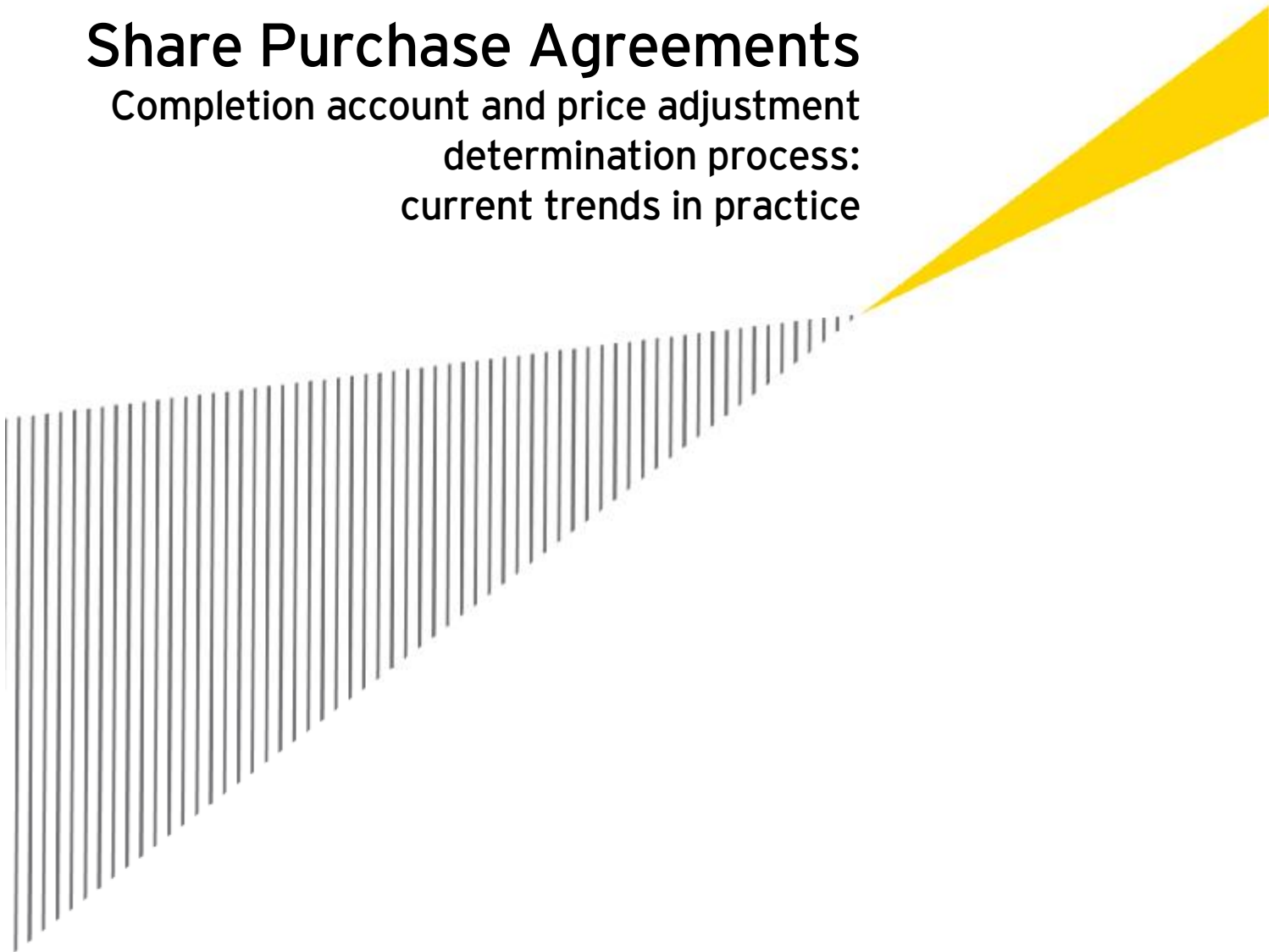


# Share Purchase Agreements

Completion account and price adjustment  
determination process:  
current trends in practice





Undertaking a professional due diligence exercise has become an established part of the standard transaction process. The due diligence findings are typically taken into account either in the purchase price, often through price adjustments based on completion accounts, or in the contractual terms of the share purchase agreement. This brochure provides an overview of trends in the completion accounts preparation and review process.

