According to Generally Accepted Accounting Principles (GAAP), when a company acquires a business, the consideration paid, assets acquired, and liabilities assumed are recorded at their fair values. The consideration paid not only includes the actual cash paid or debt incurred, but any contingent consideration payments or receipts (earn-outs) that are part of the purchase agreement. Contingent earn-outs are often structured as a multiple of a measurable performance benchmark. For example, if the acquired company makes more than $1,000,000 in sales, we will pay you 1% of the sales above $1,000,000. As the name implies, payments under these agreements are contingent upon the acquired business meeting or exceeding a pre-determined benchmark.

Recording contingent earn-outs at inception is consistent with GAAP’s requirements related to recording loss contingencies. GAAP for contingent earn-outs goes further and requires the liability (or asset) to be recorded at fair value, and increases the disclosures required in the footnotes to the financial statements. With the GAAP requirement to record contingent earn-outs at fair value at inception, what is the proper accounting treatment and requirements for subsequent changes in the contingent payments once you determine its original fair value?

The first step in determining the proper accounting treatment is to determine if the contingent payments represent additional purchase price or compensation to the sellers. Several factors go into this evaluation, but a big factor in determining the value relates to the timing of the payments. For example, if payments terminate with the termination of the seller employee, this is a strong indicator that these payments are compensation and not additional purchase price. If payments are made no matter what the employment status of the seller is, this is a strong indicator that the payments represent additional purchase price.

When contingent payments are determined to be additional compensation, the payments made under this agreement are expensed as they are incurred to the seller. If the contingent earn-out is considered to be additional purchase price, the fair value of the contingent earn-out is recorded as a liability (or asset in select cases) or equity (if equity instruments are to be issued) at the acquisition date and the fair value is considered part of the consideration paid, thus increasing the recorded purchase price. When contingent earn-outs are considered additional purchase price, payments are offset against the contingent earn-out and at the end of a reporting period, i.e. quarter end or year end, the contingent earn-out is revalued to fair value. Any gain or loss related to this revaluation is recorded through the income statement. In a situation where equity instruments are issued, GAAP does not require the contingent earn-out to be revalued to fair value and the settlement of the contingent earn-out is recorded within equity, even if different than original fair value determination.

As you can see, the basic accounting treatment for contingent earn-outs is similar to the accounting for other assets and liabilities under GAAP, but goes further and requires you to evaluate and record the agreement at fair value at the end of every reporting period. In addition, unlike a simple liability or asset, the change in fair value for non-equity settlements is recorded as a gain or loss in the income statement. With careful consideration and help from a certified public accountant, you can properly record and disclose your contingent earn-outs to ensure proper compliance GAAP.

To learn more about accounting for contingent earn-outs, contact a Boulay advisor at 952-893-9320 or learnmore@BoulayGroup.com.