Research Article

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Earnout in M&A operations in Brazil and their impact on Equity Valuation

PAGOS CONTINGENTES EN OPERACIONES DE FUSIONES Y ADQUISICIONES EN BRASIL Y SUS IMPLICACIONES PARA LA VALORACIÓN DE ACCIONES

Carlos Elder Maciel de Aquino[1*]
Universidade de São Paulo

Fabio Cunha Dower[2]
Universidade de São Paulo

Fernando Dal-Ri Murcia[1]
Universidade de São Paulo

Isabel Cristina Lopes[1]
Universidade de São Paulo

Ricardo Anhesini Souza[1]
Universidade de São Paulo

* Corresponsal author

1 Universidade de São Paulo, Faculdade de Economia, Administração, Contabilidade e Atuária, Avenida Professor Luciano Gualberto, 908, Butantã, São Paulo, SP, BRASIL.

2 Fundação Instituto de Pesquisas Contábeis, Atuariais e Financeiras – FIPECAFI, Rua Maestro Cardim 1170, Paraíso, São Paulo, SP, BRASIL

Abstract

Purpose: to evaluate the recording of information related to M&A (Mergers and Acquisitions) transactions that include earnout as an element of contingent consideration in accordance with the accounting standard IFRS 3 - Business Combination and the key aspects of accounting information disclosure as per the IASB Conceptual Framework for Financial Reporting.

Methodology: We conducted exploratory, descriptive, and qualitative research that adopted a three-dimensional view to analyze the economic, legal, and accounting aspects of business combination transactions carried out with the use of Earnout. We considered all M&A operations conducted in Brazil between 2016 and 2020 by companies listed on the Brazilian Stock Exchange, which included earnout components.

Findings: Our findings indicate that acquiring companies comply with the regulatory requirements of IFRS 3. However, they do not consistently provide uniform, comprehensive, and transparent information regarding earnout transactions.

Practical implications: This study underscores the necessity to reconsider the disclosure criteria for earnout transactions. It emphasizes the importance of providing useful information to stakeholders through financial statements and accompanying explanatory notes, enabling interested parties to comprehend the financial structure of the transaction and its potential future impacts on financial statements.

Value: This research contributes to the capital market, regulators, and other interested parties by demonstrating the economic and legal characteristics vis-à-vis the accounting treatment attributed to earnout in M&A transactions. It addresses the gap in existing literature and highlights the need to revise the criteria for disclosure of useful information.

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Resumen

Propósito: Evaluar el registro de información relacionada con transacciones de M&A (Mergers and Acquisitions) que contenían earnout como contraprestación contingente de acuerdo con la norma contable IFRS 3 – Business Combination y los aspectos de la revelación de información requerido por el IASB Conceptual Framework for Financial Reporting.

Metodología: Investigación exploratoria, descriptiva y cualitativa que buscó, en una visión tridimensional, analizar los aspectos económicos, legales y contables de las transacciones de combinación de negocios realizadas con la adopción de Earnout. Consideradas todas las operaciones de fusiones y adquisiciones realizadas en Brasil de 2016 a 2020 por empresas listadas en la Bolsa de Valores de Brasil y que contenían Earnout.

Resultados: Se observó que las empresas adquirentes cumplen con los requisitos regulatorios de la IFRS 3; sin embargo, no aportan uniformidad, integridad y transparencia a la información divulgada sobre las transacciones que contenían earnout.

Implicaciones prácticas: Revela la necesidad de repensar los criterios de divulgación de las transacciones con earnout y brindar información útil a los stakeholders a través de los estados financieros y sus notas explicativas con el fin de permitir a las partes interesadas comprender la estructura financiera de la operación y sus posibles impactos futuros en los estados financieros.

Valor: Esta investigación contribuye al mercado de capitales, a los reguladores y a otras partes interesadas al demostrar las características económicas y legales frente al tratamiento contable atribuido al earnout en transacciones de fusiones y adquisiciones, llenando un vacío bibliográfico y arrojando luz sobre la necesidad de repensar los criterios. para la divulgación de información útil.

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INTRODUCTION

Mergers and acquisitions transactions (M&A) remain uniquely positioned to rapidly drive business transformation. PwC (2021) predicts the continued use of mergers and acquisitions for innovation and R&D (Research and Development). KPMG also disclosed in their annual M&A survey in Brazil (KPMG, 2021), that only in 2020 the Brazilian market registered 1151 deals, with an increase of 11% over the previous year, and turned over around USD67 billion, with the information technology sector accounting for 43% of the number of transactions in the previous 12 months (Fusões & Aquisições, 2021).

In transactions involving the purchase and sale of equity interests, especially when there is uncertainty regarding the full achievement of the transaction's objectives - sometimes involving startups or companies that have not yet reached economic maturity - the total fixed price of the transaction at the time of the closing of the deal has given way to future payments linked to operational and/or financial goals, payable based on their achievements.

This contractual condition of contingent pricing in equity interest purchase and sale transactions is also known as earnout. Its use has intensified in recent years in Brazil, as highlighted by Piva (2019), in enhancing together the expectations of the parties involved and allowing the continuity of negotiations, bringing objectivity to the valuation of a company. Earnout therefore presupposes the capture of a future event, whether financial or not, that will influence the price or payment method of the transaction.

Earnout is a contractual payment mechanism in M&A in which a relatively large part (often around a third) of the deal consideration is deferred and payable to the target's shareholders at multiple stages following the M&A announcement, contingent upon some observable measure(s) of the target firm's future performance within prespecified periods (Barbopoulos, et al., 2018; Cain et al. 2011).

According to Viarengo et al. (2018), earnouts are contractual agreements in M&A transactions that link part of the acquisition price to the future performance of the target company. The authors warn that earnouts have their origin in disagreement and disagreement can end given the complexity of verifying their result and the risk of moral hazard on the part of the acquirer, uncertainty at the time of payment or in the determination of the price, is far from uncommon.

Viarengo et al. (2018) also understood that information asymmetries between companies in M&A negotiations often lead to substantial divergences about the expected returns of a transaction due to the significant risk of evaluating young companies operating in intangible-rich sectors such as high technology and healthcare.

While earlier studies have explored the effects of earnouts on acquirers' earnings in M&A transactions, this study stands out the first analysis based on information from transactions that took place in Brazil. It examines whether acquiring companies recorded information related to acquisitions with earnouts in accordance with the accounting standard, as well as whether the disclosure format in explanatory notes of the financial statements followed the principles of accounting information disclosure.

