



# EARN-OUT AGREEMENTS

ICAEW CORPORATE FINANCE FACULTY  
BEST-PRACTICE GUIDELINE 70

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## FOREWORD AND ACKNOWLEDGEMENTS



Getting deals over the line is rarely straightforward, and at certain points in the M&A cycle even beginning a sales process can be a challenging task. This guideline from the Corporate Finance Faculty signposts a mechanism that can help. A properly conceived and constructed earn-out provides reassurance that a fair price will be achieved, for both buyer and seller.

Whatever the most basic textbook would have its readers believe, the value of a business is never simply the sum of its future cashflows. So often, there will be differing views about future prospects. This guideline shows, step by step, how earn-out agreements can be used to secure a good outcome for all parties. To what extent will decisions made by the purchaser impact the future earnings of the business? How should these elements be prescribed, such that all parties are satisfied that the final consideration is not being manipulated?

Experienced corporate finance advisers help inform parties' decisions and support them in negotiations. I am most grateful to Patrick O'Brien, Mark Cunanan, Stephen Diver, Ed Orme, James Moore, Chrissy Wilkinson, Sue Nyman and other colleagues at Grant Thornton for drafting this expert commentary for members of the Corporate Finance Faculty. As always, the faculty's best-practice guidelines aim to be just that, the best in market practice. We do this by ensuring that they are subject to rigorous peer review by our Technical Committee, which includes experts from many leading firms of advisers and principal investors. Thanks are due to the committee, to members Tandeep Minhas and Edward Spencer, Taylor Wessing, and Amrit Mahbubani, Panmure Gordon, and to ICAEW colleagues, for their extensive, and sometimes contrasting input.

While the purpose of this guideline is to set out best practice, it does not seek to prescribe the commercial or legal terms of any transaction. That is where I hand this guide to you, our members. I do so in the hope that you will find its contents useful, possibly even invaluable, when an earn-out is the key to unlocking a deal.

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## INTRODUCTION

### Overview of earn-outs and their importance to transactions

Earn-outs are a form of deferred consideration in mergers and acquisitions (M&A) transactions, which are contingent on business performance or conditions occurring within a specified period after completion of a transaction.

Earn-outs can be an important feature of transactions. They influence value by impacting the final price paid and received for a business. As earn-outs are based on future business performance following a change of ownership, they can be complex to agree, both commercially and contractually.

Earn-outs are not used in all transactions, but they are common and are particularly prevalent during periods of economic uncertainty. They can align the interests of the purchaser and seller in the future value of the target business, given uncertainty about future performance.

This guideline aims to assist principals and advisers in considering how to agree, document and account for earn-outs. It includes general principles and common points for consideration but is not intended to be a substitute for specialist, deal-specific advice.

### Parties to an earn-out

The contracting parties to an earn-out agreement (the principals) will normally be the purchaser(s) and the seller(s) of a business, ie, the parties to the sale and purchase agreement (SPA) that governs the terms of the transaction.

If sellers are exiting the business on completion of the transaction, they will not be able to influence the post-completion performance being measured in the earn-out.

If sellers are remaining in the business, for example as employees, they may have some influence on its operations and performance to achieve the earn-out threshold. For example, they may help to secure a sales contract to achieve a revenue threshold.

However, even where this is the case, the authority to run the business may sit with its new owners. The terms of the earn-out can be designed to encourage the parties to work together effectively for the good of the business.

### When to consider using an earn-out

Earn-outs are particularly useful where:

- the purchaser is acquiring a business in a market or industry where future performance is less predictable;
- the target business is expected to experience significant growth in the near future and the seller wishes this to be factored into the price;
- it is beneficial to retain the expertise and to encourage existing management to ensure the future success of the business; or
- there is a perception gap between the parties in the valuation of the business resulting from different expectations of future performance.

In these circumstances, an earn-out can reduce the purchaser's risk of overpaying based on growth assumptions that do not transpire, while providing the seller with the opportunity to benefit from a strong post-transaction performance.

It is worth considering the implications of the earn-out mechanism, the conditions or performance measures set and how this will play out in a range of potential future scenarios at a relatively early stage in the deal negotiations. Parties will have a greater opportunity to consider reasonable and objective earn-out terms that drive alignment during the heads of terms phase than if these are only considered as part of late-stage negotiations.

A carefully agreed earn-out mechanism can result in a meeting of minds between principals and facilitate a transaction that would otherwise not be successful. A well-structured earn-out can also help drive behaviours that boost the performance of a business post-transaction.

### Earn-outs versus deferred consideration

Besides earn-outs, there are also other forms of deferred consideration. For instance, in some cases deferred consideration is payable contingent on the crystallisation of an asset post-deal. For example, sellers sometimes seek value for tax assets via the completion mechanism. If the parties are unable to agree this, perhaps due to uncertainty about the tax assets being utilised, a purchaser may agree to pass on some value post-deal if and when the cash flow benefit is realised.

Another form of deferred consideration is non-contingent, when a portion of the consideration is deferred for a period of months or in some cases years.

## EARN-OUT STRUCTURES AND METRICS

### Common structures

The most common earn-out structure is effectively an uplift to the headline price based on a multiple of future earnings before interest, tax, depreciation and amortisation (EBITDA). This is because initial headline price offers are often based on an assumed level of normalised EBITDA with an appropriate multiple applied to it. For example:

Description	Amount
<b>Initial enterprise value paid at completion*</b> Based on £10m prior year EBITDA x 10	<b>£100m</b>
<b>Deferred earn-out consideration</b> Based on £1m growth to £11m following year EBITDA (if achieved) x 10	<b>£10m</b>
<b>Total consideration*</b>	<b>£110m</b>

\*The enterprise value will usually also be subject to adjustment arising from the completion price adjustment mechanism that considers the cash, debt and working capital of the business. Please refer to ICAEW's Corporate Finance Faculty Best-Practice Guideline 64 [Completion Mechanisms: Determining the final equity value in transactions](#) for further information.

### Good versus bad earn-out structures

A good earn-out structure is one that reflects the parties' commercial intentions as regards to the proper application of the threshold(s) to the fairly measured results of the business on a like-for-like basis. Threshold(s) and conditions that are realistic, measurable and equitable to both parties would be most likely to result in an accepted outcome.

Examples of bad earn-outs might include those that are poorly drafted in the SPA, require significant judgement to calculate, or drive behaviours that damage the business in the long term, all of which could lead to disputes between the parties.

### Performance metrics

Earn-outs may depend on more than one metric, which may include a combination of financial and non-financial measures. For example, the earn-out could be payable if the target business satisfies a certain level of EBITDA, together with a revenue threshold, and retained X% of customers.

