



# Earn-out arrangements in a business combination – impact of the revised IFRS 3

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When negotiating a business acquisition, the potential consequences of the accounting is one of the furthest things from the negotiator's mind. However, it is the negotiation of the deal that establishes the method of accounting for the acquisition that will affect companies far into the future. This is the third in a series of publications looking at the issues to be considered when negotiating a business acquisition.

## Introduction

Many business acquisitions contain both an upfront payment and the potential for additional payments to be made in the future. Such payments are generally conditional on specific events, and are also often referred to as 'earn-outs'. The accounting for earn-out arrangements is dependent on:

- ▶ Whether or not it is classified as remuneration or contingent consideration; and
- ▶ The manner of settlement.

While this approach appears to be straightforward, the revised standard for accounting for business combinations (IFRS 3 *Business Combinations*) has introduced greater guidance for clarifying the earn-out, and changed the accounting for contingent consideration.

While the changes in the accounting are conceptually sound, the new approach creates new risks if the accounting impacts are not fully understood and planned for. This means additional steps will be required when negotiating an arrangement.

In this publication, we take a closer look at the changes introduced for accounting for earn-outs, by looking at the nature of these arrangements, how to classify the arrangement as remuneration or contingent consideration and how contingent consideration is to be accounted for. In particular, we will look at the effects on reported results and financial position, to help avoid surprises in the future.

### Insights: Implications of including earn-outs in business combinations

The revised accounting model is effective for business combinations occurring in annual periods beginning on or after 1 July 2009. What does management need to do before agreeing to earn-outs as part of the consideration given?

- ▶ Determine the classification likely for the future payment based on the terms and conditions and understand how changes may impact this.
- ▶ Understand the consequences of the classification of the future payment – potential additional expenses, increased volatility and greater liability.
- ▶ Understand the potential consequences of payments being different from initial expectations – financial covenants, management remuneration structures, performance measures (return on investment) and tax.
- ▶ Introduce additional procedures into the acquisition process, which can impact the acquisition time line.
- ▶ Consider involving valuers, accountants and lawyers to understand and plan for the impact of the transaction.



## Additional payments – an overview

When entering into a business combination, the parties to the arrangement may not always agree on the exact value of the business, particularly if there are uncertainties as to the success or worth of particular assets or the outcome of uncertain events. They therefore often agree to an interim value for the purposes of completing the deal, with additional future payments to be made by the acquirer. That is, they share the economic risks relating to the uncertainties about the future of the business. These future payments may be in cash or shares or other assets and may be contingent upon the achievement of specified events, and/or may be linked to future financial performance over a specified period of time. Box 1 contains examples of such payments.

### Box 1: Examples of additional payments contingent on future events

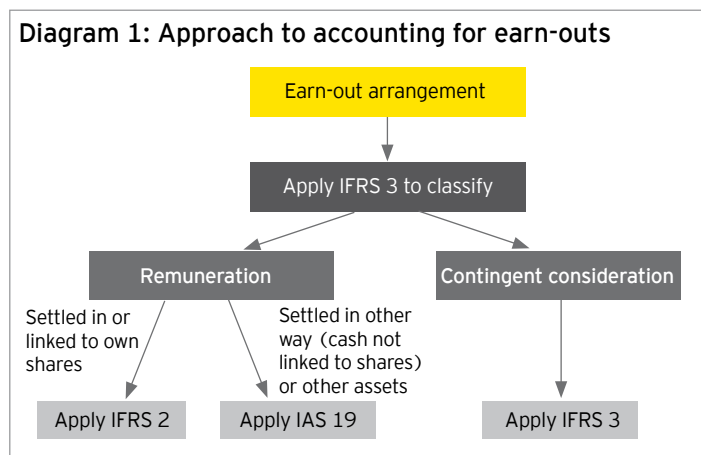
- ▶ Earnings above an agreed target over an agreed period
- ▶ Components of earnings (e.g., revenue) above an agreed target over an agreed period
- ▶ Approval of a patent/licence
- ▶ Successful completion of specified contract negotiations
- ▶ Cash flows arising from specified assets over an agreed period
- ▶ Remaining an employee of the entity for an agreed period of time

Alternatively, an arrangement can have a combination of any of the above factors.

