Feature

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Shareholders' Earn-Outs and Earnings Management

Shareholders' earn-outs in business combinations are a form of contingent considerations and represent an obligation of the acquirer to transfer additional assets or equity interests to the selling shareholders of the acquiree if certain future events occur or certain conditions are met. There is a subset of earn-outs, which stipulates that the acquirer promises to grant certain awards in the form of cash or equity to certain employees of the acquiree if certain performance objectives are achieved, or if certain conditions are met during the post-acquisition period. This type of earn-outs is referred to as compensation earn-outs.[1]

Companies may use shareholders' earn-out arrangements (earn-outs) in business combinations to bridge the gap between what the acquirer and acquiree believe the business is worth based on future financial projections. The acquisition of companies that have significant growth projections or emerging technologies and products (e.g., high-technology and bio-technology companies) are examples where an earn-out arrangement may be used. In these situations, an acquirer may negotiate some form of contingent consideration (earn-out) that will be paid to the shareholders of the acquiree if certain objectives (i.e., certain level of revenue or profitability threshold) are achieved during the post-business combination period.

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This article aims to outline the accounting guidance and its implications during the post-business combination period for shareholders’ earn-out arrangements. It specifically addresses some of the conditions and circumstances that may lead to proper classification of earn-outs as either liabilities or equity, and discusses the impact of such classification in the post-business combination earnings. A comprehensive discussion of the criteria used for classification of awards as liabilities or equity is not within the scope of this article, but nevertheless the goal is to raise awareness of any potential earnings surprises during the post-business combination periods.

ACCOUNTING FOR EARN-OUTS

Shareholders’ earn-outs are usually in the form of contingent future cash payments (classified as liabilities), or warrants (classified as either liabilities or equity). It should be noted, however, that acquirers may commit to transfer non-cash properties or securities other than warrants in earn-out arrangements. ASC 805, *Business Combination*, defines contingent consideration as an obligation of the acquirer to transfer additional assets, or equity interests, to the selling shareholders in the event that certain future events occur or conditions are met.

ASC 805-10-55-24 states that arrangements for contingent payments to shareholders can be either part of the business combination or a separate transaction (in the form of post-business combination expense), depending on the nature of the arrangements. Understanding the underlying reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement. ASC 805-10-55-25 has a comprehensive list of indicators that companies should consider in evaluating the arrangements related to earn-outs and contingent payments in a business combination.

Shareholder earn-outs are usually part of the business combination transactions. For example, an acquiree has developed a new technology and management believes that the revenues subsequent to acquisition would increase substantially as a result of that. The acquirer promises some earn-outs in the form of cash or equity to the shareholders of acquiree if the new product can generate a certain level of revenues subsequent to acquisition. This arrangement is part of the business combination transaction and the initial fair value of the earn-outs should be reflected in the purchase accounting entry.

Furthermore, the acquirers need to determine if earn-outs should be classified as equity or liability based on ASC 480, *Distinguishing Liabilities from Equity*, and ASC 815, *Derivatives and Hedging*. Cash earn-outs are typically classified as a liability, whereas equity earn-outs can be classified as either liabilities or equity.

EARN-OUTS CLASSIFIED AS EQUITY

Earn-outs classified as equity are measured initially at fair value on the acquisition date and are not typically re-measured subsequent to their initial recognition. ASC 805-30-35-1, *Contingent Consideration*, requires that the initial value recognized in equity contingent consideration arrangement on the acquisition date should not be adjusted subsequent to acquisition, even if the fair value of the arrangement on the settlement date is different.

EARN-OUTS CLASSIFIED AS LIABILITIES

Earn-outs classified as a liability are recognized at fair value on the acquisition date, assuming fair value can be determined based on ASC 450, *Contingencies* (i.e., they are probable and estimable). Any changes in the valuation of liabilities are reflected in earnings subsequent to acquisition. The acquirer should also develop a systematic approach for subsequent measurement of earn-outs.

Furthermore, if a liability initially fails to meet the probability criterion, but subsequently becomes probable, its total amount will be reflected in earnings. This is also true when the degree of probability-weighted average changes subsequent to initial measurement.

The acquirer needs to consider a best estimate discounted cash flow to measure the fair value of the liability-classified earn-outs.

