

Technical Line

Complex deal structures can affect future earnings and other metrics

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What you need to know

- ▶ Today's buyers and sellers of businesses are coming up with innovative deal structures that use contingent consideration and other instruments that allow the buyer and seller to share the economic risks for a period of time.
- ▶ Valuing and accounting for contingent consideration arrangements can be complex and often will affect future earnings, earnings per share and other operating metrics.
- ▶ Companies should carefully consider the potential consequences before entering into deals that include contingent consideration.

Overview

Because of the turbulent global economy, companies have been more cautious about mergers and acquisitions. While the overall volume of merger and acquisition (M&A) activity has decreased slightly in recent years, we are seeing an increase in the complexity of deal structures, particularly those using contingent consideration or call or put options or forward contracts (which we refer to as equity contracts) that allow the buyer and seller to share the economic risks of an acquired business for a period of time.

When buyers and sellers cannot agree on the value of a business, contingent consideration arrangements are a common way to bridge the gap. In these arrangements, part of the purchase price is contingent on future events or conditions. These arrangements, commonly referred to as "earn-outs," often are based on the earnings of the acquired business but also could be based on other factors, such as achieving technical milestones or regulatory approval.

The accounting for acquisitions using contingent consideration or equity contracts can be complex and often will affect future earnings. Before consummating these transactions, companies should fully understand the accounting implications and how those implications might affect future earnings, earnings per share (EPS) and other financial metrics.

This publication – the first in a two-part series – addresses the accounting and valuation considerations for contingent consideration issued in a business combination. The companion publication, which will be issued shortly, will address the accounting for equity contracts entered into between a buyer and a noncontrolling interest (NCI) holder when the buyer acquires a controlling interest in an acquiree.

Contingent consideration

In addition to bridging a valuation gap between buyer and seller, contingent consideration arrangements can achieve other business objectives by:

- ▶ Allowing the buyer and seller to share in the risk associated with the future performance of the business
- ▶ Creating an incentive for the seller to stay involved with the business and help drive its future success
- ▶ Providing flexibility for the buyer in financing the acquisition

Contingent consideration arrangements or earn-outs often depend on the acquiree meeting certain financial targets, such as revenues, earnings before interest and taxes (EBIT) or net income. Earn-outs also may depend on other events, such as achieving a technical milestone (e.g., drug or patent approval).

The terms and conditions of contingent consideration arrangements can vary greatly, and if a buyer does not carefully consider each of the provisions of an arrangement, unexpected charges to future earnings may result. Two of the more common issues that could affect future earnings are (1) whether the arrangement is classified as a liability or equity and (2) whether any portion of the arrangement represents employee compensation for future services.

General recognition and measurement provisions

ASC 805¹ requires an acquirer to recognize contingent consideration obligations as part of the consideration transferred in exchange for the acquired business. The recognition event for contingent consideration in a business combination is the agreement to make contingent payments, not the achievement of the contingency. Buyers must recognize and measure a contingent consideration arrangement at its acquisition-date fair value (i.e., the fair value of the obligation based on circumstances that exist as of the acquisition date).

Without robust due diligence, mergers and acquisitions with complex structures may have surprising accounting consequences.

Consideration transferred or compensation

An acquirer must assess whether any portion of a contingent consideration arrangement is in exchange for elements other than the acquired business (e.g., compensation for future service). Although these payments typically are negotiated as part of an acquisition, a different accounting treatment could be required if the payments are made to former shareholders who become employees of the combined business. Depending on the terms of the arrangement, the payment may be more appropriately accounted for separately from the business combination as compensation expense for post-combination services than as consideration transferred.

For example, when an acquirer purchases a controlling interest in an operating company, it may retain the founder or other key executives and provide them with a continued stake in the combined entity. The acquirer and former owners of the target see this as mutually beneficial: the acquirer retains managerial talent while the founders participate in the upside of the business through a continued interest. However, in these situations, it is less obvious whether the purpose of the contingent payment is to bridge a valuation gap between the buyer and seller or to compensate the executives for services to be provided to the combined entity.

