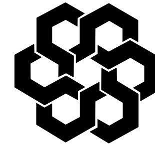

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **19 June 2007, London**

Project: **Business Combinations II**

Subject: **Indemnification Agreements (Agenda Paper 2C)**

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1. This memorandum discusses concerns that were raised by external reviewers about the Boards' April 2007 decision for an indemnification asset when the related liability is a measurement or recognition exception to the business combinations principles (for example, a liability for a tax uncertainty that is measured in accordance with FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* or IAS 12, *Income Taxes).* This memo provides the following information:

a. Prior decision and background
b. Draft language in the 5/16/07 Preballot Draft
c. External reviewer concerns and suggested revisions

Prior Decision and Background

2. At the April 2007 Joint meeting, the Boards decided that:

> If, in a business combination, an acquirer assumes a liability but requires the former owners of the acquiree to reimburse the acquirer if and when the acquirer pays the liability, the acquirer should recognize the asset for the reimbursement (indemnification) at the same amount as the related assumed liability. [FASB Minutes of the April 24, 2007 Joint Meeting]

Attachment A is an excerpt from the prior memo related to this issue.

Draft Language in the 5/16/07 Preballot Draft

3. The standard section of the preballot draft included the following related paragraphs, within the caption *exceptions to both the recognition and measurement principles*:

> **Indemnification assets**
> In some situations, the seller in a business combination (the former owners of the acquiree) will indemnify the acquirer for the outcome of particular uncertainties. [**FASB only**: An example is an uncertain tax position taken in the acquiree's income tax returns for prior years.] The acquirer shall recognize an indemnification asset, measured at the same amount as the related liability, at the same time it recognizes the related liability. For example, if the indemnification asset relates to a deferred tax liability, the asset shall be recognized at the same time and measured at the same amount as that liability is recognized and measured in accordance with paragraphs 41 and 42). [paragraph 43]

4. Paragraphs B274–276 explained the basis for the Boards' conclusion.

External Reviewer Concerns and Suggested Revisions

Clarification Suggestions (Drafting Issues)

5. External reviewers had concerns about the clarity of the following areas:

    a. **Full versus partial indemnifications:** The specific terms of the agreement may require that only a portion of the risk be indemnified by the seller. In a partial indemnification, the indemnification asset should not equal the liability; it should equal *the portion of the liability* that is covered.

    b. **Anticipated indemnification:** Clarification that the indemnification needs to be contractual and not anticipated or implied. In the mutual fund context, there has been an effort for the Board to allow recognition of non-contractual or implied indemnifications.

    c. **A better tax example:** An indemnification related to a deferred tax liability would be highly unusual. A more common example would be an indemnity that related to a tax reserve or to accrued interest for a timing-related exposure (i.e., an indemnity related to a liability for unrecognized tax benefits).

6. Based on those comments, the staff suggests the following revisions (marked) to paragraph 43:

> In some situations, the seller in a business combination (the former owners of the acquiree) ~~will~~ contractually indemnifies ~~y~~ the acquirer for the outcome of a particular contingency ~~uncertainties~~. The acquirer

shall recognize an indemnification asset at the same time as the related liability, measured using assumptions consistent with those used to measure ~~at the same amount as~~ the related liability. The measurement of the indemnification asset is limited to amount of the liability to which the indemnity relates. For example, if the indemnification agreement ~~relates to~~ fully indemnifies the acquirer for an uncertain tax position ~~deferred tax liability~~, the asset shall be ~~recognized at the same time and~~ measured at the same amount as the ~~at~~ related liability. In some circumstances, the indemnification agreement may relate only to a portion of the liability (for example, for interest payable to a tax jurisdiction for a certain tax position.) In these circumstances, the indemnification asset is measured using assumptions consistent with the measurement of the liability, limited to the contractual obligation (the interest expense measured using assumptions consistent with the measurement of the liability.) ~~is recognized and measured in accordance with paragraphs 41 and 42).~~

Incremental Issues Raised

7. External reviewers also had the following concerns that went beyond clarification:

a. **Collectibility of an indemnification asset:** The draft does not address whether (and how) the acquirer should consider the credit worthiness of the indemnifying party for the measurement of an indemnification asset.

b. **Recognition and measurement requirements after the acquisition date:** The recognition and measurement requirements for an indemnification asset after the acquisition date are not clear. One possibility would be to continue recording the indemnification asset at the same amount as the related liability, so if the liability changes so would the asset. This would link the amounts through out the existence of the contingency. Another possibility would be to account for the indemnification asset at the acquisition date and then only write down/off the asset when the liability is settled or the contingency period expires.

c. **Income statement geography of changes to indemnification assets:** Some constituents asked whether the indemnification asset should be recorded net in the statement of operations. For example if the indemnification agreement is related to an income tax uncertainty, can the write-off of the asset when the liability is reversed be recorded in the income tax line?

d. **Differentiating between arrangements that are contingent consideration and those that are indemnification:** The distinction between indemnification and contingent consideration or general customary warranties may not be clear. For example, whether contingently returnable consideration (clawbacks) are contingent consideration, an acquired contingency, or a type of guarantee/indemnification is not clear to some constituents.

e. **Indemnifications related another asset:** It is unclear whether the indemnification accounting also relates to indemnification agreements related to another asset for example a loan receivable (or only indemnified liabilities).

