

## BRIDGING THE GAAP

MINIMIZE POST-DEAL ACCOUNTING DISPUTES  
BY DEFINING BEFOREHAND HOW FINANCIAL  
STATEMENT ITEMS WILL BE VALUED

**M**any corporate acquisitions result in post-acquisition disputes that can greatly alter the value of the deal for both the buyer and the seller. These disputes often focus on generally accepted accounting principles and their application to the terms of the agreement, specifically the impact on post-closing purchase price adjustments and earnout provisions.

Acquisition agreements generally have clauses referring to initial and closing balance sheets, stating, for example, that they are to be “prepared in accordance with generally accepted accounting principles, applied on a consistent basis with past practices, policies and principles.” GAAP is also usually referred to in the earn-out benchmarks of the agreement, in clauses such as the following: “Buyer’s accounting policies and practices shall be utilized in determining Earnings Before Interest and Taxes (“EBIT”) as long as such policies are in accordance with generally accepted accounting principles consistently applied.”

But merely agreeing to adhere to GAAP does not avoid potential disagreements between buyers and sellers with respect to GAAP. GAAP is not an exact science that delivers only one correct answer. GAAP involves estimates and judgments that are based on,

among other things, historical results and management’s view of the future. Two different management teams (for example, the buyer and seller) or two different accountants involved in a transaction can have different views of the value of the same financial statement item, yet both views result in financial statements that technically are prepared in accordance with GAAP.

The seller’s financial statements may be materially in accordance with GAAP when taken as a whole but may contain specific line items that are not recorded within the technical requirements of GAAP. These line items are often the focus of post-acquisition disputes. Typical disputed financial statement items involve valuation accounts, such as accounts receivable and the likelihood of collecting those accounts receivable (or allowance for doubtful accounts), inventory obsolescence and unrecorded liabilities.

By taking preventive measures before completing the transaction, the buyer and seller can greatly mitigate or even eliminate post-acquisition accounting disputes. One key is to provide specifics in the purchase agreement on dealing with financial statement items that require judgments and estimates.

For example, the seller’s management might have calculated the allowance for doubtful accounts and reserve for obsolete inventory based on its company policies; however, the buyer might look to its actual experience after the sale to evaluate the adequacy of the allowance/reserve as of the closing.

The parties can address these differing views in the acquisition agreement

by specifying whether the seller’s policies and past practices, or the buyer’s actual results through a specified date after closing should be the viewpoint from which the accounting estimates are determined. The parties can also agree to a formula that calculates the allowance/reserve based on some objective measure such as how long the accounts receivable have been outstanding or how long the inventory has been held.

Another typical GAAP dispute is whether a liability was incurred as of the closing, but not recorded. This dispute often occurs when the seller completes the financial statements before receiving all outstanding invoices. The buyer pays the invoices received after closing and asserts that, in order for the financial statements to have been prepared in accordance with GAAP, those invoices should have been recorded as liabilities and expenses as of the closing date. The seller responds that the exclusion of those payments was its historical practice and on a year-over-year basis there is no material impact.

To avoid such disputes, the parties could specify in the agreement whether the financial statements should be prepared in accordance with GAAP or consistent with past practices, when such past practices might differ from GAAP. The parties could also set a time period after the closing through which the seller remains responsible for invoices paid by the buyer that relate to liabilities incurred before the closing.

Each party to the transaction should also be cognizant that GAAP changes over time. It can change between the

date of the initial balance sheet and the closing balance sheet. It can also change during the period covered by an earnout provision. Such changes can have an effect on the purchase price or earnout provisions that are unrelated to the operations of the business. For example, the current movement to expense stock options can significantly affect deals that contain earnout provisions, if they were not considered in establishing the

earnout targets.

To prevent such changes from affecting the transaction, the parties can specify that the GAAP in effect as of a specific date (for example, closing date) will be used.

Consideration of the meaning of "GAAP" and the language surrounding it in agreements may help mitigate subsequent disputes or give the parties a framework for negotiating certain

items. By taking preventive measures to agree on judgments or estimates prior to the closing, both the buyer and the seller can minimize the chances of costly and time-consuming litigation and arbitration proceedings. ■

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AS FEATURED IN

**The Deal**

WWW.THEDEAL.COM

REPRINT FROM JUNE 6, 2005 PP. 26  
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(ISSN 1547-7504) is published bimonthly by The Deal LLC.  
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