Segregating Contingent Consideration Between Purchase Consideration and Compensation Expense

INTRODUCTION

Excerpt – In the case of a merger or acquisition, financial reporting requires the acquirer to report a purchase price allocation (PPA) in the financial statement. PPA requires payment to be separated into components. With a growing number of transactions being based on contingent consideration, it is vital to determine whether the additional payment is consideration or compensation, to conclude a PPA for the transaction.

Changing business environments, dynamic trade policies, and rapidly evolving technology have significantly transformed the way businesses function. The rise of start-ups, easier access to capital, innovative business models, and a highly competitive environment have made companies more open to inorganic growth as compared to 10–15 years ago.

With the growing number of M&As, the complexities surrounding these transactions have also increased. There are now more stringent regulations and reporting standards on M&A. As part of a financial reporting requirement, for every transaction, the acquiring company must report a detailed purchase price allocation (PPA) in its financial statement. PPA essentially involves breaking down the price paid by the acquirer to the seller and assigning it to tangible and intangible assets. Depending on the kind of business, these asset types include PP&E, software, employees, patents, trademarks, and brands.

PPA starts with determining the value of consideration paid for the transaction. As the complete payment may not be made upfront in cash, other components of the purchase consideration need to be valued. Apart from the upfront cash payment, shares of the acquirer or some other entity, and cash payment contingent upon some future milestone can be included. Contingent consideration is increasingly being used in technology businesses, where a small part of the business value can be attributed to tangible assets.

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Determining what is contingent consideration

When a business derives its value primarily from intangible assets, there is high potential for a disagreement over valuation between the buyer and seller. The value of intangible assets is closely linked to the future performance of the business, which is variable, and both parties will have differing views on this matter. Furthermore, the same intangible asset might command a different value in another business. In such situations, contingent consideration can help in quick closure of transactions, despite disagreements over valuation. Contingent consideration is paid on achieving business milestones the seller claims are achievable. Hence, buyers can rule out uncertainty on the cost being paid and be assured of a fair deal.

Recently, transactions using the contingent consideration provision as part of the deal structure have been increasing. Given that business models are maturing, companies are going asset-light, and technology start-ups are becoming popular acquisition targets, contingent consideration is being used more often.

