

THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

BDO KNOWS: **CONTINGENT CONSIDERATION**



CONTINGENT PAYMENTS TO SELLING SHAREHOLDERS AND EMPLOYEES

► EXECUTIVE SUMMARY

In a business combination, an acquiring company may enter into a contract that includes contingent payments to the selling shareholders or employees of the target company. For example, R Company includes a contingent payment in its acquisition of Target Company when it agrees to pay the owners an additional \$1 million if the company achieves \$10 million in sales by the end of the second year after acquisition. If this payment is also contingent on the continued employment of Target Company shareholders and employees, the contingent payment will represent compensation expense rather than consideration for the acquisition. The issue of how to account for contingent payment arrangements is a frequent challenge in business combinations. The accounting for these arrangements depends on whether they represent consideration for the acquisition, or are transactions separate from the business combination, such as compensation arrangements.¹ The purpose of this publication is to familiarize you with the relevant accounting standards for such contingent arrangements, and then to illustrate the concepts with practical examples.

¹ This publication addresses accounting for contingent consideration under ASC 805-10 (formerly FASB Statement 141R, *Business Combinations*). Contingent payments associated with business combinations that occurred under FASB Statement 141, *Business Combinations*, are accounted for under ASC 450-10 (formerly FASB Statement 5, *Accounting for Contingencies*) and are not addressed in this publication.

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Stephen T. LoVullo, CPA
Partner
Lumsden & McCormick, LLP
716-856-3300

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► THE STANDARD

ASC 805-10-25-21 indicates:

"A transaction entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method....A transaction that compensates employees or former owners of the acquiree for future services...."

In addition, ASC 805-10-55-24 states:

"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 of the arrangements. Understanding the 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 805-10-55-18 provides three factors to consider when determining whether an arrangement represents consideration for the acquisition or compensation or other expense separate from the consideration:

1. **Why** does the arrangement include contingent payments? If the arrangement was a profit-sharing plan designed to benefit the target, then the arrangement may be considered part of the consideration for the acquisition. If the arrangement is a plan designed to retain employees in the period after the acquisition, then the arrangement benefits the acquirer and the combined entity and likely represents compensation expense.
2. **Who** made the arrangement for the contingent payments and who benefits? If the arrangement was established by the target, then the arrangement may be for the benefit of the target and considered a part of the consideration for the acquisition. On the other hand, if the arrangement was initiated by the acquirer, then the arrangement may be for the benefit of the acquirer of the combined entity post-acquisition.
3. **When** was the arrangement made? Whether the arrangement was made by the target prior to sale negotiations, or was made during sale negotiations at the direction of the acquirer provides evidence toward acquisition consideration and postcombination compensation expense, respectively.

Companies that acquire targets with consideration including contingent payment arrangements must analyze the facts and circumstances of the arrangement carefully. Once the acquirer reaches a conclusion on accounting for the contingent payments, the analysis supporting the conclusion should be documented in a timely manner.

► ADDITIONAL INDICATORS

ASC 805-10-55-25 provides the following additional indicators for evaluating arrangements to determine whether they represent consideration exchanged for the acquisition or a transaction separate from the business combination, when it is not otherwise clear. Evaluating the indicators is not a "check the box" exercise and can require careful judgment. ***The first indicator, continuing employment, is the factor that carries the most weight. If the payment is contingent on the continuing employment of selling shareholders or target company employees, ASC 805-10 requires the arrangement to be accounted for as compensation expense.***

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
<p>a. Continuing employment. The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document.</p>	<p>A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for postcombination services.</p>	<p>Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.</p>

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
b. 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.	Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.
c. Level of compensation.		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 rather than compensation.
d. Incremental payments to employees.	If selling shareholders who do not become employees receive lower contingent payments on a per-share 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.	
e. Number of shares owned. 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 basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.
f. Linkage to the valuation.	If the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.	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.
g. Formula for determining consideration. The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement.	A contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.	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.

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
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) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognize separately in its postcombination financial statements.	In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.

The first two examples which follow are simple fact patterns based on ASC 805-10-55-34 and 35. Note, all of the examples below are merely illustrative; actual facts and circumstances will determine the accounting in specific situations.

EXAMPLE 1 Contingent Payment to Employee at Direction of Target Company

In 2009, Target Company hired Ms. Z as its CFO under a five-year contract. Ms. Z's contract requires Target Company to pay her \$1 million if the company is acquired before her contract expires. R Company acquires Target Company in 2011. Ms. Z continued as CFO through the acquisition date and will receive \$1 million under her employment contract.

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
a. Continuing employment.		Who, When, Why: Target entered into contract with Ms. Z before sale negotiations to engage a qualified CFO. Severance is paid upon consummation of acquisition. There is no continuing employment requirement.

