# Statement of Financial Accounting Standards No. 38

Note: This Statement has been completely superseded

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FAS38 Summary

## Accounting for Preacquisition Contingencies of Purchased Enterprises

(an amendment of APB Opinion No. 16)

September 1980

Financial Accounting Standards Board
of the Financial Accounting Foundation
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**Statement of Financial Accounting Standards No. 38**

**Accounting for Preacquisition Contingencies of Purchased Enterprises**

**an amendment of APB Opinion No. 16**

**September 1980**

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Paragraph Numbers

# FAS 38: Accounting for Preacquisition Contingencies of Purchased Enterprises

## an amendment of APB Opinion No. 16

### FAS 38 Summary

This Statement specifies how an acquiring enterprise should account for contingencies of an acquired enterprise that were in existence at the purchase date and for subsequent adjustments that result from those contingencies. Amounts that can be reasonably estimated for contingencies that are considered probable are recorded as a part of the allocation of the purchase price. Subsequent adjustments are included in net income when the adjustments are determined except in limited circumstances described in this Statement.

## INTRODUCTION

1. The FASB has been asked to specify the application of FASB Statements No. 5, *Accounting for Contingencies*, and 16, *Prior Period Adjustments*, and APB Opinion No. 16, *Business Combinations*, to preacquisition contingencies [1] of purchased enterprises and adjustments that result from resolution of those contingencies. For example, an acquired enterprise might have litigation pending at the acquisition date, or an unexpected lawsuit relating to events that occurred before the acquisition might be filed shortly after that date. In such cases, do the criteria of Statement 5 apply to the estimate recorded as a part of the purchase price allocation, or, if not, what criteria do apply? Also, does Statement 16 require that a subsequent adjustment that results from a settlement of that litigation or from an estimate of the cost of a future settlement of that litigation be reported by the acquiring enterprise as an item of profit or loss in the period in which the settlement occurs or can be estimated? Alternatively, does Opinion 16 require the subsequent adjustment to be reported by the acquiring enterprise as an adjustment of the purchase allocation?

2. The Board concluded that it should amend Opinion 16 to specify criteria for recording contingent assets, contingent liabilities, and contingent impairments of assets as a part of the

allocation of the cost of an enterprise that is acquired in a business combination accounted for by the purchase method. This Statement requires either the fair value of contingencies or other amounts that can be reasonably estimated for contingencies that are considered probable to be used as the basis of allocation of the purchase price during the "allocation period" as defined in paragraph 4. Subsequent adjustments are included in the determination of net income in the period in which the adjustments are determined. This Statement does not apply to potential income tax benefits of preacquisition net operating loss carryforwards or adjustments that result from realization of those benefits. APB Opinion No. 11, *Accounting for Income Taxes*, and Opinion 16 specify the accounting for those items.

3. Appendix A provides additional background information on preacquisition contingencies. Appendix B explains the basis for the Board's conclusions. The Board has concluded that it can make an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraphs 8-10 are advisable in the circumstances.

## STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

### Definitions

4. For purposes of applying this Statement, certain terms are defined as follows:

a. *Preacquisition contingency*. A contingency of an enterprise that is acquired in a business combination accounted for by the purchase method and that is in existence before the consummation of the combination. A preacquisition contingency can be a contingent asset, a contingent liability, or a contingent impairment of an asset.

b. *Allocation period*. The period that is required to identify and quantify the assets acquired and the liabilities assumed. The "allocation period" ends when the acquiring enterprise is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable. Thus, the existence of a preacquisition contingency for which an asset, a liability, or an impairment of an asset cannot be estimated does not, of itself, extend the "allocation period." Although the time required will vary with circumstances, the "allocation period" should usually not exceed one year from the consummation of a business combination.

### Allocation of the Purchase Price

5. A preacquisition contingency other than the potential tax benefit of a loss carryforward [2] shall be included in the purchase allocation based on an amount determined as follows:

a. If the fair value of the preacquisition contingency can be determined during the "allocation period," that preacquisition contingency shall be included in the allocation of the purchase price based on that fair value.[3]

b. If the fair value of the preacquisition contingency cannot be determined during the "allocation period," that preacquisition contingency shall be included in the allocation of the purchase price based on an amount determined in accordance with the following criteria:
   (1) Information available prior to the end of the "allocation period" indicates that it is probable that an asset existed, a liability had been incurred, or an asset had been impaired at the consummation of the business combination. It is implicit in this condition that it must be probable that one or more future events will occur confirming the existence of the asset, liability, or impairment.
   (2) The amount of the asset or liability can be reasonably estimated.