An acquirer should evaluate all contingent consideration arrangements to determine whether the substance of each arrangement is compensatory in nature. If the acquirer determines that a contingent consideration arrangement is compensatory, the acquirer does not recognize a liability for contingent consideration at the acquisition date. Instead, the acquirer recognizes compensation expense over the period of the arrangement based on other applicable US GAAP (e.g., ASC 710, ASC 718²). Depending on the significance of the contingent consideration arrangement, the conclusion that the arrangement is compensatory could significantly affect the buyer's future financial results.

For example, if the arrangement is determined to be compensatory, compensation expense generally is recognized over the service period. In contrast, if the arrangement is determined to be consideration transferred, the contingent consideration liability is remeasured to fair value each reporting period. As a result, the amount and timing of post-combination expense or income likely will vary depending on whether the contingent consideration arrangement is compensatory. ASC 805 includes the following factors to consider in determining whether contingent payments to employees or selling shareholders are part of the business combination or separate compensation transactions:

Illustration 1 – Classifying payments as compensation or contingent consideration

Leads to conclusion that payments are compensation ←	Factor	→ Leads to conclusion that payments are consideration transferred
Payments forfeit on termination	Continuing employment	Payments are not affected by termination
Coincides with or exceeds payment period	Duration of continuing employment	Shorter than the payment period
Not reasonable compared to that of other key employees	Level of compensation	Reasonable compared to that of other key employees
Other non-employee selling shareholders receive lower additional payments (on a per-share basis)	Incremental payments to other non-employee selling shareholders	Other non-employee selling shareholders receive similar additional payments (on a per-share basis)
Selling shareholders remaining as employees own substantially all shares (in substance profit sharing)	Number of shares owned	Selling shareholders remaining as employees own only a small portion of shares
Payment formula consistent with other profit-sharing arrangements	Linkage of payments to valuation of business	Payment formula linked to the valuation approach (i.e., to bridge valuation gap)
Formula is based on a percentage of earnings	Formula for additional payments	Formula is based on a valuation formula, such as multiple of earnings

A contingent consideration arrangement that is forfeitable based on employment is compensation.

Only the first factor in the table above – continuing employment – is determinative. The guidance in ASC 805 requires that any arrangement under which payments are forfeited if employment is terminated be considered compensation for post-combination services. If a contingent consideration arrangement cannot be forfeited (i.e., the former owner is still entitled to the contingent payment even if his or her employment is terminated), all other factors should be evaluated to determine whether the arrangement represents additional consideration for the acquired company or compensation for post-combination services. In such situations, the determination of the appropriate accounting treatment will require the exercise of professional judgment based on the particular facts and circumstances.

Classification of contingent consideration

If the arrangement is determined to be consideration transferred, the classification of the contingent consideration arrangement is important because it could significantly affect the buyer's post-combination financial results. If the contingent consideration arrangement is classified as a liability, subsequent changes in fair value generally will be recorded through earnings. If the contingent consideration arrangement is classified as equity, subsequent remeasurement is not required. Therefore, contingent consideration arrangements that are classified as liabilities will result in recognition of income or expense in the buyer's future financial results that would not occur if the arrangement qualified for equity classification.

