Contingent Consideration Arrangements in Business Combinations

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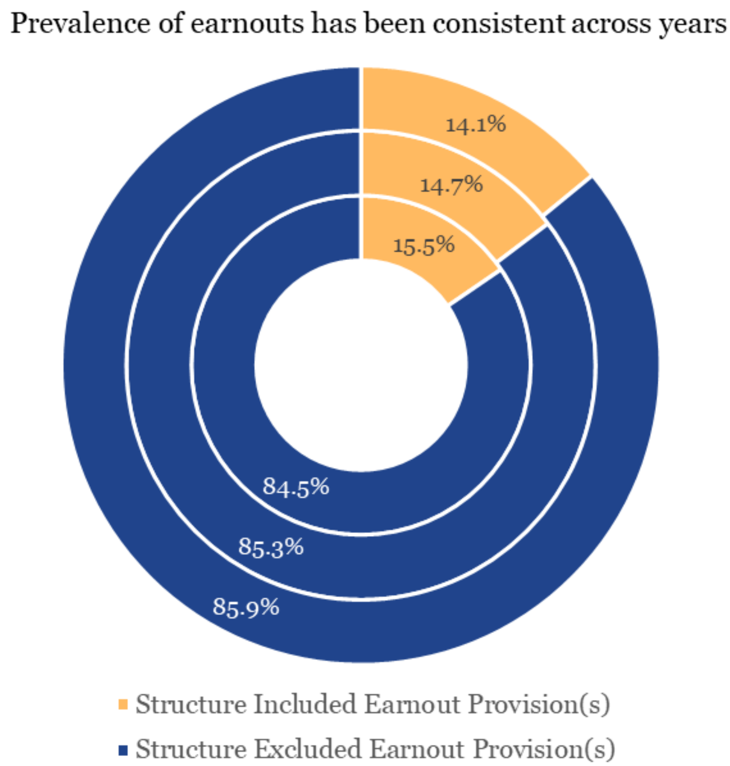
Summary

In the merger and acquisition landscape, transactions often include a variety of types of consideration transferred from the buyer, or acquirer, to the seller, including cash and the acquirer's equity instruments. The buyer and seller may also agree to have a portion of the purchase price become payable if certain contingencies, milestones, or metrics are met in the postacquisition period. These arrangements are typically referred to as contingent consideration arrangements, or earnouts, in practice. As part of preparing this publication, we collected data and analyzed transaction structures for approximately 320 M&A transactions within the software and SaaS industries for a time period covering January 1, 2020 through December 31, 2022, observing that approximately 15% of transactions involved an earnout component, without a significant difference in the prevalence of earnout components between the years, as shown in Figure 1.

Figure 1: Prevalence of Earnouts



Inner most circle represents data for CY2020, middle circle represents data for CY2021 and outermost circle represents data for CY2022.

Source: Effectus Group Analysis, SEC filings.

Pursuant to Accounting Standards Codification 805, Business Combinations ("ASC 805") consideration transferred, including contingent consideration, is measured at fair value on the acquisition date when a transaction is accounted for as a business combination. ASC Master Glossary defines contingent consideration as follows:

> *Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.*

The accounting for these arrangements can be highly complex and may require a significant degree of professional judgment. For financial reporting purposes, topics that management may consider when structuring, negotiating, and accounting for these types of arrangements include, but are not limited to, the following:

– *Is the settlement in cash or the acquirer's equity instruments?*

While cash-settled arrangements are accounted for as liabilities, equity-settled arrangements may also be liability-classified arrangements. Liability-classified contingent consideration arrangements are subject to re-measurement at fair value at each reporting period, and changes in the fair value would be recognized in earnings during such period. In contrast, equity-classified contingent consideration arrangements are not subject to remeasurement to fair value in subsequent periods, provided that these arrangements continue to meet the equity classification conditions pursuant to Accounting Standards Codification Subtopic 815-40, Derivatives and Hedging – Derivatives and Hedging—Contracts in Entity's Own Equity ("ASC 815-40"), at each reporting date. Given the differences in the accounting treatment, the structuring of the arrangements may have significant accounting implications, including volatility in the acquirer's post-acquisition earnings due to remeasuring them to fair value.

– *Is the payment or settlement contingent on continuing employment of sellers who became employees of the acquirer postacquisition?*

  While contingent payment(s) may have been negotiated as a component of the purchase price and the deal value, these types of arrangements would typically be accounted for as compensatory arrangements, resulting in the acquirer, or the combined company, recognizing the value of the contingent payments as postacquisition compensation expense, not as a component of the purchase price.

– *Are there other provisions and terms that may indicate that the substance of the arrangement is compensatory?*

  Pursuant to guidance in ASC 805, an acquirer is required to assess if any component of the purchase consideration is primarily for the benefit of the acquirer. If so, the acquirer is required to account for the arrangement separately from the business combination, commonly referred to as a separate transaction in practice. This may result in instances where components of the purchase consideration are accounted for as compensation expense in the acquirer's post-acquisition earnings instead of as consideration transferred, resulting in an unexpected earnings impact. Refer to Example 5 within the "Illustrative Examples" section for a practical example of a scenario whereby a component of the purchase price is accounted for as compensation expense in the postacquisition period.

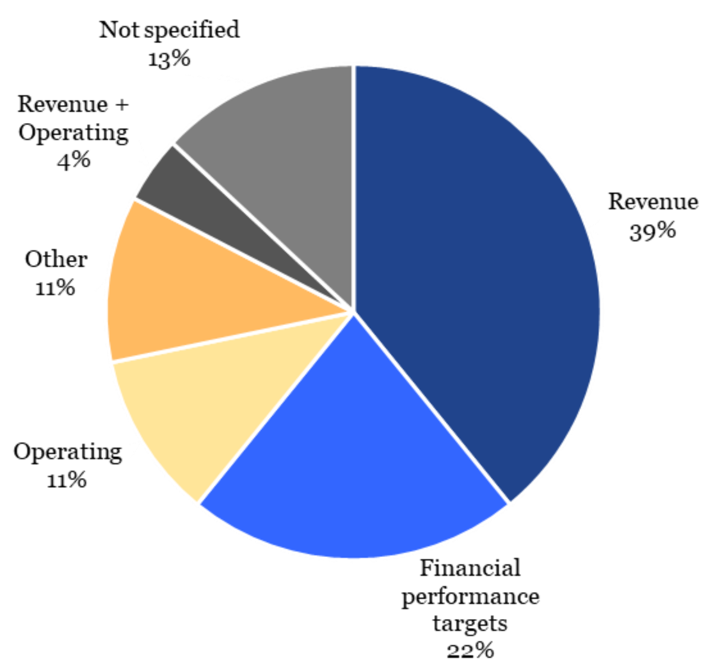
– *Does the acquirer have internal capabilities and expertise to determine the fair value of these types of instruments?*

  As a result of the complexity related to measuring the fair value of these instruments, management may be required to engage a third-party valuation firm to assist with determining the acquisition date fair value and the fair value at subsequent reporting dates.

