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LEGAL WORLD

LITIGATION AND TRANSACTIONS: from accounting loss to damages incurred

(Part 1)

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Do the accounting losses reported by the buyer of a company after the acquisition, representing a deterioration of the net assets, necessarily cause damages? How are they assessed? We will provide a number of lines of thought (Part 1) and an analytical framework (Part 2) from our experience as a litigant expert in post-acquisition litigation.

Accounting is not a science. In fact, compliance with accounting principles in a recognised set of guidelines, such as IFRS, is not a guarantee that these principles are applied uniformly. As such, two companies of equal size, working in the same business, with the same financial performance, presenting their accounts under the same guidelines can show very different accounting results. Consider three examples that highlight the importance of human judgment in the selection of accounting options:

1. Depreciation of inventories
International accounting principles recommend establishing a provision, on a case-by-case basis, in the event of obsolescence or deterioration of inventories. How is obsolescence defined? Is an item taken out of the catalogue but able to be sold at a slightly discounted price considered obsolete? Should an old spare part from ten years ago that will be used for repairs to be billed to customers be depreciated? The subjective nature of the need to establish a provision for depreciation or not is evident; this provision ultimately depends on management decisions and operational and commercial policies.

2. Losses upon termination on long-term contracts
International accounting principles (IAS 11) recommend establishing a provision for future losses, since the forecasts of margin upon termination anticipate a negative result.
In the case of contracts spread over periods of several years (construction and public works, mechanical engineering, aeronautics, etc.), these forecasts depend on multiple, far-off assumptions: material costs, use of sub-contracting, environmental uncertainties, etc. Therefore, the identification and assessment of costs upon termination depend on subjective elements as well as the judgment and the higher or lower level of caution of the operational and financial managers. Moreover, the degree of certainty about these costs increases gradually as time passes and the information is available and disseminated, often requiring adjustments of the initial hypotheses.

3. Depreciation of intangible fixed assets
International and U.S. accounting principles provide for a system for monitoring the substance and value of tangible or intangible fixed assets: the impairment test. For example, according to SFAS 142 (U.S. standards), this test involves verifying whether the book value of these assets is justified by the cash flows that these assets will yield. If this test raises a doubt, an asset valuation is performed based on the discounted cash flow that it generates. Consider the case of “goodwill”: the intangible fixed assets resulting from an acquisition, corresponding to the difference between the price paid to acquire a company and the book net asset value of this company. The impairment test will compare the cumulative cash flows

that this company will generate, not discounted, with its asset value. By definition, it therefore involves budget and forecast data, which are derived from assumptions.
While a conservative view of future activity can result in depreciation of intangible fixed assets, a more aggressive, ambitious view will preserve the value of this asset. Thus, in the case of transactions, once it takes over, the buyer of a company may need to establish significant additional provisions, which will deteriorate the net assets of the acquired company. This deterioration therefore originates in a more cautious assessment of the future position (example no. 1: more difficulties in selling the inventories in question; example no. 2: additional construction costs for risks of mistakes; example no. 3: stagnant activity or increased costs, generating lower profitability) and not in a real proven modification of the flow of operations. Whether the target's net assets were guaranteed or not by a specific clause of the acquisition agreement (for example, a guarantee that the net position at the time of the closing is at least equal to a certain amount), the buyer could then claim compensation from the Seller, all the more so given that the estimated deterioration is significant. This then raises the question of the reality of incurred damages: how could simple adjusting entries, which are often dismissed as "purely accounting entries", cause damages? Even though no new event has occurred and the noted differences are due only to extra caution or a different view of the future, how can the buyer claim to have suffered any damages? Lastly, how could these accounting adjustments, sometimes with no direct effect on the company's future cash flow, represent a deterioration of the purchased company's value?

(This article will be continued in an upcoming issue)

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Litigation and transactions: from accounting loss to damages incurred
(Part 2)
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For example, consider the fairly common case where the buyer of a company finds, after the acquisition (subsequent to the closing), that it is necessary to record inventory provisions and that it makes these adjustments. To the extent that it is an unpleasant surprise, what would be the technical justification for any damages incurred? To answer this question, we propose subjecting the adjustments in question to the following questions:

What is the effect of these adjustments on the presentation of the buyer's financial statements after consolidation of the purchased company?
If the buyer is a listed group, which therefore regularly presents consolidated accounts, the effect of these adjustments on the aggregates examined by analysts should be assessed. A significant, unanticipated increase in inventory provisions may result in severe decline in earnings, a substantial change in the opening balance (purchase accounting), and a sharp decrease in current assets, in such a way that it deteriorates the perception of the performance and the position of the assets of the group in question. The obvious consequence is the falling share price, which represents a financial loss.

Do these adjustments represent the anticipation of a future loss of cash?
The mere recognition of a bookkeeping entry depreciating the inventories does not result in a future, certain disbursement (unlike, for example, a provision recorded following a judgment by a court to pay a fine). However, this entry indicates that either the inventories in question cannot be sold at the price which the buyer expected to sell them or they must be replaced. This therefore involves a highly probable loss of opportunity of future receipts or a future disbursement, provided, of course, that the provision is properly valued. The purchased company's net worth was therefore overvalued at the time of the transaction, which represents damages.

What are the effects of these adjustments on the aggregates that were used to determine the price of the transaction? Would they have changed the price paid?
Where possible, this involves identifying the aggregates (net assets, working capital requirements, net income, EBITDA, etc.) that served as the reference for the parties and examining the effect of the adjustments on them. For example, the inventory provisions, if related to inventories that entered during the year when the operating earnings that were used to determine the price were generated, can have a significant impact. In fact, the entry of new inventories, for a value of 100, increased operating earnings by 100. If the price of the transaction was determined based on a multiple of 7 of the operating earnings (intended to reflect the profitability), the depreciation of these inventories for 100 (which means their actual value is zero) can therefore mean damages of 700 incurred by the buyer of the company. In this case, the deterioration of the net assets also has an effect on the posting of the company's profitability.

Was the buyer able to anticipate the decline in net assets, given its own investigations prior to the transaction?

As we have said, the noted decline must be an unpleasant surprise, without which there are no damages. The unpleasant surprise is often difficult to prove. In many cases, the buyer had the opportunity to perform investigations, sometimes very thorough, about the target company: a vendor due diligence examination, data room analysis, Q&A sessions, sometimes due diligence work performed by professionals on site, etc.

It is therefore necessary to maintain traceability of all information made available and the exchanges made during these processes in order to be able to demonstrate that the buyer was unaware of the existence of the state of the inventories in question when the agreement was signed.

How would these adjustments have changed the course of the transaction if they had been known prior to its conclusion?

The severity of the effect of these adjustments may go beyond its simple financial assessment. The post-transaction observation of provisions to be established for depreciation of inventories can call into question the interest in buying the company. For example, it may involve strategic inventories that are difficult to replace (adulterated old brandies). Identifying these provisions may also call into question the confidence that the buyer had in the company's management, requiring a search for new leaders.

The quantified effect of these adjustments can also prove to be so significant that it would have jeopardized the transaction. This would therefore be a deal breaker, and the approach for assessing damages would be modified: it may be a comparison between the buyer's net worth if it had not bought the company and its net worth after the transaction.

It is thus clear from this brief overview that simple adjustments in inventory value recorded from provisions can have multiple consequences, sometimes very significant, on the value of a company and therefore cause damages to its buyer. Its assessment and valuation require perfect knowledge of accounting and financial mechanisms as well as the context of the transaction and the details of how it went.

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