

The Fair Value Measurement of Earnouts and Contingent Consideration in the Context of ASC Topic 805: Business Combinations

George Haramaras

This discussion focuses on the fair value measurement of contingent consideration in business combinations for financial accounting purposes. This discussion focuses on the fair value measurement of earnouts. First, this discussion defines and distinguishes the three post-acquisition mechanisms that are often discussed in conjunction with each other: (1) the working capital adjustment, (2) the indemnification escrow account arising from the representations and warranties section in the purchase agreement, and (3) the earnout. These mechanisms are sometimes—though not always—considered contingent consideration. Then this discussion defines and reviews the accounting treatment and standards for contingent consideration. This discussion considers the various types and structures of earnouts, as the specific attributes and structure of earnouts are particularly important in the fair value measurement. Finally, this discussion examines the valuation of earnouts. Specifically, this discussion addresses the relevant principles and factors the analyst should consider in the fair value measurement of earnouts. And, this discussion considers the generally accepted valuation methods applied in the fair value measurement of earnouts.

INTRODUCTION

Mergers and acquisitions (“M&A”) are inherently complex transactions. In many M&A transactions today, numerous mechanisms exist that deal with consideration after the close of the transaction.

These post-acquisition mechanisms can serve various purposes and are typically included in M&A transactions to ensure that:

- no misrepresentations of information occur by the seller,
- the target business maintains sufficient operating working capital after the close of

the transaction so the target business can continue to operate, and

- the seller and buyer achieve alignment on:
 - the risk of future business performance,
 - the price of the target business, and
 - the objectives of future target business performance.

The primary mechanisms that address the factors listed above are typically (1) the working capital adjustment provision, (2) the indemnification

escrow account related to the representation and warranties provision, and (3) the earnout provision.

These mechanisms exist to satisfy practical, strategic objectives. However, while these mechanisms are relatively straightforward in concept, the fair value measurement of these mechanisms can be complex.

POST-ACQUISITION MECHANISMS

There are three provisions that typically involve post-acquisition consideration in some form:

1. **Working Capital Adjustments.** In the purchase agreement, a working capital adjustment provision typically establishes a targeted level of working capital (“target working capital”) for the target business at closing and allows for the adjustment of the purchase price at closing based on the variance between target working capital and the actual working capital balance on that date.

The calculation and definition of working capital as it relates to the working capital adjustment is usually defined in the purchase agreement, and it is usually calculated in accordance with U.S. generally accepted accounting principles (“GAAP”)

When the buyer and seller disagree on the definition or calculation of the working capital balance at closing, a working capital dispute ensues. It is not uncommon for purchase agreements to specify the terms for resolving such disputes.

2. **Indemnification Escrow Accounts Arising from Representations and Warranties.** Representations and warranties are legal terms where a representation is often defined as an assertion of fact, and a warranty is often defined as an assertion of fact with a promise to indemnify or reimburse should the assertion prove false.

In M&A, representations and warranties are made by one party to the counterparty in a transaction to allocate risk between the parties. Practically, representations and warranties are the relevant facts to the transaction and are made by both the buyer and the seller.

Although representations and warranties are made by both buyer and seller, the representations and warranties that the seller asserts are typically much more extensive due to the nature of a business

acquisition. Therefore, a breach of representations and warranties in an acquisition can lead to the submission of a claim for indemnification by one party (typically the buyer) for damages or losses to be paid by the counterparty (typically the seller).

In a purchase agreement, a mechanism is sometimes included where an escrow account is utilized to reserve for a potential indemnity incurred by the seller.

In this situation, a portion of the purchase price is withheld in this indemnification escrow account for a certain time period in order to satisfy any potential claims.

Increasingly typical are representations and warranties insurance policies, which are a type of insurance policy that protects against losses arising from breaches of representations and warranties.

Representations and warranties insurance can eliminate the need for indemnification escrow accounts in M&A transactions.

3. **Earnout provisions.** Earnout provisions are contractual provisions that allow for additional consideration (e.g., additional assets or equity) to be paid to the seller after the close of the transaction.

