public and nonpublic entities. Should any of the proposed amendments be different for nonpublic entities? If so, please identify those proposed amendments and describe how and why you think they should be different.

Amendments to the *FASB Accounting Standards Codification*®

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2 and 3. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u> and deleted text is ~~struck out~~.

Amendments to Subtopic 805-20

2. Supersede (and move) paragraph 805-20-35-4A and its related heading and add paragraphs 805-20-35-4B through 35-4C and their related headings, with a link to transition paragraph 805-20-65-1, as follows:

Business Combinations—Identifiable Assets and Liabilities, and Any Noncontrolling Interest

Subsequent Measurement

>> Indemnification Assets

805-20-35-4 At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized in accordance with paragraphs 805-20-25-27 through 25-28 at the **acquisition date** on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset.

~~> > Contingent Consideration Arrangements of an Acquiree Assumed by the Acquirer~~

805-20-35-4A <u>Paragraph superseded by Accounting Standards Update 2012-XX.</u> ~~Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in paragraph 805-30-35-1~~. **[Content moved to paragraph 805-20-35-4C]**

> > > Indemnification Assets Arising from Government-Assisted Acquisitions of a Financial Institution

805-20-35-4B An indemnification asset recognized at the acquisition date in accordance with paragraphs 805-20-25-27 through 25-28 as a result of a government-assisted acquisition of a financial institution involving an indemnification agreement shall be subsequently measured on the same basis as the indemnified item. In certain circumstances, the effect of the change in expected cash flows of the indemnification agreement should be amortized. Any amortization of changes in value shall be limited to any contractual limitations on the amount and term of the indemnification agreement. When considering the period of amortization, an entity shall consider the lesser of the term of the indemnification agreement and the remaining term of the indemnified assets. For example, for indemnified assets accounted for under paragraph 310-30-35-10, if the expected cash flows on the indemnified assets increase (and there is no previously recorded impairment allowance), an entity would account for the associated decrease in the indemnification asset by amortizing the change over the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets. Alternatively, if the expected cash flows on the indemnified assets increase such that a previously recorded impairment allowance is reversed, an entity would account for the associated decrease in the indemnification asset immediately in earnings. Any remaining decrease in the indemnification asset would be amortized over the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets.

> > Contingent Consideration Arrangements of an Acquiree Assumed by the Acquirer

805-20-35-4C Contingent consideration arrangements of an acquiree assumed by the acquirer in a business combination shall be measured subsequently in accordance with the guidance for contingent consideration arrangements in paragraph 805-30-35-1. **[Content moved from paragraph 805-20-35-4A]**

3. Add paragraph 805-20-65-1 and its related heading as follows:

> Transition Related to Accounting Standards Update No. 2012-XX, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution*

805-20-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 2012-XX, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution:*

a. The pending content that links to this paragraph shall be effective for fiscal years, and interim periods within those years, beginning on or after [date to be inserted after exposure].
b. An entity shall apply the pending content that links to this paragraph prospectively to any new indemnification assets acquired and to changes in expected cash flows of existing indemnification assets occurring on or after the date of adoption.
c. Earlier application of the pending content that links to this paragraph is permitted.
d. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period the entity adopts the pending content that links to this paragraph.

The amendments in this proposed Update were approved for publication by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Leslie F. Seidman, *Chairman*
Daryl E. Buck
Russell G. Golden
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Task Force's considerations in reaching the conclusions in this proposed Update. It includes the Board's basis for ratifying the Task Force conclusions when needed to supplement the Task Force's considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual Task Force and Board members gave greater weight to some factors than to others.

BC2. The amendments in this proposed Update would clarify the applicable guidance for the subsequent measurement of an indemnification asset recognized (in accordance with Subtopic 805-20) as a result of a government-assisted acquisition (FDIC or National Credit Union Association) of a financial institution. The proposed amendments would not affect the guidance relating to the recognition or initial measurement of an indemnification asset recognized (in accordance with Subtopic 805-20) as a result of a government-assisted acquisition of a financial institution.

Background Information

BC3. Subtopic 805-20 states that when a seller indemnifies an acquirer against a particular contingency or uncertainty related to all or part of a specific asset or liability acquired in a business combination, the acquirer shall record an indemnification asset at the same time it recognizes the indemnified item. The indemnification asset is initially measured on the same basis as the indemnified item, subject to a valuation allowance for uncollectible amounts. Paragraph 805-20-35-4 includes the following guidance on the subsequent accounting for an indemnification asset:

> At each subsequent reporting date, the acquirer shall measure an indemnification asset that was recognized in accordance with paragraphs 805-20-25-27 through 25-28 at the **acquisition date** on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectibility of the indemnification asset.

