

ACCOUNTING FOR POST ACQUISITION DISPUTES - NEITHER TRUE NOR FAIR?

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Kluwer Arbitration Blog

“The credit-fuelled boom was a time of competitive and crowded auctions when buyers had to execute extremely quickly at the expected price with little time to undertake financial and legal due diligence. Sellers offered few warranties, representations or covenants, and were largely successful in limiting their liability in the event of the deal turning sour.”

“According to a well-placed contact at a major arbitral institute, a significant proportion of new arbitration matters involve post-acquisition disputes; in particular, claims brought against vendors of businesses who are accused of having misrepresented, sometimes fraudulently, an acquired business’s true financial position. Many of these claims relate to transactions carried out at the peak of the M&A boom in 2007.

Having reviewed many Sale & Purchase Agreements in the months leading up to the credit crash of 2008, I am not surprised we are now seeing so many disputes coming to arbitration; to understand why, it is necessary to consider the historical market environment in which deals were concluded, as well as the structure of the Sale & Purchase Agreements themselves. The availability of cheap credit and the willingness of buyers to pay ‘top-dollar’ for acquisitions meant that the balance of power in most deals was in the hands of the seller. The credit-fuelled boom was a time of competitive and crowded auctions when buyers had to execute extremely quickly at the expected price with little time to undertake financial and legal due diligence. Sellers offered few warranties, representations or covenants, and were largely successful in limiting their liability in the event of the deal turning sour.

Crucially, the pricing structure in most deals was of the “locked box” variety rather than the traditional “completion accounts” model. Under the latter, the purchase price is adjusted post completion and any dispute between the parties as to the size of the necessary price adjustment between the expected balance sheet or working capital values and those actually acquired is heard by an independent accountant, who then provides a final determination as to any amount owing between the parties. Precisely because of the existence and use of the price-adjustment mechanism, fewer of these disputes would end up in arbitration proceedings. In contrast, the ‘locked box’ model fixes the purchase price up front, based usually using an existing balance sheet, with no adjustments post completion except “permitted leakage”. The headline (enterprise value) purchase price is usually though not always based on a multiple of EBITDA; this price is then adjusted e.g. for cash/ debt to arrive at the equity value. Given the absence of any price-adjustment post-completion, it will be readily appreciated that one of the few recourses a purchaser may have against a seller is to demonstrate that there was a misrepresentation and / or breach of warranty given in respect of the seller’s financial statements and that any such representation constituted a term or condition of the contract. Since the historical balance sheet assumes high importance in the case of a ‘locked box’ transaction, it would be highly unusual for there not be an applicable warranty.

In my experience, a purchaser wishing to prove a breach of warranty / representation over a set of financial statements has a challenge. The rest of this article explores why this is and suggests possible approaches claimants might want to consider, with the important qualification that my comments are made as a forensic accountant rather than a lawyer!

Before addressing such issues, it is firstly necessary to consider how a typical 'financial statements' warranty/ representation is drafted. Based on Sale & Purchase Agreements I have reviewed, a common formula might read something like this:

Seller warrants that the Target Financial Statements, reviewed by Large Audit Firm, have been prepared according to the Accounting Standards and reflect, in all material respects, a true and fair view of Target's financial condition, assets, liabilities and results as of the Effective Date where the capitalised items will be defined elsewhere in the contract.

One of the initial observations on the above formula is that it refers to a large audit firm having reviewed the financial statements whose truth and fairness have been warranted. At a first glance, this might appear to present a significant stumbling block to the claimant. If a (major) audit firm has given its imprimatur, following extensive work, does this mean the claimant and its advisors would have to re-perform the auditor's work to show it was negligent/ wrong in its conclusions? In practice, however, it is quite possible that the relevant financial statements were not subject to a formal year-end audit for statutory purposes; rather, the audit firm could instead have been instructed to perform only limited review procedures and hence be far less exhaustive in its work than in the case of a statutory audit. In our hypothetical example, it is also possible that the vendor deliberately withheld certain key information from the auditor, which the auditor might not have picked up on due to the limited scope of its work. In such circumstances, establishing what and was not disclosed to the auditors can be key in establishing fraudulent misrepresentation. In some circumstances, a purchaser might wish to consider a claim against the audit firm itself e.g. if the auditor was negligent in its work and wrongly issued an unqualified audit opinion.