## Table of contents

<b>Overview</b>	<b>4</b>
Completion accounts and price adjustment preparation process	4
<b>Analysis</b>	<b>5</b>
Who prepares the completion accounts and the price adjustment calculation?	5
Who reviews the completion accounts and price adjustment calculation?	6
At what date are the completion accounts prepared?	7
How many days does the preparer have to finalise the completion accounts and price adjustment calculation?	8
How many days does the reviewer have to review the completion accounts and price adjustment calculation?	8
<b>Assurance procedures undertaken by external auditors</b>	<b>9</b>
Are the completion accounts subject to procedures by an external auditor?	9
Are the price adjustments subject to procedures by an external auditor?	10
Who is responsible for the costs of the review performed by the external auditor?	10
<b>Dispute resolution process</b>	<b>11</b>
Is there a minimum threshold specified to trigger the dispute resolution process?	11
Who is in charge of dispute resolution?	11
<b>Conclusion</b>	<b>12</b>

# Overview

Our previous research has shown that whilst fixed price purchase price mechanisms are once again becoming more common, price adjustment mechanisms still feature prominently. Purchase price adjustments protect the buyer against value erosion and value leakage out of the target company until the closing date. At the same time, they should reward the seller for good management of the business until closing.

Not only is it important to agree on and specify the purchase price adjustments in the share purchase agreement (SPA), but also to agree on and specify the process to be undertaken in preparing the completion accounts on which the price adjustments are based. The structure of price adjustments, as well as the definitions of net working capital and net debt, were studied in our last SPA brochure dated October 2008.

The key issues which present themselves in this case are: which party is to be contractually obliged to prepare the completion accounts and price adjustment and what are the benefits of being the preparer; what time-frame is typically assigned to the process and what factors influence the time-frame, and; in the case that a dispute should arise over the price adjustments, what is the dispute resolution process?

This brochure explores key factors that should be considered when negotiating the completion accounts and purchase price adjustment preparation process, and presents the trends shown in practice.

## Completion account and price adjustment preparation process

Price adjustments are usually calculated based on a target value. Target values are typically based on selected balance sheet positions at the date of the last set of audited accounts, or the accounts used as the transaction basis. These values are then calculated on the same basis at closing based on financial accounts at that date ("Completion accounts")\*. The price adjustment is typically calculated as the difference between the target value and the actual amount at closing.

- ▶ Completion accounts and price adjustments are prepared (usually either by the buyer or the seller) within a specified timeframe from closing, and delivered to the counterparty for review.
- ▶ The counterparty typically has a right to review the completion accounts and price adjustments within a

specified timeframe. If the counterparty does not communicate its disagreement with the purchase price adjustments by the end of the specified timeframe, the adjustments are generally taken to be final.

- ▶ If the counterparty does not agree with the purchase price adjustments, the parties are typically given the opportunity to come to an agreement between themselves within a set period of time.
- ▶ If no agreement has been reached by the end of the specified period, a third party is typically involved. The role of the third party can be that of an arbitrator, or an expert whose decision is final.

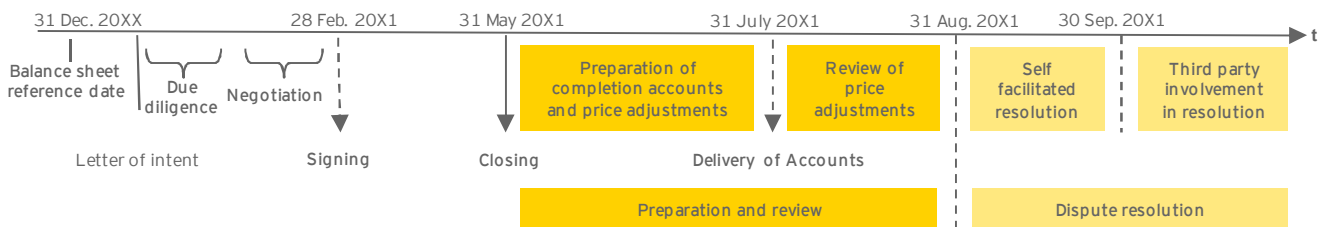


Figure 1 - Transaction overview - price adjustments based on Closing Accounts

\* Adjustments can also be based on future accounts, e.g., earn-out mechanisms

# Analysis

Ernst & Young analysed 50 SPAs with purchase price adjustment mechanisms based on completion accounts in order to identify trends in the preparation and review of completion accounts and purchase price adjustments.