Earnouts can be a useful component of the transaction structure when the buyer and seller have a disagreement on the target's valuation and the total consideration to be transferred to acquire the target company or the target's assets. In these instances, earnouts can be used to bridge a "valuation gap." Valuation gaps may arise when buyers and sellers negotiate on the value of the target company or its assets, often because of information asymmetry or differing expectations in the growth or profitability profile of the target company. In these cases, incorporating contingent consideration provisions and payments in lieu of the purchase price being paid entirely on the closing date can reduce the risk of the transaction for the acquirer, and can enable the seller to achieve its total desired purchase price if the earnout requirements are ultimately met.

Figure 2: Earnout metrics

Earnout metrics were most commonly tied to achievement of revenue or other financial metrics, such as metrics based on EBITDA or net income.



Source: Effectus Group Analysis, SEC filings.

For instance, if a seller believes that the target company will be able to achieve aggressive postacquisition revenue or EBITDA growth rates, and therefore incorporates those assumptions into its valuation model, it may arrive at a higher purchase price than the buyer is willing to pay based on a valuation model with more conservative growth rates. A way to bridge this valuation gap would be to incorporate earnout provisions into the overall transaction structure to account for the difference between the seller's and buyer's revenue and EBITDA growth rate assumptions.

Earnouts are also helpful in addressing risks and rewards faced by either party, resulting in a higher probability of successful completion of the contemplated transaction. New product launches, entering new markets, macroeconomic shocks, or to-be completed product development may have meaningful impacts on the future growth of the acquired business, and accordingly the valuation of the target company could be significantly affected by the outcome of such events. Earnout arrangements in these instances can be helpful in shifting some of the risk from the buyer to the seller while also retaining a portion of the upside to the seller.

There may be other reasons for the inclusion of earnout structures as a way to negotiate and agree on risks and rewards borne by the buyer and the sellers relating to the future performance of the target. As a result, the earnout structure and metrics can be significantly customized to the specifics of the transactions, and the risks which either party hopes to address through structuring.

Accounting for contingent consideration

Unit of Account Considerations

In order to determine the proper accounting for contingent consideration arrangements, the acquirer needs to first determine the proper unit of account for the arrangement(s), if and when the structure includes multiple payment provisions or triggers, as this will guide the level of stratification of the contingencies that must be assessed for accounting purposes. The unit of account may have significant implications in determining the appropriate classification and whether all, or a portion of, such arrangements should be accounted for as a compensatory arrangement.

ASC 805 does not provide explicit guidance on how to determine the appropriate unit of account. Accordingly, determining the unit of account requires careful consideration of the facts and circumstances as well as the substance of the arrangement. In this assessment, the legal form is not necessarily indicative of the unit of account. For instance, contingent consideration arrangements may be described within a single purchase agreement or documented within the same legal document. However, a single purchase agreement could consist of multiple units of accounting. Given the lack of authoritative guidance in ASC 805, practitioners typically refer to and analogize to other applicable generally accepted accounting principles ("GAAP") when assessing the appropriate unit of account for contingent consideration in business combinations.

As an example, the definition of a freestanding financial instrument in Accounting Standards Codification 480, Distinguishing Liabilities from Equity ("ASC 480") may be helpful to refer to when determining the appropriate unit of account. ASC 480 defines a freestanding financial instrument as a financial instrument that either: (a) was entered into separately and apart from any of the entity's other financial instruments and equity transactions or (b) was entered into in conjunction with some other transaction and is legally detachable and separately exercisable. In practice, the contingent right for the sellers to receive additional consideration is commonly non-transferable and non-assignable. However, there may be instances where certain arrangements, such as contingent value rights (CVRs), may be listed on an exchange and be traded in the public markets. In these instances, the separate tradability of the CVRs would be a strong indicator of multiple units of accounting, particularly if the arrangement consists of multiple payment triggers and if the achievement or non-achievement of a specified payment trigger does not result in the settlement, cancellation, or termination of the other contingent payments.

Additionally, factors listed in ASC 815-10-15-9 may be helpful when assessing the unit of account in instances when contingent consideration arrangements are separately structured for legal structuring purposes. Such considerations may include the following:

- Whether the contingent consideration arrangements were entered into contemporaneously and in contemplation of one another or separately and apart from one another.
- Whether the contingent consideration arrangements were executed with the same counterparty or different counterparties.
- Whether the contingent consideration arrangements relate to the same risk or different risks.

– Whether there is an apparent economic need or substantive business purpose for structuring the transactions separately that could not have also been accomplished in a single transaction or whether such apparent economic need or substantive business purpose for structuring the transactions separately does not exist.

However, professional judgment should be used in determining the weight and importance placed into each factor. For instance, earnouts, whether consisting of a single trigger or multiple triggers, would typically be negotiated as part of the overall business combination, and would be entered into contemporaneously and in contemplation of one another as part of the business combination.

In practice, the discreteness of risks, measurement periods, and payment provisions are significant considerations when determining the appropriate unit(s) of accounting. As an example, consider an arrangement that requires the acquirer to issue (deliver) 100 shares to the seller if revenues exceed $1 million in the first postacquisition year and another 100 shares if revenues exceed $1.2 million in the second postacquisition year. This type of arrangement would typically be indicative of two different units of accounting as each milestone and the associated shares can be earned independently of each other. In contrast, consider an arrangement where the acquirer will issue up to 200 shares if cumulative revenues exceed $2.2 million over a period of two years. If cumulative revenues exceed $1.0 million, the acquirer will issue 100 shares and if cumulative revenues exceed $2.2 million, the acquirer will issue another 100 shares. This type of arrangement would typically be indicative of a single unit of account as the arrangement effectively has the same risk exposure across the measurement period, albeit with a higher revenue target for the additional 100 shares.

