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The Impact of Earnouts in M&A Agreement: An Overview of Empirical Findings

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From a theoretical perspective, the use of earnouts should mitigate valuation risk of the acquirer involved in mergers and acquisitions (M&A) transaction. Earnouts contracts should reduce information asymmetries and moral hazard issues. By contrast, the definition of the terms of such contracts can be difficult and they provide several implementation issues to be faced. Based on these premises, this study aims to examine if the inclusion of earnouts is convenient and who benefits from their use. To this aim, I scrutinize academic literature examining the impact of earnouts. I perform a systematic review of studies in both accounting and financial domains that provide empirical evidence of main consequences due to the use of earnouts in M&A. Findings generally highlight a positive impact on the stock market performance of the acquirer in earnout-financed deals. Nevertheless, the positive reaction of acquirers' investors is influenced by specific features to be managed. Several issues are still uncovered and need further examination.

Keywords: earnout, merger and acquisition, empirical evidence, method of payment

Introduction

Merger and acquisitions (M&A, hereafter) are very popular growth strategies. They enable companies to obtain benefits, such as the increasing market share in a line of business, economies of scale, improving credit rating to obtain financial resources (Ghosh & Jain, 2000; Wang & Xie, 2009). However, the conclusion of M&A can be complex and time-consuming. It may require efforts to reach a satisfactory agreement for all involved companies and avoid the failure of the union (Hurtt, Kreuze, & Langsam, 2000; Epstein, 2005).

In the conclusion of M&A agreement, the acquirer faces valuation risk when he negotiates the price and the method of payment. The valuation risk is due to information asymmetries on the effective value of the target company. One or both companies involved in M&A may hold private information on their valuation and this can create adverse selection and moral hazard effects (Akerlof, 1970). To mitigate these problems, several contracting mechanisms can be introduced, such as earnouts.

An earnout agreement aims to split the purchase price of a firm in two stages. An up-front payment is carried out at the time of the M&A acquisition date and it can be in the form of cash, stock, or a combination of cash and stock. By contrast, the second payment is conditional to the satisfactory performance of the target after a predetermined period, namely, the earnout period. The deferred payment could also be in cash, stock, or a combination of both.

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A two-step payment enables the acquirer to avoid the risk of overvaluation of the target. Earnouts act as a risk-reducing mechanism to hedge against the risk of paying too much for the target (Kohers & Ang, 2000). The deferred payment, indeed, is contingent on the target's ability to achieve a measurable predetermined performance measure. Its size would be a function of the extent of the initial disagreement between merging firms on the actual value of the target. If the target does not perform as expected, the earnout payment is not due confirming the initial valuation of the acquirer on the actual value of the deal.

Due to expected benefits originating from the reduction of merger valuation risk, the use of earnouts shows a growing trend. The use of this payment mechanism has increased considerably in the last three decades peaking at almost 18% of M&A concluded in the years following the financial crisis in the late 2000s (Bates, Neyland, & Wang, 2018). In addition, the size of the earnout payment is usually a large proportion of the purchase price, reaching approximately a ratio of 33% (Cain, D. J. Denis, & D. K. Denis, 2011).

From a theoretical point of view, earnouts provide several benefits. This mechanism aims to facilitate the conclusion of M&A in the presence of substantial valuation uncertainty. They are used in M&A transactions involving privately held companies as target, when the target operates in the service or high-tech industry, holds large amounts of intangible assets or has high sales growth ratios (Kohers & Ang, 2000; Datar, Frankel, & Wolfson, 2001; Reuer, Shenkar, & Ragozzino, 2004; Cain et al., 2011; Ewelt-Knauer, Knauer, & Pex, 2011; Barbopoulos & Sudarsanam, 2012). Earnouts can also be a valuable source of transactional liquidity for financially constrained acquirers, representing an important liquidity management tool (Bates et al., 2018). In addition, the cultural background of the acquirer (Ewelt-Knauer, Gefken, Knauer, & Wiedemann, 2018) and the quality of the country's enforcement (Viarengo, Gatti, & Prencipe, 2018) affect the likelihood to use of earnouts and their size. Their use can support the post-acquisition phase because they could help to retain and motivate target managers for the successful realization of the target's potential value (Kohers & Ang, 2000; Cadman, Carrizosa, & Faurel, 2014).

