By Barry Jay Epstein

Earn Out **Agreements**

Accounting Pitfalls for Buyers and Sellers

Earn-out agreements ("earn-outs") are common features of business acquisitions and may be a necessary condition in bringing a proposed transaction to fruition. When the demanded price is predicated on the business' recent record of success, the buyer may demand that a significant portion of the agreed-upon price be contingent on future performance – typically over a three to five year period.

THE EARN-OUT MAY BE A SIMPLE FRACTION OF FUTURE earnings, a portion of earnings over some threshold amount, or a (possibly sliding) percentage of some combination of factors, such as earnings and order backlogs. Unique attributes of the industry may be taken into account in such arrangements, although in practice most are structured in a straight-forward and consistent manner.

The terms of the earn-out may or may not require that the seller remain actively involved, and the seller may be motivated to do so if the final selling price is dependent upon the seller's ability to bring about future profitability. This may occur when the selling party has strong relationships with customers, vendors, or employees. In some situations, the buyer may use the earn-out requirement as a lever to accomplish the real objective, a skills transfer from seller to buyer. In other instances, such as cutting-edge and high technology businesses lacking a track record, the seller may want the earn-out as the only practical means of capturing a high selling price, predicated on the expectation that the business will in fact "take off" within the contractual earn-out period, notwithstanding prior lack of profitability.

While earn-outs are common, a surprisingly large component of such arrangements end in acrimony and, not infrequently, litigation. Often, the root cause of the later disputes lies not with the actual economic achievements of the business, but with lack of precision in the terms of the agreement, such that even reasonable persons will legitimately disagree on how future earnings (or other measures) are to be computed for purposes of determining the payments due to the sellers. In some such instances, one or the other party will be seeking to exploit language that was intentionally left vague, yet undetected by the counter-party until a dispute ultimately arises.

The actual mechanics of earn-outs are quite basic, and there are many sources of guidance on how these can be structured. In general, some fraction of the transaction price is contingent upon future performance, with some upside potential for the seller included as an incentive, but with this usually capped at some defined amount. For example, if the initially agreed-upon transaction price is $5 million, the final arrangements may call for an immediate payment of $3 million, plus 30% of pre-tax earnings over the following three years, up to total earnings of $10 million. This offers the sellers the potential for earn-out payments of up to $3 million, for a total transaction price of $6 million, or 20% more than the originally agreed selling price. Even after considering the time value of money, this may be an attractive premium for the seller, ensuring maximum efforts to produce results and, as a by-product, give the buyer the extended opportunity to master the skills possessed by the sellers.

GAAP as a Basis for Measurement of Profitability

The most basic issue in devising earn-outs pertains to how future profitability is to be measured. Commonly, the agreement will call for measurement in conformity with generally accepted accounting principles ("GAAP"), and often there will be an audit requirement, such that the basis for the earn-out will have to be attested to by an independent accounting firm.

GAAP, of course, is not the only metric that can be agreed to, and there are many non-GAAP measures, including the very popular EBITDA (earnings before interest, taxes, depreciation and amortization). However, most contracting parties believe that by specifying GAAP as the measuring basis, future disputes will be obviated. Despite using this largely codified methodoloty, a surprisingly large number of disagreements develop even when GAAP is the agreed-upon metric.

GAAP denotes the common standards and procedures that have evolved over the decades, mostly as promulgated and codified by standard setting bodies, but also including practices which, by dint of wide and longstanding usage – and because superseding authoritative guidelines have not appeared – have become "generally accepted." Indeed, there is a formal "hierarchy of GAAP" set forth in the professional literature, which contemplates that practices merely advocated in textbooks or scholarly journal articles may rise to the level of GAAP compliance in the absence of formal guidance from a source having a higher standing in that hierarchy.

The body of GAAP is large and constantly growing, and this dynamic aspect of GAAP is often overlooked in the drafting of a wide range of contractual agreements, including earn-outs. In addition to the widely-recognized FASB standards, there are a number of secondary sources for GAAP, including the so-called specialized industry guidance set forth in *Audit and Accounting Guides* published by the American Institute of CPAs. There are also a large number of "consensuses" on issues addressed by the Emerging Issues Task Force, a separate body supervised by the FASB, created to deal with narrowly defined concerns that were unlikely to earn a place on the FASB's technical agenda. Once promulgated, these

EITF consensuses become GAAP, and they often have very far-reaching implications. For one such example, the requirement to consolidate so-called “special purpose entities” (later re-christened “variable interest entities”), which achieved notoriety during the Enron financial reporting scandal of the early 2000s, actually had its origin in an EITF position taken in 1990, which was widely ignored at the time, notwithstanding its status as GAAP.