Linking to multiple financial metrics can help ensure the broader business performance is considered. If a seller who retains a key role in the business is motivated solely to meet the revenue threshold, they may prefer to enter low margin contracts to boost the top line. If profits are the primary driver, they may be artificially achieved (such as through cost deferrals), or they could be missed due to expenditure being brought forward.

A variety of profit measures and other financial performance measures can be used for earn-outs, including:

- turnover/revenue
- gross margin
- gross margin %
- EBITDA
- earnings before interest and tax (EBIT)
- profit before tax (PBT)
- operating cash generation.

When the earn-out payments are all or nothing, subject to a specific threshold figure being hit, this can increase the risk of post-deal disputes between the parties, especially if the result is close to the threshold. This is sometimes called a cliff-edge arrangement. An alternative approach is to apply a sliding scale pay-out between an upper and lower threshold, which may reduce incentives for manipulation.

It is worth noting that the further down the earn-out metric is in the profit and loss account, the more scope there is for ambiguity and dispute.

### Other earn-out metrics

While parties will often default to the financial performance threshold that the initial offer price was primarily based on (such as the EBITDA), other thresholds, including non-financial, should also be considered. They are often the underlying drivers of financial performance, although ease and objectivity of measurement should be considered.

Examples include:

- Sales volumes
- New customers/wins
- Number of active customer accounts
- Customer satisfaction ratings
- Customer churn rates
- Progress to net-zero emissions
- New products
- Employees retained

In all cases, the parties should think carefully about whether the selected measures and metrics will incentivise and motivate the right behaviours, or if there is a risk of damage to the business. The purpose of the metrics should be to encourage management to meet realistic and achievable performance goals for the benefit of both parties after the transaction has been completed.

## KEY EARN-OUT CHALLENGES

Earn-out clauses in the SPA are often given significant attention – with good reason. It can be difficult to predict all the changes a business will undergo following a deal and the factors impacting its performance. A purchaser may expect the acquired business to benefit from synergies and their plans to improve the target business.

It can sometimes be difficult to fairly attribute any performance improvements between the pre-existing business and the purchaser's initiatives. The business might be hived up into another part of the purchaser's business, or further acquisitions might be made post-transaction. If the earn-out threshold and associated clauses in the SPA are not drafted carefully, this can increase the risk of disputes. An inappropriate earn-out threshold could encourage the seller's management team to make decisions that boost their chances of meeting the earn-out threshold but are contrary to the long-term success of the business.

If the financial results of the business during the earn-out period are close to the upper or lower thresholds within which an earn-out amount is payable, particularly if a multiple is to be applied in arriving at the price adjustment, this is likely to lead to close scrutiny of the earn-out accounts and potentially a dispute. This is because a small increment in performance could have a disproportionate impact on the amount payable by the purchaser. Such disputes can be costly and could lead to a relationship breakdown between the purchaser and the seller, who may still be in the business.

Lengthy earn-out periods of several years or more can exacerbate such challenges as the business may have changed substantially over that time.

## REFLECTING AN EARN-OUT IN THE SPA

### When to agree earn-out terms

Often a way for parties to agree the key commercial terms of the earn-out is in a heads of terms, which includes SPA terms that have been agreed in principle. At the heads of terms stage, the parties may therefore want to set out key definitions of the relevant measures and the earn-out formula. It may also be useful to include a worked example in the document.

It is advisable for the parties to consult with their respective advisers at the heads of terms stage and consider the effectiveness of the proposed earn-out to achieve the agreed commercial objectives, as well as any key risks or challenges such as the practicalities of implementing and calculating the earn-out.

### Earn-out schedule in the SPA

The earn-out schedule will establish the agreed mechanics and terms of the earn-out. It will normally include:

- the earn-out targets;
- the basis of preparation, including the procedures to be applied in preparing the earn-out accounts that are needed to derive the performance being measured;
- a set of definitions covering the financial and/or non-financial performance measures;
- the calculation or formula to determine the earn-out payment;
- dispute resolution clauses; and
- purchaser and seller conduct clauses during the period over which the earn-out will be assessed.

### Basis of preparation of earn-out accounts

The basis of preparation of earn-out accounts used for the assessment of financial performance measures that will trigger an earn-out payment, and the drafting of related accounting aspects of the SPA, should be approached with care.

### OVERVIEW OF EARN-OUT ACCOUNTS

Earn-out accounts are bespoke financial statements. They often comprise just an income statement covering the earn-out period that shows the relevant calculated financial performance measure, such as adjusted EBITDA, adjusted revenue, or other selected measures

of financial performance for comparison with an agreed target amount. The SPA must establish the principles for how to prepare the earn-out accounts and the relevant performance measure so that the relevant measure for the target business can be compared on a like-for-like basis to the agreed threshold. Financial definitions will explain all bespoke terms and set boundaries for what may be included or excluded from the relevant measure. These definitions will sit within an overall accounting framework, which will establish specific and general accounting principles and procedures that are to be applied to calculate the defined financial performance measure.

### KEY CONSIDERATIONS FOR RELEVANT FINANCIAL MEASURES

The main factor to consider when defining a financial performance measure is establishing clearly what items will be included or excluded. However, depending on the nature of the financial measure being assessed, several definitions may interact to arrive at the relevant defined term. For example, EBITDA is commonly used as a base measure for an earn-out but is not defined in accounting standards, and often does not appear as a line item in an income statement as it is a non-statutory term. A typical definition of EBITDA is the net profit of the company before interest, corporation tax, depreciation and amortisation. The terms within this definition may themselves be defined by a set of earn-out accounts, and may also require a separate definition, if not readily identifiable as a single figure in such accounts. For example, "interest means all interest and finance charges incurred, less all interest and finance income earned, each as reported in the earn-out accounts".

Once the base terms from which the financial measure will be derived are defined, the definition of the financial measure would need to cover any add-backs and deductions. For example, certain revenues and costs may need to be added back or deducted from EBITDA to arrive at adjusted EBITDA, which would be the relevant financial measure for comparison against the benchmark specified in the SPA. Simply taking the reported profit from the financial statements of the target business in the earn-out period (if they correspond to that period) may capture a range of items that are not relevant to the performance against the threshold (such as profits/losses on fixed asset disposals), or matters outside the sellers' control. Or it may capture matters that relate to post-completion changes made by the purchaser that the seller would wish to exclude, such as excessive management

charges from the purchaser's group, or the new purchaser choosing to spend significantly more on marketing than in previous years, which would depress EBITDA to below the amount the sellers would have expected. To avoid an unexpected result in a way that does not inhibit the purchaser from making choices they consider right for the business, adjusted EBITDA might for example include an adjustment to exclude any marketing cost exceeding a specified percentage of revenue for the purposes of assessing the earn-out. The nature of addbacks and deductions will be specific to each deal. Generally, the drafting should favour specificity over ambiguity to avoid a risk of a dispute later on, with the overriding goal of achieving consistency with how the threshold amount was established.