While these payments may be negotiated as part of gaining control of another entity, the accounting may not necessarily always reflect this – particularly if these payments are made to those who remain as employees of the business after it is acquired. In the latter case, depending on the exact terms of the arrangement, the payment made may be accounted for as remuneration expenses for services provided subsequent to the acquisition, rather than as part of the consideration paid for the business – thereby resulting in a significantly different reported effect of the transaction than might otherwise be expected.

In other cases, the additional payment will be accounted for as contingent consideration. Entering into the arrangement represents a present obligation of the acquirer to deliver cash or shares or other assets in the future, which is to be recognised at the date of acquisition and included as part of the consideration transferred when calculating goodwill. Depending on the terms of the arrangement, this may be recognised as a liability or equity at acquisition, with the effects of changes in the value of the liability up until settlement being recognised in the income statement.

The approach to accounting for earn-outs is summarised in diagram 1.



Therefore, the treatment of additional payments can have a significant effect on the overall financial position and subsequent performance of an entity, as summarised in table 1 and illustrated in example 1. This can have consequences on any accounting based measures used in the business, including:

- ▶ Debt covenant compliance
- ▶ Employee remuneration plans
- ▶ Return on investment assessments

In those jurisdictions where tax is tied to the accounting treatment, additional benefits may also arise due to the tax deductions generated in the arrangement. In other jurisdictions, the difference between the accounting and tax treatments may necessitate significant levels of documentation to keep track of the differences and the related deferred taxes.



**Table 1: Effect of classification of additional payments**

	Additional payment is classified as:	
	Remuneration	Contingent consideration
Date of acquisition	Not recognised	<ul style="list-style-type: none"> <li>▸ Included in consideration transferred and goodwill calculation</li> <li>▸ Creates a liability or equity</li> </ul>
Post acquisition	Expensed in income statement	<ul style="list-style-type: none"> <li>▸ Settlement of liability or equity</li> <li>▸ Changes in liability until settlement recognised in income statement</li> </ul>

**Example 1: Impact of the classification of additional payments**

Entity A acquires Entity B. Entity A agrees with the former shareholders of Entity B to pay €900, with an additional payment of €300 if the subsequent earnings of Entity B reach a specified target in three years. The former shareholders also become employees. At the date of acquisition, the fair value of the net assets of Entity B amount to €850, and the fair value of the additional payment is estimated to be €250.

Over the next three years, the cumulative earnings of Entity B (before taking into account the effects of the additional payments) amount to €1,050.

At the end of year three, Entity A pays €300 as the conditions were met.

The table below illustrates the impact on the financial position and results of classifying the payments as remuneration or contingent consideration.

	Additional payment is classified as:	
	Remuneration	Contingent consideration
Goodwill	€50*	€300**
Liability to vendors at date of acquisition	€0	€250
Reported results across the three years	€750***	€1,000****

\* €900 - €850. Consideration paid less the fair value of the net assets

\*\* €900+€250 - €850. Consideration paid plus the fair value of the additional payment less the fair value of the net assets

\*\*\* €1,050 - €300. Cumulative earnings for the three years less additional payment made

\*\*\*\*€1,050 - (€300 - €250). Cumulative earnings for the three years less the change in the liability for the additional payment



## Identifying earn-outs that are remuneration

For a number of industries, such as insurance brokers, financial planners, recruitment, medical research and advertising, the key driver of the business is the customer relationships held by key employees, or the specific skills of key employees. Retaining the key employees that hold these relationships or skills is critical to the continued success of the business, at least until the relationships or skills can be transferred to others. Invariably this is achieved through substantial additional payments in the future, which are often linked to continued employment. It is also common that these key employees are the former owners of the business. As noted above, where the employee was a shareholder, careful analysis is needed as to whether the additional payments made will be accounted for as remuneration or contingent consideration.

This will depend on the terms of the arrangement made during the negotiations. It is not necessary that all of these terms be

included in the actual contract of sale – conditions included in any employment agreements and other documents also need to be considered. Questions to be answered during the negotiation that are relevant for determining the accounting classification include:

- ▶ Why the terms are included the way they are?
- ▶ Who initiated the terms?
- ▶ When were the terms of the arrangement agreed?