The existing literature has yet to undertake an analysis of the form, quality and sufficiency of accounting information in M&A transactions with adoption of earnouts. This study simultaneously analyzes 3 dimensions: economic dimension – examining various uses and motivations for adopting earnouts, including valuation calculation; the legal dimension– which addresses legal structures and their connection with contractual aspects of the transaction; and the accounting dimension– which explores the accounting choices made and the disciplinary methods and criteria for recognizing, measuring and disclosing accounting information.

In summary, our study adopts a unique approach in the context of M&A transactions by analyzing financial statements data and disclosure practices. This innovative standpoint allows us to evaluate the comprehensiveness of this information, shedding new light on earnout features in M&A. This pioneering research aims to offer valuable insights and lays the foundation for future research, contributing to a deeper understanding of the complexities surrounding mergers and acquisitions.

The main objective of this study is to evaluate the recording and disclosing of information related to acquisitions with earnouts by the acquiring companies in accordance with an integrated view of the economic, legal, and accounting aspects of business combination transactions not covered in previous studies. As per the accounting standard IFRS 3 - Business Combination, and the main aspects of disclosure of accounting information in accordance with the Conceptual Framework for Financial Reporting (IASB, 2018), an M&A transaction requires registration in the minutes of the meeting of the board of directors or the executive board that approved it, disclosure to the market through a material fact and accounting record considering that:

1. Companies must promote the initial accounting of a business combination and, if this is incomplete at the end of the reporting period in which the combination occurs, the acquirer must report the provisional values for the items whose accounting is incomplete in their financial statements. The period for measuring and recognizing the final transaction amount is one year.
2. During the measurement period, the acquirer shall recognize adjustments to the provisional amounts retrospectively, as if the accounting for the business combination had been completed on the acquisition date; and
3. Whenever necessary, the acquirer must review and adjust comparative information for periods prior to that presented in its financial statements upon completing the initial accounting process.

Emphasis was placed on accounting analysis and, consequently, earnouts will be assessed in isolation as a component of the purchase price and should be measured at fair value. Figure 1 illustrates the classification and measurement criteria for the assets of an acquisition.

The study relied on information disclosed in business combination transactions occurring in Brazil between 2016 and 2020. Its objective is to

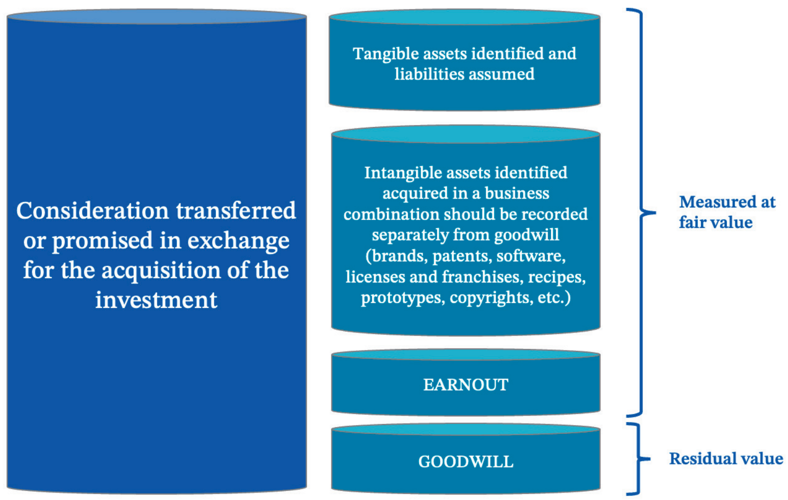

Figure 1. Accounting breakdown of the M&A transaction price. *Source: Adapted from Gelbcke et al. (2018, p.277)*

verify the companies' adherence to accounting standards in the handling and disclosing of earnout transactions from the perspective of a suspended transaction or an ongoing event.

When applicable, the study will provide recommendations for improving the accounting record, presentation, and disclosure model, thereby enabling a better understanding of the peculiarities of transactions involving earnouts. This, in turn, ensures that the information generated is important - that can make a difference in the decisions made by stakeholders as to its predictive or confirmatory value. It also ensures that the information is reliable – faithfully representing the intended operation, and comparable, allowing users to identify and understand similarities and differences between various accounting treatments and representations. Therefore, becoming more valuable for economic decision-making by users of accounting information.

To investigate the proposed problem, we aimed to address the following questions:

1. Is the disclosure of M&A transactions with earnout clauses by the acquiring companies in compliance with IFRS?
2. Do the adopted disclosure models offer transparency, completeness, and comparability of information on earnout M&A transactions and are they relevant, uniform, and consistent with each other?
3. Is there a need for adjustments to accounting standards that translate them into a better instrument for economic understanding and predicting the effects of the transaction, thereby enabling more assertive decision-making by users of accounting information? In this context, it will be assessed whether the project to amend IFRS 3 by the IASB can fill informational gaps in the current standard.

The study also seeks to challenge the academic community to move beyond the commonly adopted binary verification of compliance with regulations and instead embrace a more critical perspective by proposing regulatory changes and established concepts. Therefore, this study is justified by the importance of analyzing the current disclosure in relation to the treatment of earnouts, and by providing a new theoretical framework for disclosing M&A operations with earnouts in the financial statements. This framework can serve as support for analysts to make investment or divestment decisions. Secondly, it is relevant in the context of today's academic community and the financial and capital markets, especially considering the economic impacts of the contingent pricing.

THEORETICAL FOUNDATION

To analyze the results of this study, the literature review was structured in three distinct dimensions. The economic dimension which examined the various business objectives of the earnout feature consequently the target company's and valuation. The accounting dimension which explored the contingent consideration measurement and the accounting choices with a focus on the compliance of accounting records with to the accounting pronouncements, recognition of assets or liabilities and disclosures. The legal dimension which discussed the qualification of the operation under the prevailing legislation and the form of contractual structuring.

Economic nature of earnouts

The bibliography employed in this study on earnouts provides an overview of the main economic motivations that drive the preference for this pricing model among the parties involved in M&A operations.

Kohers and Ang (2000), in their empirical study on earnouts in M&A operations highlight the most important reasons that lead buyers and sellers in operations involving equity interests to disagree with the value of the business: the "target value" – the ideal value – of the business, as there are different expectations in this respect among parties.

The authors also cite that disagreement on price is more severe when the "target value" of the business (and its future performance) depends solely on the human capital held by the traded company, such as the strategic management team, which may or may not remain in the organization after the deal is completed.

The authors introduced the fundamental earnout concept as a means to mitigate such disagreements. It involves a "two-part payment commitment: the first part constitutes a final payment made at the time of acquisition (referred to as "front-end payment") and the second part is a deferred payment and "contingent" upon the ability to achieve certain standard performance pre-established among the involved parties".