In contrast with this position, several studies highlight potential difficulties in the definition of earnouts terms (Patschureck, Sommer, & Wöhrmann, 2015). Anecdotal evidence shows that the use of earnouts is associated with a higher litigation risk (Viarengo et al., 2018). The selection of the performance measures may be critical because they should be measurable, ambiguous definition should be avoided, and a potential manipulation in the earnout period has to be monitored. In that sense, the choice between cash or earnings-based performance measures is significant. Similarly, the negotiation on the length of the earnout period may be complex because of the conflicting interests of the seller and the acquirer. Earnouts force the seller to be subject to the risk associated with the future performance of the target (Datar et al., 2001). Therefore, the inclusion of earnouts in M&A agreement also provides several implementation issues to be faced.

Based on these arguments, it is interesting to examine if the use of earnouts is convenient and who benefits from their inclusion. Consistently, this paper aims to scrutinize previous academic literature on the earnouts effects. The analysis of empirical findings on this topic offers an opportunity to examine and discuss previous results, to provide implications for practitioners, and to suggest avenues for future research.

Publications to be reviewed are retrieved from Scopus and Web of Science databases. Documents are manually screened to restrict the analysis on empirical studies that examine earnouts effects in the accounting and financial domains. Thus, I examine documents published over the period January 2000-July 2020.

Empirical evidence suggests that the use of earnouts agreement provides several benefits. First, findings generally agree on their positive influence on the stock market performance of the acquirer. Abnormal returns

for the acquirer in both short and long term are observed. In addition, empirical evidence confirms the support of earnouts in retaining managers of the target company, influencing corporate governance structure in the post-acquisition phase. However, the analysis suggests that different issues related to the impact of earnouts are still uncovered. In particular, a further examination of accounting effects due to use of earnouts would be valuable.

The current study makes several contributions. First, it provides useful insights for practitioners motivated to conclude M&A and use earnouts payment. They can be aware of the main effects due to this choice and empirically demonstrated by previous studies. Several contextual factors, indeed, affect the success of the earnout strategy and need to be managed. In addition, it contributes to the financial and accounting literature on earnouts by suggesting avenues for future research. I stress the relevance of topics to be covered from future research and methodological issues to be addressed.

The paper is organized as follows. Section 2 describes the protocol used to analyze the previous literature. Section 3 illustrates major findings of empirical studies on earnouts effects. Finally, Section 4 is devoted to a discussion of results and their implications.

Research Design

The systematic review of academic publications on earnouts effects is performed through the development of a specific literature review protocol (Massaro, Dumay, & Guthrie, 2016). The protocol aims to: (i) identify a suitable source of documents; (ii) select keywords; (iii) delimitate the perimeter of publications to be reviewed; and (iv) identify the different streams of literature and classify publications according to the objects of earnouts effects.

At the first stage of the analysis, I sourced relevant publications by using Scopus and Web of Science databases. They are the most widespread databases frequently used for searching the literature (Guz & Rushchitsky, 2009; Aghaei Chadegani et al., 2013). They offer a broad coverage at journal, article and cited reference level (Norris & Oppenheim, 2007). Then, I performed a selection of publications by launching a keyword search. I require the keyword “earnout” or “earn out” (or “earn-out”) is included in the title and/or in the abstract and/or in the authors’ keywords. In addition, I limit the analysis to the subject areas “Business, Management & Accounting” and “Economics, Econometrics, and Finance” in Scopus and the subject area “Business Economics” in Web of Science. This procedure provided an initial sample of 41 documents in Scopus and 27 documents in Web of Science.

I delete duplicate documents between the two source of analysis and I obtain a sample of 46 univocal documents. Then, a screening of documents is performed through the analysis of the abstract to filter out sources covering unrelated topics (Cockcroft & Russell, 2018). I reviewed the abstract of documents and I exclude publications whose content is not related to earnouts in the accounting and financial domain. After excluding two papers for missing abstract, 33 papers are selected. All of them have available full texts.

Therefore, I performed a meaning-oriented analysis of remaining papers to retain papers that empirically examine the impact of earnouts. Thus, 16 papers are reviewed and discussed. A summary of the selection procedure is provided in Table 1.

In the final stage of the analysis, I coded selected articles according to the object on which earnouts effects are examined. I find that earnouts effects are investigated on: (i) acquirers’ interest; (ii) target companies; and (iii) corporate governance of merging firms.