   The criteria of this subparagraph shall be applied using the guidance provided in Statement 5 and the related FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, for application of the similar criteria of paragraph 8 of Statement 5.[4]

**Subsequent Adjustments**

6. After the end of the "allocation period," an adjustment that results from a preacquisition contingency other than a loss carryforward [5] shall be included in the determination of net income in the period in which the adjustment is determined.

## Amendment to APB Opinion No. 16

7. The following footnote is added to the end of the last sentence of paragraph 88 of Opinion 16:

> Paragraphs 4 through 6 of FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, specify how the general guidelines of this paragraph shall be applied to preacquisition contingencies.

## Effective Date and Transition

8. The provisions of this Statement shall be effective for preacquisition contingencies assumed in business combinations initiated [6] after December 15, 1980.

9. Application of the provisions of this Statement to preacquisition contingencies assumed in business combinations initiated prior to December 16, 1980 is encouraged but not required. An enterprise electing to apply the provisions of this Statement to such preacquisition contingencies shall apply either the provisions of subparagraph (a) below or the provisions of subparagraphs (a) and (b) below:

a. The provisions of this Statement shall be applied to *all* preacquisition contingencies assumed in business combinations for which the "allocation period" *has not* ended at the date of initial application. If application of this Statement to such preacquisition contingencies requires adjustments of amounts previously recorded, those adjustments shall be reported the same as other adjustments of preliminary amounts recorded during the "allocation period." Also, if the enterprise so elects,

b. The provisions of this Statement shall be applied to *all other* unresolved preacquisition contingencies [7] at the date of initial application. If the application permitted by this subparagraph is elected, adjustments that result from resolution or revised estimates of *all other* unresolved preacquisition contingencies shall be reported in accordance with the provisions of paragraph 6 of this Statement. If the previous reporting of those preacquisition contingencies in the allocation of the purchase price was not in conformity with paragraph 5 of this Statement, the provisions of this Statement may be applied retroactively at the date of initial application to *all other* unresolved preacquisition contingencies.

Except as provided in this paragraph, this Statement shall not be applied retroactively to previously issued annual or interim financial statements.

10. If the provisions of paragraph 6 of this Statement are not applied to all unresolved preacquisition contingencies as permitted by paragraph 9, financial statements for periods ending after December 15, 1980 shall include disclosure of the amount and nature of adjustments determined after December 15, 1980 that result from preacquisition contingencies and that are reported other than as specified in paragraph 6. The disclosure shall include a description of how those adjustments are reported and the effect of the adjustments on current or expected future cash flows of the enterprise.

**The provisions of this Statement need not be applied to immaterial items.**

*This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. March and Morgan dissented.*

Messrs. March and Morgan dissent because they believe that the accounting for a business acquisition required by this Statement does not properly reflect the outcome of many preacquisition contingencies. They believe subsequent adjustments arising from such contingencies should be reflected as adjustments in the purchase allocation (the alternative summarized in paragraph 26) and not as an increase or decrease in net income of the period in which the adjustment is determined necessary (the requirement in paragraph 6 of this Statement). In their view, reporting the allocated cost of assets acquired and goodwill (positive or negative) based upon the best information obtainable, including hindsight, provides more reliable information to users. They do not agree that the fine distinction made in paragraphs 19 and 21 between an amount deemed paid for an item that includes an element of risk attributable to an uncertainty and the outcome of that uncertainty is sufficiently substantive to require differences in accounting between the amount estimated for the contingency and its ultimate resolution.

They also do not agree with paragraphs 4(b) and 5(b) which for all practical purposes require that the outcome be reasonably estimable within one year to be considered in the purchase allocation. The ability to predict the resolution of litigation and later-asserted claims within one year of an acquisition is often doubtful. Legal processes involve much longer time periods, particularly for more significant cases. Although they would oppose a time limit as a matter of principle, Messrs. March and Morgan believe approximately five years would be more realistic if a period were considered desirable for practical considerations.

