Contingent Consideration

Accounting & Business Considerations

Accounting standards

Accounting Standards Codification (ASC) Topic 805, Business Combinations, requires the acquirer to recognize and measure any purchase consideration transferred at fair value (including consideration that is contingent upon future events or conditions i.e. contingent consideration).

ASC 805 defines contingent consideration as 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 (an earnout). However, contingent consideration may also give the acquirer the right to the return of previously transferred consideration if specified conditions are met (a clawback).

Depending on the specific structure and nature of settlement, contingent consideration may be liability, asset, or equity classified. This classification will determine whether a contingent consideration needs to be re-measured at subsequent reporting periods. However, not all contingent payments structured as part of an acquisition are treated as purchase consideration. For example, contingent payments tied to employment may be classified as post-acquisition compensation expense, which may not require fair value measurement. The rules governing the accounting classification of contingent payments can be complex, and such assessments should be made prior to applying fair value guidance to ensure it is applicable.

In the majority of cases, however, contingent consideration is liability classified, initially recognized at fair value with subsequent re-measurements flowing through the income statement.

Fair value concepts

ASC 820 and IFRS 13 define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions.

According to the fair value hierarchy defined in ASC 820 and IFRS 13 market observable inputs (Level 1 and Level 2) should be prioritized over unobservable inputs (Level 3). However, due to the bespoke nature of contingent consideration arrangements and the lack of quoted prices for identical or similar types of arrangements, the fair value measurement of contingent consideration will likely involve a significant number of Level 3 (unobservable) inputs. These inputs are typically used within an income approach in conjunction with complex option pricing methods to estimate the fair value of the contingent consideration.

Why structure a contingent consideration?

Contingent consideration is used as a mechanism for a buyer and seller to consummate a deal, and is therefore structured to meet the buyer and seller's respective objectives. Typical reasons for structuring a contingent consideration include:

- Bridging the valuation gap between buyer and seller;
- Aligning the interests of buyer and seller post-transaction, and incentivizing carryover management;
- Mitigating post-transaction performance risk; or
- Deferring payments until the business is performing well.

[1] International Financial Reporting Standards (IFRS) Revised Standard 3 defines contingent consideration in similar terms to those in ASC 805 and it provides the principles and requirements for recognition and measurement at fair value of any consideration transferred, including contingent consideration, in a business combination.

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Key components of contingent consideration structures

There are several key factors to consider when structuring contingent consideration arrangements, as follows.

Percentage of Total Consideration

The size of the contingent consideration relative to the total purchase consideration can vary significantly between transactions. In order to avoid over-paying, buyers may prefer a higher percentage of contingent consideration, whereas sellers (who are no longer in full control of the business) may prefer a lower percentage. Other factors such as accounting implications and valuation considerations may influence the desired size of the contingent consideration.

Underlying performance metric

There are two types of metrics related to contingent consideration: financial metrics, such as revenue and EBITDA and non-financial milestone events, such as development or technical milestones.

The metric used to determine the payment should be aligned to the objectives of structuring the contingent consideration. In many cases, a contingent consideration is structured to incentivize outperformance, or mitigate underperformance, of the acquired business. In general, the performance metric chosen should be:

- A good proxy for the future performance of the acquired business;
- Clearly defined and understandable;
- Practical, avoiding significant system changes to measure and monitor the metric; and
- Objectively measurable in order to avoid manipulation and disputes.

Payoff structure

The payoff structure sets out how the payment will be calculated based on the chosen performance metric. Typical payoff structures include performance thresholds, payment caps, and catch-up provisions used as mechanisms to recover from underperformance in subsequent periods.

While the payoff structure can be an effective tool to ensure the contingent consideration achieves its intended objectives, certain structures are more susceptible to legal disputes and can significantly increase the complexity of the fair value measurement.

Performance period

The chosen performance measurement period should balance short- and long-term incentives, preserve the performance metric's relevancy during the measurement period and consider specific industry characteristics. Specific factors to consider when setting the performance period of a contingent consideration include:

- The period over which there is heightened uncertainty with respect to the performance of the acquiree;
- The time period needed to integrate the acquired business, and the resulting impact of buyer-synergies;
- Any known / pending business milestone / events;
- The period of deferral or seller financing requirements; and
- Retention of key management, non-competes, employment contracts and incentive awards.

Form of settlement

Contingent consideration arrangements are typically settled in cash and/or buyer's stock. The form of settlement should align with the specific objectives of the transaction, and can have accounting classification, fair value measurement and business risk implications.

For example, contingent consideration settled in stock may be equity classified, require a valuation of the buyer's business (post-acquisition) and will result in the seller becoming an equity holder in the buyer's business. Complications may arise because the ultimate purchase consideration for the acquiree may depend on the performance of both the acquired business and the combined business of the buyer (including the acquired business). Anti-dilution clauses are typically considered in order to protect the seller against equity interest dilution due to buyer's issuance of new shares.

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