Fair Value of Contingent Consideration (Earn-Outs) in M&A

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Executive Summary

Contingent consideration, often structured as earn-outs, helps buyers and sellers in M&A transactions navigate differing views on price. Under accounting rules, these arrangements must be measured at fair value on the acquisition date, with potential remeasurements in future periods. Analytical approaches vary depending on the payout structure, underlying metrics, and risk characteristics. Careful attention to structure, modeling approach, and documentation of key assumptions is essential for financial reporting.

Contingent consideration refers to payments in an acquisition that depend on future events or performance, often structured as earn-outs. Earn-out arrangements can help buyers and sellers overcome three interrelated potential sticking points in M&A transactions. First, earn-outs can be a mechanism for parties to share risk, whether it is related to company-specific or market-linked performance metrics or is more idiosyncratic in nature. Second, contingent consideration arrangements help align incentives and mitigate integration-related risks when sellers continue to be involved in the business after closing. Finally, earn-outs can be useful in situations where buyers and sellers hold differing views of a company's forward prospects. With the broader economic environment marked by elevated uncertainty, contingent consideration remains a practical tool to bridge differences of opinion regarding valuation. This article highlights recent observations and outlines considerations for the fair value measurement of contingent consideration.

Broadening Use of Contingent Consideration

Many of the factors influencing M&A markets over the past two years continue into late 2025: ambiguity around interest rates and inflation outlooks, potential for labor market dislocations, and uneven demand across sectors. These conditions can widen the range of a target company's expected future performance. In turn, buyers and sellers may have greater difficulty reaching an agreement on price.

Earn-outs are a common way to reconcile disparate views on price. Transaction parties appear increasingly open to using contingent payouts, even in industries where they have not traditionally been prevalent. For instance, a 2024 review found earn-outs in roughly **one in five non-life-science transactions** over the past decade. Others have noted that middle-market transactions **increasingly** adopt earn-outs, with forecast uncertainty and valuation gaps spurring use.

Earn-outs cannot eliminate uncertainty, but they can give parties a more structured way to reach agreement when views on price differ.

Fair Value Measurement

Under ASC 805 and IFRS 3, acquirers must record the fair value of contingent consideration as part of the purchase consideration at the acquisition date. For arrangements classified as liabilities, the obligations are remeasured at subsequent reporting dates, with changes recognized in earnings. As a result, contingent consideration affects both the initial purchase price allocation and post-closing income-statement reporting.

Valuation of contingent consideration can be **more complex** than initially expected, particularly if payouts have non-linear structures (such as caps or thresholds), depend on multiple metrics, or span multi-year measurement periods. Assessing the probability of achieving performance targets, selecting discount rates, incorporating appropriate volatility assumptions, and evaluating counterparty credit risk all play a role. Larger contingent payouts may draw added scrutiny from auditors and regulators, underscoring the need for well-supported analyses.

From the perspective of **measuring the fair value** of contingent consideration, **the following areas deserve attention.**

Structure and Terms

Earn-outs may be based on financial metrics (e.g., revenue, EBITDA), or non-financial metrics (e.g., customer activity, regulatory milestones). Structures range from simple linear formulas to tiered, threshold-based, and multi-period, path-dependent mechanisms. The form of settlement (cash or equity) and the timing of payments also influence valuation and accounting treatment. Post-closing covenants, operational restrictions, and buyer control rights may influence expected performance and, consequently, fair value.

Modeling Approaches

The scenario-based method sets out a finite number of plausible outcomes (scenarios) for the underlying metric(s), assigns probabilities, estimates the contingent payment under each scenario, probability-weights the expected payoff, then discounts it to present value (with appropriate adjustments for counterparty credit risk). This method often works well when structures are linear or when the underlying risks relate to discrete, diversifiable milestones.

More complex arrangements, particularly those linked to financial metrics exposed to market or macroeconomic variability, may call for option-pricing or simulation techniques. Monte Carlo models, in particular, can capture volatility, correlations among variables, and path-dependent features such as multi-year catch-up provisions. These methods can better reflect the economic characteristics of the earn-out when payoffs behave in option-like ways.

Inputs and Assumptions

Suitable estimates of probabilities, volatility, discount rates, counterparty credit risk, and correlation assumptions (as applicable) are essential to producing a defensible valuation. Post-closing integration success and any changes to resource allocation, business strategy, or commercial emphasis can materially affect the likelihood of achieving performance targets in subsequent measurement periods.

Clear documentation of assumptions, methodologies, and source data supports transparency and aids review by management, auditors, and other stakeholders. Sensitivity testing can also help evaluate how changes in performance or underlying volatility affect both the fair value and potential future earnings volatility.

For preparers, early engagement with specialists can help align understanding of the structure, the underlying economics of the deal, and expectations around the modeling approach.

Takeaways for Transaction Parties

For buyers and sellers, willingness to entertain contingent consideration arrangements during the negotiation process can be the difference between a successful deal and a difficult closing and post-closing process. Earn-out design choices are myriad and can be adapted to address specific sticking points in a transaction. However, a measure of forethought on structure and potential outcomes, including those related to financial reporting, should be particularly useful. Objective, well-defined metrics and covenants tend to produce more predictable outcomes.

Buyers should anticipate the potential for earnings volatility if the arrangement is classified as a liability. Sellers seeking upside participation should recognize that greater uncertainty will generally result in higher variability of contingent payouts.

Conclusion

Contingent consideration remains a useful way to address differing views of future performance in a market shaped by uncertainty. While these structures can help bridge valuation gaps, they also introduce modeling and reporting considerations that require careful attention. Clear understanding of terms, appropriate analysis, and adequate documentation will help minimize surprises for preparers.

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