

Professional Perspective

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# Trends in Private Company M&A Transactions: Financial Statement Reps (2021)

**Editor's Note:** This article is part of an ongoing series analyzing the results of the American Bar Association's (ABA) Private Target M&A Deal Points Studies. For more articles in this series and studies from prior years, see Bloomberg Law's collection of [deal points Professional Perspectives](#) authored by experts from Goulston & Storrs.

Contributed by [Daniel Avery](#), Goulston & Storrs

## Market Trends: What You Need to Know

According to the American Bar Association's Private Target Mergers and Acquisitions Deal Points Studies, financial statement representations are universally required from sellers in private company M&A deals, included in almost every transaction—99% covered by the most recent study in 2021. Prior ABA studies showed these representations included within comparable levels of reported transactions.

At the same time, these financial statement representations are usually not GAAP-qualified, even if they include, as is common, a separate GAAP-specific representation. In the 2021 study, only 17% of the financial statement representations were GAAP-qualified. Over the 15+ years covered by the ABA's studies, this percentage has ranged from 14% to a high of 24%.

Sellers and buyers also continue to negotiate the precise language of financial statement representations, and whether separate “component” seller representations—i.e., representations covering “components” of or topics directly related to, financial statements, such as inventory, accounts receivable, and books and records—should also be included in their transaction documents.

## Introduction

U.S.-based M&A agreements, whether asset purchase agreement, stock purchase agreement, or merger agreement, typically contain a seller representation relating to the target company's financial statements. This article examines trends in financial statement representations in private company M&A transactions, including trends as reflected in the ABA studies.

## Scope & Prevalence of Financial Statement Representations

A typical financial statement representation may read:

Attached hereto as Schedule X are the following financial statements: (i) the audited balance sheets of the Company as of December 31, 2021, December 31, 2020 and December 31, 2019 and the related statements of income and cash flows (or the equivalent) for the fiscal years then ended; and (ii) the unaudited balance sheet of the Company as of \_\_ \_\_, 2022 and the related statements of income and cash flows (or the equivalent) for the \_\_ month period then ended. Each of the financial statements referenced above (including in all cases the notes thereto, if any), fairly presents the financial condition of the Company as of the respective dates thereof and the operating results of the Company for the periods covered thereby and has been prepared in accordance with GAAP consistently applied throughout the periods covered thereby, subject, in the case of the foregoing clause (ii), to the absence of footnote disclosures (none of which footnote disclosures would, alone or in the aggregate, be materially adverse to the business, operations, assets, liabilities, financial condition, operating results, value, cash flow or net worth of the Company).

The critical language of the financial statement representation is the “fairly presents” phrasing, i.e., that the financials “fairly present the financial condition of the Company as of the respective dates thereof and the operating results of the Company for the periods covered thereby.” The “fairly presents” standard track corresponding language within unqualified audit reports under U.S. generally accepted accounting principles (GAAP).

As a result, the seller's financial statement representation, using this language, should mirror, in large part, the audit report given to the seller by its auditors, assuming the auditors provided an unqualified report regarding the financial statements covered by the seller's representation. As a related point, assuming the seller's auditor report and the financial statement representation use the same standard and language, it's possible that the seller may have a claim against its auditors in the event of a breach of the financial statement representation—depending on any limitations on liability agreed to between the seller and the auditor and other relevant facts.

Many financial statement representations also include a materiality qualifier that qualifies the fairly presents language. For example, the representation may state that the financial statements “fairly present in all material respects the financial condition ...”

Every other year since 2005, the ABA has released its Private Target Mergers and Acquisitions Deal Points Studies. The ABA studies examine purchase agreements of publicly available transactions involving private companies. These transactions range in size but are generally considered as within the “middle market” for M&A transactions; the transaction values of the 123 deals within the 2021 study ranged from \$30 to \$750 million.

As reflected in the ABA studies, financial statement representations are consistently seen in all, or almost all, M&A purchase agreements. All nine ABA studies, other than the 2011 study, showed financial statement representations in more than 97% of reported transactions.

Although financial statement representations are quite common, related concepts are often more intensely negotiated between buyer and seller, including:

**GAAP Qualification.** One common discussion point between buyer and seller is whether or not the representation should be GAAP-qualified.

**Books and Records.** Apart from, though related to, the financial statement representation, is the “books and records” representation, whereby buyers seek assurances as to the accuracy and completeness of the target's books and records.

