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Finance ADVISORY

JUNE 11, 2014

Accounting for Earnouts under Financing Agreements

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An earnout, also known as "contingent consideration"[1] in accounting parlance, is a contractual provision in an acquisition agreement that adds a variable component to the purchase price for an acquisition. Earnouts allow a purchaser to pay a portion of the purchase price to a seller on a contingent basis if and to the extent the target business reaches certain milestones after the closing. Often these milestones are financial in nature (achieving, for example, revenue, net income or EBITDA benchmarks, or reaching a stock price target), but they can also be non-financial in nature (such as obtaining regulatory approval for a proposed line of business).

Why use an earnout? Buyers and sellers often hold differing views on the value or future prospects of the target business. An earnout can help bring both sides together in transactions where uncertainties exist by mitigating some of the risk of overpayment or underpayment. In other words, an earnout can serve as an effective risk-sharing tool to bridge the gap on purchase price expectation. Indeed, an earnout may make the difference between signing a deal and not reaching an agreement.

The presence of earnout provisions in the current acquisition environment is noteworthy. According to the M&A Market Trends Subcommittee of the Mergers & Acquisitions Committee of the American Bar Association, earnout provisions were included, on average, in 31.5 percent of the acquisition agreements analyzed in 2010 and 2012.[2] Despite their relative prevalence in acquisition transactions, incorporating them in financing agreements[3] has been haphazard. Relatively recent changes in the accounting treatment for

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1 "Contingent consideration" is defined as an obligation of the acquirer to transfer additional assets or equity interests to the former owners of a target as part of the exchange for control of a target if specified future events occur or conditions are met; *see*, Topic 805-30-20 of the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC).

2 ABA, *2011 and 2013 Private Target Mergers & Acquisitions Deal Points Study*. These two studies analyzed a combined sampling of more than 200 publicly available acquisition agreements for transactions completed in 2010 and 2012, respectively, that involved private target companies. The 2011 study of transactions completed in 2010 cited use of earnouts in 38 percent of the acquisition agreements reviewed. The 2013 study of transactions completed in 2012 cited use of earnouts in 25 percent of the acquisition agreements reviewed.

3 For purposes of this article, the term "financing agreement" is intended to have broad scope and includes credit agreements, loan agreements, indentures, note purchase agreements and other similar financing agreements.

earnouts should spark parties to revisit their application in financing agreements. These accounting changes, as described below, have had a meaningful impact on both the balance sheet and the income statement of the purchaser. Whether you are a purchaser, borrower, lender or other creditor, a basic understanding of how earnouts are treated from an accounting perspective will aid in the analysis of how they might operate within a financing agreement.

In 2007, Statement of Financial Accounting Standards 141(R) (which is codified as FASB ASC Topic 805, *Business Combinations*) made relatively dramatic changes in how acquiring companies are required to account for earnouts. Under FASB ASC 805-30-25, the fair value[4] of an earnout is required to be recorded as a ***liability*** on the balance sheet of the purchaser on the date of the acquisition if additional assets (such as cash) will be transferred to the seller (or within the equity section of the balance sheet when additional equity interests will be transferred to the seller). This is in sharp contrast to prior accounting rules, under which any post-closing earnout obligations were accounted for at the time the contingency was resolved (e.g., at the time the future event occurred or conditions were met and the payment became certain). Furthermore, FASB ASC 805-30-35 provides that earnouts recognized as a liability must be re-measured to fair value at each reporting period until the contingency is resolved. To the extent there is a change in fair value, the change must be recognized in the income statement (as a gain or a loss in earnings). Contingent consideration recorded in equity is not required to be re-measured.

If the initial measurement of fair value of a given earnout is lower (or higher) than the payment that is to be made, the results can be unusual. For example, if the fair value measurement is less than the payment to be made, a loss will be recorded in earnings. The anomaly is that the purchaser is recording a loss while the acquired business is presumably performing better than the parties expected. Conversely, if the fair value measurement is higher than the payment, a gain is recorded. Again, it is counterintuitive that the purchaser records a gain even though the acquired business does not perform to expectation.

With a basic explanation of the current accounting treatment, we turn to the application of earnout obligations in the context of a financing agreement. For an acquisitive company in particular (or lenders to an acquisitive company), it is important to analyze how earnout obligations flow through the borrower's financing agreement. Curiously, many financing agreements are silent when it comes to addressing earnout obligations.[5] Silence will likely be more detrimental to an acquisitive company subject to the restrictions and limitations imposed by a customary financing agreement.