Different counterparties and differing terms across counterparties are other indicators of different units of accounting. As an example, an acquirer acquires a target with four shareholders, one of which is the target's CEO, with each shareholder owning 25% of the target. The acquisition agreement stipulates that each shareholder will receive an incremental $1 million in cash if the target's EBITDA exceeds a certain threshold within the first post-acquisition year. However, the acquirer negotiated that the payment to the target's former CEO is also subject to the CEO's continuing employment at the combined company through the payment date. The contingent payments for the other sellers are not contingent on any employment requirements and are not subject to forfeiture if the CEO's explicit employment requirement is not met. In this instance, we would generally expect that the contingent payment for the CEO is a separate unit of account from the payments to the other sellers due to the difference in payment triggers across the multiple counterparties. Accordingly, the contingent payment to the CEO may be treated as a compensatory arrangement while the payments to the other sellers may be treated as a contingent consideration arrangement and therefore be included in the calculation of consideration transferred under GAAP.

<u>Classification Considerations</u>

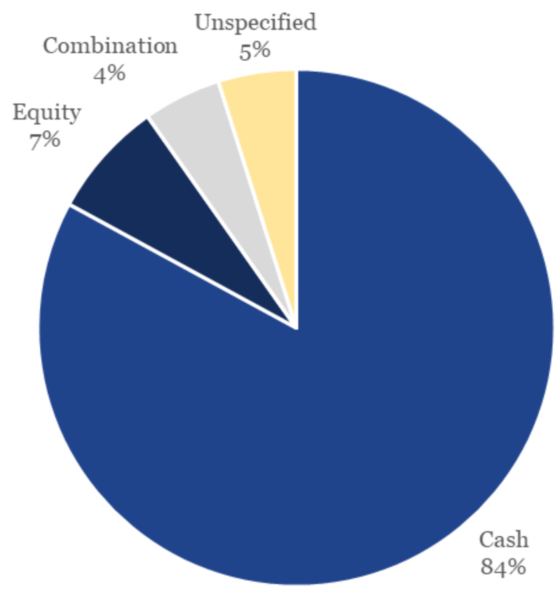
Once the acquirer has determined the appropriate unit of account for the contingent consideration arrangement(s), the buyer should then assess each unit of account for classification purposes. ASC 805 specifies that contingent consideration should be measured at fair value on the acquisition date, but ASC 805 does not address how to determine the appropriate classification of contingent consideration. Instead, ASC 805 requires that the acquirer analyzes the arrangement pursuant to other GAAP to determine the classification.

ASC 805-30-25-6 indicates that a contingent consideration arrangement should be classified as either a liability (or an asset) or as equity in accordance with ASC 480 and ASC 815-40 or other applicable GAAP. In this assessment, the settlement form and which party controls the choice of settlement form, if applicable, is important to understand. Arrangements solely settleable in cash and arrangements settleable in cash or shares, at the election of the seller(s), would be liability-classified arrangements. In contrast, arrangements solely settleable in shares or settleable in cash or shares, at the election of the acquirer, may qualify for equity classification if certain conditions are met. As shown in Figure 3, cash-settled earnouts were by far the most common settlement form for the transactions that we studied.

Given that the primary purpose of this publication is to understand the accounting for contingent consideration arrangements entered into as part of transactions accounted as business combinations under ASC 805, we will only provide a general overview of the classification guidance in ASC 480 and ASC 815-40. The codification with respect to classifying arrangements as liabilities or equity can be complex and includes case-by-case nuances that are outside the scope of this publication. We have also illustrated the classification considerations for certain arrangements through examples included herein. While these examples are illustrative of the general framework, the classification of each arrangement should be based on the facts and circumstances of such arrangement.

Figure 3: Settlement Form

Cash-settled earnout arrangements were the most prevalent settlement form by a significant margin



Source: Effectus Group Analysis, SEC filings.

ASC 480-10 requires the following instruments to be classified outside of equity (as a liability):

- Mandatorily redeemable financial instruments
- Obligations to repurchase the issuer's shares (or indexed to such obligations) by transferring assets
- Certain obligations to issue a variable number of shares whose monetary value is predominately (1) fixed, (2) varies with something other than the fair value of the issuer's equity shares or (3) varies inversely related to changes in the fair value of the issuer's equity shares.

If none of the aforementioned characteristics are applicable to a contingent consideration arrangement, the guidance in ASC 815-40 should then be assessed to determine the arrangement's classification. ASC 815-40 addresses the accounting for contracts indexed to, and potentially settled in, the issuer's equity shares. Per ASC 815-40-15-7, an entity shall evaluate whether an equity-linked financial instrument (or embedded feature), is considered indexed to its own stock using the following two-step approach:

- Evaluate the instrument's contingent exercise provisions, if any.
- Evaluate the instrument's settlement provisions.

If an entity concludes that an equity-linked instrument is considered indexed to its own stock under ASC 815-40-15, the instrument would not necessarily qualify as equity under ASC 815-40. The entity would also need to determine whether the equity classification conditions in ASC 815-40-25 are met. If so, then the equity-linked instrument would be appropriately classified and accounted for as an equity-classified arrangement instead of a liability-classified arrangement.

Our Observation: Acquirers and management teams should be aware of the accounting implications of the various structures for contingent consideration arrangements since there is a natural tension between buyers and sellers related to who bears downside risks associated with the form of earnout consideration. While contingent consideration arrangements settled in cash will be classified as a liability, subject to be measured at fair value in subsequent periods, contingent consideration arrangements settleable in the acquirer's equity instruments may meet the conditions to be equity classified in the acquirer's financial statements. However, the acquirer should not presume that such equity-settled contingent consideration arrangements will always be equity-classified for accounting purposes. In our experience, it is relatively uncommon for contingent consideration arrangements to meet the criteria for equity classification.

