



When the Clarity of Hindsight is Off-Limits in a Purchase Price Adjustment

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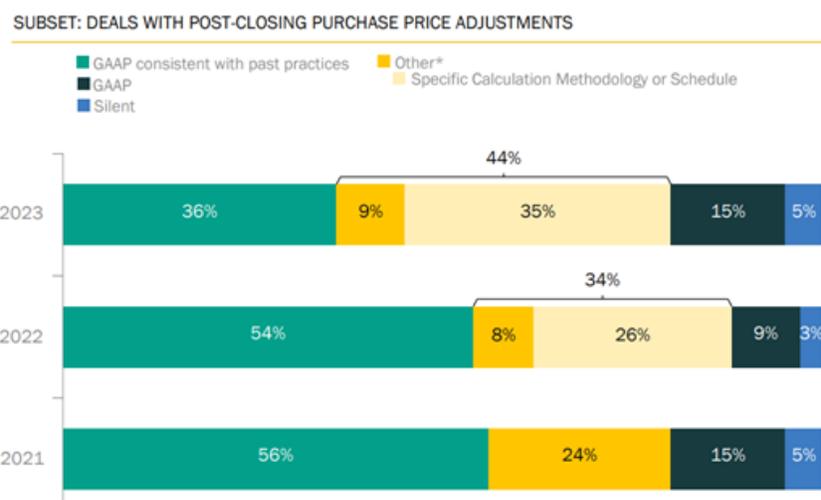
Synopsis

A recent M&A deal terms study¹ indicates that Buyers and Sellers of transactions that closed through the year-end 2023 have begun to opt for agreement language that no longer specifies “GAAP (generally accepted accounting principles) consistently applied” as a basis of preparation. Instead, parties are selecting an alternative “in accordance with the calculation worksheet attached hereto” when determining the working capital component of an acquisition target’s purchase price. This additional precision must, however, be viewed through the lens of Subsequent Events guidance as provided for in ASC 850, as the hindsight afforded to transaction parties will necessarily have limits when being used to agree on the accuracy of closing date working capital balances, particularly those that require the application of management estimates.

Observed Trend and its Significance

The authors of the deal terms study, who have decades of experience in tracking the resolution of post-closing M&A disputes (“Purchase Price Adjustments”), noted that historically, transaction parties have typically defaulted to the term “in accordance with GAAP, consistently applied” when drafting APA/SPAs. They further observed that the significance of GAAP interpretation only matters when irreconcilable differences in finalizing working capital are made to an accounting arbitration.

In an apparent effort to minimize the “grey area” associated with GAAP interpretation, and to avoid disagreements over the consistent application of GAAP with Seller’s past practices, the study identifies a material shift in deal language over a three-year period away from “GAAP consistent with past practices” (down from 56% of deals in 2021 to just 36% in 2023), and towards alternative language that calls for a different basis or a specific calculation (up from 24% of deals in 2021 to 44% of deals in 2023).



[1] SRS Acquiom (“SRSA”) “2024 M&A Deal Terms Study – An analysis of deal terms in private-target M&A transactions that closed between 2018 – 2023.”

* “Other” methodology includes, among other things, non-US accounting guidance (e.g., IFRS) and, prior to 2022 deals, a specific calculation methodology or schedule.

Observed Trend and its Significance

Although we'd like to think this trend is indicative of eliminating the battle over which of management's estimates (i.e., pre-closing, post-closing, or at the inception of arbitration) are most aligned with the methodology deployed in the closing balance sheet, deal participants are advised to take heed of the Subsequent Events rules contained in GAAP. During a dispute process before a CPA arbitrator, the Subsequent Events rules will provide guardrails to the arbitrator when determining whether the information provided by the parties can be considered when concluding on the appropriate closing date balance sheet accounts in dispute.

The Rules of the Road

Although GAAP is frequently cited as a basis of accounting in APA/SPAs, as well as in countless commercial agreements, the relationship is not reciprocal, and accordingly, there is no "M&A Dispute Resolution" or "Purchase Price Adjustment" section within the accounting guidance. Consequently, it is by analogy that GAAP is applied to, for example, closing date balance sheets.

The "Subsequent Events" guidance found in GAAP (ASC 855) is commonly applied for purposes of defining the post-closing time period for which new information can be considered in the preparation of the financial statements that are used to derive closing date working capital. ASC 855 requires that all information available through the date the financial statements are issued that provides "...additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in preparing the financial statements..." be considered in the preparation of those financial statements. These are commonly referred to as "Type-1" subsequent events.

Applying this guidance to a working capital dispute, an accountant arbitrator would be required by GAAP to consider all events and transactions that occurred prior to the preparation and issuance of the closing balance sheet when determining appropriate balances on the closing balance sheet. This is critical, as there are often months between the closing balance sheet date and the date it is proposed as final and issued.

In addition to the time lag between the date of the closing balance sheet and the date it is issued, there is also typically a significant passage of time between the date the closing balance sheet is issued and the time when the working capital dispute is formally adjudicated in arbitration. There is often disagreement about whether events and transactions relevant to estimates on the closing balance sheet that occur after the issuance of the closing balance sheet, but before the dispute process occurs, should be considered by the arbitrator. ASC 250 — Accounting Changes and Error Corrections, considers such instances to be a change in accounting estimate.

