

Presenting a live 90-minute webinar with interactive Q&A

M&A Agreements: Structuring Financial Accounting Provisions

Deciphering Valuation Techniques, GAAP Requirements,
and Financial Representations to Achieve Client Goals

THURSDAY, OCTOBER 17, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Mark Stoneman, Partner, **Armstrong Teasdale**, St. Louis

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Armstrong
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M&A Agreements: Structuring Financial Accounting Provisions

October 17, 2013

PRESENTED BY

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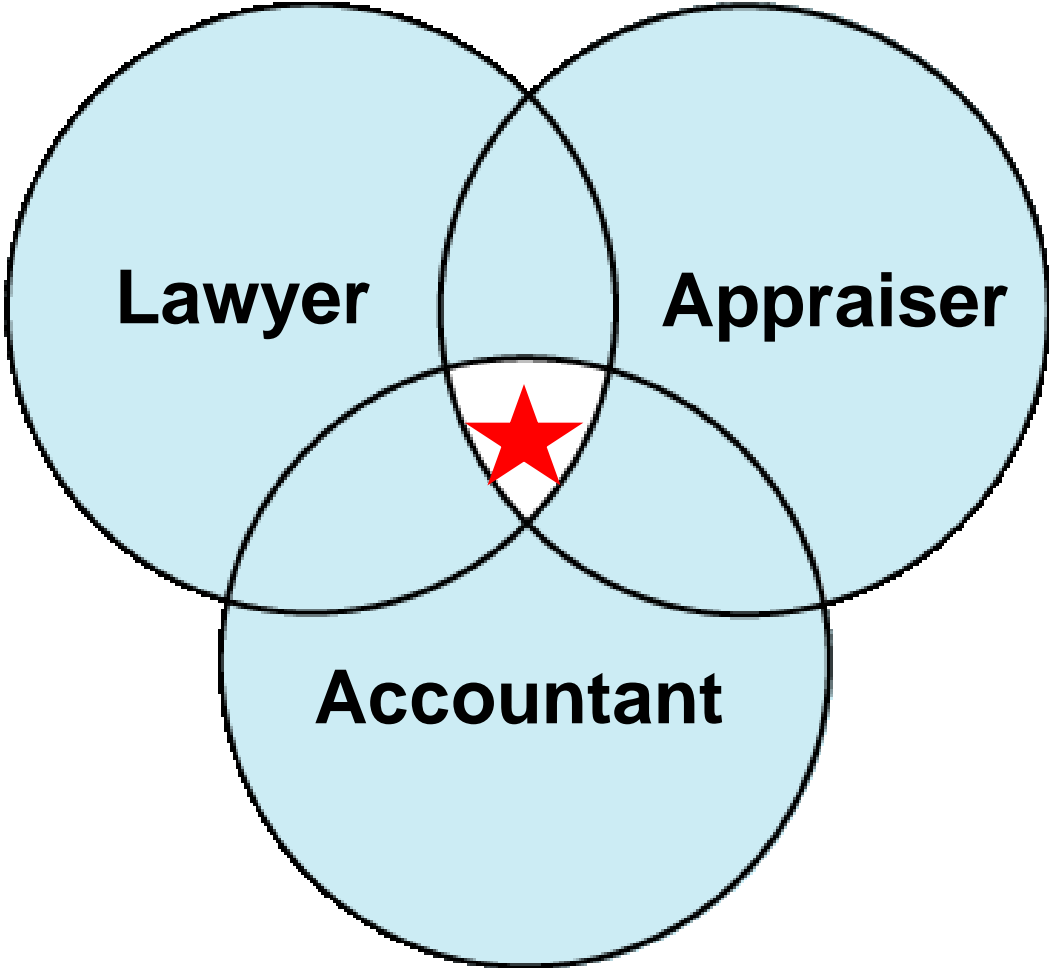
Scope of Discussion

- Financial Accounting (compared to tax provisions)
- Private Acquisition Agreements

An Example

- **Cable Company Example**
 - Buyer wants high margin customers
 - Attorney relies on “standard” agreement
- **Failure to understand interaction between 3 areas**

Critical Interaction



Goal of Presentation

- Increase understanding of key concepts
- Teach clients, lawyers, accountants and appraisers to interact more effectively
- Clients and attorneys must work together to ensure effective result

Topics to be Discussed

- **Summary of Valuation**
- **Purpose of Representations**
- **The General Financial Statements Representation**
- **Supplemental Representations**
- **How These Issues Interact with other common provisions**