For certain financial definitions, if the financial performance measure being calculated is limited to certain specific items, a narrow definition may be preferable. For example, if the relevant financial measure is revenues of certain products, it might be preferable to define this by reference to revenues from the sale of those products, rather than starting with a broader definition of revenue from which addbacks and deductions are then made. In such a case, it may be preferable to avoid defining financial measures by reference to a set of accounts, such as the statutory accounts or management accounts.

### ACCOUNTING HIERARCHY, POLICIES AND GAAP

The earn-out schedule will establish a set of accounting policies for calculating the defined financial measure and for the preparation of the earn-out accounts if applicable. It is advisable to use an accounting hierarchy to establish the accounting policies and their order of priority in case of inconsistency between the hierarchy of policies.

This hierarchy is similar to that used in completion accounts mechanisms, often in the following order of priority:

- (i) specific accounting policies as set out in the SPA;
- (ii) subject to (i), the accounting policies used in a defined reference set of historical accounts; and
- (iii) subject to (i) and (ii), the relevant generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS) to be applied.

The role of accounting policies is to clarify the accounting treatment for judgemental items where a range of interpretations or values might be regarded as reasonable under GAAP, or if a non-GAAP treatment was preferred to provide the parties with additional certainty and could reduce the risk of unexpected swings in value. An example might be accruals for staff bonuses, where the parties may agree to include an accrual based on the estimated amount payable, even if that accrual would not need to be recognised as a liability under FRS 102. This would be to ensure consistency with the assumptions used in the financial performance benchmark. In addition, specific policies may be required for consistency. For example, where the policy applied in establishing the threshold measure is different from that applied in the reference set of historical accounts, a specific policy is required to override the policy in the historical reference accounts.

The accounting policies as used in a defined set of historical accounts in limb (ii) provide an objective basis and reference point for consistent treatment of items not covered by specific accounting policies. This is normally based on the last statutory accounts of the target business. This means even if these accounting policies and practices change after the transaction, the earn-out accounts can be prepared in the same way as those used at the time of the transaction from which earn-out thresholds were derived.

It is important to identify the relevant GAAP (such as FRS 102 or IFRS) for any item not covered by specific policies that did not feature in the reference set of historical accounts. However, this should not be relied on as the basis for any items involving a significant range of reasonable potential outcomes. This is because the final result would be unpredictable and likely to be disputed if the purchaser's reasonable view causes the financial measure to fall below the earn-out threshold, whereas the seller's reasonable view would mean it exceeds it. It may also be advisable for the parties to agree to freeze the local GAAP or IFRS applied in limb (iii) of the hierarchy to avoid future changes in that local GAAP or IFRS skewing the calculation.

### **Pro forma earn-out accounts**

The basis of preparation, earn-out accounts format and the formula and mechanics for any calculations should be agreed pre-completion and set out in the SPA. It is usually advisable to attach a pro forma (or illustrative) and/or a worked example to the SPA, based on a historical set of accounts, to ensure the definitions function as intended and to minimise the scope for post-deal disputes.

### **Conduct of business clauses**

A conduct of business clause is included mainly for the seller's protection and contains clauses to restrict actions by the purchaser that may deliberately manipulate the business's reported performance during the earn-out period. One of the key aspects that should be included is the identification of the target business, separate from the purchaser's other business. As an example, the conduct clauses may state that the target business needs to be run as a discrete entity and not be merged with any other purchaser-controlled company. Other examples of conduct clauses include requiring that no part of the target business can be sold and that any transactions between the target group and purchaser's group must be on arm's length terms. If a conduct clause is breached, it may also be helpful to set out the consequences on the calculation of the earn-out.

### **Avoiding disputes on earn-outs**

When drafting the earn-out schedule, timely input and insights from the principals and all advisers on the buy and sell side can ensure the earn-out is realistic, achievable, appropriate and practical, and that the legal drafting accurately reflects the parties' intentions.

Given the value of an appropriately considered earn-out schedule and the risk of dispute from a poorly drafted schedule, we encourage parties to proactively consider and discuss the draft earn-out schedule early in the deal process to ensure the parties are reasonably and fairly considering the terms.

Other practical matters may also need to be considered, such as addressing the challenges of measuring the individual performance of a target business post completion where it is immediately integrated into the acquiring company. For example, if the accounting books and records that were maintained pre-signing are amalgamated into the accounting records of a broader business, it will no longer be possible to identify the target company's individual performance. In such circumstances, for earn-out purposes, the purchaser would be required to either keep a separate ledger for the target business or carry out procedures and processes that enable like-for-like earn-out accounts to be produced. In some cases, SPAs contain a requirement for an independent accountant to draw up the earn-out accounts for both parties. In our experience, ideally the draft earn-out accounts would be drawn up by an accountant within the business, who has historical knowledge and direct access to the underlying data.



## TAX TREATMENT OF EARN-OUTS

### Tax considerations for contracting parties

Earn-outs can be a sensitive topic from a tax perspective, which may increase the complexity of negotiations between the purchaser and seller. Inclusion of non-standard earn-out terms can also result in additional tax complexity and costs.

### SELLERS

For sellers who are or have been employees or directors of the target business, earn-outs may be treated as employment income under certain circumstances. Where this is the case, they can be subject to income tax and employee national insurance contributions (NIC) for the employee/director (with related withholding obligations imposed on the employer under the PAYE regime), as well as employer NIC and the apprenticeship levy (which represent an absolute cost for the employer).

Other sellers can normally achieve capital gains tax (CGT) treatment in relation to their disposals, with a significantly lower tax cost. Employees and directors would also be taxed under the CGT regime, unless certain tests are failed.

The incremental cost of not achieving CGT treatment can be significant. Employment income can be subject to combined income tax and employee NIC at up to 47% at the time of writing, with a further employer NIC and apprenticeship levy cost on the employing business of up to 14.3%. This compares to CGT rates of 20%, reducing to 10% where business asset disposal relief (previously entrepreneurs' relief) applies. It is anticipated that achieving CGT treatment will remain important for individual sellers for the foreseeable future and as long as CGT rates are lower than income tax rates.

### PURCHASERS

The tax consequences of an earn-out need to be understood by the purchaser as well as the seller, in light of the previously mentioned PAYE, NIC and apprenticeship levy obligations on the employing business.

The SPA negotiations will therefore be key to ensuring that purchasers are not left with any exposures, particularly where non-standard earn-out terms are

required by individual sellers. It is typical for purchasers to obtain SPA indemnities to ensure that the risk of earn-outs being taxed as employment income are placed firmly onto the sellers. Nevertheless, there are legal limitations on the ability to push employer NIC and the apprenticeship levy onto the individuals receiving an earn-out payment.

