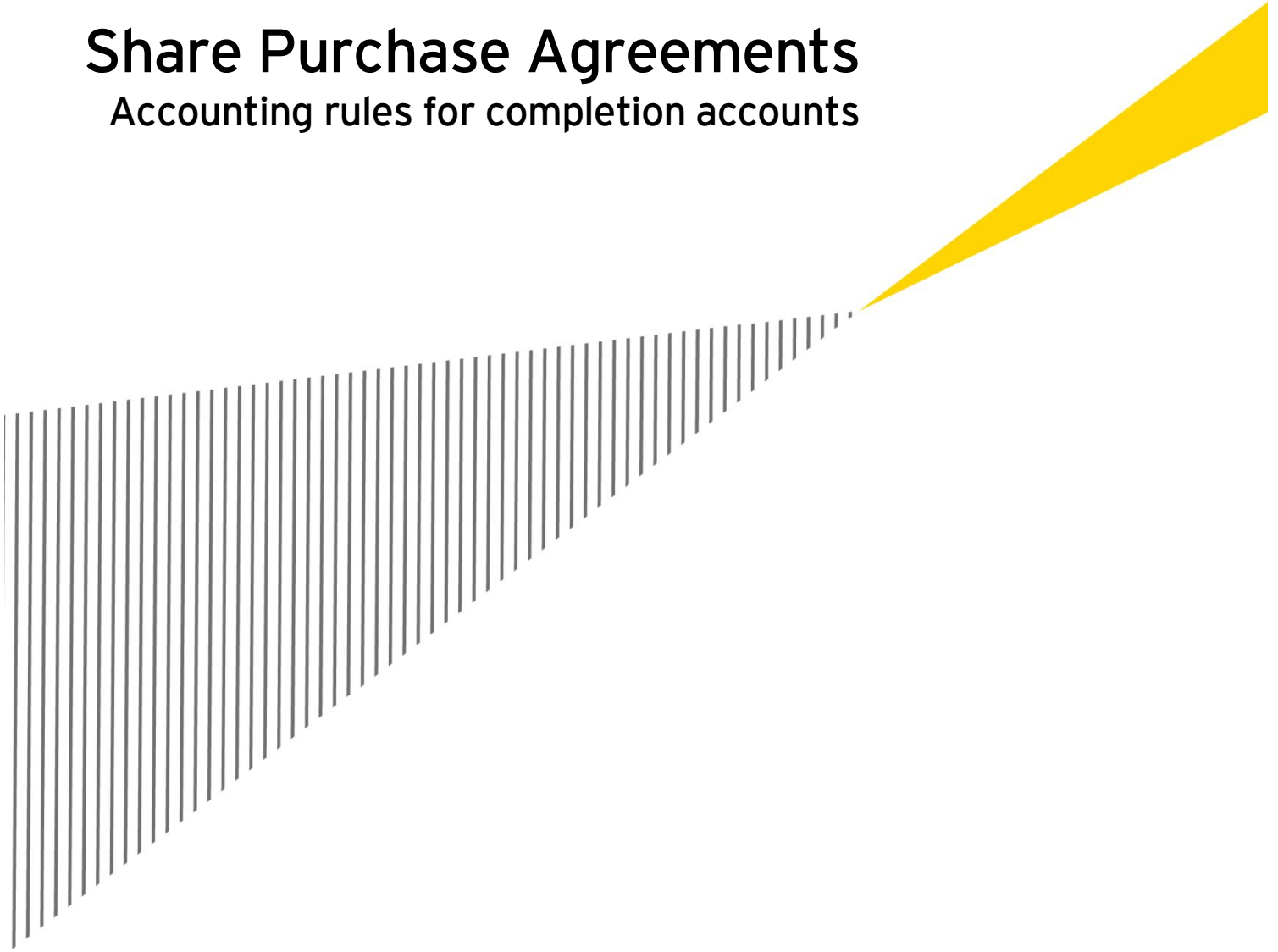


# Share Purchase Agreements

Accounting rules for completion accounts



Undertaking a professional due diligence exercise has become an established part of the standard transaction process. When the due diligence findings are taken into account in the purchase price through price adjustments based on completion accounts, it is necessary that the completion account preparation and accounting rules are specified in the share purchase agreement. This brochure provides an overview of trends in the accounting rules for completion accounts specified and items which should be considered when drafting these rules in the share purchase agreement ('SPA').

## Table of contents

<b>Overview</b>	<b>4</b>
Scope for judgement in accounting	4
<b>Analysis</b>	<b>5</b>
Specification of rules	5
Specific rules and judgemental areas	6
Hierarchy of accounting rules	6
<b>Conclusion</b>	<b>7</b>

## Overview

Price adjustments based on closing accounts are common. In such cases, the adjustment is based on the difference between a target accounting balance and the balance at the closing date. Previous research shows that the most popular price adjustments over the past few years have been working capital and net debt adjustments, or a combination of both.

However, all generally accepted accounting principles have some judgemental areas which can be used by the preparer of the completion accounts to optimise the closing accounts, and thereby the price adjustments, in their favour. As a result, it is important that the closing account preparation rules be

clearly set out in the SPA to limit the potential for purchase price disputes between the buyer and seller post closing.