Table 1

Selection of Papers

Criteria	Number of papers
Documents retrieved from Scopus	41
Documents retrieved from Web of Science	27
	68
Duplicates	22
Articles with missing abstract	2
Articles covering unrelated topics	11
Articles examining issues different from earnouts effects	16
Articles adopting analytical method	1
Final sample	16

A preliminary inspection of selected documents suggests that all of them adopt a quantitative research method based on the analysis of archival data. Several studies combine the archival analysis with a quasi-experimental research design based on the use of a propensity score matching method to address self-selection bias. Then, most of studies focus on the US context (seven articles) whereas very few studies analyze the effects in European countries (three articles). The *Journal of Banking and Finance* and the *International Review of Financial Analysis* are the main sources of articles on the earnouts effects.

Empirical Evidence on the Use of Earnouts

Table 2 summarizes empirical findings on earnout effects.

Table 2

Main Findings of Reviewed Articles

Author(s)	Year	Investigation period	Sample	Number of earnouts deals	Main empirical findings on the use of earnouts
Kohers & Ang	2000	1984-1996	938 acquisitions involving US target companies	938	The use of earnouts enable privately held targets and divested subsidiary targets to obtain higher takeover premia. Bidders obtain positive abnormal returns both in the short and the long term, especially when earnouts would be a suitable choice (e.g., high-tech takeovers, acquisitions of service firms, diversification mergers, and cross-border acquisitions).
Mantecon	2009	1985-2005	30,783 acquisitions	268	Earnouts are useful as retention bonuses. Earnout payments are associated with larger gains to acquirers of domestic assets, but there is no indication that buyers benefited from earnouts in cross-border acquisitions.
Dastidar & Zaheer	2010	1985-2004	1,435 cross-border acquisitions involving US acquirers	NA	The use of knowledge acquisition mechanisms is useful in cross-border transactions when information asymmetries exist.
Barbopoulos & Sudarsanam	2012	1986-2008	4,788 acquisitions by UK acquirers	1,251	Bidders obtain positive abnormal returns both in the short and the long term, especially when earnout is the optimal currency. Value gains are higher if the proportion of earnout in the total deal value is high.

Table 2 to be continued

Kohli & Mann	2013	1997-2008	165 acquisitions	24	Bidders obtain positive abnormal returns when earnouts are used, especially when the target operates in technology intensive sector and when acquisitions are pursued by experienced acquirers.
Lukas & Heimann	2014	2000-2013	169 earnouts acquisitions involving German acquirers	169	Investors react positively to the use of earnouts when uncertainty and the buyer's ability to reduce technological-induced information asymmetry are high. A too-long earnout period appears to be detrimental.
Cadman et al.	2014	2006-2011	10,816 acquisitions by US public acquiring firms	994	When earnouts are included primarily to help retain target firm managers, earnout fair values are closer to the maximum earnout payment amounts and managers stay longer. Investors of acquiring firms react to earnouts fair value adjustments. In earnout deals, goodwill impairments recognized by the acquirer are more likely to be timely and relevant.
Kohli	2015	1997-2008	153 Indian cross-borderac quisitions	35	Earnouts payment minimizes risk of adverse selection.
Barbopoulos & Adra	2016	1996-2010	424 deals involving privately held targets concluded by UK acquirers	299	Relatively large deferred payments and longer earnout periods are associated with higher takeover premia. The initial payment in earnout financed deals is set to be, on average, at a lower level than, or equal to, the full deal payment in comparable non-earnout financed deals.
Barbopoulos, Molyneux, & Wilson	2016	1986-2009	2,973 acquisitions by US acquirers	87	Bidders obtain positive abnormal returns both in the short and the long term, especially when the size of the earnout payment is high and when the target mangers are retained.
Elnahas, Hassan, & Ismail	2017	1984-2014	103 earnouts acquisitions	103	Managers of target firms significantly manage earnings up during the earnout period.
Danbolt, Barbopoulos, & Alexakis	2018	1992-2012	31,848 acquisitions announced by UK, US, Canadian, and Australian acquirers	4,125	First-time cross-border acquirers gain value from earnouts acquisitions. Benefits increase with unlisted target, when the cultural or geographical distance between the merging firms' countries is large and when acquiring in countries where the regulatory quality is strong.
Paudyal, Barbopoulos, & Sudarsanam	2018	1986-2013	30,553 acquisitions by US acquirers	1,842	Earnout deals outperform non-earnout deals when earnout is combined with stocks or with cash and stocks. Cross-border earnouts financed deals outperform domestic deals. Benefits are higher if merging firm utilize a method of payment that maximizes risk sharing, such an initial payment in stock followed by a deferred payment in stock.
Allee & Wangerin	2018	2007-2010	2,105 US acquisitions	302	Following the introduction of SFAS 141 (R), auditor verification increases the contractibility of accounting-based earnouts. Market reactions to earnouts deals are more positive, especially for acquisitions with risk of disputes over accounting-based performance metrics.