Secondly, in my experience, the term 'in all material respects' is rarely defined in contracts. Instead of defining 'material' as "1% of net profits" (whatever that is) or "5% of net assets (again net what?)", contracts instead usually leave the term open to (often wide) interpretation. If the warranted financial statements omit say a €10 million future liability that was not disclosed by the seller, and the purchaser becomes liable for said liability, is the purchaser justified in calling this "material"? If a set of consolidated financial statements fails to eliminate the impact of intra-group trading, is the impact "material"? Whilst there is no standard measure of, or methodology for measuring materiality in an audit context, International Financial Reporting Standards state that omissions or misstatements of items are material if they could, by their size or nature, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Judgment therefore still needs to be applied and whether some item is material or not will depend on the context.

Similar to "in all material respects", the term "true and fair" is one which sometimes causes confusion to non-accountants as to what exactly it means. At the risk of over-simplification - a full discussion of this issue would make this article several thousand words longer(!) - if a set of financial statements is said to be 'true and fair', this is generally understood to mean that they are materially (that word again!) accurate and that the user can rely on them to make informed decisions. 'True and fair' does not mean that there are no errors at all in the financial statements. By way of example, assume that the financial statements contain two errors: (i) omission of the €10 million future liability referred to in the paragraph above; and (ii) an overstatement by €10 million of a separate liability. Since the overall impact of these errors is zero, despite the existence of the errors, the financial statements may be capable of showing a 'true and fair' view, although it would be necessary to consider the nature and substance of the errors themselves before reaching such a conclusion.

My final set of comments refers to the term "Accounting Standards". In general, accounting standards are the rules, sometimes enshrined in law in certain countries, according to which accounts are required to be drawn up; they state what the minimum required level of disclosure is, the principles and/ or (again, depending on the country) prescribed rules that must be followed in calculating balances/ numbers and how certain terms are to be defined. Although there do exist internationally recognised accounting standards, these are not adopted in all countries; indeed, many countries have developed and apply their own set of accounting standards and large differences can and do exist between different countries. Even within the individual accounting standards themselves, preparers of accounts are often able to apply a certain degree of flexibility and judgement in their application of the standards; indeed, such flexibility is often required in order for financial statements to show a "true and fair view". For example, applying exactly the same accounting standard, the way that one company decides to depreciate/ amortise certain assets (e.g. plant & machinery) can differ from the treatment adopted by another company for similar assets. A claimant who is seeking to prove that the seller of a business did not correctly apply accounting standards faces a significant challenge, therefore. Critical to the claimant's chances of success is to get expert advice early on, even before a request for arbitration is issued. An obvious area of focus would be to ascertain whether, for the purposes of preparing the warranted financial statements, the seller had changed its accounting policies and/ or procedures from those it had applied in previous years and, if so such changes had been made, why? Were such changes to have been made, without good cause, this may breach the fundamental accounting principle of consistency.

I suspect that one of the main reasons why we are seeing a rise in arbitration cases concerning breach of warranty/ misrepresentation over financial statements is simply because the actual financial performance of acquisitions have fallen far short of the buyer's initial expectations, largely due to depressed economic conditions in the interim. It is worth recalling that a purchaser of a business is essentially paying for an expected future stream of cash flows; if these do not arise due to the market conditions, to what extent can this be blamed on the seller?

In practice, whilst it is true that the buyer usually only derives economic benefit from the future cash flows accruing from an acquisition, it will commonly base its purchase price on the target's historical trading performance on the assumption that the past is a reliable guide to the future. Problems arise – and we may be seeing these in the current raft on new arbitrations – when the vendor has misstated, deliberately or otherwise, the historical profitability of the target company.

Imagine that, relying on a set of financial statements, a purchaser decided to pay €100 million for a company, and had calculated the purchase price as five times the previous year's net profits of €20 million. If it subsequently transpires that net profits were overstated by €10 million, then the purchaser has actually paid €50 million too much for the business. In the absence of fraud on the part of the seller, the purchaser's task is to show that the above overstatement caused the warranted financial statements not to show "in all material respects, a true and fair view of Target's financial condition etc". If the fact of the overstatement can be proved then the purchaser may be entitled to damages, subject to the application of any limitation of liability (e.g. caps, de minimis thresholds etc). My lawyer friends advise me that, if, on the other hand, the purchaser can prove that there was a fraudulent misstatement of the financial statements on the part of the seller (e.g. the €10 million of profits were entirely fictitious), in many jurisdictions, the existence of the fraud may mean that any limitations of liability set out in the contract will no longer apply."

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