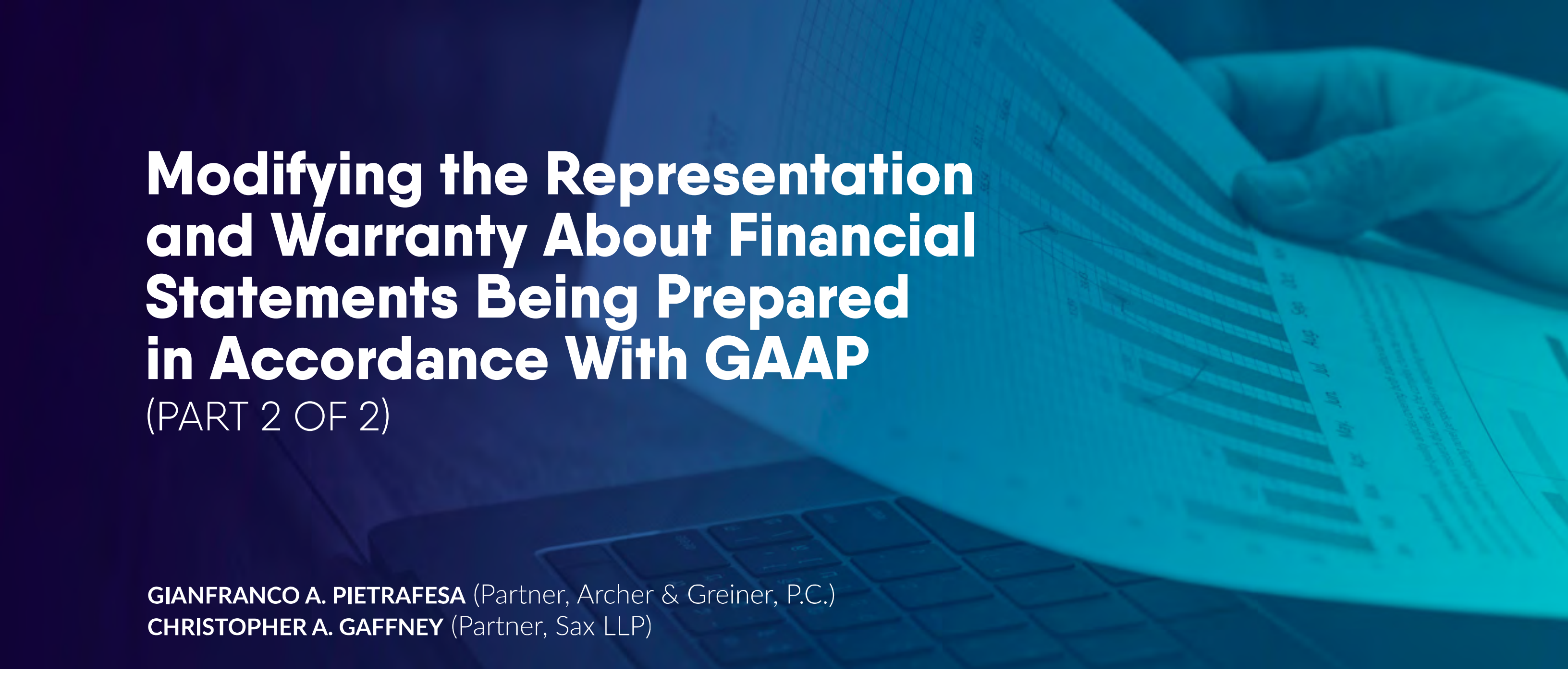

Modifying the Representation and Warranty About Financial Statements Being Prepared in Accordance With GAAP

(PART 2 OF 2)

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Part 1 of this article reviewed the customary representation and warranty ("**R&W**") in stock and asset purchase agreements concerning a target company's financial statements being prepared in accordance with generally accepted accounting principles in the United States ("**GAAP**"). It noted that many private companies, especially small, closely-held, and family-owned companies, do not prepare their financial statements in accordance with GAAP. In other words, their financial statements deviate from GAAP. Yet, many attorneys representing buyers will require the R&W to state that the company's financial statements were prepared in accordance with GAAP.

We previously proposed how attorneys representing sellers can respond to such a position by modifying the R&W. This Part 2 of the article identifies some of the more common deviations from GAAP.

Proposed R&W

In Part 1, we proposed the following R&W concerning the preparation of financial statements:

[*Alternative 1*: Except as set forth on Schedule xxx, the Financial Statements have been prepared in accordance with GAAP applied on a consistent basis throughout the periods covered by the Financial Statements.] [*Alternative 2*: The Financial Statements have been prepared in accordance with the Accounting Principles applied on a consistent basis throughout the periods covered by the Financial Statements.] The Financial Statements are consistent with the accounting records of the Company, and fairly present in all material respects the financial condition of the Company as of the dates thereof and the results of the operations and cash flows of the Company for the periods indicated.

