Post-Acquisition Disputes:

Common Pitfalls and How to Avoid Them

by Bradley J. Preber

Business owners and executives go to extraordinary lengths to make sure that the sale or purchase of a business is successful. Nevertheless, many of these transactions result in litigation or arbitration to resolve a post-acquisition dispute. Sometimes this occurs because the transaction was poorly designed. Sometimes there were untrue or misleading representations. Sometimes there was "a clash of corporate cultures." But a surprising number are the result of misunderstandings about common accounting terms.

Many purchase and sale agreements call for the seller to prepare financial statements for the business to be sold. These financial statements normally include a balance sheet reflecting the assets and liabilities on, or near, the closing date, and statements of operations and cash flows for the period immediately prior to the closing date. These statements may be audited by an independent accountant.

It is common for the buyer to prepare its own financial information for the purchased business sometime after closing has occurred. In some cases, this information is limited to a balance sheet; buyers commonly compare their balance sheet to the seller's as a way to determine if the purchase price was fair.

In certain circumstances, the buyer may prepare a more complete set of financial statements, including a balance sheet together with income and cash flow statements for a defined period of time after closing. This would be typical for transactions including earn-out provisions.

Earn-out provisions provide for supplemental payments to sellers, or to the executives of seller entities, as incentives to remain involved in the business after the sale, or to secure anti-competition agreements or other promises. Earn-outs are often based on financial performance after the sale and purchase agreement is signed. For example, earn-out bonuses may be based on hitting specified targets for sales, gross margins, net profits or cash flows.

Most of the time, the financial statements to be used for a purchase and sale are to be prepared and presented by the seller in accordance with the generally accepted accounting principles ("GAAP") in effect on, or near, the closing date, and applied on a consistent basis to prior periods. As plain and simple as that sounds, misunderstandings frequently occur between buyers and sellers over differences in the recording and reporting of amounts in the financial statements. These are the trouble spots that often give rise to post-acquisition disputes.

COMMON PITFALLS

GAAP allows management some choice regarding what accounting principles to use and how to apply them. The Accounting Principles Board in its Opinion No. 22 states that "accounting policies … are the specific accounting principles and the methods of applying those principles that are judged by management … to be the most appropriate … " In short, GAAP requires the exercise of considerable judgment and the use of estimates.

Post-acquisition disputes often occur because the seller is responsible for preparing the financial information of the business before a sale, and the buyer is responsible for preparing this information after the sale. Each uses its own independent judgment, relies on its own interpretations of GAAP and calculates its own accounting estimates. In doing so—surprise—they rarely use the same thought processes or methods. In other words, they do not prepare the financial information using identical and consistently-applied accounting policies.

To prevent these disagreements, it is critically important for all parties to understand how the presale financial statements were prepared with regard to subjective areas and estimates. In some cases, it may even be prudent to have the parties agree beforehand about the accounting policies and estimation practices to be used, right down to the detailed methodologies and calculation formulas. The good news is that the focus of discussions on these matters can generally be limited to a handful of areas—the "Pitfalls"—that frequently drive disputes. These include:

- *Materiality;*
- *Differing Accounting Policies;*
- *Accruals, allowances, loss contingencies and reserves;*
- *Cut-off issues;*
- *Expense allocations;*
- *Taxes; and*
- *Disclosures*

Let's consider these one by one.

MATERIALITY

Materiality is an accounting and auditing concept that involves a quantitative and qualitative judgment regarding what might be important to financial statement users. It may apply to a monetary amount (*i.e.*, quantitative judgment) or to the completeness of a disclosure (*i.e.*, qualitative judgment), among other items. Materiality is a subjective term, usually defined by way of a "reasonable person" rule-of-thumb.

As it relates to financial statements, materiality is typically evaluated by considering the financial statements taken as a whole. Accordingly, certain individual line items reported in financial statements (and the items making up these balances) may be considered immaterial by management or by auditors. GAAP does not apply to immaterial items, meaning that certain items reported in the financial statements may, technically, not be in compliance with GAAP.