*Members of the Financial Accounting Standards Board:*

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

## Appendix A: BACKGROUND INFORMATION

11. The original request referred to in paragraph 1 was for an interpretation of Statement 16. The request indicated that the guidance of paragraphs 10 and 21 of Statement 16 could be considered to be in conflict. Paragraphs 12 and 13 of this appendix cite those provisions of Statement 16, and paragraphs 14-16 of this appendix cite the provisions of other authoritative literature that are referred to in paragraph 21 of Statement 16.

12. Paragraph 10 of Statement 16 requires that, with specified exceptions, ". . . items of profit and loss recognized during a period, . . . including accruals of estimated losses from loss contingencies, shall be included in the determination of net income for that period. . . ." The specified exceptions are described in paragraphs 11, 13, and 14 of Statement 16 and consist of:

a. Correction of an error in the financial statements of a prior period,
b. Adjustments that result from realization of income tax benefits of preacquisition operating loss carryforwards of purchased subsidiaries, and
c. Certain adjustments related to prior interim periods of the current fiscal year.

13. With respect to adjustments that are required by Opinions 9, 11, and 16 to be reported as adjustments to paid-in capital, goodwill, or other assets, paragraph 21 of Statement 16 states that "this Statement is not intended to require those adjustments to be included in the determination of net income of the current period." Paragraphs 14 and 15, below, cite the provisions of Opinions 9 and 11 that require adjustments to be reported as adjustments to paid-in capital,

goodwill, or other assets. Paragraph 16, below, describes the provisions of Opinion 16 applicable to the purchase method of accounting for a business combination that require adjustments that result from preacquisition contingencies to be reported as adjustments to paid-in capital, goodwill, or other assets.

14. Paragraph 28 of APB Opinion No. 9, *Reporting the Results of Operations*, states that ". . . the following should be excluded from the determination of net income or the results of operations under all circumstances: (a) adjustments or charges or credits resulting from transactions in the company's own capital stock, . . . (b) transfers to and from accounts properly designated as appropriated retained earnings . . . and (c) adjustments made pursuant to a quasi-reorganization."

15. Paragraph 49 of Opinion 11 addresses reporting the tax effects of loss carryforwards of purchased subsidiaries, if not previously recognized. The paragraph states that those tax effects "should be recognized as assets at the date of purchase only if realization is assured beyond any reasonable doubt. Otherwise they should be recognized only when the tax benefits are actually realized and should be recorded as retroactive adjustments... of the purchase transactions. . . ." Paragraph 52 of Opinion 11 requires allocation of taxes to prior periods (or the opening balance of retained earnings) and to other stockholders' equity accounts in certain circumstances, none of which relate to preacquisition contingencies.

16. Paragraph 88 of Opinion 16 provides "general guides for assigning amounts to the individual assets acquired and liabilities assumed, except goodwill." The general guides in paragraph 88 include an acknowledgment that allowances for uncollectibility of receivables may be necessary and also include the statement that "an acquiring corporation should reduce the acquired goodwill retroactively for the realized tax benefits of loss carry-forwards of an acquired company not previously recorded by the acquiring corporation." Opinion 16 does not otherwise directly address preacquisition contingencies.

17. An Exposure Draft of a proposed Statement, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, was issued on December 26, 1979. The Board received 59 letters of comment in response to the Exposure Draft.

## Appendix B: BASIS FOR CONCLUSIONS

18. This appendix contains a discussion of the factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

### Overall Approach Adopted by the Board

19. This Statement distinguishes between (a) an amount deemed to have been paid for an item that includes an element of risk and (b) the gain or loss that results from the risk assumed.

20. Paragraph 5 requires that the amount paid for the contingent asset or liability be estimated. If its fair value can be determined, that fair value is used as the basis for recording the asset or liability. Otherwise, an amount determined on the basis of criteria drawn from Statement 5 is used as the best available estimate of fair value. In accordance with the rationale of Opinion 16 (which requires that all assets and liabilities of the acquired enterprise, whether recorded or unrecorded, be identified and recorded by the acquiring enterprise and that only the residual purchase price that cannot be allocated to specific assets and liabilities be allocated to goodwill), this Statement allows a period of time (the "allocation period") for discovery and quantification of preacquisition contingencies.