Additionally, according to Kohers and Ang (2000), the earnout mechanism serves two purposes that are non-mutually exclusive. It acts as a risk reduction mechanism in the face of a pricing errors in the equity interest to be acquired, stemming from substantial informational asymmetry between the buyer and by the seller. Simultaneously, it functions as a retention of strategic human capital, linked to the payment of bonuses associated with the performance of the business.

Similarly, in the context of using earnout to retain strategic human capital, Cadman et al. (2014) identify additional economic factors that promote the adoption of the earnout clause. These factors include avoiding "moral hazards" and "adverse selection" problems, which stem from information asymmetry among the parties and can lead to risk of "incorrect" selection of "target" companies by buyers. These factors, in turn, cause variations in the estimated fair value of the earnout in the periods following the closing of the deal, owing to different views of the likelihood of completion.

Barbopoulos and Danbolt (2021), noted that the overall positive earnout effect derived from the ability of earnouts to promote information sharing among merging companies, therefore, contributing to a reduction in both adverse selection and moral hazard concerns. It in turn led to a higher likelihood of merger success. They add that the use of earnout in a merger should therefore by itself be a strong indicator regarding the quality of the acquired company's managers (often owners), who are prepared to accept the earnout terms and indicate the market their commitment to maximize the performance of the combined entity during the integration phase of the deal.In addressing the concept of adverse selection, Quinn (2012) aimed to determine whether it indeed leads to the adoption of earnout or if, alternatively, the use of contingent consideration is a more effective solution for mitigating the problem of buyer uncertainty regarding information asymmetry. No significant differences were found in the analyzed sample in relation to the fair value of the earnouts at the time of acquisition and following the closing period. Consequently, the author concluded that the "adverse selection", that is, the risk of selection of companies whose acquisition might not be advantageous, is not an important factor in the adoption of earnouts. Instead, it is the buyer's lack of information which allows him to estimate the future profit potential of the acquired company.

Allee and Wangerin (2018) mention that although one of the objectives of earnouts is to remove agency conflicts, there are cases in which, contradictorily, earnout can also represent a conflict factor, as the contingent payment is directly related to the future performance of the company when the sellers, who continue to head the operation, are more interested in reaching the stipulated accounting-based performance. These authors categorize contingent payment goals into accounting-based and non-accounting-based criteria. As exemplified in their work, a non-accounting-based goal includes obtaining regulatory approval for the production of a new drug, illustrating the diverse nature of earnout objectives.

Payments related to earnouts are frequently capped for the buyer to avoid the uncertainty of the maximum acquisition consideration (Battauz et al., 2021).

A third aspect to be highlighted is related to earnouts as a "substantial source of financing" for the acquiring party and as an alternative to other funding operations, especially those that require a loan (debt) or capital (equity) to support the acquisition of companies, as highlighted by Bates et al. (2018), whose work concludes that there is evidence that earnout is not only used for economic purposes but it is also a very common source of financing, especially by companies with limited access to external capital.

Erel (2018) studied the role of earnouts as a source of financing of corporate acquisitions, noting that both the financial difficulties of the acquiring company and the high cost of external capital are factors that encourage the use of contingent payment in merger and acquisition processes.

The research results of Barbopoulos and Danbolt (2021), suggest that the earnout effect is particularly pronounced in riskier deals of private and subsidiary companies, and when announced by large and mature acquirers with perhaps more experience, and more resources to effectively design and support earnouts.

Reuer et al. (2004) examined the impact of earnout in mitigating risk in international mergers and acquisitions. They found that companies commonly employ earnouts, in high-tech and service industries. Their research highlighted that the choice to structure cross-border mergers and acquisitions with contingent payments is influenced more by the nature of the funds acquired rather than the market relationship between the acquirer and the target. This emphasizes the significance of the target industry in this decision-making process.

Furthermore, acquirers also resort to these payment methods when they lack experience in international or domestic purchases. Therefore, they understood that the contractual alternative of earnouts can partially resolve evaluation problems arising from asymmetric information.

In Brazil, the Central Bank has eased monetary policy and loosened compulsory deposit requirements, creating a substantial 'liquidity pool.' This policy stipulated that money released to banks remained out of reach to businesses (Graner, 2020; Simão & Otta, 2020). This might have encouraged M&A transactions with built-in earnout.

Datar et al. (2001) identify several economic situations in which the use of earnout is common, including when: the company has "very significant private information" (greater private information); the sector in which the acquired company operates is different from that of the acquiring company; there are few operations within a given industry, not providing an adequate benchmark; the acquired company does not have "publicly registered" assets ,and when the acquired company is in the services sector, given to the challenges in concretely measuring intangibles.

Tanure and Cançado (2005, p. 8), referring to mergers and acquisitions conducted between 1995 and 2001, verified that 45.4% of the cases did not proceed through the initial phase of the acquisition process (due diligence). For example, the purchase of Agetur by Carlson Wagonlit Travel, in which the earnout mechanism was chosen precisely to "simplifying" the purchase process and allowing a rapid deal. This highlighted an important practical facet of the use of earnouts as instruments capable of providing both parties agility and security.

Within this literary compendium, several motivations for the implementation of earnouts can be extracted, essentially that seller's and buyer's valuation occur at different times and might be based on different scenarios. The COVID-19 pandemic clearly exemplified this discrepancy as certain sectors suffered a more significant impact than others (Scaramuzzo et al., 2021). Sellers who had earnout contingent receivables possibly had to adjust a portion of their sales valuation, at a price related to a different economic situation which motivated the earlier sale of the business.

In practical terms, earnouts serve as mechanisms to align the company's surplus value expectations negotiated between buyers and sellers, on the grounds of the uncertainty of estimated future results. Zilveti and Nocetti (2020) pointed out that "the contingent price aspect serves as a bridge between seller and buyer to align expectations about the effective price of the negotiated company." In other words, it is a business-smart way out to reduce uncertainty and trading risks and get closer to the "appropriate" selling price.

Cain et al. (2011) found that earnout contracts are designed to mitigate problems associated with valuation uncertainty, concluding that earnouts size is positively associated with proxies for target value uncertainty. Earnouts periods are longer when valuation uncertainty is likely to resolve over a longer period. The choice of performance measure in earnout contracts is associated with proxies for information conveyed by that performance measure and the verifiability of that measure.

As a conclusion, these studies illustrate that earnouts are a strategy that serves different economic functions and purposes, proving to be a versatile tool capable of solutions for often conflicting business interest.

Accounting nature of earnouts

a. Conceptual Structure of Accounting

Through Law n. 11.638 (2007), Brazil began preparations to align Brazilian accounting standards with the International Accounting Standards of the International Accounting Standards Board (IASB, 2018). The Conceptual Framework for Financial Reporting (IASB, 2018) which contains the basic principles and concepts for the preparation and presentation of the financial statements was adopted.