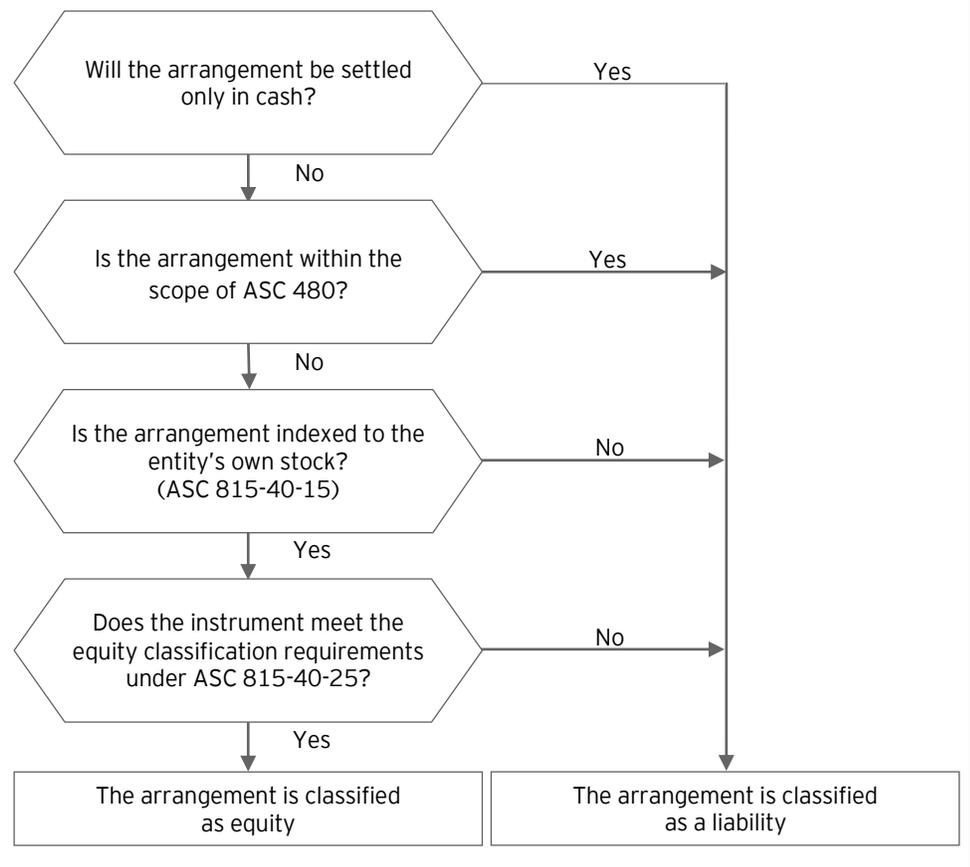
This publication does not provide comprehensive guidance on how to classify a contingent consideration arrangement. Instead, it discusses some classification considerations at a high level. All specific facts and circumstances for a particular transaction should be evaluated when determining the appropriate classification of a contingent consideration arrangement.

It is important for buyers to understand how this potential earnings volatility could affect their future financial results. Generally, the change in the fair value of the contingent consideration liability will move in concert with the change in the performance of the acquired business (i.e., if the acquired business performs well, the liability increases). This mitigates the effects of positive or negative changes in the performance of the acquired business. For example, assume a buyer agrees to transfer additional cash to a seller if the acquired business meets a specified revenue target at the end of the first year after the transaction. Also assume the business meets the revenue target and the buyer makes the cash payment. In this example, the positive financial results from achieving the revenue target would be partially offset by the negative effect on earnings resulting from the increase in the contingent consideration liability.

While ASC 805 specifies that contingent consideration arrangements be measured at their acquisition-date fair value, it requires that the buyer look to other US GAAP, including ASC 480³ and ASC 815,⁴ to determine the appropriate classification.

In general, contingent consideration arrangements that require a buyer to transfer cash or other assets will be classified as liabilities. However, contingent consideration arrangements that require settlement in the buyer's shares will not always be classified as equity. Depending on the terms, such an arrangement may be classified as a liability. Determining the appropriate classification of arrangements that require settlement in shares can be complex and often will require the exercise of professional judgment based on the particular facts and circumstances. The following flowchart provides a "road map" for determining the appropriate classification of contingent consideration arrangements.

Illustration 2 – Road map of applicable sections of the Codification to consider in determining the appropriate classification of contingent consideration



Depending on the terms, a contingent consideration arrangement that requires settlement in the buyer's shares may be classified as a liability or as equity.

If the arrangement meets the definition of a derivative, an acquirer would have to consider additional issues involving disclosure and potential use as a hedging instrument under ASC 815.

Valuation considerations

Because of the complexity of many contingent consideration arrangements, estimating their fair value is often challenging. In most instances, a contingent consideration arrangement will be valued using an income approach, typically using either a probability-weighted discounted cash flow method or an option pricing method⁵ to capture the uncertainty in the future payments.

Also, it is important to keep in mind that without a quoted price for an identical or similar liability, ASC 820 indicates that the fair value of a liability should be measured from the perspective of a market participant that holds the identical instrument as an asset.

