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CORPORATION, SECURITIES & BUSINESS LAW FORUM

The newsletter of the ISBA's Section on Corporation, Securities & Business Law

Minimizing Information Asymmetry Risk in Acquisitions with Contingent Pay-Outs: An Accountant's Perspective

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Information asymmetry exists when one party to a proposed transaction has information that the other does not, thereby conveying some advantage to that party. In most arm's-length transactions, varying degrees of information asymmetry can exist between the buyer and the seller. It is well accepted in economic theory that as information asymmetry decreases, the transaction's value becomes more transparent, which should increase the ultimate negotiated price. Simply put, buyers are more willing to pay when they feel that they have full access to information.

In the case of mergers and acquisitions – and more specifically when acquisitions are largely based on hypothesized future profitability – sellers can oftentimes be at a disadvantage in immediately realizing their high expectations for the future. Buyers, being less confident about profit potential, may demand that significant portions of agreed-upon prices be contingent on future performance. The use of contingent pay-out arrangements, most commonly earn-out agreements, can help mitigate the effects of information asymmetry as, theoretically, the eventual aggregate pay-outs will be brought into line with actual results, not the sellers' rosy scenarios.

While an earn-out agreement can usually alleviate some uncertainty, the biggest concern in devising earn-outs pertains to how future profitability is to be measured. Two commonly used metrics for profitability in earn-out agreements are net income and

EBITDA (earnings before interest, taxes, depreciation and amortization – a widely employed surrogate for operating cash flow). Almost always, agreements will call for measurements to be made "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.

Most contracting parties believe that, by specifying GAAP (the largely codified body of financial reporting rules mostly established by private sector standard setters, most prominently the FASB), future disputes will be obviated. This is far from the actual case, however. A surprisingly large number of disagreements develop even when GAAP is the agreed-upon metric.

When earn-outs are based on measurements such as net income or EBITDA, a requisite consideration is what exactly goes into (and, equally importantly, stays out of) this figure. While the widespread application of GAAP predicates a certain uniformity among financial statement presentations, there remains a surprising amount of flexibility within acceptable application of these principles. If the earn-out extends for longer than a relatively brief period, it may become increasingly challenging to competently calculate the basis upon which the earn-out payments are to be made.

In order to more fully reduce the information asymmetry between buyers and sellers,

a duty lies with sellers to complete a comprehensive due diligence of the buyers' financial statement presentations and the accounting treatments of those business transactions and events that may play a roll in ultimate pay-outs. The reason is simple. Once deals are complete, buyers, while obligated to abide by the terms of the contracts, have the power and likely also the incentive to manipulate financial statement presentations to the sellers' detriment, while still nominally complying with GAAP. By having both parties in possession of more complete understandings of which financial statement elements comprise the ultimate profitability metrics within the framework of properly applied GAAP, possible misunderstandings, disputes and future litigation can usually be mitigated.

This discussion will initially focus on recent developments in accounting standards and trends for the future that may change GAAP reporting requirements. Additionally, acceptable and legitimate changes in financial statement presentation will be discussed. Both of these areas can adversely impact sellers' earn-out contracts; thus both are significant areas for consideration during the due diligence and contract drafting phases of any acquisition or merger featuring contingent pay-out provisions.

Recent and Forthcoming New Financial Reporting Requirements

The dynamic nature of generally accepted accounting principles is necessary to

evolve with an ever-changing business environment. Some of these changes can have major effects on financial reporting in general, and on earn-out computations in particular. Thus, even faithful compliance with US GAAP as it existed at a given date (such as the merger transaction date) may not describe currently acceptable practices even a few years hence. The primary objective for parties engaging in acquisitions should be an explicit understanding of current applications of GAAP and how recent and forthcoming changes may affect the contract provisions.

An awareness of pertinent changes in financial reporting requirements can shed light on the possibility for future contention, and the need for a detailed inventory of accounting methods being applied at the time of drafting. Important areas for such attention include the following:

- **Accounting for business combinations and asset impairment:** For many years, there was some flexibility in the accounting treatment of business combinations. A merger could be accounted for as either a purchase (or acquisition) or as a pooling (uniting) of interest, with very different consequences for the financial statements of the surviving entity. Today, however, virtually all combinations must be accounted for as purchases, with the buyer recording the fair value of the acquired company's net assets¹. This differs from the pooling treatment of previous years, where the acquiring company recorded the book, or carrying, value of acquired assets on its financial statements. Additionally, under the new Financial Accounting Standards Board (FASB) standards, the difference between the purchase price and the fair value of the acquired company's net assets, which is known as goodwill, which previously was subject to amortization over a number of years (not to exceed 40 years), must now be recorded on the purchaser's books as an asset subject to an annual assessment of impairment, but not amortization.