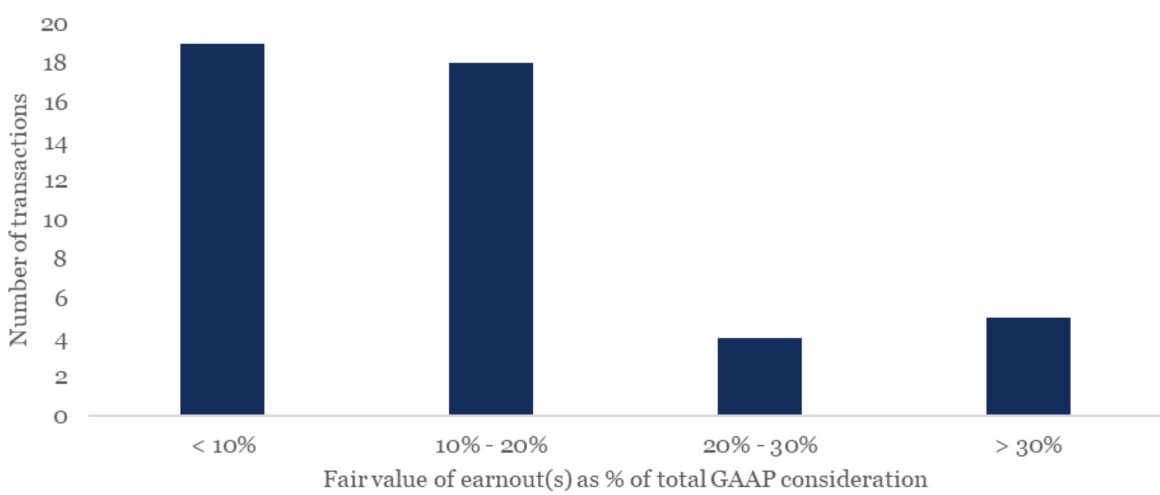
In the case of an equity-settled contingent consideration, the acquirer must perform a comprehensive assessment of the facts and circumstances of the arrangement through the guidance in ASC 480 and, if applicable, ASC 815-40. Based on the complexity and nuances within the guidance, management teams should consult with its internal technical accounting department or an external technical accounting advisor, as well as its auditors, to ensure that the accounting classification is appropriately determined. This determination may have significant subsequent accounting implications, including potential volatility in the acquirer's postacquisition earnings, as a result of the requirement for entities to measure liability-classified contingent consideration arrangements at fair value in subsequent periods with changes in fair value recognized in earnings.

Measurement and Recognition Considerations

After determining the appropriate classification of the earnout arrangement, the acquirer must then address the initial measurement and recognition upon the transaction closing. Regardless of the balance sheet classification, contingent consideration is always initially measured at fair value in accordance with ASC 805-30-30-7. The contingent consideration will be recorded as either an asset, a liability, or a component of stockholder's equity within the acquirer's postacquisition balance sheet, dependent on the assessment of classification criteria in ASC 480 and, if applicable, ASC 815-40.

Figure 4: Earnout Fair Value

Earnouts typically represented less than 20% of the fair value of total consideration transferred.



Source: Effectus Group Analysis, SEC filings.

Once the contingent consideration arrangement has been initially measured at the acquisition date, the acquirer must also understand how to account for subsequent changes in the value of such arrangements. Some changes in the fair value may be the result of additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date. Pursuant to ASC 805-10-25-14, such changes are referred to as "measurement period adjustments" if they occur during the measurement period window, which ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable, but cannot exceed one year from the acquisition date. Measurement period adjustments related to contingent consideration should be recognized by the acquirer as adjustments to the amounts provisionally recognized as of the acquisition date, and therefore would be applied to the acquisition accounting, with an offsetting impact to goodwill. In accordance with ASC 805-10-25-19, after the measurement period ends, the acquirer shall revise the accounting for a business combination only to correct an error. The determination of whether changes in the fair value measurement qualify as measurement period adjustments can be highly judgmental given the degree of subjectivity and complexity in the fair value measurement. Management teams should carefully consider and evaluate the underlying reasons for potential changes in facts and circumstances which appear to have existed as of the acquisition date but were not incorporated into the initial fair value measurement.

Other than measurement period adjustments, the following summarizes the appropriate subsequent accounting for contingent consideration arrangements:

- If the contingent consideration arrangement is initially required to be classified as a liability (or an asset), then the arrangement will be subsequently remeasured at fair value, with any changes in fair value from the previous value recorded in earnings (as a component of operations) pursuant to ASC 805-30-35-1(b).
- If the contingent consideration arrangement is initially classified as equity, then the initial fair value of the equity-classified instrument is not subsequently revalued at the period-end date, unless the arrangement does not meet the equity classification conditions in subsequent periods, pursuant to ASC 805-30-35-1(a).
- Regardless of the classification, the acquirer should consider whether facts and circumstances in subsequent periods would have resulted in the reclassification of the arrangement(s). If so, the arrangement may have to be reclassified from liability to equity or vice versa.

Once the contingency period has elapsed, or the contingency has been either achieved or not, the acquirer must determine how to properly account for the earnout settlement. Upon settlement (including partial settlements), if the contingent consideration arrangement is classified as a liability, then any transfers of assets or issuances of equity shares to satisfy the earnout will be recorded as a derecognition of the asset transferred (e.g., payment of cash) or issuance of equity shares and a corresponding reduction to the earnout liability in the post-combination balance sheet, with a potential impact to the income statement for any differences. If the contingent consideration arrangement is classified as equity, then any settlements (including partial settlements) of the earnout will be recorded entirely within equity in a manner similar to other transactions in an entity's own stock, and therefore will have no impact on the income statement.

<u>Arrangements representing GAAP Consideration Transferred or Compensation to Sellers for Future Services</u>

Often times, purchase agreements include a clause that offers contingent payments to selling shareholders who will remain as employees of the acquiree or the combined entity. In such cases, the payments to be made to the selling shareholders could be more appropriately accounted for as compensation expense for services to be provided subsequent to the acquisition date, as opposed to part of the consideration transferred to the acquired entity.

Pursuant to ASC 805-10-55-24, whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature and substance of the arrangements. Understanding the reasons why the acquisition agreement and transaction structure includes a provision for contingent payments and who initiated the arrangement are helpful to assess as part of this determination. In addition, pursuant to ASC 805-20-25-3, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions. This determination can be highly subjective and may require management's use of significant judgment to determine the appropriate accounting.

