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Current Valuation Issues

FASB STAFF POSITION NO. FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*

Industry Focus: Media and Entertainment

Overview

FASB SFAS 141(R), *Business Combinations*, requires that companies use the acquisition method to determine the value of acquired assets, assumed liabilities, and non-controlling interests in a business combination. This article focuses on the requirements for identifying acquired assets and assumed liabilities arising from contingencies and also gives consideration to FAS 141(R)-1, which was issued on April 1, 2009.

Background

In FASB Statement No. 5, *Accounting for Contingencies*, a contingency is defined "… as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur."

SFAS 141(R) provides guidance on how assets and liabilities arising from contingencies should be recognized. Contingencies associated with contracts (contractual contingencies) are to be measured at fair value at the date of acquisition. For any other contingencies (noncontractual contingencies), if "… it is more likely than not as of the acquisition date …" that an asset or liability will arise from a contingency, the assets or liabilities will also be measured at fair value at

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the time of acquisition.[1] If the more-likely-than-not guidance is not met, the acquirer shall not recognize the item as of the acquisition date.

Assuming that no additional information regarding the outcome of the contingency becomes available after the initial measurement period, an acquirer shall continue to report the fair value of the asset or liability arising from the contingency as of the acquisition date. If new information relating to the contingency becomes available and shall affect the value of the asset or liability, the liability shall be carried at the higher value versus the acquisition date amount. Conversely, the asset value shall be measured at the lower of the acquisition-date fair value or the most reasonable estimate of the projected future amount. This inconsistent treatment of assets and liabilities comports with the concept of conservatism in accounting.

The more-likely-than-not criterion is discussed more thoroughly in Paragraph A62 of the statement. The criterion refers to whether "…the acquirer has incurred an obligation to pay if a specified event - the contingency - occurs." The evaluator must decide if the business has a present obligation. Any uncertainties shall then be incorporated into the assumptions within the fair value analysis.

The statement also provides clarification on certain specific assets and liabilities arising from contingencies. For example, the guidance covers indemnification assets. As an example, a seller may indemnify the buyer by guaranteeing that losses from a contingency will not exceed a certain amount. The treatment of contingent consideration is also addressed. The changes in the fair value of contingent consideration are treated differently depending upon whether the changes occur within the defined measurement period or outside the measurement period.

Within the entertainment and media industry, assets and liabilities arising from contingencies are often an important component of acquisitions. Unlike other industries, unpredictable intangible assets such as programming, content, and branding are important aspects of the business and often among the most important aspects of the company.

FASB Guidance

FASB Staff Position No. FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*, was issued in 2009 to clarify SFAS 141(R) on the valuation of contingency issues.

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[1] SFAS No. 141 (revised 2007), *Business Combinations*, p. 8.

The statement addresses when to measure and recognize the fair value of the asset or liability arising from a contingency. If the fair value of the item can be determined at the time of acquisition (during the measurement period), the asset or liability should be recognized. If the fair value of the asset or liability arising from a contingency cannot be determined at the time of acquisition, but there is information that makes it probable that an asset or liability exists, and the fair value can be reasonably estimated, it should be recognized at the acquisition date. If neither of the above conditions is met, the contingent asset or liability shall not be recognized as of the acquisition date.

As new information becomes available, the acquiring business is required to develop a systematic approach to monitor, measure, and account for any assets or liabilities arising from contingencies on an ongoing basis.

Assets and liabilities arising from contingencies are commonplace within the media and entertainment sector. Contingency payments may be embedded within a contract such as a programming or co-branding agreement. For example, a co-branding agreement between two digital media companies may be structured whereby one company posts certain content on another media company's website. The company that posts the information may pay an annual guaranteed amount plus additional commissions or referral fees to the host website if users are redirected to the posting company's site. The likelihood and magnitude of the contingent payments must be assessed as a component of the fair value of the agreement.

Other contractual contingencies may relate to the performance of a certain programming agreement. The renewal of the agreement may be tied to the performance of the program based upon audience measurements such as share or ratings. Contingencies that could affect the media industry include contingency consideration such as earnouts, audience rating guarantees, performance based compensation, future program obligations, and pending or threatened litigation.

Non-contractual contingencies may relate to a current or potential project that is either in development or scheduled for sometime in the future. The project may be dependent upon audience or subscriber demand, competition in the marketplace, or the availability of financing.

Conclusion

With respect to assets and liabilities arising from contingencies, SFAS 141(R) provides a framework to identify and recognize these items. However, given the uncertain nature of contingencies and the requirements of fair value measurement under SFAS 157, there are many practical issues that will pose challenges to

valuation and audit practitioners. Contingencies commonly faced by acquiring entities include warranties, customer recalls/refunds, litigation-related contingencies (employee, environmental, health-related), performance-based measures. and insurance-related provisions.

Even with the clarification of SFAS 141(R) difficulties of recognition and valuation remain:

1. The more-likely-than-not criterion may be difficult to apply for certain non-contractual contingencies.
2. Legal contingencies provide valuation challenges in that there are many intangible factors that affect the probability and magnitude of any potential settlement (available financial resources, relationship of the parties involved, magnitude and timing of settlement, etc.).
3. Vague guidance on how to systematically measure and account for new information on contingencies subsequent to the initial acquisition date.

Certain intangible assets are difficult to value even without contingency provisions. Executives, auditors, attorneys, and valuation practitioners will have to take great care in quantifying the type, nature, probabilities, and valuation assumptions used to develop fair values for assets and liabilities that arise through contingencies.