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When Balance Sheet Errors Turn into Multiple EBITDA Claims

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After an M&A deal closes, the purchaser may discover information that it considers erroneous in the balance sheet accounts in the acquired company's financial statements. The purchaser believes the acquired company failed to establish appropriate reserves historically. These mistakes pop up once the purchaser's accountants carefully scrutinize past reserves and conclude they were insufficient. They may find receivables that they determine are uncollectible, or inventory that, in their judgment, was reported at more than full value on the most recent balance sheet.

Following these revelations, a purchaser often makes a correcting entry, adding a reserve expense in the final represented income statement; booking the entire additional expense in the 12-month period leading up to the acquisition; and claiming an EBITDA shortfall of the amount of the claimed expense. The purchaser then makes a claim on its representations and warranties insurance (RWI) policy stating that the amount of the expense adjustment should be multiplied by the implied deal multiple to establish its loss, which often exceeds the retention under the RWI policy. But is this the correct analysis? There are several considerations.

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Mistakes Were Made — Or Were They?

Underwriters should be on the lookout for early warning signs found within the quality of earnings reports prepared during due diligence. These may note that the target company has smaller reserves than its peers — or no reserves. Sometimes the report will not quantify the impact of rectifying this situation, or reconcile the EBITDA calculated by the purchaser to correct for it. But underwriters should recognize that this information indicates a special risk that a claim may be made later.

To evaluate these claims, insurers must assess whether the claimed error resulted in a breach of the financial statement representation. The first steps are to determine whether there was an error and,

if so, its amount. Typically these alleged errors are discovered with hindsight a year or more after the seller's financial statements were prepared. But GAAP considers only what was known or knowable to management of the financial statement's issuer at the time the financial statements were prepared.

In some cases, the receivables may not have even been due when the financial statement was made. It was only when they remained uncollected, a year later, that the purchaser decided management should have written them off. GAAP recognizes impairment of the receivables in the period in which the impairment becomes known. So it is possible that some portion of these expenses should burden financial statements for periods following the closing.

A purchaser's post-close reserving policies may also be overly aggressive. So a claim evaluation process should carefully analyze the appropriate level of reserves alleged by a purchaser, being mindful that it is possible to over-reserve. This requires evaluating several years of inventory sales or collections data.

For example, imagine a law firm that, rather atypically, reported on an accrual basis, recording its income and expenses as they occur regardless of whether cash had changed hands. If the firm recognized no bad debt expenses as it sent out bills, its accounts would likely be overstated. When setting the appropriate reserve, it would be appropriate to evaluate the law firm's historical realization rates on its receivables when preparing financial statements. But GAAP allows accounting judgments to look beyond historical results to consider factors such as general economic trends. Since some clients have more difficulty paying their bills in economic downturns, management would be expected to consider whether good or bad times were ahead when the firm set is reserves. Ultimately, GAAP considers the judgment of the law firm's management at the time of the financial statement, and not others' hindsight a year or more later.

Not All Errors Are Created Equal

If an error is established, the next step is to determine whether it was material to the issued financial statements, taken as a whole. During a typical audit, auditors establish materiality thresholds, above which incorrect information in a financial statement is deemed to have impacted decision-making. These thresholds are necessary to determine, for example, where to seek confirmations of receivables, or where to conduct physical inventory counts. The audit work papers provide evidence of the auditors' professional view of what was material for the target company at the time the financial statements were issued.

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Assuming a material error is found, the focus shifts to evaluating the insured's damage theory. If the claimed EBITDA multiple is automatically applied, it is as if the insured is saying the newly added expense will recur at that level in every future financial period. But having written off all past errors at once in the financial periods leading up to the closing, the balance sheet starts fresh. As a result, the level of expense booked by the purchaser into that trailing 12-month period cannot be expected to burden future periods.

The correct analysis of the continued effect on the target company requires identifying what amount of expense would have been attributable only to the base year, and not any prior year of company operations. The relevant question is: If the target company had historically built a reserve adequate to eliminate the alleged under-reserve, what would have been the charge for the incremental addition to the reserves in the trailing 12 months? That is the amount that will recur and may be capitalized. It is usually a fraction of the amount by which the claim was stated, and often less than the policy's retention.

Finally, the insurer should consider the circumstances surrounding the acquisition. If the acquisition process was competitive, the prospective purchaser may have had to offer an acceptable price to obtain exclusivity. In such cases, it may be doubtful that the purchaser would have changed the price even had it discovered the error before the closing, as opposed to simply adjusting the trailing 12-month EBITDA (in effect, maintaining the price and adjusting its implied multiple). This calls into question whether any capitalization of an error should occur.

Financial statement claims are first party claims. Accordingly, an insurer must often perform its claims analysis with support from only its advisors. However, in certain cases, an insured may make a parallel claim against a seller that established an escrow to cover a limited amount of indemnification claims. Communications between buyers and sellers may provide some useful information in making determinations regarding whether there was a breach, and the amount of any loss.

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