For example, say that total assets reported on the balance sheet are $10 million. Accepting that it's impractical, if not impossible, to get complete accuracy for every dollar recorded, the concept of materiality provides for an assessment of the amount of misstatement that could potentially effect the decision-making of a reasonable person. Clearly an error of $1,000, or .0001 percent of assets, would be considered immaterial. An error of $1 million, however, would be material.

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Materiality as used in connection with the sale of a business is not the same as materiality used in the preparation of financial statements. Therefore, use of financial statement materiality by the seller and buyer is typically inappropriate. Materiality for the sale and purchase of a business is defined by what is important to the seller and buyer. As a safe harbor, each party should treat items as material if there is a strong likelihood that one of the parties might consider

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it important. Therefore, the parties may need to have a number of candid discussions to get a sufficient understanding of potentially important matters. The determination of materiality by each party always includes an evaluation of monetary significance (*i.e.*, the dollar amount each party believes would influence their decision-making) and/or percentage magnitude (*i.e.*, the percent or ratio change each party considers critical). These are considered quantitative factors. Materiality also requires the parties to assess certain qualitative factors, such as the honesty, integrity and reliability of the other party.

Disputes are created because the parties fail to discuss and agree on materiality for purposes of closing the books. Consequently, the buyer finds fault with a number of items immaterial to the seller's financial statements taken as a whole. A buyer may dispute individual transactions, line items, accounts, groups of accounts, or the classification of balances that when taken together may rise to the level of an alleged material misstatement. In any case, sellers and buyers could reduce or eliminate such arguments by agreeing to definitive thresholds for materiality in connection with any rights to initiate post-acquisition disputes.

DIFFERING ACCOUNTING POLICIES

Financial statements generated in connection with the sale of a business are typically prepared and presented in accordance with GAAP, and, as discussed, GAAP allows management latitude with respect to which accounting principles to use and how to apply them. Additionally, the language "GAAP, consistently applied" is often cited in the purchase agreement and calls for the use of pre-closing accounting policies in the preparation of the financial statements, contingent on those policies being in conformity with GAAP.

Trouble frequently starts when the seller has not adequately apprised the buyer about accounting policies selected and the reasons therefore. In these cases, the buyer and seller are likely to select differing accounting policies, apply independent judgment, and arrive at divergent estimates while preparing their respective financial statements. Simply put, the seller and buyer may prepare and report financial statements using inconsistent accounting policies and differing judgments.

This pitfall can be mitigated by the seller providing a clear understanding of their historic accounting policies prior to the closing of the transaction and perhaps even including the specific language and example calculations for these policies.

ACCRUALS, ALLOWANCES, LOSS CONTINGENCIES AND RESERVES

In lay terms, accruals are estimates of revenues and assets, or expenses and liabilities, properly recorded using GAAP. Allowances and reserves generally are meant to record assets and transactions at estimated net realizable amounts as required by GAAP. Allowances for doubtful accounts receivable, inventory-obsolescence reserves, sales returns and allowances, fixed asset depreciation and goodwill impairment adjustments are common examples.

According to the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC"), loss contingencies are to be charged to income if they are "probable" and the "amount of loss can be reasonably estimated." Accruals, allowances, reserves and loss contingencies are pointin-time estimates that require significant judgment about the outcome of uncertain future events involving unpredictable courses of action. This is the equivalent of educated fortune telling for accounting matters.

For example, at the time the seller prepares the financial statements, they may believe that products in inventory are likely to be profitably sold in the future. This judgment includes assumptions about future customer buying habits, marketing programs to be used, technological changes anticipated, competitor responses known or anticipated and sales force performance. Based on this positive view for the future sales prospects of its inventory, the seller may elect not to reserve for any future losses. The buyer, using its own judgment, different assumptions and perhaps a little hindsight, may subsequently conclude that the same inventory is, and was on the date of sale, worthless and should have been fully reserved. These differing positions can result in a dispute.

To avoid post-acquisition disputes related to these types of estimates, it is important for the buyer to perform due diligence sufficient to understand and gain comfort over the seller's judgments and assumptions. Conversely, the seller

must be willing to fully disclose these judgments and assumptions to the buyer. That may be challenging if this information is deemed confidential and proprietary. Ultimately, if the buyer is uncomfortable with the seller's judgments and assumptions—or disclosure thereof—it may ask for changes before the deal is executed. Alternatively, both parties might consider reaching an agreement to use pre-defined methods, formulas and assumptions to calculate accruals, allowances, loss contingencies and reserves.