Additionally, earnout provisions are contingent upon the satisfaction of certain future events. In some earnout provisions, the buyer has the right to take back consideration paid to the seller if certain negative future events are met. In this scenario, such earnout provisions are often referred to as “clawbacks.”

These three mechanisms are typically referenced and discussed together, perhaps due to the fact that they deal with the consideration of an M&A transaction after its closing. However, for purposes of defining contingent consideration, it is important to distinguish these M&A mechanisms.

According to the *Valuations in Financial Reporting Valuation Advisory 4: Valuation of Contingent Consideration* (the “Advisory”):¹

It is common for a portion of the purchase price in a business combination to be held in escrow to cover items such as working capital adjustments or possible payments related to the seller’s satisfaction of representations and warranties . . . given that the definition of contingent consideration is an

obligation to make a payment “if specified events occur or conditions are met,” then if the release of the escrow payment is contingent on whether specified future events occur or conditions are met, the escrow payment may be considered contingent consideration. On the other hand, if the release of the escrow payment is contingent on verifying conditions *that existed at the acquisition date*, generally, the escrow payment would not be considered contingent consideration. Although typically escrow payments for general representations and warranties and working capital adjustments fall into the latter category and are not considered to be contingent consideration, the specific terms of the agreement should be reviewed before making such a determination.

The working capital adjustment and the representations and warranties provisions in the purchase agreement typically involve factors related to the transaction that existed on or before the acquisition date.

Therefore, such mechanisms related to these provisions (i.e., working capital adjustments and indemnification escrow payments) are typically not considered to be contingent consideration. That is, such mechanisms are not contingent upon events that occur after the close of the transaction.

The remainder of our discussion focuses exclusively on the fair value measurement of contingent consideration as it specifically relates to earnouts.

ACCOUNTING FOR CONTINGENT CONSIDERATION

In the fair value measurement of earnouts, it is important to first consider the relevant accounting topics associated with contingent consideration.

Contingent consideration is usually analyzed for business combination purposes, specifically in the context of the acquirer. This is because section 805-20-25-1 of the Accounting Standards Codification (“ASC”) states that “the acquirer shall recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree.”²

More specifically, ASC Topic 805 requires that the identifiable assets, liabilities, and equity (in the case of noncontrolling interest) be assigned a portion of the purchase price with respect to their fair values.

The identifiable assets, liabilities, and noncontrolling interest includes contingent consideration. ASC Topic 805-20-25-15A states the following:³

Contingent consideration arrangements of an inquiry assumed by the acquirer in a business combination shall be recognized initially at fair value in accordance with the guidance for contingent consideration arrangements in paragraph 805-30-25-5.

Further, ASC Topic 805-30-25-5, 805-30-25-6, and 805-30-25-7 state the following:^{4,5,6}

The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. The acquirer shall recognize the acquisition date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

The acquirer shall classify an obligation to pay contingent consideration as a liability or as equity in accordance with subtopics 480-10 and 815-40 or other applicable GAAP. For example, subtopic 480-10 provides guidance on whether to classify as a liability a contingent consideration arrangement that is, in substance, a put option written by the acquirer on the market price of the acquirer’s shares issued in the business combination.

The acquirer shall classify as an asset a right to the return of previously transferred consideration if specified conditions are met.

The acquirer applies the acquisition method of accounting for an acquisition under ASC Topic 805. In applying the acquisition method, all identifiable assets, liabilities, and noncontrolling interests are allocated a portion of the purchase price.

Additionally, all identifiable assets, liabilities, and noncontrolling interests are measured at fair value. Under ASC Topic 805 and the acquisition method, contingent consideration is required to be recognized.

Depending on the specific terms of the contingent consideration arrangement, contingent consideration may be recognized as either an asset, a liability, or equity.

The recognition and treatment of contingent consideration is clearly specified under ASC Topic 805. However, the ASC also specifies that contingent

consideration be measured at fair value. Regarding measuring contingent consideration at its fair value under ASC Topic 820, the Advisory summarizes:

The objective of a fair value measurement is to estimate the price at which an orderly transaction would take place between market participants under the market conditions that exist at the measurement date.