In issuing ASU 2011-04,⁶ the Financial Accounting Standards Board (FASB) concluded that in an efficient market, the price of a liability should equal the price for the corresponding item held as an asset by another party. If those prices differed, the market participant transferee (i.e., the party taking on the obligation) would be able to earn an arbitrage profit by financing the purchase of the asset with

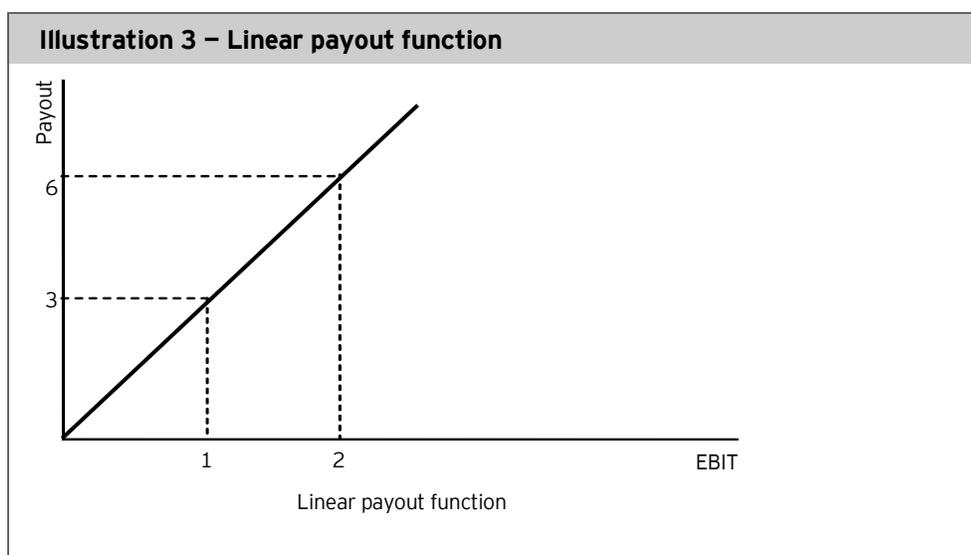
the proceeds received by taking on the liability. In such cases, the price for the liability and the price for the asset would adjust until the arbitrage opportunity was eliminated.⁷ As discussed below, the discount rate used in the valuation of a contingent consideration liability should therefore consider the risk in the future cash flows from the perspective of a market participant holding the identical instrument as an asset.

Selecting a deterministic or a probabilistic approach

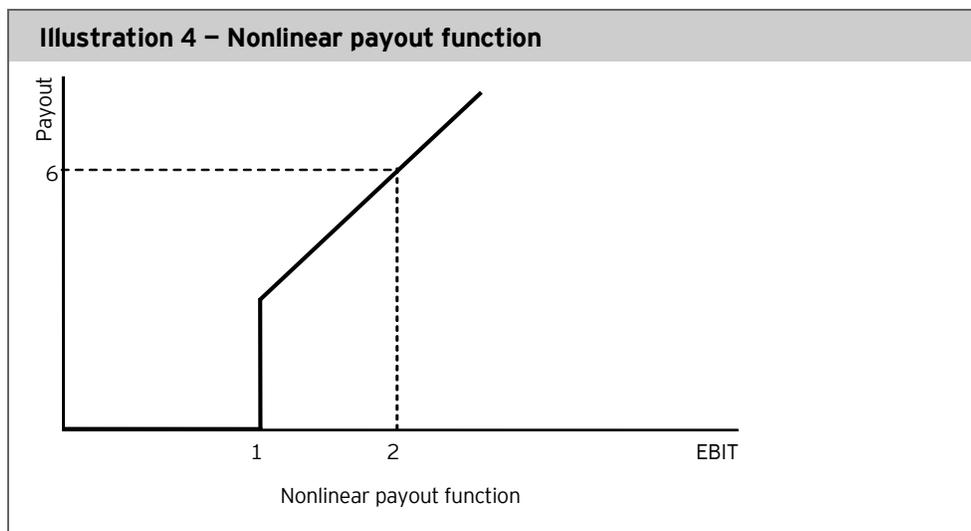
Measuring the value of a contingent consideration arrangement using the income approach requires both an understanding of the expected cash flows from the arrangement and an assessment of the discount rate for those cash flows. Two methods may be considered when estimating the expected cash flows for the contingent consideration arrangement: a deterministic approach or a probabilistic approach.