Valuation Methods

- Market-based Valuation
- Income Approach Valuation

Market-Based

- **Select accounting metric examined in comparable companies**
- **Examples include**
 - P/E
 - Price/Sales
 - Multiples of EBITDA, Earnings, etc.
- **Based upon past or current data**
- **Rule of thumb approach**

Known Company (Comparable) **Unknown Company (Target)**

$$\frac{\text{Price}}{\text{Earnings}} = \frac{\$20,000,000}{\$1,000,000} = \frac{?}{\$500,000}$$

Comparable Transactions (numbers in millions)

Company		Date	EBITDA	Sale Price	Multiple
ABC		1/1/2013	10	99	9.9
DEF		2/1/2013	6	45	7.5
GHI		3/1/2013	5	35	7
JKL		4/1/2013	15	150	10
				Average Multiple:	8.6

Issues for Market-Based Approach

- **What Multiple?**
 - *Growth?*
 - *Size of the Company?*
 - *Barriers to Entry?*
- **What about the Balance Sheet?**

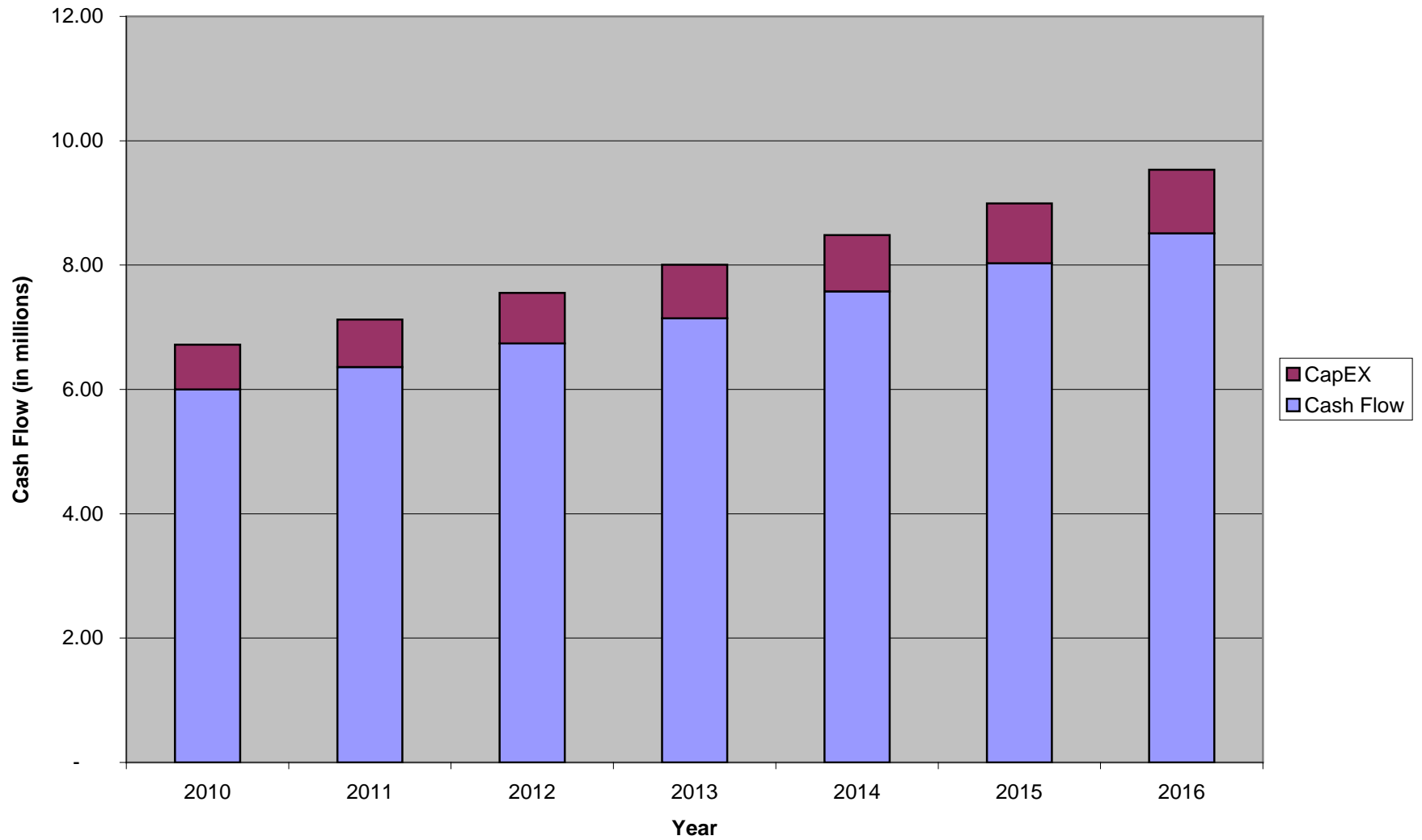
Income Approach

- Greater focus on economic values, as compared to accounting figures
- Examples:
 - Discounted Cash Flows
 - Economic Profit
 - Option pricing models
- Appraiser predicts future of target
- Can rely heavily on leading indicators

Valuing the Business

- Discounted Cash Flows
- Example

Free Cash Flow Growth



Year	Discount Rate	2010	2011	2012	2013	2014	2015	2016	NPV
Free Cash Flow	0%	6.0	6.3	6.7	7.1	7.5	8.0	8.5	50.3
	12%	6.0	5.6	5.3	5.0	4.8	4.5	4.3	35.8
