Value Claim: Non-Recurring Impact of Unknown Business or Operational Issue

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RWI valuation claims often arise from a breach of financial statement representation and warranties where the buyer asserts that the transaction was over-valued because prior earnings, on which the purchase price was based, were overstated due to a combination of overstated assets or understated liabilities. Evaluation of value claims resulting from errors in financial reps and warranties requires careful analysis for potential business or operational issues that may be the root cause of the misstatement.

When business or operations issues are the root cause of a financial reporting error and the company is able to correct or reduce the issue's impact, the overstatement of earnings may potentially have no permanent recurring impact on future earnings. Multiple-of-earnings claims are generally inapplicable to non-recurring financial statement errors. The following case studies illustrate this issue.

Case 1:
Non-Recurring Overstatement with One-Year Impact

On June 30, 2017, buyer closed on its acquisition of Delta Corp, a distributor of home health products to patients. Seller's sales, billing, and collection were tracked through Delta's proprietary medical insurance management system. After the closing, buyer discovered that accounts receivable, net of the allowance for uncollectable medical receivables, was materially overstated, resulting in a material overstatement of earnings.

Analysis of operational conditions surrounding the discovery and correction of the accounting error revealed that post-closing, while the company was investigating why it was significantly underperforming its projected cash-flow, it discovered that, due to an errant software update in the proprietary medical insurance management system during the recent fiscal year, certain insurance reimbursement claims were improperly processed, rendering them uncollectible. The company updated its information technology systems and used the corrected software to quantify the error in the seller's financial statements.

The buyer asserted that its RWI claim should be valued at the earnings multiple used to derive the purchase price multiplied by the amount of the error. However, after coordinating with buyer executives and consultants, the claim was quantified at the amount of over-statement — without applying an earnings-multiple. The error in earnings resulted from an operational issue that was corrected and therefore affected only the one year subsequent to closing. Applying an earnings-multiple presumes that the impact of a misstatement of earnings continues to affect all future years as a permanent impact. This was not the case here.

Case 2:
Non-Recurring Overstatement with Multi-Year Impact

The target company, Echo, Inc. is a contractor that provides design and installation services for renewable energy projects, primarily wind and solar power. Its major clients are electric power utilities, alternative energy companies, and high-energy use companies. Echo had expanded rapidly from its base in the southwestern United States to Texas and the southeastern states. The seller provided its December year-end financial statements for 2015 and prior years, and its six-month financial statements as of June 2016. The transaction closed in September 2016.

In March 2017, during the audit of the December 2016 financial statement, the buyer learned that profits were materially overstated due to an error in which estimated profits were recorded for contracts that were in process, but the contracts ended up with losses. The buyer's investigation revealed that the situation also resulted in an error in the June 2016 financial statements provided by the seller. The buyer's consulting firm, retained to analyze operations, reported that Echo's expansion outpaced its capability to manage projects and made recommendations that would resolve the operational problems. The buyer revised its budgets and earnings projections to reflect the impact of the lower earnings and the recovery resulting from correcting the operational problems.

The buyer asserted that its RWI claim should be valued at the earnings multiple used to derive the purchase price multiplied by the amount of the error in the June 2016 financial statements. However, because the buyer corrected the operational problem that caused the lower-than-represented earnings as of June 2016, a re-valuation of the target company based on the buyer's revised projections after correcting the operational problem in 2017 resulted in a RWI claim that was much less.

Conclusion

Both of the cases illustrate potential factors and considerations that might make a buyer unentitled to multiple-of-earnings based damages when it has mitigated the financial impacts of the business or operational causes of the error. A buyer's theoretical damages position (i.e., "had I known of the true earnings, I could have acquired the target company for less") may fail under the "had all things been known" hypothetical. In the "had all things been known" hypothetical, the seller also knows that recent earnings are temporarily depressed because of a correctable business or operational issue.

In evaluating underwriting risk or analyzing claims, it is important to keep in mind that financial statements are comprised of significant estimates and not simply the aggregation of discrete transactions. Significant recurring estimates include: profits on contracts in process, allowance for uncollectible receivables, inventory value impairment, and warranty reserves. The relative risk related to an estimate depends on many factors including industry, business conditions, and operating history.

About Andrew C. Bernstein: Andrew is a director in the forensic, litigation and valuation services group. He has over 30 years of experience in providing expert testimony and forensic accounting services. Andrew has provided expert testimony on economic damages, valuation and business issues in complex business disputes. He has testified in a range of venues including federal district court, federal bankruptcy court, state court, Delaware Chancery Court, and international arbitration.

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