21. Paragraph 6 requires that subsequent adjustments of the amounts recorded as a part of the purchase allocation be included in the determination of net income in the period in which the adjustments are determined. In contrast to the amounts deemed paid for the asset or liability, those subsequent adjustments are gains or losses that result from the uncertainties and related risks assumed in the purchase.

**Contingent Consideration**

22. A number of respondents to the Exposure Draft questioned the difference in the accounting required for preacquisition contingencies by this Statement and the accounting required for contingent consideration by Opinion 16. Opinion 16 requires that contingent consideration be accounted for based on its nature. The following examples illustrate the relationship of the accounting for contingent consideration to the nature of the agreement and contrast the nature of each agreement with the nature of a preacquisition contingency:

a. If the contingent consideration is based on subsequent earnings, the additional consideration, when determinable, increases the purchase price because the increased value that was purchased has been demonstrated. Additional goodwill was proven to exist by the achievement of the specified level of earnings. In contrast, when an enterprise changes its estimate of a preacquisition contingent liability, there is nothing to indicate that additional value has been created. A payment is expected to be required, but the payment does not demonstrate that an asset exists or is more valuable than before the payment was anticipated.
b. If the contingent consideration represents payment of amounts withheld to insure against the existence of contingencies, neither the payment of the contingent consideration nor the payment of a liability that results from the contingency with the funds withheld affects the acquiring enterprise's accounting for the business combination. The escrow is a way of protecting the buyer against risk. The buyer has agreed to pay the amount either to the seller or to a third-party claimant; and thus, the only uncertainty to the buyer is the identity of the payee. The amount of the agreed consideration that is withheld would be recorded as part of

the purchase price in the original allocation. In contrast, a change in an estimate of a preacquisition contingency for which the acquiring enterprise assumed responsibility represents a change in the total amount that will be paid out or received by the acquiring enterprise. The buyer assumed the risk and is subject to the results of that risk.

**Contingencies That Result from a Purchase**

23. A number of respondents to the Exposure Draft questioned whether this Statement should be applied to contingencies that arise from the acquisition and that did not exist prior to the acquisition. Examples provided included litigation over the acquisition and the tax effect of the purchase. The Board concluded that such contingencies are the acquiring enterprise's contingencies, rather than preacquisition contingencies of the acquired enterprise. Accordingly, Statement 16 applies to those contingencies after the initial purchase allocation.

**Criteria for Inclusion in Purchase Allocation**

24. Some believe that a distinction should be made based on whether contingencies were known to the acquiring enterprise at the date of the purchase. In their opinion, the initial recorded estimate for contingencies that were identified at the date of the purchase should be an adjustment of the purchase price and its allocation regardless of when that estimate becomes determinable. The acquiring enterprise agreed to assume those identified contingencies as a condition of the purchase, and presumably that assessment was considered directly in arriving at the purchase price; accordingly, they should be accounted for as part of the purchase. On the other hand, the discovery of contingent assets or liabilities that were *not* identified at the date of the purchase should not affect the allocation of a purchase price because unknown contingencies could not enter directly in the determination of the purchase price and discovery of unexpected assets or liabilities should not affect cost assigned to the other assets and liabilities acquired.

25. The Board rejected the approach outlined in paragraph 24 for a number of reasons, including the following:

a. An approach that would base the allocation of the purchase price on whether an item was known to the acquiring enterprise at the date of the purchase would conflict with the requirements of Opinion 16 for allocation of the cost of an enterprise accounted for by the purchase method. Paragraph 87 of Opinion 16 requires the acquiring enterprise to assign "a portion of the cost of the acquired company" to "all identifiable assets acquired . . . and liabilities assumed . . . , whether or not shown in the financial statements of the acquired company." The reference to "identifiable" does not indicate an intent to limit the allocation to items that were known at the date of the purchase.
b. A distinction based on whether contingencies were known to the acquiring enterprise at the date of the purchase could be viewed as only partially reflecting the economics of many purchase combinations. Many factors affect the purchase price in a business combination. Known contingencies would be one of those factors. Other factors might include amounts

of earnings, demonstrated growth in earnings, and unknown preacquisition contingencies, the potential existence of which would nevertheless enter into an assessment of risk and affect the purchase price.

c. If all preacquisition contingencies that result from a cause that was identified at the date of the purchase were considered part of the purchase consideration, the distinction between an identified contingency and one that was not identified would be vague.
d. A requirement that initial recorded estimates for some contingencies be recorded as adjustments of the purchase allocation could discourage an enterprise from recording timely estimates.