The Rules of the Road

ASC 250 instructs that “(a) change in accounting estimate shall not be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.” Following this guidance, an accountant arbitrator should not consider events and transactions occurring after the date the closing balance sheet was prepared and issued when determining appropriate account balances. From the perspective of neutral accountants and financial statement auditors, ASC-250 makes intuitive sense as the alternative to a prospective treatment of changes in estimates would entail a never-ending cycle of restating prior estimates and associated financial statements as actual results become known and (potentially) vary from accrual-based estimates.

In short, GAAP requires the consideration of all available information regarding events that affect conditions existing at the relevant financial statement dates (i.e., analogous to the Closing date in an M&A) through the date of their issuance or delivery to the respective party (i.e., analogous to the true-up date). ASC 855 is the de facto guide to information that is “in play” for the preparation of the balance sheet that will be used to derive the final working capital figure and requires the preparer to consider all information available through the date of preparation, or the date financial statements are “available to be issued,” but not beyond.

For the days from the end date of the subject financial statements, until the company issues their Form 10-K, which ranges from 60 to 90 days from the period-end of the annual financial statements for a public filer, the auditor gets to consider all the information known or knowable about conditions that exist at the balance sheet date of 60 to 90 days prior. Our experience has shown that in the case of a transaction that references GAAP, Buyers are often at an advantage, specifically because they are typically tasked with preparing the true-up to Seller’s closing date estimated balance sheet. Further, in matters that come before us in arbitration, sophisticated buyers experienced in the rigors of financial reporting typically hold more of an advantage over entrepreneurial sellers whom, we have found, rarely fully comply with GAAP other than during the course of their annual financial statement audit.

In light of this challenge faced by Sellers many months after the Closing date when presented with Buyer’s post-closing true-up of Seller’s estimate of Working Capital, we have written, perhaps ad nauseum, about how Sellers could avoid such a scenario by “polishing-up” their closing date estimation process or in some cases, just carving out the accounts that could give rise to a discrepancy (i.e., A/R Reserves, Deferred Revenue, Inventory, etc). Despite the reported trend away from “GAAP, consistent with past practices,” we nonetheless expect that the fallback to any ambiguity within “as provided for in the attached schedule,” will be GAAP.

Opportunities

As Capital Markets prognostication touts 2024 as poised for a rebound in M&A activity, we view our observations as planning opportunities for advisers to consider in both structuring the arbitration provisions in purchase agreements and in developing their submissions should they be called upon to assist in an arbitration.

Arbitrator Selection

Our experience indicates that accountants who regularly practice as arbitrators are much more likely to adhere to the tenets of Subsequent Events and GAAP. Accordingly, if there is an absence of accounting rigor in the subject company's recurring preparation of financial statements, party advisers who find their client in a working capital dispute are wise to consider the professional biographies and experience of the arbitrator options carefully.

Specify Timeline Parameters

In light of the likelihood that a working capital arbitration may be unavoidable or even expected in your subject transaction, take care to specify the timeline through which desired information will be permitted to enter into the arbitration proceeding. Namely, if the subject company is traditionally late in identifying relevant data and preparing its financial statements, Buyers should endeavor to negotiate for additional time to allow necessary information to surface especially if you expect closing working capital calculations to require extensive information-gathering efforts.

Alternatively, if you're on the sell-side of a target that requires an inordinate amount of additional time to firm up their financial estimates, seek to limit the extent of time permitted for financial statement preparation, specify a limited degree of variation from an agreed-to target component of working capital, or use the opportunity to negotiate some type of concession.

“Time” is of the Essence

Inevitably, the party tasked with preparing the “final” balance sheet that will drive working capital (usually the Buyer) may need additional time, post-closing, to compile this true-up. It is incumbent on the grantor of this extension (usually the Seller) to similarly specify parameters, if they so choose, to limit the subsequent events information window to that which would have resulted from the originally agreed-to purchase agreement.

Accordingly, when accommodating the delayed submission of working capital balance sheets, be specific about the date through which relevant information will be permitted to impact the judgment surrounding accounting estimates.

Conclusion

Our view is that parties are limited in the extent of hindsight data they can deploy in the resolution of a purchase price dispute but our experience with M&A Dispute Resolution indicates that there may be alternative interpretations. Accordingly, we encourage our readers to take advantage of our hindsight observations summarized herein and work to structure agreement provisions or select arbitrators to maximize your chances of prevailing in a working capital purchase price dispute arbitration.

Who We Are

Founded in 2001, DLA is a specialized boutique financial advisory firm that provides customized services and solutions to optimize businesses' financial and operational processes, while minimizing risk and driving growth and innovation. With advanced expertise that spans accounting advisory, internal audit and forensic accounting, valuation, litigation, and post-closing dispute support as well as risk and IT advisory, our team of accounting, finance, and technology professionals provides creative strategies that address your most pressing priorities and challenges. DLA LLC is headquartered in Fairfield, New Jersey, with offices in Shrewsbury, New Jersey, Boston, Chicago, and New York City.

About DLA, LLC

Founded in 2001, DLA LLC is an accounting advisory and capital markets organization focused on a comprehensive internal audit, accounting advisory, and corporate finance choice for employees, the office of the CFO, audit committees, and public accounting firms and law firms on behalf of their clients. DLA LLC is headquartered in Fairfield, New Jersey, with offices in Shrewsbury, New Jersey, Boston, Chicago, and New York City.

dla@dlallc.com | 973-575-1565 | www.dlallc.com