This suggests two areas of concern relative to contingent pay-outs. First, since other intangible assets, such as trademarks and customer lists, remain subject to amortization, care must be taken to properly allocate the cost of the intangibles to proper categories, since these affect future earnings in different ways². Secondly, in periodically testing for impairment, buyers may

aggressively determine impairments that will consequently decrease earnings used for contingent pay-outs³. If the sellers do not have understandings of the estimation involved in both of these processes, it may be easy for buyers to manipulate the purchase price allocations (e.g., to exaggerate periodic amortization charges), and/or to depress earnings via impairments.

- **Reporting the effects of accounting changes:** While financial statements primarily report the effects of current period activities, there are some situations where retrospective adjustments can affect the current year's bottom line. Traditionally, the cumulative effect of any voluntarily made accounting changes (e.g., in depreciation methods) would be reflected fully in the period the change was made⁴. In 2005, however, a new standard removed this cumulative effect requirement, substituting the necessary restatement of all earlier periods, to report them as if the newly adopted principle had always been used⁵. The main caution here, particularly relevant for attorneys drafting contingent pay-outs, is to understand the impact on comparability among reporting periods. For example, if there is no "look back" provision, changes in accounting can now "fall between the cracks" – not being included in any of the earn-out years' computations. While for most purposes the new standards makes data (after restatement) more comparable from one year to the next, the interests of earn-out parties may not be well served.
- **Accounting for guarantees:** A recent pronouncement requires that the fair value of all guarantees made be fully recognized as an obligation of the entity, with corresponding effect on the guarantor's reported expenses⁶. Previously, guarantees had been relegated to the financial statement footnotes, thus not impacting earn-out computations, with rare exceptions. While the new method is more conservative accounting than in the past, and more accurately reflects economic reality, recognizing an additional liability and expense can have a significant effect on many key financial ratios as well as reported profits. This illustrates why attorneys should consider whether contractual provisions governing contingent pay-

outs over a number of years should prohibit or limit the application of newly imposed financial reporting standards.

- **Off-balance sheet transactions:** 'Special purpose entity' has become a well-known phrase in recent years. Enron used special purpose entities for off-balance sheet transactions to fraudulently conceal billions of dollars in liabilities from shareholders. While subsequently exceptionally complex new rules have been issued on this subject, there are still many arcane areas of practice that allow an entity to structure transactions that may not disclose all of the entity's obligations to users of financial statements. The concept of special purpose entities has been replaced in current accounting standards with variable interest entities (VIEs), with many of these being subject to mandatory consolidation into the reporting entity's financial statements⁷. However, there is continuing debate over the treatment of VIEs and diversity in practice due to innocent misapplication of these requirements. The consolidation of a VIE into a buyer's financial statement, when not previously so recognized, could severely affect an earn-out agreement computation.
- **Related party transactions:** While there haven't been any new accounting standards addressing related party transactions per se, this is a subject of increasing attention in financial reporting⁸. In fact, the new standard on VIEs changes the definition of related parties when making determinations regarding the existence of VIEs. As there is virtually no means by which to ascertain that related party transactions were conducted on arm's-length terms, the mere existence of such transactions is an invitation to a contractual dispute. As disclosure of related party transactions is required by GAAP, one way of mitigating future disputes regarding this subject would be to preclude the entity from entering into any new related party transactions during the period subject to contingent pay-outs. Alternatively, if these transactions are entered into, the earn-out consideration calculations could be subjected to contractually mandated adjustments to more accurately represent the entity's performance had the entity engaged in a transaction at arm's-length.

