The CPA's Role in Quantifying Post-Acquisition Dispute Damages

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Given today's environment of bankruptcies, bank failures and recessionary pressure, consummating merger and acquisition transactions is more challenging than ever. The potential disputes arising from the challenges of an M&A transaction are numerous. The following two types of disputes are the focus of this article: working capital disputes regarding whether the financial statements were in accordance with GAAP; and indemnity claims involving whether the buyer in the transaction obtained the benefit of the bargain.

Most post-acquisition disputes involve some form of financial forensics, and therefore lend themselves to general CPA skills. More often than not, however, these disputes involve specialized business valuation skills (see sidebar "Breaking Into Business Valuation") and are well suited for experienced valuation professionals with a deep skill set in the interpretation of GAAP who are also damage experts and can be credible witnesses in this area (see sidebar "How to Get Experience in M&A-Related Disputes"). This article describes the types of issues that arise in these disputes.

Consider the following example of an M&A dispute in which a CPA may become involved:

> Company A acquires Company B for $400 million, or eight times the annual EBITDA (earnings before interest, taxes, depreciation and amortization) of $50 million. Company A alleges Company B overstated EBITDA by $10 million as a result of material misrepresentations involving GAAP violations. Company A alleges it bargained for a business worth $400 million and received a business worth $320 million, or EBITDA of $40 million × 8 (the EBITDA multiple).

Post-Acquisition Disputes

Post-acquisition disputes between an acquirer and a target company (selling shareholders or management) can arise in various ways, each with unique facts and circumstances producing a combination of accounting, valuation and legal issues. While parties to mergers and acquisitions attempt to create a purchase and sale agreement that clarifies the responsibilities and duties of each party, contracts are often imperfect and open to interpretation, resulting in disputes after the purchase and sale agreement is executed or the transaction is consummated. The most common M&A disputes involve post-closing adjustments for working capital or net assets, indemnity or fraud claims, material adverse change (MAC) claims, and earnout disputes (when both buyer and seller share the risk), among others.

Measuring Damages in M&A Disputes

In a typical acquisition transaction, the target company's purchase price will be evaluated as a multiple of trailing 12 months reported EBITDA with an adjustment for any working capital excess or deficiency above or below a contractually agreed-upon level. The target company's required level of working capital at closing will typically be negotiated, agreed upon and specified in the purchase and sale agreement. The target company's actual levels of working capital will be established by its closing balance sheet presented in accordance with GAAP. (***Note:*** The requirement for GAAP presentation of the target company's closing balance sheet is a common provision of purchase and sale agreements, however, other, non-GAAP agreed-upon accounting principles or amounts may be specified.)

Most post-acquisition disputes involve some form of financial forensics, and therefore lend themselves to general CPA skills.

Here we examine the issue of measuring damages in a dispute involving both working capital and indemnity claims. Working capital claims are typically measured on a dollar-for-dollar basis while indemnity claims can be measured dollar for dollar, over a finite period or into perpetuity. For indemnity claims that imply a permanent impairment to the value of the business, the damages may be measured "at the multiple" (the purchase price divided by the EBITDA of the subject company). The measurement of damages into future periods is predicated on assessing whether:

- The misstatement will affect future periods;
- The buyer's pricing expectations were based on future performance;
- The business was significantly devalued after the acquisition; and
- The misstatement would be "material" to a "willing buyer."

For example, the buyer may allege that $10 million of invoices was not recorded as accounts payable on the balance sheet and assert a working capital claim for a purchase price adjustment. In addition, the buyer may also assert a fraud claim alleging the seller deliberately withheld the information and that it was material to the buyer. As a result of not recording the invoices, the target company's expenses were understated, and EBITDA was overstated. The buyer may claim the purchase price was based on eight times the target's trailing 12 months EBITDA and, therefore, demand a purchase price adjustment of $80 million.

Using the example of $10 million of unrecorded invoices, the question to consider is: Will these expenses impact the target's future performance? If the invoices relate to costs to execute the transaction (one-time items), they would be assumed to be nonrecurring and have no impact on future earnings. However, if they represent incremental ongoing expenses and would have altered the buyer's valuation conclusion, that should be considered along with other economic evidence. If they relate to ordinary expenses such as payroll that is expected to continue in the future, there may be an impact on the target's future earnings and, therefore, its valuation.

Benefit-of-the-Bargain Claims

The invoice example is a fairly straightforward situation, but what if a significant customer was lost just before the transaction, and this was not disclosed to the acquirer? This is not typically a working capital claim. Because the customer's contribution to the profits of the business would impact future earnings and, therefore, current value, nondisclosure of the customer loss represents a potential claim by the buyer. To get to the core of the issue, the CPA expert needs to ask if the customer will be replaced and if its departure was part of ordinary customer turnover; or if the customer is a key source of value to the business. The buyer may make a "benefit-of-the-bargain claim" arguing it did not receive the value that was represented to it by the seller based on the failure to disclose the loss of the customer.