As SPAs are commonly prepared by lawyers (who do not normally have an accounting background), closing account preparation rules are often high level and not clearly specified.

This brochure explores key factors that should be considered when drafting completion account preparation rules.

## Extent of scope for judgement in accounting

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.

As a result, preparation of the completion accounts often plays an integral role in determining the price adjustments; hence it is important that SPAs specify the rules under which completion accounts are to be prepared.

However, accounting rules are judgemental and there is scope for varying interpretations and application, as is illustrated by the graphic below.

It is not uncommon for SPAs to just state that the completion accounts be prepared under a specific GAAP. This, however, can leave one party open to attack due to the degree of room for judgement in most GAAPs and the ability of the preparer or the reviewer of the accounts to present a different judgement that is also acceptable under the same GAAP.

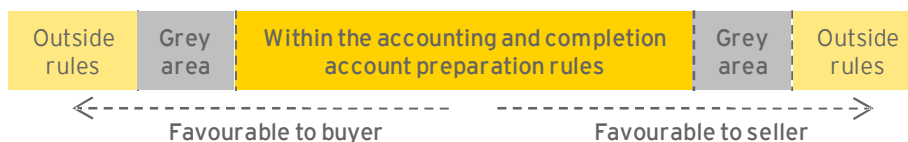


Figure 1 - Scope for manipulation of completion accounts

Using the Target's specified accounting policies as per their accounting manual to narrow the scope for interpretation is better than just specifying a GAAP, so long as both parties (especially the sellers) can be confident that the historical accounts on which the target values were calculated are in line with these policies. Better than this, is for the SPA to require the accounts be prepared on a consistent basis to the reference accounts, and in addition to this, to specify accounting policies to be applied in relation to judgemental areas in the completion accounts or areas which are borderline treatments under the specified GAAP. In practice such areas may not be apparent at the time of drafting the SPA and often a detailed due diligence is needed in order to be able to

understand the impact of pushing the boundaries within the specified GAAP.

In instances where the full balance sheet is not covered by the price adjustments (e.g., non-current assets are often not covered), it may be possible to manipulate net debt or working capital adjustments by reclassifying balances. In such cases it is important to consider how specific rules or the requirement for consistent classification can be set included in the SPA to prevent reclassification.

These preparation rules and the hierarchy of each of the rules should then be clearly specified in the SPA. The following pages contain our findings on how completion account rules are being treated in practice.

# Analysis

Ernst & Young analysed 50 SPAs with purchase price adjustment mechanisms based on completion accounts in order to identify trends in the completion account preparation rules.

## Specification of rules

### GAAP

In almost 90% of SPAs analysed, the GAAP under which the completion accounts were to be prepared was clearly specified. In situations where entities in the target group sat in more than one jurisdiction, it was not uncommon to have several GAAPs specified.

In two of the cases where the GAAP was not clearly specified in the SPA, special preparation rules, as well as the requirement for consistency with prior year financial statements was required. The remaining cases (8% of total SPAs analysed) did not specify any preparation rules at all. Such contracts leave the framework for preparation of the completion accounts and purchase price adjustments wide open for optimisation in favour of the party preparing them.

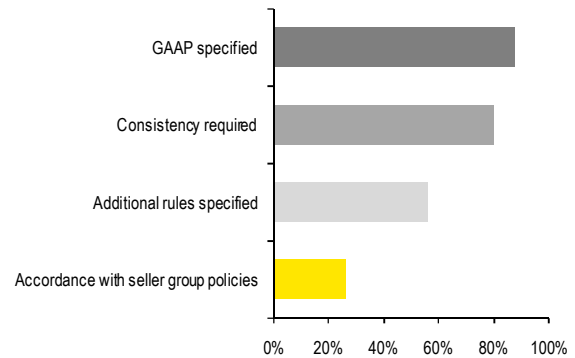


Figure 2 - Specification of accounting rules

### Consistency

As accounting standards allow for a degree of judgement, as well as more than one treatment of an item in some situations, 80% of SPAs analysed expressly required that there be an element of consistency in the application of accounting principles in the completion accounts.

In 50% of cases, the SPAs surveyed required that the accounting policies be applied on a consistent basis with the way they were applied in prior year financial statements. In such cases, it is important that the SPA specify exactly which year's financial statements are to be used as the basis for consistency, as it is possible that the application or the actual accounting policies may have changed over several years.

Consistency with "past practice" (but without reference to which period) was specified in 12% of SPAs analysed. Such wording is ambiguous and as such, is best avoided.

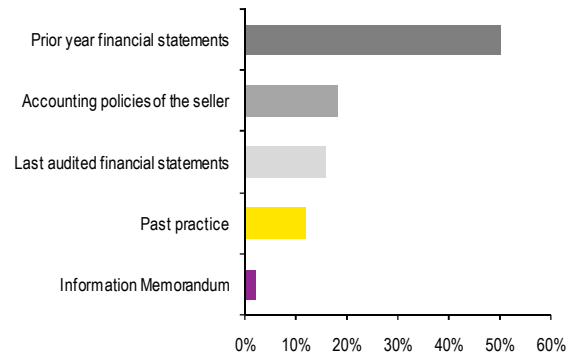


Figure 3 - Specification consistency required

### Specific rules

Often a certain GAAP will allow for more than one way to treat certain items, or there may be areas under the GAAP in which boarder line treatment is used by the target. In addition, there are often judgemental areas where the completion accounts could be manipulated. As a result, it is advisable to specify specific rules to limit surprises and disagreements later on.