- Distinguishing liabilities from equity:** Although the distinction between debt and equity seems to be straightforward, in practice there are many hybrid financial instruments that can have attributes of both debt and equity. Classification of these instruments will have a direct effect on financial statements and perhaps more noticeably on financial ratios of the company. Various recent GAAP standards have attempted to close what had been loopholes whereby the balance sheet could easily be “dressed up.” For example, a major standard was promulgated several years ago, which requires that equity subject to mandatory retirement provisions or containing options giving holders rights to demand redemption can no longer be deemed equity in the balance sheet⁹. One can imagine the controversial nature of such a standard whereby many companies would be required to report large sums of equity now as a liability. At the protest of many of these companies, FASB has issued an indefinite postponement of this requirement¹⁰. Also proposed for new GAAP standards is possible allocation of obligations to conversion features on convertible debt¹¹. A large fraction of the current professional accounting standards are devoted to the accounting for financial instruments, but as new products are invented by “financial engineers,” accounting standard setters struggle to develop yet more guidance, in a game that is apparently endless. Any further changes could likely impact earn-outs, e.g., by moving certain dividends to interest expense, which would reduce net income subject to contractual pay-outs.
- Exchanges of nonmonetary assets:** Under new standards, exchanges of nonmonetary assets (e.g. one machine traded for a similar but different one) are required to be recorded at the fair value of the asset, where previously the book value of the item traded was simply carried forward in most instances¹². While, on the surface, this may seem like only a simple change, the gain or loss now to be recognized on these exchanges will be recorded in net income, and therefore this may affect comparability of financial statements over the years. Additionally, it may offer buyers opportunities to create losses designed to reduce earn-out obligations. Sellers, and their counsel, should be

aware of the prevalence of nonmonetary exchanges in a particular company or industry and their possible effects on future financial statements.

- Forthcoming developments:** The previous paragraphs reviewed examples of recent changes in generally accepted accounting principles. A topic perhaps of greater importance for the attorney seeking edification is the historic agreement between the US standard setter, the Financial Accounting Standards Board (FASB), and its international equivalent, the International Accounting Standards Board (IASB), which calls for “convergence” between US GAAP and International Financial Reporting Standards (IFRS) within the next few years¹³. A number of changes to US GAAP have already been made in order to fulfill FASB’s commitment, in situations where IFRS were found to be superior to US GAAP, and select IFRS have been revised to converge with US GAAP, under IASB’s obligation, where the US standards appeared better. More such changes are likely to occur in the very near term¹⁴.

One example of a standard affected by this convergence process is the accounting treatment of research and development expenditures (“R&D”). Currently, US GAAP requires R&D to be expensed as incurred, whereas IFRS mandates a bifurcated system of expensing research costs and capitalizing development costs. The prospects for further advancement in the area of accounting for R&D, while imminent, could be only the beginning of a series of modifications made in attainment of a more widely applicable, codified system of accounting principles. Any such changes made during the pendency of earn-out arrangements could have impact on the buyers’ ultimate recoveries – yet another argument for a “frozen GAAP” clause in these agreements.

Last, but certainly not least, both FASB and IASB are working on major projects that would fundamentally alter the notion of revenue, and make revenue recognition dependent upon receipt of assets and/or extinguishment of liabilities. Doing so would continue and perhaps culminate the marked shift to a balance sheet orientation in accounting theory over the past thirty years.

Making such a change could potentially have enormous impact on income measurement and, if it does, would obviously have major implications for any contractual measures driven by the GAAP-basis financial statements.

Further Considerations for Greater Transparency

While it should be evident from the preceding discussion that changing standards can lead to veracious contention between parties contracting contingent pay-outs, there are additional elements about which to be cognizant in drafting contract provisions. As we’ve demonstrated above, accounting standards are constantly evolving. An element of consideration in drafting a merger agreement will be whether GAAP measurements of operating results over the defined time horizon are to 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. As indicated previously, the latter approach, often referred to as “frozen GAAP” attempts to mitigate the risks of consequences unintended by either party at the time of contract as a result of changing standards. While the negative side effects of necessitating the use of two sets of books in this approach may slightly complicate record keeping, the benefits of eliminating unforeseen risks should be enticing to a prudent contractor.

Additionally, another layer of information asymmetry can exist through the allowable variation in GAAP-compliant financial statement presentations. Certain accounting standards allow reporting entities the choice between alternative accounting treatments. Some examples of these are the choice among inventory valuation methods, depreciation methods and computing bad debt reserves for valuing customer receivables. While the reporting entity is allowed to decide which method best applies to its business environment, the opportunistic executive may choose one method over another for its eventual effect on an earn-out agreement. The risk of such manipulative tactics being undertaken by buyers is most often addressed by inserting the requirement that GAAP be “consistently applied” compared to earlier years. Unfortunately, consistent application may inadvertently mean the inclusion of GAAP-deviant methods as well. In some instances, the accounting applied by sellers had not

fully complied with GAAP, perhaps due to oversight or error. This risk underscores the need for effective due diligence before acquisitions are finalized, including detailed inventories of accounting methods being applied or misapplied by the sellers. Ideally, buyers will identify all non-GAAP methods used by sellers, and explicitly set forth the prescribed treatments post-transaction.