ASC 820-10 specifies a fair value hierarchy of inputs for consideration in fair value measurement. The fair value hierarchy classifies inputs into three levels:^{7, 8, 9}

Level 1 Inputs:

Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

Level 2 Inputs:

Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 3 Inputs:

Unobservable inputs for the asset or liability.

ASC Topic 805 also provides that in measuring the fair value of instruments classified in liabilities or equity, the fair value hierarchy should be applied.

Additionally, in measuring the fair value of liabilities and equity, quoted prices, observable inputs, and unobservable inputs may be observed in identical items held by other parties as assets.

It is important to consider ASC Topic 820 and the fair value hierarchy of inputs in the fair value measurement of contingent consideration. The fair value hierarchy can have implications for selecting a valuation approach.

PURPOSE OF AN EARNOUT

Earnouts can be executed to satisfy numerous objectives in M&A transactions. Some motivations



for relying on earnouts in transactions include the following:

- “Bridging the gap,” or settling differences in expectations of the consideration to be paid for the target company
- Mitigating the risk of not meeting future performance expectations
- Incentivizing the seller and other managers to remain (1) a part of the operations of the business and (2) invested in the future performance of the business.

Given that earnouts serve multiple objectives, and since the definition of an earnout—that is, any form of consideration that is paid post-acquisition and based on future events—is broad, earnouts exist in many forms.

The following section examines the attributes that are important for the understanding and fair value measurement of earnouts.

STRUCTURING AN EARNOUT

This section examines the components of an earnout. Specifically, this discussion examines:

1. the type of consideration paid,
2. the contingent events or metrics relied on that determine the payment of consideration, and
3. the specific structure of the payoff.

Forms of Consideration

Earnouts are typically settled in assets (most often, in cash), or in the equity of the acquirer. As previously mentioned, the buyer in an M&A transaction most often transfers assets to the seller.

It is also possible, in the case of a clawback, to structure an earnout where the seller has a contingent obligation to repay the buyer.

Metrics

Metrics represent an important attribute of earnouts. The underlying metric of an earnout represents a benchmark, or measurement, that the contingent consideration is attached to in an earnout. The underlying metric determines the amount of consideration—if any—that is paid.

The range of metrics used in earnouts is broad. The metric used generally must be quantifiable, so that the parties to the earnout provision may clearly and objectively measure the performance of the business and the consideration to be paid.

The selection of a metric serves to achieve the desired objectives of the earnout (e.g., risk mitigation, settling difference in consideration expectations, etc.). And, the metric also structures the nature of the earnout.

Underlying earnout metrics can be broadly classified into two categories:

1. Financial and nonfinancial metrics
2. Milestone event metrics

Financial and nonfinancial metrics are measurements that generally involve performance benchmarks related to the target business. As the name implies, these metrics can be financial or nonfinancial in nature.

Examples of financial metrics include revenue; net income; earnings before interest, taxes, depreciation, and amortization (“EBITDA”); margin percentage benchmarks (e.g., EBITDA margin); or other industry-specific financial earnings metrics (e.g., earnings before interest, taxes, depreciation, amortization, and exploration costs—EBITDAX—for oil and gas companies).

Examples of nonfinancial metrics include number of units (or volume) sold, rental occupancy rates, or number of customers or accounts opened.

What is consistent across financial and nonfinancial metrics is that they are tied to scalable benchmarks of the target business performance.

In contrast, milestone event metrics are tied to the outcome of a specific event. Examples of milestone event metrics are the outcome of a litigation

matter, the approval of a patent, or the acquisition of a business. These types of metrics are usually binary in that they consist of two outcomes: (1) the milestone event occurring or (2) the milestone event not occurring.

Underlying metrics are important in the fair value measurement of earnouts because:

1. they contribute, in part, to the earnout payoff structure, and
2. they determine the risk of the earnout.

These factors have implications for the present value discount rate applied in the income approach, as discussed below.

Next, this discussion examines the various payoff structures of earnouts and their fair value measurement implications.

Payoff Structures of Earnouts

The payoff structures of earnouts relate to how the payment of consideration correlates to the underlying metric of the earnout. In other words, payoff structures answer the question of how—and how much—can the earnout be expected to pay out?