**Financial Statement Component Representations.** In addition to the financial statement representation, the buyer may ask for separate representations relating to specific components of the target's balance sheet. Specifically, the buyer most often seeks representations regarding the target's accounts receivables, inventories, and fixed assets.

These three concepts, discussed individually in more detail below, are often set forth in different representations and/or locations within the M&A purchase agreement. Further, the importance of and interrelationship among these concepts are not always fully appreciated, especially among entrepreneur owner-managers and other similar sellers who have never experienced a sale or recapitalization. But for many buyers, not all seller representations are of equal import: representations tied to seller financial statements are often considered amongst the most meaningful and significant to a buyer.

## GAAP Qualification

Whether the fairly presents language in the financial statements representation should be GAAP-qualified often generates significant discussion between the parties. Including such a GAAP qualifier may provide more reliability of interpretation since, as noted above, the fairly presents standard has a meaning under GAAP. In addition, GAAP often allows for flexibility in how accounting determinations are made. Consequently, a fairly presents representation not qualified by GAAP creates uncertainty that may broaden the scope of a buyer's potential claims if the seller breaches the financial statement representation.

While the issue of whether the financial statement representation should be GAAP-qualified seems straightforward, in practice it is frequently misunderstood. For example, if the financial statement representation includes a reference to GAAP as an additional concept but not as a qualifier to the fairly presents standard. This seemingly small distinction may result in very different outcomes. The somewhat lengthy financial statement representation quoted above references GAAP but it is not a GAAP-qualified representation. Rather, that representation states that the financial statements fairly present, etc.,

“and have been prepared in accordance with GAAP consistently applied throughout the periods covered thereby.” The GAAP statement in this representation is separate from and does not qualify the fairly presents language.

It is easier to highlight the distinction using the shorter example representations cited in the 2013 ABA study referencing the ABA Model Asset Purchase Agreement. This example, which is similar to the example above, includes a GAAP component but is not considered GAAP-qualified.

The Financial Statements (i) fairly present the consolidated financial condition and the results of operations, changes in shareholders' equity, and cash flows of the Company and its Subsidiaries as at the respective dates of, and for the periods referred to in, the Financial Statements, and (ii) were prepared in accordance with GAAP, subject, in the case of the Unaudited Financial Statements, to normal recurring year-end adjustments.

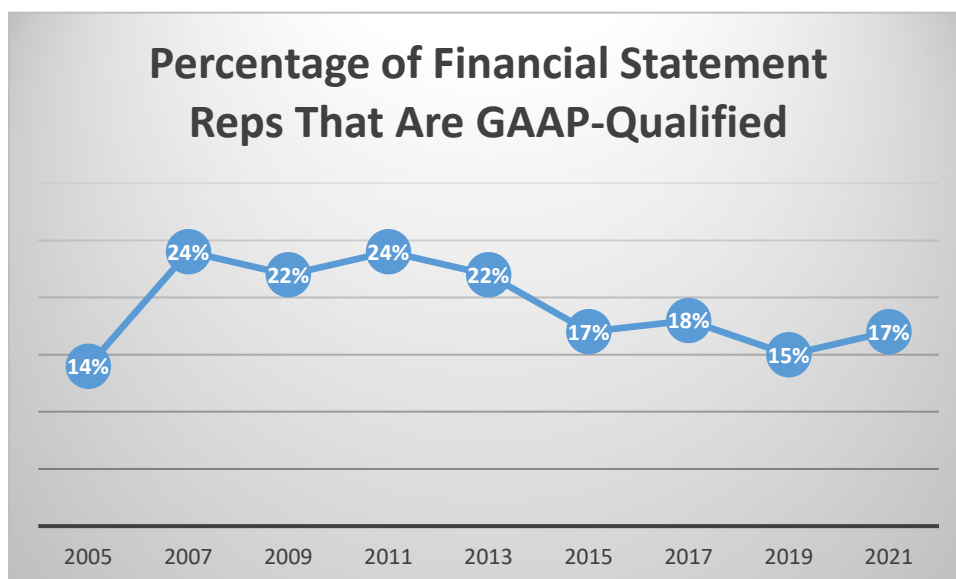
As with the longer example, the GAAP reference in this representation is separate and in addition to the fairly presents representation, and does not qualify that representation.

An example cited in the 2017 ABA study of a financial statement representation that is GAAP-qualified reads:

The financial statements fairly present (and the financial statements delivered pursuant to Section 5.8 will fairly present) the financial condition and the results of operations, changes in shareholders' equity and cash flows of [Target] as at the respective dates of and for the periods referred to in such financial statements, all in accordance with GAAP.