A deterministic approach is based on estimating the present value of the payout associated with a single estimated outcome that represents the expected probability-weighted outcome. A probabilistic approach is based on explicit consideration of the probability distribution of possible outcomes and the payout associated with each possible outcome. Companies should consider the relationship between the underlying performance metric or outcome and the payout associated with that outcome to determine whether a deterministic or probabilistic approach should be used.

A contingent consideration arrangement can be characterized as having either a linear or nonlinear relationship between outcomes and payouts. With a linear payout, the relationship between the underlying outcomes and the associated payouts is constant. For example, assume a seller will receive a payout in two years equal to three times EBIT for the trailing 12 months. This linear payout is depicted in the following graph.



In a nonlinear payout, the relationship between payouts and underlying outcomes is not constant. For example, assume a seller will receive a payout in two years as follows: if EBIT is less than \$1 million, the payout is zero; if EBIT is greater than or equal to \$1 million, the payout is three times EBIT for the trailing 12 months. This nonlinear payout is depicted in the following graph.



When estimating the fair value of a contingent consideration arrangement with a linear payout structure, a deterministic approach may be used because the payout associated with the expected (probability-weighted) outcome is equal to the probability-weighted payout associated with each possible outcome. This equivalence is illustrated in the following simplified example.

Illustration 5 – Deterministic versus probabilistic approaches with a linear payout structure

Company A acquires Company B for \$10 million in cash and an additional payout two years after the acquisition date equal to three times the EBIT for the trailing 12 months. Assume that there is a 50% probability that EBIT for the trailing 12 months will be \$1 million and there is a 50% probability that EBIT for the trailing 12 months will be \$2 million and that these are the only possible outcomes. Therefore, the expected EBIT for the trailing 12 months is \$1.5 million [(\$1 million times 50%) plus (\$2 million times 50%)].

Analysis

As shown below, the deterministic and probabilistic approaches result in identical payouts.

Deterministic	Probabilistic
$3 [(\$1\text{m} \times 50\%) + (\$2\text{m} \times 50\%)] =$	$50\% (3 \times \$1\text{m}) + 50\% (3 \times \$2\text{m}) =$
$3 \times \$1.5\text{m} =$	$\$1.5\text{m} + \$3\text{m} =$
$\$4.5\text{m}$	$\$4.5\text{m}$

The example above presents a simplified binary choice to illustrate that the outcome of the probabilistic and deterministic approaches will be the same if there is a linear payout structure, and is not necessarily a realistic representation of the possible outcomes. However, it demonstrates that the deterministic approach will produce the same outcome as the probabilistic approach when the arrangement has a linear payout structure. In such circumstances, using a deterministic approach to determine the fair value of the contingent consideration arrangement may be more efficient.

In contrast, for a nonlinear payout, the payout associated with the expected outcome generally will not equal the expected payout. The following example modifies the facts in Illustration 5 to demonstrate this.

Illustration 6 – Deterministic versus probabilistic approaches with a nonlinear payout structure

Assume the same facts as in Illustration 5, except that Company A is not required to make a contingent payment unless EBIT for the trailing 12 months is greater than \$1 million (i.e., if EBIT for the trailing 12 months is \$1 million or less, the payout is zero). Assume that the probability of EBIT for the trailing 12 months being \$1 million is 50% and the probability of EBIT for the trailing 12 months being \$2 million is 50%. The expected EBIT for the trailing 12 months is \$1.5 million [(\$1 million times 50%) plus (\$2 million times 50%)].

Analysis

As shown below, if a contingent consideration arrangement entails a nonlinear payout, the distribution of possible outcomes and the payout from each possible outcome should be explicitly considered (i.e., the appropriate cash flow would be the \$3 million payout under the probabilistic approach). Because of the nonlinear payout structure, using the deterministic approach in this example would result in an incorrect expected payout.