In general, conditions that tie the payment to continuing employment result in the additional payment being considered remuneration for services rather than additional consideration for the business. IFRS 3 itself includes a number of indicators that should be considered at the time of negotiating the arrangement in order to avoid surprises later. These indicators are summarised in table 2. Apart from the first indicator – the link to continuing employment – no single indicator is likely to be enough to be conclusive on the accounting treatment. Therefore, judgment will be required in making this assessment.

**Table 2 – Indicators to consider when classifying payments as remuneration or contingent consideration**

Lead to conclusion as remuneration	Indicators to consider when negotiating terms of additional payments to selling shareholders that remain employees	Lead to conclusion as contingent consideration
Payments forfeit on termination	Continuing employment	Payments are not affected by termination
Coincides with or exceeds payment period	Duration of required employment	Shorter than payment period
Not reasonable compared to other key employees of the group	Level of other elements of remuneration	Reasonable compared to other key employees of the group
Other non-employee selling shareholders receive lower additional payments (on a per share basis)	Incremental payments to other non-employee selling shareholders	Other non-employee selling shareholders receive similar additional payments (on a per share basis)
Selling shareholders remaining as employees owned substantially all shares (in substance profit-sharing)	Number of shares owned when all selling shareholders receive same level of additional consideration (on a per share basis)	Selling shareholders remaining as employees owned only a small portion of shares
Formula for additional payment consistent with other profit-sharing arrangements rather than the valuation approach	Linkage of payments to valuation of business	Initial consideration at low end of range of business valuation, and formula for additional payment linked to the valuation approach
Formula is based on performance, such as percentage of earnings	Formula for additional payments	Formula is based on a valuation formula, such as multiple of earnings, indicating it is connected to a business valuation



A key consideration when continuing relationships with former shareholders is the alignment of their interests with the ongoing business. One of the most effective ways of doing this is to link future payments to continued employment and performance of the business. However, as noted above, these arrangements will likely be treated as a post-combination expense, even though the primary business purpose is not remuneration for services, but rather additional compensation for the sale of the business. Therefore, alternative arrangements may need to be considered in order to achieve a similar goal (aligned interests) while using continued employment as a means to do this. The indicators in table 2 can be used as a guide when considering alternative structures. Examples of alternative arrangements that can be considered include:

- ▶ Payment for non-compete clauses
- ▶ The employee retaining an ownership interest with subsequent purchase of the interest on the occurrence of the event

Use of these alternative arrangements will, however, need careful evaluation, as the accounting may give rise to other consequences. The next edition in our *Negotiation Series* will look at the issues around non-controlling interests in subsidiaries and their subsequent purchase.

Where an earn-out is classified as remuneration, other standards will apply to determine the subsequent accounting. If the payment is in shares or linked to the value of shares, IFRS 2 *Share Based Payments* will apply. In other cases, IAS 19 *Employee Benefits* will apply.

### Contingent consideration

IFRS 3 has changed how contingent consideration is accounted for, such that a liability (or equity) must be recognised by the acquirer at the date of acquisition. The liability is recognised at its fair value, which does not necessarily represent the probable future cash flows to be made, but rather takes account of all expected outcomes together with the likelihood of each outcome occurring. Table 3 summarises the key differences in accounting for contingent consideration under IFRS 3 compared with current practice, both at the date of acquisition and in subsequent periods until settlement. In some situations, the agreement may result in a refund to the acquirer of amounts already paid, which will give rise to an asset. However, such arrangements are rare.



**Table 3: Key difference in accounting for contingent consideration**

Area of change	New approach	Old approach
Initial recognition – date of gaining control	Always creates a liability or equity	Liability created if probable and reliably measured
Initial and subsequent measurement	At fair value	At estimate of amount to be paid
Subsequent changes until settlement	*Liability income statement Equity – no recognition	Accrued interest – income statement. Adjust purchase price and goodwill for other changes

\* Whether or not subsequent changes will be recognised in the income statement is dependent on the initial classification of the contingent element as liability or equity, which in turn, is dependent on the actual terms of the agreement.

Note 1: Under the old approach, if the contingency was settled by way of equity, this was only recognised at the time of settlement with an adjustment to goodwill.

Example 2 illustrates the different accounting that applies, both on initial acquisition and in subsequent periods, where the contingent consideration arrangement is classified as a liability rather than equity.