	14%	6.0	5.5	5.1	4.8	4.4	4.1	3.8	34.1
	16%	6.0	5.4	5.0	4.5	4.1	3.8	3.4	32.5

Valuing the Business

■ DCF Issues

- *Predicting Cash Flows*
- *Appropriate Discount Rate*
 - *Comparable Investments/Competing Bidders*
 - *Risk*
 - *80% of companies use DCF to value investment opportunities, but no consensus on calculation of discount rate*

Keys from Valuation

- Valuation methods require different inputs
- Some data within financial statements is critically relevant
- Some critically relevant financial data is not within the financial statements
- Some data within financial statements has little relevance

General Representation

- Somewhat standardized
- Key points
 - Identify statements
 - Fairly present position and results
 - In accordance with GAAP
- Key issues
 - Materiality
 - Audit reports
 - Interim Financial Statements

Purpose of Representations

- Facilitate buyer due diligence
- Support closing conditions
- Allow for risk allocation/indemnification

Materiality

- **Materiality in M&A Agreements**
- **Double-Materiality**
- **Materiality in General Representation**
 - Express Materiality
 - Implied Materiality

Who Wins on Materiality

- **Depends upon bargaining power**
 - Seller's argument
 - Buyer's argument
- **Depends upon significance of provision**
 - Significance is a function of valuation method
 - Example