Deterministic	Probabilistic
$3 [(\$1m \times 50\%) + (\$2m \times 50\%)] =$	$(50\% \times 0) + 50\% (3 \times \$2m) =$
$3 \times \$1.5m =$	$0 + \$3m =$
\$4.5m	\$3m

The example above also presents a simplified binary choice to illustrate that the deterministic and probabilistic approaches provide different results when the payout structure is nonlinear. Because of this, understanding the payout structure and selecting an appropriate approach to estimate an earn-out's fair value is important. Improperly applying a deterministic approach to an arrangement for which the payout structure is nonlinear could result in an incorrect expected payout. It is also important to note that probability-weighting the possible outcomes of an earn-out does not necessarily capture all of the risks of the contingent consideration liability. As such, estimating the fair value of a contingent consideration arrangement also requires applying the appropriate discount rate. Due to the complexities involved, the determination of the fair value of the contingent consideration arrangement may require the involvement of valuation specialists.

Estimating an appropriate discount rate

The primary risks that should be considered in estimating the fair value of the contingent consideration are:

- ▶ The risk associated with the underlying outcome
- ▶ The risk associated with the nature of the payout structure (e.g., a constant, fixed payment on achievement of the contingency versus a variable payment based on a multiple of earnings)
- ▶ The risk associated with the ability of the holder to collect the contingent consideration payment (i.e., credit risk)

The first risk, which is associated with the underlying outcome, is generally represented as the required rate of return on the capital necessary to produce the outcome.

For example, if the outcome is based on a measure such as revenue or EBIT, the required rates of return on the debt and equity capital used to generate the outcome should provide the starting point for estimating the discount rate. In this case, a weighted-average cost of capital may be an appropriate rate of return. On the other hand, if the outcome is based on net income, the cost of equity may be a more appropriate rate of return because the debt capital has already received its return via the interest payment. Also, because the contingent consideration will be based on the target's performance, the risk should reflect the uncertainty specific to the target rather than to a hypothetical market participant.

The second risk is inherent in the nature of the payout structure. Although the risk of the underlying outcome may be captured in a weighted-average cost of capital or cost of equity, when the payout structure is nonlinear, there may be additional risks that need to be considered. In other words, the contractual features that define the structure of the earn-out could make it a riskier arrangement.

For example, assume there is an earn-out with the same characteristics as in Illustration 6: the payout is three times EBIT if more than \$1 million; there is a 50% probability of EBIT being \$1 million and a 50% probability of EBIT being \$2 million. The risk of EBIT being \$1,000,000 versus \$1,000,001 is small – it represents only a fraction of a percentage. However, for the earn-out, there is incremental risk associated with that last dollar of EBIT. If EBIT is \$1,000,000, the earn-out is not triggered, but if it is \$1,000,001, the payout is required.

The third risk is the ability of the holder to collect the contingent consideration payment (i.e., credit risk of the buyer). Contingent consideration arrangements generally do not represent a direct claim on the cash flows from the underlying outcome (such as a specified portion of the target's earnings) but rather a subordinate, unsecured claim on the buyer. The credit risk of the buyer should be considered, taking into account the seniority of the contingent consideration claim in the buyer's capital structure and the expected timing of the payout. The buyer's own credit risk is considered in determining fair value because ASC 820 presumes the liability is transferred to a market participant of equal credit standing.

An appropriate discount rate must be applied when estimating the fair value of a contingent consideration arrangement.

As discussed above, the fair value of a contingent consideration liability should be measured from the perspective of a market participant that holds the identical instrument as an asset. If the risk premium of the contingent consideration arrangement were to increase, the fair value would decline (i.e., due to a higher discount rate) for the holder of the contingent consideration asset. This increase in the risk premium would have a symmetrical effect on the liability. That is, the discount rate used to measure the fair value of the contingent consideration liability would also increase.

Next steps

- Companies contemplating a business combination involving the use of contingent consideration should carefully evaluate the potential effects that the arrangement might have on future earnings and other metrics.

Endnotes:

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- ¹ ASC 805, *Business Combinations*.
 - ² ASC 710, *Compensation – General*, and ASC 718, *Compensation – Stock Compensation*.
 - ³ ASC 480, *Distinguishing Liabilities from Equity*.
 - ⁴ ASC 815, *Derivatives and Hedging*.
 - ⁵ While option pricing methods commonly are used to value contingent consideration arrangements, they are not the focus of this publication.
 - ⁶ ASU 2011-04, *Fair Value Measurements and Disclosures (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*
 - ⁷ Paragraph BC34 in the Basis for Conclusions in ASU 2011-04.

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