## Who prepares the completion accounts and the price adjustment calculation?

SPAs with a price adjustment mechanism typically assign the responsibility to prepare completion accounts. The responsibility can be assigned to either the buyer or the seller or in rare cases a combination of both, or a third party. There are several benefits from clearly stating who should perform this role, as we indicate below:

### Why responsibility for completion account preparation should be agreed in the SPA

- ▶ When it is agreed in advance which party will prepare the completion accounts and price adjustment calculation, both parties are able to assess the risk that this exposes them to, and factor these into the negotiations.
- ▶ In order to avoid each party preparing different closing accounts.
- ▶ So access to information can be agreed on prior to signing to ensure that the preparer is given the appropriate level of access to target management, accounting records and historical information.

- ▶ So the preparer can plan for adequate resources and timing (including an audit, review or other agreed upon procedures which may be required to be carried out on the completion accounts and/ or price adjustment calculation).
- ▶ There may be significant costs involved in the preparation which, the preparer may want to factor in to purchase price negotiations.

The completion accounts and the price adjustment calculation are usually prepared by the same party. This was the case in 95% of the share purchase agreements with price adjustment mechanisms that we surveyed, as illustrated in the chart below. There are rare cases where this is not the case. For example, we observed one SPA where the price adjustment was required to be calculated by a committee consisting of a representative from each of the buyer, the seller, and a big 4 accounting firm, whereas preparation of the completion accounts was assigned to the seller.

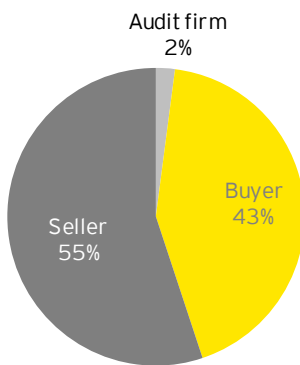


Figure 2 - Completion account preparer

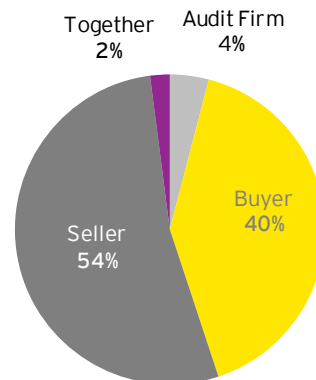


Figure 3 - Price adjustment preparer

There are areas of accounting which are inherently judgemental in nature. In preparing the completion accounts, it is possible to make different judgements on accounting values, both of which fall within the preparation rules. Furthermore, the application of accounting rules can be pushed into a grey area, where it is not clear whether the judgement made is within the rules, or outside the rules. Where different judgements can be made, it is possible that one judgement will favour one party over the other, and vice versa.

As a result, whoever prepares the accounts has the opportunity to make judgements which push the accounting values, and therefore the price adjustments in the preparer's favour.

#### Arguments for preparation by the buyer

- ▶ The buyer may argue that they need to perform a quick integration, and allowing the seller to continue on site to prepare accounts is not conducive to achieving this.
- ▶ The buyer has control of the entity from the closing date and hence during the period that the completion accounts and price adjustments are prepared. The buyer therefore has (theoretically) easier access to information.
- ▶ When the seller is an individual or a number of individuals, rather than a company, the seller may not have the resources to prepare completion accounts, whereas the buyer and the target's accounting team (now controlled by the buyer) will.
- ▶ When the seller is to remain part of the management team, the buyer can argue that if the seller prepares the completion accounts, the seller will have a clear conflict of interest, and will focus too much on this issue, rather than on their management role within the company.

#### Arguments for preparation by the seller

- ▶ The seller may argue they are more familiar with the application of the historically applied accounting policies and therefore in a better position to prepare completion accounts which are required to be either in line with the sellers accounting guidelines or consistent with past practise.
- ▶ If the Target's accounts were prepared or finalised by the Group or holding company's accounting team, the

Therefore, the party who prepares the accounts has an advantage.

Potential arguments that could be used by both parties to negotiate the role of preparer are presented below.