When determining whether an arrangement should be accounted for as contingent consideration paid to the selling shareholders or contingent payments for future services, it is helpful to analyze which party primarily benefits from the arrangement. Generally, when the acquirer (or the combined company) is the entity which receives the primary benefits from the arrangement, the payments are accounted for separately from the business combination and would result in the acquirer recognizing the contingent payments as postacquisition compensation expense. A typical example of such an arrangement is contingent payments where key employee(s), who also were acquiree shareholders, are required to be employed through the contingency period. The seller-employee(s) is only eligible to receive the portion of the contingent payment if (i) the relevant earn-out metric is met and (ii) the specified individual is employed by the company through the payment date. In these instances, the substance of the arrangement for the individual(s) is more akin to a performance-based retention bonus and the arrangement should be accounted for as a compensatory arrangement. If the buyer determines that the contingent consideration arrangement falls within the scope of compensation for future services, as opposed to GAAP consideration transferred, then other applicable GAAP must be used to determine the appropriate accounting. Such other applicable GAAP could include Accounting Standards Codification 710, Compensation – General ("ASC 710") or Accounting Standards Codification 718, Compensation – Stock Compensation ("ASC 718").

If it is not clear whether an arrangement is part of the exchange for the acquiree or a separate transaction, ASC 805-10-55-25 provides additional factors that should be considered. As an acquirer, it is important to use judgment to weigh each of the below considerations in contemplation of the transaction-specific facts and circumstances in order to determine the appropriate accounting treatment of contingent consideration arrangement, and the analysis of the factors should not merely be a check-the-box exercise.

Factor	General framework
ASC 805-10-55-25(a): The terms of continuing employment	If payments are forfeited if the employee resigns or is otherwise terminated, the payments should be accounted for as compensation. ASC 805-10-55-25(a) specifically indicates that a contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services. In these instances, the analysis of the other factors is not required. An acquirer should also consider whether there could be elements of an in-substance service period, even if the payments are not automatically forfeited upon termination of employment. For instance, if the acquiree operates in a specialized industry and the earnout metrics are not achievable without a certain individual, the substance of such payments could be to substantively retain such individual's services for the earnout period. This determination can be highly judgmental, and all facts and circumstances should be considered in the accounting conclusion.
ASC 805-10-55-25(b): The duration of continuing employment	If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation. As an example, a key seller-employee and the acquirer enter into a noncancellable two-year employment contract with an earnout duration of one year. If the services of the individual are integral to the achievement of the earnout metrics, the two-year employment contract may result in the conclusion that there is an in-substance service period for the earn-out arrangement, even if the payment is not directly linked to a continuing employment requirement.
ASC 805-10-55-25(c): Employee compensation level	Situations in which employee compensation, other than the contingent payments, is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration transferred rather than compensation. In contrast, the substance of the contingent payment may be compensatory when the individual's other compensation arrangements are not at reasonable levels. As an example, assume that an acquiree's former CEO and sole shareholder continues as an executive of the acquired business and becomes an employee of the combined company. The acquirer typically structures its management-level compensation arrangements in a manner such that a significant portion of the total compensation is tied to general financial performance of the division or business overseen by such management personnel through a cash-based performance incentive plan. As part of the business combination, the acquirer negotiates that the former CEO, as the sole shareholder of the acquiree, will receive a large contingent payment if certain performance metrics are met, but the former CEO is not eligible to participate in the standard management incentive plan of the acquirer.

	In this instance, the contingent payments may be deemed to substantively replace the bonus plan in which other similar employees would be eligible to participate, and the contingent payment could be more appropriately characterized as a compensatory arrangement. The usefulness of this factor may be limited due to various aspects, including the fact that continuing employees potentially perform services that are not comparable to or are in addition to the responsibilities of other employees, resulting in the complexity of benchmarking the reasonableness of other compensation when compared to contingent payments agreed to as part of the business combination.
ASC 805-10-55-25(d): Consistency of payout formula across shareholders	If selling shareholders who do not become employees receive lower contingent payments on a per-share or pro-rata ownership basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation. In these instances, the substance of the incremental consideration may be more indicative of additional payments for post-acquisition services instead of something that was exchanged between the acquirer and the sellers for the acquired business. In contrast, when all contingent payments are structured on a pro rata basis of preacquisition ownership and there are no employment requirements, this would typically be indicative of an arrangement that would be accounted for as contingent consideration.
ASC 805-10-55-25(e): The relative number of shares owned by the selling shareholders who remain as key employees	The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for postcombination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share or pro-rata ownership basis, that fact may indicate that the contingent payments are additional consideration transferred.
ASC 805-10-55-25(f) and 55-25(g): Linkage to the valuation / Formula for determining consideration	If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration transferred. Similarly, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. For example, assume that an acquirer forecasts that the acquiree is able to achieve $10 million in EBITDA in a conservative scenario, but may be able to achieve up to $12 million in EBITDA in a more aggressive scenario in the first postacquisition year. Further, assume that the transaction was priced on an EBITDA multiple basis, and the acquirer negotiated to pay incremental consideration on an EBITDA multiple basis if actual EBITDA is greater than $10 million but less than $12 million during the first postacquisition year. In this case, the incremental consideration paid to the acquiree should be viewed as contingent consideration in order to verify the fair value of the acquiree. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements or based on a specified percentage of earnings, that fact may suggest that the substance of the arrangement is to provide compensation.

ASC 805-10-55-25(h): Other agreements and issues	The terms of other arrangements with selling shareholders (such as noncompete agreements, executory contracts, consulting contracts, and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) might be, in substance, payments for the use of the leased property rather the payments related to the value of the acquired business. As such, the acquirer should recognize such payments separately in its postcombination financial statements.

Illustrative Examples

Example 1: Cash-Settled Contingent Consideration Arrangement based on Revenues and EBITDA

Facts: On June 30, 20X0, an acquirer (a calendar year-end) completed its acquisition of an acquiree for cash consideration of $100 million payable at the closing of the acquisition with an additional cash payment of $20 million payable to the sellers if the acquiree's revenues exceed $75 million during the one-year period following the acquisition and if the acquiree's EBITDA exceeds $15 million during the same one-year period following the acquisition. The acquisition date fair value of the contingent consideration arrangement was determined to be $12 million. The acquirer determined that the contingent consideration arrangement should be accounted for as part of the business combination, not as a separate transaction. The transaction was determined to be a business combination and did not result in the recognition of a bargain purchase gain.

Classification: As the contingent consideration will be settled through a cash payment made by the acquirer, the earnout is classified as a liability pursuant to ASC 480.