The reported result subsequent to an acquisition can be challenging to manage, as it can be counterintuitive – particularly when the contingent consideration is classified as a liability. When the contingent event occurs, reflecting the subsidiary is performing at or better than expected, the liability increases, resulting in an additional expense in the income statement, as noted in example 2. Equally, if the conditions are not met, such that no additional payments are made, the liability is reversed through the income statement – resulting in a gain. Not meeting the conditions would also be a trigger to test for impairment of goodwill, particularly where the formula is linked to the value of the business.

**Example 2: The effect of changes to IFRS 3 for accounting for contingent consideration**

Entity C acquires Entity D and agrees with the former shareholders of Entity D to pay €1,000 with an additional payment of €500 if the subsequent earnings of Entity D reach a specified target in five years. If this target is not reached, but is within 20% of that target, an additional payment of €380 is to be made. At the date of acquisition, the fair value of the net assets of Entity D amount to €900 and the fair value of the additional payment is estimated to be €195. At this date, it is not probable that any additional payment will be made.

Over the next five years, the cumulative earnings of Entity D (before taking into account the effects of the additional payments) amount to €2,000. At the end of year five, Entity C pays €500 as the target was met.

The table below summarises the accounting outcomes under the old and new approaches.

	New approach (a)	Old approach
Goodwill at date of acquisition	€295*	€100**
Liability recognised at date of acquisition	€195	€0
Reported results for the five years	€1,695***	€2,000
Settlement of contingent consideration	liability reduced to nil	€500 additional goodwill
Total goodwill after payment	€295	€600

(a) The terms of this arrangement result in the contingent consideration being classified as a liability as payments are to be made in cash.

\* €1,000 + €195 - €900. Consideration paid plus the fair value of contingent consideration, less fair value of the net assets

\*\* €1,000 - €900. Consideration paid less the fair value of the net assets

\*\*\* €2,000 - (€500 - €195). Earnings during the five years less the change in the contingent liability



If we assume that, in example 2, none of the conditions for payments were met, the liability of €195 would then be reversed and recognised as income. An impairment test would then be performed, and if an impairment charge is recognised, the amounts cannot be offset in the income statement. Such events will provide challenges to management when communicating with shareholders. To prepare for such situations, at the date of acquisition, management can prepare analyses of the effects of alternative outcomes, to understand the consequences for impairment.

Similarly, the subsequent effect on performance can impact other aspects of the business where accounting-based measures are used - primarily loan covenants, management remuneration structures and the assessment of the return on investment. It is important to understand these effects during the negotiation in order to consider whether or not changes in the terms of the acquisition may be required, or changes in these other arrangements are warranted.

For example, it may not be clear whether the settlement of a contingent consideration is included in the measures for assessing compliance with debt covenants in all cases, or only where it gives rise to an expense or gain for

accounting, or not at all. Similarly, the liability created for the potential future payment may impact debt to equity ratios. Early discussions may therefore be needed with financiers to clarify how such expenses or gains are taken into account, particularly as the income statement effect is counterintuitive. Such actions can help to avoid disputes and unpleasant surprises at a later date.

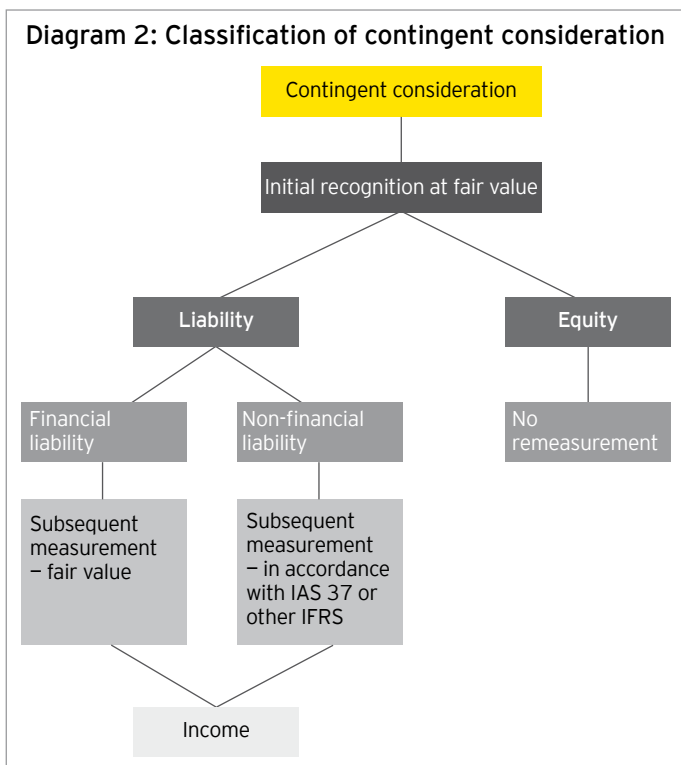
Similarly, bonus and profit sharing arrangements and return on investment analyses are often based on accounting measures. Again, it may not be clear how such expenses or gains are taken into account, or where they are, the counterintuitive nature of the outcomes may warrant amendments to the terms of the agreements before finalising the acquisition.

