

Bachelor thesis



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“The prevalence of earn-outs at NASDAQ OMX Stockholm”

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Abstract

In order to stay competitive in today's global world, a common strategy for companies is to actively seek mergers and acquisitions. The increased use of mergers and acquisitions gave rise to deal saving devices, such as the earn-out. The earn-out is a contractual agreement on an additional payment that depends on deal specific terms. Through the introduction of the International Financial Reporting Standard in 2005 for all publicly traded companies within the European Union, the earn-out has been regulated in the International Financial Reporting Standard 3 Business Combinations. As the field of mergers and acquisitions is diverse and tainted by many challenges, this would logically impose difficulties on the reporting of the earn-out.

This study aimed to first map the prevalence of the earn-out and accordingly to evaluate the initial provision with the actual earn-out payment. By reading the financial reports between 2005 and 2010 from 133 companies registered at the NASDAQ OMX Stockholm, this study attempts to answer these aims. One of the conclusions was that 47 % of the companies registered at NASDAQ OMX Stockholm Large and Mid Cap have reported the use of at least one earn-out. Furthermore, the distribution of the use of earn-outs was more prevalent in some sectors than others. Other findings in this study include that the earn-out constitutes a significant part of the total purchase price, the earn-out often leads to a payment and the reporting of the earn-out has been inconsistent. The initial provision of the earn-out was furthermore found to be rather accurate, and in some cases even identical, with the actual payment.

Glossary

Contingent Consideration	An obligation of the acquiring entity to transfer additional assets as part of a contract
Earn-out	A contractual agreement on an additional payment, depending on specific terms.
Fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction
FASB	Financial Accounting Standards Board
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
Mergers and Acquisitions	Methods by which corporations legally unify ownership of assets formerly subject to separate control.
NASDAQ OMX Large Cap	Companies with a market capitalization exceeding 1 billion Euros
NASDAQ OMX Mid Cap	Companies with a market capitalization exceeding 150 million Euros
Provision	A liability of uncertain timing or amount

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1. Introduction

This opening chapter aims to outline and explain the main features treated in this study. Starting off with background information and a problem description on the topic, the research questions will be ultimately formulated.

1.1 Background information

In a world where globalization and worldwide markets become all the more important, a common strategy to stay competitive is by actively seeking mergers and acquisitions (Hitt, Ireland & Harrison 2001). Considering the many factors that potentially could affect the success of acquisitions and therefore the risk such activity is associated with, it seems only natural that part of the price depends upon the results the acquired business produces.

An earn-out agreement is a contract between seller and buyer on a possible future additional payout, pending the success of the contract specific terms. The buyer eliminates part of the risk in terms of paying the additional price only if the negotiated targets are met and at the same time gains further insight into the seller's true future projections. This particular fact was perhaps first acknowledged by Leland & Pyle (1977) in their study on information asymmetry. The study describes a situation where the seller has private information regarding the value of the business. Hence, the negotiated terms of the earn-out contract can help shed light on the seller's expectations for the future (Tyebjee & Bruno 1984).

The use of earn-out contracts generally arises in situations when there is a difference in opinion regarding the value of the acquired company, or more specifically a "bid-ask spread" (Frankel 2005). Further, Frankel argues that buyers by nature are more conservative regarding future expectations, in comparison to the seller. Therefore an earn-out agreement seemingly can serve a purpose for both sides, as a risk sharing mechanism. If the contract is constructed in a way where key players from the acquired company shall continue working within the business after the acquisition, the earn-out serves as a motivational factor for the seller.

Further, additional studies have addressed the occurrence of adverse selection and agency costs in M & A deals, including the work of Datar, Frankel & Wolfson (2001). Their findings suggest that an earn-out clause is more likely to be used when the target is a small company with private information, which is also further emphasized by Kohers & Ang (2000). Other conclusions made in both studies include, that when fewer acquisitions have been made within a specific industry or if the acquired company has less recorded assets, the appearance of an earn-out agreement is more likely. The earn-out seemingly can serve various purposes, and because of its diversity has led to an increased use of such contracts.

The increased use of earn-outs over time is acknowledged by both Sevenius (2004) and Frankel (2005) and has become an established device in the field of mergers and acquisitions. The earn-out was ultimately going to be addressed by regulating authorities. Initially, national regulation applied, but since 2005 publicly traded companies within the European Union had to follow the regulation provided by the International Accounting Standards Board (IASB). Mergers and acquisitions have been regulated in the International Financial Reporting Standard (IFRS) 3 Business Combinations. The regulation of the earn-out however is categorised as a contingent liability and therefore regulated in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets. As mergers and acquisitions is a global activity, the ambition of facilitating for cross-border comparison is ultimately one of the overall main purposes with the IFRS. (Marton 2007).

As the reporting of earn-outs is compulsory for publicly traded companies in the European Union, yet is a complex and diverse contractual agreement, it may be interesting to further examine the occurrence and the outcome of the earn-out.

1.2 Problem description

According to Berk & DeMarzo (2011) mergers and acquisitions have increased over time, despite strong fluctuations. This seems to coincide with the view that to stay competitive, companies actively seek mergers and acquisitions (Hitt, Ireland & Harrison 2001). The increased activity in the field of mergers and acquisitions led to a correspondent boost in the use of creative tools, such as risk and deal-saving mechanisms, in the contractual agreements.

Due to the development and creation of new devices in the field of mergers and acquisitions, such as the earn-out, the demand for effective cross-border regulation ultimately increased. The regulation of mergers and acquisitions has changed for publicly traded companies within the European Union, with the introduction of the IFRS in 2005. The reporting of contingent considerations such as the earn-out is regulated by means of the IFRS 3 Business Combinations. This standard states that the earn-out shall be reported as a provision, dependent on the likelihood (i.e. more likely than not) of its payment. If it is more likely than not to lead to a payment, the earn-out shall be reported as a provision. However, the IFRS 3 was in 2009 updated as a result of an increased demand for more deal-specific information, enhanced transparency and convergence with the American counterpart, FASB. The new regulations state that the fair value method shall be applied on a potential earn-out provision. This means that the provision will be estimated to its most probable payment. Moreover, the purchase price allocation conducted along with the acquisition is final with these new regulations. If deviations from the initial expectations arise, they are to be reported over the income statement. This is in contrast to previous regulation, where deviations were to be reported as a change of goodwill.

The introduction of the IFRS has led to extensive academic research, examining the standards and implications of this framework. However, few studies address the earn-out from an accounting perspective. Instead, many studies on the earn-out have been conducted from a corporate finance perspective, including the work of Frankel (2005) and Sevenius (2004). These studies mainly treat the application of the earn-out and the explanation of its existence, rather than examining the actual reporting. This study aims instead at approaching the occurrence of the earn-out as well as the reporting of the earn-out through a merely financial accounting perspective.

Because regulation of earn-outs have been subject to change, it is interesting to investigate the reporting of the earn-out. Questions that arise are 'How prevalent is the occurrence of such contracts?' and 'How useful was this information in financial reports'?

Taking into account the many challenges M&A activity is associated with, we aim to investigate the reliability and utility of the reporting of earn-outs. More specifically, is the information provided by the company accurate and consequently useful to users of financial reports? Due to the short amount of time that has passed since the introduction of the new regulation in 2009, this study will focus on the annual reports constructed according to standards between 2005 and 2010.

1.3 Research question

In this essay an attempt will be made to answer the following research questions:

How prevalent is the use of the earn-out?

How accurate was the initial provision of the earn-out compared to the actual payment?

1.4 Purpose statement

The purpose of this essay is to map the prevalence of the earn-out and accordingly to analyze and evaluate the reporting of the earn-out. In order to analyze and evaluate the reporting of the earn-out an attempt will be made to measure the initial provision and the actual payment of earn-outs in publicly traded companies.

1.5 Limitations and scope

The aim of this study is to map the prevalence of earn-outs and compare the outcome of the earn-out to the original provision of the earn-out. Although earn-outs have been used over longer periods of time, this study will not address

acquisitions before 2005. Since 2005 the International Financial Reporting Standard regulates reporting of the earn-out in financial reports. These reports will provide the required information for this study. In 2009 the International Financial Reporting Standard 3 Business Combinations was updated, and consequently new regulations apply to new earn-outs. However, the financial reports applying the new regulations will not be included in this study because the effects were deemed too early to evaluate. The focus in this study will therefore be on earn-outs reported in financial reports between 2005 and 2010.