TARGET COMPANY: Motorcycle Sales

COMPARABLE: Harley Davidson

METRIC: 3x Sales

Reported Revenue \$10,000

Actual Revenue \$9,000

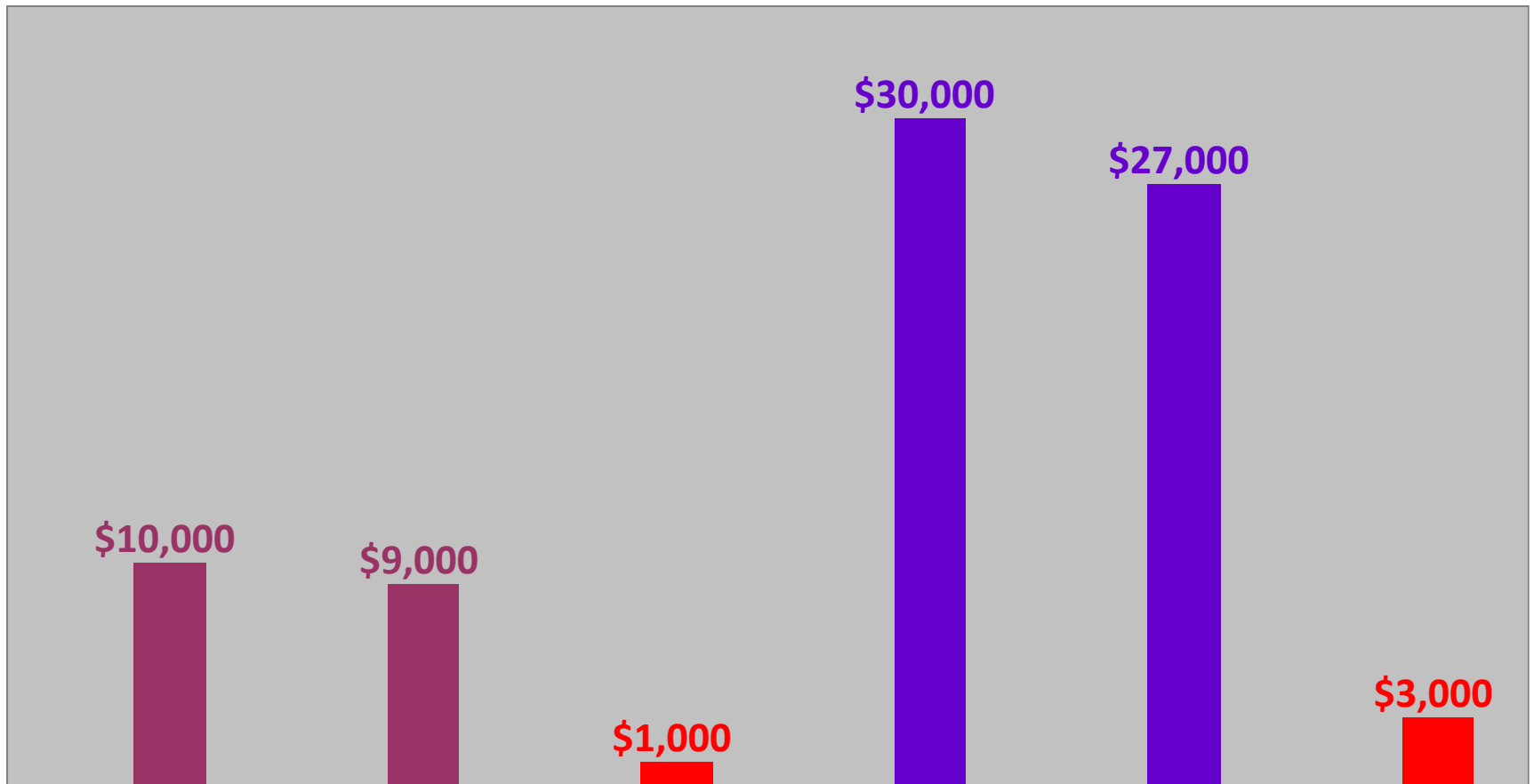
Overstatement \$1,000

Reported Valuation \$30,000

Actual Valuation \$27,000

Overstatement \$3,000

Effect of Revenue Overstatement on P/Sales Valuation



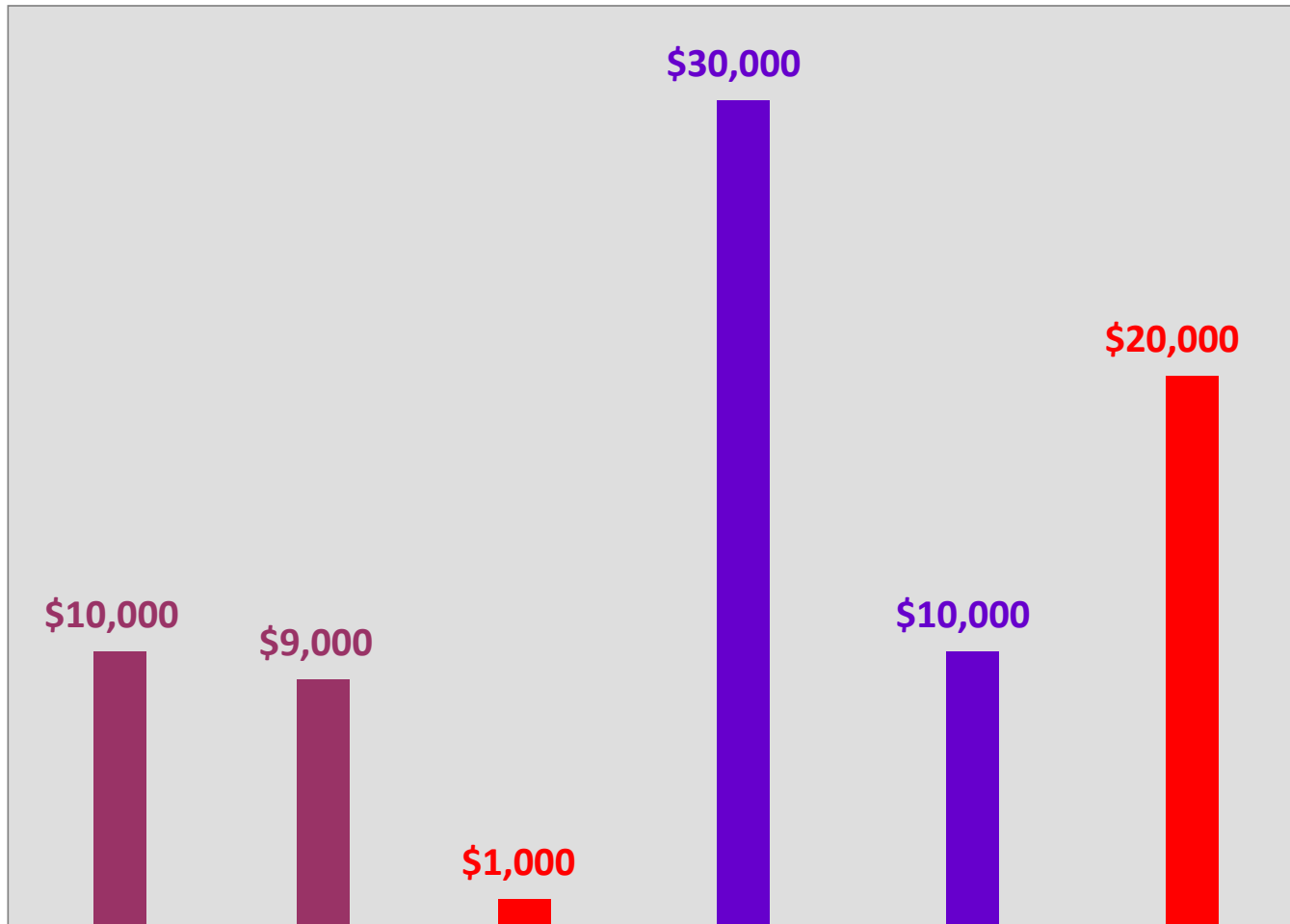
TARGET COMPANY: **Motorcycle Seller**

COMPARABLE: **Harley Davidson**

METRIC: **20x Earnings**

<i>Reported Revenue</i>	\$10,000
<i>Actual Revenue</i>	\$9,000
<i>Reported Earnings</i>	\$1,500
<i>Actual Earnings</i>	\$500
<i>Revenue Overstatement</i>	\$1,000
<i>Reported Valuation</i>	\$30,000
<i>Actual Valuation</i>	\$10,000
<i>Overstatement</i>	\$20,000

Revenue Overstatement in P/E Valuation



Existence of a Report

- **Various types of Reports**
 - Audited
 - Reviewed
 - Compiled
- **Should the General Representation change based upon report?**
 - With audit
 - Without audit

Interim Statements

- **Not in compliance with GAAP**
 - Missing Footnotes
 - Missing Year-end accruals
 - Missing audit
- **Management Statements**
- **Should General Representation Change?**

Supplemental Representations

- **Common Representations**
 - Off-Balance Sheet Liabilities
 - Inventory
 - Accounts Receivable
- **Other Possibilities**

Off-Balance Sheet Liabilities

- **Description of Representation**
- **Common reasons**
 - Contingent liabilities
 - Unknown liabilities
- **Seller tactic**

Inventory/Accounts Receivable

- Commonly involved in fraud
- Current nature of accounts
- Discretionary nature of “reserves”

