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Focus

Terms & conditions

Carried away
US GPs mull a possible tax hike

LP power
Tables turn in a tougher fundraising climate

Northern exposure
CAI's North American network

A few key men
How to draft a key man provision

Pension trouble
Liabilities in the UK

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Avoiding the honeymoon from hell

In tough economic times, the threat of post-acquisition disputes looms larger than ever.

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Mergers and acquisitions are a lot like marriages. But the bride and groom – that is, the two companies involved – may wish someone had raised an objection or two at the ceremony. If they don't find out about each other's shortcomings until after the wedding is over, then they're stuck with each other for life. Whether groom and bride-to-be or acquirer and acquiree, the parties involved usually don't anticipate the kind of disputes that can often arise.

Indeed, M&As are complicated enough without any added, ugly drama. That's why plenty of due diligence goes into appraising potential targets. But because of the subjective nature of evaluating a company's books, disputes often arise despite these analyses. These disputes can be minimized by agreeing beforehand about how financial statements should be prepared – and how the disputes themselves, if they arise, should be settled.

The credit squeeze and M&As

The current economic climate and the credit squeeze resulting from the sub-prime mortgage crisis has left banks, private equity groups, and investment firms wary of lending money and has added another layer of complexity to mergers and acquisitions. As companies' sales and profits go south, their asset values decline, and their payments slow, their liabilities will increase more quickly. As working capital dissipates, an increase in complex post-acquisition disputes is practically inevitable. Because companies are looking to get the most out of M&A opportunities in a tight market, they are focusing an increasingly critical eye on the books and records of recently acquired target properties. The pressure to increase investment returns and generate savings is greater than ever. This heightened scrutiny can lead to post-acquisition disputes.

Working capital

The crux of these disputes is often in the areas of pre- and post-acquisition working capital – that is, current assets (i.e., cash, accounts receivables, and inventory) less current liabilities (i.e., accounts payable and accrued liabilities). After all, no one will know what the working capital actually was on the day the deal closed until a few months afterward – and it is generally the acquirer, not the seller, who is doing the accounting by then. The seller might simply disagree about the mechanics of the buyer's calculations. The most contentious disputes, however, occur over how Generally Accepted Accounting Principles (GAAP) are applied to the calculation of working capital. Companies must therefore be aware of the accounting issues and post-closing pitfalls involved so that such disagreement can be prevented, or at least handled more effectively.

Culture clash?

In M&As, those who strike the deal – usually investment bankers, CFOs, and other bigwigs – are often not the ones who must work out the specific details of the transaction. Hitches can spring up because specialists from different fields, such as law and accounting, must cooperate closely, often communicating about establishing the parameters for post-closing working capital adjustments. Unfortunately, it sometimes seems that accountants and attorneys speak different languages, even when everyone's native tongue is English. It may make sense for the accountants to review drafts of the purchase agreement (especially those sections pertaining to post-closing adjustments); the attorneys may want to review the accountant's due diligence. These reviews may highlight areas of potential risk that could result in future disputes.

The GAAP gap

Although it may seem like most disputes could be avoided by the purchase agreement stating that the target and closing balance sheets must both be prepared in accordance with GAAP, GAAP itself is no panacea. Applying GAAP isn't an exact science, after all: it involves the use of

When drafting an M&A agreement, think about:

- How might working capital and the balance sheet change between signing the agreement and closing the deal?
- Have the books actually been prepared in strict accordance with GAAP?
- If not, what specific line items might be out of accord with GAAP?
- Have all liabilities, such as accrued compensated absences and accounts receivable, been considered?
- What is the impact on working capital of supposedly liquid assets like auction-rate securities?
- Are accountants, lawyers and deal makers working together to find underlying factors that can lead to disagreements?
- Have the parties agreed to binding arbitration in the event of disputes?

management's estimates and judgments based on historical results and future expectations. A common phrase typically found in these agreements – "The closing balance sheet shall be prepared in accordance with GAAP applied consistently with the policies, procedures, and methodologies of the target balance sheet" – is essentially boilerplate language.

In this case, just because it quacks like a duck doesn't mean it is one. If the books and records that gave rise to the target balance sheet have not been prepared in accordance with GAAP, both parties must agree upon whether GAAP or consistency with past practice is paramount for calculating any working capital adjustments. And remember, GAAP changes over time. When those changes occur between the start of negotiations and the date of the closing balance sheet and affect areas covered by the deal, they can also give rise to post-acquisition disputes. Additionally, the expected adoption of International Financial Reporting Standards in the US may further complicate M&A disputes.

M&As down, divestitures up

Compared with last year's first quarter, M&As were down, but the number of divestitures actually rose. As reported by Thomson Financial, global M&A volumes fell 31 percent, to $661 billion year-to-year, in this year's first quarter. But the number of global divestitures has steadily risen in recent years, from 10,074 in 2003 to 12,361 in 2007, as companies shed underperforming divisions. Whether they're buying or selling, companies must remain aware of the potential for post-acquisition disputes and should compile a laundry list of specific financial statement line items that will require scrutiny.

Acquisition agreements: avoiding Murphy's Law

To compensate for changes in assets between signing and closing, a working capital adjustment can give both the buyer and seller a sense of security. The buyer agrees to pay the seller the purchase price; if the working capital increases versus the pre-determined target amount, the seller gets more money; if it decreases, the seller gets less. Potential areas for disagreement, such as allowances for doubtful accounts, should be carefully addressed in the purchase agreement.

An allowance for doubtful accounts receivable is recorded if the acquiring company is dubious that it will ever collect the receivables. The parties can even agree upon a formula for evaluating the receivables and other assets. Squabbles over what percentage of the receivables is actually collectible are quite common. Suppose the seller has relied on long-standing company polices to calculate doubtful accounts. Then, after the sale, the acquirer uses actual collections to evaluate this allowance. To minimize such hassles, the acquisition agreement can specify whose policies will take precedence.

What happens if a liability is incurred prior to closing the books but is not properly recorded? This might result from the seller's practice applied on a year-to-year basis. But in the year of the sale, the buyer winds up paying the seller's invoices—and insisting that GAAP-wise, those invoices should have been recorded as liabilities and expensed prior to the date of the sale. Again, settling upfront on what controls, past practices or GAAP, can mitigate the problem.

GAAP's sick little secret

GAAP requires that companies account for their employees' paid vacation days – "accrued compensated absences" in accountant-speak – in a very specific way. But many otherwise GAAP-compliant companies fail to follow this requirement to the letter of the law. It's an area of GAAP that sometimes gets ignored, especially by some smaller companies.

Companies are required to set up a liability account for vacation pay and accrue it – vacation taken one year is typically "earned" by employees the previous year. But those companies that don't bother to fully comply with this accounting requirement often account for vacation pay the same way that employees understand it: by expensing it in the year it is taken on a pay-as-you-go basis. This can cause a headache come sale time. Buyers won't want to "pay" for vacations that employees have "earned" in previous periods while working for the seller; sellers without the proper accruals on their books will have the opposite perspective.

Kevin Hanley

Liquid or frozen?

Auction-rate securities were originally marketed and sold by financial institutions as safe, cash-equivalent investments. Actually long-term investments, they had traditionally been treated as cash or short-term investments on companies' balance sheets because the interest rates are periodically reset during a Dutch auction process. Their interest rates had, in fact, hovered a few points above those of money market accounts for years.

Then, with the sub-prime mortgage crisis and the subsequent credit crunch, everything changed. Wall Street investment firms withdrew their support for the auction-rate markets in February 2008, and thousands of auctions failed. As a result, default rates went into effect, and these stable, cash-like investments turned to stone. Once easy to get out of, companies that had purchased these investments were finding they could not sell auction-rate securities without taking a loss, and what was once considered a stable, cash-equivalent investment was no longer quite so stable. Some companies are now being forced to treat these as long-term assets, which has working capital implications for an M&A deal. In these market conditions, acquirers should reevaluate balance sheets with such assets very carefully.

Let's make a deal

An experienced accountant can tell you that many deals are built on – and go through based on – all sorts of factors other than just the numbers in the ledgers. Accountants with M&A experience should therefore work shoulder to shoulder with deal makers, bankers and attorneys on the technicalities of any deal. Why? Because despite a good due-diligence team, there can still be substantial differences that can cause a billion-dollar deal to end in a protracted dispute.

But what happens if, after working capital adjustments have been calculated, the applications of GAAP have been wrangled over, and the contract has been examined under a microscope, the parties still can not resolve the disputed issues? If this occurs, binding arbitration will often come into play.

Any acquisition agreement worth its salt should outline a dispute resolution procedure to be overseen by a neutral accounting firm. An accounting firm can also provide help in other roles such as consultant or testifying witness. And it might be necessary for more than one firm to become involved. Like a good marriage counselor, a wise arbitrator will keep the process on track – and help both the buyer and the seller avoid a costly, unnecessary, seemingly never-ending battle. ■