26. Some believe that all adjustments that result from preacquisition contingencies should be excluded from income of the acquiring enterprise because they are not related to the acquiring enterprise's business operations. Some of those who hold this view would accept a time limit because they believe that the connection between the adjustment and any underlying event becomes less evident as the underlying event becomes more remote; however, the time limit would be an extended period of several years.

27. The Board rejected the approach outlined in paragraph 26 for a number of reasons, including the following:

a. The usual practice in the current accounting environment is for irregularly occurring costs that result from risks assumed by the enterprise to be reflected in income when they occur. The Board did not believe that it should differentiate between risks assumed by purchase and other business risks.
b. The distinction between an adjustment related to a preacquisition contingency and an adjustment that results from current events is not always clear. For example, an enterprise may settle litigation because the cost of a successful defense would exceed the cost of the settlement. The opinion of counsel may be that the case can be successfully defended. In that case, whether the cost of the settlement relates to the preacquisition event that is the stated cause of the litigation or to the current litigious environment is not clear.

28. Some believe that all adjustments related to preacquisition contingencies should be included in income of the acquired enterprise in the period in which the adjustments are determined. They note that Statement 16 requires accruals of estimated losses from loss contingencies to be included in income in the period in which they are determined, and they believe that contingencies assumed through purchase should be accounted for the same as other contingencies. Although the Board generally agreed, it concluded that an "allocation period" was needed to permit adequate time to make reasonable estimates for the purchase allocation required by Opinion 16.

29. Several respondents to the Exposure Draft stated that changes in an estimate should be accounted for the same as the original estimate. In examining the nature of a preacquisition contingency, the Board concluded that an estimate that can be made soon after the purchase

likely would approximate the amount by which the purchase price reflected that contingency. If the eventual outcome of that contingency is significantly different, it is likely that the acquiring enterprise assumed a risk that turned out differently than expected. As indicated in paragraphs 19-21 above, the Board believes that it is appropriate for the result of a risk assumed by an enterprise to be accounted for differently than the transaction that resulted in the assumption of the risk.

**Criteria for Amount to Be Included in Purchase Allocation**

30. Paragraph 87 of Opinion 16 describes an acquiring enterprise's allocation of the cost of an acquired company to the assets acquired and liabilities assumed. That paragraph states:

> First, all identifiable assets acquired, either individually or by type, and liabilities assumed in a business combination, whether or not shown in the financial statements of the acquired company, should be assigned a portion of the cost of the acquired company, normally equal to their fair values at date of acquisition.
>
> Second, the excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill.

If "identifiable assets" includes contingent assets, paragraph 87 could be viewed as inconsistent with the practice described in paragraph 17(a) of Statement 5 that "contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization." The Board concluded that this usual practice is not applicable to a purchase allocation because revenue does not result from such an allocation; rather, the question is whether to allocate amounts paid to identifiable assets that have value or to goodwill.

31. In the Exposure Draft, the Board proposed that all contingent assets, liabilities, and impairments of assets existing in an acquired enterprise at the acquisition date be recorded based on criteria similar to the criteria in Statement 5 for recognition of an estimated loss from a loss contingency. A number of respondents to the Exposure Draft stated that the fair value of a preacquisition contingency can sometimes be determined and that fair value might not equal the amount determined in accordance with the criteria based on Statement 5.

32. The Board did not intend to modify the general requirement of paragraph 87 of Opinion 16, cited in paragraph 30 above, that the purchase allocation be based on the fair value of the assets acquired and the liabilities assumed. Rather, the criteria were provided because fair value of a preacquisition contingency usually would not be determinable. Accordingly, the Board added paragraph 5(a) to this Statement, to permit recording a preacquisition contingency based on its fair value if that fair value can be determined. Otherwise, paragraph 5(b) requires that the amount recorded be based on the criteria included in the Exposure Draft.