This accounting conceptual framework is based on the emphasis on the qualitative aspects of financial statements. In order to characterize and classify the information according to its usefulness to users, it distinguishes two groups of information: a) fundamental qualitative characteristics and understandability. Figure 2 demonstrates the structure for characterizing useful accounting information.

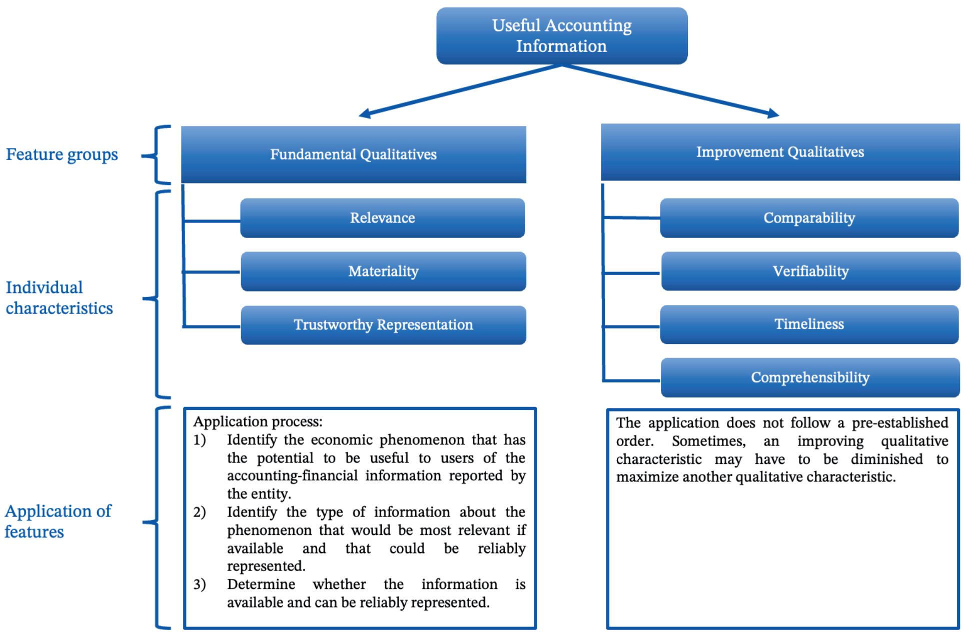

Figure 2. Characteristics of Useful Accounting Information. *Source: Aquino et al. (2019)*

For recording M&A transactions and, in this case, those with an earnout clause, the disclosure of qualitative and quantitative information help users understand the nature, amount, timing and uncertainty regarding the impacts of the contingent provision on future cash flows of the acquirer.

b. IFRS 3 – Business Combination

In 2011, Brazil adopted IFRS 3 to improve the relevance, reliability and comparability of information disclosed in financial statements of a business combination and its effects, in which the acquirer must: recognize and measure the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquired company; recognize and measure the goodwill for future profitability of the business combination or a bargain gain arising from a well negotiated acquisition; and, determine the information to be disclosed to enable financial statement users of the financial statements to assess the nature and economic and financial effects of the business combination.

IFRS 3 poses earnouts in business combination transactions as "contingent consideration", which is important to reduce the indeterminacy in the term. For example, regarding to the term "contingent" used as an expression of uncertainty about an asset or a liability in IAS 37 – Provisions, Contingent Liabilities and Contingent Assets.

This accounting standard defines earnouts as contractual obligations. The standard specifically addresses earnouts in the context of "business combination" transactions that require the acquisition of control by the acquirer and the settlement of the consideration can take the form of cash, tangible or intangible assets or shareholdings (shares and shares of the acquiring company, for example). Furthermore, settlement of the "contingent" consideration will only occur when future events or conditions take place ("soul" of the earnouts), as its "contingent" nature lies precisely in the uncertainty at the time of the transaction.

The definition also suggests the existence of two earnout models, both sharing the same essential principle (contingent consideration linked to a future condition) but with different forms of operation: one in which the contingent price is paid after the condition is met, while the other requires payment before the condition and refund to the buyer if it remains unfulfilled.

The first model tends to prevail, as it was found in all the analyzed transactions, and raises the question about the effectiveness (and practical necessity) of the second model. Regarding the second model, it is also worth noting that IFRS 3 determines the form of recognition of contingent consideration by pointing that "the acquirer must classify a contingent consideration as an asset when the agreement grants the acquirer the right to recover a portion of the consideration already transferred, subject to the fulfillment of specific conditions". Figure 3 presents the schedule to be followed for recording, measuring, calculating, and disclosing earnouts.

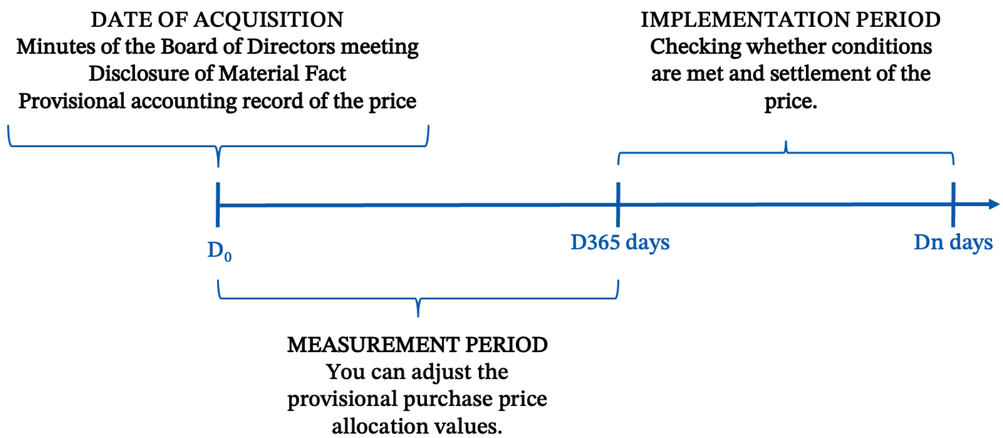

Figure 3. Schedule for earnout recording and disclosure. *Source: own elaboration*

As part of the transaction price, the measurement of earnouts, for accounting purposes, must be made at fair value on the date of the business combination, provided that the event related to the contingent consideration is probable and that the measurement is reliable. It should be recorder under Liabilities and in the corresponding entry of the adjustment against the result, as well as the fair value adjustments, or the total or partial reversal and its tax implications.

Following the closure of the transaction, the price allocation, including as regard to contingent considerations, may be changed (up to one year after the transaction) by virtue of additional information that the acquirer obtains after the acquisition date pertaining to existing facts and circumstances on this date. These are considered Measurement period adjustments.