Furthermore, this study requires specific and detailed financial information about the earn-out. Therefore this study focuses on publicly traded companies. Due to lack of specific information in financial reports, only financial reports from publicly traded companies specifying information on earn-outs will be used. The publicly traded companies used in this study are registered at NASDAQ OMX Stockholm Large and Mid Cap.

In accounting terminology the earn-out is referred to as a contingent consideration. However, the earn-out is the term commonly used in corporate finance, literature and financial reports. Therefore this study will address this phenomenon as both a contingent consideration and the earn-out, depending on the context of the occasion.

1.6 Target Audience

As this study aims to investigate the earn-out used in mergers and acquisitions, the result could plausibly be of interest to related parties in the merger and acquisitions process. Involved parties are brokers, legislators, acquirers, sellers and investors.

The result of this study should provide information on the outcome of the earn-out.

- For investors this study will indicate how accurate the initial provision of the earn-out was in comparison to the actual payment. As the earn-out is a provision, this means the amount is an estimate. Although it is an estimate it should provide investors with some relevance about the future.
- For brokers there might be an interest on acquiring information on how accurate the earn-out projections are. As earn-outs may reflect expectations on behalf of the seller and the buyer, dissatisfaction may arise. Is there a reason to continue using earn-outs? Do earn-out contracts need to be adjusted? Does the earn-out serve its purpose?
- For the seller the earn-out is a way to earn additional money and prove promised projections. When initial projections, and hence the provisions, appear to be too optimistic the seller may be dissatisfied with lower rewards.
- Legislators have over the course of the years legislated the accounting of mergers and acquisitions, by frameworks such as the IFRS and US GAAP. Their intentions have been to improve information, in particular to investors. Legislators will be able to evaluate the utility of the reported earn-outs.

- Buyers may have an interest in paying as little as possible. Depending on how the earn-out lives/fails to live up to initial expectations, a buyer may either want or not want to use an earn-out. An almost guaranteed chance of earn-outs being paid might influence buyers' attitudes.

2.Method

The upcoming chapter will outline the methodological approach used to investigate the subject of this study. It entails a detailed description and reflection of the research approach, the selection and collection of relevant data and the subsequent applied method. The aim of this section is then to assist the reader to understand the analysis and conclusions drawn in this study.

2.1 Choice of research approach and methods

This study will first and foremost address the earn-out from an accounting perspective. However, the earn-out is a device typically used in corporate finance, therefore the relation between the two fields will be treated. This will be done by mapping the prevalence of the earn-out in financial reports and thereafter attempt to evaluate the outcome of the earn-out. To evaluate the outcome of the earn-out, the reporting of the initial provision and final payment will be compared.

To gain a better understanding of the earn-out, relevant literature from both corporate finance and financial accounting was collected and examined. This would also provide a foundation for the theoretical framework. To complement the literature, relevant academic research and articles were included. After having studied applicable literature and relevant academic research, the purpose of this study was defined. Through several meetings with the tutor limitations for this study were specified and the method of approach was chosen.

This study will start of by mapping the use and spread of the earn-out in companies registered at the OMX Stockholm Large and Mid Cap, using financial reports between 2005 and 2010. To present this to the reader in a clear manner, descriptive statistics will be used. The findings will be organized and presented using tabular and graphical presentations.

2.2 Data collection

Leading up to this study various literature was studied on the subject in order to gain further insight into the practical use of earn-outs and its key aspects. The qualitative data that was used in this study is of secondary nature, meaning that it has been publicized and interpreted (Nyberg 2000). The theoretical framework of this study that was subsequently established, primarily originates from various databases, including Google scholar, Business Source Premier and JSTOR.

The quantitative data has exclusively been collected from annual reports. Since annual reports are public information in publicly traded companies, the information was obtained from the websites of the respective companies.

As the reporting of information regarding mergers and acquisitions frequently is unspecified, this study did not record the number of acquisitions in relation to the number of earn-outs. Instead, the occurrence of at least one earn-out was recorded. From the companies that did report at least one earn-out and furthermore specified at least one transaction in detail, the information for evaluating the earn-out reporting was collected. First the purchase price was collected, accordingly the maximum earn-out and thereafter the reported earn-out provision and finally the actual payment.

2.3 Sample size

The sample size used in this study consists of annual reports between 2005 and 2010 in the 133 companies currently listed on the NASDAQ OMX Stockholm Large and Mid cap. Consequently, companies that have either ceased to exist or been delisted have not been accounted for in this study. The sample size is reduced due to the lack of access to annual reports in companies whom have not been listed during the entire time period this study measures.

In addition, this study aims to measure both the prevalence of earn-out contracts and how well the initial provision reflects the actual payment. The sample size used for measuring the prevalence of earn-out contracts will include all 133 companies. However, as it turns out only 63 out of the 133 companies studied have reported the use of an earn-out. This reduces the potential sample size for measuring the outcome of an earn-out provision to 63.

2.4 Validity and reliability

The validity of this study is dependent on the ability to correctly estimate the data (Eriksson and Wiedersheim 2001). The data was retrieved from audited financial reports obtained from updated company websites. Reliability is dependent on the degree of uncertainty and unsystematic errors (Esaiason et al. 2007). This study systematically studied financial reports and collected data in a structured manner, which accordingly was documented in Excel.

As discussed in both chapter 5 analysis and chapter 6.1 conclusions, the sample size of this study is limited. This study consisted of 133 companies only, of which a further 64 companies were used for sector analysis and only 9 companies with 14 earn-outs for evaluating the earn-out outcome.

The findings of this study relate only to the companies registered at NASDAQ OMX Stockholm Large and Mid cap. Therefore, this study cannot speak for the prevalence of the earn-out elsewhere.

3. Theoretical Framework

The following chapter aims to present existing literature and theories relevant for this study. Since this study treats aspects of both financial accounting and corporate finance, this following chapter will present applicable theory for both fields. By combining and explaining both fields their relation will become both clearer and more profound.

3.1 Mergers and acquisitions

This section is included to provide the reader with background information to the earn-out. It will also create an understanding of the challenges that arise in reporting the earn-out.

As mentioned in the background of this study, seeking mergers and acquisitions is a common strategy to stay competitive in world of global competition (Hitt, Ireland & Harrison 2001). It may for example be part of a strategy to diversify, access new markets, gain market share or acquire specific skills.

Synergies can be said to be one of the most underlying, and arguably most important, motive for pursuing mergers and acquisitions. The acquirer hopes to gain positive results through the interaction with the acquired business, results that could not be reached individually. Cooperate interaction with acquired subsidiaries strives to create an enhanced combined effect, commonly known as a synergy. However, these potential synergies might not always be easy to implement (PWC 2011).

Regardless of strategy, mergers and acquisitions involve several common activities. One central key element in the field of mergers and acquisitions is the valuation of target firm. When referring to value, the aspect measured is future economic value. This may depend on the development of the firm, the financial situation and the involved risk (PriceWaterhouseCoopers 2007)

The motives for performing a valuation may be various, from the classic acquisition to preparation for a merger, credit analysis or evaluating current operations (PriceWaterhouseCoopers 2007). The purpose of the valuation affects the valuation process. What the valuation processes have in common though is the use of financial information from the financial statement. Although the aim is to estimate the future value, it uses historical financial information from financial reports. To make projections about the future, one needs to weigh in historical development and the current position.

In this remark, there is a connection between the field of corporate finance and financial accounting. The quality of financial reporting has direct effects on the valuation process used among mergers and acquisitions. Characteristics such as transparency and relevance make the reporting of financial information more significant and accurate (Marton et al. 2008).

A key element in mergers and acquisitions is to determine the price of the target firm (PriceWaterhouseCoopers 2007). If the intention is to prepare for a transaction, the price an external part pays may be different from the estimated value. The price should ultimately reflect the present value of the future cash flows a buyer expects to receive. This projecting of future cash flows is something financial reporting aims to facilitate, through accounting qualities like predictive relevancy (Marton et al. 2008)

3.1.1 Merger and acquisition challenges

Challenges in the field of mergers and acquisitions may arise both before and after the deal. This section will first address the challenges in agreeing on a deal and accordingly the challenges affecting the outcome of the deal.

In the initial negotiations of a potential acquisition there is generally a difference in opinion regarding the price of the target company. Sometimes these differences cannot be resolved, leaving a substantial gap between the two parties, also known as a bid-ask spread (Frankel 2005).

