Contingent Consideration
“Are We There Yet”

March 19, 2014
Agenda

• Contingent Consideration under FAS 141R

• Financial Statement Classification and Disclosure Reminders

• Forms of Contingent Consideration

• Contingent Consideration Valuations

• When Does it Apply? – Business Combination v. Asset Acquisition

• Internal Control Over Financial Reporting
Contingent Consideration

Introduction

- FAS 141(R), Business Combinations, a replacement of FAS 141 effective for transactions that closed on or after December 15, 2008
- FAS 141R changed the accounting for “Earn-Outs” and defined them as “Contingent Consideration”
- Contingent consideration is used as a mechanism to share risk between buyer and seller
  - Due to the uncertainty inherent in acquisition targets, buyers are resistant to paying “full-price” until technology has been proven
  - Can be used as an alternative financing mechanism, essentially delaying payment for the buyer
    - Day 1: Recognize at FV at acquisition date.
    - Day 2: Mark-to-market in earnings if classified as liability or derivative. No change if classified as equity, which is difficult to achieve.

- Increase purchase price with an increase in risk for goodwill impairment
Contingent Consideration
Accounting treatment

- Contingent consideration is recognized and measured at the acquisition date
  - Classified as an asset, liability, or equity and measured at fair value
  - If recorded as asset or liability, re-measured to fair value each reporting unit, with changes in fair value included in earnings
  - Change in fair value due to unwinding of discount rate also recorded to earnings
- A contingent consideration arrangement that is required to be settled in cash or other assets should be classified as a liability
- A contingent consideration arrangement that is required to be (or at the issuer’s option can be) settled in shares may be classified as a liability or as equity
  - Determining the classification of a contingent consideration arrangement that is expected to be settled in an entity’s own shares as a liability or equity at the acquisition date can be complex and requires analysis of the facts and circumstances of each transaction (ASC 480, ASC 815-40, and ASC 815-40-15) (Rare in the pharma industry)
Contingent Consideration
Or is it compensation?

- Earnouts that are classified as performance incentives are viewed as compensation rather than purchase price.
- If deemed to be compensation, exclude from the purchase price and are a post-acquisition expense of the buyer.
- Indicators of compensation:
  - Continuing employment condition
  - Duration of required employment relative to payment of earnout
  - Level of other (non-contingent) compensation
  - Contingent payments more than for other non-employees
  - Proportionate ownership of employees vs non-employees
  - Linkage between payment and business valuation
  - Formula of payment (linked to business value or operating metrics)
- If deemed compensation, then apply compensation guidance in ASC 718.
Contingent Consideration
Accounting treatment – Income Statement Classification

• Changes in fair value measurements may contain elements of both changes in assumptions used in the determination of fair value and changes due to the passage of time (i.e., time value of money).

• Generally, it is **not** expected an entity to separate a change in fair value into its components.

• Entities should record the entire change as a component of **operating income**.

• However, classification within operating income will depend on facts and circumstances but generally should mirror the income statement recognition for similar items outside of the business combination.
Contingent Consideration
Accounting treatment – EPS Implications

• When contingent consideration arrangements are in the form of common shares, the shares are considered contingently issuable shares and may need to be included in the computation of basic and diluted earnings per share (EPS) of the combined entity.

• The EPS guidance for contingently issuable shares is included in ASC 260, Earnings per Share (ASC 260).
Contingent Consideration
Accounting treatment – Cash Flow Classification

With respect to the statement of cash flows:

- Amounts paid in excess of the amount recorded on the acquisition date should be classified as cash flows used in **operating activities** because the difference has entered into the determination of net income.

- Payments not exceeding the acquisition-date fair value of the contingent consideration arrangement should be classified as cash flows used in **financing activities**. The consideration is analogized to a seller's financing arrangement and therefore future payments are treated as repayment of debt principal (i.e., a financing activity).
Contingent Consideration

Accounting treatment – Disclosure Considerations

- Entities should disclose the nature of the arrangement including the amount recognized at the acquisition date, how the fair value was determined, and an estimate of the range of outcomes.

- Changes to amounts initially recognized for contingent consideration should also be disclosed including any changes in the range of outcomes or differences upon settlement along with the reasons for the changes.

- Furthermore, contingent consideration arrangements that are classified as liabilities fall under the scope of ASC 820, *Fair Value Measurements*, and would require entities to disclose the fair value techniques used and fair value hierarchy in accordance with that guidance.