CUT-OFF ISSUES

Cut-off policies stop, or "cut-off," the collection of information used to prepare financial statements. With respect to acquisitions, cut-off pertains to the time allowed to collect information, two weeks for example, in order to prepare financial statements in connection with the sale. Cut-off policies are designed to identify, capture, record and report economic activity in the proper period, taking into consideration practical limitations related to document collection and the need for timely information.

Cut-off is often a post-acquisition problem because the seller and buyer use different cut-off periods. The seller is often required to prepare the preliminary financial statements within a few days after the date of sale. As such, the cut-off period is artificially shortened versus the seller's customary cut-off period. As a result, estimates are more heavily relied upon in an attempt to capture the necessary information. Later, when the buyer prepares their version of the financial statements, the cut-off period is extended using the seller's customary cut-off policy, or another applied by the buyer. A longer cut-off period may provide more accurate information, but it can differ from the estimates made by the seller's staff due to the shortened period. As a result, financial statement balances may differ between the seller and buyer, causing a dispute.

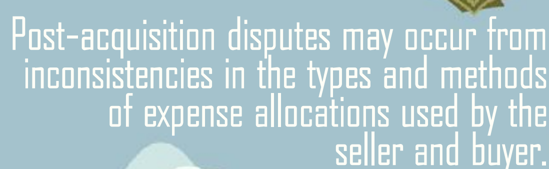
One way to preempt this issue is for both parties to agree on specific cut-off dates for specified account activity. It should be noted that irrespective of cut-off policy utilized, the financial statements must properly match expenses against revenues in the appropriate period (even if that means estimating expenses) in order to comply with GAAP.

EXPENSE ALLOCATIONS

Management may allocate expenses in an attempt to match them to corresponding revenue generating activities (*e.g.*, allocation of overhead costs to operating units). Among other benefits, allocating expenses assists management in its efforts to measure organizational performance. Post-acquisition disputes may occur from inconsistencies in the types and methods of expense allocations used by the seller and buyer. This is particularly true for sales and acquisitions that provide for deferred purchase price payments from the buyer to the seller based on future earnings, often referred to as earn-out provisions.

Earn-out provisions generally call for the buyer to pay the seller additional purchase price amounts based on future operational performance, such as net earnings or cash flows. Earn-out provisions are usually based upon a written agreement or a general understanding between the parties that the accounting methods and policies used to prepare the earn-out calculations will be consistent with those used by the seller prior to the acquisition. However, subsequent to the closing of the sale and acquisition transaction the facts and circumstances may change. These changes may cause the buyer to make business decisions that affect the type of expenses incurred and allocated to the earn-out calculations. The objective of the seller is to minimize expenses to maximize the earn-out. Conversely, the buyer's goal is to minimize the earn-out by strictly accounting for actual expenses incurred and reasonably applicable to the earn-out calculation. As a result, the parties may find themselves in a dispute over expenses.

This may be particularly true in circumstances where a business division, segment or unit of a consolidated group is sold piecemeal or acquired and accounted for by the buyer as a part of a larger consolidated enterprise. Oftentimes, divisions, segments or units of a business do not report all of the applicable expenses benefitting a division, segment or unit in



individual, stand-alone sets of financial statements. For example, expenses related to overhead and management may only be captured and reported at the parent company level. When the divisions, segments or units are consolidated into a single set of financial statements, the consolidated expenses are correct. However, for purposes of the future earn-out calculation these expenses may not have been identified by the parties on an individualized basis for the division, segment or unit sold and purchased; thereby, creating a potential future disagreement.

The source of the potential disagreement can be the seller or the buyer. If the seller fails to disclose to the buyer the expense allocations and methods used historically for the division, segment or unit sold, the seller may get an unfair windfall in the earn-out payment because the buyer fails to include such allocated costs in the earn-out calculation. On the other hand, if the buyer fails to recognize that certain expenses have not been historically and appropriately allocated to the purchased division, segment or unit during due diligence, the earn-out payment may be unfairly reduced by inconsistently applied expense allocations.