The stamp duty cost of earn-outs can also be complicated and will need to be understood by the purchaser.

### Employment income or capital gain

HM Revenue & Customs (HMRC) takes the view that, unless an earn-out received by an employee/director is further consideration for the sale of shares (or the underlying business in the case of an asset sale), it should be viewed as received by reason of employment.

HMRC has released [guidance](#)<sup>1</sup> that provides indicators of when amounts received may be classified as employment income. However, it is worth noting that none of these indicators are determinative and so the appropriate tax treatment needs to be considered on a case-by-case basis.

Although there is no clear rule for when an earn-out consideration may be regarded as employment income, tax advisers have developed rules of thumb in this area. These include elements such as the length of time the seller must remain an employee after the transaction has taken place. However, to reach an appropriate conclusion, a holistic assessment of all the factors around a particular disposal would need to be undertaken.

Where third-party investors receive elements of the earn-out consideration on the same terms as existing management/employee shareholders, this is typically a strong indication that HMRC should treat this as consideration for the sale of shares and not as employment income. This would also be the case if any of the management/employee shareholders were to cease their employment relationship shortly after the receipt of the earn-out consideration.

The following list is a summary of key HMRC indicators of an earn-out being sale consideration and therefore subject to CGT only. It should be noted that this is a non-exhaustive and indicative list only.

1. [gov.uk/hmrc-internal-manuals/employment-related-securities/ersm110940](https://www.gov.uk/hmrc-internal-manuals/employment-related-securities/ersm110940)

1. The sale agreement clearly demonstrates the earn-out is consideration given for securities in the company.
2. The value of the earn-out reflects the value of the securities given up.
3. Third-party investors and employee/management shareholders receive any earn-outs on the same terms.
4. The earn-out is not a substitute for full remuneration for continued employment within the company.
5. The earn-out is not conditional on future employment (beyond a reasonable requirement to stay to protect the value of the company).
6. There is no personal performance threshold within the earn-out.

To mitigate any potential risk, the sellers can apply for non-statutory clearance from HMRC. However, it is worth noting that HMRC is not bound to reply to a clearance application unless there is a "genuine point of uncertainty". There is also no statutory deadline to respond, although HMRC endeavours to respond within 28 days of submission.

Applying for clearance is not the only course of action and sometimes reliance is instead placed on advice from professional tax advisers, for example, where there is limited time to conclude the deal, or nervousness around leaving HMRC to opine. However, given the various factors that need to be considered in the guidance, advisers may not always be able to provide an unqualified view.

### PROTECTION FOR PURCHASERS

In light of the potential uncertainty, purchasers often include clauses in the SPA to provide protection. For example, they may:

- outline a process for determining the status of the earn-out, including the requirement to seek a non-statutory clearance application;
- provide a dispute resolution process in the event the purchaser and seller do not agree;
- establish which party will bear any tax costs and, to the extent that this is the seller, provide for an adjustment of the earn-out payment to enable effective recovery under any indemnity; or
- establish which party will benefit from any corporation tax deduction that will accrue to the target as a result of the earn-out payment being taxable as employment income and, where possible under the SPA mechanics, provide for this in the price adjustment mechanism.

### CGT treatment

Where the earn-out is not taxed as employment income, it should typically fall within the CGT regime. CGT on earn-outs is a complex area and not as relevant to the SPA negotiations, as the recipient of the earn-out payment will need to self-assess their CGT in their tax returns.

The main relevance to the SPA is requests the sellers may make for changes in the earn-out structure to accommodate their tax requirements. There are various forms of deferred consideration, each of which has a specific CGT treatment.

For a typical earn-out where the consideration is 'unascertainable' at completion, the sellers would need to value the deferred consideration entitlement at completion and report this amount as taxable at the time of the sale in the tax return for the tax year of the transaction. The tax is typically payable in this tax return irrespective of the timing for payment of the deferred consideration. On actual receipt of the earn-out, the individual will either be taxed on any additional receipt beyond that which was assumed in the initial tax filing, or crystallise a capital loss.

Other earn-out styles may comprise a maximum amount that is 'ascertainable' at the time of completion, such as a fixed sum payable dependent on a particular future event. In this instance, CGT is payable upfront on the maximum amount of consideration.

Depending on the structure, the seller may have to pay tax on proceeds that are yet to be received, and may never be received, although there is a facility for adjusting the consideration or losses to be carried back in some cases. As such, sometimes the seller will want an earn-out structure that defers payments that are unascertainable to a future time to reduce the upfront valuation.

Other sellers may wish for the maximum valuation to increase the element that may be entitled to the lower business asset disposal relief rate of CGT. This is typically only available on the completion payments.

To address the issue of unfunded CGT charges in general, a seller may ask for the earn-out to be satisfied through an entitlement to securities instead of cash. Some or all of the earn-out gain may then be rolled over into the earn-out right and subsequently into the securities, thereby deferring the gain for CGT purposes. The purchaser may also prefer this to preserve their cash. There are various alternatives for how this may be structured and potential tax elections for those who prefer early tax charges, but at a lower rate.

### Stamp duty considerations

In general, it should be assumed that the earn-out forms part of the consideration for the shares chargeable to stamp duty. However, the basis on which the current 0.5% stamp duty charge is payable on the earn-out element of a share acquisition will depend on the precise terms of the earn-out.

The financial structure of the earn-out, including any caps on the payment and any wholly variable amounts, may affect the extent of earn-out consideration that may be chargeable to stamp duty.

## ACCOUNTING FOR AN EARN-OUT IN THE STATUTORY ACCOUNTS

### Accounting for earn-outs under IFRS and FRS 102

The accounting treatment of an earn-out is dependent on which GAAP is applied. We will first consider Financial Reporting Standard (FRS) 102, before considering the differences in accounting under UK-adopted international financial reporting standards (IFRS).

A key area when assessing the accounting treatment under FRS 102 is whether the arrangement contains any bad leaver clauses that restrict the price at which shares can be sold for upon employment ceasing. In the absence of specific requirements in FRS 102, there is a rebuttable presumption that if the amount of consideration is linked in any way to continued employment, then that element of the consideration must be considered employee remuneration rather than contingent consideration. Under IFRS, an International Financial Reporting Interpretations Committee (IFRIC) agenda decision issued in January 2013 provides some clear direction as to what should be done.

The IFRIC states that an arrangement in which contingent payments are automatically forfeited if employment terminates would lead to a conclusion that the arrangement is compensation for post-combination services rather than additional consideration for an acquisition unless the service condition is not substantive. This means that it is imperative to fully assess and understand the terms of the SPA and any other side agreements that may be in place, as the accounting outcome can substantially change based on a few key terms.

