FINANCIAL ACCOUNTING SERIES

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No. 2012-06
October 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

An Amendment of the *FASB Accounting Standards Codification®*

Financial Accounting Standards Board
of the Financial Accounting Foundation

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Summary

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

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 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. The objective of this Update is to address the diversity in practice about how to interpret the terms *on the same basis* and *contractual limitations* when subsequently measuring an indemnification asset recognized in a government-assisted (Federal Deposit Insurance Corporation or National Credit Union Administration) acquisition of a financial institution that includes a loss-sharing agreement (indemnification agreement).

Who Is Affected by the Amendments in This Update?

The amendments in this Update 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 should 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 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 life of the indemnified assets).

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

The amendments in this Update 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 concluded that the amendments should resolve current diversity in practice on the subsequent measurement of these types of indemnification assets.

When Will the Amendments Be Effective?

For public and nonpublic entities, the amendments in this Update are effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. Early adoption is permitted.

The amendments should be applied prospectively to any new indemnification assets acquired after the date of adoption and to indemnification assets existing as of the date of adoption arising from a government-assisted acquisition of a financial institution.

How Do the 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 as the indemnified liability or asset. 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.

Amendments to the *FASB Accounting Standards Codification®*

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–4. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Added text is <u>underlined</u>, and deleted text is ~~struck out~~.

Amendments to Subtopic 805-20

2. Amend paragraph 805-20-35-4, 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, <u>except as noted in paragraph 805-20-35-4B,</u> 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 No. 2012-06.</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 shall be amortized. Any amortization of changes in value shall be limited to the lesser of the contractual term of the indemnification agreement and the remaining life 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 valuation allowance), an entity shall 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 valuation allowance is reversed, an entity shall account for the associated decrease in the indemnification asset immediately in earnings. Any remaining decrease in the indemnification asset shall 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. 2012-06, *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. 2012-06, *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 December 15, 2012.

b. An entity shall apply the pending content that links to this paragraph prospectively to any new indemnification assets acquired after the date of adoption and to indemnification assets existing as of 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.

4. Amend paragraph 805-20-00-1, by adding the following items to the table, as follows:

805-20-00-1 The following table identifies the changes made to this Subtopic.

Paragraph Number	**Action**	**Accounting Standards Update**	**Date**
805-20-35-4	Amended	2012-06	10/23/2012
805-20-35-4A	Superseded	2012-06	10/23/2012
805-20-35-4B	Added	2012-06	10/23/2012
805-20-35-4C	Added	2012-06	10/23/2012
805-20-65-1	Added	2012-06	10/23/2012

The amendments in this Update were adopted 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 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 Update 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 (Federal Deposit Insurance Corporation or National Credit Union Administration) of a financial institution. The amendments do 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 Subtopic 805-20 as a result of a government-assisted acquisition of a financial institution. There are differing views on how a decrease in the expected cash flows on the indemnification asset after the acquisition date should be measured when corresponding increases in expected cash flows on the assets subject to indemnification are not immediately recognized in earnings. 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*. In certain circumstances, some entities amortize the decrease in expected cash flows on an indemnification asset over the term of the indemnification agreement, while other entities amortize the decrease in expected cash flows over the remaining life of the assets subject to indemnification. Other entities reflect the decrease in expected cash flows immediately as a write-down of the indemnification asset.

Measurement

BC5. At the March 15, 2012 EITF meeting, 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 lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified assets.

BC6. In reaching the consensus-for-exposure, the majority of the Task Force members noted that any amortization of subsequent decreases in expected cash flows of the indemnification asset (as a result of an increase in the cash flows expected to be collected on the indemnified assets) 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 indemnification asset existing subsequent to the expiration of the term of the indemnification agreement. 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 valuation 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 assets subject to indemnification.

BC7. A Task Force member noted that there may be government-assisted acquisitions of a financial institution under which the contractual term of the indemnification agreement may be greater than the remaining life of the indemnified assets. In that circumstance, the Task Force agreed that any amortization of the decrease in the expected cash flows of the indemnification asset should be amortized over the lesser of the contractual term of the indemnification agreement and the remaining life 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 life of the indemnified asset. Therefore, those Task Force members believe that any 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 life of the indemnified assets. The majority of the Task Force did not agree with the view that the contractual term of the indemnification asset should not be considered when determining the amortization period for the decreases in expected cash flows of the indemnification asset.

BC9. At the March 15, 2012 EITF meeting, the Task Force reached a consensus-for-exposure on EITF Issue No. 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." A proposed Accounting Standards Update was issued on April 17, 2012, with a comment period that ended on July 16, 2012. Eight comment letters were received on the proposed Update.

BC10. At the September 11, 2012 EITF meeting, the Task Force considered the comments received on the proposed Update and affirmed its consensus-for-exposure as a consensus. In affirming its consensus, the Task Force noted that the Board's objective in Subtopic 805-20 in requiring measurement of an indemnification asset "on the same basis" is to minimize measurement anomalies that result in earnings volatility.

BC11. Furthermore, the Task Force clarified that when the unit of account is a pool under Subtopic 310-30, any amortization of changes in the value of the indemnification asset may be limited to the lesser of the contractual term of the indemnification agreement and the remaining life of the indemnified pool.

Effective Date and Transition

BC12. The Task Force concluded that the amendments in this Update should be applied prospectively. In applying that prospective method, the Task Force clarified that the amendments in this Update should be applied to indemnification assets existing as of the date of adoption, regardless of whether there is any post-adoption change in the cash flows on the indemnified assets. That is, unamortized amounts existing at the date of adoption should be amortized prospectively over the lesser of the remaining contractual term of the indemnification agreement and the remaining life of the indemnified assets. The Task Force concluded that this transition method would enhance comparability and avoid the possibility of a residual indemnification asset existing after the expiration of the term of the indemnification agreement.

BC13. The Task Force also reached a consensus that the amendments resulting from this Issue are effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2012, with early application permitted. To enhance comparability and considering the limited scope and applicability of this Update, the Task Force decided not to provide a delayed effective date for nonpublic entities. An entity should also provide the disclosures in paragraphs 250-10-50-1 through 50-3 in the period the entity adopts the amendments in this Update.

Benefits and Costs

BC14. 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.

BC15. The Task Force concluded that the amendments in this Update will improve financial reporting by eliminating diversity in practice. Because the guidance will be applied prospectively and no additional disclosures are required, the Task Force does not anticipate that entities will incur significant costs as a result of applying the amendments.

Amendments to the XBRL Taxonomy

The FASB will expose for public comment the changes to the U.S. GAAP Financial Reporting Taxonomy (UGT) that are a result of this Update. The proposed changes to the UGT will be available on the FASB website on or about November 19, 2012.

The FASB will alert the public of the availability of proposed UGT changes and the deadline for comment through an announcement on its website and in its Action Alert email service.