However, those changes arising from events occurring after the acquisition date, such as the achievement of a profit target and the achievement of the specified share price, do not constitute measurement period adjustments. In this case, changes in the fair value of the contingent consideration, which do not constitute adjustments to the measurement period, must be accounted for as a component of equity or, in specific situations, such as a contingent installment within the scope of IFRS 9 - Financial Instruments, in the income for the period (IASB, 2018).

c. IASB Business Combination Discussion Paper (DP) Evaluation – Disclosures, Goodwill, and Impairment.

The IASB issued DP 2020/1, entitled Business Combinations—Disclosures, Goodwill, and Impairment, addressed the dissatisfaction of users of financial statements regarding the level and depth of information related to business acquisition processes. The document is extensive and outlines the primary reasons for these criticisms. Essentially, the core of the discussion lies in the lack of data available for users to conclude on the success or failure of these investments, in what way this can impact the assessment of the effectiveness of the firm's governing body, as well as its inorganic growth strategy.

Although the scope of the DP is broader than this study's, the intention is to assess the extent to which entities can improve their disclosures related to business combinations, to offer more useful information to users, which matches the objective of this work. Specifically in relation to earnouts, the DP outlines that in face of contingent payment clauses, management generally finds ways to measure and disclose earnouts. And when this fails to occur, it becomes impossible to identify how that acquisition evolved – whether synergies were achieved, target markets explored or new products developed, etc. The criticism arises from the fact that in M&A, expectations are created to justify the transactions, but that there is not a proportional a posteriori accountability.

In fact, the study findings in Table 1 reveal that most acquisitions that took place before 2020 had information on the evolution of earnout in following periods. This is a relatively positive aspect of information usefulness to end users. However, even if there are disclosures about t earnout evolution, such information does not have a uniform standard of disclosure, which hinders the comparability and usefulness of the accounting information.

The legal nature of earnout

We will highlight only a few key elements of the legal nature of earnouts to provide context limited to the objectives of this study.

First, the concept of contingent consideration of the accounting standard was adopted by the Normative Instruction of the Receita Federal do Brasil [RFB] - IN 1700 (2017), for tax purposes.

The second element is that earnouts are an atypical legal transaction, whose legal conformation is not expressly addressed by legislation, which is fully abided by the Brazilian Civil Code [CCB] (Lei n. 10.406, 2002).

The third element is pertaining its conformity in conditioning part of the payment of the price to the seller only if conditions specified in the contract met. This is significant because the earnout clause could encompass two types of conditions: the "suspension" and the "resolutive", depending on the contractual terms. Pursuant to article 121 of the CCB, a clause that, deriving exclusively from the will of the parties, subordinates the effect of the legal transaction to a future and uncertain event is considered a condition.

In Brazilian law, there are two legal forms of dealing with the condition: the suspensive condition is one in which, while the condition is not verified, the seller does not acquire the right to receive the price. This is the model identified in all cases in the sample of this study. The resolutive condition is one that the transferred amount is the seller's right from the moment of sale and the buyer has the right of refund only if the condition is not met.

In practice, the suspensive condition model is the one that best serves the buyer's interests. In this sense, Piva (2017) establishes that "the link between earnouts and the suspensive condition is well understood because the condition demonstrates the desire of adjusting the future to the present; obviates unpredictability; takes into account facts that may or may not happen".

Siebeneichler (2020) asserts that, in a purchase and sale agreement, it is certain that one of the core elements of the pact signed by the parties will be the price, under the terms of the adjustment to be duly configured. Consequently, it is the buyer's duty to analyze the company in all its possible aspects before the corporate acquisition, such as labor, tax, civil, consumer relations, environmental issues.

Finally, earnouts are also not to be confused with other clauses of a resolutive nature, such as the creation of escrow accounts that aim to establish a cash reserve for the settlement of uncertainties, usually of a judicial nature.

METHODOLOGY

This study is characterized as exploratory in terms of objectives, bibliographical in relation to technical procedures; documentary as a technique for collecting information and evidence and qualitative in approaching the problem and quantitative in analyzing regulatory adherence to quantitative in analyzing regulatory adherence to accounting standards.

The empirical-analytical method was employed. According to Matias-Pereira (2012) this approach involves a common use of techniques for collecting, processing, and analyzing quantitative data. Its defining features imply a focus on practical studies, since its proposals have a technical, restorative, incrementalistic character and a strong causal concern with the causal relationship among variables. The process of validating scientific evidence is conducted through instrument tests, degrees of significance and systematization of operational definitions.

This research considered all M&A transactions in Brazil between 2016 and 2020 that included a contingent payment in the form of earnouts as disclosed by companies in the financial statements. The use of earnouts increased in the last years of the study (only 18% of transactions with this characteristic were held from 2016 to 2018, with 78% of transactions in 2019-20). Data was collected through documentary research, limited to the primary data available on the website of the acquiring companies or the CVM (Brazilian Securities Commission). To interpret the data, content analysis was performed using inference, following the rules established in the IASB Framework and IFRS 3.

This study included 50 M&A transactions that took place in Brazil between 2016 and 2020 involving companies listed on Brazil Stock Exchange and Over-the-Counter Market" (B3) and specifically, transactions that incorporated earnout as an element of contingent consideration. The sample selection is intentionally non-probabilistic, in line with the approach described by Martins and Theóphilo (2009), because there is a deliberate choice of elements which make it impossible to generalize the results.

This research evaluated the application of the standard and the companies' adherence to criteria for the recording and disclosing of M&A transactions with earnouts, in the years of their accomplishment and the following, regarding their structural, functional, accounting, legal and economic characteristics. Additionally, it analyzes the uniformity, completeness, transparency, and the usefulness of the information disclosed about these transactions to stakeholders.

To interpret data, we employed content analysis using inference based on the theoretical assumptions stablished by the IASB and IFRS 3 as the foundation for recognizing, measuring, and disclosing to users of economic-financial information on earnout transactions as contingent consideration element in a business combination. Consistent with Campos' perspective (Campos, 2004, p. 613-614), "content analysis should not be extremely linked to the text or technique, in an excessive formalism, which harms the researcher's creativity and intuition. Therefore, it should not become overly subjective, imposing the analyst's own ideas or values, in which the text is reduced to a confirmation of these ideas or values.

The methodological path was structured in three dimensions, as shown in Figure 4.