CLASSIFICATION OF EQUITY AWARDS

Classification of equity awards as liabilities or equity is a complex task. Acquirers prefer to classify equity awards as equity rather than liability since liability awards should be re-measured at the end of each period and the result is reflected in earnings. This section of the article deals with some of the criteria that distinguish equity awards from liability awards.

The acquirer must first determine the appropriate classification of a contingent consideration based on ASC 480, which requires that an earn-out arrangement be classified as a liability if it meets any of the following conditions:

- The contingent consideration is mandatorily redeemable.
- The acquirer has an obligation to repurchase the contingent equity awards by transferring assets.
- The acquirer has an unconditional obligation to issue a variable number of shares in lieu of contingent equity awards if certain event occurs.

If a financial instrument cannot be classified as a liability under ASC 480, it does not necessarily imply that it should be classified as equity. The next step is to analyze the classification of the financial instrument based on the requirements of ASC 815. If the arrangement is within the scope of ASC 815, the financial instrument is a derivative and must be classified as a liability. The arrangement is a derivative if it meets the following conditions:

- It has one or more underlyings and notional amounts.
- It has an initial investment that is less by more than a nominal amount than the initial net investment that would be required to acquire the asset.
- It can be settled net by means outside the contract such that it is readily convertible to cash (or its terms implicitly or explicitly require or permit net settlement).

Many earn-out equity arrangements are within the scope of ASC 815 and should be classified as liabilities, but there are also some exceptions. The primary exception is ASC 815-10-15-74, which requires that an arrangement must be both

indexed to an entity's own share and has equity classification. ASC 815-40-15 and 25, which are discussed in the following two paragraphs, clarify these two exceptions.

ASC 815-40-15 requires that an exercise contingency arrangement should not be based on an observable market, other than the market for the entity's own share, or an observable index, other than one measured solely by reference to the entity's own operations (i.e., the price of gold or crude oil versus the revenues and EBITDA of the company). The guidance also requires that the arrangement must be "fixed-for-fixed," which means that the arrangement must contain an explicit limit on the number of shares at a fixed exercise price.

ASC 815-40-25 has a comprehensive list of a series of conditions that a contingent consideration arrangement should possess to be classified as equity. These conditions should be applied strictly, and their applications require a detailed knowledge and analysis of the arrangement and the underlying security laws. For example, the acquirer must have sufficient authorized and unissued shares available to settle an arrangement. Equity classification of awards is often precluded because the acquirer does not have sufficient authorized and unissued shares available to settle the contingent consideration. The acquirer needs to consider all outstanding and potentially dilutive instruments (such as stock compensation awards and convertible debt) to determine if it has sufficient authorized and unissued shares available.

In summary, if an arrangement is not within the scope of ASC 480 and falls within the scope of ASC 815 and meets its criteria, it can be classified as equity at the acquisition date.

VALUATION OF EQUITY EARN-OUTS

In a business combination, all items of consideration that an acquirer transfers must be measured and recognized at fair value at the acquisition date, including consideration that is transferred contingent upon some future specified event occurring (e.g., earn-outs).

Equity shareholder awards are usually in the form of warrants, and due to the inherent uncertainty in equity shareholder earn-out arrangements, the fair value measurement of such awards is often complex and diverse in practice. The current view under ASC 820, *Fair Value Measurements*, is that a liability must be measured based on the exit price of asset holder. The most challenging aspect of an equity earn-out valuation is its nonlinearity. For example, if the post-business combination revenue exceeds a certain level, the earn-out would be paid in full; otherwise, it would be nil. There is clearly not a linear relationship in this arrangement. Thus, due to the nonlinear nature of earn-out structure and the random nature of its underlying metric, it is necessary to consider multiple scenarios and the expected future distribution of different outcomes on revenues.

As a result, valuation specialists usually use an option-pricing model or a second scenario-based model. A modified version of the Black-Scholes-Merton option-pricing model could be used to value equity shareholders' earn-outs. The valuation specialists usually tailor the shareholders' earn-out valuation models to the unique factors that affect the underlying metric that triggers the payment (e.g., EBITDA, revenue, etc.).

An acquirer generally should consider the full range of the outcomes for an earn-out arrangement and the probability of those outcomes to determine the fair value of equity awards.[2]

FAIR VALUE MEASUREMENT OF LIABILITY AWARDS

Contingent considerations classified as a liability are covered under ASC 450, *Contingencies*. When a loss contingency exists as a result of earn-out arrangements, the likelihood of its incurrence can range from probable (the future event or events are likely to occur) to remote (the chance of the future event or events occurring is slight). Topic 450 uses the terms *probable, reasonably possible* (the chance of the future event or events occurring is more than remote but less than likely), and *remote* to identify three areas within that range (ASC 450-20-25-1).