Table 2 to be continued

Song, Su, Yang, & Shen	2019	2011-2016	3,643 acquisitions by Chinese acquirers	1,151	Performance commitment contracts in Chinese deals (similar to earnouts) show positive effects measured by improved abnormal returns and decrease future stock crash risk for the acquirer.
Alexakis & Barbopoulos	2020	1980-2016	35,121 US acquisitions	2,638	Abnormal announcement period gains for acquirers involved in earnouts deals are mainly detected in acquisitions involving low-sigma acquirers.

Most of studies examine the impact of earnouts on the acquirer by analyzing the market reactions to the announcements of the deals. Kohers and Ang (2000) provided first evidence of positive abnormal returns surrounding the announcement of an earnout deal involving US targets, reporting a return of 19.1%. The positive reaction of the market is due to the structure of earnouts that serves acquiring firm investors in either case. If the target achieves expected performance goals, the acquirer shareholders get to share the unexpected higher return. If the target does not reach the performance measure, the acquirer does not overpay. More interesting, the authors underline that positive abnormal returns are explained by specific features of the transaction. Acquirers of private targets with earnouts contracts experienced higher abnormal returns than other methods of payment if earnouts would be a suitable choice (e.g., high-tech takeovers, acquisitions of service firms, diversification mergers, and cross-border acquisitions). Thus, the positive reaction of investors is influenced by the appropriate use of earnouts. These results are confirmed and extended by other studies. In particular, acquirers enjoy significant value gains if they employ earnout when it is the optimal currency at the deal level or the target industry level.

In earnouts deals, bidders obtain positive returns when the target holds assets which are “relatively intangible rich” (Barbopoulos & Sudarsanam, 2012, p. 693) or operates in a technology-intensive sector (Kohli & Mann, 2013). Earnouts outperform non-earnout offers when they are concluded from experienced (Kohli & Mann, 2013) and low-sigma acquirers (Alexakis & Barbopoulos, 2020). Value gains are also higher if the proportion of earnout in the total deal value is high (Barbopoulos & Sudarsanam, 2012; Barbopoulos et al., 2016), the earnout is combined with stocks or with cash and stocks (Paudyal et al., 2018), the level of the performance hurdle is relatively high (Song et al., 2019). If the payment method maximizes risk sharing between the merging partners, such as in stock acquisition followed by a second payment in stock, earnouts generate superior returns to acquirers (Paudyal et al., 2018). The higher is the risk sharing between involved companies, the higher is the usefulness of earnouts as effective mechanisms for mitigating the adverse selection and moral hazard issues. By contrast, too long earnouts periods—longer than three years—are detrimental because of an increased risk of legal action (Lukas & Heimann, 2014).

In the specific context of cross-border transactions, the study of Mantecon (2009) does not provide evidence of improved returns for earnouts deals. The excess return is demonstrated in other studies (Paudyal et al., 2018). Acquirers obtain wealth benefits from first-time cross-border M&A when the target company is unlisted, there is a large cultural or geographical distance between the merging firms’ countries and when the target operates in countries where the regulatory quality is strong (Danbolt et al., 2018). Therefore, in cross-border acquisitions, earnout is a useful way of hedging the risk of adverse selection by an acquirer who lacks information regarding the true worth of the target company (Kohli, 2015).

Several studies provide also evidence that gains from the use of earnout are reported over the long term in the post-acquisition period (Barbopoulos & Sudarsanam, 2012), especially if managers of the target company are retained (Barbopoulos et al., 2016).

In the accounting perspective, a significant change in the recognition of earnouts comes from the SFAS 141 (R). The revised version of the standard states that a contingent earnout liability at the fair value has to be recognized by the acquirer at the acquisition date. Then, earnouts fair value has to be adjusted in each subsequent reporting period over the life of the contract. Empirical evidence suggests that the acquirers' investors are sensitive to the announcement of accounting-based earnout deals, especially after SFAS 141 (R) (Cadman et al., 2014). The auditor verification on fair value adjustments, indeed, assures that the excess returns are more positive for transactions susceptible to disputes over accounting-based performance measures (e.g., deals involving private targets or subsidiaries of public firms) and with targets operating in high-growth industries and with more employees. The presence of a Big Four auditor strengthens this conclusion (Allee & Wangerin, 2018). In addition, the recognition of earnouts fair value adjustments is negatively associated with the decision of the acquirer to impair goodwill. Thus, in earnouts deals, goodwill impairments are more likely to be timely and relevant (Cadman et al., 2014).