In this scenario, the value of the customer to the business should be evaluated along with the target's customer turnover rates. If the loss and replacement of customers is common for the company, there may not be any damages. A financial analysis of the customer's contribution to the company could result in three potential scenarios: (1) the customer was not profitable to the company; (2) the customer was profitable to the company and was expected to have a finite life with the company; or (3) the customer was profitable, and the expectation was that the customer would be retained for years into the future. If an investigation revealed that scenario 1 was the case, there may be no damages. If scenario 2 was deemed to have occurred, it could possibly result in damages calculated based on the contribution over the life of the customer contract or some other indication of the time period the company would have realized the benefits of the customer. If the facts and assumptions support scenario 3, it could result in a revaluation of the company by excluding the cash flows related to this customer from the target's forecast or pro forma trailing 12 months EBITDA.

Parallels to Intellectual Property Damage Theory

Drawing a parallel to intellectual property damage theory, a consideration in assessing damages is using the benefit of hindsight to evaluate what actually happened with a specific claim and the target company after the transaction (known as the "Book of Wisdom" for intellectual property cases). For example, in a working capital claim, if the buyer alleges accounts receivable were overstated but collects all of the accounts receivable post-closing, it is an indication that the reported balance was valid. Likewise, if the loss of a major customer merely represents customer turnover and does not affect future performance, and the value of the company post-closing is substantially the same or greater than what the buyer expected at the time of the transaction, the buyer may have received the benefit of the bargain.

Another important factor to consider is the seller's perspective. However, if the seller made material misrepresentations, this may diminish the significance of the seller's perspective. Just because a buyer makes a claim that it would have paid less for a company, it does not mean the seller would have accepted less, particularly if in the subsequent period the business is worth at least the amount of the purchase price. This may be evidence the buyer received the benefit of the bargain. This leads to another parallel to intellectual property damage theory: the hypothetical negotiation as described in *Georgia Pacific v. U.S. Plywood Corp.* (318 F. Supp. 1116 (S.D. N.Y. 1970); see, also, "How Reasonable Is Your Royalty?" *JofA*, Sept. 08, page 56). Similar to the application of the *Georgia Pacific* factors in a reasonable royalty analysis, there are factors that both the buyer and seller would likely consider if the information surrounding the dispute had been discussed contemporaneous to the transaction. Factors to consider include:

1. **Contemporaneous Factors**
   a. Is the item in dispute a working capital or indemnity claim, or both?
   b. What period(s) does the disputed item impact—current, multiple or perpetuity?
   c. What impact does the item have on the company's cash flows?
   d. What impact does the item have on the company's overall risk profile?
   e. What impact does the item have on the comparability to guideline companies if the valuation multiple were based on such companies?
   f. What were the seller's alternatives to a sale to the buyer?

EXECUTIVE SUMMARY

■ **Legal actions involving claims** for post-acquisition purchase price adjustments are a growing area where a CPA's expertise in GAAP, financial forensics and business valuation is in high demand. A CPA may become involved in a post-M&A transaction to quantify the benefit-of-the-bargain damages in a dispute.

■ **The most common M&A disputes** involve post-closing adjustments for working capital or net assets, indemnity or fraud claims, material adverse change (MAC) claims, and earnout disputes, among others.

■ **In a dispute involving both working capital** and indemnity claims, working capital claims are typically measured on a dollar-for-dollar basis, while indemnity claims can be measured dollar for dollar, over a finite period or into perpetuity. It is not uncommon for both issues to be raised.

■ **The measurement of damages into future periods** is predicated on assessing whether the misstatement will affect future periods; the buyer's expectations were based on future performance; the business was significantly devalued after the acquisition; and the misstatement would have been "material" to a "willing buyer."

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How to Get Experience in M&A-Related Disputes

Most CPAs with an accounting and auditing background have advised a client who has acquired or sold a business or business interest. Disputes may arise related to the M&A transaction as outlined in the accompanying article. Having the requisite skills and experience to assist the client in resolving the dispute can add tremendous value to the relationship.

"If you are an experienced CPA able to interpret GAAP, you are qualified to get involved in a working capital dispute. If you're a valuation professional, you can assist in valuation and damage issues as to what the buyer paid for the deal or the bargain, versus what the deal was worth given certain misrepresentations, which may have been made by the seller," says Jeff Litvak. "CPAs with an accounting background, who are valuation experts as well, can get involved by working with attorneys who specialize in deal litigation."