In similar respect, the discovery of errors and/or misjudgment in estimations after the transaction but before the earn-out period can result in additional complications for the acquired party. Under GAAP, errors are corrected by restating the earlier periods' financial statements, in contrast to changes in accounting estimates, which are to be handled prospectively. Ideally, earn-out agreements will be explicit as to how such corrections are to be dealt with for computational purposes, regardless of the GAAP requirements.

An accountant's input on the role that close attention to generally accepted accounting principles can play in reducing the risk of litigation can be highly useful, particularly when the parties to a business acquisition or merger are pursuing separate agendas, abetted by information asymmetries extant at the transaction date. Besides the risk that new or alternatively-interpreted GAAP poses, there are other tax or accounting-driven complications that may also arise, many of which are situation-specific. For example, some buyers having complex organizational structures, with subsidiaries chartered in different states, may elect, post-transaction, to engage in legal, but notably aggressive, tax arbitrage practices among subsidiaries (e.g., via transfer pricing or inter-company loans carrying non-market interest rates). As a result, the acquired company may suffer a decreased bottom line, which could affect the sellers' earn-out payments. Unless specifically addressed in the purchase and sale agreement, it could be difficult to later argue that the buyers were not free to engage in such practices, which often do have other, valid business purposes, albeit harmful to the sellers' positions.

Negotiating complex business acquisitions and other transactions may call upon a range of skills, potentially including sophisticated economic analyses, mathematics, statistics, and game theory, in the attempt to cope with individual behaviors in the face of unknown variables. The prepared and educated practitioner can minimize the risk of future misunderstandings and litigation by bringing a complement of skills to bear. Inclusion of

GAAP analyses can improve the likelihood of successful outcomes.

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1. Statements of Financial Accounting Standards Nos. 141 and 142.

2. FAS 142 provides detailed guidance about classes of intangibles that are to be given separate recognition under US GAAP.

3. The US GAAP rules for impairment testing of assets other than goodwill are found in Statement of Financial Accounting Standards No. 144. These differ in important regards from the impairment testing regime for goodwill, set forth in SFAS No. 142. Both sets of rules rely heavily on easily-disputed assumptions, even slight changes in which can materially alter the resultant computations.

4. The former requirements were set forth in Accounting Principles Board Opinion No. 20.

5. Set forth by Statement of Financial Accounting Standards No. 154, issued May 2005, and generally effective for 2006 financial statements.

6. FASB Interpretation No. 45.

7. FASB Interpretation No. 46, issued in early 2003, was replaced by FASB Interpretation No. 46[R] later that same year. It has subsequently been clarified by at least six FASB Staff Positions.

8. Statement on Financial Accounting Standards No. 57 addresses related

party disclosures to be made in financial statements. The challenge for auditors has long been to uncover such transactions, which are not always acknowledged by management and can be difficult to identify.

9. Statement of Financial Accounting Standards No. 150.

10. FASB Staff Position FAS 150-3 indefinitely postponed application of Statement of Financial Accounting Standards No. 150 for redemption provisions associated with equity of privately held companies, unless mandatorily redeemable at fixed dates for fixed amounts or amounts determinable by reference to external indices. The main effect is to lift the requirement that equity subject to "buy-sell" agreements be classes as debt, a provision that was vehemently opposed. It is not clear when, or if, FASB will return to this topic.

11. Accounting Principles Board Opinion No. 14 addresses accounting for debt with conversion features or detachable warrants. A FASB proposal dating from 2000 would require, if adopted, that conversion features be separately recognized as an element of equity upon issuance of convertible debt. FASB has struggled with this project for years, and plans to issue another preliminary view document in 2007.

12. Formerly, guidance on accounting for exchanges of nonmonetary assets was set forth by Accounting Principles Board Opinion No. 29, whereas current reporting requirements are dictated by Statement of Financial Accounting Standards No. 153.

13. The "Norwalk Agreement" between FASB and IASB was signed in September 2002. Perhaps in response to this, and also to the European Commission's endorsement of IFRS for use by some 7,000 publicly held companies in the EU beginning in 2005, the pace of worldwide adoption of IFRS has accelerated. Currently, some 100 nations either endorse IFRS for at least some financial reporting purposes or base their national GAAP standards, to greater or lesser degree, on IFRS.

14. FASB's technical agenda currently has three projects identified as being for short-term convergence purposes (dealing with earnings per share, income taxes, and research and development costs), and IASB similarly has five such projects in process (income taxes, segment reporting, borrowing costs, joint ventures, and impairment). Readers can monitor developments on these organizations' web sites, www.fasb.org and www.iasb.org, respectively.