PERSPECTIVES

GAAP Compliance and an M&A Selling Party's Closing Date Balance Sheet

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

INTRODUCTION

Post-acquisition Mergers & Acquisitions ("M&A") disputes are often caused by the timing of a transaction closing and the subsequent true-up of the estimated closing date balance sheet. However, with adequate planning and proper draftsmanship, sellers and buyers can minimize the effect of those items that are the subject of disputed working capital calculations and contested escrow distributions, post-Closing.

GAAP COMPLIANCE

Most M&A activity involving at least one U.S.-based transaction party utilizes "GAAP" (generally accepted accounting principles) as the identified basis of financial statement preparation. It therefore stands to reason that the typical post-Closing balance sheet dispute (i.e., working capital), can be attributable to the target company's lack of closing accounting rigor, the compressed timeline of a transaction closing, and the typically lean infrastructure of the target's accounting and finance staff.

Contributing to the dollars at stake in these often-significant disputes are the divergent judgements of the buyer and seller as to what it takes to comply with GAAP pre-Closing versus post-Closing, the competing objectives of the financial stakeholders, and the information learned about pre-Closing estimates well after the transaction has closed.

COMMON FACTORS LEADING TO DISAGREEMENTS

While there are several techniques that can be applied to minimize working capital calculation disagreements between a buyer and seller in M&A, it is important to understand the causes are not typically nefarious financial statement misrepresentations, opportunistic purchase price recalculations, or the misapplication of overly complex accounting guidance.

Rather, these differences can most often be attributed to the sequence of events leading to the derivation of the closing balance sheet and the post-Closing true-up. In particular, during a transaction closing, the selling party or target is tasked with preparing an estimated closing balance sheet. This event doesn't occur in accordance with a traditional reporting period, such as a quarter- or month-end, but instead can take place at any time.

In addition, the preparation of the closing date balance sheet and the closing date often happen simultaneously. This timeline will, therefore, naturally bypass most recurring period-end financial reporting processes a company may follow at a traditional reporting period-end.

For example, Accounts Receivable reserves may not have been updated since the last set of financial statements were prepared. Similarly, an assessment of the value of inventory on-hand or an analysis of open but unreceived vendor invoices may not have been completed on that hypothetical Thursday evening during the week of July 4, when the parties struck their deal and agreed to close.

While this compressed closing timeline can pose challenges to GAAP compliance, one must also recognize that target companies are often in a state of growth and expansion, guided by an entrepreneurial visionary whose emphasis has been on product development and market share, rather than asset valuation, period-end cutoff, and the revised revenue recognition guidance.

So, how does one minimize the impact of this compressed timeline and potential absence of financial reporting depth?

TECHNIQUES FOR REDUCING THE LIKELIHOOD OF DISPUTES

One technique requires the target company to negotiate for the preparation of non-GAAP closing financial statements for certain financial statement line items. This will undoubtedly require a skilled M&A attorney's draftsmanship and some negotiating creativity, but by excluding or carving out select account balances from the closing working capital estimation and subsequent true-up process, transaction parties can reduce the likelihood of a post-Closing dispute based on allegations of under- or over-stated current liabilities and current assets.

There are also techniques that selling parties can apply to address the preparation of an estimated closing balance sheet within a compressed timeline. One of these is analogous to a dress rehearsal in theatre. By preparing for and rehearsing an abbreviated period-end close, finance and accounting staff can reduce the rigor of their recurring period-end analyses to those working capital accounts that are most material to the balance sheet, and accordingly, present an increased likelihood of post-acquisition disputes. For example, product inventory in the case of a manufacturer or retailer, short-term lease obligations for a capital-intensive target, and recurring vendor liabilities. By focusing their analysis on significant, recurring working capital account balances, the parties will not only reduce the likelihood of disputes surrounding current asset and liability balances, but they may also limit the often-associated "P&L effect" alleged in conjunction with an asserted balance sheet misstatement.

Finally, when calculating closing date balance sheets from which working capital is derived, it is important to keep in mind that "GAAP-compliance," in the case of a transaction target's period-end balance sheet, is an account-by-account analysis. The purchase price determination does not benefit from the same "financial statements taken as a whole" materiality concept applied by auditors, and every dollar adjustment to estimated closing working capital will impact the consideration paid by buyers to sellers. Accordingly, by negotiating certain non-GAAP exclusions and rehearsing for a focused account closing, selling parties will minimize the likelihood of significant purchase price adjustments.

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