A requirement for continuing employment is a binary indicator. If there are continuing employment clauses, the earn-out is remuneration, but in the absence of such clauses there are other important considerations.

These include:

- duration of continuing employment;
- level of remuneration (excluding contingent payment);
- incremental payments to employees;
- number of shares owned;
- linkage to valuation of non-contingent amounts paid; and
- formula for determining consideration.

The outcome of these considerations is not binary and the results of the assessment must be considered as a whole. Each consideration requires judgement: for example, when assessing the level of remuneration, the level of remuneration to selling shareholders must be assessed against other key employees. In more senior roles, this may be challenging if there are no comparable employees, and management must apply judgement to each consideration.

In the absence of continuing employment clauses, the assessment of whether earn-outs are consideration or remuneration can require significant management judgement. These may need to be disclosed as such in the significant judgements and estimates note of the financial statements.

Assessment of payments to selling shareholders requires an understanding of why the contingent consideration is included in the agreement, which party (the target or the purchaser) initiated the arrangement, and when the parties entered into the arrangement. The nature of the arrangement dictates whether contingent payments to selling shareholders that become employees of the combined entity are contingent consideration in a business combination or separate transactions. There are instances where the earn-out is partly contingent consideration and partly remuneration. In this instance, the estimated earn-out amount must be allocated to each element based on the terms of the SPA.

If the earn-out is remuneration, another accounting judgement that will need to be determined is whether the earn-out is accounted for as an employee benefit expense or as a share-based payment. For this determination, the criteria within FRS 102 Section 26 Share-based Payments are followed.

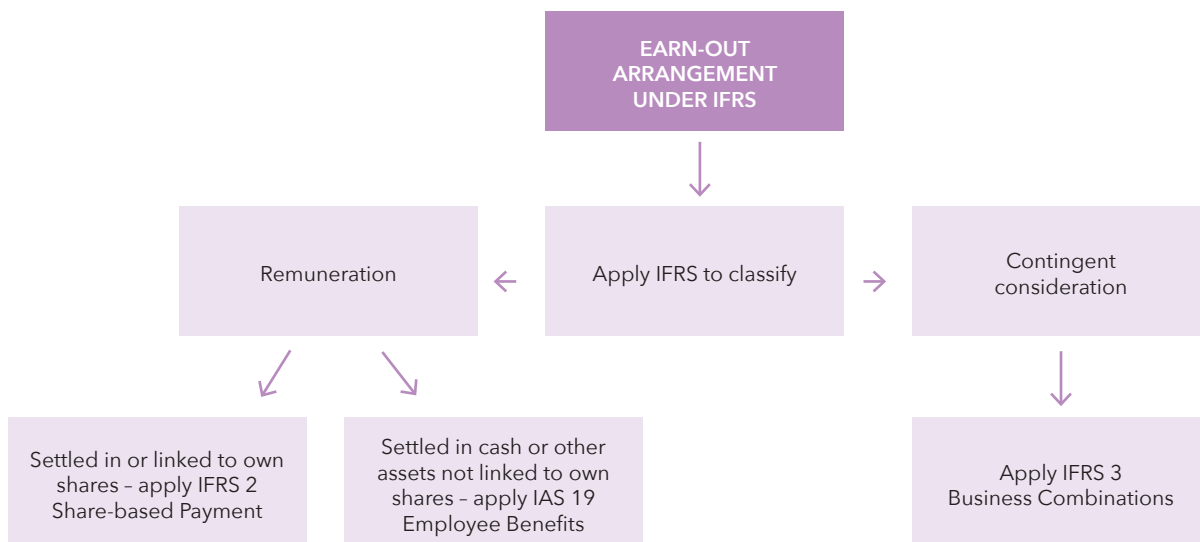
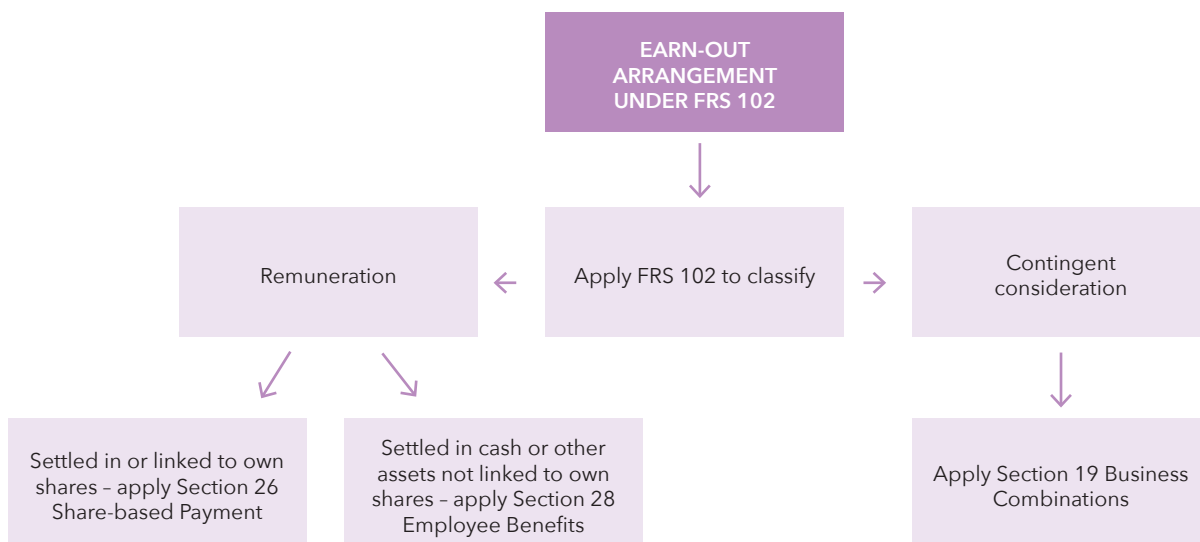
Payments that are consideration are part of the business combination. Payments that are for employee services are post-combination remuneration expenses

that will be charged to the combined group’s income statement as an employee benefit expense or share-based payment.

**Impact of the accounting treatment**

One of the key accounting impacts of earn-out arrangements is that remuneration will be recognised as an expense within the statement of profit or loss (IAS 19 Employee Benefits and Section 28 Employee Benefits in FRS 102), whereas contingent consideration

is recognised in the balance sheet as an additional component of the initial cost of investment (company only accounts) or goodwill (consolidated accounts). IFRS and FRS 102 require the amount of contingent consideration to be recognised initially as a liability in the purchaser’s financial statements. This liability must be measured at fair value on the date of acquisition, which may need to be determined by a third-party valuation expert. Subsequent measurement depends on the classification.