The complexity of the answer to the above-question greatly varies. The payoff structures of earnouts can range from simple to complex. Figure 1 below presents various payoff structures of earnouts.¹⁰

The underlying metric determines, at least partially, the payoff structure of the earnout. In the case of milestone event metrics, the payoff structure typically represents a fixed one-time payment upon the achievement of the milestone event, which is represented in the second example in Figure 1.

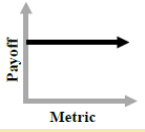
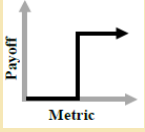
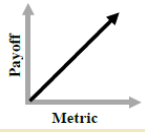
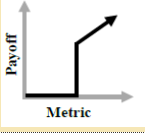
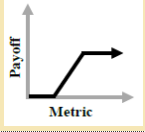
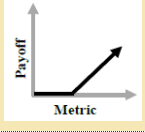
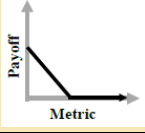
In the case of financial and nonfinancial earnout metrics, the simplest payoff structure is a fixed percentage rate of the underlying metric, as presented in the third example in Figure 1.

For financial and nonfinancial metrics, examples of complex payoff structures can incorporate some combination of:

1. tiered or changing percentage rates of payment;
2. caps or maximum payments after a certain level of metric is achieved; and
3. thresholds or the achievement of a minimum level of the given metric before payments are awarded.

The first example in Figure 1 represents a non-zero constant payout across all quantities of the

Figure 1
Illustrative Examples of Earnout Payoff Structures

Illustrative Example Earnout Structures						
Example	Earnout Structure	Payoff Resemblance to Option or Option Strategy	Payoff	Type of Payoff	Description and Risk Characteristics [a]	Recommended Income Approach Valuation Method
1	Constant (debt-like)	NA		Linear	<ul style="list-style-type: none"> • A fixed (deferred) payment. • The earnout cash flow is only subject to counterparty credit risk. 	NA
2	Milestone payment (digital/binary option)	NA		Nonlinear	<ul style="list-style-type: none"> • A fixed payment contingent upon achieving a future milestone or performance threshold. • Nonlinear payoff, where the risk of the earnout cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure (which is non-zero if the metric's risk is nondiversifiable) and counterparty credit risk. 	Scenario-Based Method
3	Linear	NA		Linear	<ul style="list-style-type: none"> • Payment is equal to a fixed percentage of the outcome for the underlying metric. • Linear payoff, where the risk of the earnout cash flow is the same as the risk of the underlying metric, plus counterparty credit risk. 	Scenario-Based Method
4	Percentage of total above a threshold	Asset-or-Nothing Call Option		Nonlinear	<ul style="list-style-type: none"> • Payment is equal to a percentage of the underlying metric, but only if a performance threshold is reached. • Nonlinear payoff, where the risk of the earnout cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure, and counterparty credit risk. 	Option Pricing Method
5	Excess above a threshold with a cap	Capped Call Option		Nonlinear	<ul style="list-style-type: none"> • Payment is equal to a percentage of the excess of the underlying metric above a performance threshold, with a payment cap. • Nonlinear payoff, where the risk of the earnout cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure, and counterparty credit risk. 	Option Pricing Method
6	Excess above a threshold	Call Option		Nonlinear	<ul style="list-style-type: none"> • Payment is equal to a percentage of the excess of the underlying metric above a performance threshold. • Nonlinear payoff, where the risk of the earnout cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure, and counterparty credit risk. 	Option Pricing Method
7	Clawback	Put Option		Nonlinear	<ul style="list-style-type: none"> • Payment is equal to a percentage of the shortfall of the underlying metric below a performance threshold. • Nonlinear payoff, where the risk of the clawback cash flow depends on the risk of the underlying metric, the impact of the nonlinear structure, and counterparty credit risk. 	Option Pricing Method

[a] The discount rate for any of these structures should consider the time value of money, as well as the risks described in this figure.
 Source: *Valuations in Financial Reporting Valuation Advisory 4: Valuation of Contingent Consideration* (Washington, D.C.: the Appraisal Foundation, February 2019).

given metric. Since the payout is nonzero across all levels of the given metric, the first example is not actually contingent consideration but deferred consideration.