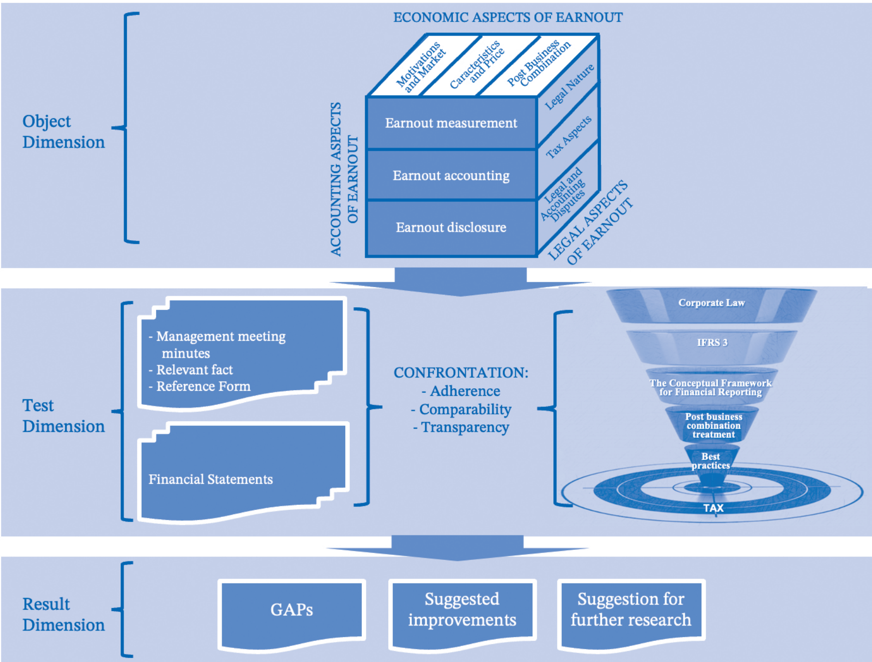

Figure 4. Research Structure. *Source: Adapted by Aquino et al. (2019)*

The dimensions shown in Figure 4 ensure that all aspects of the objects under study were contemplated and interrelated and they are described as follows:

- *Object Dimension* – in a three-dimensional perspective, aimed to identify and relate: the economic aspects of earnouts: motivation and market; features and price; and economic treatment after the business combination; the legal aspects of earnouts: its legal nature and legal-accounting controversies regarding the non-concurrent principles and rules on the earnout theme; and the accounting aspects of earnouts, regarding its measurement, accounting, and disclosure. The economic dimension (business objectives of earnout and impacts related to valuation), accounting dimension (contingent consideration, accounting choices, compliance with accounting pronouncements, recognition of assets or liabilities), and legal dimension (qualification of the operation under the legislation and the form of contractual structuring) are detailed in Chapter II – Theoretical foundation of this article,
- *Test Dimension* identified the characteristics of contracting and earnouts disclosing in M&A transactions selected for the study, collected through the minutes of the board of directors, notices to the market, reference forms and respective financial statements, and compared with IFRS 3 guidelines and principal aspects of accounting information disclosure emanating from The Conceptual Framework for Financial Reporting. By comparing accounting statements and regulatory requirements, the study aimed to measure the adherence of earnout information to existing regulations and its level of comparability and transparency, and

- *Result Dimension* analyzed companies' adherence to standards and existing gaps and identified and suggested opportunities for improvements in the treatment and disclosure of M&A operations with contingent and thematic prices for further study. This test aimed to verify the need to adapt the accounting standard that regulates earnouts to disclose better and standardized information, as well as to suggest a standardized and detailed model for disclosing M&A transactions with earnouts. This may provide the interested parties with a better understanding of the financial structure of the operation and its possible future reflections in the financial statements.

RESULTS

In the same way that M&A operations have been going through a growing process over the last few years, according to data from KPMG Brasil (KPMG, 2021), transactions that adopted earnouts as part of the purchase price also increased significantly over the study period, as shown in Table 1.

Table 1. Number of earnout transactions per year and acquirer segment.

SEGMENT	QUANTITY OF TRANSATIONS PER YEAR					TOTAL	
	2016	2017	2018	2019	2020	#	%
Commerce					5	**5**	**10%**
Education		1		3	4	**8**	**16%**
Information Technology				7	10	**17**	**34%**
Medical Services	1		2	2	5	**10**	**20%**
Miscellaneous	1	1		1	2	**5**	**10%**
Pension Plan and Insurance		1		1		**2**	**4%**
Tourism		2		1		**3**	**6%**
TOTAL	**2**	**5**	**2**	**15**	**26**	**50**	**100%**

Source: own elaboration.

As can be seen in Table 1, more than half of the transactions occurred in 2020, and in the first period of interest (2016) this percentage represented only 4% of the transactions identified. One of the main explanations is that most of the earnout operations were carried out by Information Technology companies (32%), which took place substantially in 2019 and 2020. Information Technology is an industry characterized by a greater uncertainty regarding the generation of future profits of the acquired company, a fact highlighted in the study by Zilveti and Nocetti (2020) and in Table 1.

Information Technology sector along with the Healthcare Sector and Educational Service sector experiences a higher number of transactions, indicating the prevalent use of earnouts within the service sector. This trend can be attributed to the challenges faced by buyers in estimating the future potential profit of innovative businesses, where the measurement of intangibles is inherently complex (Datar et al., 2001). These industries heavily rely on human capital to achieve their goals, adding another layer of complexity (Quinn, 2012). Moreover, many of these transactions involve privately held companies, amplifying the significance of informational asymmetry (Datar et al., 2001). Consequently, earnouts emerge as a practical solution in such scenarios, providing a flexible framework to navigate these intricate business landscapes.

Another aspect analyzed is the concentration of transactions in specific companies. Table 1 shows that transactions are concentrated only in a few companies in the Educational Service and Information Technology sectors, while in the Healthcare sector acquisitions are more dispersed. An important point that stands out in Table 2 is that only one company in the Commerce sector made acquisitions using earnouts, apparently because the acquired companies are not part of the acquirer's traditional line of business, justified by the expansion strategy of the business to other segments of the economy, which is also one of the expected factors for the use of the contingent price (Datar et al., 2001).

Another significant finding is the percentage of the earnout value pertaining to the purchase price, which is the initial earnout value, calculated at the time of price allocation. Table 2 illustrates that Tourism (on average 47%) was the sector where this price mechanism was most representative, followed by Educational Services, Pension Funds and Insurance and Commerce (all with an average of 32%). As these are sectors whose revenues can be greatly impacted by the economic situation, especially Tourism, it is possible that this factor may have led to the stipulation of a high percentage of contingent price in the agreed purchase price, since there is greater difficulty for the acquirer to clearly allocate the price of the business at the time of completion of the transaction, as highlighted in the study by Datar et al. (2001).

Table 2. Total number of transactions per acquirer for sample of M&A carried out in Brazil from 2016 to 2020.