**EARN-OUT PAYABLE IN CASH**

An earn-out payable in cash meets the definition of a financial liability. It is re-measured at fair value at every balance sheet date, with any changes recognised against the cost of investment (FRS 102) or in the income statement (IFRS).

**EARN-OUT PAYABLE IN SHARES**

Under both IFRS and FRS 102, earn-outs payable in ordinary shares may not require re-measurement through the income statement. This is dependent on the features of the earn-out and how the number of shares to be issued is determined. An earn-out payable in shares, where the number of shares varies to give the recipient of the shares a fixed value, would meet the definition of a financial liability. As a result, the liability will need to be fair valued at each reporting date and any fair value movements recognised in the profit or loss. Conversely, where performance dictates whether a fixed number of shares will or will not be issued, regardless of their fair value, the earn-out most likely meets the definition of equity and so is not re-measured through the profit or loss.

If the structure involves the shareholders of the target entity, IFRS 2 Share-based Payment and Section 26 Share-based Payments in FRS 102 may apply.

How share options are accounted for depends on the conditions attached to the award and whether existing options held by the employee in the acquired business are being replaced. Options are likely to be consideration for post-acquisition service where some of the payment is conditional on the shareholders remaining in employment after the transaction.

In such circumstances, a charge is recorded in post-acquisition earnings for employee services. These awards are made to secure and reward employees' future services rather than to acquire the existing business.

The financial consequence of earn-outs may have wide-ranging implications. The purchaser will need to consider the valuation of the earn-out and its impact on the balance sheet, particularly its impact on any financial covenants. In addition, the purchaser needs to understand the timing of payment for any potential earn-outs. If the company expects to be in growth mode with limited working capital available when an earn-out payment is due, this could cause undue stress to be put on the company to meet this obligation.

**Difference between IFRS and FRS 102**

Although IFRS is broadly aligned with FRS 102 in differentiating between remuneration and contingent consideration, and initial recognition, there is a key difference in subsequent measurement. Under IFRS, any changes to the fair value of the contingent consideration must be recognised in the statement of profit or loss. Unlike under FRS 102, it cannot be accounted for as an adjustment to either the cost of investment in company-only accounts, or goodwill in consolidated accounts. This may result in volatility in the profit or loss account, so it should be considered when assessing the earn-out arrangement.

**Proposed changes to FRS 102 impacting earn-outs**

In Financial Reporting Exposure Draft 82 (FRED 82), the Financial Reporting Council (FRC) has proposed amendments to FRS 102 that may have a significant impact on accounting for revenue and leases. This in turn could impact proposed earn-out arrangements as these are often linked to EBITDA or revenue threshold. FRED 82 is expected to be effective for periods beginning on or after 1 January 2026.

In terms of revenue recognition, businesses with long-term contracts, or which sell software licenses or provide services, are most likely to be impacted by these changes. Promises within the revenue contract will direct the accounting conclusion on whether revenue can be recognised over time, or at a point in time. This may lead to significant changes to the way revenue was previously recognised. Current FRS 102 guidance focuses on when risks and rewards are transferred to the customer, rather than when promises under the contract are fulfilled.

A business where the entity is a lessee in an operating lease arrangement will most likely see substantial changes to their EBITDA figures and balance sheet presentation because of these proposed amendments. Entities with lease portfolios of retail spaces, vehicle fleets, or other such properties will be significantly impacted. Operating profit and EBITDA will likely increase, as part of the cost of the lease will now sit in finance costs and depreciation charge, and both gross assets and liabilities will increase as a result of the on-balance sheet lease commitments. As a result, it is important to either freeze the GAAP as at the date the SPA is signed, as discussed earlier, or to accurately forecast FRED 82's expected impact and factor this into the earn-out thresholds. The former is likely to be simpler to agree but may require adjustments in the earn-out accounts versus the financial reporting at the time.

## CALCULATING AND DETERMINING AN EARN-OUT

Given that future performance is unknown at completion, and it is subject to different factors with varying degrees of control and predictability by the parties, it is important for the purchaser to mitigate the risk of disputes by setting up the appropriate processes and procedures for preparing the earn-out accounts and performing the earn-out calculation immediately following completion.

### Processes for preparing earn-out accounts

As a first step, engaging and educating the relevant finance team members on the requirements governing the earn-out accounts and earn-out calculation is important so that they are knowledgeable on the earn-out accounting principles and conduct of business. The earn-out accounting principles may differ from those used in the statutory or group financial reporting, while the conduct of business may have an impact on how the earn-out will be calculated if there are any breaches during the earn-out period. This step is especially important if they have not been involved in the M&A process, including the agreement of the earn-out schedule in the SPA.

Purchasers can consider maintaining a separate set of books if it is determined that there will be significant deviations between the earn-out accounts and the statutory or management accounts. This will be the case in many situations, given the earn-out accounting principles may set out specific accounting policies agreed between the parties or even freeze the GAAP framework to be applied in the earn-out accounts. This will be different from the acquired company's statutory or management reporting, which is subject to GAAP changes or accounting policy changes or adoptions.

Ultimately, the parties should ensure that they are familiar with the details of the agreed basis of preparation and the implications for expected future results, in terms of how certain key components will be treated.

### Ongoing communication during the earn-out period

The parties may agree to share more regular pro forma earn-out accounts prepared on an equivalent basis in order to monitor significant deviations from expectations and discuss any incorrect treatment affecting the calculations in a timely fashion, rather than waiting until the end of the period once earn-out accounts have formally been issued.

Ongoing communication between the parties during the earn-out period is essential. It can help mitigate potential disputes and address issues as they arise, when the parties' attitude to the appropriate treatment may still be tempered by the need for continued co-operation.

This will also prevent disputed matters from coming to a head all at the same time when positions may become more entrenched once the full impact on the consideration is known.

This is particularly important when there is going to be significant integration of the acquired company after completion, such as sharing of customers and/or suppliers, changes in the organisational structure and people. In these instances, we encourage purchasers to take a proactive approach in carefully assessing the impact of such integration activities and agreeing with the seller how they will impact the earn-out calculation.

We often see many purchasers facing significant challenges in measuring the individual performance of the acquired business as it has been fully integrated operationally and financially into the acquiring company.

In practice, many purchasers fail to maintain separate records of the acquired entity from the purchaser's group during the earn-out period. Instead, closer to the end of the earn-out period, or even immediately after, the finance team is tasked with working backwards to produce the earn-out accounts from the statutory or management accounts of the acquired company.

In some circumstances, operational or structural changes to the acquired company following the acquisition are made without regard to the potential impact on the earn-out.

Depending on the significance of the operational or structural changes, measuring the performance of the acquired entity during the earn-out period may be significantly hindered and will require more effort from the purchaser to construct the pro forma impact on the earn-out calculation.