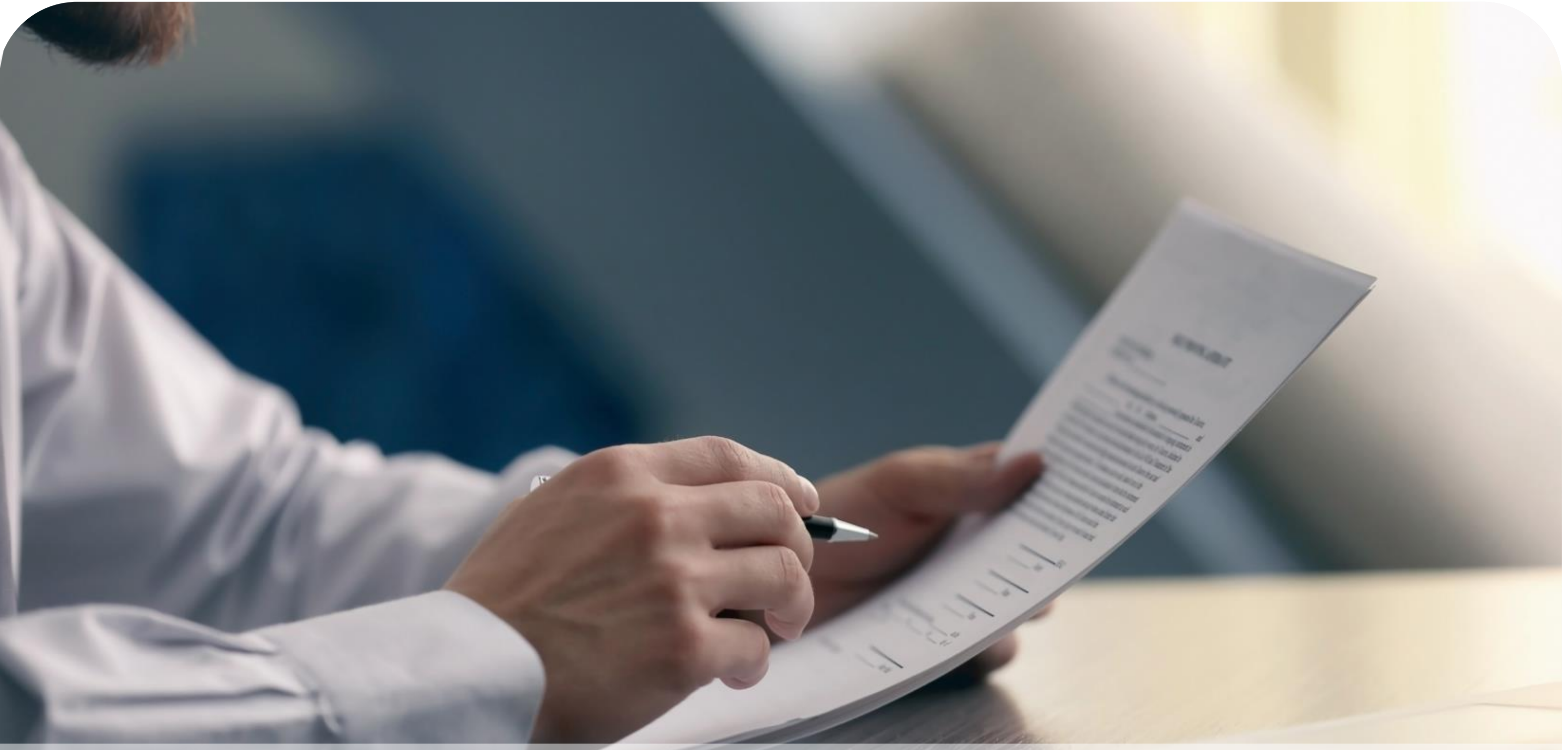
In this new business environment, there is greater significance attached to the key people running the business. Founders and management teams are critical for business continuity. To lower risk, the acquirer may retain key employees with payments in cash, other assets, or additional equity. These are future payments made after the acquisition date and if certain specified events occur or conditions are met as per the agreement at the time of the transaction. These contingencies are generally based on earnings or their components (e.g., revenue, EBITDA), instrument stock price changes over specified periods after the acquisition date, product development, patent approval, employment continuation, etc.

Issues in identifying contingent consideration

In most cases, contingent consideration symbolizes an obligation of the acquirer to transfer additional assets (cash or equity) to the selling shareholders, if predetermined future events occur or conditions are met. On the contrary, contingent consideration also allows the acquirer to regain the assets transferred earlier or equity interests from sellers of the acquired business.

A transaction that includes contingent payments must be evaluated to determine if the consideration is for post-combination services. According to ASC 805-10-55-24, this assessment requires an understanding of the reason for inclusion of contingent payments in the arrangement, the initiator of the arrangement (acquirer or acquiree), and timing of the arrangement. Additionally, arrangements between the selling shareholders and the acquiree's employees should be evaluated to determine whether such arrangements were entered into for the acquirer's benefit and thus represent compensation or consideration.

This arrangement of contingent consideration to employees and shareholders (who are also employees) prompts the vital question of whether contingent consideration is part of purchase consideration or compensation expense—this is central from the perspective of reporting. Certain guidelines have been laid out to distinguish the payment as either compensation or consideration.



FASB guidelines for segregating compensation and purchase consideration

To distinguish between compensation and consideration, the Financial Accounting Standards Board (FASB) has provided certain guidelines such as ASC 805-10-55-24. These guidelines can help identify whether the contingent payments to the selling shareholders or employees are compensation or additional consideration. Understanding the reasons for inclusion of the contingency provision, the initiator of the arrangement, and the timing of entering into the arrangement are useful in assessing the nature of the arrangement. These factors determine if the consideration is for post-combination services.

As per ASC 805-10-55-24, the assessment requires an understanding of three critical arguments:

1. Why are contingent payments included in the arrangement?
2. Which party initiated the arrangement?
3. When did the parties enter the arrangement?