There are other sources for GAAP as well – such as FASB Technical Bulletins, FASB Interpretations, FASB Staff Positions and AICPA Statements of Position – and these can have also affect the determination of operating results or other performance measures that may be identified in earn-outs. In fact, in any given year, there may be ten or twenty new standards promulgated, potentially and materially affecting GAAP earnings determinations. Being aware of recent and proposed changes to GAAP may be critical to protecting the client’s interests in negotiating the terms of a purchase or sale agreement, particularly when an earn-out feature is incorporated.

An immediate concern for parties to earn-outs is whether GAAP measurements of operating results over the defined time horizon will be based on GAAP as it exists *in the periods of measurement*, which may well change over even a short three year period, or alternatively will be based on GAAP *as it existed when the agreement was executed*. The latter approach, often referred to as “frozen GAAP,” eliminates the risk that one party or the other will benefit in ways not anticipated by the contracting parties, to the other party’s detriment. The negative aspect of such arrangements is that, effectively, “two sets of books” must be maintained, since general purpose financial reporting will have be conducted using then-current GAAP, which may evolve substantially over the term of the agreement.

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If the earn-out is for longer than a relatively short period, it may become increasingly challenging to competently calculate the basis upon which the earn-out payments are to be made. To guard against the effects of this, agreements calling for “frozen GAAP” measures should include, in an appendix, a fairly detailed and inclusive listing of GAAP requirements salient to the entity, or alternatively cite a reference work or codification that captures them as of that point in time, which the parties agree is to be complied with throughout the earn-out period, ignoring any changes to promulgated GAAP.

In addition to the naturally occurring, albeit unpredictably timed, evolution of GAAP, several other issues should at least be contemplated by parties who are tempted, or required, to employ earn-outs in business acquisitions, or by their counsel. These other concerns include voluntary changes in GAAP made by the earn-out entity; revisions from non-GAAP accounting to full GAAP compliance; and corrections of errors subsequently discovered. Regarding the first of these, it often is not fully appreciated that while the ranges of acceptable alternative methods of accounting have narrowed considerably over the past few decades, there are still many legitimate choices that can be made by reporting entities without departing from GAAP.

For example, inventories may be costed using various methods, including first-in, first-out (“FIFO”), last-in, first-out (“LIFO”), and average assumptions. These “cost flow” assumptions may be made without regard to the actual physical flow of goods. If a selling party had previously employed FIFO costing, and the buyer adopts LIFO, the effect will generally (assuming even moderately rising prices) be to reduce reported profits. This would, *ceteris paribus*, work to the detriment of the seller, and the benefit of the buyer, and not constitute a GAAP departure.

GAAP changes can be more subtle, also. For example, accrual accounting demanded by GAAP requires that customer receivables be valued at “net realizable value,” which is often less than the gross amounts owed, due to historically-based expectations regarding uncollectible accounts (bad debts), as well as merchandise returns and other allowances. As to the necessary amount of bad debt reserves, GAAP permits a range of methods to be employed, such as percentage of sales and aging of the receivables. While these specific methods should, over time, result in very similar results, in the short term these will not be identical, although both are GAAP compliant approaches.

The risk of such manipulative tactics being undertaken by buyers is most often addressed by inserting the requirement that GAAP be “consistently applied” with earlier years. Surprisingly, in many cases this simple preventative step is overlooked. If the buyer then adopts other, but acceptable, GAAP

methods, a dispute is almost a foregone conclusion. If the newly adopted methods for the acquired operation mirror GAAP previously applied by the buyer for its other, ongoing operations, it may be difficult to prevail with a claim against that entity, since its argument that it was consistently applying its GAAP accounting methods will have a good deal of face validity.

Changes from GAAP-deviant methods to GAAP-compliant ones also occur. In some instances, the accounting applied by the seller had not fully complied with GAAP, perhaps due to oversight or error. In such a circumstance, even a provision in the agreement calling on the buyer to apply GAAP consistently may prove problematic, since consistent application of existing accounting would not be GAAP, and a change to GAAP would breach the consistency requirement.

This risk underscores the need for effective "due diligence" before the acquisition is finalized, including a detailed inventory of accounting methods being applied or misapplied by the seller. Ideally, the buyer will identify all non-GAAP methods used by the seller, and explicitly set forth the prescribed treatment post-transaction, which may be *either* consistent application of the anomalous practices, *or* adoption of GAAP procedures. If this is to be done, it would serve both parties' interests if one or more historical periods were restated, on a *pro forma* basis, so that the negotiated price will reflect the entity's real economic performance potential, measured in conformity with GAAP as it is to be defined for earn-out computation purposes.