The initial measurement of earn-outs classified as a liability may indirectly impact the acquirer's post-business combination earnings. All contingent considerations are measured initially at fair value, but any changes in the initial fair value of contingent liabilities are recognized in earnings subsequently until the contingent consideration arrangement is settled.

An entity should estimate the contingent loss and accrue it by a charge to earnings if both of the following conditions are met (ASC 450-20-25-2):

- It is probable that a liability had incurred at the date of the financial statements.
- The amount of loss can be reasonably estimated.

If an amount within a range of loss appears to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, the minimum amount in the range shall be accrued. Even though the minimum amount in the range is not necessarily the amount of loss that will ultimately be determined, it is not likely that the ultimate loss will be less than the minimum amount (ASC 450-20-30-1).

The companies may also use a probability-weighted average to arrive at the best estimate for contingencies (the illustration in this article uses this approach to arrive at the most probable outcome).

After the date of an entity's financial statements, but before those financial statements are issued or are available to be issued, information may become available indicating that an additional or lower amount of cash earn-outs should have been accrued. If so, disclosure may be deemed necessary to keep the financial statements from being misleading (ASC 450-20-50-9).

ILLUSTRATION

The following two examples reflect the circumstances that lead to classification of equity awards as liabilities or equity. It depicts the circumstances that the classification of equity awards as a liability may have a more dilutive impact to post-business combination earnings.

FIRST EXAMPLE

Entity A (a publicly held company) acquires Entity S at the beginning of the first year. As part of the acquisition agreement, Entity A promises to pay shareholders of Entity S the following earn-outs if the following revenue goals are achieved at the end of the first year subsequent to acquisition.

If the revenues of Entity S exceed $1 million for the first year subsequent to acquisition, Entity A will pay to the shareholders of Entity S $50,000 cash and 10,000 warrants (fair value at $10) to purchase an equivalent number of common shares of Entity A.

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Table 1
Initial recording of earn-outs:

Cash liabilities	$40,000	($50,000 times 80% probability-weighted average)
Warrant liabilities	$72,000	(10,000 awards times $9 valuation times 80%)
Cash liabilities	$70,000	($100,000 times 70% probability-weighted average)
Warrant liabilities	$189,000	(30,000 awards times $9 valuation times 70%)

Earnings impact for the first year subsequent to acquisition:

(i) Cash earn-outs	
At the end of the year	$150,000
Less: initial liabilities recorded	110,000 ($40,000 plus $70,000)
Earnings impact	$40,000
(ii) Warrants earn-outs	
At the end of the year	$440,000 (40,000 warrants at $11)
Less: initial liabilities recorded	261,000 ($72,000 plus $189,000)
Earnings impact	$179,000

If, however, the revenues of Entity S exceed $2 million during the same period, Entity A will pay to the shareholders of Entity S an additional $100,000 cash and an additional 30,000 warrants (fair value at $10) to purchase an equivalent number of common shares of Entity A.

Assumptions:

Management of Entity A at the beginning of the year believes that the probability-weighted averages for Entity S to achieve $1 million and $2 million in revenues during the first year are 80 percent and 70 percent, respectively.

However, the revenues of Entity S were $2.2 million for the first year.

Furthermore, Entity A has sufficient authorized and unissued shares available to settle the arrangement. The Black-Scholes-Merton valuation of warrants at the beginning of the first year was at $9 and at the end of the first year was at $11.

The discount rate is assumed to be negligible.

Analysis:

(i) The arrangement appears to be within the scope of ASC 480 since Entity A is obligated to issue variable number of shares based on occurrence of certain event (in this case Entity S revenue achievement). Thus, according to ASC 480, the earn-outs in this scenario must be classified as a liability. The analysis can be stopped at this point and does not need to go any further, but as it is discussed in the following paragraph, the arrangement fails equity classification in ASC 815 for a similar reason.

(ii) The arrangement does not meet the exception requirement of ASC 815-10-15-74 for equity classification since the settlement amount of the contingent consideration does not incorporate fixed number shares even though it has a fixed exercise price (the arrangement is not "fixed-for-fixed").