### Obtaining comfort over unaudited earn-out accounts

A purchaser and seller would prefer to base the earn-out calculations on figures coming from a set of audited earn-out accounts. However, the parties should bear in mind when the SPA is being agreed that it is unlikely that the audited accounts will be available quickly after the end of the earn-out period, and

this could delay agreeing the earn-out. Even where audited accounts are available in time, they cannot be governed by the SPA or prepared and adjusted in accordance with its terms.

Getting comfort over the earn-out accounts is essential, especially if the earn-out accounts are not underpinned by audited accounts. Both the purchaser and the seller typically have a single opportunity to put forward their position on the earn-out accounts and earn-out calculation in the purchaser's submission notification and the seller's agreement or dispute notification, respectively.

This is particularly important if the financial results of the business during the earn-out period are close to the upper or lower thresholds within which an earn-out amount is payable, as this is likely to lead to much closer scrutiny of the earn-out accounts and potentially result in a dispute.

In the end, it is the common objective of the parties to achieve the best results during the earn-out period. In instances where the results are borderline, it is important to mitigate the risk of disputes by having robust reporting and monitoring processes for preparing the earn-out accounts and ongoing communication between the purchaser and the seller during the earn-out period.

## EARN-OUT CONSIDERATIONS OUTSIDE OF THE UK

Earn-outs are a common feature of M&A transactions around the world and serve a similar purpose regardless of the territory in which they take place.

With recent global events such as the Covid-19 pandemic, the war in Ukraine, inflation and rising interest rates, the performance of companies across the world has been adversely impacted and, in many ways, has become less predictable.

Earn-outs have become prevalent in global markets as a way for purchasers to reduce the risk of overpaying based on growth assumptions that may never be realised.

In some situations, earn-outs may be particularly useful when a purchaser is acquiring a business in an emerging market where future performance has yet to be proven. Whether in an established or an emerging market, earn-outs are most commonly used in the technology and communication, consumer products and healthcare and life sciences sectors, with

purchasers and sellers in these sectors mainly using EBITDA and revenue-based measurement bases.

As long as adverse global events continue and affect the performance of companies, the use of earn-outs will increase beyond the companies, sectors and territories where they are common.

## ADDITIONAL CONSIDERATIONS FOR LISTED COMPANIES

Earn-out mechanisms that involve public quoted companies buying or divesting businesses will generally have the characteristics described in this guideline for private companies. However, public companies will need to consider further matters relating to the ownership structure when entering into an earn-out.

Information and the market's perception of that information is important to public companies as it can impact their share price valuation. On the one hand, the disclosure of an earn-out could be viewed favourably as it may reduce the execution risk of return on a transaction by aligning the parties' goals and linking part of the price to the performance of the subject business. On the other hand, an earn-out creates uncertainty on the final consideration to be paid or received for a transaction. This could create a possible overhang to the share price and makes assessing its future return and whether it will be 'value accretive' more subjective.

Public companies must report more financial information more frequently than private companies, and to a wider audience of stakeholders. As described earlier, earn-outs can have a significant impact on the accounts of a purchaser or seller, including assets and liabilities, profit on disposal or cost of acquisition. When considering an earn-out structure for a deal, public companies will want to understand the effect on their statutory accounts.

Another aspect to consider is if the public company is required to publicly disclose details of an earn-out on an acquired business, this might be sensitive to the recipient of the earn-out. This could prejudice the use of an earn-out for the transaction. The earn-out may also need to be considered as part of the transaction consideration for listed companies, which could impact the classification of a transaction and ultimately whether the transaction

is subject to a shareholder vote or other regulatory obligations. This increases the execution risk and could delay the entire transaction.

These aspects should be considered and discussed with the public company's advisers, alongside other matters set out in this guideline.

## RESOLVING DISPUTES

As earn-outs can be based on performance measures a year or more after completion, parties must do their best to anticipate any potential planned or unplanned matters that might affect the performance of the business post-transaction, which are not known about at the time the SPA was signed. Such matters will often require complex drafting of the mechanism and can take a while to negotiate and agree. It is worth investing time pre-deal to ensure everyone is in agreement as earn-outs are inherently contentious and remain the most disputed area of transactions alongside completion accounts.

### Causes of disputes

Some of the most frequent causes of earn-out disputes are:

- ambiguity in the SPA drafting of the earn-out clauses;
- differing interpretation of how the performance measures should be calculated in accordance with the SPA;
- changes in the business during the earn-out period affecting the measurement; and/or
- allegations by one of the parties that there has been accounting manipulation, or that the business has been operated in a way that breaches the earn-out protection provisions in the SPA.

Parties will often disagree about which elements should be included in the earn-out accounts, particularly for items arising post-deal for which there is no specific policy or precedent. Definitions of financial measures (eg, adjusted EBITDA) often contain points of principle such as "non-recurring and exceptional items will be excluded". However, parties may not agree on the application of such principles to the specific items that arise in the earn-out period.

Issues can also arise if the target business has been transitioned to the purchaser's policies for internal and/or external reporting purposes and the approach is

different to what it would have been under the seller's policies. This can make preparation of the earn-out accounts more complex and may lead to a dispute if the SPA does not clearly set out which policies to follow.

Disputes can also arise in relation to the treatment of post-deal structural changes, such as the replacement of the target's IT, HR or accounting functions, and associated costs, with 'equivalent' purchaser-provided services and recharged costs. Equally, the treatment of any savings achieved as a result of business integrations should be considered and the SPA should set out how such savings will be accounted for.

Should a business fail to meet the earn-out threshold, a seller who no longer has operational control of the business may allege that it has been run in such a way as to intentionally reduce the prospects of having to pay the earn-out. The seller may accuse the purchaser of changing the product, pricing or other terms, deferring the recognition of revenues, or deliberately overspending on discretionary areas. Such actions will depress results in the short term, which the seller may say should be excluded due to the longer term financial benefit to the business and purchaser.

Conversely, a purchaser may believe that the previous management deliberately underspent in discretionary areas, such as training, marketing or advertising, or accelerated the recognition of revenues in the run up to the transaction. Such actions would have the short-term impact of boosting results within the earn-out period, but may have an adverse effect in the longer term. The potential for such acts should be considered when undertaking due diligence and taken account of in the SPA if identified.

### Dispute resolution process

Careful drafting of the SPA, including defining specific foreseeable situations within the agreements, can help to reduce the likelihood of disputes about how the earn-out consideration should be calculated. However the risk cannot be eliminated and the agreement should provide a clear dispute resolution process.