Measurement and recognition: The contingent consideration arrangement was initially measured at the acquisition-date fair value of the projected future settlement amount, and the acquisition-date fair value of the contingent consideration liability was determined to be $12 million. The fair value of the liability is included in the measurement of consideration transferred pursuant to ASC 805, resulting in an increase to goodwill. The recognition of the contingent consideration liability at the acquisition date will not initially impact the income statement and is a non-cash transaction that will have no initial impact on the statement of cash flows, beyond disclosure requirements for material non-cash investing and financing activities, as of the acquisition date.

On December 31, 20X0, the fair value of the contingent consideration liability increased to $15 million, resulting in the acquirer recording the following entry in its consolidated year-end financial statements:

Dr: Loss on Contingent Consideration Liability Revaluation	$3,000,000	
Cr: Contingent Consideration Liability		$3,000,000

The revaluation of the contingent consideration liability at period-end will be recorded in the income statement.

Assuming that the acquiree achieved revenues of $90 million and EBITDA of $18 million for the 12-month period ending June 30, 20X1, and the contingent payment of $20 million is due, the acquirer will record the following settlement entry in its consolidated financial statements as of June 30, 20X1:

Dr: Contingent Consideration Liability	$15,000,000[1]	
Dr: Loss on Contingent Consideration Liability Revaluation	$5,000,000[2]	
Cr: Cash (settlement amount)		$20,000,000

[1] Carrying value of contingent consideration liability immediately prior to settlement and prior to final remeasurement. It would also be acceptable for the acquirer to first record the loss on remeasurement of the liability, resulting in the carrying value of the liability being equal to $20 million, and then to record payment of the $20 million liability with a corresponding cash outflow.

[2] Settlement amount less carrying value of contingent consideration liability immediately prior to settlement.

In this example, the cash settlement of the contingent consideration liability will be recognized in the acquirer's statement of cash flows as both a cash outflow from financing activities and a cash outflow from operating activities. In accordance with Accounting Standards Codification 230, Statement of Cash Flows ("ASC 230"), specifically ASC 230-10-45-13, cash payments that are not made soon after (i.e., a relatively short period of time, such as three months or less) the consummation of a business combination to settle a contingent consideration liability will be classified as cash outflows for financing and operating activities. The portion of the cash payment up to the acquisition date fair value of the contingent consideration liability ($12 million in this example) will be classified as a financing outflow, and amounts paid in excess of the acquisition date fair value of that liability ($8 million in this example) will be classified as operating outflows.

Example 2: Fixed Share-Settled Example based on Revenues and EBITDA with single trigger threshold

Facts: Assume the same facts as Example 1, except that rather than the contingent consideration settlement being $20 million of additional cash consideration, the acquirer would issue 1 million shares of its $1 par value common stock to the sellers if the earnout triggers were achieved. Such shares are not puttable, nor do they have other contingent redemption provisions. Additionally, assume that the arrangement would meet the equity classification conditions in ASC 815-40-25, including the acquirer having sufficient authorized and unissued shares.

Classification: As the contingent consideration will be settled through the delivery of additional shares of the acquirer's common stock, the acquirer should first assess the arrangement under the guidance in ASC 480 to determine if the financial instrument is required to be classified as a liability under ASC 480. A financial instrument is within the scope of ASC 480 if it embodies an obligation for the issuer pursuant to any of the following conditions:

1. Mandatorily redeem a financial instrument. This criterion only applies to financial instruments in the form of outstanding shares.
2. Repurchase shares by transferring assets, regardless of whether the instrument is settled on a net-cash or gross physical basis.
3. Issue a variable number of shares and, at inception, its monetary value is solely or predominately:
    a. Fixed
    b. Derived from an underlying other than the fair value of the issuer's shares
    c. Moves inversely to the issuer's shares.

In this case, the shares comprising the contingent consideration are to be issued, not outstanding shares. As such, condition #1 above does not apply. Additionally, the acquirer determines that the arrangement does not require repurchasing shares by transferring assets, or delivery of shares which may be puttable or redeemable. Accordingly, condition #2 is not met.

The contingent consideration most closely aligns with the third point above, as one could view this arrangement as embodying an obligation for the acquirer to issue a variable number of shares to the sellers (either 1 million or zero), if the specified financial metrics are achieved. However, in practice, this type of arrangement is generally not considered to be settled for a variable number of shares, as the contingency is effectively an "on-off switch" that does not affect monetary amount on settlement. In other words, there are only two discrete outcomes for the contingency, which is generally viewed as embodying a fixed number of shares to be issued, and the monetary value upon settlement would be based on the fair value of a fixed number of the issuer's own shares. Therefore, the contingency does not fall within the scope of ASC 480.

Prior to concluding on equity classification, the acquirer should assess the arrangement through the lens of ASC 815-40-15 and ASC 815-40-25.

1. Is the arrangement indexed to the entity's own equity?

    Yes. The arrangement would be considered "indexed to the entity's own stock" under ASC 815-40-15 in which case equity classification is not precluded. The contingency trigger is based on the acquiree's revenue and EBITDA, both of which are observable indices calculated solely by reference to the entity's operations. Further, the settlement terms are indicative of a fixed-for-fixed forward or option, as the settlement will equal the fair value of a fixed number of the entity's equity share.

2. Does the arrangement meet the equity classification requirements in ASC 815-40-25?

Yes. As assumed in the facts and circumstances, the arrangement was determined to meet the equity classification conditions in ASC 815-40-25.

Based on the above, the acquirer concluded that the contingent consideration arrangement should be classified in shareholders' equity on the acquisition date.

Measurement and recognition: The fair value was determined to be $12 million, and the fair value is included in the measurement of consideration transferred, resulting in an increase to goodwill. Since the arrangement meets the equity classification conditions, the fair value of the earnout would be recorded as an increase in the acquirer's additional paid-in capital balance. Further, based on the equity classification, the earnout is not subject remeasurement to fair value in subsequent reporting periods, as long as the conditions for equity classification continue to be satisfied.

Upon settlement, and assuming that the acquirer issues 1 million shares due to the earnout metrics being met, the acquirer will reclassify an amount equal to the par value of such shares from additional paid-in capital to the common stock equity account.

Example 3: Variable Share-Settled Example based on Revenues and EBITDA with single trigger threshold

Facts: Assume the same facts as Example 2, except that rather than the acquirer issuing 1 million shares of its $1 par value common stock to the acquiree if the earnout triggers are achieved, the acquirer will issue a variable number of shares of its common stock to the sellers such that the total fair value of the shares issued equals $20 million. For instance, and assuming that the earnout metrics are met, the acquirer would issue 2 million shares if the closing trading price of the acquirer's common stock is $10 on the last trading date of the earn-out period.