Despite the large number of studies that examine the impact of earnouts on acquirers' perspective, very few studies provide evidence of their effects on the target company and corporate governance.

Benefits due to earnouts for target companies are investigated in terms of the takeover premium. In acquisitions of private targets and subsidiary targets, earnouts payments are associated with higher premia than in stock or cash acquisitions. Kohers and Ang (2000) calculated that the median premium in earnouts acquisitions of private targets is more than two-and-a-half times the median premium in cash or stock transactions. In earnouts acquisitions of subsidiary takeovers, the median premium is around 1.7-1.9 times the median premium in cash or stock offers. In addition, the higher is the size of earnout or the length of the earnout period, the higher is the takeover premium (Barbopoulos & Adra, 2016). Nevertheless, a difference-in-difference method is used to provide evidence of earnings management in the earnout period. Target managers significantly manage earnings upward by cutting discretionary expenses during earnout periods (Elnahas et al., 2017).

Finally, the effects of earnouts on corporate governance are measured by the percentage of retained target managers. Managers of the target can play a significant role in the realization of the target's value. The expertise of target managers, especially managers with specialized knowledge about the operations of their business, provides a valuable human capital that can improve the success of the acquisition (P. A. Stanwick & S. D. Stanwick, 2001). In that sense, empirical evidence supports the usefulness of earnouts in retaining target mangers beyond the earnout period (Kohers & Ang, 2000). The size of earnouts is higher if earnouts are included primarily to help retain target management. In this situation, target managers stay longer in the post-merger period and the need to account for earnouts fair value adjustments is lower (Cadman et al., 2014). These results confirm the use of earnouts as retention bonuses.

Conclusions and Suggested Future Work

This paper examines empirical findings on the effects due to the use of earnouts in M&A agreement. To this aim, a review of previous empirical studies in the accounting and financial domains is carried out.

The analysis of empirical findings suggests that the use of earnouts contracts provides value gains for the acquirer. Abnormal returns in the short and long term at the announcement of an earnout deal are reported. However, acquirers' investors are not interested in the use of earnouts *per sé*. Previous empirical studies highlight that the positive market reaction of acquirers' investors is associated with the use of earnouts in

specific contexts. Earnouts should be the appropriate method of payment. Earnouts are favorably valued by investors if they are used in acquisitions in which uncertainty exists and the acquirer has potential difficulties in the correct evaluation of the target company. In this context, earnouts can be perceived as a useful mechanism to reduce adverse selection and moral hazard issues. By contrast, the inappropriate use of earnouts could signal to the market that disagreements between merging firms are still unsolved and can increase the risk of future litigation. It is a significant practical implication due to empirical studies on earnouts effects.

Previous studies also highlight benefits for the target company. Earnouts are associated with higher takeover premia. However, empirical evidence of the earnouts effects on the target is still limited. Future research based on the target perspective could improve this stream of literature.

A significant issue needs to be still examined. All reviewed studies explore the acquirers' benefits from a financial perspective, through an examination of stock market performance. Earnouts contracts usually adopt accounting-based performance measures, such as earnings before interest, taxes, depreciation and amortization (EBITDA), net profit, cash flows. In particular, specific goals on accounting performance are required to the target. Therefore, I expect further studies examining the influence of earnouts parameters on the accounting-based performance measures in the post-acquisition phase (Hitt, Harrison, Ireland, & Best, 1998; Tuch & O'Sullivan, 2007; Meglio & Risberg, 2011). This could help to understand if earnouts are useful mechanisms to improve M&A performance, especially in the long run.

In addition, methodology issues need further examination. Not surprisingly all examined papers adopt a quantitative approach based on archival method of investigation. Nevertheless, considering the complexity of M&A transactions and their potential influence on the future performance of involved companies, the use of a qualitative approach may be appreciable. Interview and survey methods may bring out different reasons explaining the expected benefits arising from these contracts and their effects on the success of the acquisition. Finally, a more in-depth examination of the no-US context would improve the generalizability of findings.

During the present study, various issues relating to earnouts effects came into light on which there is a lot of scope for research. Therefore, future research in both accounting and financial domain could productively extend this literature.

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