One reason for this bid-ask spread is that the buyer on very few occasions has full access to complete information on the firm. On the other hand the seller possesses private information regarding the actual value of the firm (Leland & Pyle 1977) (Datar, Frankel & Wolfson 2001). This phenomenon is also known as information asymmetry.

Another reason is that the buyer normally has a more conservative perception of the future cash flows the company in question will produce (Frankel 2005). In contrast, the seller usually has a more optimistic view of the future cash flows, which may in part depend on his interest to receive a larger purchase price. This difference in perception is especially common when the target company consists of intangible assets, such as human capital (Kohers & Ang 2000). The valuation of human capital is generally highly subjective, and is therefore often subject to different opinions.

When the involved parties agree on a deal, there is a wide range of challenges that will affect the outcome. One major challenge over the transition period from the buyer to the seller is creating and maintaining motivation in the target firm (Frankel 2005). This also depends on the size of the target firm, where a distinction between industrial and private buyers usually is made. The operations of private target firms may be highly dependent on key employees (Kohers & Ang 2000).

Another challenge is to integrate the target firm with the existing firm, knowing that corporate cultures differ among companies (J. Berry 2005). Adapting corporate cultures may be slow moving processes and can in some cases lead to

conflicts. This may potentially affect productivity adversely and damage earnings.

These earlier- mentioned challenges of motivation and integration can be considered to be controllable challenges. However, the deal may also encounter uncontrollable challenges. One obvious challenge for the outcome of a deal is the economic situation (R. Bruner 2005). For instance an economic crisis directly following a closed deal may have a crucial effect on the outcome.

Other uncontrollable factors may be the development of the industry, where new competitors or intensified competition in general will suppress profits. The development of the market may either create more or less demand for the products and services the target company delivers. Even political intervention but also force majeure can have serious impact on the outcome of the deal. All these mentioned factors highly affect the success of mergers and acquisitions and consequently make the evaluation complex and specific for every deal (R.Bruner 2005).

Despite the many challenges and the complex environment in which mergers and acquisitions occur, R. Bruner (2005) argues that investments through acquisitions appear to pay about as well as other forms of corporate investments. Furthermore, he argues that one ought to be careful generalizing the outcome of various deals, as every transaction is considered unique.

3.1.2 Earn-out

As discussed above, there are many challenges associated with engaging in merger and acquisition activity. The earn-out may present a solution to the bid-ask spread, since it bridges the gap between the parties. By including a contingent payment dependent on the success of the negotiated terms, the buyer is able to hedge part of the risk associated with the acquisition.

Normally, the buyer has a more conservative view of the future cash flows the company in question will produce. If there is a substantial gap separating the parties, the inclusion of an earn-out can save the deal (Frankel 2005). The earn-out is a negotiated contract between the parties in order to agree on a disagreement (Kohers & Ang 2000). Provided that both parties are eager to reach an agreement, an earn-out contract can therefore be a very useful tool to make a deal happen despite extensive differences.

In a time where markets are developing more and more into a single global unit, many variables play their part in the potential success of M & A activity. Therefore, thorough consideration is necessary before an acquisition can be made. The problem is that a buyer on very few occasions has full access to information; hence, the seller has private information regarding the actual value of the firm (Leland & Pyle 1977) (Kohers & Ang 2000). This is the problem with the existence of information asymmetry. The buyer can by negotiating an earn-out agreement into the deal eliminate part of the risk. In addition, the buyer

gains valuable information regarding the true value of the targeted company by analyzing the size of the earn-out.

Considering that basically every acquisition is a unique business event, the same circumstances apply to earn-outs. Even though there are a number of common metrics, which are typically used, any given earn-out agreement is most likely going to be unique. First of all, the acquirer has to determine the main purpose of the acquisition, and after that decide what metrics, financial or non-financial that fit the bill. It doesn't necessarily have to be one or the other, commonly a combination is used. Below is an overview of common metrics as stated by Frankel (2005):

Common Metrics Used in Earn-Outs

- 1. Financial Metrics**
 - a. Revenue**
 - b. Earnings before interest, taxes, depreciation, and amortization (EBITDA)**
 - c. Net income**
 - d. Asset base**
- 2. Nonfinancial Metrics**
 - a. # of customers or contracts**
 - b. Product development milestones**
 - c. Customer retention rate**

Further, Frankel (2005) states a number of circumstances for which an earn-out is likely to appear. First of all, acquisitions of early state companies with little history often come with the inclusion of an earn-out. Even though companies are not valued based on past performance, but future expectations, the past can sometimes provide guidance for the future. The same applies to target companies with high growth. High growth can't last forever; therefore some sort of contingent payment is often included in the deal. Other circumstances include companies with new technologies or products, and targets working in high volatile markets (Kohers & Ang 2000).

There are also a number of key terms that need to be thoroughly considered when constructing an earn-out agreement. First of all, the amount of possible earn-out needs to be determined (Frankel 2005). If the deal is constructed in a way where the earn-out is a large part of the total purchase price, maybe a reconsideration of the valuation is in order. The earn-out triggers should be easily measured by clearly specified metrics in a given time period. Both parties

also need to consider the issue of control. In many cases the buyer has total control over the acquired company during the earn-out period, which makes it hard for the seller to influence the decision-making, hence the outcome of the earn-out. Therefore, the terms of the contract are key in order to successfully construct a suitable deal for both sides (Frankel 2005).

Further, a study that emphasizes the situation where the valuation of the target company is highly dependent on keeping key employees within the organization after the acquisition was made in 2000 by Kohers & Ang. They argue that a valuation difference based on human capital often complicates things even more. In order to solve this they present the earn-out as a possible deal-saver, by suggesting that contingent payments can motivate key players to stay on. An argument also supported by their empirical findings, suggesting that privately-held companies where managers/owners typically stay on, consider the earn-out a retention bonus. Given that relatively small privately held companies often possess managers with valuable expertise, human capital can be a very attractive component for the acquirer. Further, this is emphasized by the high percentage of earn-outs paid in situations when human capital is included to stay on in the earn-out agreement. In addition, these key employees tend to stay on even when the earn-out payment is completed, which allows the acquirer to keep valuable components of the acquired company post the acquisition, another positive aspect for the buyer. Consequently, the value of a company described above is highly dependent on whether or not the buyer is able to retain key employees to secure operations of the acquired company. As discussed above, there are numerous reasons for engaging in M&A activity other than the strictly financial aspects. However, these reasons are rarely accounted for in financial reports, and therefore hard to measure (Kohers & Ang 2000)

To be able to analyze the outcome of an earn-out contract by comparing the initial provision to the actual paid amount, one must have access to detailed information on the earn-out terms. Normally, companies are not very keen on publicly displaying such information, which makes it hard to draw conclusions regarding a possible absence of payment. Another problem with measuring the outcome of earn-out provisions is the lack of detailed descriptions in financial reports. Many companies make several M&A deals during a year and since there is no obligation to report acquisitions individually, earn-out provisions are not stated separately, again making it hard for the reader to draw any direct conclusions. (Kohers&Ang)

3.2 The International Accounting Standards Board

The purpose of financial accounting can be described as communicating financial information to various external stakeholders (Smith 2006). These may be shareholders, potential investors, creditors, suppliers, employees or society at large. As mergers and acquisitions and also the earn-out are agreements dealing with large sums of money, it is valuable financial information of particular

significance to shareholders and investors. Special rules apply to the reporting of the earn-out, which will be discussed in further detail later in this section.

The communication of financial information has been subject to regulation in order to satisfy the demands and needs of the users of financial reports. The regulation and the development of financial reporting, was prior to the IFRS mainly regulated on a national level, creating global variations in the shape and content of financial reports (Marton et al. 2008)

Differences between countries' financial reporting may depend on several factors. Two major factors are the shape of the financing system and the correlation between accounting and taxation (Marton et al. 2008). The United States, the UK, Ireland and Holland have a tradition of separating taxation from accounting. This meant that companies could adapt reporting to the demands made by investors and other stakeholders, in essence improving the information available (Marton et al. 2008). The tradition is characterized by a principle called 'fair-value accounting'. Fair value accounting seeks to provide the most accurate description of a company's financial situation as possible. Therefore, the regulations state that every item on the balance sheet should be reported according to its (estimated) market price, to the extent it is possible. Other countries like France, Germany and Italy have a tradition where accounting issues have close ties with tax issues. Tax issues influenced reporting, rather than investor demands.