Based on the analysis above, the contract was arranged to provide benefits to Target Company, not to R Company or the combined R Company/Target Company. Consequently, the liability to Ms. Z for \$1 million is recorded by Target Company and is treated as an assumed liability in R's acquisition of the company.

EXAMPLE 2

Contingent Payment to Employee at Direction of Acquirer

TC2 hired Mr. Y on January 1, 2008 as its CEO without a contract. In January 2011, TC2 began negotiating its sale to R Company, and R directed TC2 to provide Mr. Y with a \$1 million severance package to ensure that the company's operations continued running smoothly while the business combination was being completed. Under the contract which had an effective date of January 1, 2011, Mr. Y will receive a severance payment in cash six months after a change in control as long as he is still employed at the combined entity, i.e., he has not resigned or been terminated for cause. On July 1, 2011, R Company acquired TC2.

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
a. Continuing employment.	Who, When, Why: R Company directed TC2 to enter into a contract with Mr. Y during sale negotiations to ensure TC2 was operating properly as the transaction progressed.	
b. Duration of continuing employment.	Mr. Y receives the severance payment as long as he is still employed by R Company on December 31, 2011.	

Here, R Company accounted for the liability to Mr. Y in its postcombination financial statements as a compensation expense separate from the accounting for the acquisition. As noted above, ASC 805-10 requires contingent payments that are automatically forfeited if employment terminates to be treated as postcombination compensation. Typically, cash compensation is recognized over the postcombination service period based on Subtopic 450-20, *Loss Contingencies*. Consequently, the combined R/TC2 entity should report the compensation expense over the period from July 1 to December 31, 2011.

EXAMPLE 3

Contingent Payment to Employee at Direction of Acquirer

TC3 hired Ms. J on January 1, 2009 as its CFO without a contract. In December 2009, R Company began negotiating to buy TC3 and directed TC3 to provide Ms. J with a \$500 thousand severance package to maintain the company's financial controls and reporting. Under the contract which had an effective date of January 1, 2010, Ms. J will receive a severance payment in cash two years after a change in control as long as she is still employed at the combined entity (i.e., she has not resigned or been terminated for cause) one year after the acquisition. On January 1, 2010, R Company acquired TC3.

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
a. Continuing employment.	Who, When, Why: R Company directed TC3 to enter into a contract with Ms. J during sale negotiations to ensure TC3 had appropriate financial controls and reporting.	
b. Duration of continuing employment.	Ms. J receives severance as long as she is still employed on December 31, 2010.	

The fact that Ms. J is required to continue employment with R/TC3 in order to receive the severance is determinative, and the award is accounted for as compensation expense. Although Ms. J's severance will not be paid until December 31, 2011, her earn-out period lasts for only one year. Consequently, Ms. J's severance is accrued over the earn-out period.

EXAMPLE 4

Contingent Payment to Employees Established by Acquiree

In July 2010, the shareholders of TC4 decide to place their company on the market. In anticipation of the sale, the shareholders establish a bonus plan for their employees. If the company is acquired, the bonus plan will pay each employee who is still employed by the combined entity one year after the acquisition date 25% of their current-year salary. On January 1, 2012, R Company acquires TC4. In January 2013, R Company pays the bonuses to the TC4 employees who are still employed by the combined entity.

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
a. Continuing employment.	Who, When, Why: TC4 established the bonus plan to ensure that its skilled workforce would be in place for its anticipated acquirer.	
b. Duration of continuing employment.	In order to earn the bonus, employees must continue their employment for one year postcombination.	

While TC4 established the bonus plan, it was created to benefit its anticipated acquirer. The plan was designed to make the company more marketable and to ensure the company had continuing value once it was acquired. Also, one year of continued employment after the acquisition was required to earn the bonus. Consequently, R Company accounts for the liability to TC4's employees in its postcombination financial statements from January 1 to December 31, 2012 as compensation expense separate from the accounting for the acquisition.

EXAMPLE 5

Bonus Payment Based on EBITDA

TC5 is owned by four partners, Mr. A, Ms. B, Ms. C, and Mr. D who are CEO, COO, CFO, and Controller of the company, respectively. TC5 is acquired by R Company in 2010, and Mr. A, Ms. B, Ms. C, and Mr. D will receive contingent consideration in cash based on TC5's performance in the three-year period following the acquisition. If TC5 achieves net income over \$1 million by the third year after acquisition, the partners will earn an additional 1.5 times TC5's EBITDA in 2013. The partners are offered positions in the combined entity, but are not required to maintain their employment to earn the contingent consideration.

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
a. Continuing employment.		Not required.
c. Level of compensation.		Who, When, Why: The partners' compensation in the postcombination entity is comparable to that of the executives in peer companies.
d. Incremental payments to employees.		All selling shareholders receive a payment that is contingent on the performance of the company.
e. Number of shares owned.		All selling shareholders receive the same amount of contingent consideration on a per-share basis.
f. Linkage to the valuation.		R Company determined the contingent payment in negotiations over the sale price of TC5. R negotiated a price based on a low end valuation of TC5 and offered the contingent payment to compensate the partners for this pricing.
g. Formula for determining consideration.		The contingent payment is determined on the basis of a multiple of earnings.