Payoff structures can be classified as linear or nonlinear. The first and third examples in Figure 1 represent linear payouts. All other examples in Figure 1 represent nonlinear payouts. It is worth pointing out the linear/nonlinear distinction because this factor can contribute to the selected valuation method with regard to the earnout.

One other important item of note: certain earnout payoff structures bear similar structures to options and various option strategies, as noted in examples four through seven in Figure 1.

Due to certain earnouts' similarities with derivative option instruments, the option pricing method of the income approach can be a particularly relevant method to perform in the fair value measurement of some earnouts, specifically when the earnout payoff structure resembles an option.

A few other factors in the determination of payoff structures include the following:

- The amount of time and the time period the earnout arrangement applies to, and whether there are multiple time periods for which the earnout arrangement applies.
- Whether there are multiple underlying metrics that are driving the earnout (e.g., an earnout that pays out according to both (1) revenue figures and (2) the number of new customers).

FAIR VALUE MEASUREMENT OF EARNOUTS

Relevant Fair Value Measurement Concepts for Earnouts

According to the Advisory, there are multiple concepts that are useful in guiding the analyst in the fair value measurement of contingent consideration. These concepts are as follows:

1. Market participant assumptions
2. Probabilistic forecasts
3. Diversifiable risk and nondiversifiable risk
4. The payoff structure of earnouts
5. Risk-neutral valuation

The following discussion summarizes the above-mentioned concepts:

1. **Market Participant Assumptions.** This concept relates to the objective of fair value measurement; specifically, that fair value measurement is the “estimate of the price at which an orderly transaction would take place between market participants . . .”¹¹

In the valuation of contingent consideration, the valuation analyst should evaluate who the market participants represent. In the context of contingent consideration, it is often not immediately clear who market participants would be.

Buyers could represent a party who would seek to purchase the rights to an earnout's future payments.

2. **Probabilistic Forecasts.** Probabilistic forecasts are typically relied on in the valuation of earnouts. Probabilistic forecasts incorporate (1) various future scenarios (relating to the earnout's underlying metric and earnout payoff) and (2) their respective probabilities.

A probability distribution represents the set of these future scenarios and their probabilities, and the expected payoff represents the probability-weighted mean of the probability distribution.

3. **Diversifiable Risk and Nondiversifiable Risk.** Risk can be classified between systematic risk or unsystematic risk. Systematic risk represents risk that is applicable to the entire market.

Unsystematic risk represents risk that is specific to a security or an investment.

Systematic risk is synonymous with nondiversifiable risk, as this type of risk cannot be eliminated through diversification—a risk management strategy.

Unsystematic risk is synonymous with diversifiable risk, or risk that is specific to a company, security, or investment and can be diversified away. In valuation, risk is reflected in the rate of return investors require and is represented by the present value discount rate in the income approach.

As it relates to earnouts, part of the risk associated with the earnout can be classified as either diversifiable or nondiversifiable. Whether the risk is diversifiable or nondiversifiable generally relates to the underlying metric of an earnout.

Typically, milestone events represent diversifiable risk, while financial metrics

pegged to company performance are nondiversifiable.

Identifying the type of risk associated with the underlying metric is important because risk is a factor in the calculation and estimation of the present value discount rate in the income approach.

In addition to diversifiable and nondiversifiable risk, the credit risk of the counterparty in the earnout arrangement is also a risk factor that is incorporated in the rate of return and the present value discount rate for all types of earnouts.

However, in analyzing risk, the rate of return, and the present value discount rate, the uncertainty of the cash flow scenarios is not contemplated. This is because the uncertainty of the cash flow scenarios is already reflected in the probability-adjusted cash flow.

4. **Earnout Payoff Structure.** In addition to the diversifiable and nondiversifiable risk related to the underlying metrics of an earnout, there is sometimes additional risk associated with the earnout payoff structure.