The existence of different traditions resulted in different regulating accounting boards. In the United States the regulatory body is called the Financial Accounting Standards Board (FASB), an independent organization operating since 1973. The larger part of the western world uses the recommendations from the IASB. The IASB is a result of restructuring the former International Accounting Standard Committee in 2001. The IASB gained significant importance when the EU introduced a law in 2002, making it compulsory for publicly traded companies to follow the recommendations of IASB (Marton et al. 2008).

As financial markets developed and global trade increased, the need to compare companies across countries arose. This led to an increased demand for a cross-national accounting standard with fewer differences between countries (Marton et al. 2008). Although an attempt was made in 1973 by means of the IASC, the reconstruction in 2001 to the International Accounting Standards Board created a globally accepted institution. Furthermore, an attempt was made to converge accounting standards with the FASB through a memorandum of understanding and a project called the Convergence of Global Accounting Standards (Marton et al. 2008). The overall goal of this project is to improve comparability across countries and decrease accounting costs for multinational companies.

Before 2005 when IASB was first established as the main accounting framework in the European Union, financial reporting was based on primarily national regulations. In an attempt to accomplish a cross-border framework in order to simplify the interpretation of financial reports for international stakeholders, IFRS was implemented as the going framework. The main purpose with IFRS is

to facilitate for various international stakeholders, thus, creating a cross-border system that enhances the transparency of financial reporting (Marton 2010). However, despite the strong arguments in favor, it was never going to be an easy transition. Taking into consideration, the complexity of national accounting regulations that all needed to be accounted for in this aspiration to achieve a cross-border framework, the standards coming from IASB were always going to be highly complex and somewhat vague (Marton 2007).

In Sweden, prior to IFRS, the accounting regulations came from a number of different institutions. Although, currently the main accounting is IFRS, earlier norms and principles have not been completely left behind. There are still situations where old regulations apply, mainly because of tax issues (Smith 2006). As previously mentioned, countries with a Continental tradition have historically had a close connection between accounting and taxation; therefore, IFRS has not been fully adopted. Considering that the same circumstances apply in the vast majority of countries in the European Union, the task of creating a unified framework is certainly not easy.

The IASB provide recommendations through the IFRS. The IFRS aim to develop high quality, understandable, enforceable and globally accepted accounting standards. This study then will look at these aims from the earn-out perspective. Especially the quality of the financial reporting on the earn-out will be investigated and evaluated. Quality in financial reporting depends on several characteristics. One of the most fundamental qualities is transparency, the extent to which financial information is available to users and reflects the economic reality (Smith 2006).

“The objective of IFRS 3 is to improve the relevance, reliability and comparability of the information the reporting entity provides in its financial statements about a business combination and its effects”(IFRS 2008). The characteristics defining accounting quality are described below.

Relevance

Relevance may be defined as the ability to assist users in their decision-making and achieve their targets. For investors this is primarily to project the companies' future cash flows (Marton et al. 2008).

There can be made a distinction between two types of relevance; the first is feedback relevance and the other predictive relevance. Feedback relevance is when information improves understanding for past activities and decisions Predictive relevance is when information improves understanding of future events. (Marton et al. 2008).

The aspect of relevance significant for this study is predictive relevance. When reporting the earn-out as a provision, this needs to provide the user with relevant information about a possible future payment. When arriving at this future date, some degree of accuracy on the initial provision is desirable. That is, to have some predictive value the initial earn-out provision ought to best reflect the final additional payment. Predictive relevance can be gained if the outcome

of earn-out provisions is relatively accurate in comparison to the initial estimation.

Reliability

Another qualitative characteristic is reliability, which is the ability to reflect the economic situation of a company through accounting terms (Marton et al. 2008). When measuring aspects, certain problems arise. In order then to create a sound correlation between reporting and reality, this needs a degree of objective proof called verification. Other aspects of importance are freedom from bias and substance over form.

Comparability

A desirable quality is to be able to compare financial reports, either over time or between firms (Marton et al. 2008). The last decade efforts have been made to converge the local accounting standards to a global standard. Since corporations operate in a global world and mergers and acquisitions occur internationally, this is of particular importance for the quality of an earn-out provision.

3.2.2 Reporting of contingent considerations

Acquisitions treated by means of IFRS 3, Business Combinations are exclusively limited to situations where the acquirer gains control of the acquiree. Consequently, joint ventures or acquisitions with non-controlling interest are excluded from this standard. According to the standard all acquisitions are to be reported using the acquisition method. The acquisition method consists of the following 4 steps: (a) identifying the acquirer, (b) determining the acquisition date, (c) measuring the fair value of the acquiree, and, measuring and recognizing the assets acquired, liabilities assumed and any non-controlling interest in the acquiree, where the last step commonly is referred to as a purchase price allocation. Potential residual from the payment that might occur is to be reported as goodwill, or if the acquisition is a bargain purchase the gain shall be reported in the income statement.

If an acquisition contract contains a contingent consideration that potentially can lead to adjustments of the purchase price allocation, the acquirer shall include the amount at the time of the acquisition, if it is likely that the adjustment will take place, and provided that it can be reliably estimated.

According to the disclosure requirements of IFRS 3, the acquirer shall provide the users of its financial reports with information that enables them to evaluate the nature and financial effect of a business combination. Companies are consequently required to provide information regarding the financial effects of gains, losses, error corrections and other adjustments recognized in the time period for which the final acquisition details remain unfinished. However, it is also stated in the standard that an acquisition only has to be reported separately if it provides significant information on its own. If it is decided that individual

acquisitions do not provide such information, acquisitions are to be reported aggregated.

Since potential adjustments of the initial expectations regarding contingent considerations are reported as a change in goodwill, companies are also required to provide explanations in case of such events. If the outcome of a contingent consideration is below what was originally estimated it is to be reported as a reduction of the calculated goodwill. Based on the same logic, if the outcome exceeds the initial estimation the calculated goodwill will be increased.

The measurement principle applied in the standard is fair value. According to the standard, a contingent consideration would be recognized as a financial liability and therefore seen as a financial instrument; hence a contingent consideration would therefore be regulated in accordance with IAS 39, Financial Instruments. However, there are exceptions to the recognition (read above) and measurement principles. Contingent considerations are categorized as an exception to the recognition principle, and shall instead be reported according to the conditions in IAS 37, Provisions and Contingent Liabilities. A provision is defined as a liability of uncertain timing or amount. According to IAS 37, a provision should only be recognized as follows: (a) an entity has a present obligation as a result of a past event, (b) it is probable (ie more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and, (c) a reliable estimate can be made of the amount of the obligation. According to the standard, it is only in extremely rare cases that such an estimate cannot be made.

4. Empirical Results

In the following chapter we will present the empirical findings of this study. In order to facilitate for the readers, the results will be presented in diagrams and charts. Initially, a brief description of the sample size and data collection will be discussed in order to facilitate for the reader to better understand our findings.

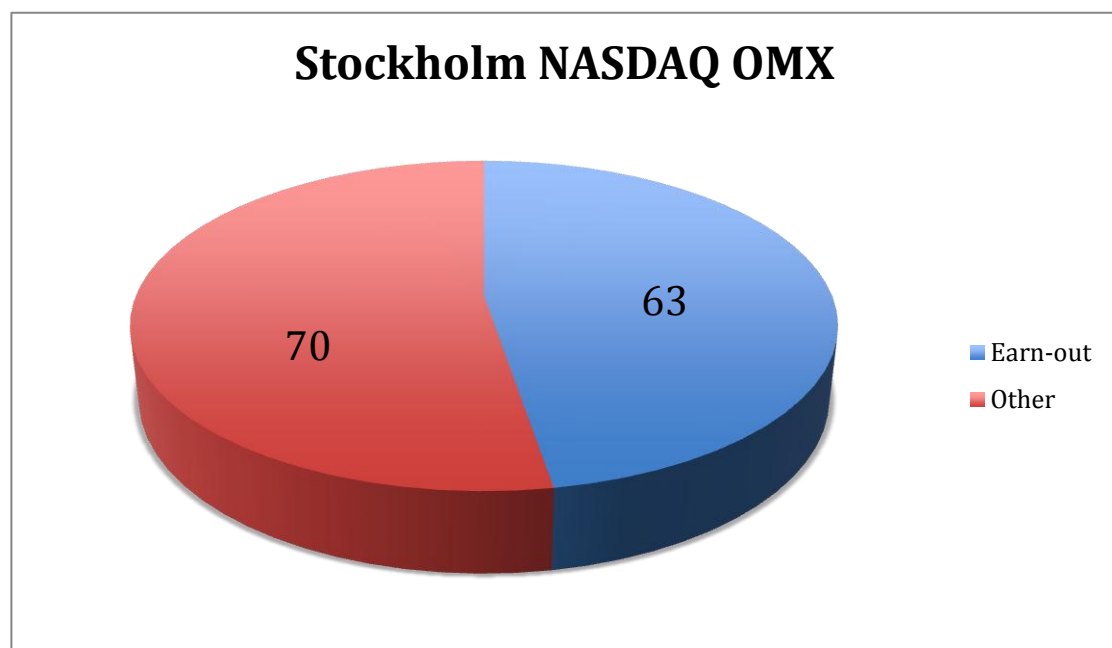
4.1 Characteristics of the data sample

The initial sample of this study consists of the 133 companies currently listed on the NASDAQ OMX Stockholm Large and Mid Cap. These companies provide the foundation for this study. However, as the aim is not only to map the prevalence of earn-outs, but also to analyze the outcome of such contracts, the sample for the latter has been reduced to the 63 companies who have used earn-outs.