When continuing employment is not required, other indicators must be carefully considered. In this situation, the factors all indicate the contingent payment is consideration for the acquisition of TC5. Pursuant to ASC 805-30-25-5, consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement. Further, this contingent consideration is recognized at its acquisition date fair value. ASC 805-30-35-1 requires the acquirer to account for contingent consideration that is classified as an asset or a liability at fair value with changes recognized in earnings in each reporting period until the contingency is resolved (as long as the changes in fair value are not measurement period adjustments²). In this fact pattern, R measures the contingent consideration obligation at fair value at each reporting date until the contingency is resolved in the third year after acquisition.

EXAMPLE 6 Bonus Payment Based on EBITDA and Compensation

TC6 is owned by four partners, Ms. E, Ms. F, Ms. G, and Mr. H who share executive responsibilities at the company. TC6 is acquired by R Company in 2011, and Ms. E, Ms. F, Ms. G, and Mr. H will receive base contingent consideration in cash of 1.5 times TC6's EBITDA in 2013 if TC6 achieves net income over \$5 million by the second year after acquisition. The partners are offered positions in the combined entity, but are not required to maintain their employment to earn the base contingent consideration. If the partners continue employment with the combined entity for three years after acquisition, they are eligible for an incremental bonus calculated as the higher of:

- His/her pro rata portion of 1.5 times TC6's EBITDA in 2014; or
- His/her pro rata portion of 1 times TC6's EBITDA in 2014 plus 2X his/her salary in 2013.

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
a. Continuing employment.	Who, When, Why: The incremental bonus is granted based on a formula if the partner remains employed.	The base contingent payment does not require continuing employment.
b. Duration of continuing employment.	The incremental bonus requires three years of postcombination employment.	
g. Formula for determining consideration.	The incremental bonus is based on a multiple of salary and EBITDA.	The base contingent payment is a multiple of (1.5 times) EBITDA.

In this fact pattern, the partners receive the base contingent payment whether or not they are employed by R/TC6 in the three-year period postcombination. The base contingent payment represents consideration for the acquisition of TC6. The incremental bonus is contingent upon the partners remaining employed by R/TC6 in the three-year period postcombination period, and should be recognized as compensation expense for postcombination services during the three-year period in which the incremental bonus is earned.

EXAMPLE 7 Last Man Standing

R Company acquires TC7 in 2012 for cash and stock and offers all employees in TC7 employment with the combined entity. The employees are also TC7 shareholders, and R places 25% of the stock for the acquisition in an irrevocable trust for the TC7 shareholders/employees subject to a four-year vesting period. If, prior to vesting, a shareholder/employee resigns or is terminated for cause, the shareholder/employee forfeits the shares held in trust allocable to him or her. Also, forfeited shares are reallocated to the remaining shareholders/employees based on their initial interest in the trust. All of the shares in the trust will ultimately be issued (if no employees remain, the trust will be distributed to charity), giving this arrangement the moniker "last man standing."

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
a. Continuing employment.	Who, When, What: R Company designed the irrevocable trust during the purchase negotiations to retain employees for the benefit of the combined company. The shareholder/employees must remain employed to vest in the trust shares.	

² Measurement period adjustments result from additional information about facts and circumstances that existed at the acquisition date that the acquirer obtained after that date.

Factors	Factors for postcombination expense	Factors for accrual in purchase accounting
b. Duration of continuing employment.	Shareholder employees must remain employed four years to vest in the trust shares.	

In an SEC staff speech in 20003, the staff stated, "the fact that the forfeiture shares were not returnable did not negate the need to assess the substance of the arrangement....In addition, the staff believes that such forfeiture provisions are included in arrangements in order to promote employee retention. The staff believes that these factors provided the greatest evidence as to the substance of the arrangement, and therefore the forfeiture shares should be accounted for as a compensatory arrangement." For this reason and because the shares in the irrevocable trust vest upon four years of postcombination employment, the contingent payments are accounted for as compensation in that period.



Stephen T. LoVullo, CPA
 Partner
 Lumsden & McCormick, LLP
 716-856-3300

³ See R. Scott Blackley's December 4, 2000 speech at the 2000 Annual National Conference on Current SEC Developments.

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►CONTACT:

Due to the complexity and judgment involved in the accounting for such arrangements, consideration should be given to consulting with BDO USA, LLP prior to consummating a transaction once you have reached preliminary conclusions on the accounting. If you would like further information or to discuss the implications of the matters discussed in this newsletter, please contact the BDO engagement partner serving you or one of the following partners:

LEE GRAUL
 312-616-4667
lgraul@bdo.com

ADAM BROWN
 214-665-0673
abrown@bdo.com