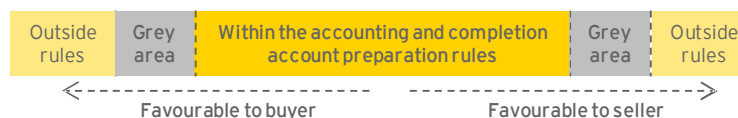


Figure 4 - Scope for manipulation of completion accounts

seller may argue that the Target (and hence the buyer) is not in a position to prepare accounts within a reasonable time period.

- ▶ If the seller remains part of the management team, then the seller can argue that they are best placed to perform the preparation in an efficient manner.
- ▶ The seller may be able to argue that by preparing the completion accounts, the buyer and Target management will have more time to concentrate on integration of the businesses.

Given the advantage held by the preparer, the reviewer should consider ways in which to protect themselves from unfavourable application of accounting policies and preparation rules. This may be achieved to some extent through stricter account preparation rules, specific rules and clauses in the SPA as well as requiring the completion accounts be audited. The requirement for an audit is discussed in more detail later on in this brochure.

Our previous SPA related brochure, dated October 2008, discussed how balance sheet positions should be defined in an exact and explicit way as a means of protection. Additional protection should be sought through ensuring the adjustment target definitions cover a significant portion of the balance sheet. For example, a narrow net working capital definition should be complemented by a broad net debt definition and vice-versa to reduce the ability of the preparer to manipulate the purchase price through reclassifications of balance sheet positions.

### Who reviews the completion accounts and price adjustment calculation?

Once the completion accounts and price adjustments have been prepared, it is typical that the counterparty has the opportunity to review them along with the calculation of the proposed adjustment to the purchase price.

In our analysis, the only case we identified where no review was specified was due to the target being a retail business where the most significant assets at closing were inventories. Additional clauses were built into this particular SPA which

allowed both the buyer and seller to be present at the stocktake performed at closing by an independent third party. In such a situation, this could be considered to mitigate some of the need for a review. In the remainder of the SPAs we surveyed, performance of a review of the completion accounts, or at least the price adjustment calculation was specified.

## At what date are the completion accounts prepared?

Although closing could theoretically be any day of the year, preparing completion accounts is typically done at month-end to be in line with regular month-end closing procedures.

There is also a clear preference for closing accounts to be prepared at year-end as shown in the pie chart below. This suggests that in some cases, the timing of the transaction closing is consciously pushed to year-end.

### Advantages of completion accounts prepared at year-end

- ▶ Statutory accounts are required to be prepared at year-end regardless of whether the entity is being sold, so by using the statutory accounts as the completion accounts, cost and time efficiencies are achieved (particularly when an audit of the closing accounts is also required).
- ▶ Seasonal impacts (particularly when price adjustments based on working capital levels are included in the share purchase agreement) should be reduced, which is an advantage when monthly financial information was not available during the due diligence process.

### Disadvantages of completion accounts prepared at year-end

- ▶ Management's focus may be concentrated elsewhere and it may not be able to devote adequate time and resources to preparation of completion accounts and price adjustments due to year-end reporting requirements. This is particularly an issue for listed companies.

- ▶ If both parties are in a position to sign the share purchase agreement, a number of months before year-end, delaying closing to year-end exposes both parties to risks and costs which they may not be willing to accept (e.g., risk of value erosion for the buyer, and the opportunity cost for the seller of having cash tied up in the target for a longer period of time).

Closing accounts based on a date that is not at a month-end are uncommon, given the view that the closing accounts process is easier to manage and administer, and it is easier to apply cut off procedures at month-end, than part way through the month.

However, it is possible to simplify the closing process for a non-month end close by taking the last month end and rolling forward certain key balance sheet accounts, and reviewing transactions between the last month end and closing.

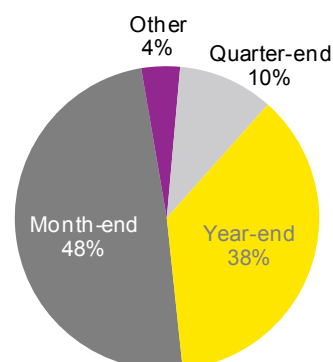


Figure 5 - Completion accounts date

## How many days does the preparer have to finalise the completion accounts and price adjustment calculation?

The length of time required to prepare the closing accounts and price adjustment calculations varies and can be dependent on the following factors:

- ▶ The duration of the Target's usual closing process
- ▶ Complexity of completion accounts to be prepared and of the price adjustment calculations.
- ▶ Whether the closing date is a normal accounts-close or reporting date.
- ▶ Ease of access to required information for preparation of the accounts.
- ▶ The complexity of the completion account preparation rules. For example, specific rules such as writing down receivables over a specified timeframe, will require additional time if this rule is not usually applied.
- ▶ Availability of accounting resources.
- ▶ Whether the accounts are to be audited or reviewed by an accounting firm.