Unlike the previous examples, the statements in this representation are all qualified by GAAP. That is, GAAP compliance is not a separate, independent statement but rather operates as a qualifier to the whole. The inclusion of a GAAP qualifier on the otherwise unqualified and broad fairly presents language of a typical financial statement representation generally makes the representation more seller-friendly. Although sellers may negotiate for the inclusion of such a qualifier, according to data from the ABA studies, GAAP-qualified financial statement representations are present in less than one-quarter of reported transactions.

**GRAPHIC—Source: ABA Private Target Mergers and Acquisitions Deal Points Studies**



## Books & Records Representations

In addition to the financial statement representation, buyers often request a “books and records” representation. Such representation may read:

The books and records and other financial records of the Company, all of which have been made available to the Buyer, are complete and correct and represent actual, bona fide transactions and have been maintained in accordance with sound business practices.

Some books and records representations may also include statements regarding the accuracy and completeness of the company's minute books. A buyer seeking a books and records representation may argue that the company's books and records are the underlying basis for its financial statements, and if those books and records are inaccurate, the financial statements may be defective notwithstanding the financial statement representation. See A.B.A. [Model Asset Purchase Agreement, §3.5 & cmt.](#) (2001).

On the other hand, the seller could counter that the financial statement representation should stand on its own and provide the buyer sufficient comfort while using an established fairly presents standard. In addition to the seller arguments against giving such a representation, private sellers, particularly smaller or closely-held companies, often have lapses in their record keeping and are simply unable to represent that its books and records are complete and correct.

## Financial Statement Component Representations

Even with a financial statement representation, a buyer may still seek additional representations regarding specific components of the company's balance sheet. Normally, these additional representations address the company's accounts receivables, inventory, and fixed assets. Examples of these representations may read:

**Receivables.** All accounts receivable reflected on the Latest Balance Sheet and all accounts receivable to be reflected on the Closing Statement (net of allowances for doubtful accounts as reflected thereon and as determined in accordance with GAAP consistently applied) (the “Accounts Receivable”) are or will be bona fide accounts receivable owing to the Company and arising in the Ordinary Course of Business, and are not subject to offset or reduction for any reason. Except as set forth on Schedule X, no Person has any Lien on Accounts Receivable or any part thereof, and no agreement for rebate, deduction, free goods, discount or other deferred price or quantity adjustment has been made with respect to any such Accounts Receivable.

**Inventory.** All of the Company's Inventory consists of a quantity and quality usable and salable in the Ordinary Course of Business, which is and will be merchantable and fit for its intended use, subject only to the reserves for Inventory writedowns or unmarketable, obsolete, defective or damaged Inventory reflected in the Latest Balance Sheet and the Closing Statement, both as determined in accordance with standard past practices of the Company. The Company has not sold, assigned, transferred, leased, licensed or otherwise encumbered any of its Inventory, except in the Ordinary Course of Business.

**Fixed Assets.** Schedule Y sets forth all of the Fixed Assets owned, leased or held by the Company, and sets forth, as to such Fixed Assets, the original purchase price and total accumulated depreciation. Each material Fixed Asset, and all Fixed Assets in the aggregate, are in reasonable operating condition, normal wear and tear excepted.

A seller may assert that these representations are unnecessary and over-reaching because the financial statement representation includes these components within the fairly presents standard. Additionally, if the purchase agreement has a purchase price adjustment based on working capital, which is common, a seller may also argue that the working capital adjustment would pick up any issues with accounts receivable and inventory, though not fixed assets, as current assets within working capital.

If the seller agrees to an accounts receivable representation, it often resists any statement guaranteeing the collectability of the company's receivables, although not included in the example above, buyers often ask for such a collections guarantee. A buyer may counter that the fairly presents standard of the financial statement representation is broad and unfocused as to any particular assets. Thus, at a minimum, the seller should give separate representations as to accounts receivable and inventory, because those assets, as current assets, are sufficiently.

In practice, sellers often get comfortable providing a fixed asset representation similar to the above, and separate accounts receivable and inventory representations are not uncommon, though inclusion of collectability guarantees within the receivables representation is more the exception than the rule.

## Conclusion

Financial statement and related representations can be tricky for M&A lawyers given the intersection between legal and accounting concepts. The facts and circumstances of a particular transaction will impact whether GAAP-qualifications, books and records representations, or balance sheet component representations are appropriate.