The nature of the arrangement decides whether the contingent payments to selling shareholders (or employees) qualify as contingent consideration in a business combination or are compensation expense. If it is unclear whether an arrangement is part of the exchange for the acquirer or a separate transaction, ASC 805-10-55-25 provides eight indicators that should be considered. These criteria must be applied to all arrangements for payments to employees or selling shareholders, including both cash compensation and share-based payment awards. All these indicators should be taken into account to determine if the payment is consideration or compensation. The table below is a quick summary of the eight indicators.

Leads to Conclusion that payments are Compensation	Factor	Leads to Conclusion that payments are Consideration
Payments forfeited on termination	**Continuing employment**	Payments unaffected by termination
Greater than or coincides with payment period	**Duration of continuing employment**	Less than the payment period
Not comparable to that of other key employees	**Level of compensation**	Comparable to that of other key employees
Non-employee selling shareholders get lower additional payments (on a per-share basis)	**Incremental payments to employees**	Non-employee selling shareholders get equal additional payments (on a per-share basis)
Selling shareholders who continue as employees own substantially all shares (in substance profit sharing)	**Number of shares owned**	Selling shareholders who continue as employees own only a small portion of shares
Payment formula consistent with other profit-sharing arrangements	**Linkage of payments to valuation of business**	Payment formula linked to the valuation approach
Based on a percentage of earnings	**Formula for determining contingent consideration**	Based on a valuation formula, like multiple of earnings
Depending on the terms of agreement	**Others**	Depending on the terms of agreement

A detailed look at each of the eight indicators will aid the understanding of when purchase consideration can be taken as consideration or compensation expense.

Continuing employment:

A contingent consideration arrangement that leads to automatic payment cancellation in the event of employment termination is considered compensation for post-combination services. If this arrangement is unaffected by employment termination, the contingent payment is taken to be additional consideration rather than compensation.

Accounting for continued employment is a key element in terms of segregating contingent consideration between compensation expense and purchase consideration. Some examples covering different scenarios are mentioned below for a better understanding of cases involving continuing employment.

- For example, Company A (the acquiree) is owned by a sole shareholder, X, who is also the CEO. Company A is acquired by Company B (the acquirer). As per the terms of the purchase agreement, Shareholder X will receive additional consideration for the acquisition based on specific EBITDA levels over the two-year period following the acquisition. Company B believes that retaining Shareholder X's services for at least this period is critical for a successful business transition. The arrangement also stipulates that Shareholder X forfeits any right to additional consideration if he is not an employee of Company B at the end of the two-year period.
    - As noted above, according to ASC 805-10-55-25, in a contingent consideration arrangement, if payments are automatically forfeited at the termination of employment, they are considered compensation for post-combination services. Accordingly, any payments made to Shareholder X for the achievement of specific EBITDA levels would be accounted as compensation cost in Company B's post-combination financial statement.
- In another example, Company X acquires Company Y. Three shareholders of Company Y are also its executive officers and agree to become employees of Company X after the acquisition. According to the agreement, after three years, every shareholder of Company Y is entitled to an additional payment if a specified revenue target is met and the individuals are still employed by Company X.
    - The future payment of shareholders of Company Y is contingent upon completion of the employment period. Therefore, Company X should recognize this as compensation in the post-combination period and not as contingent consideration.
    - If the three shareholders are not employed by Company X at the end of the period due to death, disability, or involuntary termination, they are still eligible for an additional payment. However, if their employment is terminated due to voluntary resignation or if they are dismissed, they are not entitled to additional payment.
- In yet another example, Company X acquires Company Y. Z is a shareholder and executive officer of Company Y. After the acquisition, Z becomes an employee of Company X. As per the agreement, all selling shareholders of Company Y are entitled to an additional payment after one year of the acquisition if certain performance targets are achieved. On completion of the first year, the amount due to Z will be paid only if Z is still employed at Company X. Otherwise, the contingent amount will be paid after the fifth year.
    - In this case, Z is entitled to receive the amount irrespective of his employment status. In such a scenario, it is ideal for Company X to differentiate the element that is based on continuing employment and account for it as compensation in the post-combination financial statement. Company X is likely to consider the compensatory element as the value of receiving the amount due in one year rather than in five years.
    - Such arrangements can be considered as containing a "floor" amount that is unaffected by employment and is taken as contingent consideration in the business combination.
- Company A acquires Company B and one of the latter's three shareholders, X, also the CEO, becomes an employee of Company A. If X is employed by Company A at the end of three years, X requires an additional payment from Company A. The payment, if due, would be distributed pro rata among the three shareholders based on their ownership in Company B. If X is not employed by Company A for the specified period, no shareholder will receive any additional payment.
    - In this scenario, payment is contingent upon X's employment with Company A for a specific period. The entire payment should therefore be considered as compensation.
    - In an alternate approach, as only payments to X are contingent upon continued employment, such an amount should be considered compensation, and payments to the other two shareholders should be evaluated in accordance with other terms of the agreement.
- Company X acquires Company Y and its three executives, also its shareholders, become employees of Company X. The agreement requires Company X to pay the shareholders: (1) 50% consideration at acquisition and (2) 50% consideration if the employees are still in its employ one month after the completion of the acquisition. Payment should be in proportion to their shareholding in Company Y. Contingent payment is far greater than the salary and benefits that the employees would earn in one month.