A longer period is preferable for the preparer, as it provides more time to ensure the accounts and adjustment calculations are prepared in a manner which is as favourable to them as it can be within the completion account rules. In addition, if the SPA specifies that the review period is to start from the date that the completion accounts and price adjustments are provided to the other party, a longer period is in favour of the preparer as it could allow them to deliver the completion accounts earlier than expected, thereby catching the reviewer unprepared to review, and thus with less review time.

The reviewer, on the other hand, will favour a shorter preparation time so the preparer will have time only to prepare the accounts, and not to "optimise" the completion accounts or price adjustment in their favour.

SPAs do not typically state explicitly what will happen if the agreed upon time is exceeded.

The most common time frame for completion accounts and price adjustment preparation was around 60 days, or 2 months in the SPA's we sampled. Over 30% of the SPAs surveyed specified a timeframe of around 60 days. The second most common time frame was around one month or 30 days, with 15% specifying this timeframe.

In about 4% of cases we noted that a specific time frame was not provided, but that completion accounts were required to be completed as soon as possible. This is clearly favourable to the preparer, especially when the timeframe for the review by the other party is limited, as it does not provide the reviewing party with the opportunity to plan.

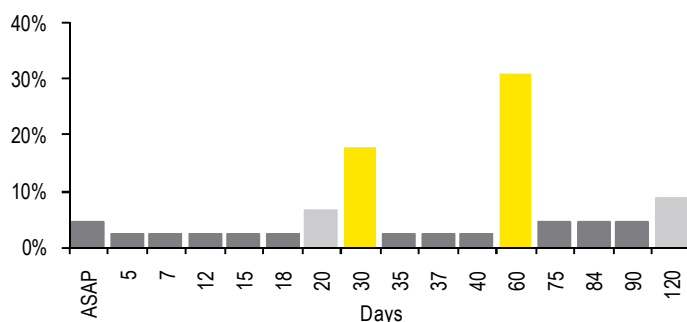


Figure 6 - Days to prepare completion accounts and price adjustments

## How many days does the reviewer have to review the completion accounts and price adjustment calculation?

Reviewers typically have significantly less time to review the completion accounts and price adjustment calculation than the preparer has to prepare them. On average, the reviewer has about half the time of the preparer.

The most common timeframe allocated to the review was around 30 days, or 1 month, with almost 40% of the SPAs reviewed stipulating around 30 days.

It is uncommon that the review period exceeds 30 days, and over 90% of the SPAs reviewed had a review period of 30 days or less.

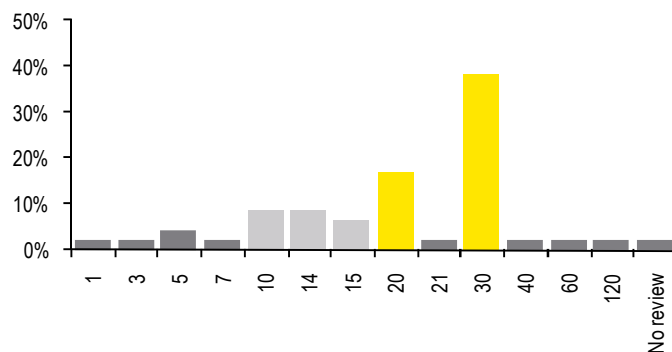


Figure 7 - Days allocated to review price adjustment

## Assurance procedures undertaken by external auditors

It can be beneficial to have an external auditor audit, review or perform agreed upon procedures on the completion accounts and/ or price adjustment calculations. The value of such procedures performed directly on the price adjustment calculations will depend on the complexity of the price adjustments agreed in the SPA. However, the advantages must be weighed against the disadvantages and each specific situation taken into account.

Where an audit or review of the completion accounts is required, it should be kept in mind that it may be of no benefit if there is no requirement that an unqualified opinion be obtained.