33. Some respondents to the Exposure Draft inquired whether it would be appropriate to base the amount recorded on the present value of the amount determined in accordance with the criteria in paragraph 5(b) because the nature of the resulting amount would be a monetary asset or liability. The Board concluded that it should not specify such a requirement because the timing of payment or receipt of a contingent item seldom would be sufficiently determinable to permit the use of a present value technique on a reasonable basis. However, this Statement does not prohibit the use of a present value if appropriate.

**Allocation Period**

34. Opinion 16 provides the general principles of accounting for a business combination by the purchase method. The acquiring enterprise determines the value of the consideration given to the sellers, the present value of the liabilities assumed, and the value of the assets acquired. The total value of the consideration given and the liabilities assumed is then allocated among the identifiable assets acquired based on their value; and the balance, if any, is allocated to "goodwill."

35. The Board recognizes that completion of the allocation process that is required by Opinion 16 may sometimes require an extended period of time. For example, appraisals might be required to determine replacement cost of plant and equipment acquired, a discovery period may be needed to identify and value intangible assets acquired, and an actuarial determination may be required to determine the pension liability to be accrued.

36. If a business combination is consummated toward the end of an acquiring enterprise's fiscal year or the acquired enterprise is very large or unusually complex, the acquiring enterprise may not be able to obtain some of the data required to complete the allocation of the cost of the purchased enterprise for inclusion in its next annual financial report. In that case, a tentative allocation might be made using the values that have been determined and preliminary estimates of the values that have not yet been determined. The portions of the allocation that relate to the data that were not available subsequently are adjusted to reflect the finally determined amounts, usually by adjusting the preliminary amount with a corresponding adjustment of goodwill.

37. The Board considered specifying a time period during which estimates of preacquisition contingencies could be recorded as part of the purchase allocation. The Board concluded that it should relate the recording of preacquisition contingencies in the purchase allocation to the nature and process of the allocation, rather than to an arbitrary time limit. However, to indicate the Board's intent that the defined "allocation period" should not be unreasonably extended, paragraph 4(b) notes that the existence of a preacquisition contingency for which an amount cannot be estimated does not, of itself, extend the "allocation period." For example, the existence of litigation for which no estimate can be made in advance of the disposition by a court does not extend the "allocation period." That paragraph also notes that the "allocation period" should usually not exceed one year from the consummation date.

38. The "allocation period" is intended to differentiate between amounts that are determined as a result of the identification and valuation process required by Opinion 16 for all assets acquired and liabilities assumed and amounts that are determined because information that was not previously obtainable becomes obtainable. Thus, the "allocation period" would continue while the acquiring enterprise's counsel was making an evaluation of a claim, but it would not continue if the counsel's evaluation were complete and resulted in the conclusion that no estimate could be made pending further negotiations with the claimant.

**Preacquisition Net Operating Loss Carryforwards**

39. A number of respondents cited the similarity of preacquisition net operating loss carryforwards to the other types of preacquisition contingencies that are addressed by this Statement and suggested that the accounting be conformed. The Board decided that it should not make that change in this Statement.

40. Some of those respondents asked whether the Board intended to completely exempt potential tax benefits of loss carryforwards from the provisions of this Statement or only to exempt them from the provisions that addressed the accounting for and reporting of subsequent changes in estimates. The Board did not intend to change the provisions of Opinions 11 and 16 with respect to preacquisition net operating loss carryforwards. Accordingly, paragraph 5 was modified to indicate the Board's intent.

**Effective Date and Transition**

41. A number of respondents to the Exposure Draft urged that the Statement be effective for adjustments resulting from purchases initiated after the effective date rather than for adjustments determined after that date. They indicated that, if the accounting required by this Statement had been in effect, the purchase price of some acquisitions would have been different or the acquisitions might not have been consummated. Several of those respondents indicated that they had disclosed the existence of a preacquisition contingency to their shareholders and had indicated that any resulting adjustment would be an adjustment of the purchase allocation.