- Future amounts should be considered in the contingent obligation tables required in SEC filings.
Contingent Consideration
Common Forms in the Pharm Industry

• Contingent consideration can be based on multiple factors:
  – Development milestones
  – Sales milestones - $X if sales reach a specified level
  – Tiered sale milestones – various level of payments if sales reach a certain level in a defined year or over a cumulative period
  – Royalties
  – Profitability or EBITDA targets
  – Stock price movements

Generally working capital settlements are not considered contingent consideration as they involve settlement of existing assets and liabilities transferred and are not based on contingent future performance.
Contingent Consideration

Royalty agreements

• Royalty agreement can be a form of contingent consideration
• Commonly seen are:
  - Seller receives future royalty and/or milestone payments
  - Licensing arrangements for products qualifying as business combinations where royalties and milestones are contingent consideration
Contingent Consideration
Seller/Licensor receives future royalty and/or milestone payments

Day 1: Buyer records fair value estimate of milestone payments and royalty payments as consideration transferred for the acquisition of the business

Day 2: Buyer marks the milestone and royalty payment estimates to market through the P&L
Contingent Consideration Valuation

Steps to value contingent consideration

1. Estimate expected future payouts
2. Discount the expected future payouts to the present

<table>
<thead>
<tr>
<th>Methodology</th>
<th>Probability-Weighted Method</th>
<th>Option Pricing Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Framework</td>
<td>Risk-adjusted</td>
<td>Risk-neutral</td>
</tr>
</tbody>
</table>
| Steps           | • Estimate scenarios of outcomes and associated probabilities  
                  • Compute expected payoff using scenario probabilities  
                  • Discount expected payoff to present value using risk-adjusted rate  
                  • Convert real-world scenarios into risk-neutral estimates  
                  • Compute expected future payoff within risk-neutral framework  
                  • Discount expected payoff in future using risk-free rate  |
| Pros            | • Intuitive and straightforward  
                  • Discount rate is known (risk-free rate)  |
| Cons            | • Difficulty in estimating appropriate discount rate  
                  • Complex and time consuming  
                  • Difficulty in converting real-world cash flows into risk-free cash flows  
                  • Certain inputs (e.g. volatility) difficult to estimate  |
Contingent Consideration
Probability-Weighted Method

• Simple example:
  – $100 million payment contingent upon obtaining FDA approval
  – Approval expected in 1 year

<table>
<thead>
<tr>
<th></th>
<th>Probability</th>
<th>Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approval obtained</td>
<td>75%</td>
<td>$100</td>
</tr>
<tr>
<td>Approval denied</td>
<td>25%</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>$75</td>
</tr>
</tbody>
</table>

Discount rate: 10%

Present value factor: 0.91

Fair value of contingent consideration: $68
Contingent Consideration
Probability-Weighted Method (cont’d)

- More complicated example:
  - Graduated payment dependent upon year 1 revenue

<table>
<thead>
<tr>
<th>Revenue Thresholds</th>
<th>Payment</th>
<th>Probability</th>
<th>Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-100M</td>
<td>$0</td>
<td>10%</td>
<td>$0</td>
</tr>
<tr>
<td>$101-200M</td>
<td>$10</td>
<td>40%</td>
<td>$4</td>
</tr>
<tr>
<td>$201-300M</td>
<td>$15</td>
<td>30%</td>
<td>$5</td>
</tr>
<tr>
<td>&gt;$300M</td>
<td>$30</td>
<td>20%</td>
<td>$6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$15</strong></td>
<td><strong>100%</strong></td>
<td></td>
</tr>
</tbody>
</table>

Discount rate 10%
Present value factor 0.91
Fair value of contingent consideration $13

- Non-linear payment structure creates complications for discount rate selection to incorporate:
  - Market/industry risk associated with achieving revenue thresholds
  - Risk associated with probability estimates
  - Credit risk associated with buyers ability to pay
  - Correlation of these risks to one another
Contingent Consideration
Option Pricing Method

- Use option pricing models (mechanically similar to Black Scholes) to value earnouts
  - For example, an earnout based on a variable payment above a certain threshold that is proportionate to revenue is similar to a call option on a company’s sales

- Valuation based on the concept of risk-neutrality that underlies most conventional option pricing methods, thus alleviating the need for discount rate derivation

- Problem arises with generating risk-neutral metrics for financial operating results
Contingent Consideration
Option Pricing Method Example

• Earnout based on revenue where payout in 2 years will be equal to 10% of revenue above a threshold of $50
• Company is currently expecting revenue of $75 and has a WACC of 15%
• Risk-free rate of return of 3%
• Probability distribution of potential revenues in 2 years are as follows:

<table>
<thead>
<tr>
<th>Revenue</th>
<th>Threshold</th>
<th>Upside</th>
<th>Probability</th>
<th>Prob.-Wtd Revenue</th>
<th>Prob.-Wtd Threshold</th>
<th>Prob.-Wtd Upside</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50</td>
<td>$50</td>
<td>$0</td>
<td>10%</td>
<td>$5</td>
<td>$5</td>
<td>$0</td>
</tr>
<tr>
<td>$60</td>
<td>$50</td>
<td>$10</td>
<td>15%</td>
<td>$9</td>
<td>$8</td>
<td>$2</td>
</tr>
<tr>
<td>$70</td>
<td>$50</td>
<td>$20</td>
<td>25%</td>
<td>$18</td>
<td>$13</td>
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<td>$80</td>
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<td>$30</td>
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<tr>
<td>$90</td>
<td>$50</td>
<td>$40</td>
<td>15%</td>
<td>$14</td>
<td>$8</td>
<td>$6</td>
</tr>
<tr>
<td>$100</td>
<td>$50</td>
<td>$50</td>
<td>10%</td>
<td>$10</td>
<td>$5</td>
<td>$5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>$75</strong></td>
<td><strong>$50</strong></td>
<td><strong>$25</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Rate of return 15% 3% ???
Present value $57 $47 ???

• Rate of return for overall revenue is known (i.e. WACC), as is the rate of return for the $50 threshold (i.e. risk-free rate), but what about the earnout payment?
Contingent Consideration
Option Pricing Method Example (cont’d)

• In the previous example, simple algebra can help determine the discount rate appropriate for the earnout payment, but what about the following case?

<table>
<thead>
<tr>
<th>Revenue</th>
<th>Threshold</th>
<th>Upside</th>
<th>Shortfall</th>
<th>Probability</th>
<th>Prob.-Wtd Revenue</th>
<th>Prob.-Wtd Threshold</th>
<th>Prob.-Wtd Upside</th>
<th>Prob.-Wtd Shortfall</th>
</tr>
</thead>
<tbody>
<tr>
<td>$40</td>
<td>$50</td>
<td>$0</td>
<td>($10)</td>
<td>10%</td>
<td>$4</td>
<td>$5</td>
<td>$0</td>
<td>($1)</td>
</tr>
<tr>
<td>$45</td>
<td>$50</td>
<td>$0</td>
<td>($5)</td>
<td>15%</td>
<td>$7</td>
<td>$8</td>
<td>$0</td>
<td>($1)</td>
</tr>
<tr>
<td>$65</td>
<td>$50</td>
<td>$15</td>
<td>$0</td>
<td>25%</td>
<td>$16</td>
<td>$13</td>
<td>$4</td>
<td>$0</td>
</tr>
<tr>
<td>$85</td>
<td>$50</td>
<td>$35</td>
<td>$0</td>
<td>25%</td>
<td>$21</td>
<td>$13</td>
<td>$9</td>
<td>$0</td>
</tr>
<tr>
<td>$105</td>
<td>$50</td>
<td>$55</td>
<td>$0</td>
<td>15%</td>
<td>$16</td>
<td>$8</td>
<td>$8</td>
<td>$0</td>
</tr>
<tr>
<td>$110</td>
<td>$50</td>
<td>$60</td>
<td>$0</td>
<td>10%</td>
<td>$11</td>
<td>$5</td>
<td>$6</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>$75</strong></td>
<td><strong>$50</strong></td>
<td><strong>$27</strong></td>
<td><strong>-$2</strong></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Rate of return 15% 3% ??? ???
Present value $57 $47 ??? ???
Contingent Consideration
Option Pricing Method (cont’d)

- Convert ‘risky’ cash flows to a certainty equivalent amount so that the discount rate is simply the risk-free rate, plus an amount for the obligor’s credit risk

- Conversion from risky to risk-neutral framework is done using a dampening factor called “market price of risk”
Contingent Consideration
When Does It Apply?

• Contingent consideration only applies in an arrangement that is considered a business combination BUT:

• Oftentimes, arrangements that on the surface appear to convey only assets, include other elements that, for accounting purposes, may mean they meet the definition of a business. This could be the case for acquisitions of intellectual property or other assets or in-licenses of intellectual property.

• The application of FAS 141 R’s business combinations guidance can lead to many transactions being considered businesses, including many early-stage projects or in-licenses that grant the licensee rights to inputs and processes.

In an asset deal contingent consideration is generally recorded when probable and reasonably estimable. Subsequent changes in the recorded amount of the contingent consideration are recorded against cost [ASC 360-10-30-1; ASC 450-20-25-2].
Finally Don’t Forget Your …..
Internal Control Over Financial Reporting

• Processes in place to determine the fair value of contingent consideration arrangements on the acquisition date and in each post combination reporting period. Considerations around controls over using external specialists.

• Processes in place to determine the appropriate classification of contingent consideration between liability, equity or derivative instrument as well as controls to track the cash flow presentation each period.

• Track separately contingent consideration under asset deals and FAS 141(R) as their post combination accounting is different

• Document controls in place to review key assumptions and cash flows each accounting period and consider changes in market conditions

• Ensure stack holders understand the volatility in earnings these arrangements are likely to create in future periods.