### **Classifying contingent consideration**

As noted above, whether or not subsequent changes in the contingent consideration will be recognised in income or equity will depend on the terms of the arrangement itself. The obligation to make additional payments will be either a liability or an equity instrument at the date of acquisition, as noted in diagram 2. The easiest approach is to first assess whether or not it meets the condition of equity. If the answer is no, then it is a liability.



**Diagram 2: Classification of contingent consideration**



The contingent consideration will be classified as equity only when:

- i) The arrangement has **no** contractual obligation to:
  - a. Deliver cash or another financial asset to the seller; or
  - b. Exchange financial assets or financial liabilities with the seller under conditions that are potentially unfavourable to the acquirer; and
- ii) The arrangement will or may be settled by issuing equity instruments, and it is either:
  - a. A non-derivative that includes no contractual obligation to deliver a variable number of own equity instruments; or
  - b. A derivative to be settled by exchanging a fixed amount of cash or financial asset for a fixed number of own equity instruments.

Historically, most contingent arrangements do not meet the criteria to be classified as equity, even if they are settled in shares, as they generally tend not to have had a fixed number of shares to be issued. Box 2 gives an example of an arrangement that would qualify as equity.

**Box 2: Example of an arrangement that meets the equity classification**

Entity E acquires the outstanding equity of Entity F by issuing 2 million shares. It also agrees to issue an additional 100,000 shares to the former shareholders if product X (under development at the time of the acquisition) receives regulatory approval within the next two years.

The next step in the analysis is to identify what type of liability the arrangement gives rise to, which determines how the liability is subsequently measured until settlement and where the changes in value, including any difference on settlement, will be recognised.

Historically, most contingent arrangements used in this case would have been classified as financial liabilities. A non-financial liability arises in those rare circumstances where the additional payment is settled by transferring a non-monetary asset.

Classification of the liability as a financial liability, however, does not mean that the standard on financial instruments will apply. The financial liability will be subsequently measured at fair value, rather than be classified into different categories of financial instruments. This therefore means that there is added volatility to reported results subsequent to the combination, until the period that the arrangement is settled. These additional charges may have consequences on the entity's ability to comply with covenants included in loan agreements. These additional costs may also impact the measurement of the return on the investment and effect management remuneration structures.

In some cases, it may not be clear whether the expenses arising from the change in the liability should be included or excluded from the calculation of the covenants, in which case, clarification may be required with financiers.



### Income tax implications

The tax consequences should also be considered at an early stage in the negotiations. In most jurisdictions, payment of contingent consideration will be incorporated in the tax base of the investment (in the acquiree) only at the time it is paid. Accordingly, this will result in the tax base of the asset (investment) and the liability being different to the accounting base at the date of acquisition. However, in most instances, this will not give rise to a deferred tax asset (on the liability) or a deferred tax liability (on the investment) at this time, due to the exemptions given in IAS 12 *Income Taxes*. However, an additional disclosure will be required regarding the deferred tax liability that is not recognised.

While the liability remains outstanding, the additional expense created from changes in the liability will usually not be tax deductible, and again would likely not give rise to a deferred tax asset. Therefore, the effective tax rate can be impacted during these periods which may require additional explanation in the financial statements.

Settlement of the liability then creates a new tax base for the investment.