Due to the flexible regulations of earn-outs, companies are not restricted to report earn-outs individually, nor specifically, which has been an ever-occurring fact in our search for information.

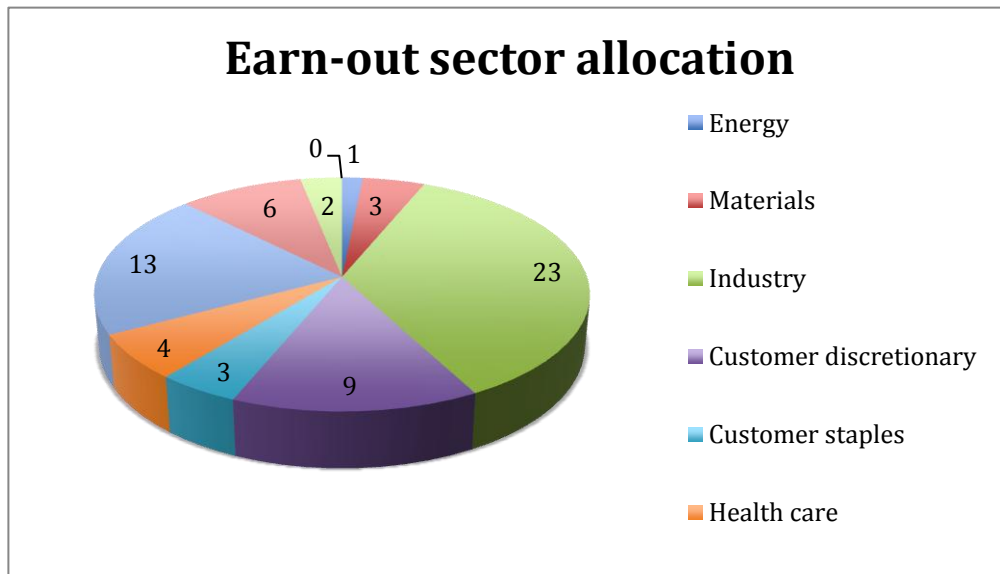
4.1.1 The prevalence of the earn-out

The findings on the occurrence of the earn-out will be presented in the pie chart below. The red area of the pie chart will represent the number of companies that reported at least one earn-out between 2005 and 2010. The blue area will represent the number of companies that have not reported an earn-out between 2005 and 2010.



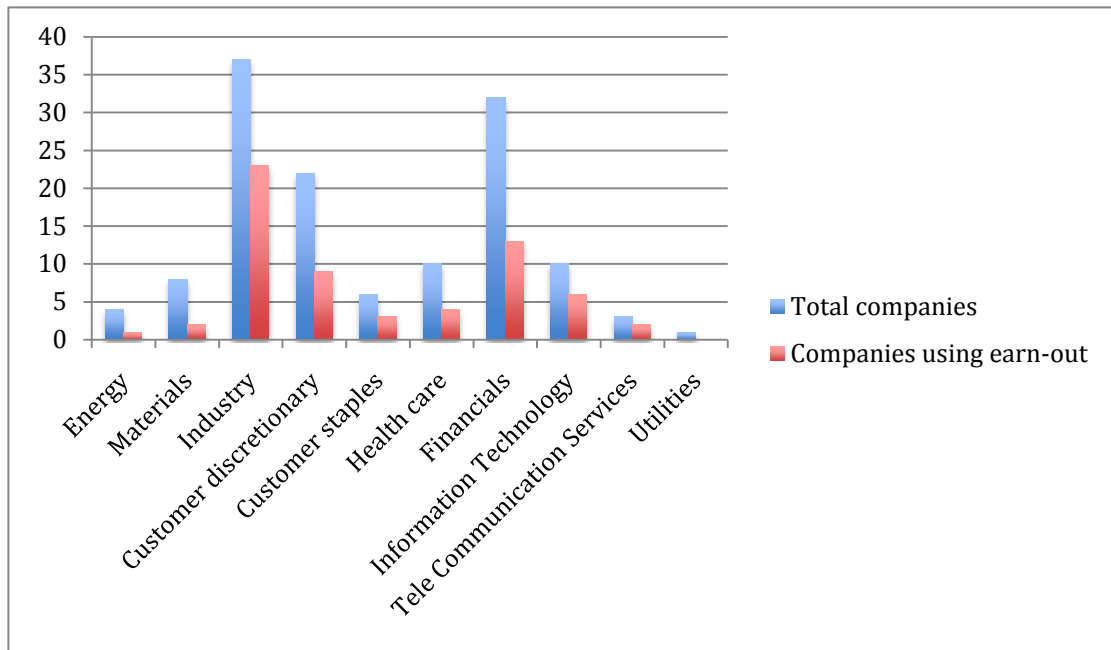
The diagram above shows that 63 companies registered currently at NASDAQ OMX Stockholm Large or Midcap have reported and used an earn-out between 2005 and 2010. That is 47% of all 133 currently listed companies.

In an attempt to investigate whether the use of earn-outs was evenly distributed at the NASDAQ OMX Stockholm, the companies that reported an earn-out were divided into respective sectors. The sector division used follows the division made by NASDAQ OMX Stockholm.



The pie chart above shows that the industry sector has reported 23 cases of the earn-out in total. The financial sector with 13 earn-outs and the customer discretionary sector with 9 earn-outs are also strongly represented in this diagram.

However, the company distribution over the earlier mentioned sectors is uneven. The following diagram will attempt to allow for better comparison of the use of earn-outs between various sectors, by displaying the number of companies active in the respective sector and the companies using the earn-out.

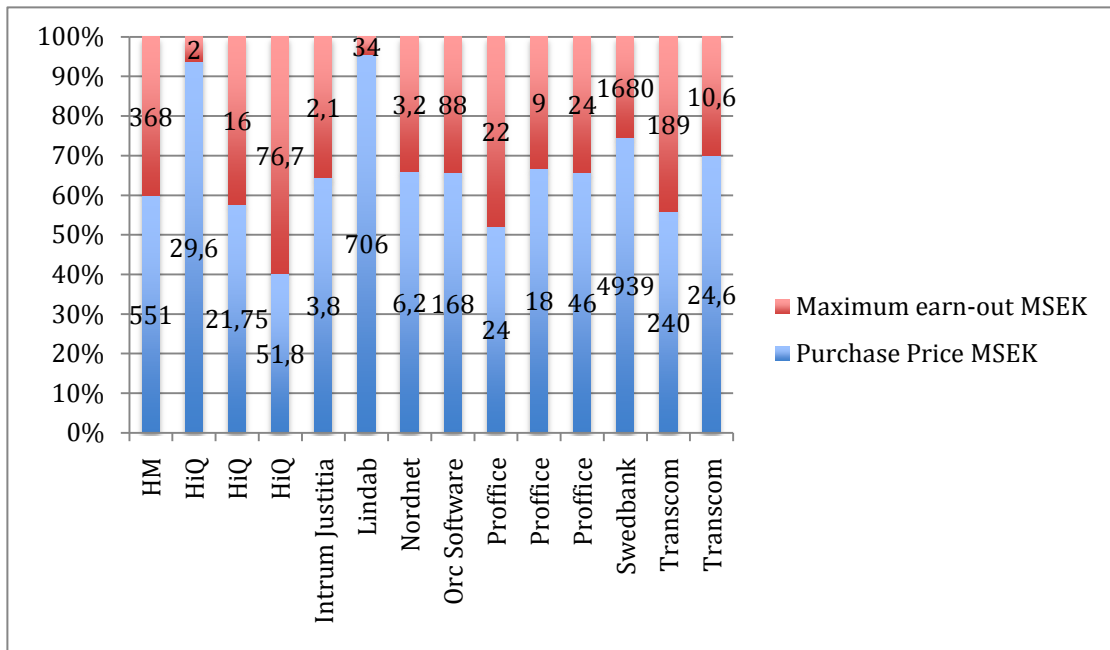


After weighing the number of companies in each sector, the picture is slightly different. In the Tele-communication Service sector 67% of the companies have reported the use of earn-outs, followed by the Industry sector with 62% and Information Technology sector with 60%. In the Energy and Material sector only 25% of the companies report the use of earn-outs. The Utility sector consists of only 1 company, which makes the figure of 0 % hard to interpret.