Classification: As the contingent consideration will be settled through the delivery of a variable number of shares of the acquirer's common stock with a monetary value equal to $20 million, the arrangement meets the characteristics of a variable-share settlement obligation where the monetary value is fixed. In particular, ASC 480-10-25-14(a) requires liability classification for an obligation that the issuer must settle in a variable number of shares when the monetary value is a "fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)." While the settlement form is in shares instead of cash, the economic substance of the arrangement is not substantially different from Example 1 since the sellers are not exposed to any of the risks and rewards associated with the acquirer's equity during the duration of the earnout period. Based on these facts and circumstances, the acquirer would classify the arrangement as a liability.

Measurement and recognition: The initial recognition of the contingent consideration liability will be the same as Example 1 above, resulting in an increase to goodwill. During the term of the arrangement, the acquirer would record gains or losses based on changes in the fair value of the arrangement.

The main difference in the accounting between this example and Example 1 would be the settlement date accounting due to the settlement form being a variable number of shares instead of cash. Assuming the same facts as Example 1, and that the common stock was valued at $10 per share on the settlement date, the acquirer would record the following entry at settlement:

Dr: Contingent Consideration Liability	$15,000,000[3]	
Dr: Loss on Contingent Consideration Liability Revaluation	$5,000,000[4]	
Cr: Common Stock Par Value		$2,000,000[5]
Cr: Additional Paid in Capital		$18,000,000[6]

In contrast to the entry above, assuming that the trading price was $5 instead of $10, the acquirer would be required to deliver four million shares, or $20 million divided by the closing trading price of $5, resulting in the allocation between the par value and additional paid-in capital being different. However, the trading price would not impact the loss on

[3] Carrying value of contingent consideration liability immediately prior to settlement, and prior to final fair value remeasurement.
[4] Settlement amount less carrying value of contingent consideration liability immediately prior to settlement.
[5] $20,000,000 fixed issuance amount / $10 per share = 2,000,000 shares * $1 par value = $2,000,000.
[6] $20,000,000 fixed issuance amount - $2,000,000 par value = $18,000,000.

fair value measurement due to the structure of the payout being in a variable number of shares with a fixed monetary value.

As a result of the liability being settled in shares, the settlement would not result in a cash outflow or directly impact the acquirer's statement of cash flows. However, the loss on revaluation of the contingent consideration liability would be an adjustment to reconcile net income (or net loss) to net cash provided by (or used in) operating activities. The acquirer should also consider appropriate disclosures for noncash investing and financing activities upon initially entering into and upon settlement of the contingent consideration arrangement and the related liability.

Example 4: Variable Share-Settled Example based on Revenues and EBITDA with multiple trigger thresholds

Facts: Assume the same facts as Example 2, except that the earnout trigger thresholds and number of shares to be issued for each respective threshold are as follows (all figures presented in the table are in millions):

Acquiree Revenue	Acquiree EBITDA	Cumulative Shares Earned
Less than $75	Less than $15	0
$75 - $80	$15 - $16	1
$80 - $85	$16 - $17	1.1
$85 - $90	$17 - $18	1.2
$90 - $95	$18 - $19	1.3
$95 - $100	$19 - $20	1.4
Greater than $100	Greater than $20	1.5

In the table above, the number of shares earned is assumed to be on a cumulative basis. For instance, the acquirer would deliver 1 million shares if the acquiree's revenues and EBITDA were $77.5 million and $15.5 million, respectively, during the earnout period. In contrast, the acquirer would deliver 1.1 million shares if the acquiree's revenues and EBITDA were $82.5 million and $16.5 million, respectively, during the earnout period.

Classification:

First, as the contingent consideration arrangement involves multiple trigger thresholds, the acquirer must determine the unit of account for the arrangement, and whether each trigger threshold would represent a single unit of account. In this case, the trigger thresholds were entered into contemporaneously and in contemplation of one another, the counterparty is the same for each trigger threshold (acquiree), and the trigger thresholds each relate to the same risks, including the equity risk of the underlying shares, and risks related to achievement of revenue and EBITDA metrics. Additionally, the performance period is the same, as the number of shares to be delivered is based on the same, albeit tiered, financial metrics during the first post-acquisition year. Therefore, the trigger thresholds and associated share settlement amounts should be viewed as a single, combined contingent consideration arrangement.

As the contingent consideration will be potentially settled through the delivery of a variable number of shares of the acquirer's common stock depending on the levels of revenue and EBITDA achieved, the acquirer should first assess the arrangement under the guidance in ASC 480. In this case, the contingent consideration arrangement in the purchase of acquiree may embody a situation in which the acquirer is issuing a variable number of shares whose monetary value is predominately derived from an underlying or a variable other than the fair value of the acquirer's shares (i.e., the acquiree's revenue and EBITDA metrics which are settlement contingencies for the arrangement). As such, the acquirer must determine which variable(s) is the predominant value driver for the overall arrangement. The more difficult it is to achieve the thresholds, we generally believe that it is more likely that monetary value of the arrangement is based predominately on achievement of the revenue and EBITDA targets instead of the acquirer's share price, and therefore the arrangement may fall within the scope of ASC 480 and require liability classification. In contrast, the predominant driver of the monetary value could be viewed as the underlying share price if the achievement of the financial metrics was highly likely, and therefore the monetary value upon settlement would be primarily driven by the fair value of the underlying shares.

The acquirer would have to exercise a significant degree of judgment in determining the appropriate classification, and consultation with the accounting advisors, valuation experts and auditors may be necessary to determine which variable (exercise contingencies or share price) would predominately influence the monetary value.

Even if the acquirer determines that the arrangement falls outside the scope of ASC 480, the arrangement does not meet the requirements for equity classification, as the scope exception under ASC 815-10-15-74(a) would not be met. Specifically, the contingent consideration would not be considered indexed to the issuer's own equity as a result of the settlement criterion, which would not equal the difference between a fixed number of the entity's equity shares and a fixed strike price. Although the strike price to be received by the acquirer at settlement would be fixed at $0 (as the contingent consideration would require no further payment by the sellers), the number of shares to be issued to the acquiree would not be fixed, but rather would depend on the levels of revenue and EBITDA achieved by the acquiree during the 12-month period post-close. Further, as the amount of an entity's annual revenue and EBITDA is not an input to the fair value of a standard fixed-for-fixed option on equity shares, the earnout would require classification as a liability.