The SPA's dispute resolution clauses should set out the steps as agreed by the parties. If the reviewing party (most commonly the seller following preparation by the purchaser) does not agree with the prepared earn-out accounts, a dispute notice will be issued. In the SPA, the parties should consider including the specific details that such a notice should cover, such as the reason for the dispute, the amount in dispute and the amount they believe to be correct (where possible),



along with the timeframe in which the notice is allowed to be issued. Caution should be exercised when including very prescriptive obligations for the detail to be included in a notice as the courts are unlikely to be sympathetic to a party that has issued a defective notice. A balance should be struck between allowing sufficient time for the parties to negotiate between themselves (including through internal escalation to management) and try to reach agreement on some, if not all, of the disputed items, while preventing one party from delaying resolution by allowing the timetable to stretch without sanction, or making delay unappealing by including the potential for interest to be payable.

If the parties are unable to agree on the earn-out amount between themselves within the specified timeframe, any remaining matters in dispute are commonly referred to an independent accountant for expert determination. Expert determination by an independent accountant is usually a quicker and cheaper way to resolve the earn-out dispute than through formal court or arbitration proceedings.

It is often useful for the SPA to be prescriptive in identifying an expert, for example including that it should be an accountant with a certain number of years post-qualification experience, or be from a defined list of firms. The SPA may include a mechanism for the parties to agree between themselves on the identity of the independent expert. If they cannot agree in a defined time period, they can turn to ICAEW, which requires a joint application from the parties. There is a fixed fee for the service of identifying an expert.

Dispute resolution clauses often prescribe aspects of the expert determination process, but parties should bear in mind that this will be superseded by the terms of the joint engagement of the independent accountant if different. The SPA should clearly define the independent accountant's role and jurisdiction, usually limited to any unresolved items that were originally set out in the dispute notice. Disputes often arise over the scope of disputed items that may be agreed or referred for expert determination, for example whether a party is prevented under the SPA from raising or amending a particular disputed item or if they are out of time. If a disputed point turns on the construction of the contract, the independent accountant may appoint legal counsel to advise them on the legal issues, at the parties' cost.

Parties should also consider including drafting clauses that stipulate the allocation of the expert's fees, for example to be split between the parties 50/50, and whether the expert determination should provide reasons for why a relevant decision has been made on an issue-by-issue basis, or just the outcome. A non-speaking/unreasoned determination offers some time and cost savings, but provides very limited opportunity for either party to challenge the determination. A speaking/reasoned award is more open to challenge by the parties as they have more information from which to identify possible grounds for a challenge. Those potential grounds will either be specified in the SPA or, in the absence of this, will be limited to manifest error, partiality or fraud.

### **Expert determination procedure**

As mentioned, the exact procedure will be determined between the parties and the independent accountant and will be set out in the independent accountant's letter of engagement. It is important to ensure the requirements of the independent accountant (including timescales for preparation and review) are reasonable and achievable by all involved, otherwise one party may find they are unable to comply, leading to procedural uncertainty and potential additional costs from side disputes.

The standard procedure is for parties to make written submissions to the expert, which should include all relevant explanations, facts, evidence and legal and/or accountancy opinion relevant to the matters to be determined. The expert will exchange each party's submission and the process will usually then allow each party to provide a written response to the other's submission. There can be exceptions, for example sequential submissions, but this is less common.

Following submissions, the independent accountant will have the option to ask questions or to request further information from the parties. Typically, these are written questions and answers, but oral hearings may occasionally be required if the written submissions are insufficient.

The parties commonly agree that the decision of the expert determiner is final and binding on the parties (except in the case of manifest error or fraud). In practice this means the expert determination process offers certainty in the finality of the outcome.

## CLOSING REMARKS

Earn-outs are increasingly common in M&A transactions in the UK and overseas and can help facilitate deals.

### **Key considerations for a successful earn-out**

- Parties and their respective advisers should work together early in the transaction process to agree the earn-out terms.
- The use of clear and unambiguous language in the SPA is vital for the earn-out's success and to reduce the chances of a dispute.
- The metrics to be measured, their timeframe and the earn-out thresholds should be carefully considered in the context of the purchaser's post-deal plans for the business.
- Taxation of earn-outs can be complex, particularly where paid to current or former employees, and certain earn-out provisions can leave the recipients with significantly less cash after tax.
- The impact on each parties' statutory accounts as purchaser and seller should be considered pre-transaction, especially where one party is a publicly quoted entity.
- In case a dispute arises, it is crucial that the SPA specifies a proper resolution process with referral of disputed items to an independent accountant.

A successful earn-out is one that reflects the parties' commercial intentions and ensures the business's post-transaction performance is measured fairly and on a like-for-like basis against the agreed thresholds, with the business benefiting from the alignment of the parties in maximising those results.

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### About Grant Thornton's Sale and Purchase Agreement Advisory team

Grant Thornton's SPA Advisory team combines completion-mechanism adjustment and dispute specialists to help principals and advisers reach an agreement on the SPA, completion accounts and earn-out accounts – protecting real monetary value, while reducing the risk of disputes. This specialist expertise is available for both domestic and cross-border transactions, across a full range of sectors.

### About Grant Thornton UK LLP

Grant Thornton in the UK is led by 200+ partners and employs over 5,000 people. Globally, we add up to 68,000 people in over 140 countries. We use this partner-led approach to offer our clients a unique experience, leveraging our global reach. Our Deals practice embodies these values with subject matter experts in all areas of the transaction lifecycle.

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Chartered accountants are talented, ethical and committed professionals. ICAEW represents more than 202,450 members and students around the world. All of the top 100 global brands employ ICAEW Chartered Accountants.\*

Founded in 1880, ICAEW has a long history of serving the public interest and we continue to work with governments, regulators and business leaders globally. And, as a world-leading improvement regulator, we supervise and monitor around 12,000 firms, holding them, and all ICAEW members and students, to the highest standards of professional competency and conduct.

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We believe that chartered accountancy can be a force for positive change. By sharing our insight, expertise and understanding we can help to create sustainable economies and a better future for all.

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\* includes parent companies. Source: ICAEW member data March 2023, Interbrand, Best Global Brands 2022

## ABOUT THE CORPORATE FINANCE FACULTY

The Corporate Finance Faculty is ICAEW's centre of professional expertise in corporate finance. It contributes to policy development and responds to consultations by international organisations, governments, regulators and other professional bodies. It provides a wide range of services, information, guidance, events and media to its members, including its highly regarded magazine Corporate Financier and its popular series of best-practice guidelines.

The three major themes for the faculty's initiatives are: Global Investment and M&A; Innovation and Sustainable Recovery; and Future Advisory Professionals.

The faculty's international network includes member organisations and individuals from major professional services groups, specialist advisory firms, companies, banks and alternative lenders, private equity, venture capital, law firms, brokers, consultants, policy-makers and academic experts. More than 40% of the faculty's members are from beyond ICAEW.

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