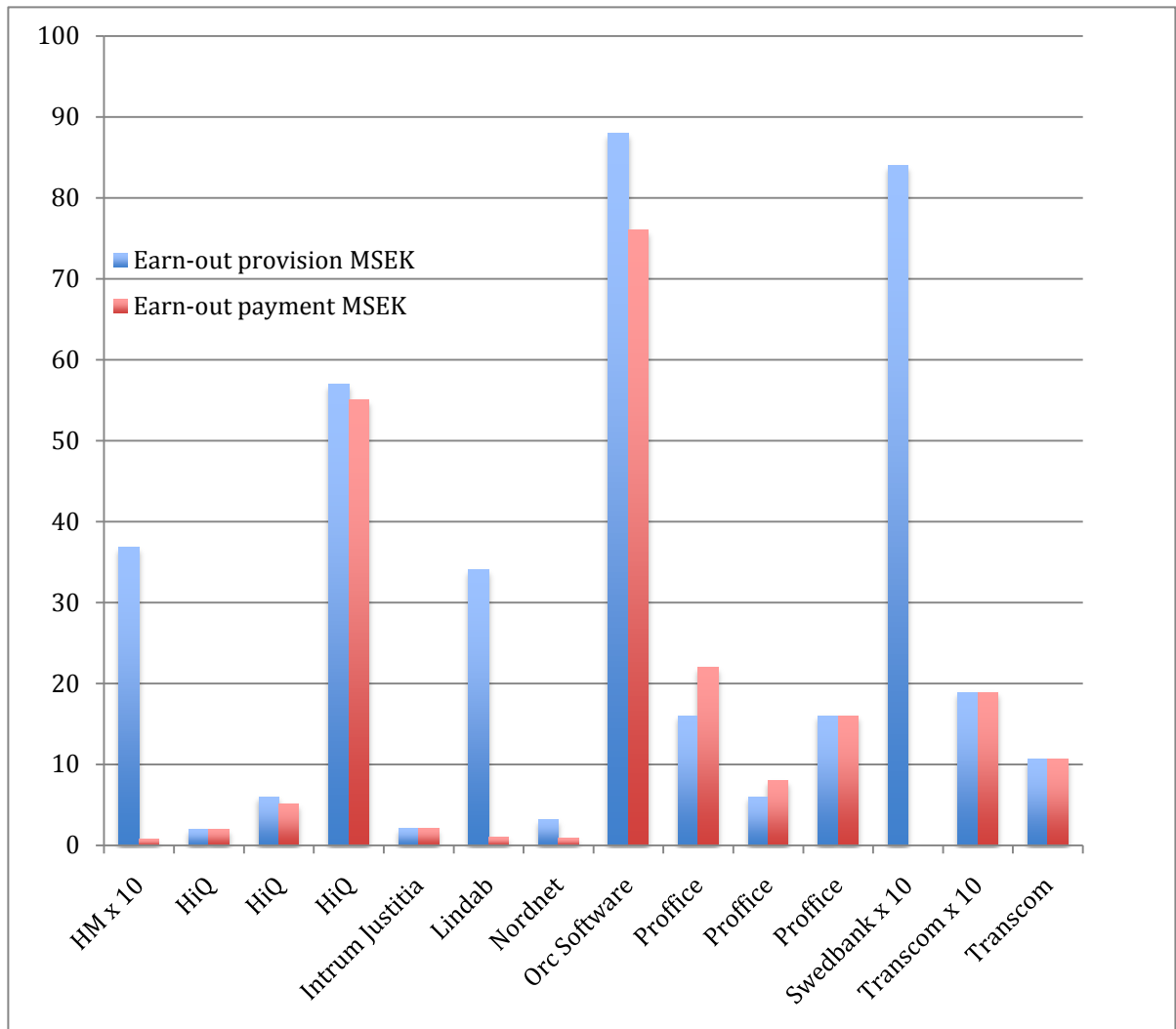
4.1.2 The outcome of the earn-out

The following section will present the findings about the outcome of the earn-out. Since companies not always specify information regarding mergers and acquisitions and earn-outs, the sample size was reduced from 63 companies to 9. In these 9 companies a total of 14 cases of specified reported earn-outs were found and subsequently used in this section.

In order to show the earn-out in relation to the maximum purchase price, the diagram below was used. This will provide the reader with some indication of the size and significance of the earn-out. The diagram displays the fixed purchase price in blue and the maximum earn-out in red.



The above diagram shows that the earn-out varies between 4.6% and 59.7% of the maximum purchase of the purchase price. On average, the earn-out constitutes 33.7% of the maximum purchase price. As this study partly aims to investigate the outcome of the earn-out, the diagram below shows the earn-out provision alongside the actual earn-out payment. The earn-out provision is shown in blue, the actual earn-out payment in red.



In order to illustrate the figures in the same diagram, the earn-out figures were reduced by a factor of 10 in the following cases: HM, Swedbank and Transcom(1). From the diagram above, one can observe that the earn-out provision and the actual earn-out payment do not always coincide. In one case the earn-out payment is zero (Swedbank) and in two cases the actual payment exceeded the initial provision. In 5 cases the initial provision coincided with the actual payment. On average the actual earn-out payment was 76.6% of the earn-out provision.

In the two cases of Transcom, the transactions were carried out in USD. These figures have been translated to SEK according to the annual average exchange rate as stated by Statistiska centralbyrån(SCB)

4.2 Presentation of the specified acquisitions

H&M's acquisition of Fabric Sweden (2008)

Initially, 60% of the company was acquired for a sum of 551 MSEK. Consequently, the earn-out used in the agreement was intended for the remaining 40% of the company. At the time of the acquisition the earn-out included in the deal was estimated to 368 MSEK. Note that the circumstances above are not the most common for which an earn-out is typically applied. The normal being that the entire company is acquired. However, this is explained by the contract specific terms used in the acquisition. Fabric Sweden was from the initial purchase of 60% provided with a put option for the remaining 40%, forcing H&M to buy the remaining part sometime during the agreed upon time period. As shown above, the remaining 40% was acquired for a mere 8 MSEK, substantially deviating from the initial estimation.

Swedbank's acquisition of OJSC Swedbank (2007)

In 2007 Swedbank acquired the Ukrainian bank OJSC for an initial purchase price of 735 MUSD. Also included in the deal was an earn-out with an upper limit of 250 MUSD, which Swedbank at the time of the acquisition estimated to a probable payout of 125 MUSD. In 2008 the final purchase price allocation was conducted and the earn-out was consequently revalued to 0.

Intrum Justitia's acquisition of Creditexpress Slovakia (2005)

In 2005 Intrum Justitia acquired Creditexpress Slovakia for an initial purchase price of 3.8 MSEK. The earn-out included in the deal was estimated to 2.1 MSEK and was constructed as a two-tier payout. In 2006 an initial sum of 1.9 MSEK was paid, followed by the remaining 0.2 MSEK in 2007 when all the terms were fulfilled.

HiQ's acquisition of Mobileyes (2007)

In 2007 HiQ acquired Mobileyes for a purchase price of 31.6 MSEK, including an earn-out of 2 MSEK. Consequently, the initial purchase price paid was 29.6 MSEK. During the same year Mobileyes accomplished the desired results, leading to a fully paid earn-out of 2 MSEK.

HiQ's acquisition of ACE (2008)

In 2008 HiQ acquired ACE for an initial purchase price of 21.75 MSEK. An earn-out with an upper limit of 16 MSEK was included in the deal. However, HiQ estimated at the time of the acquisition that the probable outcome was 6 MSEK, which was also the provision made in the purchase price allocation. The final payment in 2009 amounted to 5.1 MSEK.