### Advantages of a review/audit:

- ▶ The reviewer has more comfort that the completion accounts have been prepared in line with the preparation rules specified in the SPA.
- ▶ The reviewer may not need to spend as much time reviewing the completion accounts. This may be particularly advantageous in situations when the reviewer's human resources are limited.
- ▶ The completion accounts may be less likely to be disputed when they are audited or reviewed (when an unqualified opinion is issued).
- ▶ The preparer can use the fact that an audit has been performed to argue against unfavourable adjustments proposed by the reviewer.

### Disadvantages of a review/audit:

- ▶ The reviewer is more restricted in the arguments that can be made for adjustments to the completion accounts.
- ▶ The preparer may not be able to push the application of accounting and preparation rules to the edges of the "grey area" (as shown in the chart below).
- ▶ The process becomes more costly due to audit fees and resources to be tied up during the process.
- ▶ The process becomes longer.
- ▶ In a situation where there is a carve-out, it may be difficult to perform an audit or issue a suitable opinion, given the nature of carved out accounts and restrictions of many auditing standards.

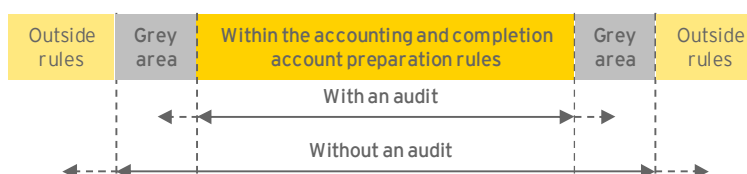


Figure 8 - Scope for manipulation of completion accounts

## Are the completion accounts subject to procedures by an external auditor?

Of the SPAs surveyed, 49% required that either an audit, review or agreed upon procedures be performed on the completion accounts, as illustrated by the chart. Of the 37% of SPAs surveyed that required the completion accounts to be audited, only 17% required that the audit opinion be unqualified.

The value of an audit where a qualified opinion is given is questionable, as it is more likely that a dispute between the seller and buyer will arise. In practise, the requirement for the opinion on the completion accounts to be unqualified does not appear to be used as frequently as it should, which leaves scope for manipulation by the preparer.

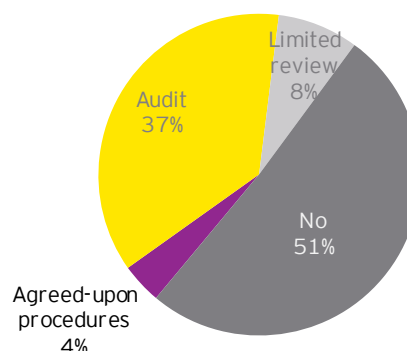


Figure 9 - Completion accounts subject to procedures by auditor

## Are the price adjustments subject to procedures by an external auditor?

Only 27% of the SPAs surveyed required that agreed upon procedures be performed on the price adjustment calculations. All of these SPAs also required that the completion accounts be subject to procedures by an external auditor.

## Who is responsible for the costs of the review performed by the external auditors?

Of the SPAs which specified procedures were to be undertaken by an external auditor, 45% required that the seller bear the costs, and 21% specified that the buyer should bear the costs. The remainder of the SPAs either required that the cost be shared between both parties (21%), or did not explicitly specify which party is liable for the costs.

In 100% of the cases where the seller was liable for the costs of procedures performed by external auditors, the external auditor to be employed was the seller's auditor. Similarly, in 100% of the cases where the buyer was made contractually liable for the costs of procedures performed by external auditors, it was the buyer's auditor who was to provide the services.

In the 13% of SPAs which did not specify which party was contractually liable for the audit costs, the completion

account date was at year-end and the accounts were subject to audit. This suggests that in such situations, the importance of stipulating in the SPA which party is liable for the costs of the audit tends to be overlooked.

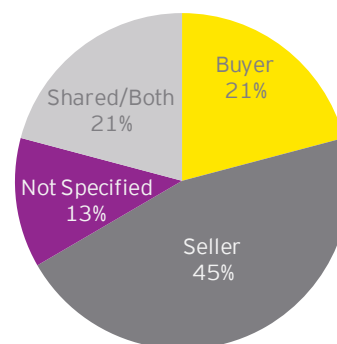


Figure 10 - Party to be liable for costs of external auditor

## Dispute resolution process

Whilst both parties may hope that the other will act in good faith under the terms set out in the SPA, price adjustment clauses have the potential to cause disputes between buyers and sellers.