Segment	Acquirer	Quantity of transactions	Earnout % per segment in relation to the purchase price
Commerce	Magazine Luiza S. A.	5	32%
Education	Anima Holding S.A.	4	32%
	Bahema Educação S.A.	3	
	Estácio Participações S.A.	1	
Information Technology	Grupo InfraCommerce	1	30%
	Linx S.A.	4	
	Locaweb Serviços de Internet S.A.	3	
	Positivo Tecnologia S/A	1	
	Singia S.A.	5	
	Totvs S.A.	3	
Medical Services	Diagnósticos da América S.A.	2	20%
	Fleury S.A.	1	
	Hapvida Participações e Investimentos S.A.	2	
	Instituto Hermes Pardini S.A.	1	
	Profarma Distribuidora de Produtos Farmacêuticos	1	
	Qualicorp Administradora de Benefícios S.A.	2	
	Rede D'Or São Luiz S.A.	1	
Miscellaneous	AES Tiete Energia S.A.	1	16%
	Sequoia Logística e Transporte S.A.	1	
	Valid Soluções S.A.	3	
Pension Plan and Insurance	WIZ Soluções e Corretagem de Seguros S.A.	2	32%
Tourism	CVC Brasil Operadora e Agência de Viagens S.A.	3	47%
TOTAL		**50**	**30%**

Source: own elaboration

However, in qualitative terms, as shown in the upper part of Table 3, most companies do not disclose their earnout measurement basis. This omission significantly impairs the usefulness of accounting information for this type of transaction, since the users cannot ascertain how earnouts will be assessed in the future, nor can they foresee the potential impact on the acquirer's results in the upcoming years. This situation is more critical in the disclosures of companies in the Information Technology sector, where 10 out of 17 transactions, did not disclose the earnout measurement basis, which is highly incompatible with the intangibility of the results of companies in this sector.

The data plotted on the left side of the Table 3 illustrates that not disclosing the earnout measurement basis is a common practice of companies of all sectors under study, except for Pension and Insurance and Tourism, where all transaction measurement metrics were clearly identified. Another finding, highlighted on the right side of the Table 3, which compensates for the lack of information on the measurement basis is that in most transactions (74%) the disclosed earnouts were maximum payment amounts, which enhances security regarding the acquirer's future impacts pertaining to that acquisition.

Table 3. Basis for measuring earnout and indicating whether earnout is minimum or maximum, by segment.

Segment	Earnout based on accounting metrics	Earnout based on non-accounting metrics	Earnout without disclosure of metrics	Total	% payment amount Quantity of transactions with earnout payment amount limit					
					Minimum		Maximum		Uninformed	
					#	%	#	%	#	%
Commerce			5	5		0%	5	14%		0%
Education	2	2	4	8		0%	6	16%	2	15%
Information Technology	6	1	10	17		0%	13	35%	4	31%
Medical Services	4	1	5	10		0%	5	14%	5	38%
Miscella-neous		2	3	5		0%	5	14%		0%
Pension Plan & Insurance	2			2		0%		0%	2	15%
Tourism	3			3		0%	3	8%		0%
TOTAL	**17**	**6**	**27**	**50**	**0**	**100%**	**37**	**100%**	**13**	**100%**

Source: Own elaboration.

Another finding pertains to disclosure of liabilities associated with acquisitions (not only those related to earnouts). Table 4 shows that most companies disclosed these obligations. It is a positive sign that users of accounting information can monitor the movement of values in the following years. However, the format and depth of this information are not homogeneous, and, in some cases, it is only possible to identify total amounts, but not by type of obligation (that is, by type of acquisition liability).

Additionally, Educational Service and Commerce companies reported less disclosures of liabilities. All Information Technology, Pension Funds and Insurance and Tourism companies presented information about these obligations, which is a positive factor, considering the importance of earnouts for these business segments and the intangibility of the companies' results.

Table 4. Disclosures of Liabilities from Acquisitions.

Segment	Disclosure of contingent liabilities related to earnout					
	YES		NO		TOTAL	
	#	%	#	%	#	%
Commerce		0%	5	31%	5	10%
Education	1	3%	7	44%	8	16%
Information Technology	17	50%		0%	17	34%
Medical Services	9	26%	1	6%	10	20%
Miscellaneous	2	6%	3	19%	5	10%
Pension Plan & Insurance	2	6%		0%	2	4%
Tourism	3	9%		0%	3	6%
TOTAL	**34**	**100%**	**16**	**100%**	**50**	**100%**

Source: own elaboration.

Financial statements along with Reference Forms, notices to the market and the minutes of the board meetings were also analyzed. In most cases, the information disclosed in the financial statements and these other documents' is aligned. (See Table 4). Information misalignments were mostly found in Commerce and Education sector, averaging 75% of transactions (see Table 5).

Another important finding is that, among the two earnout models defined in IFRS 3, only transactions that adopted the first model were identified, that is, the payment is withheld until the fulfillment of the contractual condition. This raises the questions about the practical usefulness of the second model provided for in the accounting standard, especially the Brazilian context, where legal proceedings are quite lengthy and with uncertain resolutions.

Table 5. Alignment between disclosures.

Segment	Disclosure of contingent liabilities related to earnout					
	YES		NO		TOTAL	
	#	%	#	%	#	%
Commerce		0%	5	31%	5	10%
Education	1	3%	7	44%	8	16%
Information Technology	17	50%		0%	17	34%
Medical Services	9	26%	1	6%	10	20%
Miscellaneous	2	6%	3	19%	5	10%
Pension Plan and Insurance	2	6%		0%	2	4%
Tourism	3	9%		0%	3	6%
TOTAL	**34**	**100%**	**16**	**100%**	**50**	**100%**

Source: own elaboration.

CONCLUSION

This study aimed to contribute to the capital market and other interested parties by investigating the economic and legal characteristics *vis a vis* the accounting treatment attributed to earnouts in M&A transactions carried out in Brazil and shed light on the need to reconsider the information disclosure criteria useful to stakeholders via financial statements and their explanatory notes.

As discussed previously, in many M&A transactions, accurately valuing the target company can be challenging, particularly when a portion of the price is contingent upon future performance. This introduces uncertainty since the value tied to future profitability may or may not materialize. Notably, the prevalence of contingent payments in M&A deals has increased in both Brazil and worldwide markets, underscoring the contemporary relevance of this topic.

This study takes an interdisciplinary approach, incorporating perspectives from accounting, economics, and legal dimensions, to shed light on the intricate nature of these transactions. It also highlights regulatory gaps that hinder a comprehensive understanding and measurement of such deals by stakeholders. While accounting and tax regulations touch upon the topic, they often lack the necessary precision in terms of the information that acquiring companies must disclose to financial statement users. While this information aids in understanding the business, it falls short in quantifying its potential future impact on the acquiring company's financial results. The absence of vital information can lead analysts to distorted estimates of the company's future performance.