A CPA can become involved in post-acquisition disputes in a number of ways. The CPA, as an expert in GAAP, can serve as a mediator or arbitrator in a post-acquisition dispute that involves an assertion that the target company's closing financial statements, and specifically the closing balance sheet, were not presented in accordance with GAAP or contained material errors. A CPA can also serve as an accounting expert for either the plaintiff (usually the buyer) or the defendant (usually the seller) to establish or rebut assertions surrounding the GAAP presentation contained in the target company's financial statements. A CPA also can serve as a damages/valuation expert to quantify the alleged decline in the value of the target company related to fraudulent/material misrepresentation by the seller, not properly disclosed to the buyer.

CPAs who want to become involved in working capital disputes should be very comfortable with the following core competencies:

Fundamental expertise in GAAP. "An early mistake I made in a marketing call with an attorney was to naively overlook the GAAP interpretation issues that were at the center of the working capital dispute. I made an assumption that the nature of the case would be drawing on my background as a valuation and damage expert. What the attorney wanted to know was what my expertise was in GAAP matters," says Bill Kennedy.

"An important nuance to understand is that what necessarily would apply in accounting and auditing in strict terms may not be the way it will play out in a working capital or indemnification dispute," says Litvak. "For example, on the topic of materiality, generally, most items are material to an arbitrator. Whereas, in an audit, certain items may be deemed to be material by the auditors, most every item is material in a dispute."

Valuation. "In a post-M&A dispute, valuation analysis is not a traditional USPAP (Uniform Standards of Professional Appraisal Practice) valuation but more akin to a damage analysis. The CPA will need to have expertise to understand how to recalculate the purchase price, but it is much simpler than what is done under SSVS1 (Statement on Standards for Valuation Services no. 1)," says Kennedy. The valuation aspects are very straightforward and almost fundamental, except for the issue of whether the buyer is entitled to a multiple of the misstatement.

"CPAs typically misunderstand that much of what we do is damage analysis and not pure valuation," explains Litvak. "In order to do the damage analysis in a post-M&A dispute, you have to have a valuation background. But on the valuation issues, you do not necessarily have to revalue the company—you have to value the alleged misstatement and determine if the damages are dollar for dollar or to be calculated at the multiple. So you're doing your damage analysis based on the misstatement. This is a common mistake, and performing a full-scale valuation instead of a damage analysis does not provide the best insight and information for the trier of fact. The way to prove the benefit-of-the-bargain damages is to value the misstatements, using both accounting and valuation analysis."

Experience as a testifying expert. "CPAs who are looking to obtain more experience in M&A disputes should seek out projects within their firms to try to obtain more exposure to the M&A process and become involved in transactions," says Ken Mathieu. "This will assist them in obtaining the background they need."

An important difference regarding working capital disputes is that a lot of these cases are heard in arbitration, as opposed to in court. CPAs do not necessarily need familiarity with arbitration, but they need to understand the difference. "In arbitration, you're dealing with a more sophisticated trier of fact," says Kennedy. The arbitrators involved are chosen because of their technical expertise. So the CPA may be testifying before a CPA arbitrator who is hearing evidence on the GAAP issues and making a ruling. "In a courtroom situation, the panel of jurors and perhaps even the judge probably will not understand the nuances of the more sophisticated issues of GAAP and its interpretation."

"Get to know the due diligence people in your firm or in your community," says Litvak. "As you begin to mature in this area, you'll get to know the lawyers who write the contracts and who would think of you as a neutral accounting arbiter or an expert in M&A disputes."

"It is also important to have nonlitigation exposure on M&A issues in valuation before getting into this business," says Mathieu. "Having nonlitigation exposure to these issues is important for having the credentials necessary to do this type of work."

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g. What valuation approaches and methodologies were used by the parties to the transaction?

2. **Post-Closing Factors**

a. How did the item in dispute materialize?

b. How does the financial performance of the subject company compare to the buyer's expectations at the time of the deal?

c. How does the financial performance of the subject company compare to the seller's forecasts at the time of the deal?

d. What factors influenced subsequent financial performance?

These factors are intended to provide general guidance as it is important to consider all of the facts and circumstances of each case when assessing post-merger-and-acquisition damages.

CASE STUDY

A simplified case study example helps illustrate how M&A purchase price adjustments could be claimed by a buyer against a seller in a post-acquisition dispute.

Facts. ABC Co. is a leading global supplier of axles, brakes and other components for off-highway and specialty vehicles. The buyer paid $350 million, or 8.4 times EBITDA of $41.67 million.

Buyer's claim. Two million dollars in working capital claims resulted in EBITDA being $2 million less than represented. The buyer claims it is entitled to $18.8 million in damages consisting of: (1) $2 million in dollar-for-dollar working capital adjustments, and (2) $16.8 million in lost value ($2 million lower level of EBITDA × 8.4 multiple of EBITDA paid for company) as the buyer did not receive the benefit of the bargain. Exhibit 1 shows the buyer's damages calculation.