As a result, most SPAs with price adjustments based on completion accounts also include a dispute resolution process to be followed in case the parties cannot agree on the purchase price adjustments.

Only 4% of SPAs observed did not specify a dispute resolution process for disagreements over the purchase price adjustments between the buyer and seller. The size of the transactions dealt with by these SPAs was typically very small. In such cases it is possible that the costs in relation to the dispute resolution would exceed the benefit gained by changing the price adjustment, and as such the parties may have an incentive to come to an agreement on their own.

### Is there a minimum threshold specified to trigger the dispute resolution process?

Specifying a minimum amount to trigger the dispute resolution process is designed to reduce the costs and time spent on minor disputes. Of the SPAs which specified a dispute resolution process, 23% also specified a minimum threshold ("de-minimis") to trigger the process.

Reasons why the majority of SPAs do not include a minimum threshold to trigger the dispute resolution could include:

- ▶ Perceived difficulties by the lawyers and financial advisors in determining a minimum amount.
- ▶ Given the judgemental nature of accounting, it is usually possible to find enough adjustments to get over the de-minimis. Moreover, the amount of the adjustments claimed is judgemental in itself, so a de-minimis would simply encourage the reviewer to request a larger adjustment.

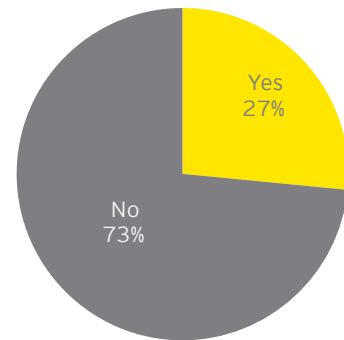


Figure 11- Price adjustments subject to procedures by auditor

### Who is in charge of the dispute resolution?

Of the SPAs which specified a dispute resolution process, 59% indicated that an audit firm be in charge of the dispute resolution, usually in the capacity as an independent expert.

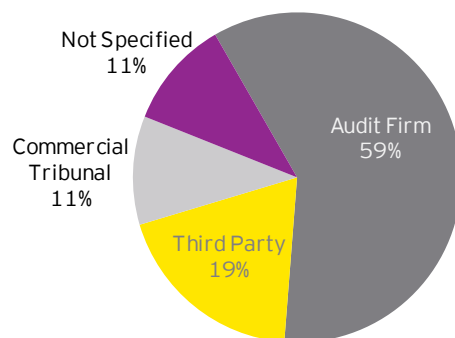


Figure 12 - Who is in charge of the dispute resolution?

## Conclusions

- ▶ The completion accounts preparation process, timing and dispute resolution procedures require careful formulation. Whether the buyer or seller prepares the completion accounts is an area of negotiation.
- ▶ The party responsible for preparation of the completion accounts and price adjustments has an advantage. Provided both parties have the resources to prepare the completion accounts, there are a number of arguments that can be used by both the buyer and the seller in negotiating the preparer role.
- ▶ The typical timeframe for the post closing process is 60 days, (2 months) to prepare the closing accounts and price adjustment calculation and 30 days (1 month) for the counterparty to review the completion accounts and price adjustment calculation.
- ▶ There is a clear preference shown in practice for completion accounts to be prepared at year end, due to the efficiencies that can be achieved through pushing the timing to year-end.
- ▶ Despite the need for the reviewer to protect themselves from the risk of "optimisation" of the completion accounts by the preparer, our experience shows that assurance procedures are not required to be performed in over 50% of cases.
- ▶ Assurance procedures undertaken by external auditors are typically of greater benefit to the reviewer than the preparer. This is due to the additional comfort that can be gained and a potential reduction in the level of review that the reviewer needs to perform. However, the reviewer is also likely to be more restricted in which adjustments can be argued for when the completion accounts have been audited.
- ▶ An unqualified opinion from assurance procedures on completion accounts (whether it be an audit or a review) is key to it being of value, particularly to the reviewer. In practice, it appears that reviewers are not insisting heavily enough that this requirement be built into the agreement as the majority of SPAs which require assurance procedures to be performed, do not require an unqualified opinion to be issued.
- ▶ As price adjustment clauses in SPAs have historically resulted in a number of disputes between buyers and sellers, almost all price adjustment SPAs stipulate a dispute resolution process

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