- To determine whether the 50% payable after one month is compensation or consideration, it is important to assess the reason for the employment period, the nature of employees' activities, and other evidence to determine whether the required stay period is substantive. If it turns out to be substantive, the payment is considered compensation expense. However, if the period is determined to be non-substantive, facts and circumstances must be analyzed to assess if the payment should be treated as consideration or compensation. Notably, in complex scenarios, it is not easy to distinguish between the two; therefore, such cases call for a deeper analysis and expert opinion.

- Company X acquires Y, a manufacturing company with revenue, expense, inventory, PP&E, customers, contracts, and liabilities. At acquisition, the fair value of Company Y is determined to be $32 million. After the acquisition, Company Y's three shareholders, who are executive officers, agree to become employees of Company X.
    - As per the terms of the agreement, Company X must pay shareholders of Company Y $2 million in cash consideration at the closing of the acquisition, and $38 million three years from the acquisition date, if the shareholders/employees remain employed by Company X. The conditional payment would be divided among shareholders based on their relative ownership percentages in Company Y.
    - In this case, future payment is contingent upon the executive officers' continuing employment. However, given the insignificant amount of consideration at closing, compared to Company Y's fair value, it is unclear whether the guidance in continuing employment, as discussed above, is applicable. This requires deeper analysis and an expert opinion.
    - If Company X considers the contingent payment as compensation by applying the continuing employment criterion, a bargain purchase gain (the difference between the fair value of the net assets acquired as of the acquisition date and the amount in consideration transferred) would be recognized as compensation over the next five years. In this case, the facts may indicate that a part of future payments (the portion representing Company Y's fair value) should be thought of as consideration and the remaining part as compensation for the post-combination period. This situation calls for a deeper analysis of specific facts and circumstances.

Duration of continuing employment:

If the period of employment required to realize contingent payment equals or surpasses the period of contingent payment, it indicates that payments are in lieu of employment and not for any other purpose. Accordingly, the payment is taken as compensation and not consideration.

Level of compensation:

If the compensation (excluding contingent payment) to shareholders, who become employees of the post-combination entity, is similar to that of other employees with similar responsibilities, the contingent payment may represent contingent consideration. This is because employees at the same level with the same degree of responsibility are not supposed to receive varying payments. Thus, excess payments in this case qualify as additional consideration and not compensation.

- For example, Company A acquires Company B, along with its Managing Director, X. After the merger, Company A has two managing directors, one from Company B (X) and the other previously working with Company A (Y). As part of the transaction, at the end of two years, Company A offers a payment of $1 million to Company B, contingent upon revenue growing by more than 12% yoy. At the end of one year, Company A's revenue increases 15% yoy.

- In this case, the managing directors X and Y are at the same level and would have similar responsibilities; they should therefore have similar compensation. The additional consideration to X, contingent upon predetermined targets, exceeds Y's compensation. Thus, it qualifies as consideration and not compensation expense.

