

DECEMBER 2015

FINANCIER
WORLDWIDE corporatefinanceintelligence



MERGERS & ACQUISITIONS

The unaccounted cost of accounting-sounding terms in purchase agreements

ADORIA LIM AND YVETTE AUSTIN SMITH

THE BRATTLE GROUP

Mergers and acquisitions can benefit companies by increasing the breadth and depth of companies' goods and services, and enabling companies to capture economies of scale. Of course, not all mergers and acquisitions go as planned. The very act of merging or acquiring (or trying to do so) can spawn litigation of various flavours such as shareholder lawsuits and antitrust litigation. While some of this litigation is likely difficult to avoid, the risk of one type of litigation – disagreements between parties over the interpretation of accounting terms of art or 'accounting-sounding' terms in purchase agreements – can easily be reduced.

Purchase agreements often contain accounting terms of art (e.g., 'accounts receivable') or phrases referencing accounting standards (e.g., 'financial statements prepared in accordance with US Generally Accepted Accounting Principles' or GAAP). Sometimes, however, the imprecise use of accounting terms of art or accounting-sounding terms in purchase agreements can quickly become a source of disagreement between parties, or worse, result in litigation.



Brattle

THE POWER OF **ECONOMICS**

Adoria Lim and Yvette Austin Smith are principals at The Brattle Group. Ms Lim can be contacted on +1 (415) 217 1000 or by email: adoria.lim@brattle.com. Ms Austin Smith can be contacted on +1 (212) 789 3650 or by email: yvette.austinsmith@brattle.com.

For example, a US District Court judge recently ruled that JPMorgan Chase was not responsible for certain mortgage repurchase obligations arising from soured mortgage-backed securities issued by Washington Mutual. JPMorgan Chase acquired WaMu in 2008. The source of the dispute was the use of the accounting-sounding term 'books and records' in the purchase agreement between the Federal Deposit Insurance Corporation (FDIC) and JPMorgan Chase. Instead of identifying specific liabilities included and excluded in the sale, the purchase agreement stated that JPMorgan assumed "all of the liabilities of the failed bank which are reflected on the books and records of the failed bank as of bank closing". The two parties subsequently fought as to the meaning of 'books and records', a term not defined under GAAP. JPMorgan Chase argued that it was responsible for the 'book value' of WaMu's liabilities at the time of the sale, whereas the FDIC argued that JPMorgan Chase was responsible for mortgage repurchase obligations in excess of WaMu's recorded liabilities.

Unfortunately, litigation involving the assumption of liabilities is not unusual. In another recent matter, a purchase agreement called for an adjustment to future proceeds payable to certain

selling shareholders. The calculation of the adjustment was, in part, based on the assumption of 'liabilities' in a subsequent purchase transaction. The parties to the agreement agreed that assumed debt was appropriate to include in the adjustment to proceeds. However, the parties disagreed on the extent to which an assumption of deferred revenue should also be included in the adjustment.

Deferred revenue is classified as a liability under GAAP. It represents advance payments from customers for goods or services that a company has yet to deliver. The parties disagreed as to whether the assumption of deferred revenue should be considered gross or net of the advance payments (i.e., cash) the company had received. The parties also disagreed about how to treat incremental costs that the company would incur to provide the future goods or services. The dispute arose because the parties had failed to consider the full implications of assumed 'liabilities' in the specific context of this company.

Another circumstance in which accounting-sounding terms can lead to disputes is the exclusion of 'unusual' or 'extraordinary' items in the calculation of an earn-out provision. As part of the negotiation of a deal, both the seller and the buyer often compute

historical and projected earnings excluding non-recurring or non-cash items to assess the acquisition target's stream of recurring future cash flows, which is what the buyer is theoretically acquiring. Because future cash flows are difficult to predict, many purchase agreements contain earn-out provisions, in which the purchase price of the acquired company is based in part on a multiple of the acquired company's future earnings following the date of acquisition.

In keeping with the notion that the buyer is paying for recurring cash flows, such earn-out provisions may exclude 'unusual' or 'extraordinary' items in the calculation of earnings. The potential problem arises a few months down the road when the acquired company has unanticipated gains and losses after the acquisition is consummated; the seller and the buyer may then discover that they have a very different understanding of what those terms mean and the resulting calculation of the earn-out provision.

First, a businessman's lay interpretation of 'unusual' or 'extraordinary' may be quite different from the definition of these terms under GAAP. Second, even if the agreement specifies that such terms should be understood with reference to GAAP, GAAP provides



very few examples of items the term 'unusual' can include, leaving a lot of room for judgment or disagreement. To make matters even more confusing, at the beginning of 2015 the Financial Accounting Standards Board updated GAAP to eliminate the presentation of an 'extraordinary item' in a company's financial statements along with the official GAAP definition of an 'extraordinary item'.

While most sellers and buyers would agree that restructuring expenses and other one-time charges such as inventory write-downs should be considered 'unusual,' consider something less clear-cut: large and unexpected foreign currency gains. The parties may have very different views on what should be considered

'unusual' because they have opposing incentives. The buyer has an incentive to exclude such gains in the calculation of an earn-out provision whereas the seller has an incentive to include them. From the buyer's perspective, if the earn-out is based on a multiple of the acquired company's earnings after the acquisition date and the foreign currency gains are not expected to reoccur, the buyer should not pay a multiple on these one-time gains, as that would result in a windfall to the seller. On the other hand, the seller would consider the unexpected gains, even if they were not expected to reoccur, a windfall to the buyer, who after the acquisition date is entitled to the company's gains. Unfortunately, these divergent views can quickly

escalate into litigation.

The bottom line is that while accounting is the 'language of business,' the imprecise use of accounting terms of art or accounting-sounding terms without specific identification of the nature of items to be included in those terms can quickly become a bone of contention and a source of litigation. When in doubt, consider the nature of an acquired company's business and the industry and environment in which it operates and draft a purchase agreement that is as specific as possible. And when you do use accounting terms of art or accounting-sounding terms in your next purchase agreement, consider consulting your accountant to make sure such terms match your intent. ■