8. The staff believes that items (a) and (b) can be resolved in an expeditious manner in the final statement. The staff recommends addressing:

a. **Item (a)** by clarifying that an indemnification asset should only be recognized to the extent that it is collectible. If the Boards' agree, the following sentence would be added to the end of paragraph 43 of the standard: "The recognized indemnification asset shall be subject to management's assessment of the collectibility of that amount."

b. **Item (b)** by requiring that the subsequent accounting for an indemnification asset be the same as the acquisition date requirements (i.e., that the acquirer, based on the specific terms of the agreement, would continue to recognize and measure the indemnification asset, using assumptions that are consistent with those used to measure the liability).

Does the Board agree with the proposed clarifications to resolve external reviewer comments- Item (a) and (b)?

9. The staff is not supportive of recommending changes to clarify the point raised in item (c) as the Statement 141 (R) guidance generally does not provide guidance on where amounts should be reflected in the statement of operations. Accordingly, the staff does not recommend a change to address these questions raised.

Does the Board agree with not providing income statement geography guidance as identified in Item (c)?

10. Items (d) and (e) raise valid concerns about the judgments that will be required in assessing whether a contractual provision warrants the exception guidance for indemnification assets that may result in inconsistent application in practice or requests for further guidance. The staff has not had the opportunity to fully investigate the potential views on these items or to propose resolutions.

Would the Board like the staff to further pursue items (d) and (e)?

11. [Paragraph omitted.]

ATTACHMENT A

Excerpt from FASB Memorandum #57; IASB Agenda Paper 2I for April 2007 Joint Meeting

D. MEASURING AND RECOGNIZING AN INDEMNIFICATION ASSET WHEN THE RELATED LIABILITY IS MEASURED OR RECOGNIZED DIFFERENTLY

19. A few constituents contacted the staff about a potential inconsistency with measuring an asset for an indemnification at fair value at the acquisition date when the related liability is measured using a different measurement attribute on that date. Resource group members contacted the staff about this issue primarily in the context of Interpretation 48.

20. Interpretation 48 requires an entity to measure a tax position that meets the more-likely-than-not recognition threshold at the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority (paragraph 8, paraphrased). A few resource group members told the staff that the acquirer in a business combination often requires the sellers to provide the acquirer with an indemnification against particular tax uncertainties. Therefore, the sellers are required to reimburse the acquirer for any payments the acquirer eventually makes for those particular tax uncertainties. In that case, at the acquisition date, the acquirer would recognize a liability for the tax uncertainty and an asset for the indemnification. The staff believes that the acquirer would have to recognize the asset and liability separately since there would be no right of setoff since the liability is owed to the taxing authority and the reimbursement would be due from the seller. The asset would be a contingency that would be measured at fair value in a business combination. The liability would be measured in accordance with Interpretation 48 since income taxes are an exception to the fair value measurement principle. The liability would likely be measured at an amount that exceeds fair value given the measurement guidance in Interpretation 48.

21. The resource group members raised only the measurement issue. It seems like a similar issue also could exist if a liability and related indemnification asset has different recognition thresholds.

22. Constituents have not contacted the IASB staff about this issue. However, the staff notes that the measurement attribute for tax uncertainties under IAS 12 is not fair value. Thus, a similar issue could exist.

23. The staff is asking whether, at the acquisition date, an acquirer should be allowed to measure or recognize the asset for an indemnification agreement differently from the related liability?

24. IAS 37 prohibits an entity from recognizing an asset for a reimbursement in excess of the liability (provision) (paragraph 53). However, in the example described above, the asset would likely be less than the liability given the measurement attribute in Interpretation 48. The staff believes that the Boards have two alternatives.

    a. **Alternative One:** The Boards can allow an acquirer, at the acquisition date and subsequently, to measure and recognize an asset for an indemnification using a different measurement attribute or recognition threshold than the liability.

    b. **Alternative Two:** The Boards can require an acquirer, at the acquisition date and subsequently, to recognize an asset for an indemnification at the same amount as the related liability. If the Boards decide that this alternative is appropriate, the staff would need to think further about any implications it could have.

25. The staff believes Alternative One might be acceptable since there are limited instances of when the liability might be measured or recognized differently. That is, most liabilities against which an acquirer would require an indemnification in a business combination would likely be contingencies that would be measured at fair value and would be subject to the same recognition thresholds as the related asset. The staff is only aware of income tax related indemnifications that result in this mismatch. Thus, the population of the types of agreements that result in this inconsistency is expected to be limited.

26. The problem with Alternative One is that because the asset and the liability were measured or recognized initially at different amounts, the amount recognized in the income statement in any reporting period after the acquisition date would not off-set each other even though, economically, it seems like they should.

27. The staff notes that if the Boards require the acquirer to recognize an asset for an indemnification at the same amount as the related liability, it would be an exception to the fair value measurement principle.

28. This issue is also arising outside of a business combination. For example, representatives from the Investment Company Institute (ICI) raised similar concerns with mutual funds when they are indemnified from the fund manager. Other types of transactions that have been raised include spin-off transactions in which a former subsidiary indemnifies a former parent or vice versa. In these other situations, concerns are raised with the measurement inconsistency and with the different recognition thresholds. If an indemnification was considered a gain contingency under Statement 5, the asset for the gain contingency would not be recognized at the same point in time that the liability for the tax uncertainty would be. Thus, this measurement inconsistently also exists outside of a business combination.

29. The staff believes the Boards should address the business combination aspect of this issue publicly. Some have suggested that the FASB's TA&I committee should consider it. However, if the FASB's TA&I group considers it but the IASB does not, a potential for creating divergence exists. Therefore, the staff would prefer that the Boards consider the issue together.

Question: Do the Boards believe that this issue should be addressed further?