There is nondiversifiable risk associated with the financial metrics of an earnout. Some earnouts with financial metrics may have complex payoff structures in that they incorporate caps, thresholds, or tiered payoffs. In cases of earnouts with complex payoff structures, the payoff structure is nonlinear. As a result, there is additional risk associated with the payoff structure.

This additional risk arises from the fact that the payoff structure does not correlate with the underlying metric at all levels of the metric. As a result, the probability of achieving the various payoff structure components should be contemplated in addition to the risk associated with the underlying metric.

5. **Adjustments for Risk-Neutrality.** As discussed, the various risks associated with the earnout contribute to the estimation of the present value discount rate.



Consider the estimation of the present value discount rate for an earnout with (1) nondiversifiable risk arising from an underlying financial metric and (2) a complex, nonlinear payoff structure.

In this scenario, the present value discount rate should reflect (1) the counterparty credit risk, (2) the risk-free rate, and (3) a risk premium for the nondiversifiable risk of the underlying metric.

An additional risk factor for the nonlinearity of the payoff structure must also be considered. This is what is referred to in the section above as the risk associated with the payoff structure.

As mentioned in the Advisory, adjusting the present value discount rate for risks associated with nonlinear payoff structures can conclude inaccurate, inconsistent results.

One method used to incorporate this risk is to adjust the probability-weighted cash flow distributions to a risk-neutral basis. In adjusting the cash flow to a risk-neutral basis, the nondiversifiable risk component of the cash flow is effectively removed.

An adjusted present value discount rate—also reflecting the removal of the nondiversifiable risk component—is then applied to the cash flow distribution.

Fair Value Measurement Methods

In the fair value measurement of assets or liabilities, and with respect to ASC Topic 820 and the fair

value hierarchy of inputs, there are three generally accepted approaches that are typically considered in the fair value measurement of earnouts: the market approach, the cost approach, and the income approach.

Although the analyst should consider these three approaches in the valuation of assets and liabilities, certain approaches and methods may be more applicable for specific assets and liabilities.

The Advisory states that in practice, “it is typically the [income] approach [that is] used to value contingent consideration. Two income approach methods the Working Group has observed being used in practice for valuing contingent consideration are the Scenario Based Method . . . and the Option Pricing Method.”

The following sections discuss the three valuation approaches in the context of the fair value measurement of earnouts. First, the discussion considers why the market and cost approaches are typically not applicable for valuing earnouts. Second, the discussion considers the scenario-based method and the option pricing method.

The Market Approach and the Cost Approach

The market approach involves the analysis of actual transactions (or observable inputs) of the same or similar assets or liabilities. From these historical transactions, the analyst:

1. analyzes relevant financial metrics and pricing multiples of these metrics and
2. applies a selected pricing multiple to the asset or liability being valued.

In the fair value measurement of contingent consideration, the market approach is usually not a viable method. This is because contingent consideration is not typically actively traded in an established market. While other markets of similar assets or liabilities may exist, they do not represent actively traded markets and, therefore, do not provide meaningful trading data.

The cost approach is based on the understanding that market participants relate value to cost. In the cost approach, the value of an asset is derived based on the amount it would take to replace the asset.

Since there is usually no way to measure the replacement cost new of contingent consideration, the cost approach is not frequently applied for the fair value measurement of earnouts.

The Income Approach

The income approach is often applied in the fair value measurement of earnouts. This discussion considers two generally accepted income approach methods that may be applied to the fair value measurement of earnouts:

1. The scenario-based method (the “SBM”)
2. The option pricing method (the “OPM”)

The Scenario-Based Method

The SBM represents a relatively straightforward method for measuring the fair value of an earnout. In the SBM, the following procedures are applied to conclude a fair value indication:

1. The analyst calculates the expected payoff of the earnout. This expected payoff represents the probability-weighted mean of the set of (a) possible scenarios and (b) their respective probabilities. Of course, the analyst calculates the expected payoff for all relevant time periods.
2. The analyst applies a selected present value discount rate to the expected payoff of the earnout. This present value discount rate should reflect various factors, including (a) the counterparty credit risk, (b) a risk premium for any extra risk above the risk-free rate (which includes diversifiable and nondiversifiable risk factors), and (c) the risk-free rate.