Corrections of accounting errors discovered after the transaction, but before the earn-out period expires, pose another risk to the smooth execution of earn-out arrangements. Under GAAP (as recently revised), errors are defined as essentially clerical phenomena, the over-looking of facts extant at the time the earlier-period financial statements were prepared. Errors

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Notwithstanding the precautions taken, the fact remains that sellers subject themselves to earn-outs at their substantial risk. The buyer controls the subsequent accounting, and even an audit requirement may not guarantee that creative or aggressive accounting manipulations might not be undertaken in an effort to deny the seller the full earn-out rewards to which it is entitled.

are corrected by restating the earlier periods' financial statements, in contrast to changes in accounting estimates, which are to be handled prospectively.

If correcting the error results in changing the pre-transaction date earnings of the operation acquired, this may well impact the earn-out agreement. In many such arrangements, the amount of earn-out payments is conditioned on a defined threshold being exceeded, and this threshold will often be the level of earnings in earlier years. For example, the earn-outs might be 30% of pre-tax income that exceeds 110% of the average of earnings over the two years preceding the sale. If a prior period adjustment is made to restate those earnings, this could be interpreted as moving the goal posts for earn-out computation purposes – an assertion that likely would be challenged by the counter-party, if it adversely affects it. Ideally, the earn-out agreement should be explicit as to how such corrections will be dealt with for computational purposes, regardless of the GAAP requirements.

Changes in accounting estimates should also be addressed, if the risk of disputes is to be mitigated. For example, if the buyer revises useful lives of plant assets downward, or estimates other items, such as necessary inventory reserves for unsalable merchandise, upward, these changes will adversely impact earnings during the earn-out period. While such changes in estimate may be entirely warranted, they will likely still come as a surprise to the seller, and a dispute may well erupt. The seller's interest would be best protected if the earn-out states that the buyer, after due diligence, accepts the accounting methods and estimates employed by the seller and agrees to continue these through the earn-out period. This would essentially limit the seller to making a claim of fraud against the seller, if it is later discovered that such methods or estimates were grossly distorted.

Notwithstanding the precautions taken, the fact remains that sellers subject themselves to earn-outs at their substantial risk. The buyer controls the subsequent accounting, and even an audit requirement may not guarantee that creative or aggressive accounting manipulations might not be undertaken in an effort to deny the seller the full earn-out rewards to which it is entitled. Indeed, the author has served as an accounting expert in several cases where just this has occurred: the independent auditors, perhaps having become too close to the client and possibly suffering from some loss of objectivity (a cardinal sin under auditing and ethical standards), have acquiesced to the client's accounting machinations which should have been clearly seen as attempts to evade obligations to the sellers of acquired businesses. With these experiences in mind, the recommendation is that earn-out agreements have specific remedies for such concerns, perhaps even naming a truly independent accounting firm as the final arbiter for any accounting related disputes.

In one recent case, the buyer of a large industrial complex made a determination, during the earn-out period, that the assets had become "impaired," which is a term of art under GAAP. The effect of this determination was to fully offset the amount due

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under the agreement. In fact, an elaborate sequence of transactions, some of which produced large gains for the entity, had been recorded in a creative manner, and then aggressive assumptions were made in applying the rather complex requirements of the accounting standard that addresses possible asset impairments. The end result was to find impairment where none actually existed, and the acquiring entity's auditors did not object, presumably because enough information was incorporated in the financial statement footnotes to enable an astute financial analyst to perceive the truth. However, since the earn-out was predicated on reported earnings – not on footnote disclosures – the buyer and its auditors were thus able to "have it both ways." A pre-defined arbitrator for accounting disputes would have possibly served as a force to dissuade these parties from attempting such a maneuver. In the absence of such a provision, an expensive litigation action was needed to resolve this matter.

A final note: While the foregoing discussion was predicated on the assumption that the earn-out will be defined in terms of GAAP, the same advice applies to arrangements calling for measurements on the tax basis or the cash basis (so called "other comprehensive bases of accounting," or "OCBOA"), or on a statutory basis of accounting (e.g., for insurance companies). Whether GAAP or some other defined basis of accounting is specified for earn-out computation purposes, the more explicit the agreement can be made, regarding such matters as changes in accounting principles, corrections of errors, and other accounting- or reporting-related matters, the less likely will be the occurrence of subsequent disputes. ■

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