However, if the actual payment differs from the liability that was recognised at acquisition, the resulting tax base will still be different from the accounting base of the investment. This difference may give rise to a deferred tax asset or liability, depending on the entity's future plans and the likelihood of realising any appreciation in value of the investment.

### Fair value considerations

Due to the impact of subsequent changes in measuring the contingent liability, determining the right value at the date of acquisition is important. This task will likely require greater analysis and diligence than in previous acquisitions and this should be built into any acquisition timeline and assessment. It may also require the involvement of external advisers. Unlike the previous standards, the cost of involving experts cannot be capitalised but must be expensed. Hence, the impact on the performance in the period of acquisition will also be affected.

Estimating the fair value of contingent consideration at acquisition date introduces some new challenges in an acquisition, which will often continue until the contingency is settled. These challenges stem from the processes and methodologies required to quantify the risks and rewards associated with these types of arrangements, as many of the criteria are specific to the entity being acquired or are otherwise not directly observable in the market. As such, determining the fair value requires judgment.

The objective of a fair value measurement of a liability is to reflect the amount for which the liability could be settled between knowledgeable, willing parties in an arm's length transaction. Each arrangement will need to be evaluated to identify the appropriate approach to be applied, taking into account the payout structure, and the associated risks. There are two alternative approaches to estimate the fair value of contingent consideration:



- ▶ The probability-weighted average of payouts associated with each possible outcome.
- ▶ The payout associated with the probability-weighted average of outcomes.

The method that gives the most reliable result in all circumstances is the probability-weighted payout approach. This method requires taking into account the range of possible outcomes, the payouts associated with each possible outcome and the probability of each outcome arising. The probability-weighted payout is then discounted. This approach is illustrated in example 3.

### Example 3: Applying the probability-weighted payout approach

Entity G acquires Entity H and as part of the arrangement, Entity G agrees to pay an additional amount of consideration to the seller in the future, as follows:

- ▶ If the 12 month earnings in two years' time (also referred to as the trailing 12 months) are €1 million or less – nothing will be paid
- ▶ If the trailing 12 months' earnings in two years' time are between €1 million and €2 million – 2 x 12 month earnings will be paid
- ▶ If the trailing 12 months' earnings in two years' time is greater than €2 million – 3 x 12 month earnings will be paid

At the date of acquisition, the possible twelve-month earnings of Entity H in two years' time are determined to be, as follows:

- €0.8 million – 40%
- €1.5 million – 40%
- €2.5 million – 20%

The probability-weighted payout is:

$$(40\% \times €0) + (40\% \times €1.5 \text{ million} \times 2) + (20\% \times €2.5 \text{ million} \times 3) = €2.7 \text{ million}$$

This €2.7 million is then discounted at the date of acquisition to determine its fair value.

Since the liability must be measured at fair value, selecting the discount rate to be applied also requires significant judgment to assess the underlying risks associated with the outcomes, and the risks of payment. More specifically, the entities own credit risk will need to be taken into account in determining the discount rate.

The fair value is to be determined at the end of each reporting period, which may require additional procedures to be incorporated into the year-end and interim close processes, additional information may need to be collected by information systems, and additional expertise may be required to perform the fair value assessment.

## Conclusion

The revised accounting for business combinations has introduced significant changes to the accounting for contingent consideration – a common element in major acquisitions. Managing the impact of this change and the consequences to the business requires advance planning and potentially involves a variety of experts such as accountants (to understand the impact on the reported results of various outcomes), lawyers (to evaluate the impact on covenants and management remuneration schemes) and valuation professionals (to determine the initial and, at times, subsequent fair values of the liability until settlement). In some cases, such assessments may require that the arrangements are renegotiated or arrangements with other parties, such as financiers and employees, are revised.

Further developments in accounting may have additional impacts in the future. Namely, new accounting standards are expected in the next two years dealing with the classification of instruments as liability or equity. It is expected that the ability to classify instruments as equity will be further restricted. In the coming year a new standard on fair value measurements is also expected, which will provide guidance and principles for determining fair value which may impact any methodologies that are developed in the coming months.

Management should also check on the status of these developments when evaluating the consequences on any acquisitions being negotiated where consideration for the business consists of earn-out arrangements that are contingent on future events.

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