HiQ's acquisition of TSG (2008)

In 2008 HiQ acquired TSG for a purchase price of 108.8 MSEK including an earn-out of 57 MSEK. However, the 57 MSEK provision made was the estimation made

by HiQ as the maximum amount agreed upon was set at 76.7 MSEK. The final payout in 2009 amounted to 55 MSEK. The slight deviation from the provision was due to currency exchange rates. Consequently, the provision was fully paid in the transaction currency of Euro.

Lindab's acquisition of Astron Buildings (2005)

In 2005 Lindab acquired Astron Buildings for an initial purchase price of 740 MSEK. The earn-out included in the deal was estimated to 34 MSEK. The final purchase price allocation was conducted in 2006, leading to a payout of 1 MSEK, and consequently to a decrease of goodwill by 33 MSEK.

Nordnet's acquisition of Deriva Financial Services (2007)

In 2007 Nordnet acquired Deriva Financial Services for a purchase price of 9.4 MSEK including a 3.2 MSEK earn-out provision, consequently the initial price paid was 6.2 MSEK. In 2008 the final purchase price allocation was conducted, leading to an earn-out payment of 0.9 MSEK.

Orc Software's acquisition of Cameron Systems

In 2005 Orc Software acquired Cameron Systems for an initial purchase price of 168 MSEK. The earn-out included in the deal was at the time of the acquisition estimated to 88 MSEK. The final purchase price allocation was conducted in 2006, leading to an earn-out payment of 76 MSEK. The deviation from the provision is somewhat due to currency exchange rates as the transaction was made in Australian dollars.

Proffice's acquisition of Henkilöstö- palvelut Oy

In 2005 Proffice acquired Henkilöstö- palvelut Oy for an initial purchase of 24 MSEK. The earn-out included in the deal was at the time of the acquisition estimated to 16 MSEK. However, as the final purchase price allocation was conducted in 2007 the earn-out payment exceeded the initial expectations and amounted to 22 MSEK.

Proffice's acquisition of Plus4You (2006)

In 2006 Proffice acquired Plus4You for an initial purchase price of 18 MSEK. The earn-out included in the deal was at the time of the acquisition estimated to 6 MSEK. In the annual report the following year the initial provision of 6 MSEK was increased to 9 MSEK. In 2008 an initial part of the earn-out was paid with a sum of 5 MSEK. And when the final purchase price allocation was conducted in 2009 another 3 MSEK was paid, leaving a deviation of 1 MSEK from the provision made in 2007.

Transcom's acquisition of Nutrumm International (2007)

In 2007 Transcom acquired Nutrumm International for an initial purchase price of 35 MUSD. The earn-out included in the deal was at the time of the acquisition estimated to 28 MUSD. According to the terms, the earn-out was to be paid over two years' time, starting with an initial payment in 2007 of 7 MUSD. In 2008 the

final purchase price allocation was conducted, leading to a full payment of the remaining 21 MUSD.

Transcom's acquisition of Cloud 10 (2009)

In 2009 Transcom acquired Cloud 10 for an initial purchase price of 3.42 MUSD. The earn-out included in the deal was at the time of the acquisition estimated to 1.48 MUSD. The final purchase price allocation was conducted in 2010, leading to a full payment of the earn-out in 2010.

5. Analysis

In the following chapter the empirical findings of this study will be analyzed by applying the theoretical framework.

5.1 The prevalence of the earn-out

One purpose of this study was to investigate the prevalence of the use of earn-outs. In order to answer this question the financial reports between 2005 and 2010 of 133 companies were studied. Due to the limited information available, the reporting of at least one earn-out was recorded and documented. Chapter 4 empirical results shows that 63 out of 133 companies had reported at least one case of an earn-out in financial reports between 2005 and 2010, which is 47% of the studied companies. Since the information regarding mergers and acquisitions often is aggregated in financial reports, no conclusion can be made on the prevalence of the earn-out in relation to the numbers of mergers and acquisitions. However, it can be stated that a substantial part of the companies use the earn-out. For 47 % of the companies the earn-out has been part of their reporting process and they have had to comply with the regulation for the earn-out as found in IFRS 3. With a substantial use of the earn-out, this makes the study on evaluating the outcome further on all the more relevant.

In the theoretical framework it was mentioned that basically every transaction is unique due to the many factors and challenges that may affect the deal (Bruner 2005). As the environment of mergers and acquisitions is unique as well as diverse, this could potentially have implications on the shape of the deal (Frankel 2005). One particular factor is the characteristic of the target company. Small and private companies but even high-growth and service sector companies (Kohers and Ang 2000) (Frankel 2005) have traditionally been more uncertain acquisitions and hence stimulated the use of earn-outs. In the empirical results chapter, the 63 companies that have used earn-outs were divided into a respective sector. Adjusting this sector division accordingly to the number of firms in each sector, it was shown that the earn-out was particularly common in the Tele communication sector (67%) and the Industry sector (62%). In the Energy and Material sector only 25% of the companies have reported the use of earn-outs. Although the sample size is limited to 63 companies, the results indicate that there seems to be a difference in the use of earn-outs in various sectors.

However, the size of respective sector affects the validity of the sector analysis. The three largest sectors being, Industrials, Financials and Customer Discretionary, combined represent a total of 101 companies, which is 76% of the companies included in the study, leaving the remaining 32 companies divided into 7 sectors. Considering the different circumstances in each sector, it is hard to analyze for example the utility sector, with only 1 company present.

Moreover, the results seem to be in line with the study conducted by Dater, Frankel, Wolfson (2001). Their study suggests that information asymmetry in association with acquisitions often is prevalent in high-tech industries and companies with low tangible assets, typically located in the service sector. In addition, cross-border acquisitions are often subject to high information asymmetry. Consequently, earn-outs seem to provide a risk-hedging mechanism for buyers in the circumstances mentioned above. As it appears from the empirical findings of this study, high-tech companies have in fact been overrepresented when it comes to the use of earn-outs. As presented in Chapter 4, Empirical Findings, the use of earn-outs reaches its highest point in the sector of Tele communication Services, with 66.7% reporting the use of an earn-out. However, with the sample in that particular sector consisting of only 3 companies, additional support is necessary before any conclusions can be drawn. Furthermore, 60% of the companies within the Information Technology sector report the use of an earn-out, providing additional foundation for the use of earn-outs in fact being more common within high-tech industries. On the other hand, earn-outs were also very much present in the Industrial sector, with 62% reporting the use of earn-outs in the time period measured.

5.2 The outcome of the earn-out

The other aim of this study was to investigate whether the initial provision of the earn-out coincided with the actual payment of the earn-out. In order to compare the provision with the payment, first the initial earn-out provision was recorded and accordingly later financial reports were studied to find the actual payment. Due to the fact that companies do not always specify the required information, the sample size used was reduced to 14 cases of the earn-outs in 9 companies. As only 9 companies report detailed information on the earn-out provision, this means that 54 out of 63 companies did not specify information regarding the use of the earn-out. In the chapter empirical results, the size of the maximum earn-out was first shown in relation to the fixed purchase price. This was done to provide an idea of the size and the significance of the earn-out. Although the maximum earn-out varies between 4.6% in Lindab and 59.7% in HiQ, the average earn-out constitutes 33.7% of the total purchase price. This means that the outcome of the earn-out is neither insignificant nor can be ignored. The outcome of the earn-out would have serious implications on the total purchase price, not least in the case of HiQ.

After presenting the relation between the fixed purchase price and the earn-out and creating an idea of its significance, the outcome of the initial provision was presented. To facilitate comparison, every earn-out provision was directly compared with the actual payment in the diagram. The result was that in 5 cases the initial provision coincided with the actual payment, namely HiQ, Intrum Justitia and Proffice. That means that in 9 cases the initial provision of the earn-out did not coincide with the actual payment. Of these 9 cases, 7 cases did not deliver the expected results and the earn-out payments were less than the initial earn-out provision. On 2 occasions the earn-out payment exceeded the provision. Only on one occasion, Swedbank, the earn-out payment was 0.

Consequently, there is a difference between the initial provision and the actual payment in 9 out of 14 cases. On average the actual payment was 76.6% of the initial provision, although with wide variations such as 0% in the case of Swedbank and 133% for Proffice.