42. The Board concluded that this Statement should be effective for preacquisition contingencies assumed in business combinations initiated after December 15, 1980. In arriving at that conclusion, the Board was concerned about the lack of comparability that may exist during a somewhat indefinite transition period, but it was influenced by expectations that may have existed at the time acquisitions were made (see preceding paragraph) and by the peculiar nature of the items in question. Disclosure of the nature of the items in question and their effect or potential effect on the enterprise's cash flows should provide adequate information for assessing the significance of those items. To ensure that adjustments of contingencies not reported in accordance with the general provisions of this Statement are disclosed, the Board specified the disclosures that are required by paragraph 10.

43. To enhance comparability, the Board also concluded that it should encourage but not require application to preacquisition contingencies assumed in business combinations initiated prior to December 16, 1980. To enhance comparability, all similar preacquisition contingencies of an enterprise should be reported in a consistent manner. Therefore, an enterprise that elects to apply this Statement to such preacquisition contingencies must apply the Statement to *all* preacquisition contingencies assumed in business combinations for which the "allocation period" *has not* ended at the date of initial application of this Statement. With respect to other unresolved preacquisition contingencies, an enterprise making the above election may also elect to apply the provisions of the Statement that address reporting of adjustments after the end of the "allocation period" to those preacquisition contingencies. That election, if exercised, must also be applied to *all other* unresolved preacquisition contingencies.

44. The Board is aware that some enterprises may not have recorded amounts as a part of a purchase allocation because better estimates, when they became available, were expected to be recorded retroactively as a part of that allocation. Accordingly, the Board concluded that enterprises that elect to apply this Statement to existing unresolved preacquisition contingencies should be permitted to record those contingent items as they would have been recorded if this Statement had been in effect at the acquisition date. That procedure should alleviate any problems that would result from applying this Statement to existing preacquisition contingencies. However, that election must be applied to *all* unresolved preacquisition contingencies if it is exercised.

**Other Matters**

45. Several respondents to the Exposure Draft requested clarification of the accounting required by this Statement in the event that the "allocation period" extends beyond a fiscal year-end. For example, would a change in the purchase allocation determined in a subsequent fiscal year result in a corresponding retroactive restatement of previously recorded amortization or depreciation? The Board decided that the same question would arise whenever the valuations required by Opinion 16 are not finalized until a subsequent fiscal year. The issue is not created by the "allocation period" used in this Statement, and that larger issue should not be resolved in this limited-scope Statement. The Board also noted that the amounts involved usually are not material because they consist of amortization of long-lived assets for a short time period.

## Footnotes

FAS38, Footnote 1--Statement 5 defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

FAS38, Footnote 2--Paragraph 49 of Opinion 11 and paragraph 88 of Opinion 16 (paragraphs 15 and 16 of this Statement) specify the accounting for the potential tax benefit of a loss carryforward of a purchased subsidiary. Opinion 11 specifies that such tax benefits are to be recognized as assets at the date of the purchase only if realization is assured beyond any reasonable doubt; otherwise, they are recognized only when realized. In the latter case, Opinion 16 specifies that those tax benefits retroactively reduce goodwill when realized.

FAS38, Footnote 3--For example, if it can be demonstrated that the parties to a business combination agreed to adjust the total consideration by an amount as a result of a newly discovered contingency, that amount would be a determined fair value of that contingency.

FAS38, Footnote 4--Interpretation 14 specifies the amount to be accrued if the reasonable estimate of the amount is a range. If some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount is accrued. If no amount within the range is a better estimate than any other amount, however, the minimum amount in the range is accrued.

FAS38, Footnote 5--See footnote 2.

FAS38, Footnote 6--The date on which a business combination is "initiated" is defined in paragraph 46(a) of Opinion 16 as "the earlier of (1) the date that the major terms of a plan, including the ratio of exchange of stock, are announced publicly or otherwise formally made known to the stockholders of any one of the combining companies or (2) the date that stockholders of a combining company are notified in writing of an exchange offer."

FAS38, Footnote 7--"*All other* unresolved preacquisition contingencies" in this paragraph refers to all unresolved preacquisition contingencies assumed in business combinations for which the "allocation period" has ended at the date of initial application of this Statement.