Of the SPAs surveyed, 56% contained additional specific rules to be applied when preparing the completion accounts.

## Specific rules/ Judgemental areas

There are a number of judgemental areas in accounting, of which some of the most common are provisioning and asset valuation.

Of the 56% of SPAs that specified additional rules, 50% contained a specific rule in relation to provisions, Other areas typically covered by specific rules include deferred taxes (these are not required to be recognised under all GAAPs), valuation of assets and contingent liabilities.

Other specific accounting policies often reflected a unique situation or circumstances of the target, tax treatment of certain items, or specific treatment of excessive reserves. In addition, there were a number of SPAs where the target was to be carved out from the seller. In such circumstances, the additional rules included specification on how the carve out was to be performed, Further details on carve outs can be found in our carve-out brochure dated September 2009.

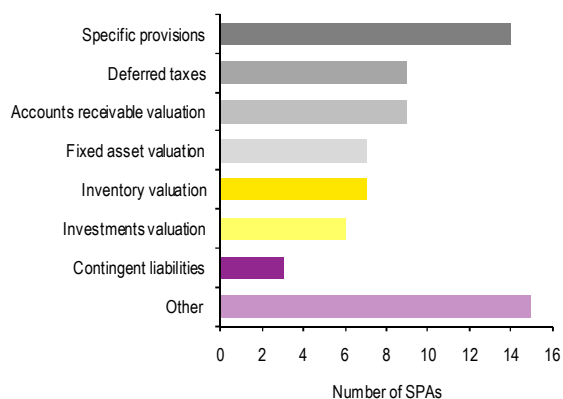


Figure 4 - Common topics for specific rules

## Hierarchy of accounting rules

84% of SPAs surveyed indicate that more than one set of rules were to be applied (i.e., a combination of GAAP, consistent basis, specific accounting rules, or other rules).

Where more than one set of rules are specified, it is possible that there may be conflicts between them. For example, a specific rule may not be in accordance with the GAAP required, and past practice may not be consistent with the specific rules or in line with GAAP. As a result, there could be some ambiguity as to which rules to apply in the completion accounts.

As a result, it is advisable that a hierarchy be specified in all cases where more than one set of rules are specified. However, in practise, it appears that a hierarchy is absent from the majority of SPAs. Only 22% of SPAs surveyed actually specified the hierarchy in which these rules should be applied.

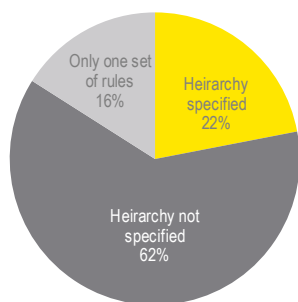


Figure 5 - Proportion of SPAs with a hierarchy specified

A workable approach to applying a hierarchy is to state that the completion accounts be prepared as follows:

- ▶ Firstly: in accordance with account specific or judgemental accounting rules specified in the "specific accounting rules" schedule in the SPA
- ▶ Secondly: on a consistent basis (although it should be noted that this would allow the completion accounts to be consistent outside of GAAP)
- ▶ Thirdly: in accordance with seller or target accounting policies (if applicable)
- ▶ Finally: in accordance with GAAP

In practice, where a hierarchy was specified, specific accounting rules were always listed first in the hierarchy, with the consistent basis most commonly being listed second, and GAAP most commonly listed last.



Figure 6 - Hierarchy of rules

## Conclusions

- ▶ The GAAP to be used should always be specified.
  - ▶ Consideration should be given to including wording to ensure that the completion accounts are prepared on a consistent basis with prior year audited accounts/ reference balance sheet. If specifying prior year accounts, it should be clearly specified which years are meant, and when there have been changes in accounting policies over several years, the accounting policy to be used should be indicated.
  - ▶ Consideration should also be given to the specification of specific accounting policies / treatment. Such specific rules should be developed with consideration of the GAAP to be applied (e.g., disallowing the release or creation of excessive reserves under Swiss OR), and the current events and situation surrounding the target (e.g., potential to reclassify items in the balance sheet which would affect net debt / working capital balances).
  - ▶ In a carve out situation, the carve out rules will have to be clearly specified in addition to any other specific accounting rules (refer to our carve-out brochure dated September 2009).
- ▶ Where multiple sets of rules for the preparation for the completion accounts are specified, it is important that a hierarchy is clearly stipulated. It is possible that the specific rules may not be in accordance with GAAP, or may be inconsistent with treatment in the prior year audited financial statements. The following hierarchy will often be appropriate:
    1. Specific accounting rules
    2. Consistent basis (e.g., with the prior year audited accounts)
    3. Seller or target accounting policies (if applicable)
    4. GAAP

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