Based on the above, the acquirer would conclude that the contingent consideration should be classified as a liability on the acquisition date.

Measurement and recognition: On the acquisition date, the fair value of the arrangement would be included in the measurement of consideration transferred and would result in an increase to goodwill.

As a result of the acquirer concluding that the arrangement is liability-classified, whether accounted for under ASC 480 or under ASC 815-40, the acquirer will be required to remeasure the fair value at each subsequent reporting period, and recognize changes in such fair value in earnings (typically as a component of income or loss from operations) during each reporting period. Given the added complexity of the arrangement, including multiple potential outcomes on the number of shares to be delivered, these types of arrangements may result in significant earnings volatility in the postacquisition period.

As a result of the liability being settled in shares, the arrangement would not result in cash outflows or directly impact the acquirer's statement of cash flows. However, gains or losses upon periodic revaluation of the contingent consideration liability would be an adjustment to reconcile net income (or net loss) to net cash provided by (or used in) operating activities. The acquirer should also consider appropriate disclosures for noncash investing and financing activities upon initially entering into and upon settlement of the contingent consideration arrangement and the related liability.

<u>Example 5: Cash-Settled Contingent Payments based on Continuing Employment Requirements</u>

Facts: On June 30, 20X0, the acquirer completed its acquisition of the acquiree for cash consideration of $100 million payable at the closing of the acquisition with an additional cash payment of $20 million payable to the two co-founders of the acquiree, or $10 million for each co-founder. Each co-founder owned 25% of the acquiree at the acquisition date.

Per the terms of the purchase agreement, the purchase price is equal to $120 million, of which $20 million is held back as a "founder holdback" and the release of the holdback is subject to postacquisition employment requirements. The release of holdback is structured such that $10 million, or $5 million for each co-founder, is released from the holdback on the first anniversary of the close date, with the remaining $10 million, or $5 million for each co-founder, to be released at the second anniversary of the close date.

The provision requiring post-acquisition employment was negotiated as part of the business combination and was a significant negotiating aspect for the acquirer to ensure continuity of the business for at least two years in the postacquisition period. Without the holdback provision, each of the co-founders would have been eligible to receive a payment of $30 million, or 25% of the purchase price, upon the closing of the transaction, based on such co-founder's ownership in the acquiree.

Each co-founder can earn the $10 million payment solely based on such co-founder's employment, and the payment for each co-founder is not forfeited if the other co-founder's employment is terminated. The acquiree's other owners all received an upfront payment, which is not subject to vesting, holdback or clawback provisions, and such upfront payment was based on each owner's pro rata ownership in the acquiree immediately prior to the acquisition.

Classification: As the additional consideration stipulated in the purchase agreement requires that the co-founders remain employed by the acquirer for a specified period after closing, the arrangement is indicative of compensation for future services, rather than contingent consideration to the selling shareholders based on the occurrence of future events or achievement of certain conditions. Per ASC 805-10-55-25(a), "arrangements in which contingent payments are automatically forfeited if employment terminates requires the contingent payments to be accounted for as compensation for postcombination services." Additionally, given that the arrangement will be settled in cash, the arrangement would typically be accounted for as a retention bonus (a deferred compensation arrangement) within the scope of ASC 710 given that the substance of the arrangement is to retain the services of the co-founders in the postacquisition period.

Measurement and recognition: In cases where contingent consideration in a business combination is tied to future service requirements, the amount of the future payment will be excluded from the measurement of consideration transferred, as calculated pursuant to ASC 805, and other applicable GAAP must then be used to determine the appropriate accounting. Generally, an entity shall recognize a periodic expense and accrual for deferred payments ratably over the service period such that the present value of the obligation is fully accrued at the date the employee attains full eligibility for the benefits pursuant to guidance in ASC 710-10-30. ASC 710-10-25-9 also indicates that when the terms of a deferred compensation arrangement are attributable to a period greater than one year, the cost of those benefits shall be accrued over the period of the employee's service in a systematic and rational manner. In this case, the deferred payments for continued employment could be accrued on a straight-line basis over the 24-month period from the acquisition date, which is a systematic and a rational manner. Other accrual patterns may also be acceptable based upon the acquiree’s accounting policies, such as an accelerated recognition pattern.

We observe that ASC 710 does not provide guidance on whether an entity should estimate forfeitures, or account for forfeitures as they occur. ASC 718, however, provides a policy election on this matter, and entities are allowed to either estimate forfeitures or recognize forfeitures as they occur. We believe that a similar accounting policy election may be acceptable for deferred payments tied to continuing employment requirements, as such a policy election would be consistent with the systematic and rational manner described in ASC 710-10-25-9. An acquirer should, however, also consider whether it can reasonably estimate whether forfeitures will occur, and the likelihood of the co-founders staying through the employment period, prior to deciding on the appropriate expense attribution methodology. In this case, the acquirer determined that it is highly likely that the co-founders will continue employment at the combined entity due to a variety of reasons, including the contingent $10 million payments per co-founder, which represent a significant financial incentive to each co-founder.

Based on these facts and circumstances, the acquirer will accrue approximately $0.8 million on a monthly basis, representing 1/24 of the total $20 million contingent payment, as a post-acquisition compensation expense. This example does not consider the impact of present value on the obligation to be accrued.

As a result of the arrangement being accounted for as a compensatory arrangement, the payments made under the arrangement would be classified as operating cash flows in the acquirer’s statement of cash flows. Under the indirect method of preparing the statement of cash flows, the accrual of the liability and settlement of the liability would be reflected as changes in the acquirer’s liability balances to reconcile net income (or net loss) to net cash provided by (or used in) operating activities.

Conclusion

The current accounting guidance with respect to the recognition and measurement of contingent consideration in business combinations contains various complexities and nuances, and improper interpretation of such guidance may result in financial reporting consequences and other downstream impacts. It is important to understand the implications of different contingent consideration structures, including how such structures will impact the initial recognition and measurement, the subsequent measurement, and the settlement of the arrangement.

Effectus Group’s team of highly skilled advisors, with extensive experience in the area of complex contingent consideration arrangements in business combinations, are here to help navigate this topic.