In the SBM, the valuation assumptions are important factors in the analysis. The analyst should estimate the expected payoff based on two assumptions:

1. A range of possible outcome scenarios
2. The associated probabilities of those scenarios

When estimating the present value discount rate, which incorporates the rate of return required by market participants for the given level of risk, various assumptions are also involved.

For both the expected payoff inputs and the inputs involved in the selection of the present value discount rate, the analyst should carefully assess the quality of the information inputs used in the SBM analysis.

In the case of the projected scenarios, which are often provided by management, the analyst should scrutinize the consistency and accuracy of those scenarios. In the case of the present value discount

rate, the valuation analyst should evaluate whether the present value discount rate reflects the comprehensive risks associated with the earnout payoff to market participants.

The Advisory recommends the SBM in the case of the fair value measurement of earnouts with:

1. milestone event metrics or
2. financial metrics with linear payoffs.

In the case of earnouts with nonlinear payoff structures, the OPM may better incorporate the additional risk associated with nonlinear payoff structures.

The Option Pricing Method

In the case of nonlinear payoff structures, additional risk may be present that is not easily estimated in the SBM. In applying the SBM to earnouts with nonlinear payoff structures, additional procedures may be required to adjust the expected payoff and the present value discount rate.

However, these additional procedures still bear the possibility that they will not fully incorporate the additional risk associated with the nonlinear payoff structure.

Earnouts with complex payoff structures often represent payoffs that are similar in nature to derivative option instruments and various option strategies.

It is for these reasons that the Advisory does not recommend using the SBM in the analysis of earnouts with nonlinear payoff structures. Instead, the OPM can be relied on to provide a more meaningful fair value measurement for earnouts with nonlinear payoff structures.

In the OPM, a distribution of scenarios and their associated probabilities determine the expected payoff of the earnout. Then, a present value discount rate is estimated that includes the counterparty credit risk, the risk-free rate, and a risk premium for any extra risk above the risk-free rate (which includes diversifiable and nondiversifiable risk factors).

This present value discount rate is not applied to the expected payoff. Instead, the diversifiable and nondiversifiable risk components are separated from the present value discount rate and used to discount the entire probability distribution of payoffs to arrive at a risk-neutral probability distribution.

The expected mean of this distribution is then discounted using a present value discount rate con-

sisting of only the risk-free rate and counterparty credit risk (as all other risk factors are neutralized).

SUMMARY AND CONCLUSION

In M&A transactions, the earnout is a popular mechanism that is utilized to achieve various objectives. While earnouts can seem to be a practical and straightforward method for aligning objectives and consideration in an M&A transaction, there are often intricacies that need to be contemplated.

In particular, the accounting and valuation treatment of earnouts can involve complex analysis and adherence to specific accounting standards. In the context of valuation, earnout payoff structures can be complex, the cash flow of the consideration can be unclear, and the risk to market participants can be challenging to quantify and incorporate.

Given these challenges, the reliance on the expertise of an analyst can alleviate and respond to issues related to the fair value measurement of earnouts.

Notes:

1. *Valuations in Financial Reporting Valuation Advisory 4: Valuation of Contingent Consideration* (Washington, DC: the Appraisal Foundation, February 2019).
2. ASC Topic 805, Business Combinations, ASC 805-20-25-1.
3. Ibid., ASC 805-20-25-15A.
4. Ibid., ASC 805-20-25-5.
5. Ibid., ASC 805-20-25-6.
6. Ibid., ASC 805-20-25-7.
7. Ibid., 820-10-35-40.
8. Ibid., 820-10-35-47.
9. Ibid., 820-10-35-52).
10. *Valuations in Financial Reporting Valuation Advisory 4: Valuation of Contingent Consideration*.
11. Ibid.

George Haramaras is an analyst in our Chicago practice office. George can be reached at (773-399-4315 or at gharamaras@willamette.com.



“Earnouts with complex payoff structures often represent payoffs that are similar in nature to derivative option instruments and various option strategies.”
