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Mercer Capital's

Financial Reporting Valuation Flash

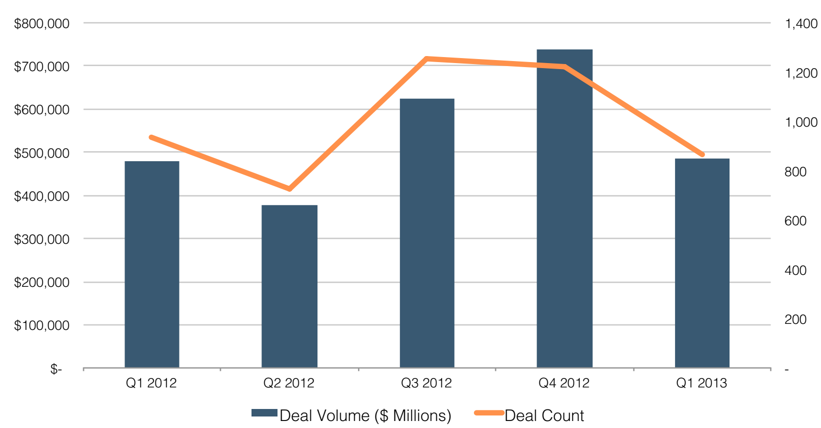
First Quarter 2013

Contingent Consideration on the Rise

Although U.S. deal volume and count grew steadily throughout 2012, activity in Q1 2013 decreased. Deal volume from Q4 2012 to Q1 2013 dropped 34%, while deal count declined 29% during the same period. Part of the spike in Q4 2012 activity was caused by sellers seeking to complete transactions before capital gains rates and other tax laws changed at the beginning of 2013. Transaction activity is now on par with the prior year's first quarter levels.

M&A Activity

2012 and Q1 2013



Source: Bloomberg LP

While deal volume moderated in Q1, there was a shift in reported deal consideration. According to Bloomberg, 9.1% of deals in Q1 2013 included contingency payments or contingent consideration as part of the total consideration, compared to less than 1% of deals in the Q4 2012.[1] The statistics and reporting of earn-out prevalence in M&A deals, varies, however, depending on the sample size. Contingent consideration is also more common in acquisitions of private companies than for publics. Another source notes that approximately 26% of transactions in 2011 included contingent consideration. Among those deals, the median amount of contingent consideration as a percentage of the purchase price was 16%. Industries with the highest usage of contingent consideration in transactions were business services, healthcare, and financial institutions.[2]

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What Is Contingent Consideration and How Is It Used?

Contingent consideration is any asset (most frequently cash, but stock and other securities can be used as well) that will be transferred from the acquirer to the seller after the transaction has been completed given that certain criteria or objectives have been reached. Common milestones include revenue or EBITDA targets, receiving FDA approval, or securing certain patents.

Contingent consideration is traditionally used to bridge the interests of the acquirer and the seller. When the success of a business hinges on specific, measurable factors, contingent consideration can help reduce risk relating to uncertainty on behalf of the acquirer.

What Are the Implications of the Current Trend in Contingent Consideration?

As more transactions involve some type of contingent consideration, it has become increasingly important for companies to identify and understand the valuation implications of this liability.

ASC 805, the section of the FASB codification that addresses business combinations, requires that:

> "The fair value of contingent consideration be recognized and measured at fair value at the acquisition date. In most cases, recognition of a liability for contingent consideration will increase the amount of goodwill recognized in the transaction."

The contingent consideration liability must be re-measured at each subsequent reporting date until resolution of the contingency, and any increases or decreases in fair value will show up on the income statement as an operating loss or gain.

How Mercer Capital Can Help

The professionals at Mercer Capital are experienced in valuing a variety of contingent liabilities. The structure and terms for contingent consideration are unique to each transaction and require careful consideration of the overall transaction, the expected financial performance of the acquired business, and the probability of achieving key milestones. Analytic approaches to valuing contingent consideration include scenario analysis, Monte Carlo models, and option pricing models. If there are contingent consideration issues on your horizon, a discussion with a valuation specialist can help determine the appropriate next steps.

Endnotes

1 Bloomberg LP.

2 Houlihan Lokey, *2011 Purchase Price Allocation Study*, August 2012.

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Financial Reporting
Valuation Services

In an environment of increasingly complex fair value reporting standards and burgeoning regulatory scrutiny, Mercer Capital helps clients resolve fair value reporting issues successfully.

We have the capability to serve the full range of fair value valuation needs, providing valuation opinions that satisfy the scrutiny of auditors, the SEC, and other regulatory bodies.

We also have broad experience with fair value issues related to public and private companies, financial institutions, private equity firms, start-up enterprises, and other closely held businesses. National audit firms consistently refer financial reporting valuation assignments to Mercer Capital.

Our professionals are nationally recognized as leaders in the valuation industry, and hold the most rigorous credentialing designations including the CFA, ASA, and CPA, among others, which are representative of the highest standards in the valuation and accounting industries. Mercer Capital has the institutional capability to tackle even the most uncommon or complex fair value issues. We understand the sensitivity of financial reporting timing needs and meet your deadline on time, every time.

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