The avoidance of problems in this area requires the seller and buyer to agree on how to calculate expense allocations at closing and in the future. However, that is predicated on the seller being willing to fully disclose expense allocations and methods to the buyer. As mentioned above, that disclosure may be difficult to obtain from the seller if this information is deemed confidential, proprietary or otherwise competitively important. Using this information, the buyer must reconcile its own expense allocation methods with those of the seller to facilitate agreement at closing.

TAXES

Tax matters can be complex and require counsel from international, state and local, employment, regulatory, federal taxation and legal professionals. Similar to the GAAP matters mentioned earlier, management judgment is required to elect tax positions and prepare tax returns. In many cases, the failure to properly assess the tax implications of a transaction can be disastrous for both the seller and the buyer.

Due to the complexities, the judgment involved and the high potential for adverse consequences, parties will often initiate disputes over small tax-related matters. This is because of the potential involvement of third party regulators (e.g., the IRS) in the resolution of most tax related matters and the associated risk of business and personal fines and penalties. In severe cases, civil or criminal charges may even be brought. Many business executives recognize this risk and address it by engaging tax advisors to counsel them, or otherwise take extra steps to secure tax opinions for important or controversial matters.

If there is a theme with respect to mitigating the potential for post-acquisition disputes, it is the need for disclosure between the buyer and seller. Tax matters are no exception. The seller must be willing to disclose potentially controversial tax positions taken. Similarly, the buyer must make it a priority to reconcile their tax positions with that of the seller in order to identify and dispose of differences that may drive post-acquisition disputes.

DISCLOSURES

Buyers often get concerned about inadequate or omitted seller disclosures due to the belief that information was hidden intentionally. Suspicions arise and trust erodes. Many times, buyers feel the only way to regain transaction integrity is to elevate the situation to a post-acquisition dispute.

To foster transparency and trust, the seller should disclose any material information needed to read and fully understand the financial statements prepared in accordance with the acquisition. In particular, due to the frequency with which disputes arise stemming from common pitfalls, the seller should be exceptionally diligent about transparency surrounding related party transactions, off-balance sheet obligations and potential adverse subsequent events. For its part, the buyer should consider redoubling due diligence efforts in these and other areas to satisfy itself that it is entering into the transaction with sufficient knowledge and comfort over the representations made by the seller.

AVOIDING COMMON PITFALLS

By attending carefully to the foregoing trouble spots, both seller and buyer will increase the likelihood that they will avoid postacquisition disputes. The following is a “short list” of items for parties to consider when preparing and presenting financial statements in connection with the sale of a business to avoid the common pitfalls:

1. Reach agreement on how the financial statements in connection with the sale are to be prepared by the parties. It may be prudent to agree on items such as accounting policies and accounting estimates to be used, including detailed methodologies and formulas.

2. Clearly identify significant liability accruals, loss contingencies and asset reserves and consider using agreed-upon methods, formulas and assumptions to evaluate and compute these estimates.

3. Understand the seller's cut-off policies and agree to use a standard cut-off policy after the sale.

4. Identify any allocations affecting the financial statements in connection with the sale and reach agreement surrounding the allocation methodologies employed.

5. Identify and agree on the inclusion of any tax assets and liabilities in the financial statements prepared for the sale. Engage professional advisors and secure tax opinions for important or controversial matters.

6. Identify and require the full and complete disclosure of important matters related to reading and understanding the financial statements prepared in connection with the sale. These are equivalent to the footnotes required under GAAP for financial reporting purposes. Buyers should consider performing due diligence procedures to determine the completeness and appropriateness of disclosures, especially with respect to related party transactions, off-balance sheet obligations and potential adverse subsequent events.

7. Consider joint access agreements to allow the parties access to any critical records (*e.g.*, financial books and records), resources (*e.g.*, key accounting personnel) and tools (*e.g.*, software applications) necessary to prepare financial statements in connection with the sale.

8. Agree to specific quantitative materiality thresholds for individual and aggregated items to qualify for dispute resolution. (Note that it is generally impractical to identify all of the qualitative factors.) abl

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