Seller's defense. Working capital claims should be settled on a dollar-for-dollar basis after the merits of each claim are established. The seller asserts that the buyer is not entitled to benefit-of-the-bargain damages of $16.8 million because: (1) the seller did not warrant/represent EBITDA

Exhibit 1 Buyer's Damages Calculation

($ Millions)

EBITDA Shortfall	$ 2
Times: Deal Multiple	8.4
Benefit-of-the-Bargain Damages	16.8
Plus: Dollar-for-Dollar Working Capital Damages	2
Total Damages	**$ 18.8**

Exhibit 2 Seller's Damages Calculation

($ Millions)

Purchase Price/Bargain	$ 350
Less: Actually Received	350
Benefit-of-the-Bargain Damages	–
Plus: Dollar-for-Dollar Working Capital Damages	2
Total Damages	**$ 2**

projections, (2) the buyer obtained the benefit of the bargain as the company was worth significantly more than the purchase price one year after the closing (company's EBITDA grew significantly post-closing), and (3) there had been no major downturn in the target company's performance after the transaction's closing directly attributable to the claimed misrepresentations. Exhibit 2 shows the seller's damages calculation.

Conclusion

Post-acquisition disputes can be fertile ground for CPA experts. While most post-acquisition disputes involve some form of financial forensics, and therefore lend themselves to skills possessed by most CPAs, more often than not, these disputes also involve business valuation principles. The CPA who possesses both skill sets can contribute valuable insight to assist the parties in resolving the dispute. Traditional post-acquisition disputes require the experience and training that CPAs acquire in their general accounting work, but with the nuances of forensic accounting, valuation and expert testimony, additional specific experience and training should be garnered before becoming involved in post-acquisition dispute engagements. ❖

Breaking Into Business Valuation

Steps for small firms to consider when entering the valuation market

An aging population, increased regulation and the move toward fair value reporting have led to increased demand for valuation services in recent years. As baby boomers approach retirement and start thinking about succession and estate planning, the first step is often valuing the family business. Changes to the tax code require people doing valuations on certain assets to be a "qualified appraiser," and the new fair value standards require valuation expertise to implement them.

While it is difficult to establish a valuation practice, it can be a rewarding specialization for your firm. Diversifying your practice will help with client retention, expand your client base, and drive revenue growth. Consider these steps for establishing a valuation practice:

Begin with your current client base. When advising clients on tax planning or estate planning issues, you will see instances where a business valuation is needed. Good first-time valuations could be small family limited partnerships or small businesses. It is common for a practitioner's first valuations to be offered to clients at below market rates in order to gain valuation experience.

Plan on spending a lot of time on your first valuations. Preparing checklists, learning how to comply with standards, and setting up models will be time-consuming. Use caution with software valuation packages as some have been found to have significant errors in their models and report-writing modules. It is important to understand the models used to develop your valuations as you should always assume you are preparing a valuation that will be defended in court.

Offer valuation services to local firms that don't have the ability to do valuations for their clients. You will most likely have to offer these services at below market rates to get things started. Your network of peers and your reputation with them will be very important if you decide to pursue this route.

Ensure that engagements are performed in accordance with any applicable guidance. The AICPA issued Statement on Standards for Valuation Services no. 1 (SSVS1) in June 2007, effective for all engagements entered into after Jan. 1, 2008. All AICPA members are required to comply with SSVS1. For CPAs, this standard has been adopted by most state accountancy boards, so check with your state licensing agency to see which standards must be followed.

Get a seasoned valuation expert to review your first reports. The report is often the end product that is seen by clients, and a well-written report can leave a lasting impression on clients and counsel. The report review, if done properly, will take several hours to perform, so plan on engaging a valuation specialist to do this work with the knowledge that you will have to pay for this review. A good place to identify experts is through the ABV locator, which is searchable by name or location, at **findanabv.org**.

Get a valuation credential. The American Society of Appraisers (ASA) and the National Association of Certified Valuation Analysts (NACVA) offer credentials available to CPAs and non-CPAs. The Accredited in Business Valuation (ABV) credential is available only to CPAs with an active license and is supported by the AICPA (visit **aicpa.org/ABV** for details). All of these credentials require an exam. The AICPA and ASA credentials also require actual experience performing valuations and minimum education requirements. A credential will be a valuable marketing tool to hold yourself out as meeting minimum requirements for knowledge and competency in performing valuation work. A credential can also identify you as an expert in litigation proceedings.

Market your valuation practice. In marketing your firm for valuation engagements, the end-user often is not the person who will hire the firm. Quite often it is the lawyer or other accounting firm that identifies the valuation specialists and engages them to do the valuation. Consider making presentations to local bar associations and bankers associations to explain what valuation is and why they should hire an expert. Networking with other local accounting firms can lead to valuable referrals for new work.

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