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Contingent Payment Contracts

Background

Contingent payment contract is a contractual arrangement between two or more parties where the settlement by one party is contingent upon occurrence of a future uncertain event. One example of a contingent payment contract is a deferred underwriting commission payable to the underwriter upon occurrence of a future event, e.g., completion of a future merger transaction by a SPAC. The commission is determined as a percentage of proceeds received in SPAC's initial IPO. Another example of a contingent payment contract is a contract for provision of legal services where cash payment to the legal provider is contingent upon successful IPO or future acquisition transaction.

Some reporting entities raised a question of how to account for contingent payment contracts under U.S. GAAP.

Analysis

Contractual vs. contingent liabilities

GAAP accounting guidance for liabilities varies depending on the type of liability. First a reporting entity needs to determine if the liability in question is considered a contingent liability or a contractual, i.e., a legal liability.

The entity is subject to contractual liability if a future settlement is required by current law (or regulation) or a contract. If the future payment is associated with an event that has already occurred (e.g. delivery of goods or provision of services, issuance of debt), that event imposes a present duty upon the entity.

Generally, for contractual liabilities there is little or no uncertainty about the likelihood of future settlement. However, the probability of payment depending on creditor intention to enforce collection or debtor intention to pay is irrelevant in determining if the liability is contractual or not. The probability of payment is also not relevant when it comes to determination of timing of recognition and measurement of contractual liabilities. Liabilities established by contract or law should be recorded at their stated or contractual amounts unless the guidance in U.S. GAAP requires otherwise (e.g., in relation to deferred revenue subject to ASC 606).

Contingent liabilities, different from contractual liabilities, as payment of these liabilities is not required by a contract or law as, for example, a customer is normally obligated to pay to a service provider. Contingent liabilities also involve uncertainty about whether a loss has been incurred.

Accrual of a contingent liability is required when (a) it is “probable” that a loss has been incurred and (b) the amount can be reasonably estimated (ASC 450-20-25-2). If the amount of the loss is a range (not a definitive amount), the reporting entity should accrue the amount that appears to be a better estimate within that range. When no amount within the range is a better estimate, the minimum amount within the range shall be accrued, even though the minimum amount may not represent the ultimate settlement amount (ASC 450-20-30-1).

While there is diversity in practice related to determining what percentage is considered “probable”, generally the use of “probable” would require at least a 70 % chance of occurrence.

Distinguishing whether the liability in question is contractual or contingent liability subject to ASC 450-20 may, in certain cases, involve judgment. In some cases, there is uncertainty as to whether a specific liability is subject to a law, i.e., the official regulation or a contract. According to the established accounting practice, if it is considered “probable” that an entity is subject to a contract or law, the respective liability is considered “contractual” and not “contingent”.

Liabilities arising from contingent payment contracts analyzed in this publication appear to be “contractual” in a sense that actual or potential payment is required by the contract. However, unlike most contractual liabilities, settlement of contingent liabilities may involve a significant degree of uncertainty.

<u>Settlement probability</u>

Par. E38 of Chapter 4, Elements of Financial Statements, FASB Conceptual Framework for Financial Reporting (CON 8) provides the following guidance in relation to contractual (or constructive) liabilities:

> *A liability has the following two essential characteristics:*
> *a. It is a present obligation;*
> *b. The obligation requires an entity to transfer or otherwise provide economic benefits to others.*

A present obligation is defined as an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction. Generally, a present obligation occurs upon occurrence of an obligating event.

Chapter 4 of CON 8 includes discussion of liabilities where the amount of payment is uncertain (par. E58, E60). For those obligations, according to CON 8, the fact that the outcome is unknown affects the measurement but not the existence of the liability (par. E60).

Note that the existing definition of liability does not refer to a specific probability threshold unlike the prior definition provided in par. 36 of superseded CON 6 Elements of Financial Statements. According to Basis for Conclusions of CON 8 (par. BC4.11):

> The definitions of both an asset and a liability in Concepts Statement 6 include the term probable and the phrases future economic benefit and past transactions or events. The term probable in the definitions in Concepts Statement 6 has been misunderstood as implying that a future economic benefit or a future sacrifice of economic benefit must be probable to a certain threshold before the definition of an asset or a liability is met. In other words, if the probability of future economic benefit is low, the asset definition is not met under that interpretation. A similar interpretation could be made for liabilities. The footnotes to the Concepts Statement 6 definition of assets and liabilities also were not helpful in clarifying the application of the term probable as used in the definitions of assets and liabilities. Accordingly, the Board decided to eliminate that term from the definitions of both assets and liabilities.