Other Supplemental Representations

- Earnings related
- Seller's Circumstances
- Leading Indicators

Earnings

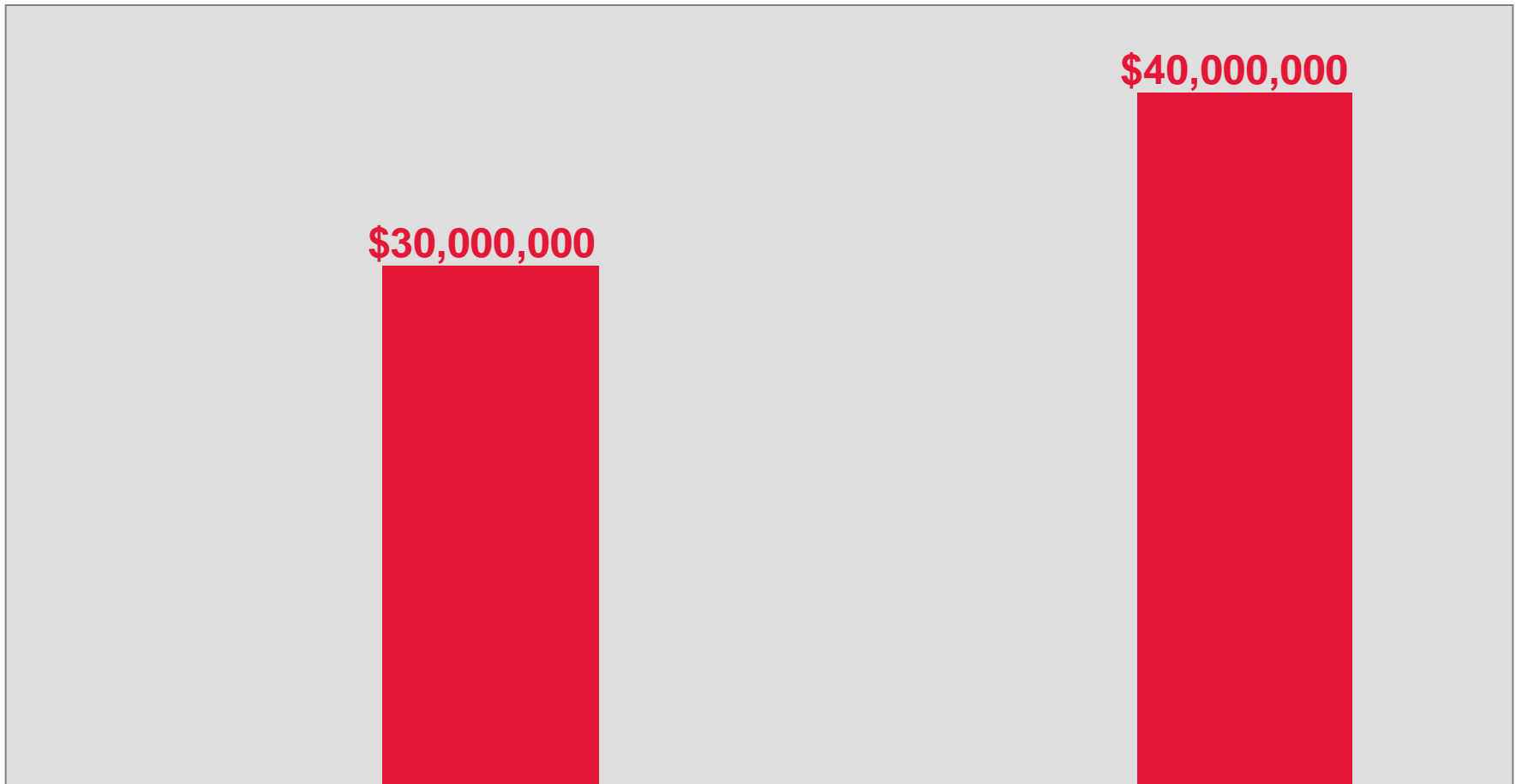
- **Confusion among similar terms**
 - Pro-forma earnings
 - Operating earnings
 - Net earnings
 - Net income
 - EBITDA
 - Adjusted or Pro-Forma

Seller's Circumstances

- Not uncommon to “add back” certain Seller expenditures
- Often, these are not itemized in financial statements
- Example

<i>Revenue</i>	\$30,000,000
<i>Cost of Goods Sold</i>	(25,000,000)
<i>Gross Profit</i>	5,000,000
<i>Administrative Expenses</i>	(3,500,000)
<i>Net Income</i>	\$1,500,000
<i>Automobile Leases</i>	\$50,000
<i>Aircraft Costs</i>	400,000
<i>Lease for Shared Office</i>	50,000
<i>Net Savings to Buyer</i>	\$500,000
<i>20x Earnings Value Increase</i>	\$10,000,000
<i>Value without Add-Backs</i>	\$30,000,000
<i>Value with Add-Backs</i>	\$40,000,000

Showing Value of Add-backs



Leading Indicators

- Not typically covered in financial statements
- Examples
 - Same-store sales
 - Number of customers/subscribers
 - Sales per square foot (retail)
 - Unit sales by product

Indirect Impact of Valuation Issues

- Impact of basket on price adjustments
- Financial Statements representation as “fundamental”
- Limitations on Types of Damages Recovered
- Overlap between Covenants and Price Adjustment
- Separate Price Adjustment Escrow

Conclusion

- **Financial Statement representations need to be tailored for:**
 - Type of business
 - Type of valuation method
- **Clients, attorneys, accountants and appraisers must work together**