Due to the unpredictable nature of a contingent consideration, and the flexibility within the regulations, the reporting of its existence has been subject to variation. For instance, only 9 out of the 63 companies reporting the use of earn-outs have on at least one occasion, provided its users with full disclosure on the outcome of the contract. Furthermore, in the companies that at least once have provided full disclosure, the reporting has not been consistent. As visualized in chapter 4, empirical results, the reporting of earn-outs has in fact varied between companies, with some companies reporting a maximum outcome of the contingency, while others report an estimation of the payout, without providing detailed information on the full, potential financial effects. The lack of transparency behind the earn-out components and the foundation, on which the estimated outcomes are based, makes it difficult for readers to interpret the potential effects it could bring. With transparency, according to Jan Marton (2010) being one of the main objectives with the IFRS, this ultimately presents a problem. However, the regulations do provide foundation for diverse reporting of contingencies, especially by not demanding information on specific acquisitions. Although this appears to contradict the disclosure requirements stated in IFRS 3, the IASB has undoubtedly allowed inconsistent reporting by providing an alternative in terms of reporting acquisitions aggregated. Companies were in a sense free to choose on their own. The regulations state that a company is obligated to report acquisitions individually if it provides significant information on its own. If not, companies are to report acquisitions aggregated, leaving stakeholders with very few details on specific acquisitions.

The question that arises is who decides if an acquisition provides significant information on its own? The point being that it is always going to come down to subjective assessments. In addition, there are numerous reasons why companies might not want to disclose information on specific acquisitions. For instance, it allows stakeholders to critically review the actions taken by the management, something that might not be desirable. Another reason for not wanting to display details on individual acquisitions could be that the information is sensitive for other reasons. The fact that a majority of companies seem to prefer to report acquisitions aggregated might be one of the reasons why the IFRS 3 recently has been subject to revision, and as we speak new regulations apply.

Considering that companies generally don't give away too many details on a specific acquisition, which has to do with the regulations that applied during the investigated time period, it is hard to analyze the outcome of an earn-out contract. Potential absence of payment or deviations from the initial expectations can be due to a number of reasons, which only the involved parties have full knowledge of. However, if the outcome either exceeds the initial expectations or if there is a complete absence of payment, assumptions regarding the success can be made. In Swedbank's acquisition of the Ukrainian

bank OJSC in 2007 an earn-out of 250 MUSD was included in the deal, with an actual payment of 0 in 2008. Due to the break-out of the financial crisis in 2008 the outcome of the earn-out is not surprising. With a global crisis of such content, especially connected to the financial sector and banks around the world, the outcome of this particular earn-out is not hard to interpret. Nevertheless, it does provide an illustration of the risk acquisitions, and cross-border acquisitions in particular are associated with (Bruner 2005).

Considering the uncertain nature of M&A activity, a contingent consideration included as a way to hedge risk is therefore naturally hard to estimate. Companies can only make their best estimation and cannot predict events beyond their control. Accordingly, earn-out provisions are to be viewed as a best guess rather than a forecast of the future. Consequently, the information stated in financial reports will from time to time deviate from reality. In the empirical results it was shown that the average earn-out payment was 76% of the initial provision, therefore deviating from the outcome. Users of financial reports should be aware of this when they make their interpretation. The information provided depends on uncertain events in the future. Therefore, maybe stakeholders will have to accept that information regarding these potential liabilities will not always be accurate. And even if earn-outs occur all the more often, and the amounts are of significance, the reporting of it will remain a mere estimation.

6. Conclusion

This chapter aims to present the conclusions drawn after analyzing the empirical results. Following the conclusions the validity of this study will be discussed. This chapter will conclusively present suggestions for further research.

6.1 Conclusions

At NASDAQ OMX Stockholm Large and Mid Cap 63 out of 133 companies reported the use of an earn-out at least once between 2005 and 2010. This represents a substantial portion, namely 47 % of all companies. Therefore the use of earn-outs in mergers and acquisitions is not an extraordinary occurrence. Furthermore, it was shown that the use of earn-outs was not evenly distributed along the various sectors at the NASDAQ OMX Stockholm. In the industry sector 62 % of the companies report an earn-out, in comparison to for example the material sector where only 25% report the use of an earn-out. It is important to stipulate that the sample size for each sector differs, thereby affecting the validity. The industry sector consisted of 37 companies but the material sector only consisted of 8 companies.

Even though this study found that the earn-out was prevalent in 47% of the 133 companies currently listed at NASDAQ OMX Stockholm, this study did not map the use of the earn-out in relation to the total amount of mergers and acquisitions. Due to the fact that many companies aggregate specific information regarding acquisitions in financial reports, and thereby the earn-out, this was not possible. It was in fact shown that 54 out of 63 companies reporting the use of at least one earn-out had on no single occasion specified the information regarding the earn-out.

This lack of specified information in financial reports regarding the earn-out reduced the sample size for the further study on the outcome of the initial provision to 9 companies with a total of 14 earn-outs. One has to bear in mind that this relates to the 133 companies the study started with. To create an understanding of the size and significance of the earn-out, and to provide support to further examine the outcome of earn-outs, the earn-out provision was put in direct relation to the fixed purchase price. Although the earn-out varied between 4.6% and 59.7% of the total purchase price, with an average of 33.7%, it illustrates that the earn-out constituted a significant portion of the maximum purchase price. This was especially true in the case of HiQ, where the earn-out constituted 59.7% of the total purchase price, and therefore the final purchase price allocation would be drastically altered upon a zero payout. Having an idea of the size of the earn-out in relation to the total purchase price, the actual payment of the earn-out was compared to the initial provision. In 5 out of 14 cases the actual payment coincided with the initial provision. Therefore, in the remaining 9 out of 14 cases the outcome deviated from the initial provision. Taking into consideration that the actual earn-out payment was on average 76.6% of the initial provision, and the many challenges of reporting the earn-out outcome, this was perhaps not a poor figure.

Further, it seems hard to recognize a trend in earn-out payments to be lower or higher than the initial provision. While in 7 out of 14 occasions the earn-out payment was less than the initial provision, there are 5 cases where the initial provision was accurate and 2 cases where it was more than the initial provision. What can be noticed is that there in 13 out of 14 cases was an actual payment. Only in the case of Swedbank in times of the financial crisis the earn-out payment was zero.

Considering the prevalence of earn-outs in the sample, namely 47% of the 133 companies, only 14% did at least on one occasion specify information of the earn-out. This means that 86% of the companies reporting at least one earn-out have not once specified information regarding the earn-out. This in turn has implications for the users of financial reports. In the cases where companies did not specify detailed information, the transparency is suffering. As this study showed that the earn-out constitutes a significant part of the total purchase price, the information reasonably would have provided the users of financial reports with valuable information.

6.2 Suggestion for Further Research

The future of the reporting of earn-outs is likely to be debated. According to the newly updated version of IFRS 3, Business Combinations a contingent consideration is to be reported with the fair value method at the time of the acquisition. In addition, the purchase price allocation conducted at the time of the acquisition is final; therefore, deviations that might occur from the initial expectations are to be reported over the income statement. According to Marton (2010) this new way of reporting is reasonable if the contingent consideration is considered part of the transaction, where both parties agree on a total purchase price. As part of the deal the seller provides insurance for the seller in terms of only receiving the additional payment if the negotiated targets are met. Subsequently, this insurance is to be valued according to the fair value method, if possible. However, if contingent considerations are viewed as a result of uncertainty, the new regulations might not be appropriate. Further, Marton (2010) argues that from the perspective of relevance, this is the correct way to report contingent considerations.

According to the old regulations any deviation from the initial expectations was to be reported as a change in goodwill, and the purchase price allocation was adjusted accordingly. A provision was only to be reported if the likelihood of a payout exceeded 50 percent. Considering the short amount of time that has passed by with the new regulations, it is hard to draw any immediate conclusions regarding the impact on financial reporting.

However, as it appears, there seem to be few advantages with making small provisions for contingent considerations, especially since the new regulations state that potential changes in the amount of the provision are to be reported over the income statement. Consequently, a higher payment than the initial expectation leads to a reduced result and vice versa. Assuming that companies generally prefer to report high results rather than low results, one could speculate that provisions for contingent considerations will be valued accordingly. Companies could potentially start using

provisions as lifelines in bad times, meaning that companies could make big provisions knowing they will never be fully paid and therefore use them as result enhancers. In a worst case scenario a provision could potentially end up being an executive's bonus. This is of course a rather harsh view, but nevertheless a possible scenario.

The new regulations however, do provide an interesting foundation to further examine the phenomenon of contingent considerations. As the updated version of IFRS 3 demands more detailed information regarding individual acquisitions, as a result, a similar study will probably present a significantly higher amount of specified cases in the future.

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