Notably, prior studies have not addressed earnout transactions with this depth and concern. Therefore, a critical gap exists in the literature that this research aims to fill. In addition to identifying deficiencies in regulatory disclosure requirements, this study offers a standardized disclosure model, promoting completeness and comparability across companies and transactions. Furthermore, it provides valuable insights for regulators to enhance existing normative provisions.

It was noticed, in line with the observations of a number of authors (Allee & Wangerin 2018; Bates et al. 2018; Cadman et al., 2014; Datar et al., 2001; Erel, 2018; KPMG, 2021; Quinn, 2012; Tanure & Cançado, 2005; Zilveti & Nocetti, 2020), the growing use of transactions with suspensive payment linked to performance metrics with greater intensity in the Medical Services and Information Technology segments and in businesses of a different nature from the buyer. Such phenomena are probably attributable to the fact that these transactions bring greater uncertainty to the forecast of future growth and results, given that the acquired companies have not yet reached their economic maturity, but generally have disruptive technologies embedded in the business and with great potential for success. The study's objective was achieved by providing answers to the study questions, and allowed one to conclude that:

a. Apart from some disclosure aspects, companies, in general, adhere to the minimum regulatory requirements for the recognition, measurement and accounting record of M&A transactions with earnout clauses. It is important to note that no emphasis or reservations by the independent auditor on the quantitative and qualitative disclosure of the test sample operations were verified.

b. However, the information disclosed is not standardized, making it difficult to compare companies.

c. In many aspects, the information disclosed was not sufficient and clear enough to allow users of the information to reasonably predict the impacts of earnout on the acquirer's future cash flows. There is no clarity and completeness regarding information such as: minimum or maximum amount to be paid as a contingent price; calculation formula and parameters used to define the calculation of the contingent price at fair value, and clear movement of payments made due to earnout.

To make the information disclosed more useful, changes in the accounting regulation are suggested to ensure standardization of the presentation of transactions in explanatory notes – initial registration and final price allocation; and greater disclosure of transaction data and parameters, as well as an evolutionary table of expected payments and actual amounts disbursed at the time of calculation of the contingent price be created.

We also explored the economic and legal elements of the deals included in the sample. With rare exceptions, the conclusion of the transaction, and the existence of the final payment made, indicates that the economic objective of the structure was achieved, as pointed out by authors mentioned in sub-item 2.1 of this article, either with the objective of supporting the cash flows of the investment or to adjust pricing as the business proved viability. Also, the legal structure has proved to be effective under Brazilian jurisdiction as none of the transactions evaluated produced claims from any of the parties (based on the disclosed financial information on contingencies of subsequent financial statements).

The study provides empirical, theoretical, and practical contributions. In line with the deficiencies pointed out, this work suggests a standardized table model for inclusion in the Explanatory Note on Investments (Appendix), containing information on the composition of the Consideration Value - Expected and Realized - | and the Recognized Fair Value in the Acquisition – PPA (Initial Allocation and Final Allocation) which contribute to the understanding of transactions with earnout by their users and, consequently, to the construction of best management practices.

Despite this, there are some limitations in this work that may hinder the generalization of the results: i) the transactions analyzed were limited to the Brazilian markets environment. A wider range of deals involving earnout feature from other geographies, could enhance the basket of observations and influence our conclusions; ii) the use of disclosed financial statements and publicly available information only, limited our analysis to those transactions carried out by publicly traded companies following disclosure standards. Private equity deals were therefore not necessarily identified and included in the analysis and iii) the study was fully based on information that was publicly available which, in some cases, could not be fully tracked and reconciled generating some misalignment data, as pointed out on table 5. Also, the analysis of the financial statements was based on content analysis of the financial statements, which brings with it a certain degree of subjectivity in the interpretation and collection of data.

While the study was not intended to comprehensively cover this broad and complex subject, it is recommended to consider applying this study to other markets and countries. It involves verifying the amount of the effective payment of the earnout compared to the initial price estimated at fair value, or at least, to measure the impact of the disclosure of earnout transactions on the return of the acquiring company's shares in the trading session immediately after the disclosure of the material notices to the market.

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APPENDIX

1. Investments

1.1. Business Arrangement

Acquisition Company X

Description of the transaction (date of transaction, company acquired, % acquired, sector of activity, business model, brands, controlled companies, number of customers, number of employees, etc.)

Financial aspects and allocation of consideration:

CONSIDERATION	Budgeted	Realized
1. **TOTAL CONSIDERATION AMOUNT:**	$	$
1.1. Cash payment on purchase date:	$	$
1.2. Deferred payment: 1st Installment in / / in the amount of $ 2nd Installment in __/__/__ in the amount of $ nth Installment in / / in the amount of $	$	$
1.3. *Contingent consideration (earnout):* *In / / (Calculation formula:) Estimated value: $* *In / / (Calculation formula:) Estimated value: $* *In __/__/__ (Calculation formula: ___) Estimated value: $* Minimum earnout amount (if any): $ Maximum earnout amount (if any): $	$	$
2. **SHAREHOLDERS' EQUITY BEFORE ADJUSTMENTS**	$	$
3. **AMOUNT TO BE ALLOCATED (1-2)**	$	$
4. **4. ALLOCATIONS:** 4.1. Brand..$ 4.2. Relationship with Customers........... $ 4.3. Non-Competition Clause .... $ 4.4. Other Allocations.............................$	$	$
5. **GOODWILL (3 – 4)**	$	$

FAIR VALUE RECOGNIZED IN THE ACQUISITION	Initial Allocation	Final Allocation (PPA)
(C) ASSETS	$	$
. Cash equivalent	$	$
. Financial investments	$	$
. Restricted financial investments	$	$
. Receivable	$	$
. Advances	$	$
. Prepaid expenses	$	$
. Taxes to be recovered	$	$
. Related parts	$	$
. Collateral and Deposits	$	$
. Immobilized	$	$
. Intangible	$	$
. Intangible PPA	$	$
(D) LIABILITIES	$	$
. Loans and financing	$	$
. Providers	$	$
. Labor obligations	$	$
. Tax obligations	$	$
. Other obligations	$	$
. Advances from customers	$	$
. Long Term Installments		
(C) TOTAL NET IDENTIFIABLE ASSETS (A – B)	$	$
(D) Goodwill generated on acquisition	$	$
(E) TOTAL CONSIDERATION (C + D)	$	$
CASH FLOW IN THE ACQUISITION	$	$
. Cash paid net of cash acquired......................$		
. Acquisition Cost... $		