According to the updated definition, the liability may be in place regardless of likelihood of expected settlement provided that a reporting entity is legally "required" to transfer or otherwise provide economic benefits to others.

Based on the above, reporting entities would recognize and measure liabilities related to contingent payment contracts ignoring any uncertainty with regards to payment. For example, underwriting commission liability would likely to be recognized at contract amount by crediting liability and debiting equity issuance cost, part of additional paid-in capital (APIC). Legal services with contingent payments would likely to be recorded by crediting accounts payable and debiting APIC for legal services provided in connection with an equity transaction. A recipient of legal services with contingent payments will have to debit earnings (not APIC) if the services in question were for on-going (e.g., filing forms of 10-Q and 10-K or other legal representation), not for expected equity issuance. As noted above, contractual liabilities will be recorded at full contractual amounts regardless of estimated probability of payment.

The above accounting treatment may result in counter-intuitive recognition practices where certain contractual liabilities will be recognized while the probability of an outflow of economic resources, e.g., in form of a cash payment, is unlikely. Specifically, recognition of such contractual liabilities will be different from contingent liabilities which are not recognized when "probable" criterion is met. Recognition of contingent contractual liabilities without regard to probability of a payment, may also result in recognition of obligations that do not require an entity to transfer or otherwise provide economic benefits to others.

The above seemingly abnormal results from the fact that current GAAP does not distinguish the following two types of probabilities: a) probability of payment dependent and intention of creditor and debtor and b) probability of payment on meeting specific contractual requirements. Both types of probabilities appear to be irrelevant when recognizing and measuring contractual liability.

Addressing the above issues is likely to require developing specific accounting guidance for contingent payment contracts. The guidance may differ depending on the terms of the contract or the arrangement in question.

One of the potential solutions would be to require measuring the liability related to contingent contract payments at "expected" or most likely payment amount, not full contractual amount. The expected value is the sum of probability-weighted amounts in a range of possible payment amounts. The most likely amount is the single most likely amount in a range of possible payment amounts. The above principle is similar to measurement of "variable consideration" per ASC 606-10-32-8. For example, if the terms of the contract is that $ 100 payable to legal provider if a transaction is closed in the future and the probability of the close is estimated to be 50%, "expected" payment is 0.5 * 100 + 0.5 * 0 or $ 50, not $ 100.

Once contractual liability is recognized, it can be derecognized only once the conditions for liability derecognition in ASC 405-20-40-1 have been met. According to ASC 405-20-40-1:

> *40-1 A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:*
>
> *a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:*
>
> *1. Delivery of cash*
>
> *2 Delivery of other financial assets*
>
> *3 Delivery of goods or services*
>
> *4 Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.*
>
> *b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this Subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.*

Contractual liability is subject to the above derecognition guidance regardless of creditor's probability assessment that the liability can be settled for less than the stated amount.

Conclusions

Liabilities arising from contingent payment contracts are considered contractual or legal liabilities, not contingent liabilities. The probability of a payment of contractual liabilities is irrelevant when determining the timing of initial recognition and measurement of the liabilities in question. The above understanding is consistent with the updated definition of liability as provided in Chapter 4, Elements of Financial Statements, CON 8. Specifically, the definition does not include any specific assessment of probability threshold. Generally, legal liabilities should be recognized when they are due in accordance with contract terms and measured at stated (full) contract value.

Contingent underwriting commission liability would likely to be recognized at contract amount by crediting liability and debiting equity issuance cost, part of additional paid-in capital (APIC). Legal services with contingent payments would likely to be recorded by crediting accounts payable and debiting APIC for legal services provided in connection with an equity transaction. A recipient of legal services with contingent payments will have to debit earnings (not APIC) if the services in question were for on-going (e.g., filing forms of 10-Q and 10-K or other legal representation), not for expected equity issuance. As noted above, contractual liabilities will be recorded at full contractual amounts regardless of estimated probability of payment.

The above accounting treatment, i.e., recognition of liabilities regardless of probability of payment, may result in counter-intuitive recognition practices where certain contractual liabilities will be recognized while the probability of actual settlement is unlikely. Specifically, recognition of such contractual liabilities is different from contingent liabilities, which are not recognized when “probable” criterion is met. Addressing the above issue is likely to require developing specific accounting guidance for contingent payment contracts. The guidance may differ depending on the terms of the contract or the arrangement in question.

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