Incremental payments to employees:

In the case of two sets of selling shareholders, we should consider those who become employees and those who do not become employees of the post-combination entity. If non-employees receive a lower contingent payment per share than the employed shareholders of the combined entity, the additional amount of contingent payment is treated as compensation to the selling shareholders who became employees. This is because the additional payment is then justified in lieu of service.

- For example, Company Z acquires Company Y and agrees to pay all key officers of Company Y an incremental cash payment of $100 per share if they remain employed with the combined company for at least one year from the acquisition date. The agreement also specifies that if these employees resign before this period, the payment of $100 per share will be cancelled. This clause was not included in Company Y's employment agreements prior to discussions that led to the business combination.
    - As we can see from the example, payments to key employees of Company Y were arranged principally for the economic benefit of Company Z. The payments would be forfeited if they do not serve the combined entity for a specified period.

Therefore, these payments are not part of the consideration transferred for Company Y and should be recorded as compensation cost in the post-combination financial statements of the combined company.

Number of shares owned:

The number of shares owned by the selling shareholders who continue as key employees of the post-combination entity may also be an indicator of contingent consideration arrangement.

If the selling shareholders, who are also key employees, continue in their roles, this becomes an arrangement where post-combination services attract additional compensation. If the contingent consideration amount per share received by non-key employees (minority shareholders) is the same, this is additional consideration. This is because in case there was no transaction, the minority shareholders would not be entitled to additional payment based on the company's performance.

Linkage to valuation:

If the initial consideration paid is based on the lower end of the valuation range (paid at acquisition date) and the valuation approach is based on that contingent formula, it means the contingent payments are additional consideration. However, if the contingent payment formula is consistent with the earlier profit-sharing arrangements, it indicates that the purpose of the arrangement is to provide compensation.

- For example, Company A acquires Company B. A part of the transaction was based on the latter's projected cash flow valuation. Company A believes the rational valuation is at the lower end of the valuation range, while Company B believes it is at the higher end. In finalizing the transaction, Company A pays an unconditional amount close to the lower range. It also agrees to pay an additional contingent consideration if the actual cash flows of Company B over the one-year period exceed the target (those used as basis to determine the upfront payment) for possible payments between the mid and high end of the valuation range. This arrangement indicates that contingent payments, if any, are additional consideration. However, as discussed in point 4 above (Incremental payments to employees), contingent payments could be still considered compensation if the continuing employees (selling shareholders) are required to work to receive the contingent payments.

Formula for determining consideration:

Determination of contingent payment based on a multiple of earnings might suggest that the obligation is a contingent consideration in the business combination. It also indicates that the formula would determine or verify the fair value of the acquiree. Meanwhile, if the contingent payment is a specified percentage of earnings, then the additional payment to employees (a profit-sharing arrangement) is compensation for their services. This is because the first condition deals with the valuation of the company, which might differ from the value agreed during the transaction; on the other hand, the second condition deals with the share of earnings.

Other agreements and issues:

Income tax treatment of contingent payments terms and other arrangements with selling shareholders (such as non-compete agreements, executory contracts, consulting contracts, and property lease agreements) may indicate that contingent payments, for an acquiree, may be attributable to something other than consideration.

- For example, along with a connection to the acquisition, the acquirer may lease property from one of the significant shareholders. Contingent payment (partial or full) to the lessor (selling shareholder) may be taken as payment for use of leased property if lease payments are substantially below the market rate. The acquirer should recognize these payments separately in its post-combination financial statement. However, if the lease rate is consistent with the market rate, contingent payments received by the selling shareholder may be considered contingent consideration in the business combination.

  An analysis of the eight factors mentioned above, in conjunction with three criteria of ASC 805-10-55-24, is imperative to determine whether post-combination employee payments can be classed as a part of the purchase consideration or as compensation expense for the post-combination entity. In certain cases, the complexity of transactions leaves much scope for the interpretation of terms, and all transactions may not fit within the framework provided in ASC. Thus, consulting an expert can significantly save time at the audit stage.

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