BC4. There is diversity in practice about how to subsequently measure an indemnification asset recognized in accordance with paragraphs 805-20-25-27 through 25-28, as a result of a government-assisted acquisition. There are differing views on how a decrease in the cash flows expected to be collected on the indemnification asset after the acquisition date should be measured. The diversity exists primarily because there are differing interpretations of the subsequent measurement guidance in paragraph 805-20-35-4, specifically, what is meant by the terms *on the same basis* and *contractual limitations*. Some entities amortize the loss on an indemnification asset over the term of the indemnification agreement, while other entities amortize the loss over the remaining term of the assets subject to indemnification. Other entities immediately write off the indemnification asset upon an increase in the expected cash flows of the assets subject to indemnification.

Measurement

BC5. The Task Force reached a consensus-for-exposure that when a reporting entity initially recognizes an indemnification asset (in accordance with Subtopic 805-20) as a result of a government-assisted acquisition of a financial institution and subsequently a change occurs in the cash flows expected to be collected on the asset subject to indemnification, the reporting entity would be required to account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification, and any amortization of changes in value would be limited to the contractual terms of the indemnification agreement.

BC6. In reaching the consensus-for-exposure, the majority of the Task Force members noted that amortization of subsequent decreases in expected cash flows of the indemnification asset should be limited to the contractual term of the indemnification agreement, because amortizing the decreases over a period longer than the term of the indemnification agreement may result in a residual asset (after the expiration of the term of the indemnification agreement) that does not meet the definition of an asset (as defined in FASB Concepts Statement No. 6, *Elements of Financial Statements*). Any decreases in the expected cash flows on the indemnification asset should be subsequently measured on the same basis as the indemnified assets. For example, for indemnified assets subject to Subtopic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality, if the expected cash flows on the indemnified assets increase such that a previously recorded impairment allowance is reversed, an entity would account for the associated decrease in the indemnification asset immediately in earnings. Any remaining decrease in the indemnification asset would be amortized over the lesser of the contractual term of the indemnification agreement and the remaining term of the assets subject to indemnification.

BC7. A Task Force member noted that there may be government-assisted acquisitions of a financial institution under which the term of the indemnification agreement may be greater than the remaining term of the indemnified assets (for example, as a result of prepayments on the underlying assets). In that circumstance, the Task Force agreed that decreases in the expected cash flows from the indemnification asset should be amortized over the lesser of the term of the indemnification agreement and the remaining term of the assets subject to indemnification.

BC8. Some Task Force members noted that the contractual term of the indemnification agreement should not be considered when amortizing subsequent decreases in expected cash flows of the indemnification asset. Those Task Force members believe that the Board's objective in requiring measurement of an indemnification asset "on the same basis" is to minimize measurement anomalies that result in earnings volatility throughout the remaining term of the indemnified asset. Therefore, those Task Force members believe that the amortization of the decrease in the cash flows expected to be collected on the indemnification asset (as a result of an increase in the cash flows expected to be collected on the indemnified assets) should occur over the remaining term of the indemnified assets. The majority of the Task Force did not agree with this view.

Transition and Early Adoption

BC9. The Task Force reached a consensus-for-exposure that the amendments in this proposed Update should be applied prospectively to any new indemnification assets acquired and changes in expected cash flows of existing indemnification assets occurring on or after the date of adoption. Prior periods would not be adjusted. The majority of the Task Force members believe that requiring retrospective application would not be cost-beneficial.

BC10. The Task Force decided that early adoption of the proposed amendments should be permitted to allow for the elimination of existing diversity as soon as is practicable.

Benefits and Costs

BC11. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Task Force's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC12. The Task Force believes that the amendments in this proposed Update will improve financial reporting by eliminating diversity in practice. Because the proposed guidance would be applied prospectively and no additional disclosures would be required, the Task Force does not anticipate that entities will incur significant costs as a result of applying the proposed amendments.

Proposed Amendments to the XBRL Taxonomy

The following proposed changes to the U.S. GAAP Financial Reporting Taxonomy (UGT) would be required if the provisions of this Exposure Draft are finalized as proposed. The proposed changes to the UGT are available for public comment in the development UGT throughout the year at www.fasb.org. Changes to the UGT for final Accounting Standards Updates will be formally exposed for public comment as part of the annual release process starting in September of each year.

Element Name	Standard Label	Documentation
EITF12CMember	EITF 12-C [Member]	EITF 12-C: Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution