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What's new with post-closing disputes?

An interview with Gary Levin, Partner and Steven Stanton, Managing Director, Deloitte Financial Advisory Services LLP

Post-closing purchase price adjustments and the resulting disputes over them are fairly common in mergers and acquisitions. Far from routine is the dramatic impact business globalization is having today on M&A activity in general and post-closing settlement in particular. Deals are increasingly rare that do not have a non-U.S. component and the cross-border complexity it brings to regulatory, tax, investment, labor, and other matters. Nevertheless, the origins of today's post-closing disputes and where the issues are likely to appear on the balance sheet are largely predictable. Both buyers and sellers can benefit from understanding what to expect.

Post-closing disputes often arise for one of four reasons

Post-closing adjustments are generally of two types: closing balance-sheet adjustments and earn-out adjustments. Balance sheet adjustments are made based on the difference between a target amount from the balance sheet (e.g., working capital, net assets, or another measure) and the amount of that measure at the closing date. Earn-out adjustments are based on a contract provision requiring a buyer to pay the seller additional consideration subsequent to the closing date if the acquired business meets certain contractually defined benchmarks.

Four factors are common triggers for post-closing disputes:

Appropriate application of generally accepted accounting principles. Various methodologies can be used to apply GAAP, and the buyer's method may be materially different from the seller's.

Industry-specific practices and guidelines. Distinct accounting practices, for example in the oil and gas industry, need to be taken into account.

Consistency (or lack of) between the buyer's closing statement and the seller's historical past practices. The buyer will typically prepare the deal closing statement using its own accounting methodologies, not the seller's historical practice.

Interpretation of contract terms. Differences over what the dispute clause is meant to cover can exist between the definition section of a contract and the contract's actual wording.

The focus of disputes: Eight types of balance sheet accounts

It's axiomatic that the more general contract provisions are relating to purchase price adjustment, the more likely parties are to see things differently when it comes time to prepare the estimates in the closing balance sheets. Whether disputes are litigated or arbitrated, these accounts are frequent targets:

Accounts subject to management estimates. Application of GAAP requires judgement, notably in such areas as accounting reserve accounts, reserve for warranties, and reserve for contingencies. Management estimates are a common issue, for example, when determining percentage of completion of a construction project.

Inventory. When valuing inventory at the lower of cost or market per accounting principles, a buyer and seller are likely to take different approaches to cost determination and arrive at different numbers. Differences in accounting methods—a buyer uses FIFO and the seller uses LIFO—need to be reflected in the purchase agreement.

Revenue. Disputes can arise related to bill and hold transactions, revenue cut-off date, and percentage of completion. Consideration should be given to the seller's normal operating cycle, long-term and significant contracts and sales, and how accounts receivable will be accounted for.

Cash. While a seemingly simple item in a transaction, cash can raise key questions that GAAP leaves somewhat to interpretation. Will the book balance or bank balance be transferred? If a seller has significant cash-on-delivery business, how will it be treated on the closing day?

Pensions. Pension liabilities will need to be valued, at the cost of either the buyer or the seller. The seller may have a historical actuarial study, which may or may not need updating. Agreement on the cutoff date for pension recipients and how to deal with medical claims incurred but not reported will need to be addressed.

Accounts payable. Cut-off issues arise for liabilities such as services rendered prior to closing that haven't been invoiced by the vendor or the seller. Whether significant debit balances should be treated as receivables will need to be addressed. Clarification of what constitutes "best effort" will be needed if the seller is responsible for after-closing A/R collections.

Contingent liabilities. Disputes, primarily over litigation reserves, are common. Questions that arise include whether unrecorded liabilities will be handled through an indemnity claim or another means and whether liabilities have been over-accrued or under-accrued. Strategy changes shortly prior to or after closing could be a red flag.

Accounts receivable. Differences in methodology for receivables aging and for calculation of the receivables allowance can create disputes. The seller cannot control the buyer's post-closing efforts to collect outstanding receivables, while a seller that maintains cash in the sale will have incentive to collect them prior to close. If the seller is responsible for collecting receivables after closing, what will represent best effort?

Sellers must be particularly careful about "historical practice

While the preparation of estimated and closing balance sheets in accordance with GAAP is a common deal provision, historical practice may be guiding the seller's accounting policies and management judgments. Historical practice is important in a purchase price dispute, but a seller whose accounting policies and principles deviate from GAAP can expect to come under scrutiny regarding GAAP compliance and may need to consider how to negotiate an adjustment. GAAP will trump historical practice considerations unless the purchase agreement is stated such that historical practice earns a premium over GAAP. A non-GAAP treatment stated in the most general terms of the dispute mechanism is likely to be challenged successfully.

When disputes arise post-closing, buyers have a distinct advantage

GAAP defines subsequent events as material events or transactions that occur subsequent to the balance sheet date, but before the financial statements are issued or available to be issued. Type I subsequent events provide additional evidence with respect to conditions that existed as of the financial statement date and must be recognized in the financial statements. Type II subsequent events provide evidence with respect to conditions that did not exist at the financial statement date, but arose subsequently.

A buyer and seller may negotiate a hard close, in which the only liabilities to be considered are invoices received as of the closing date; subsequent liabilities for resolution of legal or other matters will not be taken into account. Absent such a provision, an arbitrator could keep a Type 1 matter open for months before making a judgment, time that the buyer can use to build the case for its position in the post-closing adjustment.

Specifying the subsequent events period in the M&A agreement and ensuring that the requirements of the agreement are consistent with the parties' intentions can help in avoiding a post-closing dispute.

Five steps that can help seal the deal

The following steps can help reduce the likelihood of post-closing M&A disputes:

Define the accounting basis. State explicitly whether International Financial Reporting Standards, GAAP, or GAAP-with-exceptions applies.

Reconcile definitions in the agreement with accounting definitions in the dispute clause. Advisors and counsel can assist in establishing consistency.

Clearly define historical practices in areas where judgments and estimates come into play. Laying out warranty reserves, bad debt reserves, and reserves against inventory specifically in the agreement can help in avoiding disputes. If a dispute does arise, the arbitrator has basis for a "GAAP except for" or "GAAP under the following accounting policies or practices" judgment.

Consider when to close the books or transaction. Month-end closes are simplest, but period-end adjustments will need to be considered if the closing is not at year-end.

Consider the impact of the transaction itself on the closing balance sheet. Issues to address include the transaction costs to the seller, whether or not the costs are part of the closing working capital, and whether bonuses to executives or employees are part of working capital in the dispute.

Our take: Added care in preparation can help rein-in disputes

Most post-close disputes arise when broad purchase price adjustment provisions assign working capital a high value without reference to existing accounting policies. Disagreements can arise over how to apply GAAP to certain facts and circumstances. Buyers will understandably look for ways to increase the liabilities and decrease the assets of a deal for purposes of the working capital adjustment. While most disputes unfold in good faith, both buyers and sellers should be ready to defend their positions in the event one or the other party adopts aggressive positions and practices that deviate from expectations for how to measure changing value over time.

Contacts

For more information regarding post-closing disputes, contact:

Gary Levin
Partner | Deloitte Risk & Financial Advisory
Deloitte Financial Advisory Services LLP
glevin@deloitte.com
+1 847 867 3102

Steven Stanton
Managing Director | Deloitte Risk & Financial Advisory
Deloitte Financial Advisory Services LLP
ststanton@deloitte.com
+1 202 220 2120

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