The disclosure schedule or the definition of Accounting Principles would describe the deviations from GAAP.

Common Deviations from GAAP

It is important for a seller's accountant to review, and provide comments to, a target company's financial statements R&W. If a target company does not use an accountant to prepare its financial statements, then the seller must decide whether to engage an accountant to review the target company's accounting records and financial statements in order to review and comment on the financial statements R&W. Or, in the alternative, the seller will bear the risks associated with not engaging an accountant to do so. For example, being liable to indemnify a buyer that suffers a loss due to an inaccurate R&W about financial statements.

An attorney must work closely with a seller's accountant since most attorneys do not have the requisite knowledge of GAAP and its nuances nor the knowledge about a company's specific accounting practices. Otherwise, an attorney may not be able to modify the financial statements R&W and, perhaps more importantly, identify the deviations from GAAP.

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To adequately discuss this issue with a seller of a target company and its accountants, attorneys should be aware of some of the more common deviations from GAAP, most of which result from using a cash-basis (or a hybrid method) instead of an accrual-basis of accounting.

Cash-basis financial statements typically will report revenue ***when received*** and expenses ***when paid***. Accrual-basis financial statements under GAAP ***require*** revenue to be recognized ***when earned*** and expenses ***when incurred***. Therefore, accrual-basis financial statements prepared in accordance with GAAP will include, and cash-basis financial statements will not include, such items as accounts receivable and accounts payable.

Other common deviations from GAAP – reporting differences between cash-basis and accrual-basis (GAAP) financial statements – include the following:

	ACCRUAL-BASIS	CASH-BASIS
Deferred Revenue	Advanced payments for goods or services may be accounted for as deferred revenue and recognized in income over the period of the contract or when the goods are delivered.	Advanced payments are typically included in income when the cash payment is received.
Prepaid Expenses	Prepaid expenses are capitalized and recognized over the period to which the payments relate.	Prepaid expenses are deducted when paid.
Accrued Expenses	Accrued expenses (e.g., compensation and paid-time-off) are deducted when incurred.	Accrued expenses are deducted when paid.
Reserves for Contingent Liabilities	Companies are required to assess and record contingent liabilities and establish reserves (e.g., warranties, litigation, environmental liability, business restructuring, allowances for uncollectible receivables, etc.).	No reserves are recorded.

ACCRUAL-BASIS	CASH-BASIS
Inventory	
Companies must manage and assess inventory under GAAP; for example, noting obsolete and slow-moving inventory, and factoring overhead into the inventory valuation.	Cash-basis inventory often lacks the level of sophistication required by GAAP; for example, evaluation for obsolescence. Also, there may be instances where inventory is not even maintained under the cash-basis.
Real Estate Leases	
Companies are required to evaluate leases under ASC 842, which results in the recording of right-of-use assets (ROU) and lease liabilities to the balance sheet and periodic expenses for amortization and interest expense to the income statement.	Cash-basis generally expenses lease payments as they are made.
Depreciation	
Fixed assets may be required to be capitalized and depreciated over a specific period of time.	Depreciation may be accelerated, leading to a lower book value for fixed assets compared to accrual-basis reporting.
Impairment Testing	
Impairment testing is required for goodwill, intangibles, and property plant and equipment, which could result in a write-down of assets on the balance sheet.	No impairment testing, potentially leading to an overstatement of assets on the balance sheet when compared to the accrual-basis.
Equity-Based Compensation	
Equity-based compensation is recorded as an expense over the vesting period, using the fair value of the award determined at the grant date.	These expenses are not recognized on a cash-basis until the income is recognized by the recipient of the equity-based compensation.

ACCRUAL-BASIS	CASH-BASIS
Deferred Income Taxes	
Deferred income taxes are recognized based on the differences between the accrual-basis carrying amounts of assets and liabilities and their corresponding tax bases. As a result, GAAP financial statements report deferred tax assets or liabilities on the balance sheet, with corresponding deferred tax expenses or benefits recorded on the income statement. These deferred tax assets and liabilities represent the potential tax gain or loss that a company would recognize if the assets were sold, or the liabilities were settled at their book value.	Does not recognize deferred income taxes, limiting the insight into potential future taxable events resulting from book-tax differences.

Finally, although cash-basis financial statements may include disclosures in footnotes, these disclosures likely will not comply with GAAP. As a result, it is difficult to compare a target company's results, accounting methods, and policies with those of similar companies.

Conclusion

When a target company's financial statements are not prepared in accordance with GAAP, a seller's attorney must modify the customary R&W in a purchase agreement and disclose how the financial statements deviate from GAAP. Doing so will minimize or even eliminate claims for indemnification for any purported losses incurred by a buyer due to an inaccurate R&W about financial statements being prepared in accordance with GAAP.