SECOND EXAMPLE

Entity A (a publicly held company) acquires Entity S at the beginning of the first year. As part of the acquisition agreement, Entity A promises to pay shareholders of Entity S the following earn-outs if the following revenue goals are achieved at the end of the first and second years subsequent to acquisition.

If the revenues of Entity S exceed $1 million revenues for the first year subsequent to acquisition, Entity A will pay to the shareholders of Entity S $50,000 cash and 10,000 warrants (fair value at $10) to purchase an equivalent number of common shares.

If the revenues of Entity S exceed $2.5 million for the second year, Entity A will pay to the shareholders of Entity S additional $100,000 cash and additional 30,000 warrants (fair value at $10) to purchase an equivalent number of common shares of Entity A.

Assumptions:

Management of Entity A at the beginning of the first year believes that the probability-weighted averages for Entity S to achieve $1 million and $2 million in revenues for the first and second years are 80 percent and 70 percent, respectively. Management did not change the probability-weighted average for the second year at the end of the first year.

However, the revenues of Entity S were $2.2 million for the first year and $3.0 million for the second year.

Furthermore, Entity A has sufficient authorized and unissued shares available to settle the arrangement.

The discount rate is assumed to

Table 2
Initial recording of earn-outs:

Cash liabilities	$40,000	($50,000 times 80% probability-weighted average)
Warrants equity	$100,000	(10,000 awards times $10)
Cash liabilities	$70,000	($100,000 times 70% probability weighted average)
Warrants equity	$300,000	(30,000 awards times $10)

Earnings impact for the first year subsequent to acquisition:

Cash earn-outs	
At the end of the first year	$50,000
Less: initial liability recorded	40,000
Earnings impact	$10,000

Earnings impact for the second year subsequent to acquisition:

Cash earn-outs:	
At the end of the second year	$100,000
Less: initial liability recorded	70,000
Earnings impact	$30,000
There is no required fair value adjustment for warrants recorded as equity.	

be negligible. The achievement of earn-outs in each arrangement is independent of the other.

Analysis:

The arrangement consists of two separate contracts that each would result in the delivery of fixed number of shares. Thus, the arrangement is not a liability under ASC 480 since the number of shares is not variable in each contract and does not meet the other two requirements.

The arrangement meets the requirement of ASC 815, however, since (i) it has one underlying (revenues), (ii) it has an initial investment that is "less by more than a nominal amount (in this case nil) and (iii) the shares can be converted to cash (Entity A is a publicly traded company). But nevertheless the arrangement is subject to exception of ASC 815-10-15-74 for the following reasons: (i) it is based on an internal and operational index (i.e., revenues) rather than another observable market (e.g., gold or crude oil), and (ii) it involves a fixed number of shares and a fixed exercise price ("fixed-for-fixed" arrangement). Furthermore, Entity A has sufficient authorized and unissued shares available to settle the arrangement. Thus, the arrangement should be classified as equity (assuming that it meets all the other criteria of ASC 815-40-25).

MANAGEMENT'S JUDGMENT

Management exercises significant judgment in determining the probability of earn-out arrangements. Earn-outs could be in the form of cash or equity awards. The determination of equity versus liabilities awards also requires exercise of significant management judgment.

Classification of equity awards as equity can potentially eliminate the earnings fluctuation during the post-business combination period. Strategic navigation of an acquisition through the accounting requirements to obtain equity treatment for earn-outs can be difficult. Liability earn-outs and their valuations at the outset and in subsequent periods can create challenges for management and dilution in earnings.

Estimating the fair value of the awards could be challenging, and regularly updating the fair value of the earn-outs classified as liabilities could result in earnings surprises during the post-business combination periods.

Acquirers who do not focus on these matters when negotiating the terms and conditions of an acquisition may be surprised by the impact of earn-outs on their earnings and the unintended financial volatility during the post-business combination periods. ■

1. Rashty, Josef. "Compensation Earn-Outs and Post-business Combination Earning Surprises," *Today's CPA*, March/April, 2012, pp. 38-43 www.josefrashty.com/uploads/2/8/9/2/2892636/earn-out-pdf.pdf).
2. Zyla, Mark, et.al. "Valuing Contingent Consideration: Challenges and Solutions," *Journal of Accountancy*, November 2011. pp. 28-33 www.journalofaccountancy.com/Issues/2011/Nov/20114289.htm.

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