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U.S.-based merger and acquisition ("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. [2] This article examines trends in financial statement representations in private company M&A transactions, as reflected in the ABA studies. [3]

Scope and 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, 2017, December 31, 2016 and December 31, 2015 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 ___ __, 2018 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 matches the normal unqualified audit report under US generally accepted accounting principles ("GAAP"). [4] As a result, the seller’s financial statement representation, utilizing 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). [5] 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 American Bar Association ("ABA") has released its Private Target Mergers and Acquisitions Deal Point Studies (the "ABA studies"). The ABA studies examine purchase agreements of publicly available transactions involving private companies that occurred in the year prior to each study (and in the case of the 2017 study, including the first half of 2017). These transactions range in size but are generally considered as within the "middle market" for M&A transactions; the average transaction value within the 2017 study was $176.3 million.

As reflected in the ABA studies, financial statement representations are consistently seen in all (or almost all) M&A purchase agreements. All seven ABA studies, other than the 2011 study, showed financial statement representations in more than 97% of reported transactions. Surprisingly, the 2011 ABA study was an outlier, showing financial statement representations in only 77% of the reported transactions (the 2013 study returned to normal levels, showing financial statement representations in 99% of reported transactions). It’s unclear what caused the drop in the 2011 ABA study. However, while our experience is not dispositive, we did not see any meaningful shift away from the presence of financial statement representations in M&A purchase agreements during 2010-2011.

Although financial statement representations are quite common, there are related concepts that 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. David Linton, Managing Director at Bigelow, LLC, a boutique M&A advisory firm that represents sellers exclusively, observes: “All seller reps and warranties are important of course, but as a financial advisor representing a seller, I pay particular attention to the financial representations. For many sellers, this is where the rubber meets the road, and where they need the most guidance from their skilled M&A and legal advisors. Most successful entrepreneurs did not get that way by being expert in GAAP accounting, or even having audited financial statements; they need solid advice on where the risks really lie in the financial reps that they are giving, and an advocate that knows what ‘market’ is, but will defend the seller’s desire for a clean deal.”
**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 (and because GAAP often allows for flexibility in how accounting determinations are made). Consequently, a fairly presents representation not qualified by GAAP creates uncertainty which 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.
Books and 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. 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 utilizing 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 our experience: (1) sellers often get comfortable providing a fixed asset representation similar to the above; and (2) 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 because they involve an 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.

[1] Daniel Avery and Michael Hickey are each Directors in the Business Law Group at Goulston & Storrs, in Boston, Massachusetts. Mr. Avery is a member of the ABA’s working group which published the 2017 ABA private company M&A deal points study. This article is based on, and updates, the article of the same name co-authored by Mr. Avery and Mr. Hickey, published in Bloomberg Mergers & Acquisitions Law Report, 18 MALR 535 4/6/15. This article is one of a series of over 20 articles co-authored by Mr. Avery looking at trends in private company M&A deal points. The series is currently being updated to reflect the 2017 ABA private company study and will be published throughout 2018. The articles can be found on Goulston & Storrs’ “What’s Market” web page at [https://www.goulstonstorrs.com/whats-market/](https://www.goulstonstorrs.com/whats-market/) and on Bloomberg Law at [https://www.bloomberglaw.com/page/infocus_dealpoints](https://www.bloomberglaw.com/page/infocus_dealpoints/).

[2] Note that within this article we use the terms “seller” and “company” in the context of a stock purchase transaction—the “seller” would be the selling shareholder(s) making the representations and warranties in the M&A purchase agreement, and the “company” would be the company being acquired. In an asset purchase transaction, the “seller” would be the target company itself but for consistency we are using “seller” and “company” in a stock purchase setting.
[3] This article looks at financial statement representations in private company M&A transactions as reflected in the ABA studies. This article does not cover such representations in other types of transactions or in public-to-public M&A transactions.

[4] See McEnroe, John E. Beyond GAAP: Issues Involving the Sarbanes-Oxley Certification Language, 75 The CPA Journal, no. 4, Apr. 2005 ("The standard U.S. unqualified audit report states that the audited financial statements present fairly, in all material respects, an entity’s financial position, results of operations, and cash flows, in conformity with GAAP").

[5] Assuming the seller’s auditor report and the financial statement representation utilize 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).