A central question in analyzing the financing agreement is whether the parties elect to include or exclude earnout obligations from the definition of "indebtedness" or "debt" under the financing agreement (referred to hereinafter as "Debt"). If included in Debt, the earnout obligation could increase the borrower's leverage and consequently will affect financial covenant compliance, pricing (if leverage-based), and the ability to

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4 Valuation of contingent consideration can be quite complex. Methodologies for determining the fair value of an earnout is beyond the scope of this article.

5 In connection with this article, the author reviewed a random sampling of 116 publicly filed credit agreements that closed during the first half of 2012. Of the credit agreements reviewed, 80 credit agreements (nearly 70 percent of the sample reviewed) contained no references to earnout obligations. Conversely, nearly 30 percent of the credit agreements in the sample contained some reference to earnout obligations.

consummate certain transactions, including the incurrence of additional debt, acquisitions, investments and restricted payments to the extent they are governed by or restricted based on leverage.

As discussed above, generally accepted accounting principles (GAAP) provide that earnout obligations requiring future cash payments to a seller be accounted for as a liability on a borrower's balance sheet. If a financing agreement has a GAAP-based definition of Debt, i.e., it provides that Debt includes "all obligations that would be required to be reflected as a liability on the balance sheet in accordance with GAAP," then an earnout obligation would necessarily be included in any determination of Debt. More often, financing agreements define Debt more narrowly using a specific litany of obligations that constitute Debt. In some agreements, this litany directly addresses earnout obligations by expressly including or excluding them from Debt. In those cases where the financing agreement is silent, an earnout obligation will more likely be included in Debt, since the most common definitions of Debt include "obligations . . . for the deferred purchase price of property or services."

A fair number of recent financing agreements purport to exclude from Debt any earnout obligations "until such obligation becomes a liability on the balance sheet of such Person in accordance with GAAP." This suggests a complete misunderstanding of current accounting rules. Such a provision would comport with the pre-2007 accounting treatment of earnouts (where the earnout obligation was not accounted for until the contingency was resolved). Under the current accounting rules (FASB ASC 805-30-25), this is unnecessary since the earnout, in accordance with GAAP, would have to be recorded as liability on the date of the acquisition.

Borrowers and lenders may have legitimate reasons to include or exclude earnout obligations from Debt. Borrowers claim that the contingent nature of these obligations should not result in a full "hit" from a leverage perspective. Lenders respond that other contingent liabilities often are included in Debt, such as letter of credit obligations and guarantees of funded debt. Moreover, lenders may argue that striking similarities exist between an earnout and a seller note with offset rights, and seller notes are invariably included in Debt.

Regardless of whether one believes earnouts should be included as Debt, it is important for borrowers and lenders to consider how earnout provisions might affect their financing agreements. The parties will want to consider whether:

- earnout obligations should be included as Debt if pricing for a credit facility is leverage-based;
- financial covenants should take into account the borrower's existing earnout obligations and the intended use of earnouts on a going-forward basis;
- a specific basket or carve-out should be included if earnouts are treated as Debt in the negative covenant provision that restricts Debt;
- the borrower should notify lenders of "material" earnout obligations that are incurred, including the material terms;
- earnout obligations should be subordinated, unsecured and/or otherwise subject to leverage-based covenant tests in order to be incurred;

- to exclude earnouts from financial covenant levels that are set to regulate the borrower's ability to incur incremental debt, to pay dividends or make other restricted payments, or to effect certain investments; and
- lenders should have conditionality/covenant compliance tests in order for (i) borrowers to exercise buyout options related to earnouts or (ii) sellers to accelerate their earnout obligations.

In addition to the changes related to the balance sheet resulting from recording an earnout as a liability as of the acquisition date, the accounting rule changes for earnouts also can distort or skew a purchaser's earnings before interest, taxes, depreciation and amortization, or EBITDA. Recall that the liability booked for an earnout is required to be re-measured at certain periods, which may necessitate recording a gain or loss in a purchaser's earnings. *See*, FASB ASC 805-30-35. Also recall that these gains or losses can create anomalous results. If the acquisition in question is performing worse than the parties expected, the purchaser may be required to book a ***gain***, thereby increasing the company's EBITDA. Some financing agreements exclude these types of gains or losses by a catch-all exclusion of all non-cash gains or losses. However, when such an exclusion for non-cash items does not exist, it is entirely appropriate to exclude any non-cash gains or losses associated with the fair value re-measurement rules under FASB ASC 805-30-35.

Earnouts can be beneficial to both borrowers and lenders. They provide a tool that can mitigate the risk for both borrowers and lenders of overpaying for acquired assets. Earnouts no doubt have debt-like characteristics and lenders will seek to monitor and regulate the leverage and liquidity of their borrowers. An understanding of the accounting treatment and interrelated relationship of earnouts with the financing agreements of the purchaser should foster the use of this beneficial acquisition tool.

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